Does Europe need Eurobonds ?

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Structure of the Presentation

- **General remarks on „Does Europe need Eurobonds?“**
- **Some comments on the „Blue Bond Proposal“**
- **An alternative proposal on the design of bond issuance terms in EMU („+3Bonds“)**
  (Weber, Ulbrich, Wendorff, March 2011)

„Does Europe need Eurobonds?“

- **Maybe … but it depends on the general design of Europe**
  - Instruments must be consistent with the general framework
  - Decide on framework and then on instruments and not vice versa

- **Eurobonds fit perfectly with political and economic union**
  - Common liabilities – common decisions on economic policies (taxes, expenditure, even not to serve debt)

- **EU-Council confirmed current framework for EU/EMU**
  - EU-Treaty not fundamentally changed. No-Bail-Out confirmed
  - Member states ultimately responsible and democratically legitimated for their economic policy decisions

- **Eurobonds are incompatible with today’s Europe**
  - Would make change of EU-Treaty (and German constitution) necessary

Critical Remarks on „The Blue Bond proposal“

- **“Blue Bonds” are incompatible with today’s Europe**

- **Selective points of criticism**
  - Requests fundamental legal changes and design of EMU
  - Weaker market discipline
    - Common liabilities until <u>upper</u> bound for debt ratio is reached (60%)
  - Reduction of liquidity premium relatively small and questionable
    - Possible gains small compared to risks/related problems
    - Risk of higher risk premium for “strong” countries
    - Varying country basket: No uniform product
  - Another decision making body (Council) for redistributing risk between tax payers and fiscal management: Important problems
  - A country may decide to default against blue bonds
  - Strategic powers of countries in trouble are strengthened

Question related to „The Blue Bond proposal“

- **Why not introduce proposal without joint liabilities**
- **No savings on liquidity premium, but most important problems avoided (problems of joint liabilities, new council…)**
- **Individual countries may profit from issuing blue (preferred creditor status) and red (other) bonds**
  - If authors were right: No risk until 60%, therefore markets will agree on low risk premium for blue bonds and all countries profit from AAA
  - Countries would show commitment to stay away from 60%, because financing with red bonds would become expensive
  - Proposed new financial market regulation for red bonds may improve financial stability

The „+3Bond“ proposal: Outline

- **Honouring the letter and spirit of EU Treaty and recent EU Council decision**
  - No Bail-Out strengthened
  - Countries and investors own responsibility strengthened
  - Stabilising impact, while strengthening existing framework
  - No major institutional change

- **Proposal**
  - Compulsory incorporation of provision into standard terms and conditions for all future EMU countries bonds
  - In case of event: Granting of ESM assistance to country…
  - …maturity of bonds is extended by three years under the same terms

The „+3Bond“ proposal: Advantages

- **Legally possible, transparent and introduction of CAC window of opportunity for changing bond terms**
- **Does not constitute default with related problems**
- **Stabilises financial markets**
  - Private sector exposure maintained, investors remains responsible
  - Potential destabilising effect of preferred creditor status contained
- **Reduces risk to tax payers, contains loan volume of ESM**
- **Restricts interest cost of countries in ESM**
- **Negligible costs ex-ante for highly solvent countries, limited costs for other countries**

“+3Bonds”:
Safeguarding financial stability, strengthening investor responsibility, protecting taxpayers, reinforcing the ESM

The proposal

“+3Bonds”: Safeguarding financial market stability, strengthening investor responsibility, protecting taxpayers, reinforcing the ESM

Proposal: Compulsory incorporation of a provision into the standard terms and conditions for future euro-area government bonds: If the granting of ESM assistance is confirmed, the maturity of the bonds is extended by three years under the same terms.

- **Legally possible, transparent** and maturity extension **does not constitute a "default“** . The restructuring of the terms and conditions for bonds (2013) as a window of opportunity.
- Significantly **alleviates problem of assessing** whether **liquidity or insolvency problem**.
- **Stabilises financial markets**: The private sector largely retains its exposure, broad diversification of risk maintained, potential negative capital market effects of the preferred creditor status neutralized and private creditors retain broader responsibility.
- **Reduces risk to the taxpayer**: Loan volume of ESM can be strongly reduced (across all countries potentially at risk, the refinancing needs alone for the 2011-2013 period amount to more than 70% of total capital requirements).
- **Credibility of the restructuring option enhanced** by reduction of systemic effects of restructuring – creates incentives for fiscal discipline ex ante
- Maturity extension **restricts the interest costs** for the countries in the assistance programmes, thus involving the private sector and helping to ensure successful consolidation.
- Almost no negative effect on highly solvent countries, especially **for medium and long-term bonds** only **limited spreads** for other countries.

“+3Bonds” in detail

Bottom line for all problem solving, preventive measures and crisis resolution: the need for each member state to act responsibly

- **Europe** and the euro area **challenged by dwindling confidence** in the public finances of **some member states** .
- **No prospect** at present **of** any **seismic shift in the basic political and economic policy structures** of the EU and the euro area.
    - European Council recently expressed its opposition to any major transformation.
    - Doubtful whether a regime change – to a federalist model, a political union or a joint liability structure, for example – would receive a democratic mandate in the member states.
- The **individual member countries** will continue to **have** national decision-making **sovereignty over** broad swathes of **economic and fiscal policy**.
- **Bottom line** for all problem solving, preventive measures and crisis resolution: the **need** for each member state **to act responsibly**.
- **Main goal** is to **encourage responsible behaviour** from all parties – i.e. both governments and financial market players – through incentives that take account of the negative effects of pursuing an unsound fiscal policy on the rest of the euro area.

Improving the ways and means of preventing future crises and the ability to tackle them more effectively is decisive for euro area

- Key conditions for **avoiding future crises** are:
  - to really **toughen the SWP's** disciplinary effect on fiscal policy and not weaken it, for example, through political horse-trading,
  - to **focus macro-surveillance on problem cases** and avoid the danger of hands-on central planning that substitutes political fine-tuning for market mechanisms, and
  - to **make the financial sector far more shock-proof** so that risks stemming from financial stress on the part of banks or sovereigns are less systemic and more easily manageable.
- On top the crisis has highlighted the **need for a crisis resolution mechanism** to be kept in reserve for contingencies in which the preventive measures prove insufficient.
  - On the one hand, such a mechanism must provide an **effective means of resolving crises.**
  - On the other, it **must not eliminate ex ante the incentives for individual member states** to ensure that their fiscal policy is sound or for financial investors to carefully evaluate risks, nor should it introduce joint liability ex post.

European Council agreed on blueprint for future economic policy framework

- Prevention mechanisms are to be stiffened by **beefing up the Stability and Growth Pact** (SGP) and **stepping up macro-surveillance** with a view to **avoiding macroeconomic imbalances** that could threaten stability.
- Complement measures designed to substantially **improve the financial system's resilience** through more focused regulation and surveillance (already initiated).
- **European Stability Mechanism** (ESM) will come into force in 2013.
  - Mechanism to be **structured along the lines of the existing EFSF**.
  - **Financial assistance** is permitted only as a **last resort**, in cases where the stability of the euro area is under threat, and will be granted on condition of a strict fiscal and economic adjustment programme being adopted and implemented.
  - **Key decisions** concerning this intergovernmental mechanism must be taken **unanimously**.
  - ESM loans will be accorded **preferred creditor statu**s and will have **interest rate spreads equivalent to those on the current EFSF loans**
  - **Assistance** can generally be granted **for liquidity problems only**. Any solvency problems must be dealt with beforehand by the creditors and the government in question through agreements facilitated by collective action clauses (CACs) that are to be incorporated into the issuance terms for sovereign bonds.

Preferred creditor status – non-negotiable for providers of funding but with potentially negative capital market effects

- The **European Council** has agreed to **accord ESM loans preferred creditor status** – analogous to IMF conditionality – to protect the taxpayers of the countries providing assistance. This should be **non-negotiable** for the providers of funding.
- This status could have some **undesirable implications** for the desired involvement of the private sector:
    - **Investors in short-term bonds** would get off largely **risk-free**, whereas investors in longer-term paper would be bailed into any un-avoidable future restructuring.
    - **Longer-term investors** would then have to **bear heavier losses** than if there had been no assistance programme; their claims would be subordinated to those of the IMF and the ESM and, in the event of restructuring, they would have to **take the entire haircut**.
    - The **greater the share of preferred debt** (which itself largely stems from the financing of maturing bonds), the **larger the haircut**.
    - This could **drive down the prices of longer-dated instruments**, and the resulting need for write-downs and the likely response of investors could **generate risks to financial stability**.
    - **Secondary market purchases**, which should also be rejected for additional reasons of principle, would **exacerbate this problem even further**.

“+3Bonds”: Trigger clause extending maturity of government bonds would honour letter and spirit of Council decisions

- **Objective**: **strengthen** the **European Stability Mechanism** in line with the Council’s decisions, while **safeguarding financial market stability**.
- A simple solution to many of the problems currently under discussion that would be both **easy to implement** and **highly effective**.
  - Supplementing the **issuance terms of all bonds newly issued** by euro-area governments to include not only the planned CACs but also a **standard trigger clause extending the bond’s maturity**.
  - Under this clause, the **regular maturity** (e.g. five/ten years) of each bond would be **extended by three years** (to a total of eight/thirteen years) if the **ESM** were to accept an application for **financial assistance** from the country in question before expiry of the original date of maturity.
  - For this extended maturity, the **bond** would continue to be subject to the **agreed terms and conditions**.
  - The proposed extension is **three years** because a **large part of the reform and consolidation efforts** which the country concerned would need to under-take should have been **carried out** by the time this period has elapsed.

Improved financial market stability by introducing “+3Bonds”

- Establishing a **similar default risk independent of the length of the residual maturity**: would spread price risks across more shoulders and so make them easier to cope with.
- +3bonds ensure that all **financial investors continue to bear responsibility** for their investment and that liability is not passed on to the taxpayer in the event of a crisis.
- **Investors benefit** from strict reform and consolidation programme and the funding of deficits during the transitional phase: should **curtail the probability of default**.
- Explicit inclusion of a maturity clause in the issuance terms for government bonds would **eliminate major problems** associated with **moratoriums** with no *ex ante* provisions:
    - Triggering the clause would **not constitute a credit event** (default), since the procedure would have been laid down *ex ante* in the terms and conditions.
    - This would **eliminate the potential uncertainties** resulting from legal ambiguities (e.g. risk of **freerider behaviour** of individual creditors).
    - **Direct impact on CDS contracts** and automatic rating downgrades should remain **limited**.
    - **Changeover problems** associated with amending the conditionality of sovereign bonds likely to be **limited** given the fundamental change by including CACs
    - Large volume of euro-area government bonds should make it possible to **swiftly establish a market standard**.

Greater protection of taxpayers, sharp reduction in required fund volume and better financing conditions for crisis-stricken countries

- Key advantage for countries providing assistance is that the **need for support** within the frame-work of an assistance programme would be **dramatically reduced**.
    - It is **“only” the current deficits** (interest payments and primary deficits) that would need to be refinanced. These deficits are likely to make up **a fairly small part of the overall funding requirement** – for instance, more than two-thirds of the loans to Greece are earmarked for rolling over maturing bonds.
- The inclusion of a maturity extension clause in the issuance terms of government bonds has the added advantage that it greatly **alleviates the major difficulty of differentiating *ex ante* between liquidity and solvency problems.**
- Countries receiving assistance would also benefit from the maturity extension clause.
    - Particularly if a country unexpectedly suffers financial distress through no fault of its own (and therefore previously had relatively favourable financing conditions), the **interest payments** on the extended bonds are **likely to be lower** than under the assistance programme.
    - This would **allow the country** concerned **to consolidate more rapidly**.
    - In addition, these countries would have **planning certainty** with regard to interest payments for the duration of the extended maturity.

Improvement of market discipline might lower already limited additional borrowing costs further

- **Sovereign debtors may incur higher costs** from investors factoring in the specific risk of a maturity extension when they purchase government bonds subject to such conditionality.
  - With the increasing likelihood of an application for assistance from the ESM being made and granted during the regular maturity, the **interest rate** expected when the bonds are issued would **come increasingly close to the interest rate of a bond** which, from the outset, has a **maturity of an extra three years**.
  - Therefore the **upper bound** of the interest rate spread when the bond with a trigger clause is issued is the add**itional interest that would have to be paid on** bonds with a three-year longer maturity.
- Countries with a **good credit rating** will **barely notice any increase** in their interest rates.
  - Their interest payments **could even be lower** if the proposed bond conditionality has the effect of **reducing the threat to financial stability** posed by restructuring and thus also the likelihood of a transfer to overindebted countries, and if it helps to **improve market discipline** throughout the euro area, leading to more stability-oriented fiscal policies.
  - The interest rate spread would also **remain limited** for countries with a **weaker credit rating.** For instance, a decision of the European Council has already laid down a future shift in maturities towards **medium and long-term debt**, where the rise in the **yield curve is usually relatively flat**.