Expert Group on Debt Redemption Fund and Eurobills

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Conclusions

THE BROADER CONTEXT OF THE DISCUSSION ON JOINT ISSUANCE OF DEBT

1. Schemes of joint issuance of debt, such as a Debt Redemption Fund and Pact (DRF/P) and eurobills, were proposed in 2011 and 2012 mainly as tools to restore stability in the euro area, to reduce the debt overhang and stabilise government debt markets. The schemes have different time-lines and components, reaching from the short to the medium and long term. While they could be designed in various ways without per se pre-determining decisions on the degree of political integration in EMU in the long run, their introduction would nonetheless have long term implications: the DRF/P idea has been conceived as a temporary mechanism to deal with the overhang of public debt and thus a fiscal bridge leading to a credible "no-bail out regime" and sustained convergence. Eurobills have been designed as a means to contribute to stabilising government debt markets in times of stress and to provide a safe and liquid asset that could help foster further financial integration and that would therefore more likely become a permanent mechanism of joint issuance.

2. Based on an assessment of a DRF/P and eurobills, done in this Report for each instrument separately, it would be for policy makers to consider the potential influence of such schemes on the general long-term direction of EMU. Moreover, in a broader policy debate one should take due account of other decisions and future ideas aiming at similar objectives as the two joint issuance schemes analysed in this Report. It was not for this Expert Group to assess those other policy strands. Policy makers will have to make a global assessment of all policies, pondering their comparative merits and risks and deciding on priorities and sequencing.

3. The current debt overhang is a key legacy problem. While in part it had already been built up before through imprudent fiscal and economic policies, it was amplified through the 2008 financial crisis. Although joint issuance may provide an important contribution to the reduction of the debt overhang, in particular for highly indebted countries, it is not a substitute for the irreplaceable effort required from them to reduce their debts. That effort has to be translated in strict budgetary discipline - namely by producing the necessary primary surpluses to reduce the debt - and in the fostering of the potential growth of their economies so as to soften the burden of the financial adjustment.

4. Eliminating or substantially reducing the debt overhang is important to establish the conditions for a credible "no-bail out regime", to reinstate nominal convergence necessary for the smooth working of the monetary policy, to less need for financial assistance through the ESM, and ultimately to ensure the normal working of the monetary union under the original concept, and would therefore be in the general interest of all participants in EMU.

POSSIBLE OBJECTIVES OF SCHEMES OF JOINT ISSUANCE OF DEBT

5. The two schemes analysed in this report were designed with quite different primary objectives in mind, and each may also serve some secondary objectives:

6. The DRF/P has been conceived with the primary objective of restoring sustainable public finances by reducing public debt exceeding the SGP threshold of 60% of GDP, i.e. to deal with the public debt overhang in the euro area. It thus aims to build over its lifetime a fiscal bridge towards a renewed and lasting convergence and a credible "no-bail out regime" within the euro area. According to the original proposal this would also entail debt restructuring rules once the debt overhang has been cleared. The DRF/P would also aim, in the process, to stabilise government debt markets by eliminating the rollover risk during the roll-in phase and to create a safe and liquid asset. During its lifetime it would support monetary policy transmission. Moreover by dealing with the debt legacy problems, it would contribute to further market integration in the long term.

7. The eurobills idea has been put forward with the primary objectives of stabilising government debt markets by reducing Member States' rollover risk and of fostering the integration of financial markets through the creation of a safe and liquid asset. Such an asset would also contribute to reversing the trend towards market fragmentation and support monetary policy transmission.

8. Introduction of any scheme of joint issuance could only be one step contributing to financial market integration, amongst other possibly needed steps, including those aiming at strengthening structurally Europe's banking sector. It should also be noted that no asset is completely risk-free. Creating a jointly issued government security that will be regarded as a safe asset for investors will thus imply some residual risk to governments participating in joint issuance.

ASSESSING THE DRF/P: DESIGN, MERITS, RISKS

9. The DRF/P idea, as developed by the German Council of Economic Experts, entails a fund involving debt mutualisation (of EUR 1.7 to 2.85 trillion joint debt outstanding at peak) and a “grand pact” including a set of preconditions and constraints on participating Member States to make a joint and several liability viable.

10. The DRF/P implies a significant transfer of sovereignty during the lifetime of the DRF/P (i.e. depending on the scheme 10 to 25 years), mainly through binding consolidation agreements and associated control powers. It presupposes and fosters a strong mutual commitment of participating Member States for a long period of time. Such strong commitment would result, in the interest of all Member States, in less need for financial assistance through the ESM and unconventional monetary policy measures; it would pave the way to a credible "no-bail out regime", ensure effective monetary policy and support the normal and smooth working of EMU.

11. A DRF/P, if based on joint and several liability (which requires Treaty change, see below) and supposing it works according to the plan, could contribute significantly to tackling the legacy problem in the euro area by reducing the debt overhang. The overall debt servicing expenses of high debt countries would be lowered through a combination of the insurance element of mutualised debt and the added credibility of fiscal consolidation provided by the "pact". Moreover, the DRF/P would smooth the market access conditions of these countries.

12. A DRF/P based on a pro rata guarantee structure would offer smaller interest expense savings for countries with higher debt than a fund supported by joint and several liability, as the credit quality of the fund would be lower and would depend more on changes in the credit quality of participating Member States. Therefore, a pro rata based fund might not achieve what is necessary for a large DRF/P, covering all debt exceeding 60 % of GDP, to work.

13. To make a joint and several liability viable for highly rated countries the original proposal suggested that collateral to secure service of up to 20% of the transferred debt should be posted. This would however face legal and economic hurdles. In a pro rata scheme such collateral would thus have to be replaced by more paid-in capital. Earmarking tax revenues for servicing the debt might also be considered, but this avenue may also raise legal problems (equal treatment; constitutional problems) and the scope for earmarking tax revenues appears modest in the case of some Member States.

14. The potential merits of a DRF/P are coupled with macroeconomic and financial risks (on moral hazard risks, see points 24-29), such as a likely increase of funding costs for high-credit quality countries. The main challenge would be compliance with rules set in advance for a long period of time, which could prove unsustainable.

15. As another option, in case of a pro rata guarantee structure, a smaller DRF with a different composition could be considered, through a transfer by each participating Member State of an equal share of debt (e.g. 20 % of GDP) to the Fund. Such a scheme could make some Member States less vulnerable by reducing their debt overhang, though to a lesser extent than under the original proposal. Given its composition it would provide, during its lifetime, a useful asset for monetary policy implementation and creation of market liquidity. It could have a shorter lifetime (e.g. 10 years) than under the original proposal. That could also mitigate some moral hazard risks inherent in the scheme. The drawback of this alternative would be that at the end of the regime, debt levels would still vary and some Member States would still have considerable debt overhangs.

ASSESSING EUROBILLS: DESIGN, MERITS, RISKS

16. Eurobills would be a joint issuance of short-term government debt by the euro area Member States. Eurobills could be backed by a joint and several or a pro rata guarantee. A maximum size of eurobills issuance would be set in advance through an issuance limit. The maturities covered by eurobills could be up to two years (resulting in an approximate size of EUR 0.8 trillion of joint issuance and a maximum size of EUR 1.9 trillion (issuance limit at 30 % of total debt per country)) or up to one year (resulting in an approximate size of EUR 0.5 trillion of joint issuance and a maximum size of EUR 0.9 trillion (issuance limit at 10 % of GDP per country)).

17. Eurobills could contribute to promoting financial integration and financial stability. To the extent they create a safe and liquid instrument, eurobills could be a step towards diversifying sovereign debt holdings in bank balance sheets and thus reducing the bank-sovereign feedback loop. Market fragmentation might also be reduced and monetary policy transmission could be made easier; however, sustainable financial integration requires structural reforms of the real economy and the financial sector. Some Experts doubt that these beneficial effects can be achieved with the issuance of eurobills.

18. To the extent issuing limits are not reached, eurobills could lower the roll-over risk in particular in case of sudden changes in the perception of the markets, contributing to more stable government debt markets. Only a large eurobill fund is likely to provide this benefit in full. In normal times, when spreads on short-term debt are small, the effect on Member States' financing costs would probably be limited and would depend on the size of issuance and the liquidity premium.

19. The extent to which these objectives are attained depends on the design variants, which have not only legal dimensions but also mark trade-offs linked to financial risk-sharing and containing moral hazard.

20. Many of the objectives of eurobills would be best attained by a scheme based on joint and several liability (which would require Treaty change) and covering maturities up to two years. A scheme covering maturities only up to one year, corresponding to the traditional definition of T-bills, could still attain the objective of promoting financial integration, though on a smaller scale.

21. In case of eurobills with a pro rata guarantee, some advantages like creating a large bills market would remain intact, while the effects in reducing financing cost would be very low in normal times and significant only in times of market stress. It would appear difficult to rely on credit enhancement measures (pledging collateral, earmarking tax receipts) given the legal and economic obstacles.

22. Setting up a eurobills scheme only temporarily and which would lapse unless renewed, i.e. as a “test run”, is an option that might offer some advantages. However, there is some uncertainty as to market acceptance of a temporary scheme and particularly to whether the unwinding option is really credible and without stability risks. In any event, most of the benefits for which eurobills have been conceived could only be obtained if the scheme was set up on a permanent basis (subject to regular votes in national parliaments on concrete liabilities assumed, see point 35 below).

23. Economic and financial risks (on moral hazard risks, see points 24-29 below) of a eurobills scheme could arise for a temporary eurobills scheme, which could create uncertainty, potentially leading to problems with market reception and volatile yields. Similar risks might arise if a eurobills fund decided to stop issuance from one year to another or to exclude a non-compliant Member State from the scheme. Moreover, eurobills might pose a risk of overreliance on short-term debt in times of market volatility. This risk should be contained by clear and strict legal limits set in advance.

RISKS OF MORAL HAZARD AND HOW TO ADDRESS THEM

24. In discussions about joint issuance, "moral hazard" is understood broadly as referring to situations where one entity makes decisions about how much risk to take whereas another entity bears the cost if risks materialise. Schemes of joint issuance of debt may create moral hazard understood in that way. The moral hazard risks of such schemes could be substantial, the precise potential depending on various factors, in particular the guarantee structure, the volume of joint issuance in relation to debt left at national level, the factor of time (i.e. the duration of the scheme and the maturities of the instruments) and political constraints set on governments.

25. Given its design features, a DRF/P presents risks of moral hazard during its roll-in phase (where Member States would refinance only short-term on the markets) and during the redemption phase (during which non-compliant Member States could no longer be excluded from the scheme, and hence have leverage to exercise pressure on creditor States). Therefore, the "pact" element of the DRF/P idea includes a set of pre-conditions, constraints and safeguards to ensure repayment and make the scheme viable for highly rated Member States. In particular, a transparent, possibly quasi-automatic system of gradual interest mark-ups could function as a reward for successful or as sanction for non-compliant policy.

26. The trade-off between debt reduction and moral hazard differs depending on the design variants of a DRF/P: A fund for debt redemption down to the 60 % of GDP limit based on joint and several liability - allowing significant debt financing cost savings for some Member States - is coupled with higher moral hazard risk than a smaller pro rata fund having a shorter lifetime but offering more limited cost savings.

27. The moral hazard potential of eurobills also depends on the design variants. A small eurobills fund (i.e. covering only maturities up to one year), based on a pro rata guarantee structure and strict legal limits barring overreliance on short-term funding, might raise less concern than a more substantial fund, especially if based on joint and several liability or if coupled with a crisis prevention function. In general, a key question for evaluating the moral hazard risks of a eurobills scheme is whether, once introduced even if temporarily and on a small scale, it would arouse political and economic expectations and pressure for the scheme to become permanent and be extended to longer maturities, or whether this could be credibly excluded from the outset. There is also the question how credible a sanction of excluding a non-compliant Member State would be.

28. Robust mechanisms to contain moral hazard should be part of any scheme of joint issuance. These could include prior conditions (a period of probation and restricting eligibility for participation), reinforced competences of the European level over Member States' fiscal and economic policies in case of non-compliance, financial incentives and sanctions (e.g. mark-ups) and ensuring that market discipline will still be felt. In the view of some Experts, there should be, in the longer run, a sovereign debt restructuring mechanism either as a substitute or as a complement to reinforced governance. This view is disputed by other Experts who would rely on further transfers of fiscal powers to the European level in case of persistent non-compliance by a Member State (which would require Treaty change).

29. Given the still very limited experience with the EU's reformed economic governance framework, it may be considered prudent to first collect evidence on the efficiency of this governance and, if deemed necessary, further strengthen this governance framework, before any decisions on introducing joint issuance are taken.

LEGAL REQUIREMENTS AND LIMITS FOR INTRODUCING A DRF AND / OR EUROBILLS

30. While the current EU Treaties do not allow any schemes of joint issuance of debt resting on joint and several liability of Member States, they may allow guarantee structures based on pro rata commitments and in particular a capital structure analogous to that of the ESM.

31. The current EU Treaties do not grant sufficient competence to the EU to set up a DRF/P or a eurobills scheme (even if based on pro rata) through EU legislation. At most, absent Treaty change one could argue that it is possible to set up a temporary eurobills scheme through a combination of an Article 352 regulation (in enhanced cooperation) with an intergovernmental agreement. Such a construction would be less defendable for a DRF/P, given its far-reaching legal obligations which would bind the Member States over a considerable period of time and many of which manifestly lie outside the EU's competences.

32. Treaty amendment would be required in case some ways of containing moral hazard through further fiscal and economic policy integration, e.g. European veto powers over national budgets, were deemed necessary.

33. Some of the possible Treaty changes identified in this report could be achieved through a simplified revision of the EU Treaties, while others would require an ordinary revision procedure.

34. If a DRF/P or a eurobills scheme was established on a purely intergovernmental basis, legal limits would have to be taken into account. The EU's political institutions could not exercise any decision-making powers. The EU's economic policy coordination should not be undermined.

35. National constitutional laws pose pronounced limits to the possibilities of Member States to participate in a scheme of joint issuance of debt (see the example of Germany). There might be possible ways to respect those limits. A scheme could the more likely be found in line with those limits, the more clearly it were legally ensured that the maximum of a Member State's liability is in advance limited, that there is a possibility for regular votes in national parliaments on concrete liabilities assumed (on top of information rights and rights to influence) and that there are strict conditions and safeguards designed to ensure fiscal discipline.

DEMOCRATIC LEGITIMACY AND ACCOUNTABILITY

36. Introducing a scheme of joint issuance of debt would inevitably pose new challenges for ensuring democratic legitimacy and accountability.

37. Even if legally possible, setting up a scheme of joint issuance of debt through a purely intergovernmental construction would present serious shortcomings and problems in terms of efficiency, democratic legitimacy and accountability. Sufficient parliamentary legitimacy could hardly be ensured; the voting rules in an intergovernmental Board would pose a dilemma between accountability and efficiency. There would be a risk of creating two parallel institutional worlds competing with each other on economic governance. This should be avoided.

38. Several reasons therefore strongly plead in favour of preferring solutions based on the Community method and the EU's institutional architecture (possibly amended through EU Treaty change). If a temporary pro rata eurobills scheme is considered in absence of a change to the EU Treaties, a model combining an Article 352 act with an intergovernmental agreement could be explored.

39. Parliamentary accountability is key. Models should be found to ensure it at both levels: accountability provided by the European Parliament for decisions taken at European level, but also a key role for national parliaments given their continued "power of the purse".

OVERALL CONCLUSION

40. Both a DRF/P and eurobills would have merits in stabilising government debt markets, supporting monetary policy transmission, promoting financial stability and integration, although in different ways and with different long term implications. These merits are coupled with economic, financial and moral hazard risks, and the trade-offs depend on various design options. Given the very limited experience with the EU’s reformed economic governance, it may be considered prudent to first collect evidence on the efficiency of that governance before any decisions on schemes of joint issuance are taken. Without EU Treaty amendments, joint issuance schemes could be established only in a pro rata form, and - at least for the DRF/P - only through a purely intergovernmental construction raising democratic accountability issues. Treaty amendments would be necessary to arrive at joint issuance schemes including joint and several liability, certain forms of protection against moral hazard and appropriate attention to democratic legitimacy.