Consultation on Stability Bonds - Response of the Czech Republic

This is to respond to Consultation on Stability Bonds on behalf of the Czech Republic based on the *Green Paper on the feasibility of introducing Stability Bonds* – COM(2011)818 published by the European Commission on 23 November 2011.

The Czech Republic perceives the consultation and discussion on Stability Bonds a part of a broader discussion about potential measures to address the ongoing sovereign debt crisis in the euro-area that has had adverse effects on sovereign debt management and access to capital markets for almost all European Union Member States including those outside the euro-area. The Czech Republic welcomes such a discussion.

However, we strongly disagree with any view that might see common issuance of Stability Bonds as a sole measure that would address the ongoing sovereign debt crisis and prevent any future sovereign debt crisis. We strongly believe that, if Stability Bonds are to be implemented, they have to be set within a broad macro-economic, financial and fiscal stability framework as one of its parts and not as a corner-stone or sole saviour. We also strongly recommend to assess carefully all potential implications of implementation of Stability Bonds with an emphasis on avoiding repeating the very same mistakes that have contributed to the current sovereign debt crisis and that are closely related to building monetary union without very tight fiscal coordination or a fiscal union. Implementing common issuance of bonds without tight fiscal coordination might lead to repeating the very same sovereign debt crisis with much more severe consequences than we've experienced since spring 2010.

As the Green Paper correctly points out, "Stability Bonds must not lead to a reduction in budgetary discipline among euro-area Members States." We find this a crucial point in the whole discussion. As "the high degree of convergence in euro-area bond yields during the first decade of the euro was not, in retrospect, justified by the budgetary performance of the Member States", absolute degree of convergence in euro-area bond yields achieved by the means of common issuance of Stability Bonds would certainly not be justified by the budgetary performance of the Member States.

Therefore, very strong and tight coordination of budgetary policies of Member States would be essential (although not sufficient) condition for the Stability Bonds to contribute successfully to addressing the underlying imbalances among individual Member States. As such, not only the whole macro-economic framework within which the issuance of Stability Bonds would be set is important but so is the way how the Stability Bonds would be designed, their issuance strategy and interaction with individual Member States' issuance.

Comments on all three options envisaged in the Green Paper are as follows:

1) Full substitution of Stability Bonds for national issuance, with joint and several guarantees:

    - Such an issuance strategy would result in national bonds that would cease to be issued. In the final phase, no national issues would be outstanding on the market, and therefore no competition of the national and common issuance would occur which is a desired feature.
    - However, special attention needs to be taken with regard to a transition period when both common and national issuance would co-exist on the market. A risk

of insufficient liquidity of national bonds, as stock of these bonds would diminish over time, cannot be omitted.

- Risk of too low liquidity of the common issuance at the very beginning is rather negligible since the Stability Bonds can be issued in sufficiently large amounts from the very beginning.
- Such a scheme would result in the highest possible credit rating and the best perception of the asset among investors. AAA rating assigned to Stability Bonds under joint and several guarantees is possible. However, we do not think this can be reasonably expected. In our opinion, credit rating based on the weighted average of all Member States, presumably in the AA area, would be in our opinion more likely outcome.
- Investors' perception of the Stability Bonds would probably not be as bullet-proof as the current European benchmark, i.e. German Bund. Analogy to the EFSF bonds would be a more realistic assumption of the market perception.
- The moral hazard aspects of this scheme would be substantial and very difficult to treat in a contractual way.

2) Partial substitution of national issuance with Stability Bond issuance with joint and several guarantees:

   - Seniority of Stability Bonds to national issuance would partially eliminate the problem of higher credit quality of some Member States' national issuance which would probably contribute to increasing relative attractiveness of Stability Bonds in the eyes of investors.
   - Risk of the national issuance of the best-rated Member States competing with the Stability Bonds as the European benchmark would be lower.
   - Credit Rating Agencies might also have a more positive opinion on the credit rating of Stability Bonds with several but not joint guarantees if these were senior to national issuance.
   - However, it is important to point out that continued issuance of national bonds alongside Stability Bonds would pose significant threat for Member States with their sovereign debt level exceeding the agreed ceiling of, presumably, 60 % of GDP. The national bonds would thus be much more risky for investors depending on the volume of national issuance exceeding the ceiling.
   - Collateralization of Stability Bonds using cash, gold, shares etc. would be a way to increase attractiveness of the asset in the eyes of investors and it might also contribute to better credit rating of the bonds.

3) Partial substitution of national issuance with Stability Bond issuance with several but not joint guarantees:

   - We see no point in such a scheme. Stability Bonds would not benefit from the highest credit rating (presumably AAA) leading into not strong enough credit quality for the Stability Bonds.
   - The highest possible rating assigned to the Stability Bonds would probably be equal to some kind of weighted average of all euro-area Members States which is currently in the AA area.
   - A risk of credit rating assigned to Stability Bonds equal to the lowest-rated Member State would be substantial, though.

- From investors' point of view, Stability Bonds with several but not joint guarantees would represent substantial risk of low recovery ratio in case of sovereign default in the euro-area.
- As long as national issuance would continue alongside the issuance of Stability Bonds, there is a substantial risk that investors would prefer a national AAA-rated bond rather than Stability Bond.
- Such an issuance strategy would probably create much confusion among investors. Benefits of the common issuance would be considerably diminished when both (only) not joint guarantees and co-existing national issuance would be applied. The European government bond market would remain rather fragmented which is opposite of the goal set out in the Green Paper.

As to the possible redistribution of funding advantages between Member States as set out in the Box 2 (pp. 11), we strongly disagree with the underlying assumptions that both the higher-rated Member State and the lower-rated Member State would benefit from the lower funding costs brought about by the issuance of the Stability Bonds. We find this as a very unrealistic assumption. It would be much more realistic to expect that higher-rated Member States, i.e. fiscally sound Member States, would have to bear higher interest costs than when continuing with their national issuance.

In conclusion, the Czech Republic believes that implementation of Stability Bonds without very tight fiscal coordination and strongly enforced budgetary discipline of all Member States, i.e. some degree of fiscal union, might lead to extremely dangerous consequences. The Czech Republic finds any discussion on European common issuance, i.e. Stability Bonds, which is not closely related to discussion on rules for budgetary discipline and tight fiscal coordination, essentially pointless.