Opinion by the Swedish Parliamentary Finance Committee

2011/12:FiU19

Opinion on the Green Paper on the feasibility of introducing stability bonds

1. SUMMARY

This opinion given by the Finance Committee deals with the Commission's Green Paper on the feasibility of introducing stability bonds, presented on 23 November 2011.

The Committee notes that the proposals in the Green Paper have become irrelevant since the agreement presented by France and Germany on 5 December 2011, which rejected a system of stability bonds. Similarly, the Committee feels that there is cause to question the rationale that all euro-area countries must to a greater or lesser extent share responsibility for each other's debts. The problem of 'moral hazard' is evident in a system in which all countries are forced to bear the consequences of individual countries' lack of budget discipline. The Committee feels that this will send the wrong signals because the incentive to budget discipline and to push through the necessary reforms will be diminished.

The Committee proposes that the Chamber places this opinion on the record. The opinion contains three reservations.

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2. COMMITTEE PROPOSAL FOR A PARLIAMENTARY RESOLUTION

Green Paper on the feasibility of introducing stability bonds

That Parliament place the opinion on the record.

Reservation (1) (S) – justification

Reservation (2) (SD) – justification

Reservation (3) (V) – justification

The Committee proposes that the matter be decided in one reading.

Stockholm, 15 December 2011

For the Finance Committee,

Anna Kinberg Batra

[list of participants]

3. THE SUBJECT

3.1. The subject and its preparation

On 1 December 2011 the Lower House referred the Commission's Green Paper on the feasibility of introducing stability bonds (COM(2011) 818 final) to the Finance Committee. The Commission adopted the Green Paper on 23 November 2011.

On 6 December 2011 State Secretary Susanne Ackum informed the Committee about current EU matters, including the Green Paper on stability bonds.

All stakeholders and other interested parties will be able to participate in the consultation which the Commission has initiated through the Green Paper. The consultation will provide the Commission with the basis for determining the appropriate way to progress the matter. The consultation closed on 8 January 2012. The Commission will present its views on the best way forward by mid-February at the latest on the basis of the consultation.

4. THE COMMITTEE'S DELIBERATIONS

4.1. The Green Paper

The rationale and pre-conditions for stability bonds

The Commission states that the intensification of the euro-area sovereign debt crisis has triggered a wider debate on the feasibility of common issuance, and a significant number of advocates of common issuance believe this to be a powerful instrument to address liquidity constraints in several euro-area Member States.

Against this background, the European Parliament requested the Commission to investigate the feasibility of common issuance in the context of adopting the legislative package on euro-area economic governance (the six-pack) (Parliamentary resolution of 6 July 2011 (2010/2242(INI)). It stressed that the common issuance of stability bonds would also require a further move towards a common economic and fiscal policy.

In the Green Paper the Commission gives its view on the feasibility of the common issuance of government bonds – stability bonds – for the euro-area countries and the conditions governing them. It states in a footnote (number 2, page 2) that common issuance could, in principle, also extend to non-euro area Member States. The introduction of commonly issued stability bonds would mean a pooling of common issuance among the Member States and the sharing of associated revenue flows and debt-servicing costs. The issuance of stability bonds could be centralised in a single agency or remain decentralised at the national level with tight co-ordination among the Member States. Depending on the chosen approach to issuing the bonds (three options are presented in the Green Paper) the Member States could accept joint-and-several liability for all or part of the associated debt-servicing costs, implying a corresponding pooling of credit risk.

The Commission states that common issuance has typically been regarded as a longer-term possibility. However, more recent debate has focused on potential shorter-term benefits as a way to alleviate tension in the sovereign debt market. The introduction of stability bonds would come in parallel with further convergence and foster the establishment and implementation of the necessary framework for such convergence. The Commission states that such a parallel approach would require an immediate and decisive advance in the process of economic, financial and political integration within the euro area.

The Green Paper stresses that many of the implications of stability bonds go well beyond the technical domain and involve issues relating to national sovereignty and the process of economic and political integration. These issues include reinforced economic policy coordination and governance, a higher degree of economic convergence, and, under some options, the need for Treaty changes.

In that context, the Commission states that the more extensively credit risk is pooled among sovereigns, the lower market volatility but also market

discipline on any individual sovereign will be. Thus the fiscal stability aimed at by the stability bonds would have to rely more strongly on discipline provided by political processes.

Any type of stability bond would have to be accompanied by a substantially reinforced fiscal surveillance and policy coordination as an essential counterpart, so as to avoid moral hazard, in other words excessive risk-taking, and ensure sustainable public finances and to support competitiveness and reduction of harmful macroeconomic imbalances. Since this would necessarily have implications for fiscal sovereignty the Commission feels there should be a substantive debate in euro-area Member States.

The main benefits of stability bonds

Managing the current crisis and preventing future sovereign debt crises

The Commission feels that even if the introduction of stability bonds could take some time, prior agreement on common issuance could have an impact on market expectations and thereby lower average and marginal funding costs for those Member States currently facing funding pressures. However, it stresses, for any such effect to be durable, a roadmap towards common bonds would have to be accompanied by parallel commitments to stronger economic governance.

Reinforcing financial stability in the euro area

The Commission believes that stability bonds would help to smooth market volatility and reduce or eliminate the need for costly support and rescue measures for Member States temporarily excluded from market financing. This is because the bonds would provide all participating Member States with more secure access to refinancing, preventing a sudden loss of market access due to unwarranted risk aversion and/or herd behaviour among investors. At the same time, the Commission stresses that the positive effects of such bonds are dependent on managing the potential disincentives for fiscal discipline.

The Commission also highlights the fact that the euro-area banking system would benefit from the availability of stability bonds because they would provide a source of more robust collateral for all banks in the euro area than domestic sovereign bonds.

Facilitating transmission of monetary policy

According to the Commission, the sovereign debt crisis has impaired the transmission channel of monetary policy, as government bond yields have diverged sharply in highly volatile markets. Stability bonds would create a larger pool of safe and liquid assets which would help ensure that the monetary conditions set by the ECB passed smoothly and consistently through the sovereign bond market to the borrowing costs of enterprises and households and ultimately into aggregate demand.

Improving market efficiency

The bonds would promote efficiency in the euro-area sovereign bond market and in the broader euro-area financial system. Stability bond issuance would offer the possibility of a liquid market with high credit quality, delivering low benchmark yields and correspondingly low credit risk and liquidity premiums. The Commission also claims that the availability of a liquid euro-area benchmark would facilitate the functioning of many euro-denominated derivatives markets and be a further catalyst in integrating European securities settlement.

Enhancing the role of the euro in the global financial system

High liquidity is one of the factors contributing to the prominent and privileged role of US Treasuries in the global financial system, thereby attracting institutional investors. Accordingly, the larger issuance volumes and more liquid secondary markets implied by stability bond issuance would strengthen the position of the euro as an international reserve currency.

Preconditions for stability bonds

Limiting moral hazard

In a common issuance system in which all participants share the credit risk there is an inherent problem: moral hazard. This is because the individual lack of fiscal discipline comes to affect all participants as they share the credit risk. The Commission notes that the disciplinary impact of the market on national fiscal policy will vary depending on the specific form of a stability bond system.

Because the issuance of stability bonds may weaken market discipline the Commission believes that substantial changes in the framework for economic governance in the euro area would be required. The adoption of the new economic governance package (COM(2011) 819 and COM(2011) 821) already provides a significant safeguard but there may be a need for further action, particularly if the credit risk were to be shared. The Commission stresses that if stability bonds were to be seen as a means to circumvent market discipline, their acceptability among Member States and investors would be put in doubt.

Ensuring high credit quality and that all Member States benefit from stability bonds

If they are to be accepted by investors, stability bonds should be designed and issued so that they consider them a very safe investment. The Commission also states that the design of stability bonds would need to be sufficiently transparent to allow investors to price the underlying guarantees. Achieving a high credit quality will also be important to ensure the acceptance of stability bonds by all euro-area Member States. Support for stability bonds among those Member States already enjoying triple A ratings would therefore require an assurance of a correspondingly high credit quality for the new instrument so that the financing costs of their debt would not increase. This again would rest on a successful reduction of moral hazard. According to the Commission, the credit rating for stability bonds would

primarily depend on the credit quality of the participating Member States and the underlying guarantee structure.

Ensuring consistency with the EU Treaty

Article 125 of the Treaty on the functioning of the European Union (TFEU) prohibits Member States from assuming liabilities of another Member State. Because the design of the stability bonds must not be in breach of this prohibition amendment to the Treaty might be needed.

This could, according to the Commission, be possible using the simplified procedure if a euro-area common debt management office (DMO) were constructed under an inter-governmental framework, but would most likely require the use of the ordinary procedure if it were placed directly under EU law since it would extend the competences of the EU. Unless a specific basis is established in the Treaty, an EU-law based approach would probably require the use of Article 352 TFEU (the flexibility clause), which implies a unanimous vote of the Council and the consent of the European Parliament.

The Commission believes that issuance of stability bonds under several but not joint guarantees would be possible within the existing Treaty provisions. For example, increasing substantially the authorised lending volume of the European Stability Mechanism (ESM) and changing the lending conditions with a view to allowing it to on-lend the amounts borrowed on the markets to all euro-area Member States could be constructed in a way compatible with Article 125 TFEU, provided the pro-rata nature of the contributing key attached to the ESM remains unchanged. The same reasoning would apply to issuances of a possible common debt management office, whose liabilities would remain limited to a strictly pro-rata basis.

Further qualitative changes in governance beyond the proposals included in the 23 November package would, in the Commission's opinion, probably require changes in the Treaty.

Options for the issuance of stability bonds

Based on the degree of substitution of national issuance (full or partial) and the nature of the underlying guarantee (joint and several or several) implied, the Commission puts forward three different options for the issuance of stability bonds:

1. The full substitution of stability bond issuance for national issuance, with joint and several guarantees.

2. The partial substitution of stability bond issuance for national issuance, with joint and several guarantees.

3. The partial substitution of stability bond issuance for national issuance, with several but not joint guarantees.

The following table is the Commission's overview of the options' main features and effects (Green Paper, Table 1, page 23).

The Commission states that the options can be combined as sequential steps in a process of gradual implementation: A relatively early introduction based on a partial approach and a several guarantee structure, combined with a roadmap towards further development of this instrument and the related stronger governance. Such an upfront political roadmap could help ensuring the market acceptance of stability bonds from the outset.

Participation in the stability bond framework is, the Commission states, normally conceived for the Member States of the euro area. However, participation by Member States outside the euro area would be feasible, particularly for option 3 (footnote 27, page 23 of the Green Paper).

Table 1: Overview over the three main options

	(Option 1)	(Option 2)	(Option 3)
Main features			
– Degree of substitution of national issuance by Stability Bonds	Full	Partial	Partial
– Guarantee structure	Joint and several	Joint and several	Several with enhancements (preferential claims and collateral)
Main effects			
– on average funding costs 1/ for Stability Bond as a whole 2/ across countries	1/ Medium positive effect from very large liquidity compensated by strong moral hazard. 2/ Strong shift of benefits from higher to lower rated countries	1/ Medium positive effect, from medium liquidity and limited moral hazard 2/ Smaller shift of benefits from higher to lower rated countries. Some market pressure on MS with high level of debt and subprime credit ratings	1/ Medium positive effect, lower liquidity effect and sounder policies prompted by enhanced market discipline 2/ no impact across country. Stronger market pressure on MS with high level of debt and subprime credit ratings
– on possible moral hazard (without reinforced governance)	High	Medium, but strong market incentives for fiscal discipline	Low, strong market incentives for fiscal discipline
– on financial integration in Europe	High	Medium	Medium
– on global attractiveness of EU financial markets	High	Medium	Medium
– on financial market stability	High	High, but some challenges in case of unsustainable levels of national issuance	Low, but it may help to deal with the current crisis thanks to its rapid implementation.

Legal considerations	Probably Treaty change	Probably Treaty change	No Treaty changes required. Secondary legislation may be helpful.
Necessary minimum implementation time	Long	Medium to long	Short

Source: Green Paper page 23.

Fiscal framework for stability bonds

Even though the regulations on strengthening economic and budgetary surveillance (COM(2011) 819) and on increased monitoring of the euro-area countries in debt crisis (COM(2011) 821) together with the profound changes to the Stability and Growth Pact constitute a solid foundation for enhanced coordination of the euro-area Member States' budgetary policy, the Commission feels that the risk of moral hazard created by stability bonds requires further strengthening of the fiscal policy framework. It identifies three dimensions to such a strengthened framework:

- Increased surveillance and intrusiveness in national fiscal policy.
- Stability bonds as an element of an improved fiscal policy framework.
- Fiscal conditions for entering the system.

Increased surveillance and intrusiveness in national fiscal policies

In line with currently discussed changes, this would entail more thorough examination of draft budgets, not only for fiscally distressed countries but for all participating Member States. The Commission feels that EU approval of budgets may be needed for participating Member States under certain circumstances such as high indebtedness or deficit levels. Moreover, a much stronger monitoring framework of budgetary execution would be required.

National fiscal frameworks will be strengthened in the relatively near term by the implantation of the Directive on fiscal frameworks (which could in fact be accelerated). Furthermore, there are ongoing discussions to go further, *inter alia* by the introduction of rules translating the SGP framework in national legislation, preferably at constitutional level, and with adequate enforcement mechanisms. Other possible key reinforcements of national frameworks include the adoption of binding medium-term frameworks, independent bodies assessing the underlying assumptions of national budgets and effective coordinating mechanisms between levels of public administration.

The Commission feels that a system would have to be put in place that credibly ensures the debt service of each Member State benefiting from the issuance of stability bonds. Under no circumstances should the servicing of stability bonds come into question. One option to this end would be to grant extensive intrusive power at EU level in cases of severe financial distress, including the possibility to put the failing Member State under some form of 'administration'. Another option would be to introduce a clause for

participating countries on seniority of debt service in the stability bond system over any other spending in the national budgets.

Stability bonds as a component of an improved fiscal framework

While stability bonds create risks of moral hazard, they are also likely to change at the root the conditions in which budgetary policies are formulated and implemented. This is notably because European guidance on national budget policies (within the framework of the European Semester) would be translated into tangible figures by the very process of setting borrowing allocations to participating Member States. Indeed, the functioning of stability bonds would require devising *ex ante* ceilings for national borrowing that would then frame or at least affect national budgets.

In addition, financial incentives for sound fiscal policies could be built into the system. While yields of stability bonds would be market-based, funding costs might be differentiated across Member States depending on their fiscal positions or fiscal policies, or their market creditworthiness, as reflected by the risk-premium of national issuances over common issuances.

Fiscal conditions for entering the system

The Commission states that in order to implement the vision of stability bonds as precisely that, macro-economic and fiscal conditions might also be set for Member States in order to enter and remain in the system.

Implementation issues

Organisational set-up

Most importantly, the Commission states, the institutional structure of funding operations would need to be determined, i.e. whether a centralised debt management office (DMO) would be established or whether the essential functions could be carried out in a decentralised way by national Treasuries and DMOs. The decentralised approach would require a high degree of coordination.

The Commission sees a number of options if the decision is for a central issuance agent. First, the Commission could act as the DMO, which would speed up introduction. Second, the EFSF/ESM could be transformed into a full-scale DMO. Third, a new EU DMO could be created. The latter would require some time to become operational. The exact administrative cost cannot be calculated without all other details being defined in advance, but this would have an impact on the Member States' budgets.

An important technical issue would be how a centralised DMO would on-lend the funds raised to the Member States. The Commission sketches two options: (a) on-lending in the form of direct loans, where the Member State would receive its funding through a loan agreement; and (b) the direct purchase of all, or the agreed amount of, government bonds from the Member States by the DMO in the primary market. The second option would allow the DMO to also buy outstanding government debt in the secondary market, if needed.

The repayment of bonds would also need to be organised. The most straightforward way of doing this would, according to the Commission, be through transfers by the national authorities to the issuing agent that would organise repayment to the bondholders. In order to ensure that market participants could rely on the servicing of debt always being guaranteed and delays in payments not occurring, the DMO would need to be endowed with a stable and predictable revenue stream. The Commission points out that a debt management office at supranational level does not have a direct link to tax revenues as a national DMO does, which might reduce the market's acceptance of the debt instruments to be issued. Last, the Commission notes that even with stability bonds there would be a need for Member States' liquidity management.

Relationship with the ESM

The setting up of an agent for joint issuance of stability bonds for euro-area Member States might, according to the Commission, warrant a clarification of the division of tasks with the European Stability Mechanism. The ESM might be considered materially redundant, as joint issuance, coupled with reinforced fiscal surveillance rules, could assume the role of organising ordinary finance for Member States' governments as well as exceptional additional finance in case of serious difficulties of a Member State. However, this is not the best approach, so the ESM could remain as a separate issuer of debt for the purpose of organising and meeting exceptional financing needs.

The choice of interaction with the ESM would also depend on the respective option for stability bonds. While the ESM could be considered fairly redundant in the case of approach No 1, the position is not so clear for the other two approaches. The Commission feels that the ESM framework could even be used for the first steps towards stability bonds.

Other implementation issues

The Commission mentions other issues. For instance, consideration must be given to the appropriate legal regime under which the bonds would be issued. A decision on funding options (auctions, syndication), security characteristics and market conventions would be needed. The treatment of the bonds under national accounting rules would also have to be clarified, for example, the question of how the national debt-to-GDP ratios would be affected by stability bonds under the different guarantee structures would have to be explored.

5. THE FINANCE COMMITTEE'S POSITION

In an agreement dated 5 December 2011 Germany and France indicated that neither country was in favour of a system of stability bonds to deal with the current euro-area crisis. The statement by the euro-area's Heads of State and Government on 9 December 2011 makes no mention of stability bonds. There is also reason to question the rationale that all euro-area countries must to a greater or lesser extent share responsibility for each other's debts. The problem of 'moral hazard' is evident in a system in which all countries are forced to bear the consequences of individual countries' lack of budget discipline.

The difference in risk would appear to disappear in respect of investments in States which actually had different levels of risk. The Committee feels that this will send the wrong signals because the incentive to budget discipline and to push through the necessary reforms will be diminished. The Committee wishes to stress that Sweden, as a small, open economy, is affected by the financial stability of the euro-area Member States.

The Committee proposes that the Chamber places this opinion on the record.

6. RESERVATIONS

The Committee's proposal for a Parliamentary resolution and position have resulted in the following reservations. The heading indicates the point in the Committee's proposal dealt with in the section.

6.1. Green Paper on the feasibility of introducing stability bonds – justification (S)

By Tommy Waidelich (S), Pia Nilsson (S), Jörgen Hellman (S), Maryam Yazdanfar (S), Marie Nordén (S) and Sven-Erik Bucht (S)

Position

As a small, open economy, Sweden relies on a euro area which works. Some of our main trading partners are in euro countries. Our banks also have a major part of their lending in euro countries. In the critical situation currently prevailing in the euro area we social democrats feel that there must be greater willingness for the rescue funds already agreed upon to be used in the event of any further deterioration. It is therefore urgently necessary to continue to discuss all possible options to create stability in the euro area. We regard a system with stability bonds as such an option.

6.2. Green Paper on the feasibility of introducing stability bonds – justification (SD)

By Johnny Skalin (SD)

Position

In 2003 the Swedish population rejected the introduction of the euro as our currency. The result of the referendum also means that the Swedish people do not wish to allow the Swedish taxpayer to help finance the fiscal failures of the euro area. Cooperation on the euro is cooperation for the wrong reasons which has run its course. We therefore reject a system with stability bonds.

6.3. Green Paper on the feasibility of introducing stability bonds – justification (V)

By Ulla Andersson (V)

Position

A system of joint stability bonds creates pressure of increased supranationalism in economic policy. We are very much against such a trend, so we therefore reject a system of stability bonds.

Moreover, the current economic crisis in the euro area is not the result of budgetary indiscipline, but is an expression of the inherent weaknesses in the currency union. With no opportunity for independent monetary policy a number of southern European countries have seen their competitiveness undermined as a result of different rates of growth in productivity among the

different countries of the currency union. This has contributed to large balance of payment deficits in public finances.

It is true that some euro-area countries have significant budget deficits and/or large sovereign debts. But there are many other countries, such as the USA, the UK and Japan, which have equally large or larger budget deficits and sovereign debts – but their government bond interest rates are not going through the roof. The main reason for this is that they have central banks that can act as lender of last resort. Euro area countries do not. The European Central Bank could take on that role but the EU's rules, the 'no bail-out' clause, forbid it from doing so.

Annex

List of proposals discussed

Green Paper on the Feasibility of Introducing Stability Bonds (COM(2011) 818 final)