EXPERT GROUP ON DEBT REDEMPTION FUND AND EUROBILLS

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EXPERT GROUP ON DEBT REDEMPTION FUND AND EUROBILLS

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I. INTRODUCTION

1. Following a commitment made on 12 March 2013 to the European Parliament as part of the overall agreement on the Two Pack legislation, the European Commission established, in July 2013, this Expert Group on a Debt Redemption Fund and Eurobills. In its declaration of 12 March 2013, the Commission defined the mandate of the Expert Group as follows:

   "The Commission will establish an Expert Group to deepen the analysis on the possible merits, risks, requirements and obstacles of partial substitution of national issuance of debt through joint issuance in the form of a redemption fund and eurobills. The Group will be tasked to thoroughly assess, what could be their features in terms of legal provisions, financial architecture and the necessary complementary economic and budgetary framework. Democratic accountability will be a central issue to be considered. The Group will take into account the on-going reform of the European economic and budgetary governance and assess the added value for such instruments in this context. The Group will pay particular attention to recent and on-going reforms, such as the implementation of the two-Pack, the ESM and any other relevant instruments. In its analysis the Group will pay particular attention to sustainability of public finances, to the avoidance of moral hazard, as well as to other central issues, such as financial stability, financial integration and monetary policy transmission."

2. As is clear from this mandate, the task given by the Commission to the Expert Group was one of in-depth exploration and analysis. The Expert Group's study subject was framed by reference to two particular ideas of partial joint issuance of government debt, which as of 2011 had emerged in discussions on tackling the crisis in the euro area and shaping the future of EMU. These are : the idea of a debt redemption fund and pact (DRF/P) on the one hand, and that of "eurobills" – i.e. a scheme of joint issuance of short-term government securities – on the other.

3. The Expert Group was set up in July 2013 and has deliberated on 10 meeting days. On the basis of a Roadmap adopted at its first meeting[1], it has striven to fulfil its task – "to deepen the analysis on the possible merits, risks, requirements and obstacles" of these two ideas – by addressing various thematic aspects mentioned in the mandate. This is reflected in the 7 chapters of this Report – starting from the larger context of the development of EMU and the main possible objectives of joint issuance, followed by a detailed presentation of main issues and options of design of a DRF/P and eurobills and an assessment of their respective merits and risks, including moral hazard, and extending to an analysis of the legal feasibility as well as a discussion on democratic accountability. The final chapter contains the Expert Group's conclusions.

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[1] http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=9669&no=6.

4. It must be stressed that the Expert Group's mandate did not include developing an agenda for joint issuance of debt in the euro area or formulating policy proposals or recommendations. The Expert Group has strictly kept to the limits inherent in its mandate: its Report thoroughly explores the two ideas, presents main possible options, examines issues of economic and legal feasibility, and assesses merits and risks. This exploration does necessarily comprise highlighting advantages of some design options for the two joint issuance schemes while excluding or discouraging some other options. The Report should thus give policy makers rich material and advice for use if and when schemes of joint issuance are considered at political level.

5. However, in line with the mandate the Report does not endorse, explicitly or implicitly, either of the two ideas for joint issuance of debt, let alone propose any concrete design model for political follow-up. Indeed, the Expert Group acknowledges that schemes of joint issuance of debt, including the two ideas it was asked to study, are part of a wider panoply of possible policy ideas for the further development of EMU. It will be for the political institutions in the EU and its Member States to make a global assessment of all such ideas, pondering their comparative merits and risks and ultimately deciding on priorities and sequencing. It will also be for policy makers to consider the potential influence of the two schemes of joint issuance on the general long-term direction of EMU.

6. While offering figures where possible, e.g. about sizes of a common fund under various design options, the Expert Group refrained from advancing quantitative estimates of financial effects of any possible future joint issuance on government debt financing costs, given the complexity of future market pricing. The economic analysis set out in this Report thus rather focuses on the Experts'[2] qualitative assessment of merits and risks, based on their expertise and experience.

7. The approach followed by the Expert Group is set out in more detail in its Working Methods adopted at its first meeting[3].

8. This Report reflects exclusively the personal views and assessments of the ten members[4], who were all appointed to this Group in their personal capacity. The views contained herein cannot be attributed to the European Commission or to any other body or entity.

9. **The Expert Group has come to the following overall conclusion**: 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

[2] In this report, the word "Experts" in capital letters refers to members of the Expert Group.

[3] http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=9668&no=5.

[4] Professor Claudia Buch decided to resign from the Expert Group for personal reasons.

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.

10. The Expert Group hopes that this Report will be regarded as a useful basis for a further discussion on joint issuance of debt, and as a timely, focussed, analytical contribution to a broader policy debate which is still needed on the main avenues to be pursued for the future development of EMU.

II. THE BROADER CONTEXT OF THE DEBATE ON JOINT ISSUANCE OF DEBT

11. The discussion around joint issuance of public debt in the euro area needs to be seen in the broader context of the development of Economic and Monetary Union (EMU) since its inception.

12. The creation of EMU and the introduction of the euro were milestones of European integration. The single currency has become a symbol of European integration together with the achievement of free movement of persons, goods, services and capital within the EU and peace in Europe. As the world's second largest reserve currency, the euro is an integral feature of the global economy.

13. At the same time, does not fulfil all criteria of an optimal currency union. The current EMU framework combines centralised monetary policy with reliance on decentralised national fiscal policies under rules-based European surveillance. Tackling asymmetric country-specific shocks within the EMU is assigned to national fiscal policies, e.g. through the automatic stabilisers of tax and social security systems. The rules of the Stability and Growth Pact (SGP)[5] allow automatic stabilisers to play their role, in what is known as the cyclically adjusted budget deficit. If total debt levels already endanger debt sustainability, these stabilisers may not be effective anymore. Neither the exchange rate nor monetary policy instruments are available to react to country-specific shocks. The current economic governance framework of the euro area does not contain a central fiscal capacity. Moreover, the governance framework as it stood prior to the economic and financial crisis essentially relied on common budgetary rules set out in the SGP, coupled with limited surveillance tools and insufficient coordination of national economic policies, inadequate to prevent the build-up of economic vulnerabilities and structural weaknesses in certain Member States and in the euro area as a whole.

[5] All relevant legal texts and guidelines can be found under: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm.

14. More specifically, the following major gaps appeared in the pre-crisis economic governance and its enforcement: First, the SGP lacked effective mechanisms to ensure sustainable public finances that would kick in at a sufficiently early stage. Second, the strong yield convergence of national bonds in the euro area and hence low market pressure, despite major differences in budgetary performance, lowered, in the case of certain Member States, the incentives to take appropriate policy action. Third, the surveillance of structural reforms defined by the Lisbon Strategy to strengthen competitiveness was limited. Possible spill-over effects of financial markets and national economic policy measures within the EMU were not systematically analysed. Finally, the lack of an integrated EU-level framework on financial sector supervision and of a mechanism to address possible negative spill-over effects stemming from the financial sector on the other countries, resulted in negative loops arising between the financial system and the sovereigns in the vulnerable countries. A reversal of financial integration in the internal market occurred – a very serious aspect of the crisis. The current regulatory system for banks has incentives built in for investments into government bonds, however problems of banks in certain Member States are also linked to the competitive weaknesses of the economy in those countries.

15. The economic and financial crisis showed the weaknesses of EMU's incomplete design. Several Member States experienced a sovereign debt crisis when spreads reached record levels in end of 2011 and beginning of 2012, reflecting perceived default probabilities and a shift towards other sovereign issuers perceived as 'safest havens'. This is highlighted in the charts in Annex 1.

16. Some euro area Member States are now confronted with a substantial debt overhang, which in part had already been built up before through imprudent fiscal and economic policies but was amplified through the 2008 financial crisis and the need for urgent bank recapitalisations and to attend to the social impacts of the extraordinary crisis. Indeed, the crisis had considerable asymmetrical effects on euro area Member States, also due to the sudden change of perception of international investors regarding some economies. Furthermore, the European authorities recommended, then, an active use of national budgets to counteract the recessionary effects triggered by the crisis in the European economies. The ensuing recession, itself, widened the resulting budget deficits through the operation of the automatic stabilizers. Notwithstanding the shortcomings referred to in paragraphs 5 to 7 above, stress in sovereign bond markets has increased during the crisis with systemic implications difficult to avoid or reverse in a short time span. As a result, euro-area Member States' ratio of government debt to GDP increased by almost a third in the past five years, and more than doubled in some countries.

17. The unprecedented crisis has led the EU since 2010 to pursue reform of the economic governance framework (see II.1. below). Policy leaders, civil society and academics have set out both long-term visions for the development of EMU and various schemes for the joint issuance of debt (see II.2. below).

II.1. A new reinforced economic governance and financial sector framework

Economic and fiscal policy surveillance

18. The various components of economic, budgetary and structural surveillance procedures are now fully integrated in the European Semester — the EU's annual cycle of economic policy surveillance and coordination. Within this framework, the Commission analyses national economic policies over the first six months of each calendar year, and subsequently country-specific recommendations are issued, to be taken into account by Member States in the second half of the year.

19. The first legislative package of 2011 to reinforce economic governance (the 'six-pack')[6] introduced a new Macroeconomic Imbalances Procedure (MIP) to detect imbalances and competitiveness developments in Member States at an early stage and to assess their potential spill-over effects. The procedure is backed up by enforcement provisions in the form of financial sanctions for euro-area Member States that fail to take the corrective action recommended by the Council.

20. The six-pack also reinforced the SGP by introducing an expenditure rule and the possibility of sanctions early in the procedure. It involves stronger enforcement tools for countries with an excessive deficit and an excessive debt level, including through a new reversed qualified majority rule.

21. The next step of economic governance reform was the intergovernmental Treaty on Stability, Coordination and Governance in Economic and Monetary Union (TSCG)[7]. In this Treaty euro area signatory Member States have committed to integrating the core principles of the SGP into their national legal order. They will also set up national correction mechanisms supervised by an independent monitoring body to ensure compliance with the SGP.

22. The second legislative package for governance reform (the 'two-pack')[8] entered into force in May 2013. It obliges euro-area Member States to submit their annual draft budgetary plans for the following year to the Commission ahead of parliamentary adoption. The Commission scrutinises these plans and issues opinions. The opinions are not legally binding and the strongest instrument at the Commission's disposal is asking for revision of the plan (which would not delay national adoption procedures). In November 2013, the Commission carried out this exercise for the first time; it did not ask for a resubmission[9].

23. In 2013, the EU further aligned its cohesion policy with the new economic governance framework. Under new rules on EU funding programmes for 2014-20, Member States' cohesion policy are to address the relevant reforms identified in

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6 Official Journal L 306 of 23 November 2011.

7 Signed by all EU Member States except the Czech Republic, Croatia and the UK. http://www.consilium.europa.eu/media/1478399/07_-_tscg.en12.pdf

8 Regulations (EU) 472/2013 and 473/2013.

9 See Regulation (EU) 473/2013. Regulation (EU) 472/2013 formalises the monitoring and surveillance procedures for euro-area Member States under macroeconomic adjustment programmes.

country-specific recommendations in the European Semester[10]. If necessary, the Commission can ask Member States to modify programmes to support key structural reforms. In the event of non-compliance with Council decisions adopted within the SGP or the MIP, the Commission can — and in certain cases, must — propose suspension of commitments and even payments to the Council, which decides by reverse qualified majority vote[11].

24. Finally, the December 2013 European Council[12] discussed a system of mutually agreed contractual arrangements and associated solidarity mechanisms, embedded in the European Semester, to facilitate and support Member States' reforms in areas that are key for growth, competitiveness and jobs and are essential for the smooth functioning of EMU. The European Council aims to reach overall agreement on this in October 2014.

Banking union and financial sector regulation

25. The EU has embarked on an ambitious and substantial financial reform agenda. The aim is to make financial institutions and markets more resilient and to break the feedback loops between banks and sovereigns and vice versa. Following the setting-up in 2010 of an EU-wide system of financial supervisors composed of three supervisory authorities and a macro-prudential watchdog[13], a major element of this reform agenda is the creation of a 'banking union', comprising single centralised mechanisms for the supervision and restructuring of banks, which will be indispensable to ensure financial stability and growth in the euro area. The main elements are:

    (a) The recently adopted Single Supervisory Mechanism (SSM)[14] was a first step. From 2014, important banks will be supervised by the European Central Bank. To facilitate the transition from national to European supervision, balance sheet assessments will be carried out in 2014 and a stress-testing exercise by the European Banking Authority (EBA) will follow.

    (b) The Bank Recovery and Resolution Directive, on which political agreement was reached in December 2013[15], will provide a toolkit for the resolution of non-viable banks. Authorities will have at their disposal inter alia the power to bail-in shareholders and certain creditors, and the option of transferring assets

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[10] Article 23 of Regulation (EU) 1303/2013 of the European Parliament and of the Council of 17 December 2013; OJ L 347, 20.12.2013, p. 320.

[11] A more limited mechanism was in force in the previous budgetary period but applicable only to the Cohesion Fund. It was applied once in 2012.

[12] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/140245.pdf.

[13] i.e. the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB), see OJ L 331, 15.12.2010.

[14] OJ L 287, 29.10.2013, p. 5.

[15] European Commission, MEMO/13/1140.

to a bridge bank. Solving the legacy problem on banks' balance sheets is of key importance for financial stability.

(c) The third step towards an integrated banking union will be the establishment of a Single Resolution Mechanism (SRM) including a Single Resolution Fund[16]. This will involve centralised decision-making on the resolution of banks and a single resolution fund (to be built up gradually). The legislative procedure should be concluded in this legislature.

(d) Furthermore, measures are underway to empower the ESM to recapitalize banks directly as a last resort, once the SSM is established after finalisation of the operational framework and following the necessary national procedures.

(e) To increase stability in the banking sector, prudential requirements for banks have been strengthened under the fourth Capital Requirements Directive[17] and the Capital Requirements Regulation[18] (CRD4/CRR).

(f) In the view of some experts, additional steps may be needed in the longer run to reconsider regulatory incentives to investments in government bonds.

26. Overall, while this area falls outside the mandate of the Expert Group, it is necessary to underline the importance of banking union and financial sector regulation for financial stability and financial integration in the euro area and the EU as a whole.

European Stabilisation Mechanism (ESM)

27. A key part of the crisis response was the development of a crisis resolution mechanism to address financial market fragility and mitigate the risk of contagion across Member States.

28. In May 2010, two temporary crisis resolution mechanisms were established: the European Financial Stabilisation Mechanism (EFSM)[19] and the European Financial Stability Facility (EFSF)[20]. As the crisis continued, the euro-area Member States decided in 2012 to create a permanent crisis resolution mechanism — the European Stability Mechanism (ESM)[21]; the EFSF and the EFSM are being phased out. The ESM provides for a financial firewall of EUR 500 billion and raises the funds

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16 COM(2013) 520 final.

17 OJ L 176, 27.6.2013, p. 338.

18 OJ L 176, 27.6.2013, p. 1.

19 OJ L 118 of 12.5.2010, p.1. The EFSM is a financial support instrument backed by the resources of the EU budget, and based on the existing Treaty framework.

20 http://www.efsf.europa.eu/attachments/20111019_efsf_framework_agreement_en.pdf. The EFSF is a company owned by the euro area Member States, incorporated in Luxembourg, whose functioning is regulated in an intergovernmental agreement. The EFSF's lending capacity is backed solely by guarantees of participating Member States, and is accessible only to the euro area Member States.

21 http://esm.europa.eu/pdf/esm_treaty_en.pdf.

needed for its financial assistance by issuing debt securities with maturities of up to 30 years. The ESM is an intergovernmental instrument with a *pro rata* guarantee structure. ESM issuance is backed by paid-in capital of EUR 80 billion and an irrevocable and unconditional obligation on ESM Member States to provide their contribution to the authorised capital stock (total EUR 700 billion) in accordance with an agreed contribution key. The crisis-resolution mechanisms allowed for financial assistance to be granted to five Member States under strict conditionality[22]. The establishment of the permanent ESM, together with the enactment of reinforced governance, sent important signals for stabilisation in the euro area. The ESM Treaty also requires that Collective Action Clauses (CACs) be included as of 1 January 2013 in all new euro-area government securities with maturity above one year[23] — an innovation of which the impact still needs to be assessed.

Monetary policy

29. Within its mandate, the ECB has taken important measures to contain the financial crisis, notably by lowering official refinancing rates almost to zero. It also modified collateral rules. It launched the Securities Market Programme[24] (SMP) in 2010 (meanwhile terminated) and has provided banks with access to exceptionally long-term refinancing operations[25] (LTROs) in three allotments since 2011. In September 2012, the ECB announced its readiness to undertake Outright Monetary Transactions[26] (OMT) in the secondary markets for sovereign bonds. The objective is to safeguard an appropriate monetary policy transmission and the singleness of the monetary policy. A necessary condition for OMT is strict and effective conditionality in the legal framework of an ESM programme (be it a full macroeconomic adjustment programme or a precautionary programme, provided that it includes the possibility of ESM primary market purchases). Transactions would focus on government bonds with maturity between one and three years. The liquidity created would be fully sterilised. The ECB would terminate its operations if the objectives are achieved or if there is non-compliance with the macroeconomic adjustment or precautionary programme.

Outlook

30. The first effects of the new economic governance framework can be seen in national policies pursuing structural reforms, fiscal consolidation and targeted growth incentives. Reinforced economic governance, combined with unconventional monetary policy measures and a permanent ESM, have contributed to financial

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[22] Greece, Portugal, Ireland, Cyprus and — under a special setting limited to the banking sector - Spain.

[23] Article 12(3) ESM Treaty. Collective Action Clauses are clauses included in government securities which facilitate agreements of private-sector creditors to a possible modification of such securities through majority decision of bondholders.

[24] http://www.ecb.europa.eu/press/pr/date/2010/html/pr100510.en.html.

[25] http://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html.

[26] ECB's announcement: http://www.ecb.europa.eu/press/pressconf/2012/html/is120802.en.html#qa — and on the technical features of the ECB's OMT — http://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

stability. That said, work continues on significant policy elements and more experience with implementation and enforcement is needed to assess the effectiveness of the new governance. The completion of banking union will also be a key factor contributing to financial sector stability.

II.2. Proposals for joint debt issuance and the debate on longer-term visions for EMU

31. The crisis has prompted policy leaders, civil society actors and academia to develop various general long-term concepts for EMU and to propose various possible schemes of joint issuance of debt. As regards the latter, the focus has shifted several times: whereas joint issuance schemes had been discussed before the crisis as a possible avenue of further integrating EMU, in 2011 they were proposed with the concrete goal to bring the extraordinary yield spreads back down and stabilise public finances and government debt markets in the euro area. Meanwhile, some time having lapsed since the moments of peak of the crisis, the discussion is covering also further potentials of joint issuance schemes such as promoting financial integration and supporting monetary policy transmission.

32. In 2011, the Commission issued a Green Paper specifically on joint issuance of debt[27], and a number of other bodies, think-thanks and academics developed proposals on that topic. Subsequently, among the general documents proposed by political actors were the Commission's communication "A blueprint for a deep and genuine economic and monetary union – Launching a European Debate"[28] (hereinafter : "Blueprint") and the report "Towards a genuine economic and monetary union"[29] prepared by President Van Rompuy in close collaboration with the Presidents of the Commission, the Eurogroup and the ECB, both of end of 2012. One can also cite several major contributions from academic government-counselling bodies or think-tanks[30]. Many of these general documents and reports also discuss joint issuance of debt. As some of the long-term visions themselves diverge quite radically from each other, so do the views on the objectives of any model of joint issuance of debt.

33. To illustrate this by example, it may suffice to recall on the one hand the long-term vision of the Commission's Blueprint and on the other hand that set out in the reports of the German Council of Economic Experts (GCEE):

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[27] Green Paper on the feasibility of introducing Stability Bonds, COM(2011) 818 final. See also, taking this Green Paper up, the EP resolution of 16 January 2013 on the feasibility of introducing Stability Bonds (2012/2028(INI)).

[28] COM(2012) 777 final/2 of 30.11.2012.

[29] http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf.

[30] French Council of Economic Analysis, *A three-stage plan to reunify the euro area*, March 2013, and *Completing the euro – les notes du Conseil d'analyse économique*, No 3, April 2013; German Council of Economic Experts, *Annual Economic Reports* 2011 and 2013; Pisany-Ferry, Vihriälä, Wolff, *Options for euro-area fiscal capacity*. Policy contribution, 2013, Brueghel; Tommaso Padoa-Schioppa Group, Completing the Euro: A road map towards fiscal union in Europe, June 2012 Glienicker Gruppe, *Towards a euro Union,* October 2013; P. de Boissieu, T. de Bruijn, A. Vitorino, S. Wall, *Remaking Europe*, Synopia, September 2013.

(1) The Blueprint sets out a vision of a strong long-term integration in the euro area and distinguishes between three stages (short, medium and long term) to get there. Partial joint issuance of debt through a DRF or through eurobills is mentioned as a possible part of the medium-term stage to be coupled with further steps towards reinforced central powers over budgetary and economic policy matters. These medium-term elements would pave the way for a long term state of a full fiscal and economic union with a central budget and fiscal capacity fulfilling a stabilising function, an EU empowered to tax and/or raise revenue by indebting itself, and a true EMU Treasury (within the Commission)[31]. Already the medium term was qualified as requiring some Treaty change, which would be more substantial for the long-term perspective. Moreover, this vision would require a strong commitment of governments and citizens to accept transferring more national sovereignty for the benefit of further integration, stability of the common currency and long-term economic growth.

(2) An alternative long-term EMU vision, as proposed by the GCEE, would foresee in essence a return to the principles of the (pre-crisis) Maastricht framework and to a politically credible no bail-out culture[32]. This concept aims at avoiding any permanent mutualisation. A Debt Redemption Fund and Pact (DRF/P), as a scheme of joint issuance of debt, would be a temporary tool to reduce the debt overhang. It would work as a "fiscal bridge" to a long-term steady state in which there will be no need for bail-outs and no permanent mutualisation of debt, but – according to the GCEE - rather a government debt restructuring mechanism.

34. Schemes of joint debt issuance can thus be part of very different concepts for the general long-term future of EMU and the degree of integration in the euro area[33]. The various schemes also have their own distinct timelines reaching from the short to the medium and long term: The DRF/P idea (for its precise definition, see Chapter IV below) has been proposed as temporary joint issuance, though for a considerable period of time, tackling the legacy of excessive public debt in the euro area and serving as a bridge to a long-term steady state where Member States regain credible fiscal autonomy and strictly respect the SGP. Eurobills (for their precise definition, see Chapter V below), conversely, have been conceived as a measure introducing a safe and liquid asset that would foster further financial integration and stabilise government debt markets especially in times of stress. Eurobills would more likely become a permanent mechanism of joint issuance than a DRF/P.

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[31] On the idea of a fiscal capacity, see also the report prepared by President Van Rompuy in close collaboration with the Presidents of the Commission, the Eurogroup and the ECB; Pisany-Ferry, Vihriälä, Wolff, ibidem. IMF Staff Discussion Note, *'Toward a Fiscal Union for the Euro Area'*, September 2013, https://www.imf.org/external/pubs/ft/sdn/2013/sdn1309.pdf.

[32] As distinct from the legal no bail-out rule in Article 125, which is respected in the current economic governance architecture, as confirmed by the European Court of Justice in the *Pringle* judgment (Case C-370/12).

[33] For example Claessens et al. (2012) identify eurobills and a DRF as a possible path to long-term joint issuance (S. Claessens, A. Mody and S. Vallee (2012), 'Paths to Eurobonds', IMF Working Paper, WP12/172).

35. Hence, while the two instruments studied in this report – a DRF/P and Eurobills - do not necessarily pre-determine future decisions on the degree of integration in EMU in the long run, their introduction would nonetheless have long term implications. Either scheme if introduced has a potential to influence EMU to move towards one general long-term direction or another. In accordance with the Group's mandate, this report studies each of the two instruments separately regarding their merits and risks. Moreover, it looks at the two ideas as possible policy options for the short to medium term, a time frame including both possibilities under the current EU Treaties and possible Treaty change. Nonetheless, the assessment includes also, to the extent appropriate, the long-term components and implications of either scheme. Based on an analytical assessment of a DRF/P and eurobills as offered in this Report, but also on an ensuing wider political discussion, it would ultimately be for policy makers to consider the potential influence of such schemes on the general long-term direction of EMU.

36. Moreover, in a broader policy debate one should take due account of other decisions taken and future ideas being developed or discussed that share similar objectives with the two joint issuance of debt schemes analysed in this report. Indeed, banking union also serves the overall aims of financial stability and integration. Ideas of creating a fiscal capacity for the euro area have been proposed with different functions, be they for targeted support for national reform efforts resulting from European economic governance and/or for enhancing Member States' capacity to absorb macroeconomic shocks. Ideas on a central fiscal capacity and on joint issuance of debt may have common aspects: a central fiscal capacity could also entail some form of joint issuance in case the fiscal capacity was granted a right to borrow from the markets (rather than being financed through Member State contributions). However, such a fiscal capacity would mean a new vertical relation between the Member States and the central European level. This is different from the ideas of joint issuance discussed here, which would entail horizontal debt-pooling and financial risk-sharing between Member States. Reference should also be made in this context to the new economic governance and ongoing discussions on its further strengthening, to the ESM as well as to the ECB's unconventional monetary policy measures, and to the discussion on sovereign debt restructuring[34].

37. This Expert Group did not focus on those other policy strands and future ideas.Opinions differ as to which policy avenues should have highest priority in the coming years to strengthen the euro area and as to whether schemes for the joint issuance of debt are among them. Ultimately policy makers will have to make a global assessment of the comparative merits and risks of the various avenues and on priorities and on sequencing.

38. This Report examines the possible objectives, merits and risks of DRF/P and eurobills ideas from a broader perspective. This should include analysing how they could contribute to a more integrated euro area that remains open to non-euro Member States; to fostering a well-functioning and stable single financial market;

[34] See, in particular, Committee on International Economic Policy and Reform, 'Revisiting Sovereign Bankruptcy', October 2013, Chapters IV and V; See also GCEE Annual Economic Report 2010; Holtemöller and Knedlik 2011.

and to building strong mutual trust underpinned by a shared commitment to consolidation and reforms fostering long-term competitiveness and growth. However it should be also borne in mind the economy is still dealing with the excessive debt that in some cases triggered the crisis and in others is an effect of the crisis itself. Therefore the analysis of joint issuance schemes needs to include the potential of both ideas to address the legacy of the crisis as well as to prevent and address future liquidity crises.

39. 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.

III. OBJECTIVES OF JOINT ISSUANCE OF GOVERNMENT DEBT

40. This chapter identifies the potential objectives and advantages of joint issuance. Chapters IV and V present the concepts of DRF/P and eurobills in more detail and analyse their respective merits, in terms of their adequacy to attain their respective objectives and advantages, and their economic and financial risks.

41. The DRF/P and eurobills were designed with quite different primary objectives in mind. Both of the schemes may however also serve to meet further objectives. The primary objective of the DRF/P is to restore sustainable public finances by reducing public debt where it exceede the SGP criteria, i.e. to deal with the public debt overhang as a legacy problem in the euro area. The DRF/P would aim at building 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. In the process, the DRF/P would also aim to stabilise government debt markets by reducing 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.

42. The eurobills main objective is to stabilise government debt markets by reducing the rollover risk. Moreover, eurobills could foster the integration of financial markets through the creation of a safe and liquid asset. Such asset could contribute to reversing the trend towards market fragmentation and support the monetary policy transmission.

III.1. Financial integration and monetary policy

43. One of the consequences of the crisis is the fact that few financial assets are considered to be safe. At the same time banks in the euro area need assets that can be held as liquidity buffers, sold at relatively stable prices and used as collateral in refinancing operations. The existence of such asset in the euro area could reduce the

impact of deteriorating credit ratings of individual Member States on the domestic banking system's access to finance. Therefore, one of the objectives of joint issuance of government debt could be creating a safe and liquid asset.

44. The creation of safe asset would benefit the financial sector, although the benefits are difficult to quantify. Short-term bills are, due to their quality, instruments that would support the monetary policy transmission mechanism. Joint issuance of short-term government securities would provide an asset that is easy to exchange against central bank or commercial bank money. It could therefore provide a stable liquidity buffer for banks and could secure banks' access to funding both on the interbank market and from the central bank which could contribute to financial stability. The availability of safe or low-risk financial assets will become even more important in the light of CRD4 (as a consequence of the Basel III agreement) and the obligations it puts on banks to hold sufficient liquidity reserves. Jointly issued debt would be a very liquid asset and could be a safe one, but its credit and market risks would to a large extent depend on the exact design of the instrument (e.g. its guarantee structure, see Chapters IV and V below).

45. If jointly issued government securities could be perceived as a safe asset, this might reduce the aggregate borrowing cost for the euro area (depending on the design of such securities, see Chapters IV and V). A safe asset status could help ensure that the monetary conditions set by the ECB translate smoothly into lower borrowing costs for enterprises and households and ultimately into aggregate demand. It should 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.

Safe asset

There is no asset that is completely risk-free, as all assets are subject to risks which should be accurately reflected in their prices. A **safe asset** from an investor perspective should provide full protection from credit, market, and idiosyncratic risk. In other words, it must be a liquid asset that has minimal risk of default (and that minimal risk should not be positively correlated with risk of other financial assets). In the Basel III framework[1] a high-quality liquid asset is defined as an asset that can be easily and immediately converted into cash at little or no loss of value. The concept of `marketability' is therefore key. High-quality liquid assets should also ideally be eligible at central banks for intraday liquidity needs and overnight liquidity facilities.

Safe assets play an important role in the financial system. One of their main uses is as high-quality collateral for repos, central bank repos and over-the-counter derivative transactions. Safe assets provide a benchmark for the entire financial markets, i.e. a reference rate for the pricing, hedging and valuation of risky assets, and a basis for assessing of performance. Safe assets also play a role in central banks' liquidity operations[2]. In portfolio allocation they are used as a store of value. In banks and, to a lesser extent in insurance companies and pension funds, safe assets play a key role in day-to-day asset-liability management. In the case of banks the high demand for safe assets is also related to prudential regulation, and as recently globally reinforced by Basel III, i.e. for liquidity requirements.

During the financial crisis, flight to quality, the decline of the perceived safety of public debt of developed economies and the related increase in price of safety put the focus on a possibly increasing shortage of safe assets. Against this background, several proposals were made since 2011 with the main aim of creating a safe asset. Amongst those were, on the one hand, proposals to create eurobills. On the other hand, in 2011 a group of economists presented a proposal for creating European Safe Bond (so-called ESBies), a particularly safe asset created by pooling and tranching euro-area government debt.[3]

[1] Basel Committee on Banking Supervision, Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010

[2] IMF, Global Financial Stability Report, April 2012

[3] The euro-nomics group, European Safe Bonds (ESBies), http://euro-nomics.com/wp-content/uploads/2011/09/ESBiesWEBsept262011.pdf

46. Jointly issued government bonds might also become the benchmark for pricing and discounting. Benchmark securities attract trading volume — typically from index-based investment strategies, and relative-value strategies, where the benchmark is used as a hedging security. The liquidity that benchmarks securitites offer investors has value, which is reflected in the lower yield.

47. Another objective of joint issuance would be to contribute to reversing the trend towards fragmentation of financial markets, which is one of the most negative effects of the crisis. Market fragmentation results in efficiency losses for wider EU capital markets and a higher cost of financing particularly for the private sector in more vulnerable Member States. The monetary policy is unevenly reflected in the cost of funding in some Member States. This makes the economic recovery even more difficult and delays the return to the economic growth path. Market fragmentation has left some Member States facing higher financing costs (also reflected in funding costs for their banks that are transmitted onwards to their customers) which may have a negative impact on economic growth and employment and render public acceptance of economic adjustment even more

difficult. Moreover, insufficient financial integration also impairs working of the Internal Market by creating very uneven conditions for competition for firms located in these Member States.

48. Market fragmentation could be effectively addressed by promoting financial integration and the single market in banking and finance. This could, therefore, be one of the objectives of joint issuance. Overcoming market fragmentation in securities markets and banking (by attenuating the banking-sovereign feedback loop) would facilitate the flow of capital across the euro area thus improving the potential economic growth. A strengthened single market in banking accompanied by adequate regulation of the financial sector could improve access to financing for companies, regardless of their location. More integrated capital markets would allow reaping the benefits of the monetary union.

49. To the extent that joint issuance could achieve convergence in financial markets and in financing costs for Member States, it could also reduce the need for unconventional measures to support monetary policy transmission. Access to bank finance worsened for many economic actors, as a result of impaired monetary policy transmission. Some Experts argue that a safe asset would smooth monetary policy transmission improving access to bank finance for the real economy, and in particular SMEs.

50. Some Experts would note that financial integration is possible without debt mutualisation and that the introduction of any scheme of joint issuance would have limited impact on the degree of financial market integration unless steps are taken towards strengthening structurally the European banking sector. According to the same Experts' view even in a financially integrated system structural differences, as well as solvency and liquidity risks across countries, can and should be reflected in interest rates spreads.

III.2. Sustainability of public finances and financial stability

51. In terms of sustainability of public finances an objective of joint issuance would be to tackle the legacy of excessive public debt in the euro area by reducing the burden of debt service for highly indebted countries and private borrowers. The debt overhang now stands as a stumbling stone in the path both of lasting fiscal consolidation and of economic growth and creates a dangerous vicious circle, which is particularly powerful in countries where debt is perceived as being less sustainable: without growth it is much harder to make debt sustainable, and the less debt is perceived as being sustainable the more difficult it is to resume the necessary economic growth.

52. Most of the euro-area Member States need to carry out politically sensitive reforms in order to strengthen their competitiveness and create sustainable growth, which would be a necessary condition for a smooth debt overhang reduction and for which joint issuance is not a substitute. The challenges of introducing these reforms are amplified by financial market fragmentation or volatility of bond markets. Joint issuance could contribute to addressing these difficulties by allowing sufficient time and increasing Member States' financial space for carrying out such reforms. On the other hand, if not accompanied by adequate safeguards against moral hazard, joint issuance could even delay politically difficult reforms.

53. Joint issuance schemes could hence build a fiscal bridge towards a renewed and lasting convergence in the euro area which would in turn facilitate the monetary policy for the euro area. One of the most economically harmful consequences of the crisis is some reversal of convergence in euro area that needs to be addressed.

54. The 'fiscal bridge' that the DRF/P would aim to build, could also lead to a fully credible 'no-bail out regime'. Under the DRF/P rationale, reducing government debt across the euro area would allow the euro area to be brought to a steady state where Member States have regained sustainable finances giving them appropriate space to conduct economic policies without building up excessive debt again and in principle without needing further financial assistance.

55. Due to insufficient fiscal consolidation and/or urgent bank recapitalisations, the generalised repricing of risk made high levels of debt very costly to finance and, as a result, several Member States experienced a sovereign debt crisis. One of the objectives of joint issuance would be to improve the euro area's resilience to future financial crises. A deep and liquid bond market that could help to prevent self-fulfilling liquidity runs would be one of the potential results of joint issuance of government debt. The roll-over/refinancing risk may also be reduced, as joint issuance would provide all participating Member States with more secure access to refinancing, preventing a loss of market access due to suddenly increasing risk aversion and/or herd behaviour among investors. This could also provide assistance to Member States exiting a programme by ensuring better financing conditions.

56. Joint issuance could also contribute to reducing the negative feedback loop between domestic banks and their sovereign. If the negative feedback loop is reduced, contagion will spread less easily and the resilience of the euro area as a whole will improve. Joint issuance would however, be only one possible step towards fully tackling this problem. Other steps relating to banking union (effective banking supervision, regulatory reform, dealing with the private debt legacy in the financial sector) are also needed, and this report cannot assess their relative importance.

57. Joint issuance could also provide a financial buffer against effects that asymmetric shocks may deploy through capital markets on public finances, thus providing one specific form of macroeconomic risk sharing. During the recent crisis, some Member States were more affected than others by the financial crisis, depending on the relative size of their banking sector and for example the existence of real-estate bubbles. The impact of the financial crisis rapidly reached the public sector through financial markets, mainly through a significant increase inyields. In case of joint issuance investors would assess the risks emerging in one or several Member States in combination with the financial conditions in the euro area as a whole. A change in yields would therefore occur across all euro area Member States, representing a specific form of macroeconomic risk sharing.

IV. THE DEBT REDEMPTION FUND AND PACT IDEA: DESIGN, MERITS, RISKS

58. The Debt Redemption Fund and Pact (DRF/P) idea was first developed in November 2011, and was later updated, by the German Council of Economic Experts (GCEE). This report takes in principle the concept as developed by the GCEE as reference basis, except as for the design variants expressly mentioned and assessed below — see also the illustrative table on main models for DRF/P in Annex 2. This Chapter sets out the basic features of the DRF/P and its design variants (IV.1.), assesses the adequacy of the DRF/P in terms of meeting the objectives set out in Chapter III (IV.2.) and examines the economic and financial risks (IV.3.).

IV.1. Basic features and design variants of a DRF/P

IV.1.1. The basic concept of a DRF/P as developed by the GCEE

59. The DRF/P[35] has two basic components: a 'fund' and a 'pact' that only together create a scheme that can achieve its purpose, i.e. to reduce, through temporary (over approx. 25 years) mutualisation of debt, the current public debt overhang and thereby create the conditions for a stable state of EMU. After the DRF/P ends, financial risk sharing would be limited to the financial stability mechanisms, be subject to strict conditionality and be activated only as a last-resort measure in an acute crisis.

60. The fund part of the DRF/P would provide the structure for the temporary mutualisation of debt exceeding 60% of GDP. During a roll-in phase (of maximum 6 years), participating Member States would transfer part of their debt (the part exceeding 60% of GDP) to the redemption fund. The fund would issue joint debt backed by a joint and several guarantee. During the roll-in phase, the proceeds from issuing the bonds would serve to refinance national bonds with a maturity of more than two years on the day the scheme is introduced. The total amount of debt to be transferred to the fund would be set in advance.

61. The maximum volume of the fund at the end of the roll-in phase would be approximately EUR 2.85 trillion, while the total sum of all amounts of debt transferred to the fund and refinanced by it would be around EUR 3.1 trillion (see Annexes 2 to 4)[36]. Each Member State would have to redeem the transferred debt over a period of 20–25 years. The payments to the fund would be set as a percentage

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[35] See German Council of Economic Experts (2011), 'Assume responsibility for Europe', Annual Report 2011/12 for the initial proposal and H. Doluca, M. Hübner, D. Rumpf and B. Weigert (2012), 'The European Redemption Pact: An illustrative Guide', GCEE Working Paper 02/2012 for more details on one possible way of implementing the initial GCEE proposal. See further the GCEE's Sondergutachten of 5. July 2012. Alternatives were, among others, proposed by C. Pierpaolo Parello and V. Visco (2012) 'The European Redemption Fund: A comparison of Two Proposals', MPRA 42874.

[36] Countries participating in the DRF/P would already start serving and redeeming their debt at the beginning of the roll-in phase. As a consequence, even though the size of the DRF/P grows during the roll-in phase, its maximum size would be slightly smaller than the total sum of all amounts refinanced by the DRF/P, see H. Doluca, M. Hübner, D. Rumpf and B. Weigert (2012), 'The European Redemption Pact: Implementation and Macroeconomic Effects', Intereconomics 2012, pp. 230, 236.

of each Member State's GDP, and would therefore fluctuate with the economic cycle. The repayments would require a steady primary surplus to be maintained throughout the redemption process. In principle, the interest savings resulting from joint issuance backed by a joint and several guarantee and a reduction in the liquidity premium would enable most of the participating Member States to achieve primary surpluses more easily. In the GCEE proposal, participation in the scheme would be limited to euro-area Member States who have debt of more than 60% of GDP and who are not in a financial assistance programme.

62. The pact part of the DRF/P would consist of a comprehensive set of rules designed to address moral hazard and to ensure that repayments are made. The rules would include the following pre-conditions, constraints and safeguards:

    (a) Each Member State would be required to introduce debt brakes into their constitutional law, as meanwhile foreseen by the TSCG; however, going beyond the TSCG, the GCEE calls for implementation (not only transposition) of such debt brakes being enforced by an independent body at European level (e.g. the European Court of Justice).

    (b) Each Member State would have to conclude binding 'consolidation agreements' with the European level imposing a path of budgetary consolidation and structural reforms in a way similar to conditionality of current ESM programmes but extending over the whole 25-year period of the DRF/P.

    (c) Each Member State would have to earmark national tax revenues specifically for payment obligations to the DRF.

    (d) Each Member State would have to deposit collateral of 20% of the value of transferred debt with the DRF.

63. In case of breach of obligations the DRF/P scheme would foresee reactions and sanctions such as: calling-in of collaterals, stopping the debt transfer during the roll-in phase, an increase in interest rates (i.e. mark-ups) and earmarked tax revenues, open market operations by the DRF[37]. Ultimately suspension and exclusion of a Member State from the DRF/P could be considered together with a transfer into an ESM programme with strict policy conditionality. At least some of these reactions and sanctions should be triggered immediately and automatically in case of breach of obligations, excluding elements of political discretion.

64. The GCEE's original proposal for a DRF/DRP envisages partial and temporary mutualization as a means to creating the conditions for very limited mutualisation as soon as the legacy debt overhangs from the present crisis have been overcome[38].

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[37] The GCEE proposed that in case of breach of rules, the DRF could sell government bonds of the country in question, which would increase the supply of such bonds and increase the refinancing costs for the country's nationally issued bonds that continue to circulate on the market, see GCEE Special Report 2012.

[38] The link between the DRF/P proposal and such a long-term proposal:
http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/special_report_2012.pdf.
For the proposal of such a regime itself, see:

The GCEE's proposal for joint issuance was therefore inseparably linked with a contemporary agreement introducing on an effective regime for debt restructuring, which would act both preventively as a debt brake as well as serve as anchor for the mutualisation scheme. It is important to stress that introducing a regime for restructuring sovereign debt in a situation of a prevailing debt overhangs would either not be credible or destabilizing, if credible. However, once debt levels in all Member States have fallen to the level of 60 percent – as envisaged by the DRF/P – a new regime would become applicable. A country surpassing a predefined higher debt threshold[39] could then be subject to restructuring in case of a roll-over crisis. This was proposed to be implemented through amended ESM lending conditions foreseeing bail-in. The effect of such a rule for debt restructuring was expected by the GCEE to be twofold: first, it was expected to provide a clear and binding framework which would limit bail-out expectations and therefore facilitate the pricing of sovereign risk. Second it was expected to discourage countries from overborrowing and/or taking over liabilities form the financial sector. Thus, it was envisaged that such a debt restructuring regime would align incentives and act as a second line of defence in case other governance mechanisms failed.

65. For the GCEE, a long-term debt restructuring regime would be an integral part of the DRF/P idea, necessary to address the long-term moral hazard potential (see below Chapter VI). However, some Experts note that there are other opinions in the Expert Group according to which the DRF/P can be conceived without such a component and possibly instead with permanently reinforced central powers of fiscal control. A detailed analysis of the feasibility, desirability and content of a long-term sovereign debt restructuring regime was not done by the Expert Group.

66. Finally, the DRF/P has been proposed by the GCEE to be set up through an intergovernmental treaty amongst the participating euro area Member States and with intergovernmental decision-making amongst those States. The big guarantor Member States would have a veto power for major management decisions[40]. The legitimacy problems of this construction will be addressed in Chapter VIII. Moreover, as shown in Chapter VII, EU Treaty change would be necessary to allow for joint and several liability underpinning a DRF. One could then also use such Treaty amendment procedure to create a DRF/P as part of EU law.

IV.1.2. Guarantee structure

67. The GCEE originally proposed that the DRF should be backed by a joint and several guarantee, i.e. each bond issued by the DRF would benefit from a guarantee given by each Member State up to its full amount. The entire DRF would, therefore, be fully guaranteed by each participating euro-area Member State. If difficulties arose

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http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_four_2011.pdf pages 142ff. See also Committee on International Economic Policy and Reform, 'Revisiting Sovereign Bankruptcy', October 2013, chapters IV and V.

[39] The GCEE's suggestion was 90% of GDP.

[40] See Special Report 2012. According to the GCEE such a veto power would be needed because of German constitutional law, see Schorkopf, Verfassungsrechtliche Grenzen und Möglichkeiten für eine Umsetzung des Schuldentilgungspaktes des Sachverständigenrates, Gutachten 2012, pp. 38 et s. Cf. also now judgment of the German Constitutional Court of 18 March 2014 on the ESM Treaty.

in repaying of the DRF bonds, a Member State of the investor's choice would be required to pay the full amount, which means that there would not be a default vis-à-vis investors.

68. After the roll-in phase, the maximum financial exposure of each participating Member State would thus be around EUR 2.85 trillion (including the Member State's own debt that has been refinanced through the fund)[41]. Given that this level of exposure would be impossible for smaller countries to bear if a large Member State failed to pay, markets would consider the joint and several guarantee to be meaningful only for the largest and most solvent Member States.

69. Under this guarantee structure the yields, and therefore the financing costs of the DRF, could be similar to those of the best-rated participating Member State (It would, however, be likely to increase the financing costs of that Member State, see below).

70. Given that joint and several liability would require a change to the EU Treaties (see Chapter VII), and might also be difficult to reconcile with at least some national constitutions, an alternative DRF with a *pro rata* guarantee structure is also assessed[42]. Such guarantee could be based on the ESM model with capital subscribed *pro rata* by shareholders which has been accepted by the European Court of Justice as being in line with EU law (see Chapter VII). The capital of the DRF would consist of a small fraction of paid-in capital and a larger fraction of committed callable capital, subscribed by each participating Member State *pro rata* according to a key reflecting its share in transferred debt – quite different to the ESM capital key.

71. The main feature of the *pro rata* structure is the limiting of each participating Member State's liability to an amount equal to its share in the capital. Since some of the countries participating in the *pro rata* liability as 'guarantors' have relatively high debt and related lower credit ratings, there is a risk that the credit rating of the DRF would be rather low under a *pro rata* guarantee structure. The *pro rata* scheme would thus require paid in capital.

72. In this context one may also look into the potential of credit enhancement measures, as were anyway foreseen in the GCEE model although mainly for avoidance of moral hazard and as 'guarantees' for the interests of creditor Member States. The first measure that was proposed by the GCEE would be to require pledging collateral of 20% of the value of the transferred debt. As far as assets held by central banks are concerned this is legally excluded by the prohibition of monetary financing in Article 123 TFEU (see Chapter VII). One might doubt about whether Member States would be able to pledge other assets as a collateral equal to 20% of the value of transferred debt.

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[41] See Annex 2.

[42] Such a possible alternative was also subsequently envisaged by the GCEE itself, see Special Report of 5 July 2012.

73. The second measure proposed by the GCEE was to earmark tax revenues for the servicing of redemption payments. For some Member States, however, projected disbursements to the DRF could amount to one third of their total current indirect tax receipts, which suggests that the scope for earmarking existing tax revenues appears modest. Furthermore, a direct earmarking of tax revenues for the servicing of payments to the redemption fund only (i.e. earmarking in the strict sense) would limit the amount of income available to the holders of 'national' part of debt and subsequently would lower the credit quality of the remaining national debt. If understood in this sense, the proposal may also raise legal problems under pari passu clauses as it would create more beneficial treatment of the DRF/P vis-à-vis other creditors of the Member State concerned. The latter problem would be avoided if the 'earmarking' idea is understood in a broader, non-technical sense, as an obligation for participating Member States to introduce new taxes with proceeds reserved for the servicing of public debt towards all creditors alike. There might however be problems of national constitutional law in case of either concept of 'earmarking'.

74. Analysis of the suggested credit enhancement measures confirms that a DRF in original size based on a *pro rata* guarantee would be less viable than with joint and several liability. A DRF with a *pro rata* guarantee would have a smaller interest-saving advantage and, the redemption phase would therefore need to be longer.

75. Variants of a smaller DRF with *pro rata* guarantee could also be explored. Two such alternatives are outlined and discussed here: (i) transfer of debt above 75% of GDP only and (ii) transfer of debt equivalent in value to 20% of GDP.

IV.1.3. Overall size of the fund and its composition

76. A DRF modelled according to the original proposal would, based on latest available data (see Annexes 2 and 4), entail a total amount of debt transferred of EUR 3.1 trillion (with EUR 2.85 trillion joint debt outstanding at peak) and would be composed of 10 euro area Member States. The highest share would be held by Italy, followed by France and Germany. As the original proposal assumed a joint and several guarantee, the composition would not have a significant effect on the credit quality of the Fund bond.

77. In case of a transfer of debt above 75% of GDP of each Member State, instead of 60%, only 8 euro area Member States would participate in the DRF (see Annexes 2 and 4)[43]. The maximum volume of the DRF under this option would amount to approximately EUR 1,7 trillion, which still would ensure a big and liquid market. The highest share in the fund would be held by Italy (EUR 901bn), followed by France (EUR 363bn) and Spain (EUR 188bn) with Germany holding a smaller share (EUR 92bn). The overall debt reduction achieved would be less and the highly indebted countries' share of the fund would be larger. This option may not be viable on a *pro rata* basis because of the predominance of highly indebted countries.

78. The transfer of debt equal to 20% of GDP would result in a fund of approximately EUR 1.9 trillion. With the amount of the debt transferred dependent on GDP, the

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[43] i.e. Austria, Belgium, France, Germany, Ireland, Italy, Malta, Spain, and if programme countries are included, also Cyprus, Greece and Portugal.

fund's composition would be similar to the ECB's capital key and to the ESM (see table in Annex 2).

79. Apart from reducing the total volume of the DRF, this latter variant would avoid one problem of the GCEE’s original proposal, which was that countries would have very different stakes in the DRF and benefit from the interest-saving advantages of the DRF in starkly unequal terms.

80. It would also make it possible to include more or even all euro area Member States, thus to reduce the mismatch between the euro-area governance and that of the DRF, although there would be different trade-offs depending on the various options on membership (see next Section).

81. This variant could make some highly indebted Member States less vulnerable by reducing their debt overhang, even though to a lesser extent than under the original proposal. Moreover, the demanding ‘pact constraints’ (notably the ‘consolidation agreements’) of the DFR/P would help to develop a culture of fiscal discipline and structural reforms which could translate into further reductions of the debt overhang after the DRF/P’s expiry as anyway required under EU law and the TSCG[44]. Furthermore, given its composition which would more closely mirror that of the ECB capital, the scheme would provide, during its lifetime, a useful asset for monetary policy implementation and creation of market liquidity.

82. The drawback of this variant is that, at the end of the regime, debt levels would still vary and some Member States would still have considerable debt overhangs. The logic of the original DRF/P idea, that the euro area could start afresh once the legacy problem is eliminated, would not be fully attained. Overall, while this scenario would not fully conform with the objectives originally set up for the DRF/P, it could be conform with some objectives of joint debt issuance, such as providing a safe asset and supporting monetary policy transmission.

IV.1.4. Membership

83. Two variants of the DRF/P idea, i.e. including all euro area Member States with debt above a certain threshold or excluding programme countries — may be explored.

84. In the options with all euro area Member States with debt above certain threshold the overall volume of the fund would be higher and the credit quality — at least in absence of joint and several liability — would deteriorate. In addition, the ESM is arguably the most appropriate tool to use to address the situation of these countries and to secure their financing while they are in the programme. However, excluding the countries placed in a programme from a DFR/P would mean that, during the roll-in phase, these countries would be the only euro area Member States to finance themselves for longer maturities directly on the markets, where they could face even more adverse conditions. All countries would still be refinancing debt below 2 years. A possible third option might be to foresee that these countries can — and

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[44] The DRF/P as originally proposed would appear to be stricter than the legal requirements meanwhile put in place through the Six Pack and the TSGC in several respects, but this is not entirely clear, see below footnote 46.

must — join the DRF/P once they have exited their programme. This is a question ultimately calling for a political judgment.

85. Another issue to be considered is the status of those euro-area Member States whose debt level is below 60% of GDP. Under an ‘equal-share option’ they could be included in the scheme, to reduce their debt by an amount equal to 20% of GDP. A voluntary participation could be envisaged for such euro-area Member States who wish to take part for financial or political reasons (i.e. lower financing costs, and take part in the decision-making, see Chapter VIII).

IV.1.5. Flexibility in the redemption phase

86. The redemption phase could allow for some flexibility. This could serve as an incentive for countries with low debt levels to participate, and could also be used to allow repayment to be postponed for countries struck by serious economic imbalances. However, there is also the view that the mere possibility of granting such flexibility could add to the potential moral hazard created under a DRF/P and go against debt reduction as the main objective of the DRF/P. Moreover, according to this view the flexibility is not necessary as all participating countries have access to financial markets and, if necessary, can alleviate any shock by entering an ESM programme.

87. The DRF/P could also provide for a slower pace of redemption than foreseen in the GCEE proposal, which would reduce the required primary surplus and might increase the likelihood of debt reduction targets being met. Therefore, the consequence would be either a significantly longer overall lifetime of the DRF/P, or roughly the same lifetime as assumed by the GCEE but with a downsized fund (see IV.1.3 above).

IV.1.6. Mark-ups

88. The DRF/P could also have a built-in mechanism of financial incentives in the form of a transparent, possibly quasi-automatic system of gradual interest rate mark-ups. It could mean that Member States entering the DRF/P at a higher debt level would be subject to a small interest mark-up, which would then be gradually and automatically reduced as the Member State reduces its debt level[45]. Such a mark-up system could function as a reward for prudent fiscal policies. It could have a significant potential to influence the conduct of policy-makers and hence ensure compliance with fiscal rules. On the other hand, the mark-up could take away part of the advantage of the DRF/P in terms of debt servicing cost savings; therefore it would have to be set low enough for the DRF/P still to play its role in facilitating fiscal adjustment.

IV.1.7. Debt management issues

89. Given its size and the timeframe the DRF/P would require a centralised Debt Management Office at a European level that would however work in cooperation

[45] For instance, for any country participating in a DRF/P with a debt level of above 80% GDP, a mark-up defined as a linear spread of 0.15 pp per excess 10% of GDP could be applied (i.e. a country with a debt of 100% of GDP would incur a 0.3 pp spread, one with 120% of GDP would incur a 0.6 pp spread).

with the national debt management offices. The DRF/P proposal would also require significant surveillance measures and decision-making powers to be put in place to ensure that rules are respected and so as to be able to react to any breach of the rules. This would however be beyond the technical remit of a DMO and these powers would instead have to be granted to political institutions acting with appropriate legitimacy and accountability.

IV.2. Analysis of merits of a DRF/P in terms of adequacy to attain the various objectives

IV.2.1. Sustainability of public finances and financial stability

a) Reduction of debt levels and easing the burden of debt service on current budgets

90. The DRF/P would address the debt overhang and could be envisaged as a way to help the vicious circle of unsustainable debt and low economic growth to stop. At the same time, by helping to clear the systemic implications of the present situation, the DRF/P could enhance the future credibility of the no bail-out principle.

91. The DRF/P could lower the cost of financing government debt for at least some Member States, by reducing yields spreads and financing costs for Member States participating in this scheme. The extent of such savings on borrowing costs would greatly depend on the guarantee structure and benchmark interest rates. Narrowing the large spreads that occurred at the peak of the crisis (and which have meanwhile decreased considerably) and thus allowing highly indebted countries to achieve their fiscal goals has been the key intention of the DRF/P.

92. Overall, the cost of financing could be lowered most by a DRF with a joint and several guarantee, as this would go furthest in lowering the credit risk premium. Although the yields on the "national" part of the debt might increase, it is expected that the overall debt servicing expenses of high debt countries might be lowered through a combination of the insurance element of mutualised debt and the added credibility of fiscal consolidation provided by the "pact". The impact could additionally be reinforced by the decline in the liquidity premium, at least right after the end of the roll-in phase.

93. Under a scheme of the size originally proposed and supported by a *pro rata* guarantee the effect is rather uncertain, however, as the size of the fund and in particular its composition (i.e. the fact that highly indebted Member States will have a relatively high share in the guarantee) would increase the cost of financing at least for Member States with a higher credit quality. This is why, as an alternative option in the case of a *pro rata* guarantee structure, a smaller DRF with a different composition could be considered, with each participating Member State transferring an equal share of debt. The decline in the liquidity premium when the fund is still of substantial size could bring some cost savings. Moreover, in case of small Member States, there are still questions about the liquidity premium on the remainder of the issuance.

b) Reducing the bank-sovereign feedback loop

94. With a safe and liquid asset (such as DRF securities) bank balance sheets would be more resilient against sovereign stress. As a result, part of banks' lending to their own governments would be lower and the link between a national banking system and its sovereign would be substantially weakened. Addressing this feedback loop should have a positive effect on wider financial stability.

95. Moreover, DRF bonds could be a stable asset, thereby contributing to greater stability of banks' balance sheets. Combined with the effect of lowering the banking sector's exposure to its own government, this would strengthen the sector's resilience and make it less sensitive to macroeconomic shocks.

c) Improving the resilience of the euro area

96. The DRF/P has the potential to improve the resilience of the euro area to future financial crises. For the banking sector, improvement would be achieved due to the stabilising effect of a safe asset. For governments, it would come during the roll-in phase, through guaranteed access to the market and lower cost of financing of a significant part of its debt.

97. The DRF/P would also lower the risk of contagion and give Member States time and a framework to implement fiscal and structural reform. Moreover, by ensuring the financing of a significant part of their debt the scheme would support Member State's efforts in carrying out politically sensitive structural reforms. At the same time, the conditionality included in the consolidation agreement would help ensure that such reforms are indeed carried out.

d) Providing financial buffer against effects of asymmetric shocks

98. A DRF/P could ensure financing of highly indebted governments at lower cost and smooth their market access conditions. A DRF/P could therefore provide a financial buffer against the effects of asymmetric shocks. A DRF/P could deal with the debt overhang and contribute to restoring all Member States to a long-term stable financial position, thereby lowering the roll-over risk particularly in the event of sudden changes in market perception, and ensuring market access.

e) A strong overall commitment for sustainability of public finances and financial stability

99. Overall, the DRF/P, with both its "fund" and its "Pact" elements, would presuppose and foster a strong mutual commitment of participating Member States for a long period of time. Such strong commitment would result in less need for financial assistance through the ESM, contribute to effective monetary policy and pave the way to a credible "no bail out regime". In that sense, the DRF/P should not be reduced to a scheme which would offer advantages only for highly indebted Member States and entail only cost and risks for the others. Rather, the merits of the scheme – as those of other possible schemes of joint issuance - would be in the long-term interests of all Member States.

IV.2.2. Financial integration and monetary policy

100. The DRF/P particularly if backed by a joint and several guarantee could reduce the extent to which the credit risk of a sovereign is reflected in the financing cost for banks. With a DRF/P built on the basis of a *pro rata* guarantee the effect might depend on the respective shares of Member States. Moreover, an integrated and very liquid market for government securities would be attractive for a wide range of domestic and foreign investors, including central banks, and used as collateral.

101. A safe asset that would set benchmark yields could also contribute to stimulating issuance by non-sovereign issuers, e.g. corporations, municipalities, and financial firms, and therefore help developing alternatives to bank-based financial intermediation in Europe. The availability of a liquid euro-area benchmark could also facilitate the functioning of euro-denominated derivatives markets. DRF/P securities could become benchmark securities for pricing and discounting, which would attract trading volume. The liquidity that benchmarks attract has inherent value, which is reflected in their lower yield. In these ways, a DRF/P could therefore lead to lower financing costs for both the public and private sector in the euro area and thereby underpin the economy's longer-term growth potential.

102. A DRF/P could strengthen general market confidence, and could have a positive overall impact on financial markets and financial intermediation. The reducing debt overhang could therefore contribute to financial integration in the long term.

IV.2.3. Complementing the EU economic governance framework

103. An important feature of the DRF/P is that besides a jointly-issued debt it also entails a conditionality and reform framework for participating Member States. This could potentially strengthen the EU economic governance framework in the long term (given the long period of existence of a DRF/P). The strict rules built into the DRF/P, including binding consolidation agreements, could result in a strengthening of the practical implementation and enforcement of the EU's economic policy coordination and fiscal multilateral surveillance mechanisms. This presupposes that the additional conditionality of a DRF/P is embedded in the EU's economic governance and that parallel worlds of decision-making are avoided (see Chapter VIII). There might also be an incentive effect from a system of mark-ups.

IV.3. Possible adverse economic and financial effects and risks of a DRF/P

104. The DRF/P has an overriding objective to reduce government debt levels across the euro-area. This objective can be met if the DRF/P works effectively, over the whole period of its existence, in accordance with its strict rules and underlying macroeconomic assumptions. However, the economic, financial and political effort necessary for setting up a DRF/P could also entail some adverse effects, challenges and risks. These would be mitigated to some extent in case of a smaller DRF/P with a shorter time horizon. Three types of them may be highlighted:

105. First, as regards funding cost: the DRF/P scheme with joint and several guarantee is likely to translate into higher financing cost for the highest-credit quality Member States, as, for them, part of the 'flight-to-quality' effect would be reversed – as may anyway happen in the fullness of time -, and as they would be taking on large contingent liabilities. The joint and several guarantee could also have an adverse

effect on the creditworthiness of small Member States, as it is difficult to imagine that a small Member State would be able to act on its guarantee for a large, highly-indebted Member State. Therefore, the guarantee would actually be the responsibility of very few, large and low-debt Member States.

106. The DRF/P framework ensures that a low level of debt and related credit quality would be fully achieved only after a number of years (although some positive effects on the markets could be expected significantly earlier), while during the fund's existence , the stronger Member States could be challenged if the joint and several guarantee is to be called on.

107. A DRF/P with a *pro rata* guarantee would also be likely to result in a higher financing cost for highly-rated Member States, and for the low-rated ones, the interest cost savings necessary to realise the pact part of the DRF/P would be smaller than with joint and several liability, which could pose some risks for meeting the commitments. The share of highly-indebted guarantors could be relatively high with an adverse effect on credit quality. Once the guarantee and, by extension, the entire scheme, is not credible the risk of market rejection increases substantially. This risk could be mitigated by the alternative option of a smaller DRF with a different composition.

108. Secondly, the objectives of joint issuance that are linked to financial market functioning would be best met during the initial phase, when the size and liquidity of the DRF will be greatest. As the liquidity would systematically decrease, the benefits in terms of safe asset, monetary policy transmission and liquidity premium would be phased out, however the decrease in the overall liquidity could be offset by the overall financing cost savings of the participating Member States. This risk would go away if during the life-time of the DRF/P the euro-area integrated further towards common budget or if other safe assets were created.

109. Thirdly, there may be macroeconomic policy risks if the primary surpluses required to fulfil the redemption plan turn out to be too high. The DRF might pose a dilemma between flexibility and moral hazard: the strict rules of the DRF/P — which are motivated by a concern to address the high moral hazard potential — seem to lack the flexibility that might be needed in case of a new external shock to the economies (such flexibility is built-in the TSCG and the SGP). The original proposal takes however such a possibility into account by setting the redemption payments to the fund as a percentage of GDP so that they fluctuate with the economic cycle. However, according to some Experts this may not be enough to allow governments to react flexibly and adequately to unforeseen economic situations during the long period of 25 years[46]. That being said, other Experts would note that primary

[46] The DRF/P as originally proposed would appear to be stricter than the legal requirements meanwhile put in place through the Six Pack and the TSGC in several respects: It would include binding consolidation agreements imposing budgetary consolidation and structural reforms in a way similar to current ESM programmes, but for *each of the participating Member States* and applying over the whole lifetime of the DRF/P – this goes much further than the non-binding country-specific recommendations of the current governance. Moreover, the redemption payment obligations, as defined at the outset, would have to be strictly honoured each year whereas the current EU rules and the TSGC still allow some fiscal flexibility in case of external shocks to the economies. That said, the DRF/P idea was developed before the TSGC and the Six Pack rules and some Experts consider that the

surpluses required under a DRF/P might, depending on its design, not be higher or could even be lower than the ones required to ensure respect the revised SGP and the TSGC and to secure debt sustainability. A DRF/P could arguably be useful to help (at least some) Member States to achieve them more easily due to lower financing costs.

110. The lack of flexibility could affect the credibility of the scheme in two ways: first, if the rules are not changed one or more Member States may not be able to meet their commitments towards the Fund and its other creditors. Second, if the rules are changed the moral hazard related to the scheme will go up significantly. In both cases, the credibility of the scheme would be seriously undermined, weakening somewhat the stabilising effect unless there are mechanisms that mitigate those risks as for example the ESM.

111. Overall, from the macroeconomic policy point of view, the main challenge of a DRF/P would be the compliance with the rules set in advance for a number of years, which could prove unsustainable or produce side effects that might offset the benefits of the scheme. Furthermore, from a macroeconomic and political economy point of view, once the DRF/P is established the political pressure for permanent debt mutualisation may start building up. This is why the original GCEE proposal included a requirement to hold a referendum in Member States for any extension of the DRF/P.

V. THE EUROBILLS IDEA: DESIGN, MERITS, RISKS

112. Several proposals on eurobills have been published[47] so far, with differences in features such as type of guarantee or maturity. This chapter does not explore any single proposal, but rather describes and assesses various features and design variants that the eurobills might have (V.1.) before turning to their adequacy in terms of attaining objectives (V.2.) and to economic and financial risks (V.3.).

V.1. Basic features and design variants of eurobills

113. In this report eurobills are understood as government fixed-income securities up to a predefined, rather short-term maturity (up to one or two years), jointly issued by the euro area Member States. The Member States would have to give up the right to issue national debt within the range of maturities covered by eurobills, i.e. eurobills

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idea could also be understood or adapted so as to as merely take over the degree of fiscal obligations under the current EU rules.

[47] See for example: EPDA (2008), 'A common European Government Bond', Discussion paper, September 2008, together with a summary of the survey and discussion in SIFMA (2009), 'Towards a Common European T-Bill', Briefing Note, March 2009. C. Hellwig and T. Philippon (2011), 'Eurobills, not Eurobonds', voxeu.org, 2 December 2011; ELEC (2012), 'The ELEC 'Euro T-Bill Fund', 27 January 2012; Graham Bishop,'The Temporary Eurobill Fund', originally published September 2012, last update December 2013 http://www.grahambishop.com/StaticPage.aspx?SAID=411; http://www.grahambishop.com/StaticPage.aspx?SAID=448.

would become the only short-term euro-area government debt. Member States would continue to issue longer maturity bonds. A maximum size of the eurobills issuance would be set in advance through limits on a country per country basis. Moreover, the ceilings for financing through joint issuance would have to be annually set for each participating Member State. There would also be rules and mechanisms designed to contain moral hazard, going as far as a system for possible exclusion from the joint issuance scheme (see Chapter VI).

114. In addition to the common elements described above, several features of eurobills would have to be defined, for example:

- the guarantee structure of a eurobills fund;
- the precise maturities covered;
- membership;
- the scheme's duration;
- technical aspects of issuance (options for the roll-in phase; back-to-back issuance vs pooled issuance, etc);
- debt-management issues.

See also the table of main eurobill models in Annex 5.

V.1.1. Guarantee structure

115. With *pro rata* guarantee structures, each guaranteeing Member State would be liable for its share in the eurobills issuance. Following the example of the ESM's capital structure, the capital of a eurobills fund would consist of a small fraction of paid-in capital and a larger fraction of committed callable capital, subscribed by each participating Member State *pro rata* according to a key set in the founding legal text, and perhaps credit enhancement (see below). In contrast, under joint and several guarantees, each Member State would also be liable for any other Member State's share: the entire volume of eurobills would be fully guaranteed by each participating euro-area Member State (for a more detailed description of these two guarantee structures, see Chapter IV.1.2. above).

116. A *pro rata* structure limits the liability of each participating Member State to its share in the capital as set in the founding legal text and consequently limits the element of financial risk sharing. This feature may furthermore comply with the current EU Treaties as confirmed by the ECJ (see Chapter VII below). At the same time, it would also mean that any change in the sovereign rating of a (large) participating Member State would very likely result in a corresponding change in the eurobills' credit rating.

117. The joint and several guarantee (which would require Treaty change, see Chapter VII), is likely to contribute to a significantly greater decrease in credit risk premia, since issuance by lower-rated Member States could benefit from the credit quality of higher-rated Member States. The yield of eurobills issued under a joint and several guarantee might be comparable to the yield of current T-bills issued by the highest-

rated Member States, or could possibly be even lower, due to the higher liquidity of the eurobills markets.

118. A *pro rata* guarantee would have a lower impact on Member States' (average) cost of financing than a joint and several guarantee would, as in principle a *pro rata* guarantee implies that the eurobills' credit risk premium would be a function of the participating Member States' credit risk premia.

119. If a credible back-stop might sufficiently reduce the likelihood that eurobills are not redeemed, there would be a potential for lowering the credit risk premium of the bills. For example, the ESM could provide such a backstop, by providing financial assistance to a euro area Member State in case financial strains of a Member State are affecting the credit quality of that Member State and consequently of the eurobills. However, a backstop, such as the ESM, while being an economically important factor for investors' confidence, could not be a legal part of the guarantee structure of the eurobills fund itself. Therefore it could not replace the existence of adequate capital of the eurobills fund. Moreover, the capacity of a backstop to generate additional investor confidence would also depend on its size in relation to the total size of eurobills issuance. It is doubtful whether the current lending power of the ESM (EUR 500 bn) would be enough, in case of a large eurobills fund issuing up to 2-year maturity and difficulties arising in a Member State.

120. Member States with a very low credit risk might face a situation in which eurobills backed by a *pro rata* guarantee have a higher credit risk than their current T-bills. The exact difference is difficult to forecast as it would depend on actual market conditions and on several features of the eurobills scheme, i.e. the overall size of eurobills issuance, its relation to the capital of a eurobills fund, the participating Member States and the existence of credible backstops.

121. However, regardless of the type of guarantee, eurobills could contribute to increasing the resilience of Member States against crises related to the state of the domestic banking sector, by reducing the bank–sovereign feedback loop and strengthening financial stability, through lower exposure of banks to the domestic government debt.

122. Both types of guarantee would bring benefits in terms of pooling the issuance and a lower average cost of financing due to a lower liquidity premium. The impact on the liquidity premium would depend on the size of the new market. In general, the overall liquidity premia of Member States' issuance would fall (although for some Member States there may not be a significant difference), as the liquidity premia on eurobills would decrease and the liquidity premium of the remainder of the outstanding debt should in principle remain unchanged. However, it should be stressed that with a *pro rata* guarantee, the scheme's strength and creditworthiness are dependent on its size, even if there is a backstop, and its size depends mostly on the range of maturities covered by eurobills.

123. As far as the credit enhancement measures are concerned all the pros and cons discussed in Chapter IV on the DRF/P would also apply to eurobills. However, given the short maturity of eurobills credit enhancement measures may appear less relevant, but this would also depend on the size of a eurobills fund and on how

realistic in practice one deems the possibility that a eurobills fund could decide to stop or reduce issuance of eurobills from one year to another.

V.1.2. Maturities covered

124. Traditionally T-bills cover maturities of up to one year. Therefore, one possibility would be for eurobills to cover that maturity range, i.e. from very short (e.g. one week) up to one year. The alternative would be eurobills with maturities of up to two years. The difference between these two options for the overall estimated size of the fund is significant. For eurobills with maturities below one year the estimated amount based on the current situation (i.e. based on a snapshot of the euro area Member States' outstanding short-term debt, as of 6 February 2014) would be about EUR 493 bn, while including all the issuance reaching maturity within two years would result in the amount of about EUR 780 bn. When excluding Member States under programme these figures would be EUR 470 bn and EUR 738 bn respectively (see table in Annex 5).

125. Issuing short-term euro-area government debt only with eurobills would ensure that a large and liquid market is quickly built up. However, the prudent management of government debt would have to be ensured and a sound overall maturity structure would have to be put in place.

126. The more limited range of maturities, i.e. up to one year, would make the size of the eurobill pool smaller and would result in lower marketability. However, a smaller (though still substantial) joint issuance might also have some advantages. Firstly, in the case of a *pro rata* guarantee it would need less capital to support the guarantee which would improve the credit quality. Secondly, a smaller part of issuance done jointly could involve lower moral hazard. Moreover, if the fund is designed as temporary it would be more credible if the maturity of bills is not too long.

127. The size of the eurobills issuance would also depend on the amount to be issued for the financing needs of each Member State. In order to avoid an overreliance on short-term financing it is necessary to cap the issuance of eurobills available to each euro-area Member State. The specific limit to be set should strike the right balance between the size and liquidity of the market, transparency and credit quality/credibility. The limits could be set in absolute terms, i.e. nominal amount for each Member State or as a relative limit defined as a percentage of total government debt or of GDP. The exact limits on issuance would obviously depend also on the chosen range of maturities of eurobills. The definition of country-specific limits to issuance could be complicated as at the moment the dispersion of the share of T-bills in overall outstanding debt across euro area Member States is relatively high. If, in case of a eurobills fund covering maturities up to 2 years, an absolute legal limit for issuance through eurobills is set at 30% of total debt per country, the estimated maximum size of the fund would be around EUR 1.9 trillion (or EUR 1.8 trillion if programme countries are excluded) – notwithstanding the fact that in normal market conditions (i.e. no problems with market access) the size of the scheme would be lower. In case of a fund going up to one year only and capped at 10% of a country's GDP, the estimated maximum size of the fund would be around EUR 960 billion (or EUR 908 billion if programme countries are excluded) (see table in Annex 5).

128. Eurobills would be the only short-term euro-denominated government securities collectively issued by euro-area governments, while medium- and long-term issuance would be organised exactly as it is now. However, credit enhancement measures (granting seniority or earmarking specific streams of revenue) could indirectly worsen the credit quality of 'national' issuance; this is one of the reasons why such measures are assessed critically here (see above).

129. On the other hand, by potentially increasing financial stability and ensuring a smooth short-term issuance at lower cost eurobills could improve the general financial situation of Member States. They could also possibly have a positive effect on the market perception of Member States' medium- and long-term issuance.

V.1.3. Membership

130. There are three basic options for accepting participants into the eurobills scheme:

a. Compulsory participation of all euro-area Member States

131. Under this option all euro-area Member States would be obliged to participate in eurobill issuance. This would mean a simple design structure, a large issuance size and a high significance of the issuance on the market, as well as equal access to short-term financing for all Member States. Such a scheme could be a sign of commitment to monetary union from all Member States. However, the approach might raise questions about credit quality, due to the fact that some Member States, in particular those under an adjustment programme, have lower credit quality. On the other hand, Member States under programme are subject to additional surveillance and conditionality that aim to restore the credit quality and re-establish market access for all maturities. Including programme countries would limit the stigma effect and create positive incentives working towards exiting the programme.

b. Euro-area Member States excluding programme countries

132. Under this option, the average, and minimum, credit quality of participating Member States would be higher. This fact would be especially relevant for the credit quality of jointly-issued debt that would not rely on joint and several liability. The size of the fund would be somewhat smaller than under option a., although it would still be substantial. Programme countries would join the eurobill issuance scheme once they have left the programme. However, during the programmes, access to short-term funding markets by programme countries could be further impeded as they would then have to compete with safe and liquid eurobills. Therefore, one of the potential benefits of eurobills, i.e. the increased resilience to confidence crises, could be partially lost if the most vulnerable countries are not included.

c. Voluntary participation

133. Member States could alternatively be free to choose participating or not. Such a choice could be given at the inception of the scheme, or on a more continuous basis. However, this option is not viable if primarily lower rated and small issuers would choose to participate. Also, there are risks to the overall liquidity of the instrument (if participation would generally be limited) and the stability of markets and the instrument (if participation would be subject to repeated changes). Moreover, this option would not meet the goal of further integration of the euro area.

d. Conditional participation

134. There could be further conditions for eligibility, designed to contain moral hazard, such as strict compliance with EU economic governance (current or possibly further reinforced), proven over a predefined period of time before being admitted to the scheme ('period of probation', see Chapter VI).

V.1.4. Duration

135. One of the proposals presents eurobills as a temporary scheme. Such an arrangement would serve as a 'trial run' for a permanent scheme and would allow Member States to see how the scheme would work in practice, how it would be perceived by investors and how it would affect the financial sector and the broader economy. It could also be considered for legal and accountability reasons (see Chapters VII and VIII)[48]. Some Experts argue that if the scheme proved to be unworkable for some reason it could be easily unwound and, if announced as temporary from the beginning, without causing market disruption. However, other Experts argue that a eurobill scheme would, in any event, raise market expectations of it becoming more permanent, so going back to purely national issues would involve some stability risk. The size of this risk increases with the size of a temporary eurobills fund. Even if set up only temporarily, a eurobills scheme would be able to respond to liquidity crises by ensuring that all Member States have constant access to short-term financing.

136. On the other hand, most of the benefits for which eurobills were conceived could only be obtained if the scheme was permanent. First, a temporary scheme would be difficult to market with investors, against other global short-term instruments, even in the absence of adequate alternatives within the euro area itself. In general, investors need confidence in a long-term perspective before they buy securities and only then will they adjust their investment strategies and, in the case of institutional investors, procedures. Second, possible effects on monetary policy would be more persistent under a permanent scheme. Finally, if eurobills are to serve further euro-area financial markets integration they would have to be permanent.

V.1.5. Technical aspects of the issuance

137. From a technical/financial point of view, the introduction of eurobills could be relatively quick and straightforward. If all Member States refinance their T-bills with eurobills, then a significant proportion of euro-area short-term issuance would be carried out through eurobills already after three months. After one year, the issuance would be close to the target.

138. The most transparent kind of issuance, which would also facilitate the distribution of revenue flows and debt-servicing costs, would be back-to-back issuance, i.e. the issuing entity would issue only the volumes to the extent and once requested by Member States. After issuance, the proceeds would be distributed according to their requests, and at maturity the Member States would repay (at par) the same amount of issuance. While this approach is simple and transparent, it could at times cause difficulties in building appropriate sizes and, in case there are delayed payments (for

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[48] It should also be noted that, even in case of a permanent scheme, there might be constitutional requirements for regular votes in national parliaments on concrete liabilities assumed, see Chapter VII.

whatever reason, e.g. technical failure) could pose a threat to the scheme's liquidity. This problem could be addressed by creating a small liquidity buffer of called-up capital and granting the issuing entity treasury management functions.

139. Alternatively, the issuing entity would issue eurobills on the basis of a pre-established plan. This plan would be prepared on the basis of Member States' annual financing plans and should include the amounts to be allocated to specific national governments. The issuing entity would be in charge of forecasting cash flows and carrying out the assets-liabilities management. Periodically (e.g. monthly) the issuing entity would allocate the issuance and, based on this allocation, calculate the cost of issuance to be allocated to Member States. The issuing entity should aim to minimise borrowing costs, it should therefore have the possibility of frontloading/pre-funding and of general cash-flow management (in brief, it would in principle not issue back-to-back). The fund management should include building up a liquid market (i.e. building appropriate benchmarks), avoiding accumulation of the cost at maturity, and ensuring appropriate distribution of issuance across maturities (taking into account all the limitations imposed by the demand from Member States). The issuing entity should periodically report on its activities and monitor the country limits. This approach would make it possible to better develop reliable and predictable market structures.

V.1.6. Debt management issues

140. Eurobills issuance would need an institutional framework in order to function properly. The main tasks of the Debt Management Offices (DMOs) are usually to carry out government debt management policy by minimising the financing cost at the given level of risk and cash management. For eurobills the tasks of a debt manager would also include coordination with national DMOs, for instance to avoid overreliance on short-term bills/debt, since short-term bills and long-term bonds would be managed by different entities.

141. The eurobills issuance could be organised in two main ways: (i) by national DMOs or (ii) by a European Debt Management Office (EDMO). The decentralised framework would mean fewer changes to the existing one. As respective agents for all euro-area Member States, national DMOs would issue a (clearly pre-defined) fraction of the eurobill pool in addition to their respective medium- and long-term bonds. In practice, DMOs would be able to supply many of the necessary services to ensure large volumes of subscriptions from a wide variety of international investors. However, sufficient coordination at the central level would be necessary.

142. Alternatively an EDMO would be a centralised body responsible for eurobill issuance, and would work in cooperation with national DMOs. The establishment of such an EDMO would initially create additional challenges and costs. Centralised eurobills issuance would also ensure a greater transparency due to better control and reporting mechanisms. The EDMO would also be responsible for contacts with investors and primary dealers. The choice between the two above-mentioned options has consequences as regards the build-up of human resources and expertise needed at European level.

143. The alternative discussed here concerns the narrower tasks of technical debt management, but not political decision-making and the wider consequences of

moving to joint issuance for the EU's present institutional system, see Chapters VII and VIII for a discussion of these questions.

V.1.7. Functions of a eurobills scheme: a simple government finance tool or a tool with an — additional or alternative — crisis prevention function

144. A eurobill scheme could possibly also have some broader elements of discretion about issuing volumes, so as to give the scheme an explicit crisis prevention function complementary to — or even instead of — the ordinary government financing function. One might for example provide for the possibility of a political decision at euro-area level to exceptionally and temporarily authorise Member States exposed to particular financial strain to benefit from eurobills issuance beyond the limits mentioned above. These Member States would then need to agree on a plan to gradually reduce their reliance on eurobills in the future. This discretionary mechanism would give the eurobill scheme additional functionality of providing ad hoc financial assistance (similar and in complement to the ESM), on top of its ordinary government financing function.

145. A still further-reaching proposal, serving the same objective, would be to foresee issuance of joint T-bills only on an ad-hoc basis in the framework of a revised ESM ('contingent eurobills'). The proposal foresees a compulsory, permanent credit line for all euro area Member States as a precautionary measure. In case of a liquidity crisis, such a credit line would mean that contingent eurobills are issued by the ESM to fund up to a certain limit deficits and redemptions of the Member State in difficulty during one year. If the situation is not normalised after one year, then a normal ESM programme would be triggered automatically for that Member State.

146. Such solutions could allow Member States to overcome temporary liquidity problems without the stigma and the programme conditionality of an ESM programme. The counterarguments are that such crisis prevention functionality would mix different instruments serving different purposes and would raise moral hazard. The 'contingent eurobills' variant would not entail regular issuance of eurobills and hence would not lead to the creation of a safe asset and would not facilitate market integration.

147. These proposals could be discussed in case of a future reform of the ESM, to which they are more closely connected than to the debate about eurobills. Therefore, they are not examined in greater depth in this report.

V.2. Analysis of merits of eurobills in terms of adequacy to attain the various objectives

V.2.1. Financial integration and monetary policy

a) Creating a safe and liquid asset

148. The goal with eurobills would be to create them as a safe and liquid asset. To the extent that this succeeds — which depends on a number of factors, in particular on the guarantee structure, chosen limits, the composition of the Fund and resulting

credit quality — there could be tangible benefits for the banking sector in particular. Short-term bills are instruments that could support the monetary policy transmission mechanism. Furthermore, by providing a safe and very liquid asset to be used as collateral, eurobills could improve financial stability. The critical importance of risk-free or low-risk financial assets will, going forward, be increased by Basel III/CRD4 and its obligations on banks to hold sufficient liquidity reserves. They would also ensure banks' access to funding both on the interbank market and from the central bank.

149. A safe asset status could help to ensure that the monetary conditions set by the ECB would pass smoothly and consistently on to enterprises' and households' borrowing costs and ultimately on to aggregate demand. Moreover, a more integrated market could reduce the bank-sovereign feedback loop.

150. Eurobills could also become the benchmark securities for pricing and discounting as regards the maturities covered. Benchmark securities attract trading volume, typically from index-based investment strategies and relative-value strategies, where the benchmark is used as a hedging security. The liquidity that benchmarks attract has value, which is reflected in the lower yield.

151. Safe assets are also means of transactions in financial markets and are necessary for a properly working financial system. This is particularly important in times of crisis when the risk of assets needs to be reassessed and when the government becomes the only provider of safe liquidity due to the counterparty risk increasing. In general, governments have a comparative advantage in risk aggregation and governments have direct access to allocation of resources through the tax and spending system.

b) Reversing the trend towards fragmentation of financial markets and financial markets integration

152. Eurobills as a single euro-area wide short-term government security could be a step towards further euro-area integration and as such could contribute to reducing fragmentation of markets for short-term government securities. An integrated and very liquid market for short-term government securities would be attractive to a wide range of domestic and foreign investors. Due to their liquidity, eurobills could also be kept as foreign reserves by non-euro area and third-country central banks.

153. Eurobills could strengthen general market confidence, with an overall positive impact on financial markets and financial intermediation. In particular, eurobills could address the multiple equilibria that characterise euro-area government bond markets[49]. Moreover, by weakening the link between banks' balance sheets and the

[49] Multiple equilibria refers to a system in which there is more than one equilibrium. For instance, during the crisis some countries ended up in a vicious circle as debt sustainability depends on sovereign bond yields, which in turn depend on market perception of debt sustainability. Put differently, if markets perceived the debt not to be sustainable, the yields could go up and the country could have ended up in a "bad" equilibrium. The specific case of euro area government debt markets has been analysed by Paul De Grauwe in "The Governance of a Fragile Eurozone" (2011).

sovereign eurobills could address market fragmentation and to a certain extent improve monetary policy transmission.

154. Eurobills would set benchmark yields at the short end of the yield curve and could contribute to stimulating issuance by non-sovereign issuers, e.g. corporations, municipalities, and financial firms, and therefore help develop alternatives to bank-based financial intermediation in Europe. The availability of a liquid euro-area benchmark would also facilitate the functioning of euro-denominated derivatives markets.

V.2.2. Sustainability of public finances and financial stability

a) Improving the resilience of the euro area

155. Eurobills have a potential to further improve the resilience of the euro area to future financial crises. For the banking sector the improvement would come through the stabilising effect that a safe asset would have on the functioning of the financial market. For the sovereigns, to the extent that issuance limits are not reached, more secure market access via eurobills, and the positive implication on the liquidity of participating Member States, could support their credit quality and credit ratings. Moreover, if the limit on eurobills issuance could be increased under exceptional circumstances and/or certain conditions, it would serve as a tool for addressing specific liquidity crisis issues in Member States. However this option could create higher moral hazard.

156. Eurobills would be designed to credibly contribute to preventing only temporary problems with market access, which can quickly become self-fulfilling. Therefore it should be clear that in case of fundamental problems a programme within the ESM framework would rather have to be used.

157. By potentially addressing problems with market access, eurobills could also lower the risk of contagion. If there is a more serious problem with access to the bond market, countries would still need to convince market investors of their solvency. At the same time, eurobills would give them time to implement credible fiscal reforms. However, the suitability of eurobills as a tool to address problems with market access would also depend on the eurobills scheme's relationship with the ESM.

158. By providing Member States with more stable market access, eurobills could support their efforts in carrying out politically sensitive structural reforms by allowing sufficient time and possibly increasing the financial space for such reforms. This could be achieved by more stable, and possibly lower, financing cost.

b) Costs of financing

159. In normal times interest rates should not differ across the Member States, therefore financing cost reduction is not a major consideration for eurobills. The cost of financing would be lowered by eurobills with a joint and several guarantee, which would ensure the greatest effect in terms of lowering the credit risk premium. As described above, eurobills with a *pro rata* guarantee would probably deliver a diminished overall effect on debt servicing costs. The liquidity premium would be smaller in case of a relatively higher size of issuance, i.e. covering all euro area Member States issuance up to 2 years.

160. Finally, a permanent scheme would reassure investors that it is worthwhile to include eurobills in their investment strategies. It would anchor eurobills in markets more firmly, raise investors' confidence further and better allow for the development of derivatives markets for eurobills. This could lead to additional advantages for borrowing costs.

c) Reducing the feedback loop between national banks and their sovereign

161. The availability of eurobills, which would help to diversify sovereign debt holdings, could make banks' balance sheets more shock resilient against sovereign stress. As a result, the link between a national banking system and its sovereign could be weakened. Eurobills could therefore be one step, admittedly amongst several others, that could help weaken the bank-sovereign feedback loop as banks' lending to their respective governments would be accordingly lower. Addressing this feedback loop could have a significant positive effect on financial stability at large.

162. One could already go some way in the direction of attaining this objective by simply removing the 'national stamp' on the government debt, thus lowering banks' exposure to their own sovereign. This effect would be further strengthened by the stability of the instrument itself, in particular if based on joint and several guarantee. Moreover, the more issuance is done jointly, the lower the exposure of banking sector to its own government. A permanent character of the scheme would appear to be necessary to meet this objective.

d) Providing financial buffer against effects of asymmetric shocks

163. Eurobills would ensure access by Member States to a short term financing, which would allow having a more stable financing and, for several Member States, at lower yields for the participating sovereign borrowers. 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, allowing to avoid a liquidity crisis and by doing so also lower the probability unconventional monetary policy measures will have to be used. Only a large eurobill fund is likely to provide this benefit in full.

e) Further assistance to Member States exiting a programme

164. For Member States exiting a programme an ensured access to short-term financing through eurobills could smooth the transition from the programme to the full market financing and help to contain financing cost in particular in case of volatility of the cost of longer-term financing.

165. Often Member States under programme do not issue in the long end of the curve and rather rely on T-bills. The cost of the financing is usually higher than for other euro-area governments, in line with the lower credit quality. By lowering the cost at the end of the programme eurobills would provide a Member State breathing space to rebuild market confidence necessary to regain full market access.

V.2.3. Complementing the EU economic governance framework

166. A eurobills framework accompanied by conditionality on participating Member States could complement the EU economic governance framework by introducing a tangible (also financial, in particular for Member States with lower credit quality)

incentive to comply fully with country specific recommendations. The practical implementation and enforcement of the EU's economic governance (current or reinforced) could be strengthened if there are clear rules linking a Member State's access to eurobill financing to strict compliance with these mechanisms (i.e. sanctions and possibly suspension/exclusion in case of non-compliance).

167. Establishing an EDMO would reinforce coordination between Member States on debt issuance at technical level.

V.3. Possible adverse economic and financial effects and risks of eurobills

168. A feature of a eurobill scheme that could contribute to lower stability of the scheme and thereby have adverse economic and financial effects is its possible temporary nature. A temporary scheme, apart from lower effectiveness of meeting the objectives as described above, could encounter problems with market reception as it may create some confusion among market participants. In particular, a possibility that the scheme's continuation could depend on political decisions creates risks of periodical market instability resulting in volatile yields which would further have some impact on the banks' balance sheets and the wider economy. In an extreme case, due to the instability the scheme could face market rejection, which could have a destabilising effect on the financial sector and the wider economy.

169. Similar financial risks might arise, depending on the circumstances, if a eurobills fund decided to stop issuance from one year to another or to exclude a Member State from the scheme, as a response to non-compliance with economic governance rules. For some Experts even if a eurobills foresees such exclusion rules, these would not be credible since a threat to exclude a non-compliant Member State, or to stop joint issuance altogether, would create immediate additional stress on all highly indebted participant Member States.

170. Some Experts note that the costs and benefits of eurobills cannot be discussed without looking into political economy aspects and the underlying dynamics of joint issuance. Many of the benefits of eurobills are private sector benefits which accrue to the banks that have improved access to safe and liquid assets. Benefits for the public sector would arise from the reduction of negative externalities due to lower liquidity risk and, indirectly, from a more stable banking system. The European banking and sovereign debt crisis has shown however that the greatest externalities arise from solvency problems. Also, the effects of a eurobill scheme are strongest when the scheme is permanent and when it includes a joint and several guarantee. In the view of these Experts, this increases the risk of political pressure to extend the scheme beyond the originally planned time period and even beyond originally planned maturities.

171. Another risk that eurobills could entail is the overreliance on the short-term, jointly issued debt. In particular if the version with a cap of 30% of debt was adopted it would significantly increase issuance of short-term debt compared to the situation today. The overreliance could create an increased refinancing risk which could contribute to higher volatility of cost of financing in times of market volatility[50].

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[50] L.H. Hoogduin, B. Ozturk and P. Wierts, (2011), Public Debt Managers' Behaviour: Interactions with Macropolicies, Revue Economique, vol. 62, no. 6, pp. 1105-1122.

The wider the range of maturities covered by a eurobills scheme, the more seriously this risk would need to be taken — i.e. there is a substantially larger risk in case of a eurobills fund covering maturities of up to two years than for a fund covering T-bills up to one year maximum. This risk would have to be addressed by setting strict legal limits on issuance on a country basis, which in view of different practices across the euro area may be challenging. There is a trade-off between containing credibly any risk of overreliance on short-term debt through such strict rules, and variants of eurobills scheme which foresee discretionary political decisions allowing a Member State to roll in extra maturities in a liquidity crisis.

172. Finally, if based on joint and several guarantee eurobills could possibly increase the financing cost for the high-credit quality Member States, as in their case part of the 'flight-to-quality' effect could be reversed. However, that effect would probably be lower than in the case of a DRF/P, given the short maturity of bills.

VI. RISKS OF MORAL HAZARD AND HOW TO ADDRESS THEM

VI.1. Risk sharing and moral hazard: conceptual background

173. The notion of moral hazard in economic theory was developed in the context of analysing the reasons for excessive risk-taking and market failure, in particular in insurance and financial markets. A very broad definition of moral hazard by Paul Krugman defines it as 'any situation in which one person makes the decision about how much risk to take while someone else bears the cost if things go badly'[51].

174. Schemes for joint issuance of debt may create moral hazard. Governments may put at risk the sustainability of public finances by accumulating high debt levels or fast rising deficits or in the extreme case they might default on their debt, if they know that other governments will bear at least part of the risk.

175. Debt mutualisation can create misaligned incentives in a number of different ways. The willingness to reform and to implement unpopular policy measures may decline. Typically, structural reforms entail upfront costs while the gains materialise only gradually over time. Also, in many reforms, the allocation of immediate losses for particular groups of society or professions is clear, while the benefits for the tax payer are more diffuse, more difficult to verify and emerge with a significant time lag going beyond the political cycle.

176. For these reasons of political economy, policymakers in Member States benefiting from joint issuance of debt could be inclined to delay or avoid reforms that would in the medium-term improve the prospects of the economy in general and the debt service capacity in particular, but could reduce popularity in the short run. In a fragile political situation, policymakers may even engage in policies of 'a flash in the pan' nature (e.g. expenditure programmes adjusted to the political cycle) with a

[51] P. Krugman, The Return of Depression Economics and the Crisis of 2008, 2009, p. 63.

high risk of failure in the medium term because the losses incurred by those policies can be shared — while the short-term benefits accrue to the domestic politics.

177. From a different angle, there could also be counter-productive incentives for policymakers in 'guarantor' countries, meaning that it could be politically difficult to suspend or terminate a process of joint debt issuance once it is well underway, even if the conditions were no longer fulfilled and the rules might have been breached. Politicians in a guarantor country would not easily accept responsibility for having triggered an event leading to major financial instability.

178. Whereas as regards the private banking sector moral hazard is typically characterised by an agency problem, caused by asymmetric information where the principal cannot observe the actions taken by the agent without incurring costs ('hidden action')[52], in the context of joint issuance the moral hazard discussion is more linked to the underlying potential conflict between sharing of financial risks amongst Member States while maintaining their national budgetary sovereignty. As a result some governments would be inclined to take more risk that they would otherwise. Thus, the problem is not so much lack of information, but rather the question which degree of central control or sanctions in case of non-compliance is needed as a basis for moving to joint issuance. Furthermore, the "locked-in effect" of schemes of joint issuance – i.e. the problem that once a scheme of joint issuance has been set up it becomes difficult for individual Member States to leave it again – is also part of the discussion on moral hazard.

VI.2. Possible ways of containing moral hazard associated with joint issuance of debt in the form of DRF/P or eurobills

179. This chapter assesses several possible mechanisms that could be considered in order to contain moral hazard. The common aim of such mechanisms is to induce all Member States participating in a scheme of joint issuance to pursue sound fiscal and economic policies which minimise the risk that the guarantee structure would ever be activated. This chapter is necessarily limited to discussing moral hazard issues specifically related to a possible introduction of joint issuance of debt; it would be outside the scope of the Expert Group to look into moral hazard aspects of alternative policy avenues.

VI.2.1. Ex-ante conditions: restricting eligibility for participation

180. A first set of possible instruments would consist of ex ante conditions that a Member State would have to fulfil before being allowed to join a scheme of joint issuance.

181. One might, first, think of a requirement that only Member States that pass a debt sustainability analysis (DSA) are eligible for joint issuance, which would exclude insolvent countries[53]. This requirement raises several questions. The first question is

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[52] On moral hazard as an agency problem caused by asymmetric information, see Basu and Stiglitz (2013) for a discussion in the context of the euro area.

[53] Cf. also Article 6 of Regulation 472/2013 ('Two pack') requiring a debt sustainability assessment where a Member State requests financial assistance from the EFSM, the ESM, or the EFSF.

how stringent the assumptions of a DSA should be and how clearly liquidity and solvency problems could be distinguished from one another. Such a criterion could be difficult to apply in and of itself because debt sustainability is endogenous: it may be enhanced through the prospect of participating in a joint issuance (given that the interest burden for highly indebted countries would decrease) and deteriorated by an exclusion from it. Next, if one envisaged a DSA, then one would have to have an answer ready on how to proceed with a Member State not passing the test. To avoid financial instability, at this stage the answer could only be that the country would need a financial assistance programme such as the ESM.

182. A simpler way of formulating an ex ante condition could be to restrict participation to countries that are not in a financial assistance programme. After all, these programmes have the objective of assisting the Member State to regain credible debt service capacity.

183. A further possible ex ante eligibility condition could be to require ratification of the TSCG and its taking effect in national law (as attested by the Commission)[54] before a Member State can join a scheme of joint issuance.

VI.2.2. Ex-ante conditions: Period of probation

184. A more demanding ex ante condition would be to stipulate a ‘period of probation’. This idea would be inspired by the conditions for introducing the euro as set out in the Maastricht Treaty. For instance, one could foresee a period of n years during which the solidity of, and compliance with, the new economic governance (current or further amended, see next Section) is tested before a scheme of joint issuance is introduced. One would agree at the outset that if the result is positive, a joint issuance scheme would be introduced for all euro area Member States. Alternatively, it could be first introduced for those that have not been found in breach of their obligations during the probation period and the others could be admitted subsequently after their probation. Some Experts consider that a period of probation is inadequate in case of a DRF/P, which was designed to tackle the pressing problem of the debt overhang in the euro area without delay.

185. This ‘period of probation’ idea should be distinguished from the idea of setting up a limited instrument of joint issuance of debt as temporary and lapsing ex officio unless it was renewed by unanimous decision, i.e. a ‘test run’ model. Unlike in the case of a ‘period or probation’, a ‘test run’ model would mean that joint issuance would be tested in parallel to the EU’s new economic governance. This model has been suggested only for eurobills. It would presuppose that eurobills can in practice be introduced on a temporary basis and be discontinued without giving rise to political problems or financial stability risks, a hypothesis that is strongly contested by some Experts, who would underline the importance of putting in place all precautions deemed necessary before establishing a scheme of joint issuance.

[54] I.e., technically speaking, compliance with Article 3(2) of the TSGC as attested by the Commission in accordance with Article 8(1) TSGC.

VI.2.3. Political constraints on Member States' fiscal and economic policies: ex post control and/or ex ante powers

186. Another avenue of measures to contain moral hazard consists of limiting Member States' possibilities of pursuing imprudent policies by setting constraints on their autonomy of decision-making and moving certain key decisions to the European level. This has in fact been the approach adopted in the economic governance processes introduced since spring 2010 as quid pro quo for the establishment of the financial assistance facilities. The resulting reforms — six-pack, two-pack, the TSCG, macro-economic conditionality, the single rule book and single supervisory mechanism — have already increased the intensity of EU/euro-area level influencing and monitoring Member States' fiscal, economic and regulatory policies.

187. Inevitably policy-makers considering schemes of joint issuance of debt would need to assess whether these new governance mechanisms as they stand today are effective and strong enough to contain the additional potential for moral hazard created by joint issuance of debt, and, which additional measures could be taken to strengthen them if deemed necessary. The Expert Group cannot make such judgments in place of political decision-makers, but merely offer some analytical remarks.

188. As to the effectiveness of these new mechanisms, it is obviously very early to assess it. As already noted, the new economic governance architecture has only recently been set up and its implementation and enforcement started; significant further work is still underway (see Chapter II.1.). Thus, the jury is still out.

189. The new set of rules contains significant judgmental elements and margins of appreciation. This is true for some key criteria framed in terms of technically difficult concepts (e.g. 'structural fiscal balance') that can be operationalised in several ways or for clauses catering for exceptional circumstances. It should however be acknowledged that the rules of the SGP have been tightened and many elements of semi-automaticity have now been built in; whether it would be possible or wise to go further in reducing margins of appreciation is itself open to debate.

190. A further relevant aspect has to do with the limits in legal effects of EU governance decisions. The strongest instruments of the framework are still in form of ex post control of national action (i.e., the procedural steps and sanctions in the SGP and the new MIP), whereas the new ex ante elements of fiscal and economic policy coordination still rely on recommendations rather than binding powers. In particular, this is the case of the Commission's opinions on draft budgetary plans in the two-pack (although the Commission's right to ask for resubmission of a draft budgetary plan has some preventive effect). All decisions on fiscal matters continue to ultimately be taken at the national level, and there are currently no legal means to hinder a Member State ex ante from taking them or to impose amendments even if a decision breaches EU obligations. A drawback of the intergovernmental TSCG is that the Court of Justice can only be seized on questions of correct taking effect of the debt brake rules but not on their application. In addition, there is a need to substantially strengthen common ownership amongst political actors of the reformed economic governance system. The practical authority of country-specific recommendations issued within the European semester largely hinges on this issue.

191. In light of the above, the Commission in its ‘Blueprint’ argues that despite the major recent overhaul of budgetary and economic governance, moving towards more mutualisation of financial risk would require bringing coordination of budgetary policy one step further through collective control over national budgetary policy in defined situations[55]. This could be achieved in various ways. Regarding ex post control of national budgetary policy, one possible further step would be to eliminate the current Treaty-based exclusions of European Court of Justice competence for the concrete implementation of the TSCG and for infringements against the SGP. Another possible limited step beyond today’s two-pack would be to announce the imposition of a deposit if a draft budgetary plan does not meet the MTO requirement, thus giving a stronger ex ante reaction from Europe directly within the national budgetary procedure.

192. A significant further step in terms of ex ante powers, as argued for in the Blueprint, would be that the EU institutions are granted a legal right to veto a draft budget in the specific case of inconsistency with a Member State’s fiscal obligations under EU law. This would of course be a limitation of national budgetary autonomy, but triggered only in case of breaches of pre-agreed legal rules and leaving unaffected a Member State’s freedom to make its own policy choices in order to reach compliance (i.e. regarding revenues and expenditure within the budget). In other words, it would be a targeted power of veto, limited to defined situations of breach of a Member State’s legal obligations.

193. An alternative option would be to strengthen the governance framework through centralised binding powers only in a relatively late stage of procedures, but still early enough to avoid market access problems. Thus, when Member States have repeatedly disregarded EU recommendations within an excessive deficit or macroeconomic imbalances procedure, at a given point an EU institution should have binding intervention powers; these could be powers to veto a budget and/or powers to require national decisions being amended or action being taken. This option, as much as the one set out in the previous para, would require Treaty change (see Chapter VII). According to some Experts, the strict fiscal policies that are needed for a very long time to tackle the legacy debts would, furthermore, be credible only if a central fiscal capacity was also created to take care of macroeconomic stabilisation.

194. An even much more far-reaching step would be to make Member States’ central government quantitative targets of the budgets systematically subject to European level approval, or alternatively, to grant a European authority powers to amend national budgets. There is certain logic to calling for this: national budgets would be approved at central level or made subject to amendments by the central level, given that part of the revenue for them would also come from the central level through joint issuance. In a sense, these very far-reaching models would amount to removing national budgetary sovereignty and, by the same token, any moral hazard potential. However, these models would also raise much more serious constitutional and democratic accountability issues than the other steps discussed here.

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[55] See Blueprint, Section 3.2.1. See also French Council of Economic Analysis, ‘A three-stage plan to reunify the Euro area, 2013, p. 19 et seq.; ‘Completing the Euro’, 2013 p. 5.

195. Other factors outside the budget itself such as the efficiency of the public sector and the productive capacity of the economy are nonetheless important determinants of the sustainability of any given level of debt. Therefore, economic and structural policies are relevant for containing moral hazard as well. In theory, a system of oversight and even approval of key government decisions could be considered, however, such deep intrusions into national sovereignty appear hardly realistic in the medium term. One step short of this would be to foresee the conclusion of contracts setting out, ex ante, structural reform paths, a step which would however require a more thorough assessment[56].

VI.2.4. Collateral and credit enhancement

196. Pledging collateral is a standard instrument to help align the interests of a guarantor and a guaranteed party. In the event of default, the party having pledged collateral would have to surrender the collateral to the guarantor, thus bearing a part of the burden. This prospect creates an incentive for acting prudently.

197. While widely used in private debt contracts, requiring collateral between sovereigns is associated with some challenges. The main problem here is that the financial assets most frequently suggested to serve as collateral cannot be pledged by governments without violating the prohibition of monetary financing of the TFEU (see Chapter VII).

198. Earmarking the proceeds from specific taxes (such as VAT or a wealth tax) for servicing payments would be another way of making such payments more certain and reduce the potential for moral hazard. Such earmarking has been in fact used in a number of guarantee arrangements in the 19th and early 20th centuries[57]. However, there are downsides related to legal and constitutional problems (see Chapters IV and V above).

VI.2.5. Incentives — Financial reactions, sanctions and rewards

199. In any rule-based system, it needs to be defined how possible departures from the rules are penalised, but also how positive incentives supporting maximum efforts to obey to the rules can be incorporated in the system. Sanctions for negative outcomes (and/or rewards for meeting targets) are a standard way to mitigate the problem of moral hazard.

200. Sanctions in the form of non-interest-bearing deposits and fines are already a part of the existing governance framework as reinforced by the six-pack, even though they have not been used so far. They are linked to taking ‘effective action’ to correct a significant deviation from the medium-term objective for the structural balance (MTO), an excessive deficit or an identified excessive macroeconomic imbalance. Both actions involve judgmental elements, which are more significant in the case of the Macroeconomic Imbalance Procedure (MIP) but less so in the reinforced

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[56] The European Council of December 2013 discussed this idea without making decisions and referred the matter to its meeting in October 2014, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/140245.pdf.
For an assessment, see the Annual Economic Report of the GCEE 2013.

[57] Esteves, Coskun Tuncer, 2013.

Stability and Growth Pact (SGP), whose procedural steps are so tightly regulated that the system can be qualified as semi-automatic. A certain margin of appreciation is anyway inherent in any sanctioning scheme, in the light of the proportionality principle.

201. In addition, the EU's funding programmes are now made subject to macroeconomic conditionality under which commitments and even payments must — in a semi-automatic way — be suspended in defined cases of violation of the economic governance. These are technically not sanctions, but financial reactions protecting the efficient use of EU money. For the Member States concerned the suspension creates an incentive to comply with the governance rules.

202. On the one hand, in case of a joint issuance scheme one could raise the effective level of sanctions as compared to the current six-pack rules. On the other hand, an often mentioned drawback of financial sanctions is that they only aggravate the situation when a Member State is already in financial difficulty. They best suit the situations where the non-complying Member State still has access to market financing at reasonable rates. In order to be more efficient a sanction threat should be foreseen earlier in a policy process.

203. Non-pecuniary sanctions, such as the suspension of voting rights, could be used also in dire financial situations. However, this avenue, given its extremely serious political consequences, would require to set up a very cumbersome procedure (cf. Article 7 TEU) which would hardly be efficient.

204. One might also consider positive incentives, i.e. rewards for a successful performance or implementation of policy conditionality. In particular, joint issuance of debt would offer new possibilities for a built-in mechanism of financial incentives through interest mark-ups. A transparent, possibly quasi-automatic system of gradual interest rate mark-ups could function as a reward for successful or as sanction for non-compliant policy. Such a system would appear particularly appropriate in case of a DRF/P (see Chapter IV1.6. above), but less pertinent for eurobills. It could have a greater potential to actually influence the conduct of policy-makers and hence ensure compliance with fiscal rules than financial sanctions.

205. In case the avenue of mutually agreed contractual arrangements and associated solidarity mechanisms — as discussed during the 2013 December European Council[58] — is further pursued, one could explore the links between such a system and a possible joint issuance scheme, but one should then also discuss potential negative incentives of such a system on a Member State's readiness to tackle urgent reforms. In the DRF/P model, the 'consolidation agreements' would in a way seem to be functional substitutes to such contractual arrangements, although they would be conceived as fully binding and as covering a longer period.

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[58] http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/140245.pdf.

VI.2.6. Suspension or exclusion from the scheme in case of non-compliance

206. The ultimate sanction in case of a breach of common rules would be suspension or exclusion from joint issuance. Such a mechanism appears in all proposals submitted so far, although it differs depending on the nature of the scheme. In case of a DRF/P, the transfer of any further debt to the common fund during the roll-in phase could be stopped. The outright exclusion from the fund would not be really feasible once a Member State has rolled-in a significant amount of debt. In the case of eurobills, there could be mechanisms of suspension and exclusion from joint issuance pro futuro. The mere existence of suspension or exclusion procedures would deploy some deterrent effect and thus contribute to containing moral hazard. In practice unexpected side-effects may however pose financial stability risks. This would depend on each specific case.

VI.2.7. Market discipline

207. A crucial question is to what extent market discipline — i.e. the role of financial markets in imposing discipline on policy-makers to carry out sustainable fiscal policy and necessary structural reforms — can effectively work in practice and, if so, still be felt in case of partial joint issuance.

208. It is generally agreed that until the recent past, market discipline did not function correctly in the euro area: before 2010 the sovereign debt markets did not send signals to policy makers, and then they over-reacted when the crisis broke out, leading to very wide spreads reflecting on the one hand perceived default probabilities of vulnerable euro-area Member States, and on the other hand the flight to 'core' sovereign debt, considered the most sustainable (safest havens). Interest rate spreads have now narrowed down again to a more sustainable level but not to the pre-crisis levels.

209. As regards the future, one can validly take very different views on whether and how market discipline can at all work to keep moral hazard in check:

210. Under a sceptic view, market discipline has a highly digital character: it is either on or off. It may be on, but then hinders monetary policy and raises calls for unconventional policies. Or it is off, because financial market actors stick to their pre-crisis assumption that individual euro-area Member States would always be bailed-out by other Member States. Following this view, containing moral hazard would depend largely if not entirely on a strong economic governance.

211. Under another view, market discipline will function only once EMU is able to increase incentives for building up sufficient buffers against shocks and thus by preventing public debt from becoming unsustainable. According to this view, the credibility of market discipline is enhanced by a robust crisis management mechanism which would include, in the long run, a government debt restructuring regime.

212. Those who take a more optimistic view on market discipline would claim that although it was ineffective in the past, it is working already better now, with bond yields spreads working to some extent as a disciplining tool on governments. It might work still better in the future, following further progress of the on-going reforms (e.g. banking union) in the financial sector. For example, in the view of

some Experts the domestic banking sector vulnerability to the risk of sovereign default can be reduced by limiting banks' exposure to sovereign debt by regulation or by creating alternative safe debt instruments. Banking sectors in euro-area Member States could be made safer by a further tightening of capital requirements, effective common supervision, and a robust crisis management and resolution mechanism at the European level.

213. If one followed the assumption that market discipline can in the future have a real, functional effect on policymakers, then any schemes of *partial* joint issuance should be designed in such a way that market signals will still be felt. The potential for this might vary with the design of a scheme: Joint issuance under *pro rata* guarantees implies more sensitivity to market discipline than joint and several guarantees. Likewise, the relative share of joint issuance as compared to debt staying national may also be a relevant factor: the moral hazard potential of a small, *pro rata* eurobill regime with a strict legal cap on joint issuance (i.e. only maturities up to 1 year and a cap for eurobills at 10% of GDP per country) would be significantly lower than that of a big common fund operating under a joint and several guarantee (i.e. of eurobills up to two year's maturities or a large DRF). Some Experts would however argue that joint issuance even if partial, would tend to remove a market discipline that would otherwise function correctly: If a scheme of joint issuance is introduced even though Member States retain control over their fiscal, economic and social policies, it would tend – at least for the maturities covered - to equalise interest rates that otherwise would reflect the market's perception of a complete set of national policies and hence signal to each Member State individually the risks associated with its policy course.

VI.2.8. Debt restructuring as a possible long-term element

214. In some of the proposals made, one component designed to contain moral hazard is to set up a regime for restructuring of sovereign debt, which would be put in place only once the problems of debt overhang have been overcome[59]. A restructuring regime would, according to its proponents, disincentivise overborrowing because sovereigns would face higher costs as debt levels increase and it would improve credit risk pricing because creditors would be able to forecast sovereign risks. The argument is made that all other instruments, such as market discipline and the threat of a suspension or exclusion from joint issuance, would work effectively only if there is a credible scenario under which a sovereign could default without uncontrollable damage to others.

215. There are very divergent opinions on the feasibility and desirability of this idea which is subject to discussion[60]. For one group within the Expert Group, the building up of such a debt restructuring regime would be an important preventive way to contain moral hazard. For these Experts, a future debt restructuring mechanism could either be a complement to reinforced governance, i.e. a second

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[59] See GCEE Annual Economic Reports 2011 and 2013. The GCEE proposed that the restructuring regime should be implemented through a revision of ESM lending policies.

[60] See, in particular, Committee on International Economic Policy and Reform, 'Revisiting Sovereign Bankruptcy', October 2013, Chapters IV and V; see also GCEE Annual Economic Report 2010; Holtemöller and Knedlik 2011.

line of defence, or a substitute to further intrusion into national decision-making; the latter case would be more in line with the current, decentralised model of fiscal decision-making and responsibility where Member States keep the main policy competences. A second group of Experts strongly disagrees with the idea of a debt restructuring mechanism; these Experts 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). The advocates of a debt restructuring regime acknowledge that it is an idea for the longer term, only to become applicable once the debt legacy problem has been solved, and could not be put in place within the coming years (although it would according to the proponents have to be agreed upon in packages with any scheme of joint issuance). The Expert Group did not do an assessment of the feasibility, desirability and possible content of a debt restructuring regime.

VI.3. Moral hazard and ways of addressing it, in the specific cases of a DRF/P and of eurobills

VI.3.1. Moral hazard and ways of addressing it in case of a DRF/P

216. A DRF/P scheme raises a significant potential of moral hazard, in particular if conceived on the basis of joint and several liability of participating Member States. Even a voluminous DRF, such as originally proposed, would only provide for partial issuance of debt, with debt up to 60% of GDP remaining national. However, moral hazard could be high both during a roll-in phase when participating Member States could satisfy their refinancing (except for short term maturities) from the DRF as well as during the redemption phase. After all participating Member States will have transferred large volumes of debt to the joint scheme, an exclusion of individual Member States starting to deviate from agreed rules would be impossible. Highly indebted Member States would hence have leverage to exercise pressure on creditor States. Political pressure may also start building up in the sense of keeping permanent debt mutualisation even after the end of the DRF/P, which is why the original GCEE proposal included a referendum requirement for any extension of the scheme.

217. In light of the above, the DRF/P, as devised by the GCEE, included most of the instruments discussed above as part of the 'pact', to keep moral hazard incentives in check:

- eligibility restricted to Member States not in financial assistance programmes,
- a precondition of ratification of the (possibly reinforced) TSCG,
- individual 'consolidation agreements' would be required for each Member State,
- financial incentives and sanctions (interest rate mark-ups, possible secondary market transactions),
- suspension of the outsourcing of debt during the roll-in phase in case of breaches of rules,
- part of the sovereign debt would remain under purely national responsibility,

- a long-term debt restructuring mechanism.

218. Conversely, two of the elements listed in Section VI.2. above were not included in the original proposal. One is the idea of a 'period of probation'. The absence of this element seems to be due to the design of the DRF/P proposal of 2011 as a crisis response tool. But in principle, a period of probation could be stipulated to test the reinforced EMU governance before a DRF/P is set in motion. The second missing element was a possible transfer to the European level of ex ante powers of intrusion in the national budgetary procedures. True, the original DRF/P proposal contained the 'consolidation agreements' which would set stringent budgetary policy conditions, but the question remained open how and by which body these would be enforced after the roll-in phase. If a Treaty change is considered to clear the way for a joint and several guarantee structure for a DRF/P, the transfer of such powers and their exercise through the Community method and integration of a strengthened TSCG in the EU framework should be considered in order to ensure legitimacy and efficiency.

219. A downsized and 'equal share' variant of a DRF/P operating under pro-rata would present a different trade-off between expected results and moral hazard risks. Vulnerable Member States would benefit from a lower debt cost savings effect and remain more exposed to market discipline, and the time-spans both for the roll-in phase and the redemption phase would be considerably shorter — these factors mitigate moral hazard.

VI.3.2. Moral hazard and ways of addressing it in case of eurobills

220. Eurobills also evoke a moral hazard potential which, depending on the design variants and assumptions on the functioning of the scheme, might either be lower than or rise just as high as that of a DRF/P. The relevant determinants are however in part different ones.

221. The first and most important factor is, again, the guarantee structure: A *pro rata* guarantee structure would, in comparison with joint and several liability, mitigate moral hazard for two reasons: first, since each participating Member State always has to factor in the limits of the others' liability, and second, since a deteriorating credit quality of a participating Member State due to its fiscal and economic problems would directly result in higher financing costs also of the eurobills, with adverse effects being felt by all.

222. Next, the specific structure of partial joint issuance under the eurobills model would, according to some Experts, contribute to reducing moral hazard. A key feature here is the short maturity of the instrument, which implies de facto seniority with regard to other, longer-term liabilities.

223. Thus, if a Member State does not adhere to the rules as expected, roll-over may be denied or the conditions changed (e.g. reducing the amount that can be rolled-over into eurobills and thereby increasing the national debt part). The short maturities also make it possible to construe temporariness or early termination or reduction of the scheme if legally foreseen. There would also be a legal cap on joint issuance; this cap would mean that the majority (at least 70%) of each Member States' debt would remain exposed to normal market discipline at all times.

224. On the other hand, the above arguments greatly hinge on how credible the assumption is that in practice the just-mentioned limits will be maintained and that the options to terminate or reduce eurobills can really be used. According to some Experts, a eurobills scheme, even if launched temporarily and on a small scale, would likely arouse political and economic expectations and even pressure for the scheme to become permanent and be extended ('political economy' argument). They anticipate that eurobills even if introduced temporarily are necessarily there to stay, that they might induce overreliance on short-term debt, that markets will expect them to be only precursors of longer-term joint issuance, given that the economic effects of eurobills as such would arguably remain modest. Furthermore, under this view the options of simply terminating or reducing issuance of eurobills from one year to the next in case of problems, or of excluding a non-complying Member State from the scheme, are unlikely to be used in the light of political difficulties or financial stability risks. Indeed, it is argued that the threat to exclude a non-compliant Member State, or to stop joint issuance altogether, would create immediate additional stress on all highly indebted participating countries and would therefore not be credible. These Experts are of the opinion that the introduction of eurobills — whether temporary or permanent — should therefore only be considered after a further substantial reinforcement of ex ante powers of the central level over national budget and economic policies requiring Treaty change (see Chapter VII).

225. Finally, moral hazard is probably higher in those design options, suggested by some Experts, that already build in some flexibility to overstep the normal limits, e.g. by allowing a temporary overreliance on eurobills above the normal limit for a Member State in a liquidity crisis. This is one of the reasons why other Experts would discard such options.

226. Against this background, robust mechanisms to contain moral hazard are also warranted in case of eurobills. Indeed, the proponents of the idea themselves stress that eurobills are not substitutes for improved economic governance and fiscal discipline[61].

VI.4. Conclusion

227. As an overall conclusion, both a DRF/P and a eurobills scheme may create moral hazard risks which depending on the concrete design could be very substantial. Some Experts would underline the importance of putting in place all precautions deemed necessary before establishing a scheme of joint issuance. Given the still very limited experience with the EU's current, recently 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 the governance framework before any decisions are taken on introducing joint issuance.

[61] Hellwig and Philippon 2011.

VII. LEGAL ASPECTS OF JOINT ISSUANCE OF DEBT IN THE FORM OF A DRF/P OR EUROBILLS

VII.1. Legal requirements and limits under the current EU Treaties

228. A crucial aspect of feasibility concerns the legal requirements and limits posed by the current EU Treaties to the introduction of a DRF/P and/or eurobills: what is possible under the current EU Treaties and in which cases would introduction of these instruments require a Treaty amendment? Two aspects need to be analysed: substantive requirements under the current Treaties and the extent of current EU competence.

VII.1.1. Substantive requirements flowing from Article 125 TFEU ('no bail-out clause')

229. The main substantive requirement to be taken into account is Article 125 TFEU (see Annex 6 for wording of this and other relevant Treaty provisions), the 'no bail-out clause', which was interpreted by the Court of Justice in the *Pringle* judgment[62].

230. While the prohibition in Article 125 TFEU needs to be respected in all aspects of the financial design of a DRF/P and eurobills, the most relevant question concerns the guarantee structure of such instruments.

231. A guarantee structure based on joint and several liability of the participating Member States would mean that each participating Member State would give a legal guarantee to pay, to the holders of securities issued by a joint DRF or eurobill fund, the full amount of such securities in the event of default by the issuing fund itself. 'Joint and several' implies that a security-holder can turn to any participant Member State of his/her choice to claim payment of the full amount guaranteed, regardless of the fact that other Member States have also issued a guarantee.

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[62] Judgment of 27 November 2012 in Case C-370/12, *Thomas Pringle* v. *Government of Ireland and others*, not yet reported (nyr) [hereinafter 'the *Pringle* judgment'].
On this judgment see, *inter alia*, : E. De Lhoneux, & C. Vassilopoulos, *The European Stability Mechanism before the Court of Justice of the European Union: comments on the Pringle case*, 2014, p.1-74; V. Borger, *The ESM and the European Court's Predicament in* Pringle, 14 German Law Journal (2013), pp. 113-14; P. Craig, *Pringle: Legal Reasoning, Text, Purpose and Teleology*, 20 Maastricht Journal of European and Comparative Law 1 (2013), pp. 3-11; B. de Witte & T. Beukers, *The Court of Justice approves the creation of the European Stability Mechanism outside the EU legal order:* Pringle, 50 *Common Market Law Review* (2013), pp. 805-848; S. Adam & F. J. Mena Parras, *The European Stability Mechanism through the Legal Manderings of the Union's Constitutionalism: Comment on* Pringle, 38 European Law Review (2013), pp. 848-863; J-P Keppenne & B. Smulders, in: von der Groeben/Schwarze (Eds.), *Kommentar zum EUV/AEUV*, 7 ed. 2014 (forthcoming), *Artikel 125;* M. Selmayr, ZÖR 2013, pp. 259 - 284.
The compatibility of financial assistance mechanisms with Article 125 TFEU was also examined by scholars before the *Pringle* judgment was rendered – see, *inter alia*, Chr. Calliess, Das europäische Solidaritätsprinzip und die Krise des Euro – von der Rechtsgemeinschaft zur Solidaritätsgemeinschaft?, FCE 01/11; A. De Gregorio Merino, *Legal Developments in the Economic and Monetary Union During the Debt Crisis: The Mechanism of Financial Assistance*, 49 Common Market Law Review (2012), pp. 1613-1646; J. -V. Louis, *The No-Bailout Clause and Rescue Packages*, 47 Common Market Law Review (2010), pp. 976-979; M. Ruffert, *The European Debt Crisis and European Union Law*, 48 Common Market Law Review (2011), pp. 1785-1786.

232. The just-described scheme of joint and several liability needs to be distinguished from other guarantee structures based on the idea of a *pro rata* liability. Such a structure has been used for the EFSF: Each participating Member State gives a guarantee for the securities issued by the EFSF; however, the guarantee does not cover the full amount of the security but merely a part, being defined in accordance with the Member State's share in the "guarantee contribution key" in the EFSF (that key in turn corresponds to each country's share in the paid-up capital of the ECB). The ESM is also based on a *pro rata* structure, although differently construed than in the EFSF: here, the Member States do not give guarantees to the holders of ESM securities; instead, they are obliged, under the ESM Treaty, to pay in callable capital in case the ESM needs it (e.g., if a beneficiary Member State does not pay back a loan to the ESM). But the ESM Treaty limits the liability of each ESM Member, in all circumstances, to its portion of the authorised capital stock at its issue price; no provision of the Treaty may be interpreted as leading to payment obligations higher than the portion of the authorised capital stock corresponding to each ESM Member, as specified in Annex II of the Treaty, without prior agreement of each Member's representative and due regard to national procedures[63].

233. Legal scrutiny against the benchmark of Article 125 TFEU leads to the conclusion that any form of joint issuance of debt which is underpinned by a joint and several guarantee of the participating Member States goes directly against the prohibition in that Article[64]. Joint and several liability means, by definition, that each Member State would "assume the commitments" of the rest of the participating Member States: by honouring its guarantee, a Member State frees not only the issuing fund[65] but also each of the other Member States from their liabilities towards the bondholders. That is precisely what is prohibited by the wording of Article 125 TFEU ("shall not assume the commitments"). Joint and several liability would also go against the rationale of that Article, which is "to ensure that the Member States remain subject to the logic of the market when they enter into debt, since that ought to prompt them to maintain budgetary discipline"[66]. When one Member State assumes a guarantee for the debt of another Member State directly vis-à-vis the latter's creditors, then the latter Member State is no longer submitted to the logic of the markets for that debt.

234. The *Pringle* judgment, where the Court of Justice has confirmed the conformity of the ESM Treaty with Article 125, only confirms this conclusion. The ESM is not based on joint and several liability of Member States, but only on *pro rata* commitments to pay in callable capital. In the ESM Treaty no Member State assumes any guarantee for the debt of other Member States. True, in *Pringle*, based

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63 See Article 8(5) ESM Treaty and Declaration of the parties to the ESM Treaty of 27 September 2012.

64 Likewise, A. De Gregorio Merino, *'Legal Developments in the Economic and Monetary Union during the Debt Crisis: The Mechanism of Financial Assistance'*, 49 *Common Market Law Review* (2012), p.1626 ; V. Borger, *'How the Debt Crisis Exposes the Development of Solidarity in the Euro Area'*, 9 *European Constitutional Law Review* (2013), p. 36; Blueprint, Section 3.2.2. and 3.2.3.

65 That fund being a 'body of public law' created jointly by the Member States, i.e. an emanation of them, see Advocate General Kokott's view in the Pringle case, points 110 and 153.

66 Judgment C-370/12, Pringle, point 135.

on a teleological interpretation of Article 125, the Court holds that not all forms of financial assistance amongst Member States are forbidden by that Article 125. It formulates two conditions for assistance to be compatible with Article 125 – it must be indispensable for the safeguarding of the financial stability of the euro area as a whole and subject to strict conditions[67] – and it accepts the ESM as satisfying these conditions. But in doing so, the Court expressly notes that the ESM does not act as guarantor for the debt of the beneficiary Member State, who will remain responsible vis-à-vis its creditors[68]. The starting point for the Court is always that each Member State remains solely responsible for its own debt[69]. Therefore, *Pringle* cannot be invoked as authority for the compatibility with Article 125 TFEU of other schemes that, contrary to the ESM, entail guarantees by one Member State for the debt of another vis-à-vis the latter's creditor, even if such schemes purportedly serve the stability of the euro area and are made subject to strict conditions.

235. Mostly before the *Pringle* judgment, various attempts have been made by some lawyers to avoid the conclusion that joint and several guarantees breach Article 125. The lines of argument are presented and commented hereafter:

- Some have argued that, given its wording, Article 125 only forbids a Member State from guaranteeing to another Member State but not to a separate legal entity set up as an international organisation, such as a DRF[70]. This argument overlooks that the Article must also extend to guaranteeing for any international organisation which is controlled by the Member States and thus an emanation of them, lest the "effet utile" of the Article be easily undermined. The argument was also discarded in the *Pringle* case[71]. In any event, joint and several liability implies that if one Member State pays in full on its guarantee, it pays not only for the joint fund but also frees the other Member States from their guarantees.

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[67] Point 136.

[68] Point 138: *'As regards the ESM Treaty, it is clear, first, that the instruments for stability support of which the ESM may make use under Articles 14 to 18 of the ESM Treaty demonstrate that the ESM will not act as guarantor of the debts of the recipient Member State. The latter will remain responsible to its creditors for its financial commitments.'*

[69] This is confirmed by Advocate-General Kokott's view in the same case (see points 115 and 116): *'....as a matter of principle, the voluntary assumption of liability for the commitments of another Member States would be in breach of Article 125 TFEU. However, the financial assistance instruments of the ESM Treaty do not constitute such guarantees of the commitments of another Member State. As stated above, the financial assistance instruments require on each occasion a decision of the Board of Governors, and to that extent there is no prior liability of the ESM. Moreover, neither loans nor the purchase of bonds guarantee to the creditors of a Member State repayment of the sums owed to them ... no guarantee of the commitments of its Member States is involved in the financial assistance instruments which the ESM has at its disposal...'*.

[70] M. Nettesheim, *'Der Schuldentilgungsfonds: Rechtliche Rahmenbedingungen eines umstrittenen Instruments zur Eurorettung'*, in: M. Breuer et al. (eds.), Der Staat im Recht, 2013, p. 603, 607-610.

[71] See AG Kokott (*ibid.*) and point 175 of the Court's judgment, which equates the ESM with the participating Member States for the purposes of Article 273 TFEU.

- One might argue that, following the *Pringle* judgment, only the two 'teleological' conditions it refers to (need to safeguard financial stability of the euro area, strict conditions) are relevant for any scheme of assistance and that it should not matter whether a scheme involves guarantees. However, as shown above, this is inconsistent with the wording of Article 125, its purpose and indeed the judgment itself: giving a guarantee (in the legal sense) is 'assuming the commitments' and hence forbidden by Article 125;
- In a similar vein, some have argued that Article 125 should not stand in the way of a DRF/P given that a DRF/P serves precisely to attain the stability objectives of the Treaty, by separating past from future debt and enabling Member States to respect their Treaty obligations for future debt (kept below 60% GDP), whereas past debt is set aside for controlled redemption[72]. In the wording or legislative history of Article 125 or in the *Pringle* judgment, however, there is no basis for such a radical reconstruction. The Article lays down an absolute prohibition, without any threshold or distinction between 'old' and 'new' debt. Its purpose is to avoid moral hazard by making each Member State responsible, vis-à-vis its creditors, for all its debt[73]. It also follows that Article 125(2) could not be used by the Council to operate such a reconstruction of the 'no bail-out' clause;
- Some argue that a DRF/P or a eurobills scheme could be regarded as a 'specific project' within the meaning of the built-in exception in Article 125(1)[74]. However, that notion, like any exception to a general rule, must be interpreted strictly, as referring to truly specific projects, e.g. involving infrastructure jointly realised and financed by more than one Member State (such as a bridge or a tunnel linking them)[75]. It cannot apply to a broad scheme set up to refinance government debt across the board.

236. On the other hand, alternative financial designs for joint issuance that are not based on joint and several liability may pass muster under Article 125 TFEU. In particular, this may be the case for a design equivalent to the ESM, where participating Member States do not give a guarantee to bondholders of the ESM, but merely commit to inject capital on a *pro rata* basis and where fulfilment of their obligation to inject capital dos not reduce, let alone relieve, the other Member States from their

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[72] J. Delpla & J. von Weizäcker, The Blue Bond Proposal, Bruegel, Brussels, Bruegel Policy Paper, May 2012, n°2010/3 available at http://www.bruegel.org/publications/publication-detail/publication/403-the-blue-bond-proposal/#comment-, p.6. *Contra* F. Allemand, *'La faisabilité juridique des projets d'euro-obligations*, 48 *Revue trimestrielle de droit européen* 3 (2012), p. 580.

[73] *Pringle* judgment, point 135.

[74] Cf. F. Martucci, *"Le défaut souverain en droit de l'Union européenne – Les instruments de droit de l'Union européenne pour remédier à l'insolvabilité des Etats"*, in : M. Audit (dir.), *Insolvabilité des Etats et dettes souveraines,* L.G.D.J, 2011, pp. 233-276.

[75] On the built-in exception in Article 125 (1), see J-P Keppenne & B. Smulders, in: von der Groeben/Schwarze (Eds.), Kommentar zum EUV/ AEUV, 7 ed. 2014 (forthcoming), Artikel 125 ; F. Allemand, 'La faisabilité juridique des projets d'euro-obligations, 48 *Revue trimestrielle de droit européen* 3 (2012), p. 582.

obligations vis-à-vis the ESM. The *Pringle* judgment has unambiguously cleared such a capital structure from the point of view of Article 125. Hence it could be transposed to a DRF/P or a eurobills fund. Furthermore, compliance of a DRF/P or eurobills with Article 125 from a teleological perspective could be ensured by appropriate means to contain moral hazard (Chapter VI above).

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

VII.1.2. Substantive requirements flowing from the prohibition of monetary financing (Article 123 TFEU)

238. When discussing collateral for a DRF/P or a eurobills scheme, the Treaty's prohibition of monetary financing (Article 123 TFEU) needs to be borne in mind. This is relevant as regards gold and foreign currency reserves. In the euro area, Member States' gold reserves are owned mostly by the national central banks (or, in a few cases, by the government, but even there the authority to manage the reserve may be entrusted by law to the central bank). Under Article 123 TFEU, the ECB or national central banks may not provide any credit facility *inter alia* to governments or any bodies governed by public law. This means that gold reserves held or administered by central banks may not be disposed of by the Member States, even acting in agreement with the central banks, as collateral for a scheme which serves to raise finances for national budgets. The same is true for foreign currency reserves held by national central banks.

VII.1.3. Issues of competence for establishing a DRF/P or eurobills and for complementary steps to address moral hazard: through EU law or intergovernmentally?

239. Another question that needs to be analysed is whether there would be competence under the current EU Treaties for setting up a DRF/P or a eurobills scheme, even if it is in line with Article 125 (i.e. on a *pro rata* basis), through an EU legislative act. This is important, since establishing a DRF/P or a eurobills scheme within the framework of Union law would entail decision-making by the EU institutions under the Community method and its model of democratic accountability. Significantly, the European Parliament invited the Commission to make a legislative proposal under EU law to establish a DRF/P, not to come forward with an intergovernmental construction[76].

240. The first legal base to be scrutinised is Article 136 TFEU, which refers *inter alia* to the ordinary legislative procedure in Article 121(6) TFEU.

241. This legal base, which was used for part of the six-pack and for the two pack, allows for legislative acts (regulations, directives or decisions), adopted by co-decision of the Parliament and the Council applying only to the Member States of the euro area; only those States being entitled to vote in the Council. Article 136 (1)(a) requires

[76] See resolution of 16 January 2013 on the feasibility of introducing Stability Bonds (2012/2028(INI)), annex.

legislation that aim at "strengthening the coordination and surveillance of budgetary discipline of the Member States". Moreover, since this legal base is part of the Treaty Title on the EU's economic and monetary policy, any legislation based on it must stay within the nature and extent of EU competences in the field of economic policy (of which budgetary policy is a part), which are limited to coordinating Member States' economic policies (see Articles 2 (3) and 5 (1) TFEU). In defining the EU's role as one of coordination, the EU Treaties presuppose that Member States ultimately remain sovereign in their budgetary and Treasury functions – even if such sovereignty is limited by the obligations of fiscal discipline organised by the EU Treaties - and that the Union cannot replace, even in part, Member States in the exercise of these functions.

242. Applying these conditions to the ideas at hand, it becomes clear that Article 136 is not suitable. When looking at their purpose, even if one could say that a DRF/P or eurobills also served the strengthening of Member States' budgetary discipline, their immediate and preponderant purpose would be the financing of Member States' sovereign debt, a purpose lying outside the scope of Article 136. In any event, a DRF/P established at European level would not simply be a mechanism to coordinate and monitor the issuance of public debt by the Member States. Rather, it would entail setting up a legal entity distinct from the Member States and mutualising part of their debt issuance. Moreover, the DRF/P idea would also include a number of strict obligations as outlined in Chapter IV above. Similarly, a eurobills scheme would require a distinct legal entity issuing short-term public debt on account of the Member States, up to limits set for each Member State at European level, combined with a legal prohibition for Member States to issue short term debt themselves. All the above shows that in setting up a DRF/P or a eurobill scheme the EU would in part replace classic national Treasury functions and thus elements of national budgetary sovereignty (e.g., the right to issue government debt, to determine the issuing schedule and and to decide on the ratio between short and long term debt); this would necessarily go beyond the boundaries of economic policy coordination[77].

243. Therefore, there is no competence under Article 136 TFEU to establish a DRF/P or a eurobills scheme.

244. The other legal base to be examined is Article 352 TFEU (the flexibility clause)[78]. In short, recourse to that clause requires there to be a need for Union action to attain one of the Union’s objectives as set out in the Treaties, within the framework of Union policies, and an absence of an express competence in the Treaties for such action. Also, the Court of Justice has made it clear that any measure adopted on this

[77] In a similar vein, the Court of Justice has found, in *Pringle*, that since the Union’s role is limited to coordinating measures, the Treaties confer no specific power to establish a stability mechanism (like the ESM); see *Pringle* judgment at point 64.

[78] At point 67 of its *Pringle* judgment, the Court of Justice has left open whether Article 352 could be used for setting up a stability mechanism of the kind of the ESM.

base must stay within the general framework set by the Treaties and not amount, in substance, to a modification of the Treaties[79].

245. The conditions expressly figuring in Article 352 TFEU could arguably be met for an act establishing a DRF/P or eurobills, to the extent one could qualify a DRF/P or eurobills as an action necessary to safeguard the financial stability of the euro area (which is a fundamental EU objective, see Article 3 (4) TEU). However, there are clear limits flowing from the unwritten requirement, stemming from the case law, that an Article 352 cannot exceed the general framework of the EU Treaties and bring about a reform which would, in substance, require a proper amendment to the Treaties. The "general framework of the Treaties" is based on the premise of budgetary sovereignty of the Member States – though limited by the fiscal discipline foreseen in Article 126 TFEU - and on a role of the Union being limited to coordinating such budgetary policies and enforcing such discipline. This is confirmed by the Union's own resources system. Under Article 311 TFEU, the Union's own resources are determined by a unanimous Council decision requiring ratification by the Member States (normally involving the consent of national parliaments which hold the budgetary powers). This ratification requirement in Article 311 assumes the budgetary sovereignty of the Member States and their parliaments. Article 352 could, hence, not be used to impose any obligations on Member States to mobilise their fiscal resources for a common EU measure, since that would circumvent the ratification requirement in Article 311 and impinge on budgetary sovereignty of Member States. Nor could an Article 352 act dictate the way in which Member States raise money to finance their budgets. Bearing in mind the above, an EU legislative act based on Article 352 could certainly not impose on Member States an obligation to become part of a scheme of joint issuance of debt nor limit their right to issue national government debt. It could not force, either, Member States to make payments to a fund operating joint issuance or to guarantee for joint issuance.

246. One could take the legal view, given the above, that Article 352 simply does not allow for the adoption of any act introducing a DRF/P or a eurobills scheme since, by thus replacing classic national treasury functions and affecting national budgetary sovereignty, such an act would necessarily go beyond the general framework of the Treaties.

247. However, an alternative view can also be defended. Under that view it might be possible to set up, through a regulation based on Article 352, an EU structure managed by an EU institution (e.g., the Commission) and put at the disposal of the Member States for the joint issuance of short term sovereign debt (i.e. eurobills). But such an act would have to leave, as a matter of EU law, each Member State with the choice of making use or not of the joint issuance structure thus set up. It could only formulate certain conditions to be fulfilled by Member States if they wish to participate (such as, for example, accepting annual EU decisions on limits per country for the financing through joint issuance, the commitment not to issue own short term debt during the participation in the structure, a *pro rata* commitment of capital etc.). Since such commitments would by definition be short-term in the case of eurobills, an Article 352 act so construed could be defended as not impinging on

[79] See Opinion A-2/94, [1996] ECR I-1759, points 30 and 35.

budgetary sovereignty of Member States and as not exceeding the general framework of the Treaties.

248. However, in order to secure the necessary stability of a eurobills scheme such an Article 352 act alone would probably not suffice. It would have to be combined with an intergovernmental agreement whereby the euro area Member States commit, in a legally binding way, to effectively make use of the joint platform established by the EU act, for a predefined time-span, and to meet the conditions of participation.

249. While it would be more complex to set up, the considerable advantage of such a combination of an Article 352 act with an intergovernmental agreement, over a purely intergovernmental construction, would be that the EU's institutional framework could be used for setting up a eurobills scheme, thereby avoiding the serious problems of compatibility with EU economic governance and of accountability signalled below (Chapter VIII). But one can also expect serious legal objections against such a model: some could say that, as a matter of principle, an EU legal act which cannot sensibly apply without a parallel intergovernmental act goes against the principle of autonomy of EU law; some might also contest that an EU act which alone does not suffice to address a problem cannot "prove necessary to attain one of the objectives of the Treaty" within the meaning of Article 352.

250. In any event, such a combination model would seem much less well defendable for a DRF/P than for eurobills. The DRF/P including its "grand pact" components represents a complex and comprehensive legal framework entailing a series of very far-reaching legal obligations which, what is more, would bind Member States over a considerable period of time. Many of these lie manifestly outside the EU's competencies, such as: the obligation to refinance all debt over two year maturity through the DRF/P during the roll-in phase, the obligation to earmark tax revenues for the fund, and the establishment of a sovereign debt restructuring regime (to apply even permanently after the redemption). Therefore, when looking at the DRF/P legal framework as a whole, the elements just mentioned, which clearly go beyond the current framework of the Treaties, quite patently eclipse the aspect of setting up a platform for joint issuance. In addition the whole scheme would entail legal obligations for a long period of time. These factors make a combination model including an Article 352 act appear hardly defendable for a DRF/P scheme.

251. One complication is that Article 352 requires a unanimous act of the Council (normally at EU-28) and the consent of the European Parliament[80]. While it is conceptually possible to adopt an Article 352 act as applying only in the euro area, it is not possible to exclude non-euro area Member States outright from the decision-making. This could be achieved only through the enhanced cooperation mechanism, which does not appear excluded for Article 352[81] but presupposes that

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[80] Under special constitutional requirements, certain governments (e.g. Germany's) cannot consent to such an act until their parliaments have adopted an authorisation.

[81] The European Parliament considers this possible – see resolution of 12 December 2013 on constitutional problems of a multitier governance in the European Union (2012/2078(INI), point 17 [hereinafter EP resolution on multitier governance].

an attempt is first made to have the act unanimously adopted by the EU-28[82]. Therefore, the Council acting as EU-18 (euro-area countries only) could adopt the act only if all non-euro-area Member States agreed to stay out. If enhanced cooperation were used, Article 332 TFEU would guarantee that non-participating Member States would be subject to no indirect financial exposure, via the EU budget, to a fund set up on the basis of Article 352.

252. A further dimension to be mentioned in this context concerns the fact that some of the ways of avoiding moral hazard, as discussed above (Chapter VI), reach or surpass the limits of current EU competence and thus raise the question of Treaty change. Such Treaty change would be required, for instance, to create a European right to require a revision of national budgets in line with European commitments; this would mean changing the nature of the Commission's opinions on national draft budgets so as to make them binding (i.e. a veto right over a national budget in the event of breaches of fiscal obligations). *A fortiori*, creating powers to require specific national acts being taken or amended, or even making annual budgets subject to systematic approval at European level, would require Treaty change. As regards deeper economic policy integration in the euro area, one would need to study further whether, and under what circumstances, 'contractual arrangements' negotiated between each euro area Member State and the Commission, approved by the Council and providing for measures for growth, competitiveness and job creation could be made fully binding and enforceable on the basis of the current Treaties.

253. If, absent or pending a change in the EU Treaties, one considered a purely intergovernmental basis for setting up a DRF/P or a eurobills scheme, e.g. following the model of the ESM Treaty, the institutional and accountability consequences would have to be borne in mind.

254. In a purely intergovernmental construction, the Member States' governments alone exercise all decision-making power at European level. It is true that, in the ESM Treaty, the Commission and also the European Central Bank perform various tasks. However, these tasks have been entrusted to them intergovernmentally, i.e. outside the Union framework, by the Member States under the so-called "Bangladesh" model[83]. The *Pringle* judgment has defined the limits of that model[84] : the nature of the entrusted tasks must be limited to functions such as coordination or management; they are performed on behalf of the entrusting Member States (or the

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[82] Be it as a proposal to set up a joint issuance platform available to all Member States or only to those in the euro area.

[83] Named after the 'Aid to Bangladesh' judgment of the Court of Justice (C-181/91 and C-248/91, European Parliament v. *Council and Commission*, [1993] ECR I-3685) where this model was first recognised. For completeness, it should be mentioned that the Treaty on Stability, Coordination and Governance in the euro area (TSCG) — another treaty concluded outside EU law — follows a model that differs again from that of the ESM Treaty: it does not set up any institutional structure of its own, but mainly contains substantive commitments of budgetary discipline, compliance with which the Commission and the Council can monitor under powers granted by the EU Treaties. This model cannot be transposed to the context of joint issuance of debt.

[84] See *Pringle* judgment, points 155–165.

intergovernmental organisation they created, i.e. the ESM) and cannot entail any decision-making power; and they must not alter the essential character of the powers of the institutions laid down by the EU Treaties. A debated point is whether all EU Member States (not only the euro area Member States) would need to consent to a "Bangladesh mandate". That is the legal position defended by some, contested however by others[85]. In the cases of the EFSF and the ESM, all Member States did declare their common agreement.

255. Consequently, in the case of a DRF/P and/or a eurobills scheme (as with the ESM), the Commission could be asked to perform preparatory and management tasks, but it would in this respect be subordinated to an intergovernmental body — such as a Board of Governors — composed of the governments of the euro-area Member States with exclusive decision-making power; no decisional powers could be conferred on it or indeed on the other political EU institutions, the Council or the European Parliament (whereas the Court of Justice could have limited jurisdiction[86]). The European Parliament could not be granted powers to pass legislative rules or consent to key acts (such as appointments) and the Commission would not be accountable to it for action taken exclusively on behalf of euro area Member States. In other words, democratic accountability would have to rest, under such a model, exclusively with national parliaments and their ability to control the conduct of the government representatives on the board. The difficulties, with such a model, of ensuring true parliamentary accountability for pan-European decisions affecting all will be discussed in Chapter VIII below.

256. Moreover, any intergovernmental decision-making powers of a DRF/P and or a eurobills fund board must not be so far-reaching as to affect the powers of coordinating Member States' economic policies assigned by the EU Treaties to the Union institutions[87]. Precisely which constraints are imposed by this axiom is difficult to say, but the Court of Justice would hardly accept a scheme whereby the powers of an intergovernmental body to influence the fiscal and economic policies of all euro area Member States (not only those in financial difficulty and needing assistance) would go against or overshadow those of the Union institutions under Articles 121, 126 and 136 TFEU. Indeed, in *Pringle*, the Court accepted the powers of the ESM Board on the basis that the ESM 'is not concerned with the coordination of economic policies'[88], but with providing *ad hoc* financial stability support to countries with severe financing problems. One may wonder whether this principle developed by the Court would still be respected, for instance, if DRF/P legal arrangements provided for the negotiation and approval, by an intergovernmental

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[85] See *Pro* A. De Gregorio Merino, *Legal Developments in the Economic and Monetary Union during the Debt Crisis: The Mechanism of Financial Assistance*, 49 Common Market Law Review (2012), p. 1638;. *Contra* S. Peers, *Towards a New Form of EU Law?: The Use of EU Institutions outside the EU Legal Framework*, 9 European Constitutional Law Review (2013), p. 54. Both positions were also defended by certain Member States and EU institutions at the hearing in the *Pringle* case before the Court of Justice. The *Pringle* judgment does not take a stance on the question.

[86] Article 273 TFEU, see *Pringle* judgment, points 170–177.

[87] *Pringle* judgment, points 108–114.

[88] *Pringle* judgment, point 110.

governing body, of binding consolidation agreements with each participating Member State that imposed fiscal policy conditionality and structural reforms. In the case of eurobills, similar concerns could be raised with regard to annual decisions by an intergovernmental eurobills board determining Member States' annual financing rights depending on their fiscal and economic policy conduct. In both cases, there is arguably a risk that the centre of most powerful collective decision-making would shift from the Union institutions to an intergovernmental board.

VII.2. Issues arising under national constitutional laws, in particular budget autonomy of national parliaments

257. National constitutional laws pose limits, derived in particular from the principle of national parliaments' budget autonomy, to Member States' scope for participating in a scheme of joint issuance of debt. The discussion in German constitutional law has been particularly active (see Annex 7), but similar principles and constraints can be expected to apply in other Member States. Further noteworthy examples are Estonia's constitutional law on the budget autonomy of the national parliament, as developed in the Estonian Supreme Court's 2012 judgment on the ESM Treaty[89], and Finland's constitutional law, as developed in statements by the Finnish Constitutional Law Committee[90] [91].

258. It would go beyond the scope of this report to examine in detail whether and in what circumstances joint issuance of debt and national guarantees for it could satisfy the requirements of national constitutional law. In the light of the principles of German constitutional law, the following general point can however be made with due caution: The more clearly it would be legally ensured, in an act establishing joint issuance of debt, that the maximum liability incurred by a ("creditor") Member State, even if significant, is strictly limited in advance, that there are regular authorising decisions by the national parliament for concrete liabilities assumed (as well as parliamentary information rights and rights to influence the management of the scheme) and that the scheme encompasses strict conditions and safeguards designed to ensure fiscal discipline on all participant States, the more likely the scheme could be found in line with the constitutional limits at issue. Applying this general point to possible DRF/P or eurobills regimes is challenging, but there might be possible solutions (see Annex 7).

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[89] The English translation of the judgment of 7 July 2012 is available at http://www.riigikohus.ee/?id=1347. For a comment of this judgment, see C. Ginter, *'Constitutionality of the European Stability Mechanism in Estonia: Applying Proportionality to Sovereignty'*, 9 *European Constitutional Law Review* (2013), pp. 335-354.

[90] For a comment of the Statements of the Finnish Constitutional Law Committee, see P. Leino & J. Salminen, *'The Euro Crisis and Its Constitutional Consequences for Finland: Is There Room for National Politics in EU Decision-Making?'*, 9 *European Constitutional Law Review* (2013), pp. 451-479.

[91] See also the judgment of the Austrian Constitutional Court of 16 March 2013 on the ESM Treaty (which however does not centre around budget autonomy of the national parliament).

259. In general, the limits of national constitutional laws apply in a similar way regardless of whether a DRF/P or eurobills are introduced by amendment to the EU Treaties or through intergovernmental agreement.

260. A final point to bear in mind concerns the further transfers to the EU level of sovereignty on fiscal and economic policy matters, which some[92] see as political prerequisites for introducing joint issuance of debt. Some of these, e.g. creating consent or veto powers over national budgets, may require constitutional amendments in most, if not all, Member States. Depending on the design, such amendments may or may not require a referendum. This is less likely if such new centralised powers are limited to reacting to Member States' violation of their legal fiscal obligations rather than involving broad discretion to steer policies.

VII.3. Possible designs of legal instruments needed for introducing a DRF/P or eurobills

261. To the extent that introducing DRF/P or eurobills requires amendment of the EU Treaties, the distinction in Article 48 TEU between the ordinary and simplified Treaty revision procedures becomes relevant.

262. If the only Treaty change considered was to create an exception to the 'no bail-out' clause, allowing for joint and several guarantees, the simplified procedure in Article 48(6) TEU could be applied (as with the 2012 European Council decision amending Article 136 TFEU).

263. If, in contrast, one also wanted to create a new legislative competence for the EU to set up a DRF/P or eurobills, then the ordinary revision procedure pursuant to Article 48 (2) to (5) TEU would have to be followed, since the revision would imply an increase of the EU's competences. The same is true if one wanted to increase the EU's powers of control over national budget policies and / or strengthen economic policy coordination at EU level.

264. In any event, one should not over-emphasise the distinction between the two procedures. The 'simplified' procedure is not so much simpler than the ordinary one. Both require unanimity and ratification by all Member States and as regards ratifications under national constitutional laws there is normally no difference between the two. The only significant difference is that there is no need to convene a 'convention' in the simplified procedure, whereas in the ordinary procedure this is obligatory unless the European Council, with the consent of the European Parliament, decides not to do so given the limited extent of the proposed amendments. Given the stakes in introducing joint issuance, a convention to discuss these topics might be considered appropriate from the point of view of democratic legitimacy.

[92] See in particular Blueprint, Section 3.2.1.: 'However, moving towards more mutualisation of financial risk would require bringing the coordination of budgetary policy one step further by ensuring that there is collective control and national budgetary policy in defined situations'.

VIII. DEMOCRATIC LEGITIMACY AND ACCOUNTABILITY IN CASE OF INTRODUCTION OF A DRF/P OR EUROBILLS

VIII.1. Cornerstones of the debate

265. Only shortly after the entry into force of the Lisbon Treaty, whose central theme was to strengthen the EU's democratic legitimacy, intense discussion about how best to ensure legitimacy has resurged in the framework of the crisis affecting the euro area and measures taken to respond to it.

266. This is not surprising. When the crisis struck, it became clear that one of the main problems lay in the insufficient design and implementation of fiscal surveillance and economic policy coordination. A momentum built up in favour of correcting these deficiencies and reinforcing the EU's economic governance framework (see Chapter II).

267. In a second stage, experience of implementing new rules and agreements and visions for deeper EMU have triggered discussion on whether the new framework ensures sufficient democratic legitimacy and accountability, or whether executive and ‘technocratic’ actors are becoming too strong (in particular vis-à-vis ‘programme countries’).

268. On the other hand, programmes and mechanisms that have been created in order to assist countries facing severe problems, have raised another angle of the legitimacy and accountability issue, as part of the opinion spectrum in some Member States felt beingled by their governments and the EU actors into enormous financial liabilities.

269. Joint issuance of debt in the form of DRF/P and/or eurobills could intensify this discussion, for two reasons. On the one hand, joint issuance might increase the risk that financial burden can be created for one Member State's finances as a result of policy decisions made by other Member States (the magnitude of that risk depending on the design of joint issuance). On the other hand, a framework would be needed where decisions are taken based on an efficient and transparent governance framework in order for the DRF/P or eurobills to be viable and trusted by the markets.

270. Joint issuance would necessarily entail a significant further deepening of EMU through a centralised and / or collective exercise of still more powers, affecting citizens in their daily lives. The challenge is to ensure that, even after such deepening, democratic legitimacy is adequate.

VIII.2. The framework of the discussion on legitimacy

VIII.2.1. Conceptual remarks

271. The two concepts "(democratic) legitimacy" and "accountability" are often used as synonyms. But legitimacy is the wider concept; accountability is a subset. Legitimacy requires institutions formed in line with democratic processes and mandated to take decisions influencing citizens' well-being. Usually a distinction is made between input and output legitimacy: Input legitimacy means factors enhancing the contributions made to the political process and rests on participation and representation of citizens in politics, mainly through elections ("government of

the people and by the people"). Output legitimacy rests of the quality of the output of the political process: the ability of public authorities to solve the problems of the citizens and thereby enhancing their adhesion to decisions made and to the polity ("government for the people")[93].

272. Accountability means that government action needs to respond to the citizens, mostly through control by the people's representatives, i.e. parliamentary accountability. This is a key factor creating democratic legitimacy, but not the only one. Parliamentary action encompasses not only holding the executive accountable, but, at least as important, includes decisions reserved to the parliament such as law-making, voting on budgets, ratifying treaties etc.

273. Parliamentary legitimacy and accountability remains key to guaranteeing democracy, but there are other factors enhancing legitimacy of governmental action: direct democracy tools, participation of civil society and social partners, accountability of political action vis-à-vis citizens and public opinion thanks to transparency and free pluralistic media, adequate judicial control, independence of certain bodies and agencies.

VIII.2.2. Democratic legitimacy in the EU currently, in particular in the area of economic governance

274. In general, the EU institutional model based on the Community method ensures a high level of legitimacy, within a unique model of supranational democracy perfected by the Lisbon Treaty. The institutional triangle of European Parliament, Council (qualified majority voting) and Commission, with its built-in checks and balances, generates legitimacy by striking a delicate balance of different Member States', stakeholders' and citizens' interests. Representative democracy is achieved by the European Parliament directly representing the citizens and by governments being accountable to their parliaments for their action in the Council. National parliaments now also interact directly with the institutions (through subsidiarity control, the Commission explaining its governance positions to them, etc.). There are state-of-the-art rules on transparency and smart regulation (e.g. impact assessment). A high level of judicial protection is ensured by the European Court of Justice in cooperation with national courts.

275. However, this whole model applies only within the limits of EU competence. As yet, this extends largely to regulatory policies and not so much to redistributive policies, the latter (except the EU's funds under its regional policy) remaining largely within the remit of Member States and national parliaments[94]. In particular, the European Parliament has no power to raise taxes. The "power of the purse" or "budgetary sovereignty" – the power to decide on the level of taxation of citizens

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[93] On the distinctions between accountability and legitimacy and between input and output legitimacy, see *inter alia* B. Laffan, *The Fourth Pillar of a Genuine EMU — Democratic Legitimacy and Accountability*, Discussion Paper for Informal Meeting of Ministers for European Affairs (2013) http://www.eu2013.ie/media/eupresidency/content/meetingagendasanddocs/dt/The-Fourth-Pillar-of-a-Genuine-EMU.docx.

[94] M. Dawson & F. de Witte, *Constitutional Balance in the EU after the Euro-Crisis*, 76 Modern Law Review 5 (2013), p. 824.

and the power to decide on government spending – ultimately rests with the national parliaments (even though budgetary sovereignty is limited by EU Treaty and secondary law rules and the TSCG)[95].

276. Whatever the merits of long-term visions involving an autonomous EU power of taxation, a substantial central budget and a large-scale pooling of sovereignty over the conduct of economic policy at EU level[96], in the short to medium term at least reflections on democratic legitimacy in the further development of EMU need to keep in mind both the EU's institutional model ensuring legitimacy for European decisions and the key role of national parliaments as the holders of the power of the purse.

277. The new architecture of EU economic governance, as built up since 2010, is already arousing discussion: 'the European level' has a greater say than before over redistributive policies (European Semester, six-pack, two-pack, conditionality vis-à-vis programme countries). Some criticise a preponderance of executive and 'technocratic' actors in this architecture and find it unsatisfactory from the point of view of democratic legitimacy and accountability[97]. On the other hand, some crucial steps had to be taken via intergovernmental agreements (notably the ESM Treaty and the TSCG) rather than the Community method, drawing criticism as to legitimacy and accountability[98].

278. This report cannot delve into this ongoing general debate. Rather, it focuses on legitimacy and accountability in the event of future moves to deepen EMU via joint issuance of debt through a DRF/P or eurobills. It identifies the specific aspects of such schemes that would pose new challenges for ensuring an adequate level of democratic legitimacy (see Section VIII.3) and discusses possible solutions (see Sections VIII.4 and 5).

VIII.2.3. General principles guiding the reflection

279. Some guiding principles are taken as common ground by the EU institutions:

- In European integration, there is always a need to ensure a level of legitimacy and accountability commensurate to the degree to which sovereignty is transferred,

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95 M. Ruffert, *The European Debt Crisis and European Union Law*, 48 Common Market Law Review (2011), pp. 1 789-1 790.

96 See the 'Blueprint' Communication from the Commission.

97 B. Crum, *Saving the Euro at the Cost of Democracy?*, 51 Journal of Common Market Studies 4, pp. 621-622; P. Leino & J. Salminen, *The Euro Crisis and Its Constitutional Consequences for Finland: Is There Room for National Politics in EU Decision-Making?*, 9 European Constitutional Law Review (2013), p. 463.

98 K. Tuori, *The European Financial Crisis — Constitutional Aspects and Implication*, EUI Working Paper LAW No 2012/28, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2171824, p. 43-47; M. Dawson & F. de Witte, *Constitutional Balance in the EU after the Euro-Crisis*, 76 Modern Law Review 5 (2013), p. 829. For a general overview, see also now J.-P. Keppenne, *'The Economic and Monetary Union: Constitutional and Institutional Aspects of the Economic Governance within the EU – Institutional Report'* for FIDE 2014, forthcoming.

i.e. the more significant the powers transferred to the central level, the harder one needs to think about ensuring legitimacy[99];

- Ensuring democratic legitimacy in deepening EMU is not a side issue; it is a cornerstone. Without acceptance by the citizens there cannot be a lasting EMU[100].
- Democratic legitimacy and accountability need to be ensured "at the level where decisions are taken and implemented"[101]. The European Parliament and Commission stress that where economic governance decisions are taken at European level, only a European parliamentary assembly can provide adequate legitimacy for them, and that is the European Parliament (since no one wants to build up new competing institutions). However, as long as budgetary sovereignty rests largely at national level, national parliaments are key in providing legitimacy for budgetary decisions. Moreover, there is a key role of national parliaments in implementation, through concrete national fiscal and economic policies, of what is agreed through EU economic governance.
- Any moves to deepen EMU should build on the EU's institutional framework and preserve the integrity of the EU as a whole[102], i.e. there must be no split between EMU and the EU at large and no competing set of new institutions should be built up.

VIII.3. Problem analysis: Aspects of introducing a DRF/P and eurobills which pose new challenges for ensuring democratic legitimacy and accountability

280. In general, the main accountability problem is that joint issuance of debt may — if objectives are not achieved — result in a considerable financial burden for a given Member State's finances, for which that Member State's parliament is accountable to its citizens, although the burden is the result of policy decisions made over time by other Member States under the responsibility of other parliaments[103]. To prevent such a scenario, schemes of joint issuance of debt involve new powers to be exercised centrally. For these powers, accountability at central level must be organised. If there is only decentralised accountability for new control powers in

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[99] See Blueprint, point 4.1, p. 35.

[100] Ibid.

[101] See, most recently, Conclusions of the European Council, 24-25 October 2013, European Council document EUCO 169/13, point 35 (same wording in earlier conclusions, of December 2012 and June 2013, European Council documents EUCO 104/2/13 and EUCO 205/12); report by President H. Van Rompuy in close collaboration with the Presidents of the Commission, the Eurogroup and the ECB 5 December 2012, point V, p. 16 http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf; Blueprint, point 4.1, p. 35; EP resolution on multitier governance, point 27.

[102] Blueprint, Box 1, p. 13, Conclusions of the European Council, of 27/28 June 2013, European Council document EUCO 104/2/13; Van Rompuy Report, point V, p. 17; EP resolution on multitier governance, point 6; EP resolution of 12 June 2013 on *Strengthening European democracy in the future EMU* (2013/2672(RSP)), point 3 [hereinafter EP resolution on strengthening European democracy in the future EMU].

[103] Blueprint, Section 4.3, p. 40. Of course, this problem is not entirely new; to some extent it already exists in the context of the ESM today.

joint issuance of debt schemes, the problem can arise that parliaments of potential 'creditor' countries are seen as co-deciding fiscal matters of other countries.

281. Looking more closely, one may distinguish three areas in which introducing joint issuance of debt through DRF/P or eurobills would pose new challenges for ensuring legitimacy and accountability:

VIII.3.1. Decisions to establish a DRF/P or eurobills and aspects of design and operation

282. The decisions needed to set up a DRF/P or eurobills are far-reaching and therefore require a high level of democratic legitimacy. They include the actual decision of principle to introduce joint issuance of debt between participating euro-area Member States; the flipside of that, i.e. a ban on issuing national securities of the same maturities; and the whole basic legal framework governing a DRF/P or a eurobills scheme.

283. A number of factors are relevant:

- The duration: for a DRF/P committing Member States over a long period of time, i.e. up to 25 years, a particularly strong legitimacy basis is required. The issue might be easier for eurobills entailing only short term liability and if the scheme can be construed as temporary, but not if it is permanent or prone to become so given market expectations.
- The size of financial commitments and the guarantee structure: A joint and several liability poses harder legitimacy issues for likely creditor Member States whose financial exposure would then largely depend on decisions taken by other governments. But admittedly, even *pro rata* liability would lead to high potential commitments (in case capital is foreseen and called).
- A requirement to earmark some tax proceeds for European debt servicing over a considerable time span would call for legislation which can only be passed by national parliaments.
- The various pre-conditions, constraints and safeguards that are part of the "pact" element of the DRF/P idea also raise democratic legitimacy issues: notably the requirement that each participating Member State submits itself to "consolidation agreements" imposing fiscal conditionality and structural reforms over a long period of time.

VIII.3.2. The ongoing management of a DRF/P or eurobills

284. Once a DRF/P or a eurobills scheme is set up, it must be managed during its whole cycle. This would involve various decision-making powers at central level, whose importance and intensity depends on concrete design of the scheme. In any event, for accountability purposes one should distinguish between two very different types of decision-making. There will be day-to-day sovereign debt management. This could be left to a European DMO, possibly as an independent body, without raising accountability problems. But there will also be powers to make political decisions at central level having far-reaching consequences for the Member State(s) concerned. These decisions may include:

- decisions periodically allocating proceeds from the scheme, i.e. deciding about annual ceilings for financing through joint issuance,
- decisions on sanctions for fiscal non-compliance of a Member State, or on positive incentives rewarding compliance,
- and the ultimate sanction, of suspending or excluding a Member State from joint issuance.

285. It is obvious that strong democratic legitimacy must be provided for such decisions to be taken at EU level.

VIII.3.3. Issues of accountability related to further complementary transfers of power in the area of fiscal and economic policies to avoid moral hazard

286. Several of the ways identified above to tackle moral hazard could involve a substantial further strengthening of the EU's economic governance. This includes in particular enhanced control over national budgetary policies (in particular, by creating a European right to require a revision of national budgets in line with European commitments, i.e. a "veto right") or stronger powers of intrusion vis-à-vis a Member State which has repeatedly failed to follow EU recommendations in an excessive deficit or macroeconomic imbalances procedure.

287. Such developments would constitute major steps towards further European integration. They would also call for solid democratic legitimacy for the exercise of the powers transferred.

VIII.4. Efficiency and accountability problems of models based on a purely intergovernmental construction

288. A fundamental choice facing European decision-makers envisaging the introduction of a DRF/P or eurobills is between using the Community method or an intergovernmental avenue. This choice has not only legal implications but also a profound impact on efficiency, legitimacy and accountability.

289. In principle, as shown above the Community method is deemed to ensure both appropriate democratic legitimacy for supranational decisions and efficient decision-making through QMV (or reverse QMV) while ensuring equity between all Member States. But the legal analysis shows that absent Treaty change the Community method is not sufficient to create a DRF/P or eurobills (see Chapter VII); moreover, even should it apply one would have to take into account, both from a constitutional law and an accountability perspective, the continuing responsibilities of national parliaments holding the power of the purse.

290. That said, by comparison with the Community method, a path of *purely* intergovernmental decision-making outside the EU Treaties would pose significant additional problems. In particular, a purely intergovernmental construction for a DRF/P or eurobills, which would create important decision-making powers at European level, would present serious shortcomings from the point of view of efficiency, democratic legitimacy and accountability.

291. Decision-making powers could then only be conferred exclusively to an intergovernmental body composed of representatives of national ministries (i.e. like the ESM Board). There could be virtually no European Parliament involvement and no decision-making role for the Commission (which could only perform certain functions on behalf of Member States). This means that there would be two parallel worlds of institutional decision-making, competing with each other and potentially generating confusion and efficiency losses as compared with a model using the Union institutions for all economic governance decisions (not to mention the legal problems that would arise if intergovernmental decision-making were to be preponderant over EU decision-making[104]).

292. Moreover, under such a purely intergovernmental model, accountability for central decisions could be ensured only by individual national parliaments scrutinising their governments' actions in an intergovernmental board.

293. This is unsatisfactory not only as such as a means of ensuring accountability: understandably, national parliaments act in principle on the basis of national interests, not those of citizens at the other end of Europe who are also affected by the matter in question. Also, it is a huge challenge for them, on top of their intrinsic national functions, effectively to follow and scrutinise highly complex and rapidly moving European financial negotiations. It may even appear problematic, as a matter of democratic theory, if as a result of joint issuance the parliament of one country were seen as regularly co-deciding the fiscal matters of another[105].

294. What is more, a purely intergovernmental model raises an dilemma between legitimacy/accountability and efficiency: accountability for central decisions can be genuinely conveyed by national parliaments vis-à-vis citizens in all states only if the unanimity rule applies. However, that rule creates risks of deadlock which can be problematic, particularly in the context of joint issuance schemes that require continual, smooth decision-making. On the other hand, qualified majority voting in an intergovernmental setting means that individual Member States can be outvoted without a supranational parliament intervening and without the checks and balances of the Community method. This problem is aggravated by an *asymmetric* qualified majority rule such as that applying in the ESM context, i.e. 85% voting, where some large Member States effectively have a veto right while the others do not[106]. In the ESM, this rule applies only exceptionally, in emergencies[107], and smaller Member

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[104] See Chapter VII.1.3.5.

[105] As distinct from ESM programmes, where a country in an exceptional situation of financial difficulty needs to request financial assistance to regain its budget sovereignty and in return agrees, with the lenders, conditionality implemented through measures decided and legitimised through its own parliament alone.

[106] C. Ginter & R. Narits, *The Perspective of a Small Member State to the Democratic Deficiency of the ESM*, 38 Review of Central and East European Law (2013), p. 65; M. Dawson & F. de Witte, *Constitutional Balance in the EU after the Euro-Crisis*, 76 5 (2013), p. 838.

[107] The emergency procedure in Article 4(4) of the ESM Treaty, for decision-making by a 85% shareholders' vote, is applicable only where the Commission and the ECB both conclude that failure urgently to adopt a decision to grant or implement assistance would threaten the economic and financial stability of the euro area.

States are unlikely readily to accept its extension to regular decision-making in a scheme of joint issuance. The classic qualified majority voting of the Community method, embedded in a broader system of checks and balances, would address the issue more effectively and ensure a balance of efficiency and legitimacy.

295. Lastly, in a purely intergovernmental setting there is only limited judicial protection and enforcement by the European Court of Justice and less transparency than in the EU institutional system.

296. In sum, a number of factors plead strongly in favour of solutions based on the Community method and the EU's institutional architecture, whether amended through Treaty change or under the current Treaties (i.e. exploring a combination of an Article 352 TFEU decision and an intergovernmental agreement), rather than purely intergovernmental constructions. Such an approach would provide a better basis for responding to the accountability challenges posed by joint issuance, or at least avoid raising new accountability concerns.

VIII.5. Possible models ensuring democratic accountability in case of establishing a DRF/P or eurobills

VIII.5.1. The challenge: ensuring parliamentary legitimacy both at European and at national level without mixing the levels

297. It is clear from the above that an adequate level of legitimacy for a scheme of joint issuance of debt cannot be achieved without strong *parliamentary* legitimacy and accountability, and that cannot be sustainably achieved at European level (i.e. by the European Parliament) or by national parliaments alone.

298. Models should therefore be found that ensure accountability at both levels: accountability by the European Parliament for decisions taken at European level by using the Community method (possibly reformed), but also a key role for national parliaments given their continued 'power of the purse'[108].

299. Inter-parliamentary cooperation, i.e. regular meetings between members of the European Parliament and of national parliaments[109], is valuable, since it builds mutual understanding and common ownership for EMU. In itself, however, it is not the solution to the legitimacy issues raised. No votes can be taken at inter-parliamentary meetings. Democratic legitimacy for far-reaching political decisions requires a representative parliamentary assembly in which votes are taken. That is the European Parliament for decisions at European level, and national parliaments for national decisions and matters of national fiscal responsibility.

300. The challenge is thus to devise models generating legitimacy through parliaments at both levels without mixing the levels.

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[108] On this approach, see Blueprint, Section 4.

[109] See Protocol No 1 of the EU Treaties, now practised once a year in the 'parliamentary week' on the European Semester.

VIII.5.2. Legitimacy through an EU Treaty amendment procedure

301. Amendments to the EU Treaties require ratification in accordance with Member States' constitutional provisions, which provide for parliamentary approval procedures and (in some cases) referenda. This may trigger intense public discussion in the Member States and Europe-wide. Therefore, were EU Treaty changes (as identified in this report) to be launched, that process would, in itself, generate considerable legitimacy for a future DRF/P or eurobills scheme.

VIII.5.3. A possible legitimacy model for a DRF/P

302. A DRF/P would presuppose a 'grand pact' entailing considerable financial commitments from the participating Member States, pre-decided for a long period and applying quasi-automatically, far-reaching obligations for their fiscal and economic policies, and strong corresponding control and enforcement powers at the centre.

303. This would seem to require — as a first element ensuring legitimacy — a comprehensive legal instrument detailing all obligations with sufficient precision and submitted for ratification by national parliaments in accordance with their constitutional requirements. This could be achieved either by a separate international Treaty, or – for a DRF/P established under EU law – by foreseeing, in the EU Treaties, a Council act, adopted by unanimity of the euro area Member States with the consent of the European Parliament and entering in force only once ratified by each parliament of those Member States.

304. A second element ensuring legitimacy would concern the implementation and management of the DRF/P at European level over the period of its existence. It would be to entrust those implementing functions to the Commission, accountable to the European Parliament; possibly the most far-reaching decisions could also be entrusted to the Council, voting by QMV or reverse QMV (with only the MS participating in the DRF/P voting), on proposal from the Commission. This second element presupposes of course an EU legislative basis for the DRF/P to be created through Treaty change. If one opted for a purely intergovernmental approach, through a separate Treaty, then no easy solution appears available for ensuring legitimacy for far-reaching implementing decisions at European level, and for avoiding efficiency problems created by two parallel worlds of decision making.

305. There should be a third element, applying to the "consolidation agreements" imposing fiscal conditionality and structural reforms predetermined over a long period of time. Those agreements should be negotiated between the national government concerned (with a mandate from its parliament) and the Commission (accountable to the European Parliament) and, before conclusion, should be approved by the respective national parliament and by the Council.

VIII.5.4. A possible legitimacy model for eurobills

306. The legitimacy issue arises in a somewhat different form for eurobills: on the one hand, they involve only short-term (and probably, overall, more modest) financial liabilities for Member States participating in the joint issuance, but on the other hand the scheme, even if temporary at first, could open the way to permanent,

though partial, debt mutualisation (In contrast, the DRF/P is explicitly temporary, but covering a very long period).

307. This suggests that one element ensuring legitimacy could have to do with the temporary or reversable nature of the scheme: it could first be introduced by a legal act valid for a limited period (e.g. five years), after which it would automatically lapse unless renewed through appropriate democratic procedures. If EU Treaty change were not to be envisaged in the short term, one could consider doing this by a combination of an Article 352 act and an intergovernmental agreement, both limited in time, and renewal could take place in the context of Treaty change. That said, for the longer term it should be borne in mind that most of the benefits for which eurobills have been conceived would be achieved under a permanent scheme (see Chapter V above).

308. Another possible element would be allowing, within a permanent scheme, periodic consent votes by national parliaments, whether in all Member States or where required by constitutional law. For instance, a permanent eurobills scheme could involve a periodic decision (e.g. every five years) establishing the financial framework for joint issuance through a unanimous Council act (euro-area Member States only) requiring national ratification, similar to the Own Resources Decision. Further analysis would be needed to determine whether, in addition, constitutional laws might even require an annual decision by the national parliament to authorise the Member State's liabilities under a eurobill fund. While further enhancing accountability, such a system of annual decisions could also hamper efficient decision-making within the scheme. Therefore, any such scheme should involve a legally pre-determined multiannual financial framework (e.g. of five years) ensuring stability and predictability.

309. Implementing and management functions should be conferred on the Commission, accountable to the European Parliament. The most far-reaching decisions could also be entrusted to the Council, voting by QMV or reverse QMV, or even the EU legislator (EP and Council together) for a budgetary veto right[110] on a proposal from the Commission.

310. Finally, to the extent a eurobills scheme is combined with binding contractual arrangements to contain moral hazard, such arrangements should be negotiated between the national government concerned (with a mandate from its parliament) and the Commission (accountable to the European Parliament) and, before conclusion, approved by the national parliament and the Council.

VIII.5.5. Institutional adaptations to optimise democratic legitimacy at European level

311. Finally, without going in detail, one can recall the various measures set out in the 'Blueprint' and the European Parliament's resolution of 20 November 2012[111] which would optimise the democratic legitimacy and accountability at European

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[110] See Blueprint, Section 4.3, p. 38.

[111] European Parliament resolution of 20 November 2012 'Towards a genuine Economic and Monetary Union' (2012/2151(INI)).

level in EMU matters, some of them pragmatic measures that could be implemented more easily while others might require Treaty change. The former category of measures includes:

- EP involvement in the European semester and strengthening inter-parliamentary cooperation;
- Strengthening the approach of comply-or-explain (publicly) in case the Council makes changes to the Commission's economic surveillance proposals;
- Setting up a special European Parliament (sub-)committee on euro matters in charge of any scrutiny and decision-making pertaining specially to the Euro area.

312. Although much of this is more part of a general debate on the institutional future of the EU there is a link to this report. The idea of a special euro committee or subcommittee of the European Parliament might be an answer to be given to those who argue that the Parliament cannot, because of its composition, really legitimise far-reaching decisions that concern only the euro area[112]. Such a euro (sub)committee could be set up under the current legal framework. A Treaty amendment would only be required if one wanted to formally restrict its composition to MEPs elected in euro area countries, or if it is granted special decision-making powers beyond those of other European Parliament committees, i.e. a greater weight in the preparation of Parliament acts or even a possibility to take certain acts in lieu of the Plenary. Treaty amendment might also be required for a further reinforcement of the position of the Commission Vice-President for the Euro and for creating a 'special relationship of confidence and scrutiny' between him and a 'euro committee' of the European Parliament.

[112] On this issue, see e.g. K. Tuori, loc. Cit., p. 46 (speaking of 'democratic asymmetric'); see also French Council of Economic Analysis, 'Completing the Euro', April 2013, p.7.

IX. 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.