Response to the EU Consultation Green Paper on the

THE FEASIBILITY OF INTRODUCING “STABILITY BONDS”

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Section I – Preliminary considerations

When addressing the question of the feasibility of introducing "Stability Bonds" as defined in the Green Paper ("GP"), a number of preliminary questions need to be answered which seem to have been overlooked in the description of the "rational and preconditions" enumerated in the introduction (**GP, p. 3-8)**. These questions concern mainly: the timing of the consultation, a closer look at the objectives, the expectations of the "market" (investors) and structural issues such as the role of the ECB within such a context.

We strongly believe that building a consensus on these matters, as a precondition for assessing the feasibility of introducing Stability Bonds, will considerably simplify the evaluation process by eliminating, ex ante, number of the proposals that have been circulating, which should prove to be incompatible with the objectives as defined.

Timing

It appears extremely difficult to dissociate an objective assessment of "Stability Bond" issuance from the current context of the heightened "sovereign debt" crisis. Indeed, the framework of an integrated market for common issuance of sovereign debt must be considered as a "long term" project capable of resilience under a variety of economic scenarios which must include periods of recession, economic expansion, higher or lower inflation or interest rates, etc. Even if it is essential that the prevailing exceptionally stressful environment should be manageable within the chosen framework, it would, nevertheless, be mistaken, to use it as the only benchmark against which the most effective long term structural choices are selected.

Objectives

The GP mentions (**GP, Rationale 1.2, p.5**) the shift from an approach assessing:

> "The benefits of enhanced market efficiency through enhanced liquidity in euro-area sovereign bond market and the wider euro-area financial system toward crisis management and stability aspects."

To the extent that the crisis has made the question of Stability Bonds even more relevant and more urgent than heretofore, it would be a major error to believe that the original aims deserve to be compromised as a trade off in order to achieve these more recent additional objectives. The stated aims of creating a large liquid market of "risk free" securities (**GP, improving market efficiency p. 6**), capable of providing a credible investment alternative to US Treasury securities, should be the touchstone against which any of the alternatives discussed in the GP should be "benchmarked".

In particular, the concept of "*risk free investment*" is considered in the GP mainly in terms of liquidity/solvency as broadly measured through the "Rating" mechanism, totally overlooking the key aspect of "monetary sovereignty". Indulging in a highly complex statistical comparison (**GP, box p. 7-8**) between USD and Euro denominated sovereign bonds, issued since 1999, to draw conclusions on "liquidity and solvency premiums" is a largely meaningless exercise. Indeed it compares an issuer (the USA) having access to a lender of last resort (the Federal Reserve Bank) with a series of issuers (Eurozone Members) which have no such access. If on the one hand investors in UST securities are exposed to interest rate and inflation risks (and additional FX risk for foreign investors), they are, however, immune to "solvency" risk (if one does not take into account the risk of Congress refusing to increase the debt ceiling as needed). On the other hand, investors in Euro denominated EMU sovereign bonds are fully exposed to the "solvency" risk of the individual issuers – **as long as the ECB is not empowered with full "lender of last resort" status, accountable to a single democratic and legitimate political authority –** as well as FX risk in case of a Eurozone break up. Indeed, the reintroduction of national currencies would explicit the imbedded FX risk exposure and further accentuate the risk of insolvency of Eurozone issuers.

Expectations

The GP appears to give far more weight the presumed objectives and/or constraints of the "Issuers/Guarantors" than satisfying equally legitimate interests and concerns of investors. This may be the result of a subconscious bias which takes into account what the authors of the consultation believe to be pragmatic limits to the "transfers of sovereignty" implied by the issuance of Stability Bonds. The occurrence of the crisis, that has exacerbated the perception of "risk" associated with sovereign issuance, only reinforces the obligation to tailor the structure of Stability Bonds to the requirements of investors. Indeed, if a gradual approach might have been considered feasible in more "normal times", the crisis imposes that the chosen structure offers, from its inception, all the characteristics needed to weather the extremely stressful conditions currently prevailing as well as remaining efficient over the longer term.

In order to attract a maximum amount of investor interest (needed to refinance the considerable amount of maturing debt on acceptable terms), particular attention must be given to a series of characteristics. These include:

- The transparency, simplicity and strength of the credit structure (guarantee mechanism) of the Stability Bonds.
- The Bonds status relative to comparable "sovereign" instruments.
- The resilience of the technical mechanisms that ensure punctual servicing of principal and interest payments.
- The market characteristics in terms of liquidity, fungibility, eligibility as collateral, etc.[1]

It is therefore essential to strike an appropriate balance between the legitimate interests of the Sovereign Issuers/Guarantors, representing the "citizens/taxpayers" and those of investors providing the funds.

Structural issues

It has become quite obvious that the issuance of Stability Bonds is only conceivable within the framework of a further significant integration of EMU Members economic and budgetary policies. Such integration, with appropriate regulatory supervision as well as effective enforcement mechanisms, has already been initiated by the Commission in its recent proposals on reinforced surveillance, made public simultaneously with the GP and should be reinforced by the Treaty change proposals to be submitted jointly by France and Germany prior to the next EU summit on December 9th.

Enacting rapidly these proposals is essential to provide an appropriate underpinning to the necessary extension/revision of the ECB's mandate, so that it is able to exercise the full prerogatives of a Central Bank. These include acting as lender of last resort (to financial markets rather than to governments) as well as conducting an independent "foreign exchange" policy in the interests of all Eurozone Members.

For the reasons exposed here above, it is only when the Eurozone will be endowed with a Central Bank exercising full sovereign powers in its area of competence that the necessary conditions will exist to implement a full program of Stability Bonds having characteristics – in particular in relation to the key question of "solvency" – comparable to the US Treasury market. This should remain a key long term objective of any proposal.

In the following section, we outline a specific proposal for structuring "Stability Bonds" which takes into account, the questions raised in this first section. It is very largely based on an earlier study proposed in

[1] These characteristics are discussed in more detail in Section II hereunder.

January 2011 by the Thomas More Institute[2] updated to consider more recent developments.

Section II – Proposal concerning the establishment of a permanent European Crisis Management Mechanism and the issuance of "Stability Bonds"

The recent significant aggravation of the "sovereign risk" crisis imposes that any proposal for the long term issuance of "Stability Bonds" be also adapted to serve the purposes of a Permanent European Crisis Management Mechanism. We have therefore chosen, for clarity's sake, to address first the more complex question of issuance by Member States facing financial difficulties and thereafter examine how such a system could be made more "flexible" when extended to issuance of Stability Bonds by Member States in the ordinary course of Sovereign Debt management.

In the outline hereunder, there has been a deliberate attempt to reconcile considerations of a "political" nature, many of which are referred to in the GP, aimed at protecting EU citizens/taxpayers, with the objective constraints imposed by the workings of financial markets, including the protection of legitimate investor interests.

The need to establish a Permanent Crisis Management Mechanism surfaced when it became clear, in the light of the Irish and subsequent Portuguese crisis, that the measures decided in the spring of 2010 – in particular the creation of the European Financial Stability Fund ("EFSF") – were proving totally inadequate to alleviate the fears of investors. Followed the initiation of a vicious circle in which questions relating to the solvency of additional EMU members and/or their respective banking sectors (Spain, Italy) and more recently affecting Belgium and even France, has raised the spectre of the implosion of EMU which, for the first time, has become a realistic concern. This development raised, in turn, the question of the survival of the single currency and implicitly that of the ultimate survival of the EU itself.

However, there can be no doubt that the economic and financial foundations of the Euro as a "currency", as well as those concerning EMU area as a whole, are strong, particularly when compared to those of the United States, the United Kingdom or Japan, three major economies which remain, however, in full control of their "monetary" sovereignty. Even if in terms of budgetary deficits or public indebtedness the EMU "aggregates" should not worry excessively financial markets, too little attention has been given to the fact that by pooling their monetary sovereignty, EMU countries have created a situation in which the economic as well as legal position of their respective "national debt" in relation to their "national sovereignty" has been profoundly altered. Markets have been prompt to distinguish between countries who retain control over their respective monetary policies and their own national currencies and EMU members which, having abandoned their monetary sovereignty, have also lost the political and financial control over the "foreign" currency (the Euro) that they have decided to use in common.

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[2] Paul Goldschmidt, *The establishment of a permanent European Crisis Management Mechanism and the issuance of "Euro Bonds" : proposals for two distinct but complementary issues*, Thomas More Institute, January 10th 2011, available on http://www.institut-thomas-more.org/en/actualite/the-establishment-of-a-permanent-european-crisis-management-mechanism-and-the-issuance-of-euro-bonds-proposals-for-two-distinct-but-complementary-issues.html.

A. permanent European Crisis Management Mechanism

A first question concerns the need for such a mechanism. It is clearly the fundamental role played by the local "currency" in any market economy that commands that this essential "transmission mechanism" be soundly and prudently managed in the interests of each and every of its users; as far as the Euro is concerned, it is a matter of the "pari passu" interests of the 330 million citizens of EMU's 17 member States.

While the ECB has successfully preserved the "value" of the Euro in terms of "purchasing power" by controlling "price stability" within the Eurozone in conformity with its mandate, it is, however, totally outside of its current remit and ability to influence a series of other parameters (such as levels of indebtedness, budget deficits or competitivity) whose disequilibria, either internal or cross border, can weigh heavily on the solvency individual EMU member States.

It follows that, in the absence of a credible mechanism, capable of restoring confidence in the public debt securities of EMU participants (so as to make them comparable to the trust benefitting other public issuers), financial markets will be prone to penalise the weaker issuers, compromising their ability to access markets and thus their solvency.

Default by an EMU Government does not necessarily lead to the implosion of EMU and the disappearance of the Euro but such a development can only be avoided to the extent that the prevention of "contagion" remains **firmly under control**. However, sharing the same currency and belonging to the EU "single market" has created an extremely dense interdependent network linking EMU members to their respective banking sectors (that are closely tied through their reciprocal financing needs) as well as within the entire EMU banking sector itself, as was demonstrated in the Irish crisis. A "sovereign" default increases dramatically the "**systemic**" risk of contagion which should render the mere consideration of such a scenario totally unacceptable for all EMU members. Furthermore a "programmed" exit from EMU – be it by its strongest or weaker members – would create systemic risks of a similar nature which forbid its implementation.

Proof of the absolute need for setting up a permanent intervention mechanism is therefore unquestionable. Let us now turn to examine the characteristics that need to be embedded in such a system.

There are three separate aspects that must be distinguished concerning the credibility of the mechanism:

- **The financial credibility of the "Borrower", responsible for the primary funding, which ensures the interface with investors (the market).** Its solvency must be beyond question which implies that it is totally independent from the final Beneficiary which – by definition – is in a precarious situation. In addition, its securities must *necessarily* benefit from the highest rating, so that, in the eyes of the market, the Borrower's securities will integrate the highest standards of acceptability, benefit from a liquid secondary market and be acceptable as collateral by the ECB.

- **The credibility of the structure framing the on-lending by the Borrower to the final Beneficiary**. This concerns the "conditionality" appended to the loans and the accompanying surveillance mechanism as well as the specific financial conditions pertaining to each drawdown. Its main purpose is to reassure the (direct/indirect) guarantors of the loans who would be called upon in the event of default of the Beneficiary.

- **The credibility of the arrangements by which the Borrower can fund itself in the event of default of the financial Beneficiary.** This entails a "political" negotiation which establishes in which form the solidarity between EMU members is organised in the event one of them defaults.

Let us outline how it is possible to conceive of a system which would articulate in a coherent manner the requirements described here above.

1) As far as the financial credibility of the Borrower is concerned, the most elegant and ideal solution is to transform the existent EFSF/ESM into a fully fledged EU "Debt Agency" benefitting of its unconditional "Budgetary Guarantee".

Such a structure would meet all the requirements outlined here above from the standpoint of market acceptability of the Borrower's securities as it provides – "by construction" – the **joint and several guarantee** of all 27 EU member States. This solution offers the advantages of simplicity and transparency and, in addition, avoids any need for a Treaty change. It implies however amending the "financial perspectives" which will have to provide for an adequate and revisable debt ceiling.

The proposal does, however, create an important "political" problem insofar as it transgresses two taboos that have been partially responsible for the unsatisfactory structures currently in place. The first of these taboos concerns the transformation of the *several* guarantees provided to the ESFS by EMU members into *joint and several* guarantees, move that has been always strongly resisted by Germany. The second would be to enlist the guarantee of all EU Members for a mechanism which, at least initially, is meant for the benefit of EMU members only and which should, on that count alone, provoke considerable opposition, in particular from the United Kingdom.

Without underestimating these difficulties, it should be possible to significantly reduce their impact through the appropriate structuring of the two complementary aspects, referred to hereunder, which ensure the credibility of the mechanism as a whole.

2) As far as the credibility of the structure of the "on-lending" by the Borrower to the Beneficiary, the "conditionality", based on the criteria imposed by the EU (and the IMF), should be complemented, on each drawdown, by the issuance by the Beneficiary for the benefit of the Borrower of "serial covered bonds" corresponding to the debt service of the loan.

The basic idea is that the additional security provided by the "covered bond" structure, derived from the pledging of specific resources of the Beneficiary to ensure the punctual servicing of the debt, would constitute an important assurance for the guarantors and reduce commensurately the risk of being called under their guarantee. In exchange for the additional security provided by the Beneficiary, the financial conditions of each drawdown would be identical to those obtained in the market by the Borrower (with the possibility of adding a de minimus 0.05% servicing fee) reducing considerably the financing costs of the Beneficiary compared with the current conditions of EFSF funded loans.

3) As far as the mechanism through which the Borrower funds itself in the event of a default by the Beneficiary, it is suggested that the ECB be authorised to "purchase" at face value the covered bonds held by the Borrower on the eve of their respective maturities. This would allow the Borrower to meet, whatever the circumstances, its obligations towards its own bondholders (and extinguish any EU budget guarantee obligations).

Within such a mechanism, EMU members would be asked transfer their current guarantee in favour of the EFSF to the exclusive benefit of the ECB (separately from their implicit *joint* guarantee given to the EU budget). It would be perfectly possible to maintain at this level a structure of "*several*" guarantees limiting, for each EMU member, his commitment to his quota (with or without the need for a 20% enhancement) as it would not affect the perception by investors (or rating agencies) of the soundness of the securities issued by the Borrower.

If this structure was implemented, it should be complemented by an agreement covering the interventions of the ECB in the public debt markets of its shareholders which is, at present, the centre of intense discussions: for instance, the ECB could refrain from any intervention in the market of its Member's national debt securities in the event that the Member had recourse to the Stabilisation Mechanism. Indeed, because the ECB would be contractually committed to acquire the "covered bonds" pledged to the Borrower on the eve of their maturity, it would be prudent to limit the Central Bank's balance sheet exposure to these issuers.

A further requirement (to be compulsorily included in the loan conditionality) would be that, in exchange for the ECB's contractual obligation to acquire the covered bonds as described, the National Central Bank of the Beneficiary (a member of the European System of Central Banks) would be charged with the supervision of the security attached to the issuance of the covered bonds, providing additional assurance to the ECB of the punctual servicing of the related debt.

B) General issuance of "Stability Bonds"

The scheme described here above meets largely the criteria deemed necessary to ensure the long term credibility of the mechanism in the eyes of the market; it would also contribute to the creation of a more stable environment for EMU and the Euro.

Viewed in this light, it is possible to envisage broadening the scope of the mechanism in order to provide answers to two additional important objectives: the first aims at providing a suitable justification for the participation in the scheme of non EMU members; the second at creating a broad market for EU securities (Stability Bonds), providing all EU Members with access to a competitive financial instrument comparable to the US Treasury Securities market.

1) Justification for the participation of non EMU members

In exchange for their joint and several guarantee given to the budget and stemming directly from the Treaty itself, one could envisage that all EU Member States would be given access to funding of their respective national debt through the European Agency for Debt Issuance on an equal footing with EMU members. If a country availed itself of this privilege, it would assume its corresponding share of the guarantee mechanism benefitting the ECB; its National Central Bank would be responsible for the supervision of the collateral securing the "covered bonds" pledged to the Borrower within the framework of the loan conditionality.

2) Establishment of a broad market for EU public debt securities (Stability Bonds)

The GP aims at establishing a long term deep and liquid market for securities representative of the EU's largely underused borrowing capacity, which is meant to operate under normal market conditions.

These securities, referred to in the past in general and somewhat ambiguous terms as "Euro Bonds or Eurobonds", have been the subject of various schemes, some of which have been developed in considerable detail. However, because of extensive doubts concerning their practical feasibility, none have been able to galvanise so far sufficient "political" support. The GP aims at starting the process of a detailed preliminary assessment of the feasibility of such a scheme, a necessary precondition to implementation. To clarify the subject, it has regrouped most of these schemes in three categories, differentiated in terms of the proposed guarantee mechanism (joint and several or only several) and in terms of scope (replacing all or only part of an EMU Member's sovereign debt requirements).

Starting from the outline applicable to the Crisis Management Mechanism, described here above, one could consider extending the mandate of the EU Debt Agency (the Borrower) to allow for the funding of Member States within the "*ordinary*" task of managing their respective national public debts. While the "*stabilisation*" mandate of the Agency would be exercised as outlined in Section II-A, its mandate as an "*ordinary*" Borrower would be subject to significantly greater flexibility as described hereunder.

Let us revisit the three aspects that ensure the credibility of the mechanism in the light of this new objective.

1) There are no changes required concerning the structure of the Borrower which must retain the benefit – for all its operations –of an EU Budget Guarantee.

This is necessary in order to ensure that its securities benefit from a stable guarantee mechanism as well as being fungible, providing investors with adequate liquidity and benefitting from the broadest market acceptance.

2) Regarding the structure of the on-lending from the Borrower to the Beneficiary, conditionality would be a function of respecting a series or criteria derived from the Commission proposals updating the Stability and Growth Pact (SGP), implementing the "European Semester", the "Six Pack" as well as the more recent proposals reinforcing economic and budgetary surveillance, including – if implemented – new obligations resulting from future Treaty changes.

The criteria would relate to a series of objective "indicators" concerning the budget deficit, the level of indebtedness(public and private), other economic imbalances (competitivity) who's appropriate articulation would provide "mechanically" an "EU Rating" graduated from 1 to 3. This rating would apply to the Beneficiary's entire extant debt and would be updated on a regular basis, at least annually, during the European Semester exercise.

- **A "1" Rating** would require meeting more stringent conditions (to be defined) than the pure and simple compliance with the minimum acceptable level of agreed indicators. It would allow the Beneficiary to dispense with any specific loan conditionality. It would nevertheless be subject to the obligation of pledging debt securities whose value at maturity corresponds to its debt servicing obligations. This pledge would become subject to "enhancement" in the form of providing "cover" in case of a downgrade of the **EU rating**. In such a case, the Beneficiary would have the option to prepay his loan (subject only to a penalty covering possible reinvestment losses by the Borrower).

- **A "2" Rating** would be assigned to a Beneficiary meeting all the minimum levels of agreed indicators. The only conditionality attached to the loan would be the pledge of serial covered bonds to the Borrower in order to guarantee the punctual servicing of the debt.

- **A "3" Rating** would apply to the outstanding debt of a Beneficiary that would be the subject of recommendations, procedures or sanctions envisaged within the framework of the European Semester. The entire procedure described here above for execution of the Agency's "*stabilisation*" mandate would apply, including conditionality required by the EU (and IMF).

Such a Rating system, if applied objectively (the applied methodology should be made public) and without any political interference, could serve as a way to reduce significantly the market impact of rating changes by private Agencies.

Recourse to the Debt Agency's "*ordinary*" funding program by a Member State would remain purely voluntary. It should be expected that countries who retain direct access to markets at more favourable conditions would abstain, as is the case for Germany and a fast diminishing number of other issuers when compared with conditions obtained by the European Financial Stabilisation Mechanism which serves currently as the benchmark for EU budget guaranteed issues. One can however expect, with the progressive development of a deep and broad market for "Stability Bonds", that issuing conditions obtainable through the Agency will prove advantageous for an ever growing number of Member States.

3) As regards the mechanism ensuring the financing of the Borrower's debt servicing obligations, the specific roles assigned to the ECB and the participating National Central Banks would be applicable

This covers in particular the "*several*" guarantee benefiting the ECB issued by EMU members securing the Beneficiary's debt service obligations, which would automatically be extended to any EU Member State participating in the scheme.

Section III – Conclusion

In relation to the various options outlined in the GP, the necessary preconditions, deemed indispensable to satisfy minimum investor acceptance, clearly rule out any structure based on a several guarantee by EU/EMU Member States. Indeed, such a structure is inherently unstable as it is directly influenced by the performance of its weakest Members; as such it is not compatible with ensuring that the highest Rating is conferred and maintained on Stability Bonds over time. A joint and several guarantee structure is therefore indispensable.

An further benefit of having recourse to the EU budget guarantee is to ensure the uniformity of the explicit/implicit credit structure underpinning the issuance of all securities benefitting from the joint and several guarantee of the 27 Member States; in addition to securities to be issued by the future "EU Debt Agency", they include issues by the EFSM (if maintained), EU macro financial assistance programs to non EU Members as well as issues of the EIB. That is why it is also far from optimal to consider a joint and several guarantee mechanism limited to the EMU Members only. Indeed, a differentiated credit structure with other EU issues would create confusion and could lead to unwelcome market distortions in the primary/secondary markets of the newly created Stability Bonds or impinge negatively on the market for the other EU guaranteed issuers.

The interests of non EMU Members are adequately protected by subordinating any call on their guarantee to a first call limited to EMU participants. This "political" agreement between the 27 would not change the market's evaluation of Stability Bonds. This concept is also totally compatible with the recognition of the fundamental interests that all 27 Member States have in the soundness of the Euro, a fact clearly demonstrated by the appeals of the UK Government (and others) for the Eurozone to enact adequate measures to resolve the crisis. It requires however a minimum degree of solidarity between the 27 without which the whole EU project is bound to fail.

Concerning the choice between total or partial substitution of Stability Bonds for national sovereign issues, this should be left to the choice of individual Member States. As long as some can benefit from more attractive conditions, it seems inappropriate to impose on them a more onerous system. Proposals envisaging "compensation" between Beneficiaries on a "formula" basis are unnecessarily complicated and will give rise to endless controversy over time. It would also remove one of the major incentives for participating in the scheme by weaker Members who are in the greatest need of low cost financing. The discipline should be the direct result of the strengthened surveillance backed by enforceable sanctions, including intrusion of the EU in the national policies of countries failing to meet their commitments.

Finally, the proposed scheme offers significant pragmatic advantages in terms of **implementation**. Indeed, recognising that Treaty changes are inherently uncertain, complex and lengthy processes, one could accelerate the issuance of Stability Bonds by adhering in the interim to the procedures applicable currently by the EU Financial Macro-economic Assistance. Covenants negotiated in the loan agreement on a bilateral basis between the Borrower and the Beneficiary (the equivalent of the MOUs negotiated between the EU and third country beneficiaries) could include, on a voluntarily "**contractual**" basis, conditionality that integrates covenants equivalent to the requirements that would ultimately flow from both the new EU legislative proposals under consideration as well as future Treaty modifications. This would allow issuance to proceed without having to wait for the unanimous Treaty adoption and ratification process to be completed while providing the necessary time to follow the standard procedure for Treaty modifications.

Such an approach seems indispensable to reconcile the urgency of showing the market that determined action is being taken to address the crisis while simultaneously giving sufficient time to ensure the democratic legitimacy of the process. It provides for a fair "political compromise" which should prove acceptable to all Member States. They will, indeed, both collectively and individually, benefit from the Union's more stable financial footing.

The Euro's credibility will also be considerably enhanced by dissociating the questions relating to the solvency of individual Member States from those concerning the survival of the single currency. Consequently, it should enhance significantly the EU's bargaining power at international level and strengthen its independence vis à vis other major actors (China in particular) who, in the current environment, could exert undue influence if their creditor status was brought to bear to the detriment of individual Member States.

Armed with such a mechanism, the Union could also aspire to exercise greater influence within the G20 and weigh more effectively on the reform of the international monetary system and the governance of globalised financial markets.

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