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CO-ORDINATED PUBLIC DEBT ISSUANCE IN THE EURO AREA

- REPORT OF THE GIOVANNINI GROUP–

Executive Summary

The introduction of the euro has created the conditions for a substantially more integrated euro-area public debt market. A considerable harmonisation of national market conventions has already been achieved but important differences remain in the issuance techniques and instruments of the national debt agencies. These differences are a source of market fragmentation, evidence of which is to be found in euro-area yield spreads, where some issuers are obliged to offer a premium greater than would seem to be justified by credit risk. Accordingly, greater co-ordination in debt issuance would suggest scope for efficiency gains to the extent that market fragmentation would be reduced.

The extent to which more co-ordinated debt issuance could reduce market fragmentation would depend upon the degree of co-ordination involved. The Group considered four hypotheses for tighter co-ordination in debt issuance. While not exhaustive, these hypotheses cover the spectrum of possible arrangements, ranging from a limited extension of current procedures to the most advanced form of co-ordination involving the establishment of a single benchmark issuer for the euro area as a whole. In assessing the four hypotheses, the Group distinguished between looser co-ordination arrangements which would be agreed outside the framework of the Treaty and more advanced arrangements that would be likely to require legal or institutional changes.

The views of the Group on the benefits of more co-ordinated debt issuance were mixed. Some pointed to liquidity premia and problems of deliverability into futures contracts, as evidence that decentralised issuance is a source of inefficiency in the functioning of the euro-area market. Others argued that the market is still young in terms of its functioning and that spreads are not sufficiently large or volatile to cause any great concern. Moreover, it was argued that any proposal requiring significant and time-consuming change would face scepticism in markets that are evolving so rapidly, and consequently priority should be given to the transparency and predictability of issuance and to improving the existing market infrastructure. Co-ordination involving a joint or single debt instrument was not regarded as a practical option for the euro area as a whole. However, it was agreed that such arrangements could benefit smaller Member States that have limited issuance and that are currently paying a liquidity premium on their debt.

The Group acknowledged that the pace of structural change in euro-area financial markets means that the context for assessing the merits of co-ordinated public debt issuance may change significantly in the coming years. Accordingly, there will be a need to keep the topic under review and, if necessary, to update the analysis presented in this report.

1. Introduction

1.1 The introduction of the euro on 1 January 1999 created the conditions for a substantially more integrated public debt market in the euro area. From the outset, the euro-area Member States agreed that all new issuance and outstanding stocks of their debt should be re-denominated into euro. The result was to create a euro-area public debt market that is comparable to the US Treasuries market both in terms of size and issuance volume[1]. Unlike the situation in the United States, however, issuance of public debt in the euro area is decentralised under the responsibility of 11 (soon to be 12) separate national agencies. Differences in issuance techniques and instruments between these national agencies continue to fragment the euro-area market.

1.2 There has already been a considerable harmonisation of market conventions for euro-area public debt, based on bilateral co-operation between national debt agencies and multilateral co-operation within the Brouhns Group[2]. As part of this effort, national debt agencies have also agreed to exchange information on issuance techniques and have published indicative calendars of issuance. Despite these initiatives, euro-area public debt issuance remains an essentially non co-operative activity in which issuers compete for investors. While competition in public debt issuance is a positive force for market integration, it can give rise to price distortions and to persistently less favourable terms for the relatively illiquid instruments of smaller issuers. The liquidity premium has already become a concern for smaller euro-area issuers and is likely to grow in importance as budgetary consolidation reduces the supply of public debt across the area as a whole. In light of continued market fragmentation and the associated liquidity premia paid by smaller issuers, there have been calls - echoed in the conclusions of the special Lisbon European Council - for a more co-ordinated approach to euro-area public debt issuance.

1.3 Arguments in favour of more co-ordinated public debt issuance focus on improving the efficiency of euro-area financial markets, although some investors and financial intermediaries might see their investment options and arbitrage possibilities reduced. At this stage, smaller euro-area issuers would seem to have most to gain. A more homogenous public debt market would imply greater substitutability between various euro-denominated issues and would thereby help to ease liquidity constraints in the smaller markets. For the benchmark issuers, i.e. Germany and France, the likely gains from further market integration seem more limited. It is conceivable, therefore, that measures to increase co-ordination in debt issuance could be confined to a subset of euro-area Member States.

1.4 This report examines four hypotheses for increased co-ordination in public debt issuance in the euro area, ranging from a limited extension of current procedures to the establishment of a single benchmark issuer for the euro area as a whole. As background to the analysis, Section 2 summarises recent developments in the euro-area public debt

[1] The euro-area government debt market was about € 3,200 billion in 1999, equivalent to approximately 52% of GDP.

[2] This is the Economic and Financial Committee sub-group on EU Government Bonds and Bills Markets, which is chaired by Gregoire Brouhns of the Belgian Treasury.

market focusing on the evolution of sovereign yield spreads as evidence of market fragmentation. In Section 3, the rationale for more co-ordinated debt issuance is explored and, on this basis, Section 4 presents the four progressively advanced hypotheses for co-ordination. Section 5 reports the views of the Group participants on the need for and the benefits from co-ordination.

2. Evidence of fragmentation in the euro-area government debt market

2.1 Two main parameters can serve as indicators of the remaining fragmentation in the euro-area public debt market. These are the size and structure of the market and the spreads between sovereign issuers.

- ***Size and structure:*** At the beginning of 1999, government bond markets in the three main world currencies were of roughly equal size, € 2,500-3,000 billion. If the euro-area market is disaggregated, however, it is clear that even the largest segment - the Italian market - is less than half the size of the US market. Excluding the three largest national segments (Italy, Germany and France), the remaining euro-area public debt market constitutes less than ten per cent of the US market (see Table 1). Current trends in issuance diverge sharply between the three markets. Net issuance has been falling in the United States, while there has been a slight increase in euro-area net issuance. Japan has experienced a massive increase in net issuance, making it the world's largest issuer of public debt at the beginning of 2000. These trends are likely to continue for at least the coming two to three years.

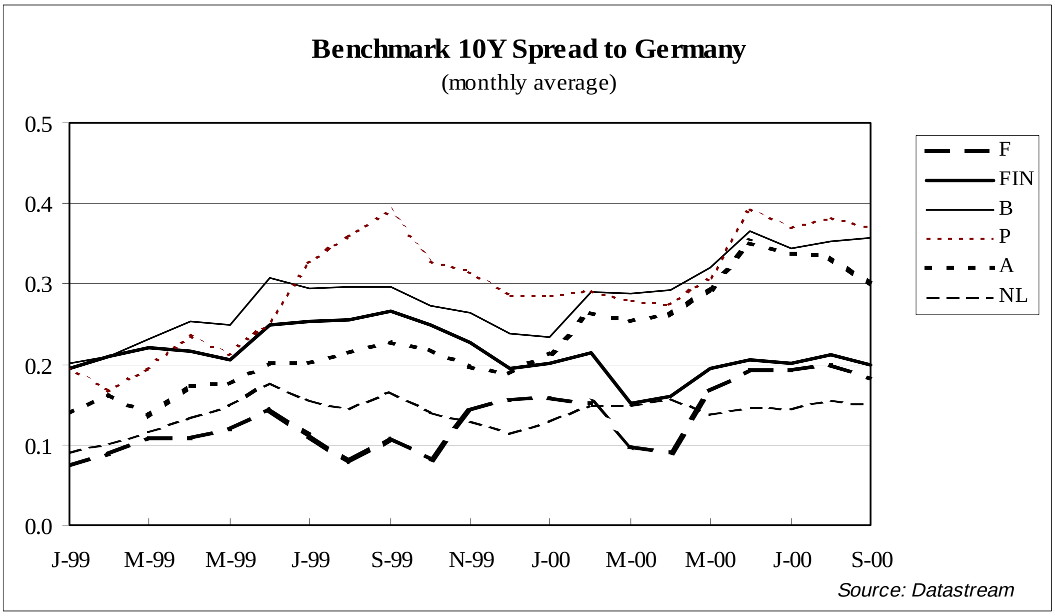
- ***Spreads between Sovereign issuers:*** A brief review of secondary market trading in the euro area supports the view that liquidity is increasingly concentrated in the very big benchmark issues. As a result, it seems that smaller euro-area Member States with limited issuing volume are obliged to offer a spread over benchmark greater than could be justified by differences in credit rating alone. On the other hand, the benchmark issuers, Germany and to some extent France, enjoy very favourable issuing terms. The impact of the perceived liquidity premium can be seen in the evolution of the spreads vis-à-vis the relevant benchmark over the last two years (see Graphs 1 and 2). As an example, Austrian and Dutch securities used to trade in a very narrow range to German government bonds (+/- 5 basis points) due mainly to the stability of the exchange rate between the three currencies. Although the introduction of the euro implies the elimination of exchange risk, the spreads between the three bonds have widened substantially (by about 20 basis points) against the two smaller issuers. In other Member States such as Finland and Ireland, the picture is more complex. These two issuers have significantly reduced the supply of securities, and the spread to the German bund has been more stable, implying that scarcity rather than liquidity has been the dominant factor.

Table 1. Size and structure of world government bond markets

Outstanding at end of year	1999	2000	*% of Total National Bond Market*	Issuance in 2000 Gross	Redem.	Net
Germany	768	793	*30*	152	127	25
Italy	928	943	*78*	145	130	15
France	711	758	*76*	90	43	47
Netherlands	174	182	*57*	26	18	8
Belgium	195	198	*70*	25	22	3
Spain	223	239	*74*	19	3	16
Austria	80	84	*54*	18	14	4
Finland	44	45	*79*	4	3	1
Portugal	36	38	*76*	9	7	2
Ireland	23	21	*73*	2	4	-2
United Kingdom	466	456	*44*	12	22	-10
Sweden	94	84	*46*	3	13	-10
Denmark	82	78	*29*	8	12	-4
Euro area	3182	3301	*46*	490	371	119
EU	3824	3919	*44*	513	418	95
US	2460	2310	*15*	130	280	-150
Japan	2795	3465	*73*	700	30	670

Note: Amounts in € bn. For Japan, end of fiscal year, March
Source: European Commission, Merrill Lynch.

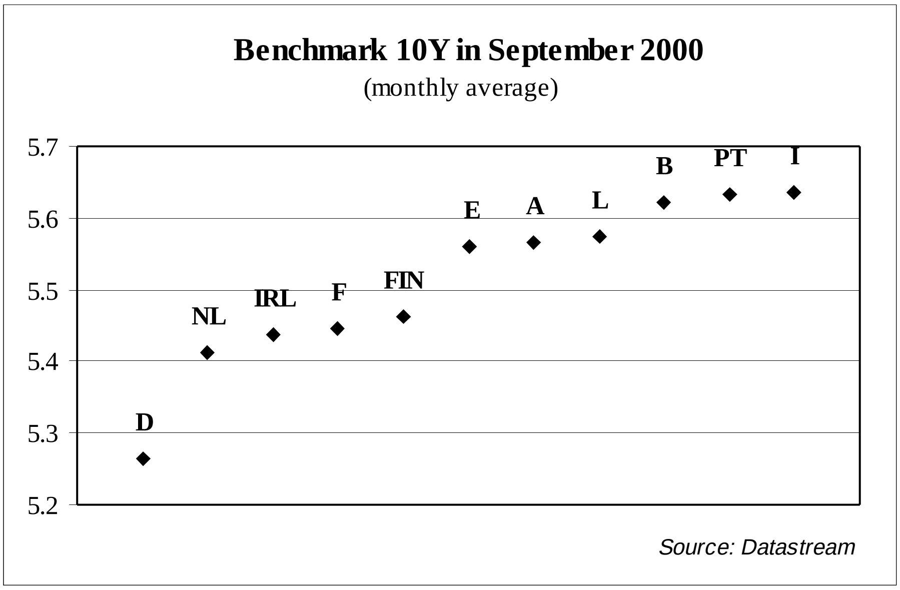
Graph 1. Sovereign yield spreads in bps, Jan 1999 - September 2000



Smaller Member States with limited financing needs have also seen increased competition from non-sovereign borrowers such as large corporate and pfandbriefe issuers. On a few occasions, corporate multi-currency bond issues have totalled €10 to

€15 billion with over €3 billion raised in euro. Some Jumbo Pfandbriefe issues reach € 3 to € 5 billion in outstanding amount in a continuous fashion that closely resembles the borrowing practice of governments. Freddie Mac, the US Federal Mortgage Agency, has recently implemented plans to issue €5 billion of euro-denominated reference notes on a quarterly basis.

Graph 2. Sovereign yield spreads in bps, September 2000



3. Rationale for more co-ordinated issuance of euro-area public debt.

3.1 The rationale for more co-ordinated issuance of euro-area public debt derives from a view that the current decentralised approach is an obstacle to full market integration. The persistence of significant yield spreads between euro-area sovereign issuers with highly comparable credit standing has been cited as evidence of market fragmentation due to national differences in instruments, primary issuance techniques and liquidity. By addressing these sources of fragmentation, it has been argued that the non credit-risk components of euro-area yield spreads could be substantially reduced.

3.2 While allowing for differences in Member States' perceptions, a number of general arguments can be made in favour of more co-ordinated public debt issuance in the euro area. These are:

- Market fragmentation would be reduced to the extent that co-ordination went beyond current arrangements to include harmonisation of issuing techniques, standards, procedures and regulations. Harmonisation in these areas would tend to increase the homogeneity of euro-denominated public debt and thereby improve market liquidity.

- Co-ordination based on a common issuing calendar would avoid inefficiencies arising from competition among issuers, e.g. a tendency toward more discretionary issuance so as to avail of temporary improvements in market liquidity. A single issuing calendar would also benefit investors by ensuring steadier and more predictable supply conditions, thereby minimising the risk of market distortions due to uncertainty and/or clashes in the timing of issuance.

- More advanced co-ordination based on some form of joint issuance would substantially improve market integration, while creating scope for larger volume issues. Larger issue sizes would enhance liquidity in the cash market and would widen the potential to establish area-wide benchmarks along the yield curve.

- The larger and more liquid debt issues facilitated by co-ordination based on joint issuance would improve the possibilities of delivery into actively traded futures contracts. By allowing more active interest risk management, successful futures contracts would further enhance liquidity in the cash market in a mutually reinforcing process.

The common theme in these arguments is that co-ordination offers efficiency gains by creating a more homogenous public debt market that would imply greater substitutability between various euro-denominated issues and would thereby help to ease liquidity constraints, particularly for smaller issuers.

4. Some hypotheses for co-ordination of euro-area government debt issuance

4.1 The extent to which more co-ordinated issuance of euro-area public debt can reduce market fragmentation and increase liquidity will, of course, depend upon the degree of co-ordination involved. In this section, a set of four hypotheses for intensified co-ordination is considered. The set of hypotheses is not meant to be exhaustive but spans the range of possible co-ordination arrangements, i.e. from relatively loose co-ordination on technical issues to a very advanced form of co-operation involving a single debt issuer and single debt instrument for the euro area.

Hypothesis 1: Co-ordination on technical aspects of debt issuance

4.2 There is already limited co-ordination between national debt agencies in the euro area in the form of bilateral and multilateral exchanges of information on issuance techniques, instruments and issuing calendars. It is difficult to assess the extent to which these arrangements have reduced market fragmentation. However, current euro-area yield spreads would suggest that there is scope to develop further co-ordination on technical aspects of debt issuance for some or all of the Member States. In more developed form, this type of co-ordination could be extended to include agreement on:

- a common issuance calendar to improve efficiency in market supply;
- identical coupon and maturity dates to allow greater comparability between different national issues;
- a common primary dealership system, including similar or overlapping membership, standard terms of remuneration and identical quote sizes, bid/ask spreads; and

- a common real-time clearing and settlement system that ensures a uniform processing of completed transactions thereby facilitating the management of cross-border sales and purchases.

4.3 The extent to which increased co-ordination on these technical matters would improve the overall liquidity of euro-area public debt is unclear. However, the smaller euro-area issuers could gain substantially in terms of liquidity, resulting in a compression of euro-area yield spreads. The compression of spreads would also depend on the evolution of other spread components such as the derivatives premium. Development of a successful multi-deliverable futures contract among the participating issuers might be possible, although the issuers would need to be broadly of the same credit quality with the basis risk in the contract being influenced by changes in their perceived credit standing. If one issuer were to have a systematically lower credit standing, the futures contract would be likely to become a single deliverable contract.

Hypothesis 2: Creation of a joint debt instrument with several country-specific tranches

4.4 A second hypothesis for co-ordination in public debt issuance would involve not only common issuance terms and conditions but also a joint debt instrument underpinned by the *several* guarantees of the participants. Guarantees of a several nature would mean that each participant guarantees only its portion (or tranche) of the joint instrument, turning each tranche into an individually distinguishable legal object. As with hypothesis 1, this type of arrangement would appeal mainly to smaller issuers but would probably have a greater effect in reducing yield spreads because the joint instrument would imply greater liquidity. Development of an active futures contract would be facilitated by the use of a joint instrument, so long as issuance were of sufficient volume and regularity to maintain the necessary liquidity in the underlying cash market. The absence of a joint guarantee should ensure no change in the credit risk premium faced individually by the participant issuers, although the credit component of the spread on the joint instrument would be likely to emerge as an average of the issuers' credit spreads.

4.5 A possible approach to this type of issuance would be for a group of (smaller) Member States to issue instruments under a common title but with each instrument guaranteed by the issuing Member State. To create market liquidity, the instruments issued under common title would need to have identical characteristics, e.g. coupons and maturity, and the participant issuers would need to have identical credit ratings, probably AAA. The participant issuers could then agree to re-open issues as they each required. Investors would choose either to buy the instruments in generic form, i.e. under the common title, or they could specify a particular Member State instrument. The intention would be to induce investors to value each Member State instrument more clearly and to emphasise their substitutability. A potential problem would be the small size and limited frequency of issuance under the common title due to the relatively modest borrowing requirements of the smaller Member States with AAA credit rating. However, this problem might be overcome by enriching the issue with an exchange programme or by issuing with identical characteristics to the instrument of a more liquid issuer. The main attractions of this approach would be the possibility of replication in issuance and the fact that the success of the instrument would be decided on the basis of a market assessment.

Hypothesis 3: Creation of a single euro-area debt instrument backed by joint guarantees

4.6 A third hypothesis for co-ordination in public debt issuance would again involve the creation of a single debt instrument, but backed by the *joint and several* guarantees of participating issuers. Unlike in hypothesis 2, guarantees of a joint and several nature mean that each participant guarantees the totality of the obligations of the joint instrument, thereby making it an indivisible legal object. This would give an investor legal recourse to all the participating issuers, in the case that not all the obligations under the terms and conditions of the single debt instrument have been fully met. The single instrument would facilitate a reduction in liquidity premia and derivatives premia to the extent that issues were sufficiently large and regular and to the extent that there would be delivery into an actively traded futures contract. In this arrangement, however, the cross-default nature of the guarantees would be likely to have an effect on credit spreads if the participant issuers were of different standings. Legal certainty on the structure and nature of the guarantees would be essential to sustain this form of co-ordination.

4.7 The relatively advanced form of co-ordination implied by a jointly backed single debt instrument would hold out the prospect of securing a substantial reduction in euro-area yield spreads. On the other hand, the implementation of such an arrangement would be complex for a variety of legal and technical reasons. For example, the cross-default element would need to be made consistent with the Treaty provisions on fiscal discipline, particularly Article 103 which prohibits Member States from being liable for or assuming the commitments of other Member States. Second, the joint guarantee would need to be carefully structured so as not to violate the covenants in existing bond prospectuses and loan agreements. Third, the institutional arrangements needed for issuance of the single instrument – for example, the creation of a body responsible for such issuance - would require special attention. Fourth, the set of participating issuers would probably need to be closed so as to ensure the comparability of different issues over time, thereby precluding any extension of participation in the arrangement over time.

Hypothesis 4: Borrowing by a Community institution for on lending to euro-area Member States.

4. 8 A fourth hypothesis for co-ordination in euro-area public debt issuance would involve borrowing by a Community institution for on-lending to Member States.[3] A

[3] An idea of this type was proposed by former Commissioner de Silguy in a speech to the Corporation of London in July 1999.

precedent for such an arrangement exists in that the European Commission borrows on capital markets to fund, for example, its balance of payments facility and to finance programmes of financial assistance for third countries. These borrowings have a AAA rating on the basis of a joint and several guarantee of the 15 Member States (which in turn derives from their Treaty obligations). Clearly, however, an arrangement under which all or a part of the borrowing of euro-area Member States were to be conducted via a Community institution would be materially different from existing activities in terms of the volume of borrowing and the permanence of the borrowing programme.

4.9 The sustainability of a Community guarantee of this type would, as a minimum, necessitate strict adherence by individual participants to the limits on deficits and debts laid down in the Treaty and elaborated in the Stability and Growth Pact. Unlike in hypothesis 3, participation in this arrangement could be extended over time since the comparability of different issues would not be affected. To create benchmark issues, the Community institution responsible for issuance would need to issue at a limited set of maturities and on the basis of a pre-announced calendar to reach targets for size and liquidity as well as the desired level of transparency. For reasons of efficiency, it would seem desirable to avoid issuing debt each time a participating Member State required funding at a particular maturity. Also, a situation should be avoided where the Community institution would be required to hold money and assume substantial interest rate risk (or be highly active in swaps and futures markets to manage that risk). To ensure stable and predictable issuance by the Community institution, a substantial part of the borrowing requirements of the participating Member States would have to be covered by such an arrangement.

4.10 The creation of a new Community institution for debt issuance could be time consuming and might even require a Treaty amendment. Moreover, the new institution would issue on behalf of the Community as a whole so that non-participating Member States (and even non euro-area Member States) would be required to guarantee the debt of the participating Member States. The net result could be a deterioration in the borrowing terms for non-participant Member States with relatively high credit ratings particularly if they were cross-guaranteeing the debt of participant Member States with lower credit ratings. As in hypothesis 3, the compatibility of this arrangement with the Treaty provisions on fiscal discipline would need to be addressed.

5. Assessment and views of the Group

5.1 While there was recognition within the Group that the market for euro-area public debt remains fragmented, views on the benefits of more co-ordinated debt issuance were mixed. Some members argued that imperfections in the functioning of the market, such as lack of liquidity and problems with deliverability into futures contracts, could be linked to the current structure of decentralised issuance. Among the factors seen as pointing in this direction were (i) the persistent out-performance of some sovereign issues relative to others with identical credit rating; (ii) the appearance of three distinct segments in the euro-area market in terms of spread between issuers; (iii) the persistent home bias among investors in the euro area (except Germany); and (iv) non-EU investors' preference for particular sovereign issues. In light of these factors, there was some sympathy for the argument that some issuers might benefit from more co-ordinated debt issuance.

5.2 Others argued that it is too early to make a definite judgement on the longer-term functioning of the euro-area public debt market. In view of the time required to rollover a bond portfolio, it could be several years before investors can act in an unconstrained manner in the market. Meanwhile, tax and accounting implications from the "pre-EMU" period could also be a distorting factor in the market. On this basis, there was a view that existing arrangements for co-ordination were broadly adequate and that any changes would need to be undertaken with caution. It was noted that no major conflict in the calendars of issuers has been experienced to date and that most issuers have become more transparent and predictable in their issuance policies. While market inefficiencies clearly exist, e.g. linked to difficulties with clearing and settlement and with differences in regulatory environment, these could be solved more directly rather than by measures to centralise debt issuance. Similarly, problems in the futures market with an insufficient pool of deliverable securities could be addressed directly by restructuring the way contracts are settled in the direction of cash settlement or settlement against an index of bonds.

5.3 As the Group examined the four hypotheses for more co-ordinated debt issuance, it was noted that arrangements under hypotheses 1 and 2 differ qualitatively from those under hypotheses 3 and 4. Arrangements under the first two hypotheses would be on a strictly intergovernmental basis. As these would be agreed outside the framework of the Treaty, no change either in Community legislation or institutional infrastructure would be needed. While participating issuers would be required to abide by common rules on technical issues, there would be no cross-guarantees of debt issued by the participants. Consequently the credit risk of individual issuers would not be affected. On the other hand, the credibility of these looser forms of co-ordination would reflect their vulnerability to the eventual termination of such schemes.

5.4 The co-ordination arrangements under hypotheses 3 and 4 would involve a cross-guarantee of the debt issued. Although the scope for further market integration would be greater in these more advanced forms of co-ordination and the possibility of large, liquid and predictable issues based on one issuing calendar would facilitate the emergence of benchmark debt instruments, issuance would have to be based on a timetable established by the issuing entity in close co-operation with the Member States. The credit rating of all participating Member States would be merged both in contractual terms and in terms of financial market perception. If a Community institution were to become the single issuer, the question of non-participating Member States which would de facto cross guarantee the debt of the participating Member States would have to be addressed. This raises legal and institutional aspects that go beyond the scope of this report.

5.5 Co-ordinated debt issuance was seen as most attractive for the smaller issuers and there was a relatively detailed discussion of the possibilities for joint issuance by the relevant Member States. For joint issuance to be successful in boosting liquidity in the cash market and in allowing deliverability into an actively traded futures contract, single issues of between € 15 billion and € 20 billion would be required on a regular basis. It was felt that most (if not all) of the smaller Member States would need to participate in the joint issuance to ensure the necessary size and regularity in issuance. Without wide participation, it could take too long to build up liquidity in any jointly issued instrument, given differences in maturity profiles among the participants and other constraints.

5.6 In terms of narrowing of spreads, there was scepticism about the scale of benefits to be derived from increased co-ordination in debt issuance, even for the smaller issuers. As euro-area yield spreads have remained below 50 basis points for 10-year maturities, savings from compression of spreads would be relatively modest. These savings would be further reduced to the extent that they were achieved at the cost of an increase in the yields of larger issuers. Moreover, it was argued that yield spreads might not be susceptible to complete elimination, even between issuers of identical credit rating. To the extent that bonds are used for collateral purposes, they can become “special” in repo transactions. Tax effects can also be important in this context.

5.7 The advantages of creating a single euro-area debt instrument that could successfully compete for funds on the global capital market in competition with US Treasuries and JGBs were acknowledged in principle. It was also agreed that the euro-area market could benefit from the establishment of a clear "benchmark" issuer, e.g. through facilitated pricing of non-sovereign issuance and the creation of a homogeneous euro yield curve. However, there was a broad consensus that there would be difficulties associated with such far-reaching co-ordination that are of a nature which go beyond the remit of the Group. In this context, it was argued that any proposal requiring significant and time-consuming change would face scepticism in markets that are evolving so rapidly.

5.8 The Group also drew attention to an important caveat to these findings: financial markets are experiencing significant changes as a result of globalisation, structural change, deregulation and, of course, the impact of the euro itself. Any analysis therefore risks being by-passed by events. While they go beyond the scope of this report, the Group noted several relevant developments. Concerning the role of government issues as benchmarks, for example, the development of non-public debt markets and the decline in the share of government issuance in total debt issuance have important implications. Debt issues of US institutions such as Fannie Mae and Freddie Mac, or European Pfandbriefe, to the extent that they have characteristics similar to those of government issues, may eventually act as substitutes for government debt and obtain benchmark status. The US swap market has indeed already become a benchmark for pricing corporate debt. In the secondary markets, the development of electronic trading systems has important implications for liquidity and has already led to changes in issuing strategies and techniques.