STABILITY BONDS: A BRIEF COMMENT IN RESPONSE TO THE GREEN PAPER

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1 It is clear, simply by looking at the example of the United States, that, if organized well, Stability Bonds would be of benefit to all member states, including those with AAA ratings at present. An AAA rating does not convey a specific price as is clear by the range of premia the various AAA countries have to pay over the rates for comparable US government debt securities. The first question, therefore, is *how can the euro area, which is slightly less indebted than the US in total terms achieved costs of finance that are at least as good as the US*? (Current rates are of course always misleading as they depend in part on the particular stance of monetary policy.) All parts of the euro would obviously want to benefit from the best terms that are available.

2 Second, the proposals, as set out in the Green Paper, address what a system should look like in normal times when the euro area's fiscal position appears stable. This misses the most important contribution that Stability Bonds could make, which is to help in stabilizing the present position. An AAA rating for the euro area would be compatible with the whole of current debt, including that of Greece, Ireland, Italy Portugal and Spain, who are currently facing market pressure, provided they are part of an agreed recovery programme. The second issue therefore is *how can the Stability Bond programme be combined with the ESM/EFSF to cover all debt financing?*

3 It is only Option 1 of the proposed Stability Bond Programme as set out that would cover all debt. The concern expressed is that under those circumstances there would be moral hazard and that the danger would be that all debt would get downgraded because of the marginal problems. This however assumes that all Stability Bonds would have the same character. Annex 2 contains a brief mention of how bonds might have different seniority but this is a different point. As soon as some bonds are more junior they will attract a risk premium and this will result in exactly the problem that is being sought to avoid at present namely that the member states in difficulty have to pay a premium and this merely makes their indebtedness more unsustainable.

4 The advantage of the ESM/EFSF is that it imposes very strict conditions on the countries that are supported. Hence the borrowing of the highest risk countries is more constrained than that of the others and what the other member states offer, with the help of the IMF, is special support in the form of providing marginal debt at near the finest rates in order to improve the chance of resolving the problem. Providing the debt is serviced then all member states gain. Those who receive the funding get a lower cost, those providing the funding get a small margin over their own borrowing rates. This gives an automatic means of allowing Stability Bonds to cover all debt. The problem is who should issue them.

5 Under option 1 issuance would be coordinated and even if there is not a euro area level Debt Management Office there would have to be a mechanism for agreeing whether a

member state could issue debt direct or whether it had to do it under the ESM/EFSF. Under Options 2 and 3 there would be three levels of issuance: Stability Bonds; national debt and ESM/EFSF debt. In that case two boundaries would have to be set. The various fiscal measures agreed or in train envisage a different boundary described in terms of excessive deficits, excessive imbalances or excessive debt. A member state not complying would attract penalties from its fellow members as well as penalties from the market.

6 Having all these different conditions would make the system very complicated. It would therefore make most sense for the various conditions to be coordinated otherwise there will be a rather large number of different circumstances, e.g.

a. Compliant with fiscal rules and below debt level required for Stability Bonds
b. Non-compliant with fiscal rules but below debt level required for Stability Bonds
c. Compliant with fiscal rules but above debt level required for Stability Bonds
d. Non-compliant with fiscal rules but above debt level required for Stability Bonds
e. Compliant with fiscal rules but in need of ESM/EFSF support
f. Non-compliant with fiscal rules but in need of ESM/EFSF support

The simplest of coordination would be to equate fiscal compliance and Stability Bond eligibility. This would eliminate cases c and d, which would be the case under Option 1 anyway.

7 Case b would then offer a much harsher set of penalties if a non-fiscally compliant member state were to be exposed not just to non-interest bearing deposits and fines but also to non-eligibility for Stability Bonds for new issues and hence having to pay the risk premium. Indeed this would probably make the deposits and fines unnecessary. It also imposes a step change on a member state rather than the gradation at present where borrowing costs increase the greater the perceived fiscal difficulty. This then would be a clear downside of the Stability Bond proposals as it would be more difficult to impose such progressive pressures. Such a progressive arrangement would only be possible if a member state could lose Stability status for some of its existing bonds at some trigger. However, that would not enable all member states to obtain the finest rates of interest and would come close to the present system where the cost of Stability Bonds would depend upon the market's view of the chance of Stability status being maintained for the life of the bond.

8 If these arrangements were applied the would then be only four circumstances

a. Compliant and part of the Stability Bond programme
b. Under special constraints and participating in the ESM/EFSF
c. Non-compliant and excluded from new Stability Bond issues
d. In or approaching default

Member states would get the finest terms available under Case a. There would pay a small margin under Case b as they would not raising the funding themselves but through the ESM/EFSF but with a special programme of actions to return to stability. Case c member states would face a very considerable penalty and would have a very strong incentive either to return to Case a or seek agreed special treatment under Case b, unless they were large and/or had low debt. Case d would only occur if a member state chose not to comply or could not mobilize the political support to do so.

9 My suggestion is thus simple. Enable all member states to access Stability Bonds provided they are fiscally compliant and hence enjoy better terms than are available at present. Provide ESM/EFSF support under terms that entail a return to stability, so troubled members also get almost the same fine rates with a small margin for transaction and other costs. The non-fiscally compliant members will then face major pressures to comply, unless their fiscal position is quite strong, in which case the rules would probably be unduly harsh.

An Addendum

10 All the proposals are one sided. They offer no great incentive for member states to do anything other than comply. Those who do not comply are penalized. Any state that was to choose to run its debt down much further than the minimum required receives only limited benefits in terms of a lower interest burden because it already has the finest rates. However, the euro area as a whole benefits as this helps reduce the cost of debt. The appropriate incentive would be to offer such countries some small benefit, perhaps in terms of reduced net budgetary contributions or interest rate rebates. While the system is asymmetric, even if a programme for reducing debt generally can be agreed, it will tend only to achieve the plan at best and will have little chance of improving more rapidly. With such an incentive the prudent members would have some reward for helping the general good – a perception which is sadly lacking in the present arrangements, resulting in an unwillingness to expand the ESM/EFSF or indeed to support the concept of Stability Bonds which the subject of the paper.