A two-year refinancing for all € bill/most bond maturities until 2013: An "EMU Bond Fund" Proposal

25th November 2011

Executive Summary

Policy-makers must take the time to explore the "reasonably foreseeable" consequences of proposed actions. They must avoid any that have an obvious and well-known capacity to produce a bad outcome for society within a few years, even if it may alleviate the current pain for a few weeks or months. But we are acutely aware of the relentless pressure of the 24x7 media to fire a "bazooka" in time for the next news bulletin. We reject this short-term approach to policy-making and propose an immediate solution but also manifestly creating a rising tide of benefits in the medium term.

We see the global economic turmoil and note that the eurozone – as an integrated economic entity – seems set to surmount its current difficulties if its members provide a limited amount of mutual support. The autumn forecasts from the European Commission for 2013 are illuminating:

	Growth, % GDP	Inflation, % (CPI)	Current Account, % GDP	Budget Deficit, % GDP	Gross Government Debt, % GDP
Eurozone	3.1	1.6	0.5	3.2	87.8
US	*2.8*	*1.6*	*-3.5*	*5.0*	*107.1*

Our modest proposal is designed to provide a limited degree of mutual support that will be sufficient to allow adequate time to states that are themselves trying to restore their competitiveness. Then they can demonstrate to their creditors that the first fruits of good policies are visible, and that the policies are entrenched into their political structure in a way that limits the risk of sudden reversal.

If the eurozone demonstrates that it is on track to meet these initial economic (and political) goals of renewed competitiveness and sound public finance, then its individual members will have a compelling story to tell the investors of the world.

Our proposal for an "EMU Bond Fund" is:

- After a euro area State's economic policies have been approved by ECOFIN in the European Semester as both economically effective and politically durable;
- Then all such States should pool their short-term borrowing via a Fund that would only last four years. The Fund would borrow in the markets for, at most, a two year term – to match the borrowing profile of its client States;
- The borrowings of the Fund would enjoy a "guarantee" involving all participating euro area States. **We are launching a survey to test the acceptability of different levels of guarantee;**
- The fund's capacity would be large enough to fund for the next two years all the maturing bonds of euro area states that were unable to access the capital markets on normal terms;
- Interest surcharges would be applied to those States that breached the Stability and Growth Pact (SGP);
- States that became subject to sustained SGP sanctions would cease to be eligible to borrow further from the Fund in the future.

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Introduction

The Heads of State or Government, at their 26 October 2011 Euro Summit, reaffirmed that the euro is at the core of the European project. They committed themselves to strengthen the economic union to make it commensurate with the monetary union. This report does not seek to debate the wider solutions to the current crisis. Instead, it focuses only on the narrow question of designing a programme of issuance of "EMU bonds" that would achieve the practical objectives that might be expected if the political decision is taken to issue bonds jointly. However, we consider such bonds to be a step that merits serious consideration in the light of the European Commission's Green Paper. Such a Fund could be one component in solving the crisis, and encouraging the fiscal discipline and enhanced competitiveness that should prevent new ones in the future.

We propose to introduce joint financing of new public debt of euro area member states for a period of four years through the issuance of short-dated “EMU bonds”. This would be done via a completely simple, transparent fund so the fragmentation of the euro area’s national public bond markets would start to be eliminated. This would be a step to strengthen the euro area’s financial architecture to defend us better against financial crises – though only internally at this stage. But the difficulties that the US and Japan are experiencing in tackling their much bigger debt and deficit problems suggests it would be prudent to create such defences even today.

Why and for what purpose? Essentially for three reasons:

1. To complement the existing package of measures (included in the ‘six-pack’) to strengthen fiscal discipline and competitiveness in the eurozone

2. To protect euro area Member States from sharp swings in market sentiment that – through spill-over effects via highly integrated financial markets – hurt not only the ‘weak’ and ‘misbehaved’. Member states of a monetary union issue debt in a currency over which they have no control. That is why they are so sensitive to movements of distrust that have self-fulfilling properties even though, i**n aggregate, euro area public finances are in relatively good shape.**

3. To create deeper markets in public bonds of euro area states, bringing about increased liquidity and thus lower funding costs.

The introduction of EMU bonds will be based on the guarantees of all participating member states for the EMU Bond Fund. The scheme has to be well designed, e.g. to exclude risks of moral hazard. For that reason, we propose to start with EMU bonds with up to two year maturity. Our concept is that the Fund would cease to issue new securities after four years. However, we would leave the door open to designing and implementing a more permanent EMU bond mechanism in the light of experience and progress achieved towards a fiscal union. EMU bonds with longer maturities could be added to a similar scheme in the future, after fiscal discipline is demonstrably embedded in all euro area states. Eventually, it might even be desirable to include all euro area public debt. But the whole process must avoid moral hazard or the creation of a “transfer union” in the euro area.

Such a fund would be an expression of solidarity amongst the eurozone member states, but solidarity is a two-way street. The stronger nations would support the weaker in return for the weaker undertaking reforms that should strengthen them in the future. If they resile from those reforms, then correspondingly they resile from any expectation of further support from the stronger.

The proposal

Objective

The proposed scheme should be seen as a way to stabilize the monetary union, strengthen monetary integration and complement the TFEU and the SGP with an incentive and disciplinary mechanism – a "carrot and stick" approach. **The key benefit of the whole scheme is that markets can be sure that, at a minimum, ALL bond maturities during the next four years for participating states can be rolled over for two years at the lowest possible interest rate.** Given the commitment to balanced budgets in the future, debt ratios should decline steadily though it will still be many years before the euro area average drops to the 60% goal.

- **Incentive**- the ability to borrow at the then-lowest rate available in the euro area.
- **Discipline** - two components:
  - An interest rate surcharge on those breaching the SGP;
  - Exclusion from new issuance for those subjected to continuing SGP sanctions.

Outlining the three elements

i. **A new legal entity will be established** - initially by separate Treaty and perhaps ultimately through amendment of the Treaty on the Functioning of the European Union (TFEU). It shall be called the EMU Bond Fund and will finance a modest part of its members' public debt.

ii. **The EMU Bond Fund will finance itself by issuing short term debt "EMU bonds" under guarantees from all its members**. Its bills and bonds would match closely the financing needs of the members, so there would be no mismatch of assets and liabilities that might require financial engineering. It would be the epitome of simplicity and "plain vanilla" financing.

iii. **Participating Member States would be subject to a graduated series of automatic sanctions** if their fiscal performance fell below target**.**

1. Borrowers

The only borrowers from the fund would be members of the euro area <u>not</u> in receipt of special assistance <u>and</u> whose overall economic policies have been accepted by the ECOFIN - initially during the second European Semester in the first half of 2012. Such agreed economic policies should normally **entitle** a State to borrow from the EFSF - if needed due to market conditions. Our proposal assumes that ECOFIN will only accept policy proposals from states where it has also examined (and publicly explained) the political process that will ensure the policies are implemented - both effectively and durably. Borrowers from the EMU Bond Fund must not be subject to continuing sanctions under the SGP.

2. Initial participation

Participation is on a voluntary basis and any group of countries can start but we believe it is essential that at least Germany and France participate at the outset, hopefully with Italy and Spain. However, the strong assumption is that all euro area states would participate to gain maximum benefit. The initial launch should be accomplished quickly – preferably under the normal budget procedures of each member state. But we recognise that lawyers may advise a more specific legal framework once the immediate crisis has passed that necessitates urgent action.

It would be quite understandable that the other euro area states would no longer be willing to offer any guarantees after a significant period of intense advice and pressure from fellow euro area Ministers that led on to the imposition of SGP sanctions on a state. The suspension of a state from the fund would be a very serious sanction for that state.

3. Treaty amongst the members

There would be a Treaty between the eurozone members to ratify the detailed arrangements so that the binding nature of the commitment is quite clear. This would be similar to the original Schengen Treaty and might in the fullness of time be absorbed into the main Treaty on the Functioning of the European Union. It would commit members to agree to use “enhanced co-operation” as necessary to enable the machinery of the European Union to be utilised to achieve financial and economic stability within the eurozone. This may require an amendment to Article 136 TFEU to allow further inner coordination among eurozone States than is thus far permitted.

4. Life of the EMU Bond Fund

The Fund would terminate after say four years as that should have given weaker States some more breathing space. We expect that, during this period, members should (i) get enough time to restore order to their public finances (i.e. restore market trust) and (ii) start seeing the positive effects of their structural reforms.

During that time, euro area members might decide to make far-reaching Treaty changes about closer economic integration and financing. This scheme does not assume such developments, nor preclude them. Afterwards, in the absence of such reforms, each member would have to borrow in the markets in its own name and on terms determined by its own credibility.

5. Size

- **All participating Euro area member states would be obliged to use the EMU Bond Fund** to finance all short term borrowings. Simply re-financing all such existing bills would give the Fund a €600 billion size.
- For example, if <u>all</u> the participants also re-financed the bonds maturing in 2012 and 2013 via the Fund, then its size would be just short of €2,500 bn, or 27% of the participants’ GDP. (for reference, a corresponding re-financing by the US would be about 34% of its GDP)
- But the top credits would also have the option of not using the facility to roll over maturing bonds, rather than bills. Instead they would have to issue longer–dated bonds that do not compete with the Fund. If Germany, France, Austria, Finland and Netherlands do not re-finance their maturing bonds in this way, then the ceiling could be under €1,500 bn – or 15% of all participants GDP.

6. Up to two-year issues

The fund would issue bills and bonds with up to two year maturities. Each bond issued by the EMU Bond Fund would be subject to a guarantee from all participating euro area member states. Each issue might have to be separately approved by Eurogroup.

At the end of the two year period, all euro area states should have complied with their Stability Plans (to be approved in the 1H 2012 European Semester) and be well on the way to drastically reduced deficits. Moreover, they should have fulfilled their commitments to insert a “constitutional” type of balanced budget rule. That combination should enable them to resume borrowing for much longer maturities at sensible rates.

7. Interest rate payable

The normal interest rate payable on loans to participating euro area states would be the fund’s own cost of borrowing plus a fee to cover the administration costs. Such an interest rate will not trigger an unsustainable surge in borrowing costs. Indeed, for many states it will offer a significant benefit.

8. Guarantees

- **In an ideal world, the EMU Bond Fund would be the subject of joint and several guarantees of all the participants** whereby each State is liable for the entire issuance**.** Nevertheless, joint and several liability may be difficult to achieve in view of large variations in size and strength of the Member States. Moreover, there are clear political difficulties in doing that at all, let alone quickly given the need for ratification by national Parliaments and possibly a Treaty change. The uncertainties generated by this process would only compound market nervousness.

- The current joint bond issuance scheme (EFSF) relies on pro rata liability, i.e. guarantees for specified amounts that reflect the EFSF guarantors’ share in the ECB, with borrowing nations ‘stepping out’ of the guarantee. The future ESM will work on the basis of capital contributions of individual Member States, i.e. also on the basis of limited liability for specified amounts only.

- An alternative approach for the EMU Bond Fund might be a “several” liability” that is *pro rata*. If the balance outstanding could rise as high as 15% of GDP, then perhaps the “guarantee sum” for the Fund should be set at 20% of GDP – giving a 33% over-guarantee. So each participating state would give a *pro-rata* guarantee limited to 20% of its GDP. Without any over-guarantee, there would be no credit enhancement from the existing situation. **To discover precise attitudes to this subject, we have provided a survey for different types of respondents: click here.** We hope to use this information to develop these ideas further so that we can provide a detailed proposal to the European Commission’s Consultative Green Paper in January.

- Once a Member State decides to participate in the pool of guarantees on specific bond issues, it is not possible to abandon those guarantees. If a state were suspended from access to the Fund, then a new series of bills/bonds would have to be initiated after such a suspension with a different pool of guarantors.

9. Penalties and sanctions

- *Interest rate surcharge:* **Participating states would pay a surcharge to the fund that increases when they are in "excessive deficit"** - as determined by the ECOFIN Council pursuant to the TFEU and the Stability and Growth Pact (SGP). These surcharges would be used to create buffers in the fund and act as an insurance premium against future financial problems.

  The surcharge payments would be retained in the EMU Bond Fund to build up a reserve first-loss pool to absorb any future losses. If a member state corrects the deficits and imbalances, then some of the accumulated surcharges would be rebated after 3 years of compliance with the SGP.

- *Exclusion:* A state may be suspended from the arrangement if it fails to continue meeting the criteria for participation – having its economic policies accepted by the Eurogroup (see 1 above). Presumably, the state would not then be eligible for funding from the EFSF (or the ESM if it were operational at that stage). So the Eurogroup would already have taken the effective decision to push that state to the very brink.

  That step would be a political choice, but one that would have enormous implications for the application of market discipline as bond buyers would have received a very powerful signal about the potential borrower's creditworthiness. The euro area would then be in roughly the same position as today if a major state were to be at imminent risk of default. However, the euro area would have provided a four year period of grace for the state to put its house in order. If it has failed to take the opportunity, then default was inevitable anyway.

  To re-iterate our introductory comments: the EMU Bond Fund would be an expression of solidarity amongst the eurozone member states, but solidarity is a two-way street. The stronger nations would support the weaker in return for the weaker undertaking reforms that should strengthen them in the future. If they resile from those reforms, then correspondingly they resile from any expectation of further support from the stronger.

10. Administration

This would be provided jointly by the debt offices of participating states – modelled along the lines of the Euro System of Central Banks. Supervision, calculation of the surcharges and balance sheet management of the system will take place at the central level in the EMU Bond Fund, but would be mainly a light, co-ordinating role.

Benefits

The Fund offers many potential benefits at this delicate stage of the financial crisis:

i. This scheme guarantees access to finance at "reasonable" cost for all member states, stabilizes the monetary union, shelters countries from strong swings in market sentiment and improves fiscal discipline in the eurozone. These points are explained below.
ii. The announcement would be a huge political statement about commitment to resolve the problems of some Euro area member states and deepen economic union substantially. It would be the "big bazooka" that an outsider has called for!
iii. The combination of great liquidity and being the "safest" haven in the eurozone (reflecting the probability that the Fund's bonds will be the <u>only</u> short-term haven) should make the Fund's yields close to the lowest of all so that most participating states would see an interest cost saving. Naturally, any solution to the crisis will automatically remove the "safe haven" discount in German/Dutch yields. For Germany, the real question is not a few basis points of interest cost on a small part of their debt but the economic benefits of a vibrant single market with over 300 million customers, with no foreign exchange risk for doing business.
iv. As the bonds would be manifestly the best possible credit of the eurozone, they will have a high rating. These bonds would genuinely approach the "risk-free asset" concept that underpins current bank and insurance regulation – but this would be by virtue of economic reality, rather than regulators' statements. As such, they would be eligible collateral at the ECB and the NCBs of the Eurosystem and be a natural asset for banks to hold. Accordingly, they would be expected to be very actively traded and become the most marketable financial instrument in the eurozone, with ultimate liquidity flowing from both the short maturity and collective strength of the guarantors.
v. During the course of 2011, all eurozone states have continued their SGP commitments to improve their budgetary position and have continued that over the next three years as part of the first European Semester process. So any perception of reduced credit risk should be re-inforced because the aggregate budget deficit of the eurozone is planned to fall from 4.5% this year to about 1.4% of GDP in 2014. So the first issues of two-year bonds from the fund would thus fall due for repayment at a time when the eurozone members should have demonstrated the reality of their commitment to budgetary discipline.
vi. During the interim, there would be no doubt that all participating states would not experience any difficulty in rolling over maturing bonds at the very lowest interest costs, thus underpinning their debt dynamics. The Fund must be given enough headroom in size so that all bond maturities from states without a top credit rating in the next two years could be accommodated as well as maintaining the size of existing bill programmes.
vii. The surcharges and the ultimate sanction of being excluded from the scheme if a Member State fails to improve its public finances will act as a big stick.

Appendix I: About ELEC

ELEC is a network of European entrepreneurs of goodwill, aimed at putting timely intellectual pressure on European decision makers to further economic integration in Europe. It acts in complete independence from national or private interests, public authorities or any pressure group.

Established in 1946, ELEC was in 1948 one of the founding members of the European Movement. Its mission includes the mobilisation of its members in support of projects that embody the European common interests through the circulation of information, the organization of debates and the publication of papers on important European themes.

ELEC is built as a federation of national sections present in a number of European countries. The membership of its national sections is drawn largely from economic and financial circles; but it also maintains close contacts with senior national and European civil servants as well as academics and policy makers, whose expertise and influence stimulate the exchanges and broaden their scope and quality.

NOTE: This publication is issued by a number of members of the Monetary Panel of ELEC – acting in their personal capacity. It does not necessarily represent the official views of ELEC.

Appendix II: Participants in the Working Group

All members participated in their personal capacity and do not represent the views of their institution. Naturally, not all members agree with every aspect of the scheme. We are grateful to others who contributed to the discussions and provided illuminating insights.

The participants came from Austria (Franz Nauschnigg, OeNB), France (René Karsenti, ICMA), Spain (Nicolás Trillo Ezquerra, BBVA), UK (Graham Bishop) and the Netherlands (Niels Gilbert, DNB; René Smits, University of Amsterdam; Wim Boonstra and Shahin Kamalodin, Rabobank; Marko Bos, European Movement, Netherlands.)

Wim Boonstra acted as Chairman and Graham Bishop as Rapporteur.

Appendix III: Survey on implications of various levels of guarantee

The most difficult task at present is to achieve a balance between the levels of guarantee that **sufficient** types of financial market participants will accept so that the scheme can provide the necessary quantity and certainty of funding. On the other side of the balance, key Governments must be willing to provide such guarantees – and **quickly**. In the light of the results received, we will refine some practical details of the plan and submit it to the European Commission in January 2012.

The only short-dated euro-area government paper that will be issued for the next four years would be the obligations of the EMU Bond Fund. There would be a spread of maturities – but with a maximum of two years. So all euro area Treasury bills and similar would roll into the Fund upon maturity. They will be structured to be eligible for re-discount at the ECB.

The on-line survey is available here and the questions that will be asked are set out below:

1. Are you?
    - Involved with the risk management of a major EU-domiciled bank
    - Institutional bond/money market fund manager (anywhere)
    - Euro area politician
    - Euro area/EU institution official
    - Other
2. What level of guarantee is the minimum to enable your bank/financial institution/fund to purchase the Fund's securities?
    - "Several" guarantees that only match each state's borrowings from the Fund
    - "Several" guarantees that over-guarantee the Fund obligations by at least say 30%
    - "Joint and several guarantee" by all participating euro-area states (including Germany)

3. Is a rating necessary for you to purchase?
    - AAA
    - Investment grade
    - Not necessary
4. If you need a rating,
    - is this an internal rule
    - national regulation
    - EU requirement
5. Must the security be eligible for repo at the ECB?
6. Any other comments/observations to elaborate on your answers?

If you would be willing to discuss your answers with the Rapporteur, please supply your institution, function and e-mail address.