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POLICY DEPARTMENT
ECONOMIC AND SCIENTIFIC POLICY **A**



Economic and Monetary Affairs

Employment and Social Affairs

Environment, Public Health and Food Safety

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**EURO AREA GOVERNANCE - IDEAS FOR
CRISIS MANAGEMENT REFORM**

STUDY COMPILATION

ECON



DIRECTORATE GENERAL FOR INTERNAL POLICIES
POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

**Euro Area Governance -
Ideas for Crisis Management Reform**

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Abstract

This compilation study tackles the question of euro area and EU governance reform from the perspective of (sovereign) crisis management. It focuses predominantly on crisis mitigation and resolution mechanisms (rather than crisis prevention). The introduction briefly discusses the origins and effects of the crisis for the euro area as well as the whole of EU27. The study goes on to summarize and compare the contributions and to provide a brief legal evaluation and an extensive chronology. The contributions in chapter 2 analyze the impact and future of the crisis management institutions decided in May 2010 - the European Financial Stability Facility (EFSF) as well as the European Financial Stability Mechanism (EFSM). Chapter 3 considers the market impact and institutional design of sovereign default. Chapter 4 looks at commonly issued bonds (Eurobonds). The compilation study is a collection of contributions from practitioners and academics alike.

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CONTENTS

- LIST OF ABBREVIATIONS iv**
- EXECUTIVE SUMMARY 1**

- 1. QUO VADIS CRISIS MANAGEMENT?..... 3**
 - 1.1 What happened?..... 4
 - 1.2 Crisis Management in the EU in 2010..... 5
 - 1.3 EMF and Beyond: The Design of (Orderly) Sovereign Default..... 8
 - 1.4 Reforms in Debt Issuance - Eurobonds..... 11
 - 1.5 Legal Challenges of Proposed Solutions 14
 - 1.6 Chronology of the Sovereign Debt Crisis - Nov 2009 - July 2010..... 18

- 2. CRISIS MANAGEMENT IN THE EU IN 2010..... 22**
 - 2.1 Building a Crisis Management Framework..... 23**
 - by Sony Kapoor..... 23

 - 2.2 What Follows After EFSM and EFSF?..... 43**
 - by Stefan Gerlach 43

 - 2.3 The Future of Euro Area Financial Stability Policy 51**
 - by Karl Whelan 51

- 3. (ORDERLY) SOVEREIGN DEFAULT PROCEDURE FOR THE EURO AREA? 62**
 - 3.1 Market Impact of Orderly Sovereign Default 63**
 - by Kern Alexander 63

 - 3.2 Market Impact of Orderly Sovereign Default 79**
 - by Marco Lamandini..... 79

- 4. EUROBONDS - AN ADDITIONAL DEBT ISSUANCE INSTRUMENT? 88**
 - 4.1 EU Public Debt Management and Eurobonds 89**
 - by Carlo A. Favero and Alessandro Missale 89

 - 4.2 The Feasibility of Commonly Issued Government Bonds 111**
 - by the Association of Financial Markets Europe (AFME) 111

LIST OF ABBREVIATIONS

AFME	Association for Financial Markets in Europe
BoE	Bank of England
BoJ	Bank of Japan
BoP	Balance of Payments
CAC	Collective Action Clause
CDS	Credit Default Swap
EC	European Commission
ECB	European Central Bank
ECON	Economic and Monetary Affairs (Committee)
EFSA	European Fiscal Stability Agency
EFSF	European Financial Stability Facility
EFSM	European Financial Stability Mechanism
EIB	European Investment Bank
ELEC	European League for Economic Co-operation
EMF	European Monetary Fund
EMU	European Monetary Union
EP	European Parliament
EU	European Union
EUR	Euro
EPDA	European Primary Dealers Association
FED	US Federal Reserve
FIRF	Financial Institution Recapitalization Fund

- GDP** Gross Domestic Product
- IMF** International Monetary Fund
- IDRM** International Debt Restructuring Mechanism
- MoU** Memorandum of Understanding
- MS** (EU) Member States
- SDRM** Sovereign Debt Restructuring Mechanism
- SGP** Stability and Growth Pact
- SNB** Swiss National Bank
- SNB** Standard & Poor's
- SPV** Special Purpose Vehicle
- SWOT** Strengths Weaknesses Opportunities Threats
- TEU** Treaty on the European Union
- TFEU** Treaty on the Functioning of the European Union

EXECUTIVE SUMMARY

Following the imminent threat of Greek default in the spring of 2010, EU policy makers stepped in with an ambitious package. Having already reacted with a €110 billion package for Greece in April 2010, on the morning of May 10 2010, finance ministers of EU Member States agreed an unprecedented package to defend the euro, totalling at a potential maximum of about €750 billion. Moreover, the ECB surprised markets by announcing an unprecedented scheme to buy up government bonds on the financial markets. These moves were a necessary ultima ratio. In the end, the only alternative to the agreed packages would have been a default by Greece on its debt. In the present institutional setting, a Greek default would have caused a systemic crisis with a "disorderly" chain of public and private bankruptcies, a banking crisis, and a much deeper recession.

This compilation study tackles the question of euro area and EU governance reform from the perspective of (sovereign) crisis management. Crisis prevention, crisis mitigation and crisis resolution are all crucial elements of crisis management. The policy regime in place in the EU up to now can be seen as incomplete because of its complete negligence for the last two stages, crisis mitigation and crisis resolution. Evidently the crisis prevention part was neither very successful. This compilation addresses the mid and long term consequences of the decisions taken in the spring of 2010. Furthermore, it asks what other steps need to be taken, and which other mechanisms may need to be reformed, or created, in order to safeguard the stability of the euro area.

Chapter 1 consists of a comprehensive introduction and summary into the topic. It briefly discusses the origins and effects of the crisis for the euro area as well as the whole of EU27 and goes on to summarize and compare the contributions and to provide a brief legal evaluation and an extensive chronology of the sovereign debt crisis between November 2009 and August 2010.

In chapter 2, Sony Kapoor (2.1) spans a wide framework focussing on crisis management. Kapoor applies a "Strengths Weaknesses Opportunities Threats" (SWOT) approach to analyzing the EFSF mechanism. Specifically, he recommends various improvements to the EFSF such as preferred creditor status for EFSF funding lines, reducing the interest charged and the provision of guarantees instead of loans. In the same chapter, Professors Stefan Gerlach (Goethe University Frankfurt) and Karl Whelan (University College Dublin) look at the mid and long term consequences of the emergency measures (2.2 and 2.3). Both agree in the assessment that the EFSF needs to be made permanent. However, on its own that is not enough and the reform package will also need some additional elements in order to function.

Whether one believes that the present emergency lending institutions EFSM and EFSF should be made permanent, or not, what transpires out of virtually all contributions on the subject is that these institutions alone will not solve the problem. More importantly, the existence of these institutions may not even be at the heart of the matter. Whether they remain or not, the EU will need decisive concomitant action on both the fiscal and financial sector front (on both of which the Commission has started preparations).

The EFSF may help in case of illiquidity of a country, i.e. a temporary inability to service debt in spite of fundamental solvency. But what about a sustained inability to master the debt burden? Chapter 3 addresses this aspect that presently requires more clarity, namely the institutional design of sovereign debt restructuring, or default, the "end game". The importance of clarifying this worst case scenario, also as an ex ante deterrent, has been voiced more frequently. The question is whether a sovereign default procedure can be designed that would allow for default in an orderly fashion, and what the market impact of such a default would be.

In this compilation, members of the ECON Financial Experts Panel, Professors Kern Alexander (3.1) and Marco Lamandini (3.2) were asked whether sovereign default can be handled in a more orderly fashion, drawing from the experience of earlier liquidity and solvency crises of sovereigns.

Lamandini and Alexander seem to agree that default by Greece or another peripheral EMU country would not necessarily by itself have triggered a systematic banking crisis entailing the need of additional (substantial) state aids. The real risks for most EU sovereigns derives from their assumption of balance sheet risks of their banking sectors which were incurred by the banks during the boom years preceding the credit crunch, and the *implicit* state guarantees on which their banking sectors have come to rely.

However, on the optimal design of sovereign bankruptcy procedure, the authors differ. The choice here is between a centralized (statutory debt restructuring agency) vs. a decentralized (collective action clauses) solution. This dilemma is by no means new but has been present for decades. Sovereign defaults and debt restructurings (mostly in the developing and emerging world) have given rise to this discussion. The last time this discussion resurfaced prominently was following the Argentine default in 2001 and in 2002. At the time, the IMF presented its ideas of a Statutory Debt Restructuring Regime (SDRM). In his contribution, Sony Kapoor provides two further alternatives, an International Debt Restructuring Mechanism (IDRM) fitting into the statutory proposals, and voluntary restructurings fitting into the decentralized proposals. In other words, both avenues remain possible.

The final chapter (4.1 and 4.2) opens another question which has been on the agenda for some time yet probably never really got enough serious consideration – commonly issued bonds, or Eurobonds. Eurobonds are by no means new - e.g. the EIB issues a kind of Eurobond by borrowing on the financial markets. But what about the idea of using Eurobonds on a wider scale for general government finance in both peace times (crisis prevention) as well as in times of crisis (crisis mitigation)? Europe has seen an unprecedented amount of government bond issuance over the past two years. Parameters that need to be taken into account in the possible design of Eurobonds are numerous, and include at least the issuing entity, the purpose of the issue, whether the issue is replacing or complementing national issuance as well as very importantly, the guarantee mechanism.

In chapter 4.1, Alessandro Missale and Carlo Favero present a comprehensive empirical analysis of three different scenarios for Eurobonds. As a voice by the markets themselves, the Association of Financial Markets in Europe (AFME), contribute in chapter 4.2. The conclusions that can be drawn out of the two contributions in chapter 4 include at least the following:

Missale and Favero suggest that the potential real benefits of Eurobonds in terms of diminished liquidity risk, risk insurance and enhanced market integration can only be achieved with a Eurobond issued (and guaranteed) by all Members States jointly, as otherwise efficiency gains would presumably not outweigh the costs of inflexible debt management and increased coordination. This stands in contrast to the AFME proposal of several distinct liabilities of Member States. With joint liability, however, the potential mutualisation of risks (among others) continues to present a serious counterargument to issuing Eurobonds and more analysis is needed to see if a design can be found where this risk is minimized; Eurobonds could also strengthen the euro as an international reserve currency, carrying real benefits as the euro could compete more effectively with the US dollar as benchmark safe investment (safe-haven). Both contributions agree that the maximum amount of debt obligations would have to be capped, and any additional borrowing would have to be conducted with national bonds. Eurobonds would also have to be made senior to any national debt issued after the start of the programme. More evidence and analysis is needed, involving both buyers and sellers. At the very least it seems advisable that Eurobonds should not be ruled out at the outset.

1. QUO VADIS CRISIS MANAGEMENT?

The troubles originating in a subsection of the US real estate market in the summer of 2007 quickly snow-balled into a full-scale financial crisis touching all sectors of the global economy. Similar to earlier crises, the latest stage of this development is the emergence of a sovereign debt crisis with markets increasingly doubtful about states' abilities to repay their debts. Greece has seen its credit supply dry up and has effectively been bailed out. Countries such as Spain, Portugal and Ireland were at a certain point on the brink of seeing similarly adverse market reactions and have had their debt downgraded. Iceland (not an EU Member State but whose financial system is inextricably intertwined with European capital markets) went effectively bankrupt. Most other countries, even if not directly affected, have pre-emptively attempted to calm markets by tightening their fiscal belts.

While the financial crisis (in the private sector), as an exogenous shock, might have triggered the sovereign crisis, it is equally true that many Member States have been running reckless fiscal deficits and the euro area governance structures have not been fit to identify harmful trends and to prevent what happened. Although fiscal policy is at its centre, this failure of economic governance is not limited to fiscal policy but bears a more general macroeconomic component including diverging developments in unit labour costs, productivity, current accounts, real interest rates and other variables. Finally, the 'uncertainty over the end game', the absence of crisis resolution mechanisms (for sovereign default) in the euro area, has probably exacerbated the crisis. Solutions to these three components, namely the fiscal, the macroeconomic and the crisis resolution need to be coherent towards each other and also, very importantly, need to be coherent with any private sector (financial sector) solutions discussed. In the present crisis, the private and the public problems go hand in hand and therefore the 'circuit-breaker' for debt that needs to be found needs to be strong enough to address both sectors.

In the coming months, these issues will have to be analyzed in much more detail than this present compilation is capable to do. Next to the heavy political and legislative agenda of its Economic and Monetary Affairs Committee (ECON), the European Parliament's research services (Economic and Scientific Policy Department) has been active in this area and more recently published in June 2010 a comprehensive compilation of briefing papers on "Euro Area Governance" as well as on "Unconventional ECB Monetary Policy". In the same vein, in August 2010, the European Parliament published a briefing on the EP's role in the "European Semester", the proposed harmonized schedule for scrutinizing public finances, as well as a briefing paper on "Fiscal Coordination in Europe". In parallel with this publication, comprehensive proposals to reform the multilateral surveillance regulation are also published in a separate compilation.¹

As it is impossible to do everything in one study, this study compilation specifically tackles the question of governance reform from the perspective of (sovereign) crisis management, focussing on crisis mitigation and resolution looking at lending instruments and debt issuance in normal and crisis times. Most prominently it analyzes the options for (orderly) sovereign default as well as Eurobonds. It collects suggestions from practitioners and academics alike. To set the scene for the individual authors' contributions, the introduction briefly discusses the origins and effects of the crisis for the euro area as well as the whole of EU27. It then goes on to comparatively summarize the contributions, provides a brief legal evaluation and an extensive chronology.

¹ All above mentioned EP studies can be found on <http://www.europarl.europa.eu/activities/committees/studies.do?language=EN>, searching for 'Economic and Monetary Affairs'.

1.1 What happened?

The euro area

The euro area shares a common currency and thus a common monetary policy whilst fiscal policy remains largely the prerogative of individual Member States' governments - a domain where they enjoy almost complete sovereignty.

At the wake the entry into the third stage of EMU in 1999, and the introduction of the euro, there were doubts as to whether a single currency could survive without some elements of common fiscal policy, such as fiscal stabilisation mechanisms, or even common (federal) taxes. At least the theory of monetary union seemed to teach that it could not.² For a long time, this debate was muted as the first ten years of the euro coincided with years of moderate economic growth, unprecedented financial globalization and ample liquidity, which seemed to make the question obsolete. Since the spring of 2010 at the latest, this question is coming back to the agenda with full force.

A (minimum) common compromise to support monetary union with fiscal policies had found its form in the Stability and Growth Pact (SGP). The well known criteria that states should respect are fixed at an annual budget deficit no higher than 3% of GDP and a national debt lower than 60% of GDP, otherwise an Excessive Deficit Procedure (EDP) with sanctions could in theory be implemented. In the crisis, both the *preventive* and *corrective* mechanisms embedded in the SGP have failed due to lacking political will for enforcement. Both these mechanisms are currently under revision and the regulations that govern their implementation may be subject to changes soon.

Of the euro area Member States, Greece was first to falter following the revision of its budget deficit numbers at the end of 2009. Uncertainty was further increased by the fact that Greek officials had consistently falsified national accounts. Greece quickly saw its private sector funding evaporate and it was becoming increasingly unlikely that it should be able to roll-over its debts. Spreads on Greek paper effectively decoupled from German Bunds.

This put policy makers in a bind, and all the more so as investors suddenly started to take a hard look at some of the other countries' financials. Countries such as Spain, Ireland and Portugal saw their spreads increase as markets became seriously worried about contagion. The challenges confronting the most indebted countries were indeed considerable, and continue to be so. In the beginning of 2010, Spain alone was faced with raising €448 billion in gross financing needs up to the end of 2012. Greece required €158 billion; Portugal, €70 billion; and Ireland, €69 billion. EU Heads of State reacted first stepped with a €110 billion intergovernmental rescue package for Greece, but soon stepped up with an unprecedentedly ambitious package (see 1.2 below).

The EU27

The different Member States were affected in a variety of ways. A full analysis of the impact of the crisis on the Member States is beyond the scope of this study, however some remarks appear pertinent:

The freedoms of the internal market allowed some countries to run-up large external deficits as the private sector borrowed heavily in foreign currency. Countries such as Latvia, Estonia and Bulgaria with hard currency pegs had effectively kept real interest rates too low for too long, in some cases even negative, thus distorting private sector decisions.

² See e.g. Fatas, Antonio (1998): Does EMU need a Fiscal Federation? INSEAD Discussion Paper, <http://faculty.insead.edu/fatas/fiscalfe.pdf> for a useful discussion.

For these countries, the currency regime proved an important factor in determining the economic impact of the crisis. Other countries with floating exchange rates to the euro with large foreign currency denominated private sector debts inflicted serious economic pain on borrowers whose income was denominated in local currencies by allowing their currencies to depreciate. Countries hardest hit were those with the largest external imbalances through excessive reliance on foreign capital flows. Hungary, Latvia and Romania faced external funding gaps and applied for Balance-of-Payments (BoP) assistance from the EU. Moreover, the ECB played an important role in mitigating currency fluctuations for instance through widely rumoured "secret" swap lines with the Polish and Hungarian central banks. In this light, some consideration should be given to the need to reform economic surveillance to avoid individual countries running up large imbalances in the common (financial) market.

On the other hand, yet other states outside of the euro area effectively devalued against the euro helping them to ease their economic pain. This is the case for example for Great Britain and Sweden. However, as the British example shows even a cheaper local currency cannot substitute for responsible fiscal policies.

This brief description already by itself shows the challenge of designing rules for the euro zone, vs. the EU27, i.e. adding countries whose currency is not the euro. The picture gets yet more complicated if non-EU countries with close financial links to the EU are considered, such as Iceland. This analysis, however, is beyond the scope of this study which concentrates largely on the euro area.

1.2 Crisis Management in the EU in 2010

Following the imminent threat of Greek default, EU policy makers stepped in with an ambitious package. On the morning of May 10th 2010, finance ministers of EU Member States agreed a package to defend the euro, totalling at a potential maximum of about **€750 billion**. Moreover, soon after, the ECB surprised markets by announcing an unprecedented scheme to buy up government bonds on the financial markets. Concretely, three separate mechanisms to deliver those €750 billion were announced:

1. A **€60 billion rapid reaction stabilization fund**, controlled by the European Commission. The mechanism is modelled on an existing scheme for non-euro Member States, the BoP assistance facility. The money is borrowed by the Commission on the markets, using the EU budget as collateral. Because the EU budget cannot legally go into deficit, all 27 Member States are liable if money from this €60 billion pot is disbursed and not paid back.
2. A **"special purpose vehicle" (SPV)**, which was created by an intergovernmental agreement among euro area members. This SPV is intended to raise up to **€440 billion** on the markets using a mix of loans and loan guarantees from the euro area members. It has been set up under Luxembourg law, with all Member States as shareholders, and would require unanimity among all Member States in order to disburse any funds. The fund should work in the same way as the €110 billion rescue package first agreed for Greece: it should involve money and budget discipline measures from the IMF, and it should be a package of bilateral loans from each of the 16 euro area members, rather than open-ended loan guarantees.
3. The IMF agreed to match every two euros of EU rescue money with one of its own. As a result, the **IMF contribution could rise up to a maximum €250 billion**.
4. Finally, the **European Central Bank agreed to start buying up government bonds** on the financial markets. Many commentators say that this was a dangerous shift away from its inflation-fighting mission, and a serious compromise on its independence. The ECB defended itself by claiming that they could "sterilize" (i.e. neutralize) the buying of bonds in their other open market operations, thereby leaving the money supply unchanged.

In the end, the only alternative to the agreed package was a Greek default on its debt. However, the EU lacked a formal "orderly" debt restructuring mechanism. Such a mechanism could have been carried through with investors taking a hit and some "hair-cut" being implemented on the debt. In its absence, and banks' balance sheets already strained from the previous crisis (or more correctly the previous stage of the same crisis), losses expected by a potential Greek default sapped market confidence threatening a freeze in the intra-bank market. In other words, in the absence of a default mechanism, a Greek default would have caused a systemic crisis with a "disorderly" chain of public and private bankruptcies, a banking crisis, and a much deeper recession.

Against this background, in the first part of this compilation study **Sony Kapoor (chapter 2.1)** spans a wide framework from the perspective of crisis management. Kapoor applies a "Strengths Weaknesses Opportunities Threats" (SWOT) approach to analyzing the EFSF mechanism, which is reproduced (below). He makes concrete suggestions as to how to improve the design of the EFSF and EFSM. Specifically, he recommends various improvements to the EFSF such as preferred creditor status for EFSF funding lines, reducing the interest charged and the provision of guarantees instead of loans.

In contributions written for the Monetary Dialogue of the EP with ECB President Trichet in September 2010, Professors **Stefan Gerlach** (Goethe University Frankfurt) and **Karl Whelan** (University College Dublin) look at the mid- and long term consequences of these emergency measures (chapters **2.2 and 2.3**).³ Both agree in the assessment that the EFSF needs to be made permanent. However, on its own that is not enough and the reform package will also need some additional elements in order to function.

Gerlach stresses the need of a considerably enhanced fiscal surveillance regime and a reinforced SGP (more automated and graduated sanctions) together with the establishment of a European Fiscal Stability Agency (EFSA). This EFSA would be operationally independent of Member State governments and EU institutions, and it would need to be composed of experts (no more than nine). For Whelan, a variant of the European Monetary Fund could serve to manage sovereign defaults in a more orderly manner, albeit not to prevent them altogether. However, most importantly, this EMF would not be financed by contributions of the "sinners" (as in the original Gros/Mayer proposal, see 1.3) but by profits made in transactions of the use of the fund. This would have the possible benefit of not requiring any Treaty changes.

Indeed, there is a crucial link between sovereign crisis resolution and the financial sector crisis resolutions, as well as supervision and regulation of banks. Whelan stresses this link, stating the exceptionally dire state of European banks was the main reason why the EFSF was created. More healthy and better re-capitalized banks should be able to withstand to an orderly sovereign default in the future. According to Whelan, bank supervisors also need to publish regular stress tests, change their regulations on the risk weighting of sovereign debt and also very importantly put a new private resolution procedure in place, modelled along the lines of Willem Buiter's pan-European Financial Institution Recapitalization Fund (FIRF).⁴ The need to solve the private financial sector problems simultaneously with the sovereign problems is forcefully echoed by Sony Kapoor (2.1). As Kapoor states, the two sectors are inherently interconnected, as "sovereigns provide the final backstop for the banking sector and the banking sector in turn is a significant provider of finance to sovereigns" (p. 31).

³ These two are selected papers. Additional papers on the same topic can be found on the ECON homepage: <http://www.europarl.europa.eu/activities/committees/editoDisplay.do;jsessionid=56AB67E59EA52D9CD2A83354ACE94B63.node1?language=EN&menuId=2061&id=1&body=ECON>

⁴ Willem Buiter, Citibank Global Economics View Paper 'Sovereign Debt Problems in Advanced Economies', 26 April 2010.

BOX: SWOT ANALYSIS OF THE EFSF (AND EFSM)

Strengths

- Substantial as long as the problem is limited to the periphery
- Involving all other members so increasing peer time incentives to monitor each other and limit moral hazard
- No upfront funding needed

Weaknesses

- Primarily intended to be liquidity management tool
- Tackling a liquidity problem with a liquidity management tool solves it but tackling a solvency problem with this would make it worse and transfer the burden of adjustment from the private sector and international governments to euro area governments which would be politically poisonous
- The one month time period for action from request to issue can be too long in the midst of a crisis
- The two stage process of the EFSF/EFSM issuing bonds and then giving the MS government a loan is needlessly complicated and expensive
- Temporary
- Too small to have any real impact especially if any of the larger MS gets into trouble. They can just about mitigate rollover risk for say a month, but then again, it might be much more sensible to issue guarantees instead of bonds
- The cost of funds provided (around 5%) is too high. A 5% interest burden would be very difficult for a country such as Greece to bear given its fragile fiscal situation
- The MS have decided against going for a preferred creditor status which exposes them to much higher levels of credit risk
- Because of the current structure (where the MS getting EFSF support no longer stands behind it) the size of the fund would diminish exactly when the demand for it would grow

Opportunities

- Could be the precursor of an EU wide or at least euro area wide fiscal instrument
- Can be made permanent to provide crisis mitigating liquidity support
- Could force the discussions on a more integrated EU crisis management framework
- Might grow with the size of the EU budget (the EUR 60 billion EFSM supported by the Commission budget), a longer-term objective of ever closer union
- The EFSM should be the first port of call in the event of a crisis, and could effectively guarantee a much larger sum, e.g. EUR 300 billion or so (see below)

Threats

- At the high interest rates at which funds are being offered, this could exacerbate the solvency problem and be self defeating
- If there are losses inflicted on other MS, this could potentially be in violation of the spirit, if not the letter of the Treaty
- Such losses may also harden political opposition to 'ever closer union' and may exacerbate MS tensions
- It is a network of bilateral loan agreements that make it possible for MS to pull out
- The fund does not have ultimate seniority over other loans
- Issuance of bonds by the EFSF might have a crowding out effect on MS bonds

Source: Chapter 2.1, Sony Kapoor

Whether one believes that the present emergency lending institutions EFSM and EFSF should be made permanent, or not, what transpires out of virtually all contributions on the subject is that these institutions alone will not solve the problem. More importantly, the existence of these institutions may not even be at the heart of the matter. At the time of finalizing this compilation in September 2010, the sovereign bond spreads for some countries in the euro area were diverging again, after an initial convergence in the period following the decision on the EFSF. This is anecdotal evidence indicating that markets do not regard the EFSF as an ultimate solution. So whether they remain or not, it is clear that the EU will need decisive concomitant action on both the fiscal and financial sector front.

To discuss all necessary measures to fight the crisis in detail is beyond the scope of this paper. The focus on the crisis management framework in three different sequences (as proposed by Sony Kapoor) may help to structure the debate: 1) Crisis prevention; 2) Crisis mitigation and 3) Crisis resolution. The truth of the matter is that any complete and coherent crisis management reform will have to address all the three stages. The policy regime in place in the EU up to now can be seen as incomplete because of its complete negligence for the last two stages, crisis mitigation and crisis resolution. This compilation attempts to provide ideas to close this gap.⁵

1.3 EMF and Beyond: The Design of (Orderly) Sovereign Default

Prevention, mitigation and resolution are all crucial elements of crisis management. Plausibly, the EFSF may be part of a crisis mitigation toolset, and possibly sufficient to fight off a liquidity crisis, i.e. a temporary inability to pay. But what if the underlying problems of a country are more structural and persistent in nature? This would indicate solvency problems. Admittedly, the problem in the case of sovereign states, as opposed to firms, is that the line between illiquidity and insolvency may be difficult, if not impossible, to draw.

Especially in the light of the developments in emerging markets in the last decades (Mexico 1995, Russia 1998, Argentina 2001) some contemporary theorists no longer believe that it is necessary to draw a sharp line between runs on debt (illiquidity) and solvency crises.⁶ For several reasons, they are very difficult to distinguish in practice. The distinction is made ambiguous because short-term debt, a characteristic of a liquidity crisis, can be a reflection of "solvency" problems. Moreover, when sovereign debt is subject to a run the actual solvency can easily be diminished. The fundamentally adverse effects of a run occur, whether the run is on an ex-ante solvent or insolvent debtor.⁷ Moreover, "lasting" insolvency and illiquidity are difficult to separate as an appropriate distinction requires the satisfactory valuation of the debtor. Yet applying market value to a sovereign fails in its very concept. These are reasons why the distinction between insolvency and illiquidity might not always be unequivocal. Nevertheless the conceptual distinction is an important one for policy.

⁵ Incidentally, a similar analysis containing very similar elements was recently conducted by Daniela Schwarzer and Sebastian Dullien (2010): *Umgang mit Staatsbankrotten in der Eurozone*, SWP-Studie, S19, Juli 2010, Berlin.

⁶ For a useful discussion, see e.g. Makipaa, Arttu (2002), *Bankruptcy Procedures for Sovereign Debtors*, University of Heidelberg; or Rogoff, Kenneth & Jeromin Zettelmayer (2002): "The History of Sovereign Bankruptcy: A History of Ideas", *IMF Working Paper WP/02/133*.

⁷ An analogy to the two-period Diamond/Dybvig (1983) debtor-multiple-creditor framework illustrates how illiquidity carries the potential to lead to insolvency. If the liquid assets of the sovereign are not enough to pay some of the debt due in period 1 and therefore a run on debt is triggered, funds necessary to generate period 2 output (eventually generating funds for repayment) will be missing. An unfortunate resolution of illiquidity in period 1, destroying period 2 output, hence leads to self-fulfilling insolvency. (Source: Diamond, Douglas W. and Philip H. Dybvig, (1983): "Bank Runs, Deposit Insurance, and Liquidity", *Journal of Political Economy*, 91(3), pp. 401-419.)

Assuming problems with fundamental solvency, capital injections alone will not solve the problem. Indeed the aspect that presently requires more clarity is the institutional design of sovereign debt restructuring, or default, i.e. the specific rules governing the worst case scenario, the "end game". The importance of clarifying this worst case scenario, also as an ex ante deterrent, has been voiced frequently by many commentators.

The question is whether a sovereign default procedure can be designed that would allow for default in an orderly fashion, and what the market impact of such a default would be. In this compilation, members of the ECON Financial Experts Panel, Professors **Kern Alexander (3.1)** and **Marco Lamandini (3.2)** were asked whether sovereign default can be handled in a more 'orderly' fashion, drawing from the experience of earlier liquidity and solvency crises of sovereigns.

The basis for these considerations is the European Monetary Fund (EMF), as proposed by Daniel Gros and Thomas Mayer, inter alia in their contribution for the European Parliament in March 2010⁸, presented below in its main elements.

European Monetary Fund (EMF)

- *Rational:* Creation of a *permanent* fund to discourage speculation against individual Members States. The availability of non-market funding should allow countries facing difficulties to outlast any temporary liquidity dry-ups
- *Set-up:* Member States create a common fund to help states in financial difficulties thereby mutualising risk. Debtor countries would have to comply with conditions set by the fund to tap financing. The fund could try to reduce moral hazard by allowing for an orderly default procedure, applying haircuts to credits and providing liquidity
- *Benefits:* Orderly default mechanism introduced, tighter supervision through involvement of the fund
- *Drawbacks:* Questionable credibility of sanctions, financing mechanism unlikely to contain moral hazard, financing by already fiscally strained governments
- One such proposal is that of Daniel Gros and Thomas Mayer:
 - *Financing:* Rates based on debt levels: 1% of stock of debt in excess of 60% of GDP + 1% of amount of deficit in excess of 3%
 - *Conditionality:* For own contributions approval of fiscal programme of the fund; for amounts in excess of own contributions only with adjustment programme from Commission and fund

Both Lamandini and Alexander agree that the present mechanisms (EFSF, EFSM) on their own are not sufficient. First and foremost, an orderly default mechanism should be compatible with the mechanisms. The road to a full blown EMF is deemed somewhat more difficult but nonetheless possible. However, this is probably feasible only through the enhanced cooperation procedure, which is not an easy road to take.

⁸ Gros, Mayer: How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund (2010), Monetary Dialogue March 2010 Briefing Paper, European Parliament.

The authors also seem to agree that Greek or other peripheral EMU country defaults would not necessarily by itself trigger a systematically relevant banking crisis which could entail the need of additional (substantial) state aids. As Alexander suggests, the real risks for most EU sovereigns derives from their assumption of balance sheet risks from their banking sectors which were incurred by the banks during the boom years preceding the credit crunch and which now threaten the viability of the sovereign finances of several EU Member States.

So what type of default arrangements should be established for sovereigns? Here the authors diverge. Kern Alexander (3.1) presents lessons from earlier restructurings (the Mexican tesobono crisis) and argues for a decentralised approach to sovereign debt restructuring based on collective action clauses (CAC) which facilitate negotiations between creditors and sovereigns and which is based on harmonised EU principles and guidelines and administered by a EU sovereign debt agency. On the other hand, Marco Lamandini argues for a swift introduction of a European statutory sovereign default procedure also in order to reconcile the EFSF and EFSM with their legal basis. He lists a useful series of statutory provisions which should be incorporated into the European sovereign default procedure.

The differing conclusions of the two authors go to show how difficult it is to design such sovereign default (or bankruptcy) procedure in an optimal way. Here again, the recurring dilemma in a sense is that of a centralized (statutory) vs. a decentralized (collective action clauses) solution. This dilemma is by no means new but has been present for decades. Sovereign defaults and debt restructurings (mostly in the developing and emerging world) have given rise to this discussion. The last time this discussion resurfaced prominently was following the Argentine default in 2001. In 2002, the IMF presented its ideas of a Sovereign Debt Restructuring Regime (SDRM).

In terms of effective crisis resolution, Sony Kapoor's (2.1) main proposal is that of an international debt restructuring mechanism (IDRM), not restricted to the euro area or the EU. Only an institution that is widely (i.e. globally) accepted by all parties (incl. private sector and foreign governments,) can effectively play the role of arbiter here. In Kapoor's argumentation, there is no reason why a new IDRM could not also be used of for a long-needed developing (and emerging) country debt restructuring. The IMF's proposed SDRM, the US Chapter 9 model (for municipalities), Paris and London club restructurings, Brady bond restructurings and several other voluntary restructurings and defaults offer a series of instructive lessons on the best design for such an international mechanism. Sony Kapoor also provides an alternative proposal fitting into the decentralized proposals, the "non default voluntary restructuring".

In conclusion, both avenues remain possible. The opposing arguments on the optimal design of sovereign default and restructuring show that the jury is indeed still out and a lot of details remain to be clarified. However, the urgency to act may have considerably increased.

1.4 Reforms in Debt Issuance - Eurobonds

The final chapter of this compilation study opens another question which has been on the agenda for some time yet probably never really got enough serious consideration – commonly issued bonds, or Eurobonds. Eurobonds are by no means new - the EIB issues a kind of Eurobond by borrowing in the financial markets, and the Commission borrows for its BoP facility with an equivalent instrument. Finally, the proposed EFSF bonds would also be Eurobonds in a sense.

But what about the idea of using Eurobonds on a wider scale for general government finance in both peace times as well as in times of crisis? Despite popular fears on this subject, this issue merits at least a fresh look. This is justified not least because as a result of the global financial crisis, Europe has seen an unprecedented amount of government bond issuance over the past two years.

The following presents some general characteristics of a Eurobond:

Eurobonds

- *Rational:* Creation of a *common issuer* to discourage speculation against individual Members States
- *Set-up:* Eurobonds could be set-up either to replace all existing issuances or to provide an additional funding source to Member States. They could be issued by all or some Member States. They could be guaranteed by all (joint liability) or each Member State would remain liable only for its own share (distinct, or several, liabilities)
- *Potential Benefits:* Liquidity gains, safe-haven investment status of euro as reserve currency, institutionalisation of systemic crisis response mechanism, risk insurance, market access
- *Potential Drawbacks:* Mutualisation of risks, potential to blunt market signals through implicit bail-out, inflexible management, continuous large issuance necessary

As the subsequent analysis in chapters 4.1 and 4.2 shows, the devil with Eurobonds, as with so many other proposals, can lie in the detail. Many different versions of designs of Eurobonds have been proposed, and indeed the variables to consider in sovereign debt issuance are not trivial. While its potential benefits are known since the Giovannini group report in 2000⁹, more recently many economists have suggested it as an element in the euro area reform (see 4.1). Most prominently and also most concretely, Jakob von Weizsäcker and Jacques Delpla brought forward the so called Blue Bond proposal.¹⁰

In chapter 4.1, **Alessandro Missale and Carlo Favero** present a comprehensive empirical analysis of three different scenarios for Eurobonds. They argue that a "*common Eurobond making each participating issuer liable only for its own share could be agreed upon by the Member States with the lowest credit risk premia: Finland, France and Germany. However, the efficiency gains from this weak form of cooperation in terms of market integration and liquidity would be limited if not offset by the higher costs of an inflexible debt management. To reap the liquidity benefits of a unified market, the Eurobonds should be issued by all euro-area Member States or by an EU Institution.*

⁹ Giovannini Group Report (2000), Co-ordinated Public Debt Issuance in the Euro Area, November.

¹⁰ Delpla, Jacques and von Weizsäcker, Jakob (2010): The Blue Bond Proposal. Bruegel Policy Brief 2010/03.

*But only a common bond jointly guaranteed by all euro-area Member States could reach the "safe-haven" status and the size needed to compete with the US Treasury market. The mutualisation of credit risks faces however strong political opposition, because of fears of relaxed fiscal discipline and inequitable sharing of its benefits and costs. Although solutions to these problems can be found, more evidence is needed on the benefits and costs of a common Eurobond to convince potential issuers."*¹¹

The main characteristics of the three types of Eurobonds they consider are given here:

Table 1: Summary of Main Characteristics of the three Types of Eurobond

Characteristic	Type 1	Type 2	Type 3
Issuing Entity	Independent Agency	Independent Agency or EMU Fund	EU Institution EC or EIB
Participation	Open	Open	27 EU Member States
Country Fixed Shares	Yes	No but limits on debt of each participant	No but limits on debt of each EU Member
Guarantees	Several	Several and Joint explicit	Several and Joint from EU Treaty
Mutualisation of Default Risk	No	Yes	Yes
Credit Rating	Weighted Average of participants	Reflect Rating of larger participants. Highest (AAA) if all euro-area Members join	Highest (AAA)
Liquidity	Conditional on Market Size and Participation	Conditional on Market Size and Participation	Conditional on Market Size
Management	Inflexible	Flexible	Flexible
Legal Obstacles	None	Change in TFEU Art.125 No-Bailout	Change in TFEU

Source: Chapter 4.1, Alessandro Missale and Carlo Favero

Since commonly issued bonds would have to be sold on the markets, it seems particularly useful to include in this analysis a voice by the markets themselves, that of the **Association of Financial Markets in Europe (AFME)**, in chapter 4.2, as a final contribution to this compilation.

AFME is particularly well placed to analyze the subject since they have already presented relevant market data on two occasions: In September 2008, AFME's European Prime Dealers Association (EPDA) published a research paper exploring the benefits and drawbacks of a common European bond from a market perspective¹².

¹¹ Abstract of Missale/Favero contribution in chapter 5.1.

¹² "A common European Government Bond", published in September 2008.; http://www.sifma.org/research/pdf/EPDA-SIFMA-Common-Bond-Report_0810.pdf.

The paper was based on a survey of Primary Dealers' views on the pricing of possible European common debt instruments and consisted of both a qualitative and quantitative analysis. From the results of this paper, the EPDA published a briefing note¹³ in March 2009 on the specifics of a possible common European "T-bill" (US Treasury Bills, i.e. short term debt obligations).

AFMEs contribution in 4.2 summarises the results of both studies and places them in the context of current market developments. Their contribution provides some guidance on the preferred shape (by market participants) of a common bond programme. Another characteristic of the scenarios studied by AFME is that all their alternative scenarios respect the non-bailout clause in Art. 125 TFEU as they foresee limited liability of each MS in their respective share in the issuance.

The conclusions that can be drawn out of the two contributions in chapter 4 include at least the following:

- Missale and Favero suggest that the potential real benefits of Eurobonds in terms of diminished liquidity risk, risk insurance and enhanced market integration can only be achieved with a Eurobond issued (and guaranteed) by all Member States jointly, as otherwise efficiency gains would presumably not outweigh the costs of inflexible debt management and increased coordination. This stands in contrast to the AFME proposal of several liability of Member States;
- With joint liability, however, the potential mutualisation of risks continues to present a serious counterargument to issuing Eurobonds and more analysis is needed to see if a design can be found where this risk is minimised; on the other hand, joint liability can also pool risk and therefore ensure effective insurance and act as a de facto crisis prevention mechanism;
- Eurobonds could also strengthen the euro as an international reserve currency, carrying real benefits as the euro could compete more effectively with the US dollar as benchmark safe investment (safe-haven);
- Both contributions agree that the maximum amount of debt obligations would have to be capped, and any additional borrowing would have to be conducted with national bonds. Eurobonds would also have to be made senior to any national debt issued after the start of the programme. This indeed echoes main characteristics of the Blue Bond proposal;
- More evidence and analysis is needed, involving both buyers and sellers. What is certain at this stage is that Eurobonds should not be ruled out from the outset.

¹³ 'Towards a Common European T-bill' ; <http://www.afme.eu/document.aspx?id=2684>.

1.5 Legal Challenges of Proposed Solutions

The basic legal background

The Lisbon Treaty (Treaty on the Functioning of the European Union, 'TFEU') maintained its basic approach to European economic policy which, according to the principle of subsidiarity, should, in principle, be carried out by Member States (MS) who must respect the coordination obligations enshrined in the Treaty. The most important Articles in relation to economic governance are:

- According to **Article 119 TFEU**, economic policy is a matter of common interest to be coordinated via the Council. The coordination procedure is set out in the revised **Article 121 TFEU**, which has strengthened the role of the European Commission, and introduced the possibility of closer coordination for Euro-Member States and of Council decisions without voting rights for the Member State(s) concerned.
- Major structural principles are stipulated by **Articles 123 and 124 TFEU** (prohibiting the financing of Member States' public debt via the ECB, national central banks or preferred access to financial institutions) and **Article 125 TFEU** (the no-bailout clause, which declines responsibility of the EU and Member States for the sovereign debt of other MS).
- However, **Article 122 TFEU** opens the possibility of financial assistance for euro-MS in extraordinary circumstances. For non-euro MS, **Article 143 TFEU** stipulates a possibility for BoP assistance.
- The procedure and enforcement of the reformed Stability and Growth Pact (SGP) is covered in **Article 126 TFEU**. The 'preventive' part of the SGP is detailed in a Council regulation¹⁴; this is also the case for the 'corrective' part¹⁵. Currently, there are no provisions dealing with the procedure of an orderly sovereign default of a MS.

Thus, economic policy falls under the responsibility of MS, whilst also respecting the aims and being subject to the procedures of the Treaty. The approach of economic coordination is generally based on MS' ex-ante general compliance; (internal and external) 'peer pressure' is (meant to be) exercised in the case of non-compliance.

The legal basis of existing approaches for crisis management

The most important crisis measures (as presented above in 1.2) were *inter alia* based on Article 122 TFEU. Admittedly, the measures are not entirely undisputed as regards their compatibility with the Treaty. The main legal criticism regarding the rescue package is that the scope of Article 122 (2) TFEU was extended to the maximum to allow the conditions of the rescue package to fit in. This was done in order to avoid that the provisions of the rescue package would fall into the scope of Article 125 (1) TFEU and thus infringe the no-bailout clause.

Legal base for some reform proposals and the necessity for Treaty changes

The main ideas and proposals made in this compilation study are listed below and presented with regard to their compatibility with the Treaty, or respectively with regard to their necessity for Treaty changes. In addition to the contributions in this compilation, two earlier European Parliament publications are added: that of Gros and Mayer on the EMF¹⁶ as well as

¹⁴ Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209, 2.8.1997, p. 1); amended by Council Regulation (EC) No 1055/2005 of 27 June 2005 (OJ L 174, 7.7.2005, p. 1).

¹⁵ Council Regulation (EC) No 1056/2005 of 27 June 2005 amending Regulation (EC) No 1467/97 on speeding-up and clarifying the implementation of the excessive deficit procedure (OJ L 174, 7.7.2005, p. 5).

¹⁶ D. Gros/T.Mayer, How to deal with sovereign debt default in Europe: Towards a Euro(pean) Monetary Fund, Intereconomics 2010.

a paper by Jean Pisani-Ferry¹⁷ for the Monetary Dialogue in June 2010. It should be noted that other authors in this compilation make additional suggestions.¹⁸ However, these are left out of this analysis as they are mostly variants of the EMF-proposal. Nonetheless, many questions and details certainly remain open to further academic discussion.

Table 2: Proposals in relation to TFEU and the necessity of a Treaty change

TFEU	EMF	Orderly Sovereign Default Procedure	Eurobonds
	(as proposed by Gros/Mayer)	(Lamandini, Alexander, Pisani-Ferry)	(Favero/Missale, AFME, Pisani-Ferry)
Art. 122	Häde ¹⁹ sees a possibility to base certain parts of an EMF concept on Art. 122(2) in connection with Art. 352 (leaving out e.g. legal claims, EU guarantees, contributions from violating MS, suspension of voting rights).	Lamandini proposes that an orderly sovereign default procedure should come as an EU regulation and should have the same legal basis as the current rescue package (EFSF and EFSM). He doubts the current legal basis of Art. 122 and recommends the enhanced cooperation procedure of Art 20 TEU ²⁰ . Alexander proposes Collective Action Clauses (CACs) to be implemented into contractual agreements ²¹ .	
Art. 125	Gros notes that purists would see EMF violating the no-bailout clause of Art. 125, but argues that only an EMF facility would make the clause credible and give it 'teeth' (pure no-bailout clause viewed as unrealistic).	Pisani-Ferry argues that there has never been a "no assistance principle" in the Treaty nor would such a principle have been credible ²² .	AFME argues that all six of their proposed options comply with Art. 125 because they are all based on exclusive liability of each MS, i.e. no common liability ²³ . The proposed "Guarantee Fund" would not infringe Art. 125 because it shall be administered by an independent agency. The hypotheses 2 and 3 of the Favero/Missale proposal stipulate common liability for all debts by participants of the bond (i.e. Euro-MS or EU MS respectively) which would infringe Art. 125 ²⁴ . Pisani-Ferry ²⁵ argues for a split of debt (blue: until 60% of GDP, red: the rest) in which for the lower (blue) level a joint responsibility is proposed. This would infringe Art. 125 ²⁶ .

¹⁷ Jean Pisani-Ferry (2010): Euro are governance – What went wrong, how to repair it?, European Parliament, Monetary Dialogue contribution June 2010.

¹⁸ Stefan Gerlach (2.2) argues for a EFSA (European Financial Stability Agency), and Lars Calmfors (separate publication) argues for a crisis resolution mechanism and an EFC (European Fiscal Council).

¹⁹ U. Häde, Legal evaluation of a European Monetary Fund, Intereconomics 2010, p. 64.

²⁰ M. Lamandini, section 6 and 7.

²¹ K. Alexander section 3.1.1. and 3.1.2.

²² J. Pisani-Ferry, section 2.4 and 3.3.

²³ AFME, Chapter 2.

²⁴ C. Favero, A. Missale, section 6.1.

²⁵ Quoting Delpla, J. and von Weizsacker, J. (2010): The Blue Bond Proposal. Bruegel Policy Brief 2010/03.

²⁶ J. Pisani-Ferry, section 2.4 and 3.3.

Table 2: contd.

TFEU	EMF	Orderly Sovereign Default Procedure	Eurobonds
	(as proposed by Gros/Mayer ²⁷)	(Lamandini, Alexander, Pisani-Ferry)	(Favero/Missale, AFME, Pisani-Ferry)
Art. 126	Contributions to EMF as fines according to Art.126. But Häde sees Treaty change necessary for such financing.		
Art. 309			According to Favero/Missale, if the EIB should be the common issuer of Eurobonds, its mandate would need to be extended to finance MS deficit ²⁸ .
Art. 326	Council to authorise (optional) enhanced cooperation (Art. 20 TEU and 326ff.) - presumably between Euro-MSs to implement EMF.		
Art. 352		Proposal Alexander: A new EU agency responsible for the implementation of CACs and administering the contribution to the new EU fund could be established under current EU law ²⁹ .	If the EU Commission were to be the issuer of Eurobonds, it would remain to be seen whether Art. 352 could serve as a viable legal basis.
T r e a t y c h a n g e ?	Yes ³⁰ - at least for certain aspects ³¹ of the proposed concept.	No. According to Lamandini, an EU regulation to establish a statute for orderly sovereign default should be established via the so far never used mechanism of enhanced cooperation, Art. 20 TEU. No, if the Alexander's proposal were to be followed. No, according to Pisani-Ferry, Art. 125 and 143 have to be interpreted differently.	No, if the proposals of separate liability by AFME were to be followed. Yes, regarding hypotheses 2 and 3 of Favero/Missale. No, if according to Pisani-Ferry Art. 125 and 143 are interpreted differently.

²⁷ D. Gros/T.Mayer, How to deal with sovereign debt default in Europe: Towards a Euro(pean) Monetary Fund, Intereconomics 2010, p. 64.

²⁸ C. Favero, A. Missale, section 6.1.

²⁹ K. Alexander, section 3.2

³⁰ Please also see the similar proposal in the contribution of K. Alexander (3.1) on a new EU fund which would not require Treaty changes.

³¹ As described above, e.g. see Article 126 TFEU in this table.

Treaty changes

Regarding Treaty changes the following arguments should be taken into account:

- As many of the authors in this compilation point out, the political appetite for a new Treaty change is not very high - the drawn out negotiations and cumbersome ratification process of the Lisbon Treaty are indicative of the many obstacles involved.
- As regards certain proposals, different specific Treaty changes would be necessary, e.g. a change of Article 309 TFEU concerning the tasks of the EIB were it to become the issuer of the Eurobonds proposed by Favero/Missale. Concerning their suggestion of Eurobonds being issued by the European Commission, it would have to be evaluated whether Article 352 TFEU (the use of annex competence) could be a suitable legal basis.
- However, for those concepts requiring Treaty changes, two approaches could be envisaged: a) via Article 48(6) TEU, simplified procedure or b) via Article 48(3) TEU, regular revision procedure. The latter would require the assembly of a convention. However, even the simplified procedure would require unanimity in the Council and ratification.

Conclusion

From a legal perspective - also in view of the balance between Articles 122 and 125 TFEU - it can be observed that several authors (Gros/Mayer, Pisani-Ferry, Lamandini) commonly doubt a very strict interpretation of the no-bailout clause in Article 125 TFEU. As evidenced in the preceding discussion and final adoption procedure of the rescue package, it is ultimately a decision for MS as to whether they define themselves a political union which jointly vouches for its members and provides community assistance (at least for the euro area).

1.6 Chronology of the Sovereign Debt Crisis - Nov 2009 - July 2010

- 05-11-2009 The newly elected **Greek government** announces its 2010 draft budget with the projected budget deficit at 12.7%, double the previously announced figure, shocking markets and the EU.
- Greek sovereign spreads decouple from Bund spreads.
- Fitch cuts the Greek rating to A-.
- Separately, the BoE maintains its rate at 0.5% but increases the size of its Asset Purchase Programme by GBP 25 billion to GBP 200 billion.
- 20-11-2009 A final budget draft with **Greece** aiming to cut the deficit to 8.7% of GDP in 2010 to show EU partners and markets it is serious about restoring fiscal health. It also sees public debt rising to 121% of GDP in 2010 from 113.4% in 2009.
- 07-11-2009 **S&P** puts the Greece's A- sovereign rating on negative watch.
- 08-11-2009 **Fitch** cuts Greek debt to BBB+ with a negative outlook, the first time in 10 years a ratings agency has put Greece below the A investment grade.
- 14-12-2009 **Greek government** announces further budget cuts in the hope of re-establishing the trust by markets and EU partners.
- 16-12-2009 Unconvinced, **S&P** cuts Greece's rating by one notch to BBB+ from A-.
- 22-12-2009 Moody's, as the last of the rating agencies, also cuts Greece's rating.
- 14-01-2010 **Greek government** unveils a stability program saying it will aim to cut its budget gap to 2.8% of GDP in 2012 from 12.7% in 2009.
- 18-01-2010 **ECB** discontinues the Swiss franc liquidity-providing operations against the background of declining demand and improved conditions in the funding markets.
- 27-01-2010 The **ECB, BoE, BoJ** and **other central banks** decide to discontinue their temporary liquidity swap lines with the **Fed** as no longer needed given the improvements observed in the functioning of funding markets globally.
- 03-02-2010 The **EU Commission** says it backs Greece's plan to reduce its budget deficit below 3% of GDP by 2012 and urges further cuts especially in its wage bill.
- 16-02-2010 The **Council** gives notice to Greece to correct its government deficit by 2012, setting out a timetable for corrective measures.
- 24-02-2010 A one-day general strike against the austerity measures in Greece.
- 25-02-2010 **Joint IMF** and **EU mission** to Greece offers a gloomy assessment of the nation's economy, predicting a deeper than expected recession and higher borrowing costs.
- 03-03-2010 A new package of public sector pay cuts and tax increases is passed by the **Greek government** including a raise of VAT by 2% to 21%, cutting public sector salary bonuses by 30%, increases in tax on fuel, tobacco and alcohol, as well as freezing state-funded pensions in 2010.
- The **ECB** endorses these measures as "convincing".
- 24-03-2010 **FITCH** downgrades **Portugal** sovereign reflecting widespread worries circling around the solvency of the so called PIGS (Portugal, Italy, Greece and Spain), further spooking the market. The euro falls to a 10-months low

against the dollar. However, trade-weighted the euro is only 7 per cent below its all time high.

- 25-03-2010 **Euro area leaders** agree on potential rescue measures. As "ultima ratio" a standby facility for Greece consisting of a mixture of bilateral loans and funding from the IMF was put in place, covering €25 billion of which 2/3 would be in bilateral loans.
- 30-03-2010 **Greece** manages to tap credit markets for €5 billion bond issuance but with interest demanded still at roughly twice the level of Germany amidst low demand. Spreads of 334 bps to equivalent German bonds.
- 08-04-2010 **Greece** faces the worst bond market jitters to date. Yields rise above 7.5%, the Greek 10-year spread to benchmark German bunds widened to 440 bps by midday and CDS for Greek sovereign trades at higher levels than even Iceland's. Markets remain fundamentally unconvinced about the proposed rescue package.
- ECB** retracts on language about a tightening of collateral standards earlier in the year. In particular, no changes will be made to the current haircut schedule foreseen for central government debt instruments in the BBB+ to BBB- range, i.e. Greek government bonds can be used as collateral.
- Ratings agency **Fitch** downgraded Greek government debt by two notches, from BBB+ to BBB-, that is to one notch above junk.
- 11-04-2010 **Euro area finance ministers** flesh out rescue measures agreeing on the provision of €30 billion in loans in the first year with an additional €15 billion to be provided by the **IMF**. The loan deal comprises a three-year financing programme at interest rates of about 5%, based on IMF formulas. Greece still hopes not having to tap its European partners.
- 21-04-2010 **Greece** began talks today on activating the emergency aid package as the International Monetary Fund called the country's fiscal crisis a "wake-up call" on sovereign-debt risks. Greek officials met counterparts from the euro area, the IMF and the ECB to begin hammering out the conditions that Greece will have to accept to tap the funds.
- 22-04-2010 **Greece** revises its estimated budget deficit upwards by 90 bps from 12.7% to 13.6% further undermining market confidence in Greek figures and policy. Yields demanded on Greek sovereign near 10%.
- 23-04-2010 **Greece** officially requests the activation of the rescue package.
- 27-04-2010 **S&P** downgrades **Greece** to junk and lowers **Portugal** two notches. Widespread contagion fears lead markets lower.
- 29-04-2010 **S&P** downgrades **Spain** one notch to AA putting it on par with Slovenia. Markets spiral as investors offload Spanish stocks and bonds.
- 02-05-2010 **EU finance ministers, the IMF and the Greek government** agree on the details for the rescue plan pledging a total of €110 billion. Greece agrees to budget cuts to the tune of €30 billion.
- 03-05-2010 The **ECB**, in an unprecedented move, decided to suspend the application of the minimum credit rating threshold for credit operations for debt instruments issued by Greece.
- 04-05-2010 **Stock markets** close sharply down on contagion fears, notably for Spain. Simultaneously, the **euro** slides lower.

- 06-05-2010 Live coverage of **deadly riots and general strikes in Greece** put fear into the hearts of investors. The Dow Jones at one point traded off more than 9% (temporarily erasing USD 1 trillion of market value) in outright panic before closing 3.2% lower at the end of a shambolic session.
- 09-05-2010 **European leaders** agreed to a **€750 billion rescue fund** to be provided by **euro area members, the Commission and the IMF**. Separately, the **ECB** said it would intervene directly in bond markets on behalf of individual countries - this throws serious doubt on its independency and the credibility of its inflation fighting mission. The ECB reopens its swap line with the Fed.
- 10-05-2010 **Stock markets** jump as contagion fears eased. The euro trades up.
- 11-05-2010 **Bail-out euphoria fades** quickly as commentators start voicing concerns about the Europe's ability to impose fiscal discipline on its profligate members and about the ECB's credibility. Markets and the euro are down. Gold is near its all-time high due to worries that euro area inflation expectations might become unhinged.
- 12-05-2010 The **EU Commission** suggests that national governments should submit their national budgets to it for review before passing them to national governments.
- 13-05-2010 Both **Spain** and **Portugal** announce a series of new austerity measures in a bid to stave falling confidence of the markets. Inflation turns negative in Spain for the first time since 1986.
- 17-05-2010 The **euro falls** against the dollar to its lowest level since April 2006.
- 18-05-2010 **ECB** reveals bond market interventions of €16.5 billion.
- 19-05-2010 **Berlin** bans the naked short selling of certain financial institutions and euro area government debt. Shares are sharply lower and the euro hits a fresh four year low.
- 24-05-2010 The new **UK** government announces circa GBP 6 billion of budget cuts to curb the ballooning deficit; more cuts are to be in the pipeline.
- 25-05-2010 **Spanish banking concerns** and the risk of war on the Korean peninsula drive markets lower. The single currency drops to within one yen of its lowest level in more than eight years after the **IMF** urged Spain to do more to overhaul its ailing banks, adding to speculation Europe's financial institutions may face more losses.
- 01-06-2010 The **ECB** predicts further write-downs of banks totalling up to €195 billion this year and next but remains cautiously optimistic that banks could absorb these losses without "major problems". Total ECB bond purchases add up to €40 billion.
- 04-06-2010 The **euro dips** under the symbolic level of USD 1.20 at the end of the trading week where new fears about a potential default of **Hungary** added to nervousness about European economies and US job market data disappointed.
- 07-06-2010 The **euro** falls further against the dollar. Yields on government debt of **Italy** and **Spain** hit fresh peaks to levels higher than before the announcement of the rescue package on 9 May 2010. Not surprisingly, markets clamour for the ECB's government bond purchases which have been focussed so far on Greek, Irish and Portuguese bonds to be extended to Italy and Spain - as to allow the market to offload more risk to the ECB. In a sign of market stress, liquidity is very thin in most of the euro area bond markets except for the most liquid instruments.

Germany announces austerity measures to the tune of €80 billion.

Euro area rescue measures as announced on 9 May 2010 are finalised.

17-06-2010 At the end of several days with buoyant financial markets, **EU leaders** in Brussels agreed to a fresh set of measures to restore confidence in Europe's battered banking sector including the publication of stress tests for banks.

21-06-2010 **France** is rumoured to be discussing more spending cuts up to €100 billion to bring France's budget in line with EU directives.

27-06-2010 **G20 leaders** agreed to tighten capital buffer rules for banks but with some delay before these measures should take effect. Furthermore, a compromise on fiscal deficits was agreed promising which were promised to be halved by 2013.

29-06-2010 In a sign of continuing stress in the funding markets, **Spanish banks** demand the extension of the **ECB's €442 billion unlimited one-year liquidity facility**. The ECB announces to replace it with maturities no longer than three months. The implication of this is that Spanish banks are currently unable to fund themselves in the open market.

07-07-2010 In a clear sign that funding markets continue to be under strain, **European commercial banks** have begun using their gold holdings to raise cash with the **Bank for International Settlements**.

Euribor, the rate at which euro area banks lend to each other, has risen for 27 successive days, while markets are nervous about the impending release of bank stress tests in Europe, scheduled to be published at the end of the month.

09-07-2010 The **Swiss National Bank** is rumoured have suffered paper losses of up to EUR €7.5 billion from huge interventions in the currency markets to restrain the value of the franc.

13-07-2010 **Estonia** gets green light to join the euro on 1 January 2011.

19-07-2010 **Moody's downgrades Ireland's** sovereign rating to A2 with outlook stable.

Hungary saw the IMF and EU postpone the conclusion of a budgetary review in Budapest, insisting that the government must rethink its proposals.

Estonia sees its rating upgraded due to its prospects of joining the euro.

22-07-2010 The **IMF** criticises the stress tests for banks as not transparent enough calling into doubt whether they would thus be apt at reinstating credibility in the banks.

23-07-2010 **Stress test results** are published after market closes. Of the 91 banks tested across the 27 Member States 7 failed to show a tier one capital ratio of 6%.

Some criticism was voiced regarding the disclosure of banks' sovereign debt exposure. Contrary to prior agreement, **some German banks** including Deutsche Bank, Postbank, Hypo Real Estate, mutual groups DZ and WGZ, and Landesbank Berlin did not give details on their respective exposures.

20-08-2010 **The initial bail-out euphoria** in the markets shows signs of fading out. Spreads of PIGS countries on the German Bund continue on the widening drift.

2. CRISIS MANAGEMENT IN THE EU IN 2010

2.1 BUILDING A CRISIS MANAGEMENT FRAMEWORK

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Abstract

The euro area has faced an unprecedented crisis. While there are several lessons to be learnt from this crisis, in this contribution we focus on just one: how to improve crisis management in the EU in general, and the euro area in particular. We ascribe three aspects to successful crisis management: 1) crisis prevention 2) crisis mitigation and 3) crisis resolution.

The EU has already taken some steps to improve crisis management in the euro area; many others have been suggested by other commentators. In this policy brief, we develop a comprehensive framework for crisis management, briefly evaluate the steps taken and the suggestion already on the table and suggest some new but politically feasible ways forward.

Contents

- 1. Background25**
- 2. Introduction25**
- 3. Designing an effective crisis management framework27**
- 4. Crisis Prevention28**
- 5. Crisis Mitigation32**
- 6. Crisis resolution37**
- 7. Conclusion.....41**

1. Background

While the discussion of the euro area crisis has focused primarily on issues in the sovereign debt market, it is instructive to remember at the outset that this crisis is not primarily a sovereign crisis but one that originated in the private financial sector. As often happens in credit crises, private sector debt is taken on to public balance sheets which makes them fragile and can, as in this case, result in serious dislocations of the sovereign debt market.

Though Greece's problems have at least partly had to do with misreporting statistics and a genuinely unsustainable public balance sheet, the problems faced by countries such as Ireland and Spain originated primarily in excessive risk taking and unsustainable levels of activity in the private financial markets. In fact, Ireland and Spain were the star pupils of the Stability and Growth Pact, hitherto the euro area's main bulwark against fiscal problems while bigger states such as Germany and France violated the pact at least as often as they respected its provisions. In the decade prior to the crisis, Ireland halved its debt stock to 23% of GDP and Spain reduced its debt burden from 60% to 40%.

That is why any discussion on the management of the euro area's fiscal problems cannot be had in isolation from a discussion of crisis management in the financial sector. In fact, as this paper highlights, there are several lessons that can be usefully applied to the management of sovereign debt crisis from measures that have been suggested and used in the management of crises in the financial sector. What makes these lessons particularly useful is that discussions on the management of banking crises are more advanced than the discussions on managing sovereign debt problems.

Thus far, the policy discussions on handling problems with sovereign debt

- 1) have ignored the role of problems in the financial sector;
- 2) have assumed unrealistic levels of government control of economic outcomes;
- 3) have focussed primarily on crisis mitigation rather than crisis resolution
- 4) have ignored the limits and idiosyncrasies of policy making in modern democracies;
- 5) have ignored the difficulties in bringing about structural changes and have forgotten that
- 6) in order to try and achieve multiple policy objectives, governments need to have a larger portfolio of policy instruments.

2. Introduction

In order to influence policy making on economic governance in the EU, it is important to highlight the assumptions and parameters that are implicit in our approach to improving the crisis management framework in the euro area. At minimum, any such framework must successfully address 1) the problems faced by Greece on the one hand, 2) and Spain & Ireland on the other. It must also address 3) the underlying all-critical question of how best to manage continuing divergences within the euro area in a way that is not destabilizing. Our aim in this contribution is to devise a complete crisis management framework that would tackle these three distinct aspects of the ongoing crisis.

In suggesting this framework, we make the following **assumptions** from which the conclusions and policy proposals put forward in this paper naturally follow:

- No new institution should be established unless really needed – the EU institutional landscape is already too fragmented
- Political appetite from Member States (MS) for 'an ever closer fiscal union' is likely to remain particularly low in the near future
- Changes to the Treaty, at least in the short term, are not really possible

- Given a choice we have a preference for a pre-planned crisis management system that minimises the role of ad hoc midnight emergency cabinets
- Fiscal transfers to other MS are against the spirit, if not the letter of the Treaty and should avoided as far as possible especially since they can trigger a political backlash
- While prevention is better than cure, it is never foolproof so we need to always be prepared for contingencies.

Next, we list some **observations** which form the basis for our analysis:

- In today's increasingly complex and interconnected world, there are serious limits to the degree of influence that government policies can have on economic decision making
- Such limits are especially binding in an open free market economy where the room that governments have for manoeuvre is seriously limited
- Room for national level policy action in the euro area is especially constricted because of loss of monetary policy autonomy, the confines (at least on paper) of the Stability and Growth Pact, highly interconnected financial markets and an increasingly harmonized regulatory environment
- Economic outcomes are partly deterministic and partly stochastic so even with the best of intentions there are limits to what governments can do and control in their economies

Our objectives, assumptions and observations lead us to conclude that the European Economic Governance **discussions need to focus on four things** in particular.

1. Better economic policy co-ordination to the extent this is possible under the terms of the current treaty and prevailing political climate. Co-ordination, it is to be remembered, is not the same as uniformity
2. A recognition that even with the best of intentions and good co-ordination, euro area economies are structurally, culturally and politically different enough so that substantial economic divergences are likely to continue into the near future. Since these cannot be wished away, policy makers need to focus on devising instruments and approaches that can help mitigate potential negative impacts, such as large imbalances, that might result from these divergences
3. A recognition that even with better co-ordination and new policy instruments in place, the threat of future crises would remain ever present so any sensible policy making would need to put in place an effective crisis management system for the euro area
4. Effective crisis management frameworks must be put in place for both sovereigns as well as the financial (banking) sector. Sovereigns provide the final backstop for the banking sector and the banking sector in turn is a significant provider of finance to sovereigns. The high degree of interdependence between the financial sector and sovereigns has become clear in this crisis. Banking crises often lead to sovereign debt problems and sovereign debt problems will almost inevitably increase the likelihood of a banking collapse

Now that we have stated our assumptions and methodology upfront, the rest of this paper will address the design of an effective crisis management framework for sovereigns in the euro area. The underlying assumption here is that a parallel crisis management framework for the financial sector is already being put in place (The Financial Crisis, Causes & Cures, Re-Define Book, 2010).

3. Designing an effective crisis management framework

Crisis management is firstly and foremost about minimising the likelihood of occurrence by putting in place effective ex ante risk reducing policies – **Crisis prevention**. No matter how good such policies look on paper, economic externalities, and endogenous developments in financial markets or stochastic factors can dislocate even the best plans and trigger potentially destabilizing disturbances in the financial markets. These often take the form of liquidity black holes and/or asset prices collapses and/or a collapse in confidence. The challenge at this stage is to contain the crisis, limit damage, stop widespread contagion and restore confidence – **Crisis mitigation**. Even with the best of efforts to contain a crisis, sometimes it will deepen and spread. Under such a scenario, mitigation gives way to rescue and making a fresh start – **Crisis resolution**.

In fire-fighting terms, prevention comes from having a strong fire code, responsible behaviour and taking appropriate precautions. The distinction between crisis mitigation and resolution is somewhat arbitrary but nonetheless critical. Crisis mitigation is about putting out an incipient fire and stopping it from spreading. It will involve the use of smoke alarms, hand-held fire extinguishers, fire blankets and fire doors. Mitigating a crisis or a fire successfully often entails little cost or damage and going back to the 'normal state of affairs' is usually easy.

If the crisis or fire is too large or the mitigation tools are inadequate, the problems deepen and spread and cause widespread damage. This is where the big boys, the fire brigade or in the case of financial markets, recapitalizations or bankruptcy are needed to help limit damage and make a fresh start. The degree of collateral damage and the possibility of a healthy fresh start depend on the quality of crisis resolution and rescue measures, or in the case of fire, on the quality and response time of fire brigades and the existence of appropriate insurance policies.

Crisis prevention depends on 1) responsible fiscal and monetary policies, 2) sound regulation, 3) a countercyclical approach to policy making, 4) moderate to low levels of public and private debt, 5) minimising imbalances and 6) having sufficient room for policy manoeuvre to lean against unfavourable developments. Better co-ordination and surveillance can help too, particularly in the context of the euro area. Prudence and policy space are critical here.

Crisis mitigation has a lot to do with 1) moving quickly to restore confidence in the financial markets, 2) provision of temporary liquidity and balance of payment support and 3) ring fencing problems so as to minimise contagion. Speed of intervention, minimising conditionality and a credible scale of intervention are critical at this stage. Having a much clearer view of the endgame, in case mitigation fails, can also help calm nerves and restore some semblance of order in the market.

Crisis resolution often entails substantial costs and involves structural changes, particularly for private sector entities. 1) ex-ante contingency plans, 2) formalized speedy resolution frameworks and 3) the possibility of orderly restructuring are all essential elements of an effective crisis resolution toolkit. A fair burden sharing procedure, predictability and the possibility of redemption are critical at this stage.

Thus, an effective crisis management framework for the EU will focus on putting crisis prevention, crisis mitigation and crisis resolution tools in place for both the financial sector and sovereigns. In the next section, we discuss some of the main features that such a framework will entail, list what new policy measures have been put on the table and make suggestions on how to improve and strengthen the nascent crisis management apparatus that will need to be a central part of any reform of EU economic governance.

4. Crisis Prevention

A crisis prevention framework will focus on stopping the build up of excessive risks in the financial system as well as on limiting fiscal and macroeconomic imbalances. This is best achieved through a combination of: 1) prudent principles and targets 2) better euro area level co-ordination 3) that are owned by MS and 4) the availability and use of appropriate policy tools 5) in a countercyclical manner so as to minimise the build-up of risks. Importantly, such an approach would necessarily include private and public financial activity and have a macro and micro dimension.

We have at our disposal a set of five major policy categories that, at least in theory, can be used to manage economies in a way that best helps prevent the occurrence of a crisis. These are: 1) monetary policy 2) fiscal policy 3) regulatory policy 4) policies on competitiveness and 5) structural policies, listed in a rough order of short term flexibility.

However, not all of these policies are available to euro area governments. Even when policy space was available, it was not always used appropriately. In particular, euro area governments face some critical challenges which are that:

- Monetary policy is conducted by the ECB and national governments have no room for adjusting this to better fit local economic conditions
- The Stability and Growth Pact (SGP) has limited room for manoeuvre of fiscal policy (if not very effectively)
- Regulatory policy for the financial sector was lax and allowed far too much risks to build up in euro area financial systems
- Competitiveness has been ignored because the current account imbalances that allowed divergences in competitiveness to be sustained were ignored both by the SGP and by the financial regulators, and
- The political economy of structural policies is such that it is very hard to change them.

This meant that the divergent growth and inflation rates in the euro area led to sustained negative real interest rates in countries such as Ireland, Spain and Greece which brought about asset bubbles, especially in Spain and Greece. These bubbles were financed, in part, by financial institutions in low inflation slow growth economies such as France and Germany. When the financial crisis hit, both sets of countries were vulnerable and as public balance sheets absorbed financial system risk, markets reassessed the credit worthiness of countries within the euro area.

The fiscal balances that the SGP observed missed the build-up of these risks altogether and by the time Spain saw its fiscal account turn from being in surplus to having a 10% deficit, it was too late for crisis prevention measures to have any effect and the EU was forced to turn to crisis mitigation. This has been one of the drivers of efforts at the EU level to improve the crisis prevention framework in the euro area. Several policy measures have been suggested, some by EU institutions, others by academics and think tanks. We discuss these briefly and make our own suggestions for improvements.

EU Measures

The main measures already agreed (at least in principle) under this category are:

Measures to reduce financial sector risk

- The institution of a macro prudential approach to financial regulation that will monitor the build up of systemic risk
- Improving the quality and quantity of liquidity and capital buffers that 'leaves some powder dry' within financial institutions and reduces the likelihood of financial sector disturbances
- The introduction of countercyclical capital buffers that will help lean against excessive risk build up
- Other risk reducing regulatory measures such as derivative reform, compensation reform, regulating hedge funds

Measures to reduce fiscal risk

- Improving the quality, scope and timeliness of economic information in order to facilitate better co-ordination at the EU level and the introduction of the European Semester
- Strengthening the sanctions under the SGP and focusing not just on the values of the deficit and debt stock parameters but also their rate of change and the scope for early intervention before limits are breached
- Strengthening the EU macroeconomic framework which is currently very weak
- A renewed call to focus on policies for structural reform and measures to restore competitiveness in euro area countries that are lagging behind

Other suggestions include:

- 1) Introducing National Fiscal Councils
- 2) Taxing debt levels in excess of 60% (directly or indirectly)
- 3) Stronger sanctions in terms of withdrawing access to the ECB and to the EFSF in case of excessive debt levels
- 4) SGP implementation through an independent body at the EC level
- 5) The issuance of Eurobonds in various forms.

Policy discussion

The biggest indictment of the SGP in its current form was that Spain and Ireland, which did not violate the SGP and ran surpluses, were amongst the countries most vulnerable to the sovereign debt crisis. The SGP, with its exclusive focus on fiscal balances, completely ignored private sector imbalances and the related current account imbalances. So extending the mandate of the SGP to monitor risk building and excessive private sector, financial sector and current account imbalances is the sensible thing to do.

However, while fiscal policy might, at least for the most part, be under government control, other economic outcomes are the collective results of millions of individual decisions by economic actors so governments can at best have only a limited influence on them. The EU and its constituent states are not command-economies, so there are serious limits to what even willing governments are able to accomplish in the name of co-ordination or reduction of imbalances.

So, while the European semester, peer review of budgets and enhanced efforts at co-ordination are welcome steps there should be an explicit recognition at the outset that these steps will not eliminate imbalances and divergences but can only mitigate them somewhat.

Since most of the domestically originating observed financial instability in the EU can be traced back to intra-euro area divergences, there is an urgent need to also devise additional policy instruments that give governments more policy space to 1) try and mitigate divergences and 2) make sure that any divergences are managed to minimise imbalances and the externalities and financial instabilities associated with them.

Negative real interest rates were the major drivers of housing bubbles in countries such as Spain and Ireland and one of the causes of over-indebtedness in Greece. In the absence of any monetary policy space to manage significant real interest rate divergences, **the main options available to euro area countries are:**

- Using fiscal policy as the main adjustment tool. However, in order to compensate for the negative real interest rates observed in a country such as Spain, the government would have needed to run a fiscal surplus of the order of 8%-10% of GDP which, any political economist would agree, is next to impossible.
- Using structural policies and wage adjustments as the main policy tool. The problem here is that governments have only limited control on wage policies and that structural reforms of this kind are extremely difficult. Wage restraint in a time of fast economic growth is almost unheard of. While ideally there should be more structural reforms of the kind the EU has been calling for over decades, we should not delude ourselves with the likelihood and extent of any such reforms that might happen.

In other large economic federations such as the United States, fiscal transfers and labour mobility are far higher and offer stronger adjustment mechanisms to mitigate any problems caused by divergences but neither of these is an option for the euro area in the medium term.

The problems with other suggested proposals such as National Fiscal Councils, the European Monetary Fund, the Blue Bond proposal etc are that they all focus on the symptoms (fiscal accounts) rather than the fundamental causes, such as: limits to government fiat, stochastic economic shocks and the lack of sufficient policy space to run a countercyclical policy. The implicit assumption in many of these proposals is that it was a lack of willingness on the parts of euro area governments, rather than a lack of ability or policy options, that led us into this crisis. This assumption is seriously flawed.

Our Recommendations

In order to further strengthen the crisis prevention framework in the euro area, we propose:

- **Introducing differentiated reserve requirements run by national central banks:** Because the spread of real interest rates is a continuing source of divergences and imbalances, allowing national central banks to require domestic banking operations to hold different amounts of unremunerated (zero interest) reserves against liabilities can help adjust real interest rates so they are more suitable for the national economic conditions. This will help reduce the build up of excessive risks and imbalances. Currently the ECB levies uniform reserve requirements that it pays interest on. This will need to change. If this is legally complicated, a similar end-result can be achieved by using asset based reserves.
- **Using a countercyclical prudential and regulatory policy :** Member States have at their disposal a number of instruments such as asset based reserve requirements, loan to value ratios, financial transaction taxes, loan loss reverse targets and bank levies that can be used counter cyclically in conjunction with or as a substitute for the liability based reserves we have suggested above.
- **Using GDP Linked Bonds:** Member states could start issuing GDP linked bonds where the interest is linked to the GDP growth rate so debt service payments increase in boom times when a country can most afford them and fall in a slowdown giving the country some breathing space and thus acting to stop a temporary economic dip from turning into a recession. These bonds hardwire an automatic counter-cyclical fiscal policy which is stabilizing for the economy. Market surveys indicate that there is a growing appetite for such bonds.
- **Stress testing budgets and contingency budget plans:** Member states should be obliged to stress test their budgets against a number of scenarios that are decided by the European Commission, publish the results and take them into account to introduce more counter cyclicity in fiscal policy. In addition to this, MS should be made to publish contingency plans for fiscal policy that detail what a MS would do in the event of facing fiscal problems that would need to include 1) where it would obtain temporary liquidity from – how much and at what rate 2) which taxes it would raise 3) which expenditures would it cut 4) how it would deal with a solvency problem.
- **Lengthen the maturity profile of country debt:** The Commission should introduce minimum targets on the average maturity profile of a country's debt since, as we saw in the present crisis, MS such as the UK that had a longer maturity profile on their debt found it easier to tide over temporary dislocations in sovereign debt markets compared to MS with shorter maturity profiles who faced the prospect of rolling over large fractions of their debt under stressed market conditions.

5. Crisis Mitigation

Crisis mitigation is all about nipping incipient problems in the financial sector and the sovereign debt markets in the bud. Crisis mitigation comes into play at the first hint of financial market dislocation.

Since market expectations feed back into prices, which affect fundamentals as well as the future evolution of fundamentals, these expectations can become self-fulfilling. Contagion can come about as low confidence feeds back into expectations and afflicts other parts of the market portfolio. So a circuit breaker mechanism that can halt this feedback cycle should be at the core of crisis mitigation.

Crisis mitigation comprises four main sets of policies: 1) provision of liquidity 2) measures to restore confidence 3) limiting contagion and 4) having a predictable next stage in case mitigation does not work.

In fact, the main focus of new policies and measures in the euro area has been on crisis mitigation, where a number of new measures have already been introduced.

EU Measures

BOX: EU Crisis Mitigation Facilities						
Facility Name	Legal Entity	Institution	Form of Support	Amount	Scope	Terms
ESFM	Private Entity	EC	Loan or Guarantee	EUR 60 billion	All MS	Non Concessional
EFSF	MoU	Eurofin	Loan or Guarantee	EUR 440 billion	Euro MS	Non Concessional
EBoP	EC	EC	Loan or Guarantee	EUR 60 billion	Non Euro MS	Non Concessional
Macro	EC	EC			Non MS	
ECB Bond Purchase	ECB	ECB	Market Support	EUR 60 billion?	Euro MS	No Explicit Concessional
Greek Rescue	IMF/ EU MS Bilateral	IMF		EUR 110 billion	Greece	Mixed

For the private financial sector, the crisis mitigation measures that have been introduced are: 1) temporary expansion of deposit guarantee schemes 2) provision of extensive government guarantees for bond issues by banks 3) confidence enhancing stress tests and 4) ECB measures (see Box below).

Additional measures that are being discussed and have been proposed include: 1) introducing minimum liquidity buffers 2) expanding capital buffers 3) issuance of contingent capital.

For sovereigns, measures put in place include 1) the rescue package for Greece 2) the EFSM 3) the EFSF 4) ECB measures (see Box below).

BOX: Crisis Mitigation Measures introduced by the ECB

For the financial sector

- Extra 12,6 and 1 month lending operations for commercial banks in addition to its normal 1 week and 3 month operations.
- Full allocation in some liquidity operations wherein banks were given access to unlimited funds at a given rate.
- Offering banks dollar funding which was mobilized through a dollar swap with the US Fed.
- Reducing the quality of collateral against which it lent from debt rated at least A to BBB-.
- Narrowing the interest rate corridor for its overnight deposit and lending facilities.
- Intervention in the market for covered bonds by instituting a EUR 60 billion facility. These bonds were backed by Mortgages or Public Sector loans.

For sovereigns

- Exempting Greek debt from minimum credit rating requirements for the purpose of collateral.
- Purchasing Greek, Irish and Spanish debt in the secondary market in order to help reduce some of the excessive margins the markets were charging these countries on their debt rollover.

Source: ECB Website and Financial Times

Policy discussion

The ECB's contribution to crisis mitigation measures has been large and substantial, especially for the banking sector. Many of the new facilities listed above were not envisioned at the time the ECB was designed and have not been formally a part of its policy armoury. So a first useful policy move would be to hardwire many of these 'new' facilities into the policy apparatus of the ECB so these could predictably be used as crisis mitigation tools in a future crisis.

There has been a renewed and growing interest in the idea of introducing Eurobonds. Much of the debate is somewhat misinformed and there is a perception that Eurobonds are 'new'. However Eurobonds of one kind or another have been in existence for several years now. The EIB borrowing in financial markets is a Eurobond as is borrowing by the EC for its Balance of Payment facility. If the EFSF ever issues any bonds, these too will be Eurobonds. There are several important aspects which need to be discussed for a true and accurate picture of what Eurobonds can and cannot do and whether they are indeed the panacea that several proponents sometimes make them out to be. For this it is important to remember that there are several different parameters that go into the design of such a bond so two Eurobonds with different design parameters would look very different from each other. The main parameters are: 1) Issuing entity 2) Purpose of issue 3) whether they are issued in lieu of or in addition to national bonds 4) guarantee mechanism.

Eurobonds can prove to be useful both for crisis prevention and crisis resolution and may also have a role in crisis mitigation but it is critical to remember that they are not a panacea. A more detailed appraisal of Eurobonds is contained in this compilation of papers so we do not expand on this discussion.

BOX: SWOT ANALYSIS OF THE EFSF (AND EFSM)

Strengths

- Substantial as long as the problem is limited to the periphery
- Involving all other members so increasing peace time incentives to monitor each other and limit moral hazard
- No upfront funding needed

Weaknesses

- Intended to only be primarily liquidity management tool
- Tackling a liquidity problem with a liquidity management tool solves it but tackling a solvency problem with this would make it worse and transfer the burden of adjustment from the private sector and international governments to euro area governments which would be politically poisonous
- The one month time period for action from request to issue can be too long in the midst of a crisis.
- The two stage process of the EFSF/EFSM issuing bonds and then giving the MS government a loan is needlessly complicated and expensive
- Temporary
- Too small to have any real impact especially if any of the larger MS gets into trouble. They can just about mitigate rollover risk for say a month, but then again, it might be much more sensible to issue guarantees instead of bonds
- The cost of funds provided (around 5%) is too high. A 5% interest burden would be very difficult for a country such as Greece to bear given its fragile fiscal situation
- The MS have decided against going for a preferred creditor status which exposes them to much higher levels of credit risk
- Because of the current structure (where the MS getting EFSF support no longer stands behind it) the size of the fund would diminish exactly when the demand for it would grow

Opportunities

- Could be the precursor of an EU wide or at least euro area wide fiscal instrument
- Can be made permanent to provide crisis mitigating liquidity support
- Could force the discussions on a more integrated EU crisis management framework
- Might grow with the size of the EU budget (the EUR 60 billion EFSM supported by the Commission budget), a longer-term objective of ever closer union.
- The EFSM should be the first port of call in the event of a crisis, and could effectively guarantee a much larger sum, e.g. EUR 300 billion or so (see below)

Threats

- At the high interest rates at which funds are being offered, this could exacerbate the solvency problem and be self defeating
- If there are losses inflicted on other Member States, this could potentially be in violation of the spirit, if not the letter of the Treaty
- Such losses may also harden political opposition to 'ever closer union' and may exacerbate MS tensions
- It is a network of bilateral loan agreements that make it possible for MS to pull out
- The fund does not have ultimate seniority over other loans
- Issuance of bonds by the EFSF might have a crowding out effect on MS bonds

Our Recommendations

While the EFSM/EFSF design is far from perfect, it can provide the basis for a good crisis mitigation tool for the euro area, particularly if policy suggestions for improving the set up are taken on board. Some of these are

- **A formalization of liquidity provision for sovereigns:** Because the IMF, the traditional provider of liquidity support for crisis mitigation is too small for most large euro area economies, the EU needs an additional vehicle to supplement the IMF's funds. We recommend that the EFSF should be made permanent to serve this purpose and its present minimum institutional structure is ideal for providing liquidity to euro area members on the back of an IMF program. The EFSM/EFSF should explicitly be only a liquidity support vehicle with clear safeguards against credit losses.
- **Preferred creditor status for the EFSF funding lines:** These safeguards can take the form of a preferred creditor status equivalent to the formalized US debtor in possession financing for working capital under the Chapter 11 bankruptcy framework or the less formal preferred creditor status conferred on multilaterals such as the IMF and the World Bank. EU Member States should formally institute changes into their domestic law so the EFSF or EFSM are treated as de jure preferred creditor at par with the similar status that multilateral organizations such as the IMF enjoy.
- **Reduce the rate of interest charged:** Since by definition the EFSF will provide support to MS in trouble, the penalty interest rate charge seems misplaced. Though a similar penalty is sometimes levied on the provision of liquidity support by central banks to the private sector, the situation with sovereign states is different enough not to justify a similar treatment. The IMF typically (as in the case of Greece) provides temporary support at a lower cost of funds. So the EFSF should provide funds at cost or at the rate at which the IMF is lending to the MS in question. A 5% interest rate in the case of Greece would simply worsen its finances.
- **The EFSM/EFSF should provide 'working capital' for crisis resolution:** As will be discussed in the next section, crisis mitigation measures are not always enough. This means that MS would sometimes need to restructure their debts. They will temporarily lose market access during this process but will still need access to funds. This is where a liquidity support facility such as the EFSF can continue to be useful by providing such funds but only under a clear legal guarantee for being first in line to get repaid should the crisis resolution process go awry.
- **The EFSM/EFSF should provide guarantees not loans (see box below):** We strongly believe that there are several advantages to the EFSM/EFSF providing bond guarantees rather than loans. A 3-5 years guaranteed bond issue program should provide enough time to deal with both liquidity and solvency problems that any MS faced. While the "guarantee over loan" change does not address the problem posed by the "no bailout clause" per se, it does avoid duplication and excessive transaction costs that are associated with the process of first issuing EFSF bonds and then making loans to MS.

The second big advantage of a guarantee mechanism is that it is much quicker to use so in the event of a liquidity emergency, guarantees can be issued for 'new bond issuance' more or less instantaneously rather than having to wait a month which the current suggested framework of EFSF issuance/MS loans would imply.

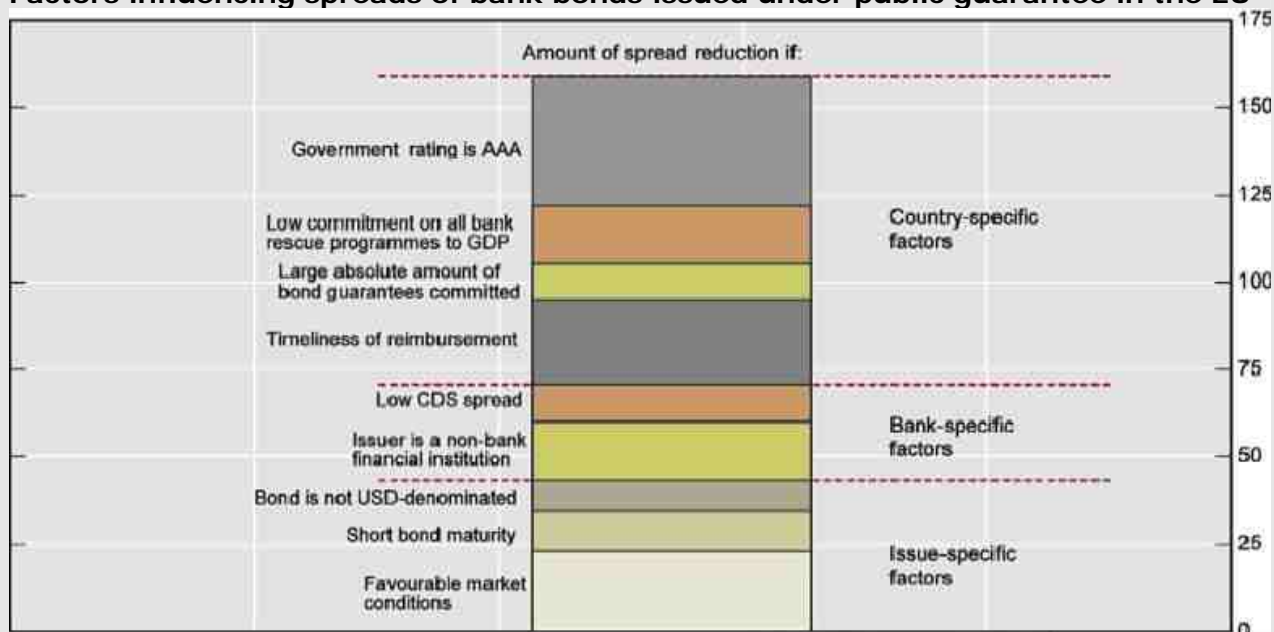
The third big advantage of a guarantee scheme is that it can help leverage a limited amount of funds. Looking at the model that MBIA and AMBAC, two municipal bond insurers in the US used before the financial crisis hit, it is clear that the EUR 60 billion EFSM could for example easily support a bond guarantee program between EUR 200 billion and EUR 300 billion in size with the EFSF capable of supporting a proportionately larger guarantee program.

The alternative, if a decision not to use leverage is taken, would still be to use the EFSF/EFSM to issue euro to euro guarantees for MS bonds rather than use outright bond issuance since it would reduce the double counting of outstanding debt for euro area MS and the market consistently under prices guarantees. This would mean that the debt statistics of euro area MS as a whole would look more favourable on paper and it is likely that the overall interest costs to euro area MS would be lower.

BOX: THE EU BOND GUARANTEE PROGRAM FOR BANKS

More than EUR 600 billion of bonds were successfully issued by EU banks under Member State guarantees, and these were very effective in stemming the crisis. This concept should be translated to sovereign bonds.

Factors influencing spreads of bank bonds issued under public guarantee in the EU



Source: "Government guarantees on bank funding: Should we extend them into 2010 despite improved bank profitability and the schemes' distortionary effects?" Vox EU column by Aviram Levy and Fabio Panetta, 2009

As the previous graph shows, the most important determinant of the cost of issuing guaranteed bonds is the strength of the guarantee (the country specific factors in the graph) with the nature of the issuing entity and liquidity of the bond issue being far less important.

The governments that issue the guaranteed bonds can be forced to accept conditionalities and pay a fee that in principle can be equivalent to the current plans under the EFSM/EFSF. We suggest, however, that any fee should not be payable upfront and should only be recovered once the sovereign in trouble has recovered. So the fee should be contingent on a healthy exit, which would reduce the likelihood of a self defeating outcome where the high cost of guarantees could potentially drive a government facing a liquidity problem into insolvency.

Another advantage of these short-term guarantees is that they are self extinguishing. As funding markets improved in 2009, EU banks issued less and less of these guaranteed bonds and the guarantee automatically expires when the bond matures.

EU banks have issued more than EUR 600 billion of government guaranteed bonds since the collapse of Lehman brothers and this has been a crucial crisis mitigation and liquidity provision instrument for banks which otherwise would have potentially collapsed after the crisis reduced possibilities for reasonably priced funding.

The cost of guarantees at 0.5% for bonds can be used as a benchmark for states. UK, German and French banks all issued more than EUR 100 billion of guaranteed bonds each. At one point, in the first quarter of 2009, as much as 30% of the funding needs of European banks were met through the issuance of guaranteed bonds.

6. Crisis resolution

Crisis resolution measures are mostly about restructuring debt and defining the burden of losses, which in the case of a firm involve 1) winding up or 2) declaring bankruptcy or receiving capital injections. For sovereign states these involve the restructuring of debt liabilities, with or without a formal default.

There has been little progress on instituting crisis resolution measures in the EU so far. Work is in progress on making provisions for a predictable and fast mechanism for resolving financial institutions but crisis resolution work for sovereign debt problems is not formally on the agenda of policy makers.

EU Measures - Head in the sand

EU leaders seem to have decided to put their heads in the sand and hope that the Greek storm is temporary and will blow away. While a number of steps, as discussed in the previous section, have been taken to present liquidity support to Greece, none of them account for the possibility that the Greek sovereign debt situation is simply unsustainable. With debt levels expected to stabilize around 150% GDP, a sharp downward revision to the GDP, increasing interest rates payable and the bulk of interest payments being made to Greek bondholders outside the country, it is unlikely that Greece will be able to repay its debts on existing terms.

Even if one suspends disbelief for a minute and assumes that Greece will be able to service its debts, it remains very difficult to justify why the burden should be shouldered exclusively by Greek public finances and why at least some of the burden should not fall on the private sector owners of Greek bonds. Bleeding a patient to cure him did not work in the middle ages. There is no reason why it would work now.

(There are some who say that this is the only way Greece will make the reforms that are strictly necessary for its long term vitality. That might be so. But the collateral damage being inflicted on several poorer segments of the Greek society is hard to justify. Surely there is a less round-about way of bringing this about.)

Other suggestions

Other commentators have made suggestions for putting in place debt resolution measures for the euro area in general and Greece in particular. These have in most cases involved suggestions for setting up a European Monetary Fund or a European Debt Mechanism. There have also been additional suggestions for putting in place collective action clauses (see contribution in this compilation).

However, for reasons elaborated in the next section, we do not find these suggestions to be wholly convincing though there are important aspects that can prove useful in the design of a more comprehensive crisis resolution mechanism.

Policy discussion

The EU's actions on insisting that Greece does not have a solvency problem are understandable in the context that policy makers did not want to spook the markets into a panic. However, these are ultimately self defeating and while the case for ignoring solvency issues might have been stronger in May, the sooner these are acknowledged and dealt with the better it is for all actors involved – the financial markets, Greece and the other euro area MS. Market panic has subsided for the time being and efforts should be made to refer Greece from crisis mitigation to crisis resolution treatment within the 2010 calendar year.

By refusing to acknowledge the depth of Greece's problems upfront, the EU has boxed itself into a serious corner. The longer we wait to recognize that Greece has a solvency issue, not just a liquidity problem, the bigger the burden of any eventual adjustment will need to be borne by the public sector in the EU as an ever increasing proportion of outstanding Greek debt will be directly or indirectly owed to fellow Member States. Such fiscal burden sharing would not only be politically poisonous but will also be against the spirit, if not the letter of the Treaty.

That is why Greek debt needs to be restructured, and done as quickly as possible, to enable the bulk of the burden to be shared between the Greek public sector on the one hand and the largely private sector holders of Greek debt inside and outside the EU on the other. This is primarily an issue of burden sharing between these two constituencies and should have been explicitly recognized to be so.

An increasing number of commentators have been calling for the restricting of Greek debts. There have been proposals to set up a European Monetary Fund (EMF) or a European Debt Mechanism (EDM), driven primarily by recognition to put in place a framework that would allow for sovereign bankruptcy.

However, there are already far too many institutions in the EU and the economic governance structure is already far too fragmented, so the establishment of yet another institution should be avoided to the extent possible.

Moreover, foreign governments hold more than \$1 trillion of euro area government debt and would be highly uncomfortable with any EU based institution being able to assign haircuts on holdings of euro area bonds due to potential for conflict of interest. That is why any institutional structure that deals with euro area state insolvency or debt restructuring has to be international and independent from the EU.

The IMF's Sovereign Debt Restructuring Mechanism failed to win widespread support partly because it was seen to be too close to the public sector by private bond holders, and in addition it was seen as potentially conflicted since the IMF too would have exposure to sovereigns whose debts it would help restructure. The right lesson from that is again that the EU cannot depend on an EU institution for restructuring as this would not be seen to be fair by the private sector, which is expected to bear a large part of the burden of any euro area government debt restructuring.

Because both foreign governments and the private sector will bear costs of the haircuts, it is essential to have an institution that would be acceptable to them and which would be seen to be independent of excessive government influence in general and the EU influence in particular. That is why we are strongly in favour of an international mechanism for debt resolution not a European one.

Adding collective action clauses to all future bond issues in Europe has also been proposed as a measure that can help a country restructure its debts when it gets into trouble. By itself this is a good idea, but 1) it involves a long transition period and 2) restructuring even with collective action clauses involves a long and tedious negotiation process with each outstanding bond issue needing to be separately negotiated. Also, 3) it is far too dependent on the likelihood of a reasonable agreement with the majority of bondholders to be a first best solution to countries facing over indebtedness. So a formal bankruptcy or debt resolution mechanism is preferable over a solution that simply involves collective action clauses.

Our Recommendations

Changing debt contracts has significant friction costs. Messy restructuring, in particular, involves significant economic pain both for creditors and debtors, and involves large deadweight losses. That is why it would be much better to put in place a predictable and independent sovereign debt resolution mechanism *ex ante* so that this can play a disciplining role in crisis prevention as well and enable a more efficient and fairer burden sharing.

This is the **ONLY** way to deal with sovereign solvency problems of the kind faced by Greece, especially as long as the no bailout clause exists and prevents other countries from picking up the tab. This in any case would be dangerous under the current political climate, when resentment against Greece in other MS is at an all time high.

The (direct) burden sharing has to be between the public and the private sector even if this might mean that other EU governments would then face a fiscal burden in order to recapitalize their private financial sector. This would be disciplining, reduce moral hazard, give these EU governments the opportunity to assert more control on their financial institutions including by changing management and it would be technically compatible with the no bailout clause in the EU treaty.

While some discussions have suggested putting in place pan-EU debt restricting mechanism, we believe that it would be strange, perhaps even irresponsible, to put in place a mechanism that applies to the EU alone, especially when poor developing countries have been (and will be again) in far greater fiscal trouble. Under the current fiscal scenarios, it is not just poor developing countries but several other rich countries such as Iceland that are in much worse shape than most euro area countries. Plus, it risks sending negative signals to the market that it is only euro area countries that can default.

Countries in the developing world are much more likely to need restructuring of their debts to other governments, multilateral organizations and the private sector. It would be a missed opportunity and go against the principles of coherence with development policy that are part of EU policy if the sovereign debt restricting mechanism the EU supports will not be open to developing countries. This is the third reason for putting in place an international rather than an EU specific mechanism.

The international environment has changed from 2002 and the IMF might be more acceptable this time round. Failing this, the BIS may be another interesting option. Or an independent arbitration panel or legal mechanism set up under the aegis of the UN with international statutory authority.

BOX: Instituting an International Debt Restructuring Mechanism (IDRM) for Crisis Resolution

The first best choice is for the EU to revive discussions on an international sovereign debt restructuring mechanism. The IMF's proposed SDRM, the US Chapter 9 model, Paris and London club restructurings, Brady bond restructurings and several other voluntary restructurings and defaults offer a series of instructive lessons on the best design for such an international mechanism.

An IDRM:

- 1) should be based on principles of burden sharing contained in the chapter 9 municipal bankruptcy code of the United States
- 2) extensively use GDP linked bonds and Eurobonds as exit instruments
- 3) operate quickly targeting the timeline for a sovereign bankruptcy of less than 6 months
- 4) make provision for adequate debtor in possession financing
- 5) use an independent panel of experts who are supported by a dedicated secretariat
- 6) address both loans and bonds
- 7) cover liabilities owed to both private and public entities and
- 8) operate under the aegis of a respected international body with a statutory status

Source: Tackling Sovereign Debt Systematically, Re-Define, 2010

BOX: Non Default Voluntary Restructuring

A default by sovereigns will have a large friction cost that creates deadweight losses and is usually very time consuming, especially in the absence of a formal institutional mechanism to deal with sovereign bankruptcy. Developing countries such as Jamaica have successfully restructured their bonds voluntarily. Such an option should be considered for Greece especially if the political will to institutionalize a formal sovereign bankruptcy mechanism cannot be mustered.

Under such a scenario payment terms on outstanding debts that would include both bonds and loans can be changed so as to reduce the effective burden of debt without triggering formal default. This helps avoid the friction costs associated with such an event. Lengthening the maturity period and reducing the interest rate payable are the two main tools that can a country mitigate its debt burden.

Here, there are a number of lessons that can be learnt from the Brady bond restructurings of the 1970s. Issuing gold standard Eurobonds or bonds guaranteed by other EU countries or a mechanism such as the EFSF in exchange for existing Greek bonds with an implicit haircut of 30%-50% would be a good way forward. Introducing a GDP linked payment component into these new bonds would further help reduce upfront costs for Greece without damaging longer term economic growth prospects. Market surveys indicate a growing appetite for such bonds.

Source: Tackling Sovereign Debt Systematically, Re-Define, 2010

7. Conclusion

The objective of this contribution is two-fold, 1) to put forward a comprehensive crisis management framework 2) and to make policy suggestions improving the various elements that comprise this framework.

In this paper we have shown that, in order to be complete, a crisis management framework will need to have three distinct but inter-related elements 1) prevention 2) mitigation and 3) resolution. Furthermore, we have highlighted how the policy discussions in the EU on the handling of sovereign crisis have thus far focussed their attention mostly on prevention and mitigation with no serious discussion of provisions for resolution.

The paper has also exposed how the ongoing discussions on crisis prevention are based on unrealistic and flawed assumptions. We have attempted to make serious new suggestions on how to improve the crisis prevention framework within the euro area which are based on a more realistic interpretation of the political economy of policy making in the euro area.

The policy measures adopted by the EU on crisis mitigation, which is where the firepower of the ECB and the EU has been concentrated, while substantial, still have room for improvement. We have put forward a number of concrete measures that could be taken in this regard.

Finally, we provide some ideas on building crisis resolution tools as a means of completing the euro area crisis management framework.

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2.2 WHAT FOLLOWS AFTER EFSM AND EFSF?

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Abstract

The near fiscal collapse of Greece last spring has triggered intense activity to prevent the fiscal crisis from intensifying and spreading more broadly across the euro area. This efforts lead to establishment of the European Financial Stability Mechanism (EFSM) on May 10 2010 and the European Financial Stability Facility (EFSF) on June 7. The crisis has also triggered a discussion of how to strengthen the Stability and the Growth Pact (SGP), which to date has been the main institutional mechanism to reduce the likelihood and severity of a public debt crisis. Furthermore and more importantly, the possibility of introducing an explicit Crisis Management Framework, which so far has been lacking, has received a great deal of attention. A specific issue in this context is what should come after, if anything, the EFSM and the EFSF, which will only be operative for a three-year period (although they may take some time to close after that).

This note has four sections. The first of these reviews some of the weaknesses of the SGP. Section 2 turns to the EFSM and the EFSF, and argues that the fact they are temporary is problematic since they may provide little incentive for government to change fiscal policy in a lasting way. Section 3 turns to what features a well-functioning regime for the resolution and management of crises must have. Section 4 makes some concrete suggestions for strengthening of the institutional framework and Section 5 concludes.

Contents

- 1. Institutional weaknesses to date45**
- 2. The EFSM and the EFSF46**
- 3. Reducing the risk of a public debt crisis in the euro area47**
 - 3.1 Less discretion and more automaticity 47
 - 3.2 Improving fiscal surveillance 47
 - 3.3 Graduated sanctions 47
 - 3.4 Greater emphasis on the level of debt than on deficits 47
 - 3.5 Greater focus on incentives and less on rules..... 47
- 4. Suggestions for a new framework48**
 - 4.1 Redesigning the SGP 48
 - 4.2 Establishment of European Fiscal Stability Agency 49
 - 4.3 The EFSF..... 49
- 5. Conclusions49**

1. Institutional weaknesses to date

It is useful to start by briefly reviewing the reasons why the SPG proved ineffective in avoiding the crisis and why it is necessary to have a clear framework for the management of crises.

The purpose of the SPG was to avoid the risk of a fiscal crisis by preventing euro area governments from accumulating (too) large public debts. The historical record, as well as the most recent experience, indicates that if the public debt is large and growing, bond holders may become concerned that the government might not be able to service and repay it. In turn, this may lead them to hesitate to roll-over bonds when they mature, triggering a sovereign debt crisis.

While the intentions behind the SGP were thus correct, why wasn't it adhered to? Several factors appear to have played a role.

The main reason was a lack of commitment to the SGP by euro area governments. The root of this problem is the fact that decisions regarding government spending and taxation involve redistribution of income and wealth and are therefore intensely political. Governments do not wish these to be restricted and therefore strive to avoid being seen as interfering in each other's fiscal policy decisions in the hope of reciprocal treatment. This hesitancy to comment on violations of the SGP and to invoke the Excessive Deficit Procedure meant that there was little incentive for countries to adhere to the SGP. Moreover, since no European country has experienced a public debt crisis in recent decades, some governments no doubt remained unconvinced about the dangers of large public debts.

This lack of commitment to the Pact was largely due to design problems that rendered it ineffective. Several weaknesses are now evident.

- First, there was a lack of automaticity in the application of the excessive deficit procedure and the SGP relied too much on peer pressure. In a small group of countries interacting on a range of issues that generate ample opportunity for trading off different objectives, it was difficult to forge agreement about the need to enforce the rules.
- Second, the sanctions were too abrupt and therefore too punitive to be used. Consider a government that sees economic activity, and therefore tax revenues, grow below trend. If this pushes the budget deficit about the 3% limit, the SGP required the country to tighten fiscal policy at a time of economic weakness, exacerbating swings in the economy.

Of course, the solution to this problem is to strengthen the government's fiscal position in good times so that a large recession would not push the deficit beyond the 3% limit. But such long-term policies are unlikely to be adopted in a situation in which governments face short-term political pressures.

- Third, there was a lack of clarity about whether excessive deficits were due to bad policy or bad luck, which made it difficult to the peer pressure mechanism to operate.

Budget outcomes are volatile and largely determined by the state of the economy rather than changes in fiscal policy. Thus, business cycle contractions reduce tax collections and increase the pool eligible for unemployment benefits and income support. Governments could thus argue that budget deficits occurred despite their best efforts to adhere to the rules.

Furthermore, it is difficult to enforce the rules of the SGP since budget outcomes are only known with a lag. While this problem could be avoided by holding governments accountable by using deficits forecasts, these are sensitive to assumptions made about economic growth. The fact that recessions tend to be correlated across countries implied that when one country saw its deficit worsen, so did the others. This was not conducive to peer pressure.

A further weakness in the pre-crisis regime was the absence of a crisis management framework. This was arguably not an accident but intended to support the SGP by demonstrating that there would be no support for countries that broke the rules and found themselves in a fiscal crisis. However, the lack of a framework led governments and market participants to guess that a sovereign default in the euro area and the likelihood that this would trigger a banking crisis would force euro area members to launch a rescue. Paradoxically, the failure to prepare for a sovereign debt crisis in Europe may have made such a crisis more likely.

To improve fiscal discipline, it is important to have a crisis management framework that credibly promises a rescue, but also provides disincentives to governments and lenders. That requires the bailout conditions to be unattractive, both economically and politically, to governments so that they provide firm incentives to avoid a crisis. In particular, assistance must also be subject to strict conditionality and involve stringent reporting requirements. Arguably more importantly, they must be unattractive to creditors so that financial institutions hesitate to lend to governments whose debts are large. For instance, financial assistance should involve automatic debt restructuring that entails a large reduction in the net present value of coupons and the principal.

2. The EFSM and the EFSF

As noted above, the Greek turmoil led to the establishment of the EFSM and the EFSF. The former was intended as a stop-gap measure, without a formalized superstructure, in order to avoid an immediate fiscal collapse of Greece. The latter was given a stronger institutional basis – it was established as a special purpose vehicle under Luxembourg law and given staff – but was designed to operate only for a three-year period. The intention appears to have been to demonstrate that the support given to Greece is exceptional and that it has three years to sanitize its public finances. After that, no support would be available for countries that had disregarded the SGP.

However, the temporary nature of the EFSF reduces its effectiveness since it signals that we will soon return to the pre-crisis situation where the SGP, although renegotiated, is again the only institutional arrangement designed to limit the risk of fiscal crisis. Rather than hoping that ambiguity about whether financial support will be available if needed will lead governments to adopt sounder fiscal policies, it seems much better to adopt a permanent framework that specifies under what conditions any help would be made available.

While the adoption of a permanent Crisis Management Framework in response to the Greek crisis might have been seen as undesirable because it would introduce moral hazard by holding out the prospect of financial support to governments borrowing imprudently, the point of such a framework is precisely to deter and prevent governments from accumulating too much debt so as to reduce the likelihood of a public debt crisis. As noted above, that requires the bailout conditions to be unattractive to governments and creditors alike.

3. Reducing the risk of a public debt crisis in the euro area

In order to reduce the likelihood of a repetition of the Greek crisis, a framework for the prevention and management of crises is needed. For the framework to be effective, it needs to be designed carefully. Before making some concrete suggestions for the institutional structure of the framework, this section asks what features it should have.

3.1 Less discretion and more automaticity

One problem with the SPG was that it relied on governments to take action to invoke the excessive deficits procedure against a peer. For the reasons discussed above, governments would naturally hesitate to do so. While a fully automatic SGP would not be credible since it would suggest that the system was out-of-control and therefore lack legitimacy, it is necessary to introduce a presumption that the excessive deficits procedure will be invoked unless euro area governments collectively take action to set it aside.

3.2 Improving fiscal surveillance

The role of short-term political influence in the surveillance of fiscal policy must be reduced. Decisions about whether countries are in compliance with the SGP should be made by a politically independent organ. In order for it to be able to do so, governments must make available more information, and with shorter delay, about their fiscal positions. They should also make available for review the assumptions (regarding growth, debt service costs, one-off items etc.) made when preparing annual budgets.

3.3 Graduated sanctions

Sanctions need to be graduated and of several forms. Rather than have the excessive deficit procedure come into play discontinuously at a deficit 3%, when, because of its procyclical effects, it cannot be enforced, interventions should start early and become progressively stronger. Initially, they should be primarily of a non-financial form and focus on ensuring whether countries seek to abide with the SGP, not to punish transgressors. This is important for building political consensus behind the revised SGP, which will be crucial for ensuring compliance with it.

3.4 Greater emphasis on the level of debt than on deficits

While the SGP introduced limits on both deficits and debt-to-GDP ratios, the latter provisions were not enforced because too many countries were in violation of them, in some cases egregiously. Since deficits are less important than levels of debt – the main reason deficits are important is that they signal higher future debt levels – this was unfortunate since it shifted the focus away from reducing debt levels.

3.5 Greater focus on incentives and less on rules

Finally, the SGP should focus less on rules and more on incentives that promote better fiscal policy. A common view before the crisis was that market discipline would provide incentives to limit debts and deficits since investors would hesitate to lend to governments with large debts and demand higher interest rates.

However, this mechanism was inoperative because the interest rate demanded depends not only on the probability that a government will default, but also on the likelihood that it will receive financial support if it does.

Unfortunately, investors did not believe that the no-bailout rule of the SGP would be enforced since a default would risk triggering a generalized banking crisis in Europe. In the absence of effective market discipline, a mechanism to raise borrowing costs to provide incentives to limit debt must be found.³²

4. Suggestions for a new framework

In light of the analysis above, what institutions are necessary to guard against a future fiscal crisis in the euro area? How should the SGP be redesigned? And what should follow after the EFSM and the EFSF?

4.1 Redesigning the SGP

The SGP needs to be strengthened. Below I sketch a set of reforms that could be contemplated.

First, the SGP will need to come into play at much smaller deficits and at lower levels of debt than is presently the case. Countries experiencing deficits greater than 1.5% of GDP and/or a public debt of 60% of GDP should enter a "surveillance regime."³³ This regime would require them to provide the European Commission, the ECB and a new European Fiscal Stability Agency (EFSA) with data on budget outcomes, and budget plans for fiscal consolidation. However, there would be no presumption that any immediate policy action needs to follow.

If the budget deficit is greater than 3% or the public debt is greater than 90% of GDP, the country would enter an "enhanced surveillance regime." This would require governments to present plans to reduce deficits and debt. Moreover, national budgets would need to be presented to the Commission, the ECB and the EFSA for public comment before adoption. If the budget deficit exceeded 5% of GDP or the public debt is greater than 110% of GDP, the country would enter a "strict surveillance regime." Under this, the Commission and the EFSA would send resident representatives to follow public finance developments on site and in real time.

To provide incentives to reduce debt, a new Fiscal Stability Charge should be introduced. The annual charge will equal 1% of the stock of public debt above 60% of GDP and will be paid by the national treasury.³⁴ The charge will be paid to the European Commission, which will return it to the euro area governments on a pro rata basis. Thus, for the euro area governments as a group, the net cost will be zero: the scheme will simply shift the cost of running Europe to the countries that have the largest debt and are most likely to need fiscal assistance.

Given the weak state of public finances currently, the rules would only apply to debt issued after January 1 2011. Since only a fraction of public debt is rolled over annually, it will take some time before the 60% limit is reached.³⁵

³² The idea here is that the cost of borrowing is currently too low since it does not capture the "bailout insurance" that membership in the euro area entails.

³³ The proposed thresholds for deficits and debts are only meant as illustrations.

³⁴ Thus, a country with a stock of public debt equal to 100% GDP would pay 0.4% of GDP per year.

³⁵ As an illustration, consider a country that has a debt to GDP ratio of 100%, that the debt all has a maturity of 10 years and that the maturity dates are evenly spaced. Thus, this country issues debt equal to 10% of GDP per year. By January 2017 it will have issued new debt equal to 60% of GDP and will that year pay a Fiscal Stability Charge of 0.1% of GDP. Next year, the charge will rise to 0.2% of GDP and so on until it reaches 1% of GDP by 2021.

4.2 Establishment of European Fiscal Stability Agency

The objective of strengthening the SGP is to reduce the likelihood that a euro area member will suffer a public debt crisis. But the recent experience has demonstrated that euro area governments are too hesitant to enforce the rules for them to be effective. The EFSA will be created as an independent organ to ensure proper surveillance and to trigger the different sanctions of the SGP.

The main objective of the EFSA is to review annually euro area governments' compliance with the SGP. It will do so by preparing annual reports on fiscal policy developments. Furthermore, it will determine what countries should enter the "surveillance regime" and the "enhanced surveillance regime" of the SGP, and it will be the main organ conducting that surveillance, including appointing resident fiscal policy experts to those countries for which that is required.

For such an institution to be effective, it must be small and not be afraid to take controversial positions. In turn, this requires it to have operational independence from euro area governments and other EU organs.³⁶ Since determining whether a country is in compliance with the SGP involves judgment and not a mechanical application of rules, it would be appropriate for that decision to be taken by a committee of experts of no more than nine members, rather than a single person, through majority voting. The committee members must be independent (that is, not be civil servants or politically active) and must not be permitted to seek or take advice from the outside. Moreover, they must be recognized experts in the area of banking, fiscal policy or monetary policy. They would be appointed by the euro area governments for a non-renewable term of 8 years. The appointments would be staggered.

4.3 The EFSF

But even if a revised and strengthened SGP, coupled with stricter surveillance through the new EFSA, will reduce the likelihood of a public debt crisis in Europe, there will always remain some risk of a new crisis. Since the EFSF has been established to deal with a sovereign debt crisis, but is designed to be operational for only three years, it is essential to make this facility permanent. While it would be possible to replace it with a similar institution, the EFSF already exists and already have a detailed set of rules regarding its operations.³⁷

Although these rules can be renegotiated and other regimes could be contemplated, at the current stage it seem premature to do so. Instead, attention should focus on redesigning of the SGP and the establishment of the EFSA.³⁸

5. Conclusions

To reduce the likelihood and consequences of another fiscal crisis in the euro area, several steps are desirable. The following steps seem crucial and should be taken promptly:

1. The SGP must be reinforced. It should involve more automaticity, have graduated sanctions and focus on providing incentives for better policy.
2. Fiscal surveillance and, in particular, adherence to the SGP must be strengthened by the establishment of the EFSA. This should be small and independent.
3. The EFSF must be transformed into a permanent institution.

³⁶ In turn, that requires it to be financially independent.

³⁷ See the "EFSF Framework Agreement" and the By-Laws of the EFSF, both of June 7 2010.

³⁸ See also Daniel Gros and Thomas Mayer, "How to deal with sovereign default in Europe: Create the European Monetary Fund now!", CEPS Policy Brief, No. 202, February 2010 (updated May 17 2010).

2.3 THE FUTURE OF EURO AREA FINANCIAL STABILITY POLICY

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Abstract

The past few months have exposed serious problems in relation to Europe's ability to cope with financial stress. Placing the new Financial Stability funds on a permanent basis, in the form of a new European Monetary Fund will be required if Europe is to deal effectively with the serious debt problems of some euro area countries. However, this fund should exist to manage sovereign defaults in an orderly manner, not to prevent them altogether. Bank supervisors also need to publish regular stress tests, change their regulations on the risk weighting of sovereign debt and put new resolution procedures in place. Together, these reforms will allow Europe to deal with future sovereign debt problems without provoking a crisis.

Contents

- 1. Introduction 53**
- 2. A sovereign debt safety net..... 53**
 - Formalising the Safety Net: A European Monetary Fund 53
 - Mechanics a European Monetary Fund 54
 - Allowing for Orderly Default 56
- 3. Improved European Banking Supervision..... 57**
- 4. Financial stability is not “saving the euro” 60**
- References 60**

1. Introduction

The sovereign debt crisis has exposed a number of serious problems in relation to Europe's ability to cope with financial stress. On May 9th a series of bailout funds for euro area countries were announced: €440 billion in the form of a European Financial Stability Facility or EFSF (a special purpose vehicle funded by euro area Member States), €60 billion in the form of a European Financial Stability Mechanism or EFSM (funded by the European Commission) and €250 billion made available by the IMF.

As I discussed in my previous briefing paper, while the public discussion of this decision has focused on the idea that this agreement was aimed at preserving the euro as the common currency, the truth was more prosaic: The European banking system was already in a fragile state and would not have coped with a series of sovereign defaults. The need to maintain financial stability, specifically banking sector stability, was what prompted the unprecedented announcement of the bailout funds.

The announcement of the emergency bailout funds have helped to restore some stability to European sovereign bond markets, though spreads on the debt of some of the countries with weak fiscal positions, such as Ireland, have widened in recent months. In addition, the subsequent EU-wide stress test has provided some clarification of the extent to which European banks are exposed to sovereign debt, though the funding situation for many banks still remains very challenging.

Despite the progress made in the past few months in dealing with the sovereign debt crisis, we are still a long way from having permanent institutions in place that can deal with the type of crisis situations that arose this year. The EFSF and EFSM are explicitly temporary in nature, intended to expire after three years, while the IMF contingency support is also likely to be available for a limited time.

In this paper, I first discuss what is likely to follow the EFSF and EFSM in relation to dealing with the sovereign debt issues. I argue that two principal approaches need to be taken. First, the temporary mechanisms should be formalised in the form of a European Monetary Fund, as proposed by Daniel Gros and Thomas Meyer. I outline how such a fund should operate, arguing that we need to be able to deal with sovereign defaults in the euro area in an orderly manner. Second, European banking regulation and supervision needs to be strengthened with the aim of making the banking system more robust to sovereign defaults. Finally, I offer some brief comments on the connection between the current crisis and the future of the euro as a common currency.

2. A sovereign debt safety net

Formalising the Safety Net: A European Monetary Fund

Even among those who may agree that the introduction of the €750 billion bailout fund was necessary, there are going to be different opinions as to how best to proceed from the current situation.

Those who are concerned about the moral hazard implications of the bailout fund are likely to recommend taking a hardline approach to future sovereign debt problems. This position views the recent bailout funds announcements (and actual bailout of Greece) as highly unfortunate events brought on by crisis circumstances and argues in favour of returning as soon as possible to a position in which "no bailouts" is again the prevailing position of the EU in relation to sovereign debt problems.

According to this argument, the key preparation work that needs to be done during the three years that the EFSF and EFSM are in place relates to fiscal adjustment and the reconstruction of fiscal institutions in European countries. To prevent the need for future bailouts, this approach would emphasise that the key priorities for the next few years are:

- (a) The adoption of budgetary adjustment plans that put all euro area countries back on the path to fiscal stability.
- (b) A new tougher approach to monitoring of national budgets by the EU Commission.
- (c) The introduction of improved national budgetary institutions which will see a greater role for external assessment and for fiscal rules.

There is an important ongoing debate within the various European institutions about how to achieve these improvements in budgetary management with many good ideas being discussed by the Van Rompuy Task Force. It is to be hoped that improved institutions will indeed deliver a more sustainable fiscal future.

It would be unwise, however, to believe that improved fiscal rules will allow us to rule out the possibility of severe fiscal problems arising in one or a number of euro area countries, so that the EFSF and EFSM can simply be allowed to expire without providing a replacement. There are a number of reasons for this:

- (a) A number of European countries are in precarious fiscal positions and adjustment plans are likely to take a number of years. Thus, it is unlikely that those European countries currently under threat will be restored to fiscal stability by 2013.
- (b) The health of the European banking system remains in question. The most likely trigger for sovereign defaults in the next few years is a prolonged period of slow growth or perhaps a double-dip recession. Should this occur, it will also have a negative effect on the capital position of the banking system and this would lead to the reoccurrence of the joint sovereign/banking problems that have emerged this year. In other words, we cannot assume that future fiscal problems will occur against the background of a strong banking system, which could allow for a more hardline "no bailout" approach.

For these reasons, preparations should be made to formalise the EFSF and EFSM into a single fund to assist euro area countries that are having difficulty with sovereign borrowing. In line with the proposals by Daniel Gros and Thomas Meyer (2010) which were circulated prior to the events of May this year, I will refer to this fund as a European Monetary Fund or EMF.

Mechanics a European Monetary Fund

How would an EMF work in practice?

Loan Distribution

In terms of its key job of making loans to European countries that are shut out of sovereign debt markets, the detailed framework agreement for the European Financial Stability Facility provides most of the ingredients for what appears to be a workable model that can be taken up by a future European Monetary Fund that is put on a permanent basis.

In relation to the decision to administer a loan from the EMF to a European country, the loan application should trigger a process in which the European Commission and the EMF analyse the country's economic and budgetary position and agree a fiscal adjustment program that must be adhered to if the loan program is to be maintained. This program can then be recommended to the Eurogroup of finance ministers who make the final decision on making the loan.

Staffing and Ongoing Monitoring

The EMF should be well enough staffed to be able to deal with emergency requests and the associated negotiations about fiscal adjustment in a timely manner. This raises the question, of course, of how to maintain a high quality and motivated staff for the EMF given the likelihood that its loan-making services are probably not going to be used most of time. The answer to this is that the EMF should be centrally involved in the ongoing (and improved) process of monitoring of national budgets under the Stability and Growth Pact. Up to now, this process has been handled by the European Commission. However, if an EMF is to be the organisation charged with helping out European countries in severe financial trouble, then it will be necessary and appropriate for them to maintain an ongoing engagement with each country that is eligible to obtain loans from the fund.

Financing

The EFSF also provides a clear model for how the EMF can be financed. euro area countries provide guarantees that allow for a Special Purpose Vehicle to be over-collateralised and thus be AAA rated. The SPV can then borrow on the bond market and lend the funds to applicant countries at a higher rate, reflecting the potential default risk. Any profits made from these transactions can then be retained to further capitalise the fund.

Of course, while the EFSF's structure is an obvious model for the initial capitalisation of the fund, one can imagine other ways to finance the fund on an ongoing basis. Gros and Meyer have proposed that the fund be financed in a way that acts as an ongoing incentive for countries to comply with the guidelines of the Stability and Growth Pact. Specifically, Gros and Meyer recommend that participating countries should contribute a fraction of each percentage point of GDP for which their debt-GDP ratio exceeds 60 percent and another fraction for each percentage point of GDP for which their deficit exceeds 3 percent.

The Gros-Mayer proposal suggests a mechanism for financing an EMF that would also help to reduce the likelihood that the fund is called upon. As a solution to an economics optimisation problem, it is both clever and efficient. However, I suspect it would prove very difficult to get this particular proposal implemented in practice. Governments in countries that currently have high debt ratios are likely to feel under enough pressure to get their fiscal houses in order over the next few years, so this additional pressure would be likely to be very unwelcome. Also, while the proposal may be politically popular in those countries with relatively low debts, it would be extremely unpopular in high debt countries. Insisting on such a proposal may end up undermining the continuation of the current bailout funds in a new guise.

Another question about this financing proposal is whether it would require a new Treaty. The current structure of the EFSF did not require any legal changes to the European Treaty as it is justified by Article 122 of the current consolidated Treaty on the grounds that it allows emergency help to a country facing "severe difficulties caused by natural disasters or exceptional occurrences beyond its control". For this reason, it would not appear that putting the facility on a permanent basis would necessarily require a new Treaty.³⁹

³⁹ This situation may change depending on the outcome of the German's Constitutional Court's examination of this issue.

However, it seems more likely that binding arrangements in which euro area countries are mandated to make specific contributions to an EMF based on their current debt and debt levels would require a new Treaty. If this was the case (and I am not a legal expert, so it may not be) it would seem unlikely that such a Treaty could survive the complex ratification process.

Allowing for Orderly Default

If the current bailout arrangements are to be formalised, an important question that arises is exactly what precedent has been set by the decisions made in May 2010. One potential interpretation is that the establishment of the EFSF has meant that the EU is committed to the principle that no euro area Member State can default. Indeed, much of public discussion in the run-up to the May 9th announcement focused on the idea that it would be unthinkable for a euro area country to default on its sovereign debt. The idea that the euro is more than an economic construct but part of a greater political project is commonly mentioned to justify the need to avoid default by a member country: euro membership, it is often argued, brings with it an obligation of all members to prevent a default on the part of their partners in the monetary union.

The Need for Potential Default

While the idea that default by a euro area country is unthinkable is commonly expressed, not least by leading politicians and central bankers, this ambition is too far-reaching and is unlikely to be achieved. Instead, I believe the more credible approach is the one that has been stressed by leading German politicians, most notably Wolfgang Schäuble, which is to emphasise the need for procedures to manage default by a euro area country in an orderly manner.⁴⁰

Greece is likely to provide an early testing ground for an EMF's approach to the question of sovereign default. The Greek adjustment plan is an ambitious one, with very large adjustments required to bring the budget deficit back towards the 3 percent range by 2014. However, this plan can hardly be considered a final solution to Greece's fiscal problems. The plan envisages Greece having a debt-GDP ratio in 2013 of 149% and with a flow of debt interest payments of over 8 percent of GDP. At that point, however, Greece's primary balance will be in surplus. Faced with a huge debt burden but with the ability to survive without new net borrowing, the Greek government will have a strong incentive to consider restructuring its debt and, ultimately, this will be a national decision.

The role of an EMF should not be to prevent a sovereign default or debt restructuring but rather to ensure that it occurs in an orderly manner that minimises disruptions in the defaulting country as well as knock-on effects on other sovereign borrowers and financial markets. Disruption to economic activity within the defaulting country can be achieved by the provision of loans to the government that is restructuring its debt, assisting it up until the point where it has regained credibility with private bond markets.

Mechanics of Default

In relation to minimising the impact on financial markets, Gross and Mayer have proposed that the EMF would set the terms of a restructuring, taking over all of the defaulting country's sovereign debt at a haircut set at a level that is designed to avoid financial system instability. This strikes me as perhaps too deep an involvement for the EMF.

⁴⁰ Jacques Melitz (2010) has also presented a strong case for the need to allow for possible sovereign defaults in the Euro area.

It is likely that an EMF will be a key creditor for countries that are facing default: Countries in this situation will almost certainly already have significant loans from the EMF. However, the EMF's debt is likely to only have the same status as other sovereign debt. In an interview with Dow Jones Newswire, EFSF Chief Executive Klaus Regling confirmed that "Unlike the IMF, the EFSF will not be a preferred creditor. It will have the same standing as any other sovereign claim on the country, *pari passu*."⁴¹

If this precedent is followed, then the EMF can play a key role in debt restructuring negotiations by indicating the terms of the haircuts that they see as appropriate for their loans. However, ultimately, the outcome of these negotiations should involve the government of the defaulting country, private sector creditors as well as the EMF. I would not recommend that the EMF take over all claims against the defaulting country by means of offering a haircut that is more generous to bondholders than they would obtain in bilateral negotiations with the defaulting government.

An important long-run benefit of a Greek default is that it would allow a future role for bond market monitoring of national sovereign debt risk. If bond market participants understand that euro area sovereign debt can still be defaulted on despite the existence of an EMF, then we are likely to see the markets pay close attention to ongoing fiscal developments in high debt countries. We would also likely see a continuation of higher spreads on peripheral euro area sovereign debt than prevailed prior to the current crisis: This would provide a market-based incentive for countries to reduce their debt levels, as markets would reward countries that get the fiscal houses in order with lower borrowing rates.

In emphasising the need for a framework for orderly defaults with realistic haircuts, I am aware of course that the EMF will have to take financial stability considerations into account. There can be little doubt that a series of sovereign defaults with large haircuts would have caused severe financial stability problems during Summer 2010 given the current weak state of the European banking system. However, as I discuss below, it is important that the next few years see an improvement in European bank capital levels and also the introduction of efficient resolution regimes for failed banks. Together, these steps will help to minimise the "collateral damage" of a future default.

Implications of Defaults for Political Support for Europe

Finally, what of the idea that a sovereign default would undermine support for the euro within the defaulting country? I think it is far from clear that this would be the case.

A debt restructuring may be associated with a painful fiscal adjustment program and may also be a cause for national embarrassment. However, if a country's government has reached the point where default is being considered, then it is likely that the alternative approach of soldiering on under a huge debt burden will also be very painful. Even if the EU could somehow ensure that a country in this situation did not default (and it's not clear that it can ensure this) it would be unlikely that the citizens of the country would be grateful to the EU (or the euro) for facilitating this outcome.

3. Improved European Banking Supervision

The Financial Stability referred to in the EFSF and EFSM relates largely to the stability of the European banking system. Uncertainty about the exposures of European banks to distressed sovereign debt has made funding conditions difficult for banks throughout Europe. The need to avoid the type of financial meltdown that accompanied the Lehmans default of 2008 was the principle motivating force behind the establishment of the bailout funds.

⁴¹ See www.efinancialnews.com/story/2010-07-19/klaus-regling-explains-the-eu-stability-fund

In addition to the permanent establishment of a European Monetary Fund, the other key direction in which policy needs to adjust is the improvement of the supervision and regulation of the European banking sector to avoid a repeat of the situation that arose this year. One clear requirement is for an increase in bank capital ratios and an improvement in capital quality. This development will make the whole banking system more capable of coping with losses of any sort. It is to be hoped that the ongoing Basle 3 negotiations will see some steps taken in this direction, though it is disappointing to see proposals for tougher regulation apparently being consistently watered down in the negotiations.

In addition to higher capital ratios, there are three areas where I believe there is a need for new approaches.

Stress Tests

One of the key problems that generated the financial tensions that begun in 2007 and rapidly worsened after September 2008 was the uncertainty about the size of the holdings by various banks of subprime mortgage backed securities as well as uncertainty about the value of the cashflows underlying these complex securities. Sovereign bonds are not complex securities but banks can sometimes be restrictive in relation to public disclosure of the composition of their sovereign bond holdings and uncertainty about these holdings was a factor in the recent period of financial turmoil.

For this reason, the stress tests performed by the Committee of European Banking Supervisors (CEBS) in July were a useful exercise. They clarified the extent of sovereign bond holding of various types across Europe's leading banks. The particular "stress test" applied was not, however, particularly stressful. Most sovereign bonds are kept on "banking books" as opposed to "trading books" for accounting purposes. With the short time horizon examined (only up to 2011) and the assumption of no sovereign default during this period, the CEBS exercise did not provide an accurate picture of the exposure of the European banking system to a true stress scenario in which there are sovereign defaults.

That said, the exercise did help to get enough information into the public domain to allow others to perform more accurate stress tests: For example, both Citibank and the OECD have released analyses that indicate the full scale of the exposures to sovereign debt and they clearly illustrate that such defaults would trigger serious problems.⁴²

These stress tests should now become a regular event, occurring at least once a year. In addition, it may be a good idea to hand responsibility for the design of the stress test over to the new European Systemic Risk Board. Hopefully, these exercises will become more honest about the likely outcome of stress scenarios if placed in the hand of a body charged with preventing systemic financial instability.

Regulatory Treatment of Sovereign Debt

One reason that banks hold sovereign debt is that the Basle capital adequacy rules deem them to be a very low risk and thus allow banks to increase their leverage. Indeed, the Basle 2 rules allow sovereign debt rated above AA- to carry a risk weight of zero while similarly rated corporate bonds have a risk weight of 20%.⁴³ Similarly, government bonds rated from A+ to A- to have a risk weight of 20% while similarly rated corporate bonds have a risk weight of 50%. This regulatory approach can mean that banks that have considerable holdings of sovereign bonds may appear to be well capitalised but are, in fact, highly vulnerable to sovereign defaults. Whatever emerges from the Basle 3 negotiations, European regulators should end this asymmetry between the regulatory treatment of sovereign and corporate bonds.

⁴² See Citibank research note of 26 July 2010 "European Bank Stress Tests: Delight in Details, Headlines Underwhelm" and the OECD paper by Blundell-Wignall and Slovik.

⁴³ See page 19 of BIS (2006) for the sovereign bond figures and page 23 for the corporate bond figures.

In addition, regulators should enforce strict limits on the extent to which banks hold the debt of their own country's government. The tendency to hold large amounts of local country debt may be due to the continuation of long-standing practices that pre-date EMU. It is also likely that, in recent years, there has been pressure on banks that have been helped by government bailouts of various kinds to respond in kind by providing funding for their sovereign. However, this is a dangerous practice from a financial stability perspective: These bonds are a particularly poor "hedge" for banks because they are likely to default during periods when the rest of a bank's balance sheet is also deteriorating due to poor local economic conditions.

Recapitalisation and Resolution Regimes

Finally, just as the best approach to sovereign default risk is to accept that every so often countries will default, the best approach to handling the financial stability implications of such a default is to accept that, despite regulators best efforts to ensure that banks are equipped to cope, some European banks will get into severe trouble when such defaults occur.

Europe needs to have an agreed set of rules as to how to deal with failing banks, so as to avoid a repeat of the spectacle of late 2008's ad hoc patchwork of liability guarantee and recapitalisation programs. Two sets of policies need to be developed: Policies for dealing with systemically important banks that are becoming undercapitalised and policies for dealing with failed banks.

On recapitalisation, I am inclined to support Willem Buiter's call for a pan-European Financial Institution Recapitalisation Fund (FIRF), funded by national governments and perhaps also by taxes on financial activity.⁴⁴ This fund could work hand in hand with a new tougher approach to bank capital standards. Large European banks that fail stress tests could be given the choice of raising capital externally or accepting equity investment from the FIRF. The terms of these investments and the policy on subsequent sales of equity shares would be standardised and designed to maximise a return for the fund.

In some cases, however, banks may turn out to be insolvent and recapitalisation by an FIRF would be a poor use of taxpayer funds. In this situation, it is important that regulators intervene once capitalisation falls below a certain level and put the bank into resolution regime, which sees the banks creditors compensated in accordance with their seniority. The legal structure for such a regime could follow the Special Resolution Regime established in the UK.

Depending on the financial stability situation prevailing at the time, regulators can decide whether or not public funds should be provided to compensate senior bond holders and other providers of longer-term funding. However, it is important that there be agreement that providers of Tier One capital (equity and subordinated bond holders) are not compensated. If providers of risk capital to large European banks believe that there are limits to how much downside risk they will have to take on, then the cycle of excessive risk taking by banks followed by banking system failure, is likely to continue.

⁴⁴ See Buiter's Citibank Global Economics View paper "Sovereign Debt Problems in Advanced Industrial Countries".

4. Financial stability is not “saving the euro”

Finally, I think it is important to put this discussion into some perspective and to understand what is, and what is not, at stake in relation to these proposals.

It is important that Europe put in place a framework for dealing with severe fiscal problems in its Member States. Disorderly sovereign defaults, perhaps combined with the need to reduce a budget deficit to zero, can cause unnecessary trouble for the defaulting country's citizens. They can also cause serious problems for financial institutions inside and outside the defaulting countries and the recent global crisis has painfully provided more evidence for how financial instability can trigger serious disruptions in the real economy.

For all of these reasons, Europe needs to implement some serious institutional reforms in the area of budgetary policy, emergency assistance for distressed sovereigns and banking sector stability. These reforms matter for all EU countries, not just the members of the euro area. However, because euro area members do not have the option of devaluing, they are more likely to fall victim to sovereign debt and financial stability problems in the face of a severe recession.

In this sense, the reforms that are under discussion need to be implemented if the euro area is to maintain financial and fiscal stability. However, the continued use of overheated language about “saving the euro” or even “supporting the stability of the euro” is, in my opinion, inaccurate and unhelpful. euro area countries that experience a sovereign default are not, in fact, likely to leave the euro after the default. The series of practical problems associated with unilaterally issuing a new currency and then devaluing it (see Eichengreen, 2007) are such that it is unlikely to be considered as an option by defaulting countries.

The euro may still break up, however, if it becomes unpopular with the public in core countries such as France and Germany. If new institutions such as a European Monetary Fund are seen institutionalising bailouts to less disciplined euro area countries, they may play an important role in undermining the euro. Those who support these new institutions will need to ensure that they are well designed if they are to improve, rather than damage, the euro's chances of survival as a common European currency.

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3. (ORDERLY) SOVEREIGN DEFAULT PROCEDURE FOR THE EURO AREA?

3.1 MARKET IMPACT OF ORDERLY SOVEREIGN DEFAULT

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Abstract

The financial crisis led to a severe economic downturn in Europe, culminating in further sovereign debt problems for many euro area governments. The Greek sovereign debt crisis raises important questions about the adequacy of Europe's sovereign debt default and restructuring process. The paper examines the market impact of an orderly sovereign default, and what type of orderly default arrangements should be established by the EU to facilitate a more efficient restructuring process. The paper argues for a decentralised approach to sovereign debt restructuring based on collective action clauses which facilitates negotiations between creditors and sovereigns and which is based on harmonised EU principles and guidelines and administered by a EU sovereign debt agency.

Contents

Executive Summary..... 65

1. The Greek crisis and the sovereign debt problem..... 66

 The Greek Crisis..... 66

 Lessons from the Mexican 'tesobono' crisis..... 66

 European Monetary Fund..... 68

2. Market impact of sovereign debt shocks 69

 EU Bank Stress Tests 69

 The European Financial Stability Facility (EFSF) 70

3. Reforming Sovereign Debt Restructuring in the EU 72

 A Decentralized EU Institutional Approach..... 72

 EU Financial Stability Fund..... 75

Conclusion..... 76

References 77

Executive Summary

The global financial crisis has led to a severe recession in Europe culminating in sovereign debt problems for many euro area governments. Greece was particularly hard hit because of fiscal mismanagement and unsustainably high levels of public debt, resulting in an extraordinary and unprecedented bailout by euro area governments and the IMF with the creation of the European Financial Stability Facility. The Greek crisis demonstrates the inadequate macro-economic crisis management framework in the EU and the need to establish a more orderly sovereign debt restructuring process.

Europe presently does not have a legal or formal institutional framework to resolve a sovereign debt default or restructuring. Indeed, the Greek crisis and the growing sovereign debt problems of other EU states raise important questions whether EU policymakers should establish a formalised institutional process across the EU to promote more orderly sovereign debt restructurings. The paper analyses a number of corollary questions about how such a process could work without undermining market discipline, and what powers, if any, should be allocated to EU institutions to oversee sovereign debt restructurings and whether this complies with the EU treaties. It further examines what set of principles should guide policymakers in devising such an institutional framework and whether this could help indebted countries avoid a damaging loss of investor confidence and destabilising market volatility.

In addressing these issues, this paper examines two main areas:

- 1) the market impact of an orderly sovereign default or restructuring and the efficacy of the newly-created European Financial Stability Facility (EFSF), and
- 2) what type of orderly sovereign default arrangements should the EU establish for its Member States which experience liquidity or solvency problems.

In evaluating the first question, the paper reviews the proposal for a European Monetary Fund and the operational structure of the EFSF. These approaches intend to remove the risk of disorderly default, which is the main risk that countries in a fiscal crisis pose to financial stability in the euro-area. Although the establishment of the EFSF has brought some stability to European financial markets and has resulted in lower spreads on the sovereign debt of Greece and other vulnerable euro-area states, it is intended to be a short-term measure designed to restore investor confidence in euro area sovereign debt.

The paper will also examine the results of the recent EU bank stress test scenarios overseen by the Committee of European Banking Supervisors (CEBS). The stress tests show that 84 of the 91 EU banks are well-capitalised and moreover do not have excessive exposures to sovereign debt investments.⁴⁵ In fact, most of EU sovereign debt is held by non-bank institutional investors, both regulated and non-regulated alternative investment funds, meaning that a sovereign default would probably not result in an EU banking crisis because of banks' relatively low level of exposures to EU sovereign debt, but instead would lead to large losses for pension funds, insurance companies and hedge funds with less likelihood of leading to a systemic financial crisis. The chapter suggests that the real risks for most EU sovereigns derives from their assumption of balance sheet risks from their banking sectors which were incurred by the banks during the boom years preceding the credit crunch and which now threaten the viability of the sovereign finances of several EU states.

The second area examines the weaknesses of the existing institutional framework for sovereign debt default and sets forth some principles and guidelines for reform of the sovereign debt restructuring process.

⁴⁵ See discussion in Chapter 2.

The paper argues that the EU should adopt a decentralised sovereign debt default and restructuring process that emphasises the use of collective action clauses (CAC) to facilitate negotiations and restructuring creditor claims when a sovereign is experiencing financial difficulties. EU legislation should harmonise the principles and guidelines that govern the operation of CACs, but parties should be permitted some freedom to decide certain CAC repayment terms and some of the parameters of the restructuring process. (3.1) Also, EU institutions should create an EU sovereign debt agency (3.2) that would oversee the application of EU principles and guidelines for Member State sovereign debt negotiations and contract formation and would provide market data on sovereign debt markets to market participants and sovereigns. The EU sovereign debt agency could also administer a European Financial Stability Fund that would be created to provide liquidity to states experiencing financial distress if the state in question fulfils the requisite conditions for obtaining support. The Fund would be financed by a small transaction tax on all sovereign bond trading and derivative instruments. (3.2)

1. The Greek crisis and the sovereign debt problem

1.1 The Greek crisis

The problems arising from the Greek sovereign debt crisis raise important issues regarding how the EU and the euro area institutions should assist Member States which are experiencing liquidity and/or solvency problems. The EU lacks a fiscal policy dimension to assist states experiencing financial difficulties in crisis situations. Indeed, Article 125 of the Lisbon Treaty (TFEU) prohibits EU institutions from bailing out EU states experiencing fiscal problems.⁴⁶ Article 122 TFEU, however, provides the legal basis for EU institutional and Member State support, as it calls for political and financial solidarity with Member States that are in severe difficulties. Paragraph 2 of Article 122 authorises the Council to grant financial assistance from the Union to a Member State if the state in question is in, or seriously threatened with, severe difficulties caused by natural disasters or 'exceptional occurrences beyond its control'. Although a state facing serious budgetary constraints and financing problems would certainly not qualify for the natural disaster exception, it might qualify for the 'exceptional occurrences beyond its control' case on the grounds that a self-inflicted budgetary limitation in combination with a global financial crisis that caused a substantial reduction in the country's GDP is an exceptional occurrence beyond its control.

Based on the Treaty provisions, the EU could adopt institutional reforms that provide state guarantees to Member States experiencing serious financial difficulties the causes of which are partly beyond their control. The mismanagement of the Greek economy, exacerbated by the collapse of world trade and hence the collapse of shipping revenues, led to cumulative severe pressures on the bond sales necessary to fund the Greek government deficit. Since Greek government bonds are denominated in euros, investors faced no currency risk. However, they did face increasing fears of default. The reaction in European capitals was to initiate a protracted, indecisive debate on raising the funds for a Greek "bail-out". As vague pronouncements were piled on indecision, the fear of default increased, so that when the €120 billion bail-out was at last agreed, it proved inadequate as a defence against the rising tide of default pessimism. The Greek crisis, along with the recent sovereign debt difficulties of a number of EU states, has defined the shape of necessary institutional and market reforms to be considered in this paper.

⁴⁶ Article 125 (1) TFEU excludes the allocation of liability to the Union and the Member States for the commitments of another Member State.

1.2 Lessons from the Mexican 'tesobono' crisis

The confused handling of the Greek crisis stands in stark contrast to the rapid and effective measures taken by the United States Government in the Mexican debt crisis of December 1994, which was very similar in important respects to the Greek crisis. The Mexican government had borrowed billions of dollars of short-term US dollar denominated debt when the economy was growing. When Mexico fell into a severe recession in 1994, it was forced to devalue the peso. This drove up the value of its sovereign bonds or 'tesobonos', as they were known. Investors in Mexican government tesobonos faced a complex mixture of currency risk and default risk.

By late 1994, Mexican government finances were collapsing with US\$25 billion coming due in a few months while central bank reserves had fallen to less than US\$6 billion. In devising a rescue plan, US policymakers and the IMF had not forgotten the Latin American debt crisis of 1982 in which the Mexican government had defaulted on US\$80 billion in loans from large – mainly US – banks, creating a contagion that spread rapidly across Latin American countries, causing them to seek emergency refinancing of their US dollar denominated loans from foreign banks. The US government intervened with guarantees for the loans only after defaults led to the near failure of several large US banks: the U.S.'s slow response in providing emergency liquidity support in the form of loan guarantees worsened the crisis and plunged Latin America into a severe recession that stunted its economic development for nearly a decade.

In contrast, during the 1994 Mexican crisis, the Clinton administration, acting with support from the International Monetary Fund, assembled a \$50 billion emergency package in a few days, predominantly in the form of guarantees, which stemmed the investor run and rapidly restored confidence.⁴⁷ Although the 1994 crisis was smaller than the Latin American crisis of the early 1980s, it could have threatened financial stability throughout Latin America and in other developing countries.⁴⁸ Moreover, the growing integration of international trade and financial markets suggests that the negative externalities of financial risk-taking can spread more quickly across borders and threaten global financial stability.

In contrast, if a credible euro area institution had guaranteed Greek bonds at the outset and had imposed adequate fiscal adjustments and facilitated restructuring of bondholder claims, the immediate crisis would probably have been over sooner, at much lower costs. Instead, the euro area's leading states, Germany and France – dithered and allowed the Greek crisis to worsen considerably. It was not until an emergency meeting of EU finance ministers held on 9 May 2010 where they agreed to adopt an extraordinary rescue package guaranteeing all of Greece's sovereign bonds and the bonds of other euro area members by establishing an off balance sheet entity which would issue bonds worth up to 660 billion euros (including an IMF 250 billion facility) to banks and other investors which would be fully guaranteed by euro area states. The emergency rescue package essentially bailed out the banks and other creditors who had purchased Greek sovereign debt and it imposed the burden of adjustment almost entirely on the taxpayers of Greece and indirectly on the taxpayers of all euro area states. The Greek rescue package will have the effect of increasing moral hazard for the creditors of EU sovereign states by incentivising them to make more and riskier loans to euro area states with the cost of any adjustment borne by the debtor state and indirectly by European taxpayers.

⁴⁷ As Alan Greenspan recounts in his autobiography: "Mexico ended up using only a fraction of the credit. The minute confidence was restored, it paid the money back-the United States actually profited \$500 million on the deal". Greenspan (2007).

⁴⁸ The North American Free Trade Agreement had liberalised much of cross-border finance and trade between Mexico and the U.S. with the result that the two economies were increasingly integrated and exposed to the economic and social problems which both experienced.

The confusion and delay in putting together the guarantee fed the flames of volatility and it is now not clear that even this sum will be enough. A more damaging sequence of events would be difficult to imagine, but worse may come. Having at last chosen to follow a sensible guarantee strategy, the euro area governments plan to resuscitate the Stability and Growth Pact. The euro area was and continues to be gripped by deficit hysteria, with all governments being forced to commit to massive cuts in public expenditure. It appears that the path to recovery may be paved with higher unemployment and bankruptcy.⁴⁹

1.3 European Monetary Fund

The absence of an EU sovereign debt restructuring framework and sovereign default mechanism has led to a proposal for a European Monetary Fund which could provide financial support to EU states which have already adopted the euro. The proponents of the EMF, such as Daniel Gros and Thomas Mayer, argue that a sovereign default mechanism is necessary for the following reason:

The strongest negotiating asset of a debtor is always that default cannot be contemplated because it would bring down the entire financial system. This is why it is crucial to create mechanisms to minimise the unavoidable disruption resulting from a default. Market discipline can only be established if default is possible because its costs can be contained.⁵⁰

The idea of the EMF is premised on the notion that sovereign defaults are good economic policy if a state has assumed unsustainable debt and that an orderly default can be permitted because its costs can be contained.⁵¹ This is an important assumption that drives the EMF proposal. The proposed EMF has been supported by the German Finance Minister and the IMF Managing Director.⁵²

The EMF proposal is an important development in the debate over whether to establish a centralised sovereign default support mechanism in the EU. Under the proposal, it would be operated by the euro area states but is open to participation by all EU states if they satisfy the requisite conditions. Serious legal concerns have been raised about whether the EMF can be established through the enhanced cooperation framework of Article 236ff TFEU and whether it violates the no-bailout prohibition of Article 125 TFEU and qualifies for the exceptions in Article 122 TFEU.⁵³ It is submitted that in addition to the legal concerns, the adoption of the proposed EMF would represent a substantial centralisation of EU institutional authority to provide guarantees to ailing EU sovereign debtors without an adequate market-based framework to encourage or facilitate negotiations between creditors and sovereigns over the restructuring of sovereign debt. Nevertheless, the EMF proposal is under serious consideration by EU policymakers and will continue to play an important role in the debate over a reformed sovereign default mechanism in the EU.

⁴⁹ As the *Financial Times* leader argued on 25th May 2010:

"growth is a precondition for stability, not something to be traded off against it. Putting countries on the rack of debt deflation will not stabilise their economies, only destabilise their politics".

⁵⁰ Daniel Gros and Thomas Mayer, 2010, 'How to Deal with the Threat of Sovereign Default in EU: Towards a Euro(pean) Monetary Fund', *Intereconomics - Forum*, (2) pp. 64-68.

⁵¹ The mechanics of the EMF proposal are analysed in a compilation of papers published by the European Parliament and will not be discussed further in this paper. For further analysis, see generally *Intereconomics – Forum* (2) pp. 64-95.

⁵² Dominique Strauss-Kahn, IMF Managing Director, Lecture at King's College, Cambridge, Institute for the New Economics Teaching (INET) conference, (10 April 2010).

⁵³ Ulrich Häde, 2010, 'Legal Evaluation of a European Monetary Fund' (2010) *Intereconomics – Forum vol. 2*, pp. 69-72.

2. Market impact of sovereign debt shocks

2.1 EU Bank Stress Tests

The EU Council mandated the Committee of European Bank Supervisors (CEBS) to conduct a second EU-wide bank stress test in July 2010 in cooperation with the European Commission, the ECB, and EU national supervisory authorities.⁵⁴ The stress test's overall objective was to provide policymakers with information to assess the robustness of the EU banking system against adverse economic developments and the ability of individual EU banks to absorb potential shocks to their balance sheets, including sovereign debt risks.

EU regulators announced the results of the stress tests on 23 July 2010 that showed that 84 of the 91 tested EU-based banks did not need additional capital under an adverse or worst-case scenario of a financial crisis. Investor reaction to the stress test results was positive, as bank shares increased sharply and the costs of insuring their bonds against default declined significantly.⁵⁵ With only 7 of the tested banks needing capital support under an adverse scenario, the results suggested that EU banks are recovering from the credit crunch and withstanding the economic downturn.⁵⁶ It should be emphasized, however, that the results of the stress test exercises do not provide forecasts for the EU and euro area economies, but instead provide 'what-if' scenarios with plausible but extreme assumptions which are not likely to occur.

Under the hypothetical adverse scenario which includes a sovereign debt shock, the bank capital ratios of the 91 banks would fall mainly because of credit impairment losses of 472.8 billion euros over a two year period and trading losses of 25.9 billion euros over this period.⁵⁷ Moreover, losses associated with a sovereign default involving one or more sovereigns would reach 67.2 billion euros over a two year period, of which 38.9 billion euros would be valuation losses of sovereign exposures arising from the trading book. Total impairments and trading losses under the adverse scenario, including the sovereign debt losses, would be 565.9 billion euros.

Under the adverse scenario which included a sovereign debt shock, the impact on bank capital levels was not severe. To demonstrate this, Appendix A contains a sample of large banks based in six representative EU countries and shows the impact on bank balance sheets of, respectively, credit impairments, trading losses and sovereign debt shocks. The important point for this analysis is that the reduction in bank capital levels because of a sovereign debt shock was small relative to the reduction because of credit impairments and trading losses. For example, under a normal scenario, Deutsche Bank would hold 13.2% tier one regulatory capital, but under an adverse stress testing scenario which excluded a sovereign debt shock it would suffer additional credit impairments and trading losses which reduced its tier one capital to 10.3%. However, if the adverse scenario includes a sovereign debt shock, its tier one capital only falls another 0.6% to 9.7%.⁵⁸

⁵⁴ The Council Decision was based on the ECOFIN decision at its 2 December 2009 meeting. See http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111706.pdf. The first EU bank stress tests were conducted in 2009 and were reported to the September 2009 Financial Stability Table of the Economic and Finance Committee of the EU Council (EFC) and then to the October 2009 meeting of the ECOFIN. The EFC then requested CEBS to carry out a second test in 2010 that would assess the overall resilience of the EU banking sector to shocks and the ability of individual banks to absorb shocks on credit and market risks and their dependence on public sector support. See CEBS, 'Aggregate outcome of the EU wide stress test exercise coordinated by CEBS in cooperation with the ECB' (23 July 2010) p. 10.

⁵⁵ Sara Schaefer Munoz and David Enrich, 'Irish Banks Rattling Nerves', *Wall Street Journal* (13 Aug. 2010) C2.

⁵⁶ Simon Boughey, 'Stress tests bring renewed optimism to bank credits', *The Financial News*, (2 Aug. 2010) p. 27.

⁵⁷ See CEBS, above n. 54.

⁵⁸ Similar results were found for other large, systemically important banks in different EU states. BNP Paribas held tier one capital of 11.4% under normal conditions, which dropped to 9.7% under stressed conditions excluding a sovereign debt shock. If the stressed conditions included a sovereign debt shock, however, the bank's capital only fell another 0.1% to 9.6%.⁵⁸ Similarly, the results for Barclays plc show that it held tier one capital of 15.8%

The results of the stress tests for the 91 banks demonstrate that sovereign debt shocks are not a significant source of banking instability in the EU. The 91 EU banks that were stress tested had relatively low exposures to sovereign debt which suggests therefore that any sovereign debt losses arising from default or restructuring would not directly threaten the stability of the banking system.

Nevertheless, it should not be forgotten that financial crises do not have to arise from bank defaults: in the period leading up to the credit crisis in 2007 banks were over-capitalised and it was the loss of liquidity in the wholesale capital markets which caused the securitisation markets to fail. Wholesale capital markets can go into panic mode without a bank failure and when economic fundamentals appear to be sound. Investor behaviour can sometimes be irrational and focus on events that can trigger a crisis but which do not appear to the rational investor to affect the health of the financial system. A sudden loss of investor confidence in sovereign bonds could happen because of what average investor opinion believes average investor opinion to be *ad infinitum* in a Keynesian sense.⁵⁹ Moreover, the impact on market stability of bank exposures to sovereign debt is not the only way that sovereign debt problems can threaten financial stability. In fact, the assumption by sovereigns of banking sector liabilities and assets in the recent crisis, either through direct guarantees of bank liabilities or by taking an ownership interests in banks and/or assuming the risks of their toxic assets, has created another channel whereby financial sector instability and bank fragility can seriously weaken the balance sheets of sovereigns.⁶⁰ This has been the case not only for euro area states experiencing financial difficulties such as Greece, Portugal, Spain and Ireland, but also for states such as Germany whose stronger economic growth has been accompanied by surging fiscal deficits arising in part from the assumed liabilities of bailed-out German banks.⁶¹

2.2 The European Financial Stability Facility (EFSF)

The European Financial Stability Facility (EFSF) was approved by Council on 10 May 2010 to provide funding support to euro area states who are in financial difficulties.⁶² euro area states (excluding Greece) pledged 440 billion euros to the fund that will be guaranteed by these 15 states according to their respective contributions to the capital of the European Central Bank.⁶³ To enhance its creditworthiness, the fund has a cash reserve of 20% in addition to the amount pledged by each member. It is designed to be a short-term financing arrangement that will last for only three years, after which, the fund will be dissolved if no member has drawn on it.⁶⁴

under normal conditions which fell to 13.9% with credit impairments and trading losses excluding sovereign debt shocks. Its capital level fell only 0.2% from 13.7% to 13.5% with the sovereign debt shock. See Appendix A.

⁵⁹ See JM Keynes, *The General Theory of Employment, Interest and Money* [1935](1964 ed.) (Harcourt Brace: Orlando) chap. 12, analogising investor decision-making to the British newspaper beauty contests of the 1930s in which readers selected winners based on what average opinion believed average opinion to be and not on whom they actually believed to be, or should be, the winner.

⁶⁰ See Munoz and Enrich, above n. 55, C2, providing data on how Irish sovereign bond spreads are growing significantly, in part, because of the government's assumption of liabilities of the largest Irish banks; see also, Boughy, above n. 56, p. 27, providing data on the extent of the Irish government's liabilities and toxic assets assumed from partial nationalisation of the largest Irish banks. Also, the extent to which the German government's deficit has surged in 2010 is due, in part, to its assumption of the liabilities and toxic assets of some large German banks.

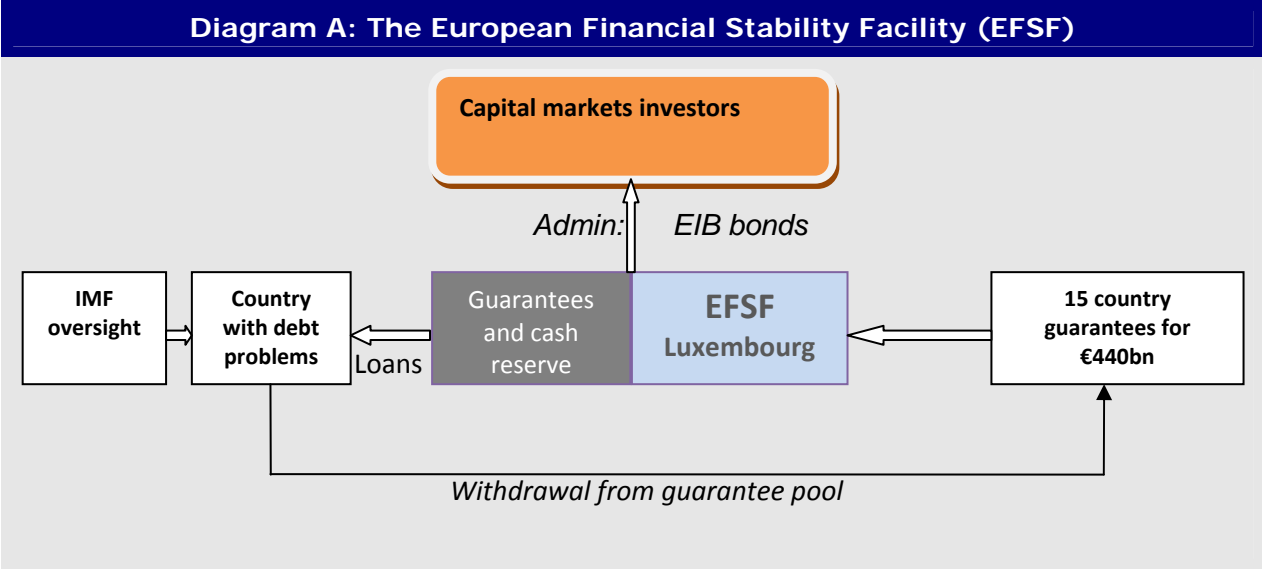
⁶¹ See Geoffrey T. Smith, 'German deficit surges despite strong growth', *WSJ*, (25, Aug. 2010) p. 4, stating and supporting with data from the German Federal Statistics Office, Destatis, '[t]he deficit figures are a stark reminder of the cost of bailing out some German banks after they racked up disastrous losses during the financial crisis.'

⁶² Council Regulation No. 9606/2010. See also Decision of the 16 euro area Member States (7 June 2010)(Luxembourg). The EFSF has a basic securitisation structure but with no tranches. Unlike other securitisations, there is no actual exchange of collateral

⁶³ For example, Germany's pro rata share of the fund is 122.85 billion euros, while France's share is 92.3 billion euros, and Italy's has a 81 billion share.

⁶⁴ The EFSF will close down in three years on 30 June 2013, unless there is a financial operation in which a euro area state draws on the fund, in which case the EFSF's existence would be prolonged until the last obligation was fully repaid,

The EFSF relies for most of its operational support from the German Debt Office and the European Investment Bank. It is an off balance sheet special purpose vehicle that will issue bonds to the market.⁶⁵ Before a euro-area member receives assistance, the Eurogroup must ask the IMF, the European Commission, and the European Central Bank to analyse the request of the country seeking assistance. The IMF and the EU institutions can then deliberate before making the final decision to authorise the euro-area finance ministers to approve the EFSF to raise money. At that point, the German Debt Office will work closely with the EIB to issue the bonds as agent for the EFSF.⁶⁶



Source: The German Debt Office

Much uncertainty surrounds the fund: little is known about who will buy the bonds it issues, nor how it will operate, or what will happen if more than one country attempts to draw on it.⁶⁷ The fund has attracted criticism as 'an attempt to resolve the crisis with imaginary money rather than providing real money and having to find it somewhere.'⁶⁸ Moreover, if several countries seek assistance at once, there is a risk that the fund could be exhausted, but fund proponents argue that this is unlikely because foreign investors are returning to the sovereign debt markets.⁶⁹ Euro-area states can also use the fund to bail out their banks. The recent problems of August 2010 involving Irish state-owned banks suggest that tapping the fund will be a real possibility for Ireland in the near future.

The creation of the EFSF initially brought some stability to European financial markets and restored some investor confidence in Greek sovereign debt and in the debt of other vulnerable euro area sovereign debtors.

⁶⁵ It is not clear yet whether it will receive a Triple-A rating. The EFSF argues that the Triple-A rating is justified based on the 20% reserve fund it will have in addition to the amounts contributed by each euro area state.

⁶⁶ The EFSF can guarantee bonds up to 440 billion euros but in actual fact this will be less because the guarantee applies to 120% of the value of the bonds based on the 20% excess cash reserve which is designed to enhance the creditworthiness of the bonds for a Triple-A rating.

⁶⁷ The EFSF is incorporated and domiciled under Luxembourg law and as of July it has 12 employees including Klaus Regling who was appointed as chief executive on 1 July. In an interview with the *Financial News* (19 July 2010), he stated that the EFSF will obtain Triple-A status in August 2010. He also said that the EFSF had not received any requests for funding by its Member States but that, if it did so, funds could be made available within one month.

⁶⁸ Liz Chong, 'Klaus Regling explains the EU's stability fund', *The Financial News*, p. 8, quoting David Watts.

⁶⁹ See comments of EFSF CEO Klaus Regling, citing the Chinese foreign exchange department's announcement in July 2010 that it would buy more Spanish government bonds. *The Financial News*, 'Special purpose vehicle set on rescue mission', p. 9.

EU bank stress test results also had the effect of calming concerns about the health of EU banks by showing that, under certain stress scenarios, EU banks were not inadequately capitalised nor dangerously exposed to a sovereign debt default. Nevertheless, EU financial markets remain fragile: Ireland's state-owned banks continue to report growing pre-tax losses in August 2010 which has increased the costs of the country's credit default insurance (CDS) by 36% since 1 August 2010. The renewed troubles with Ireland's state-owned banks suggest that the newly-created EFSF and the bank stress tests have not sufficiently eased investor concerns about EU financial institutions and by extension have rekindled fears about the solvency of some deeply indebted EU sovereigns, such as Greece, Ireland, Portugal and Italy. These concerns have led financial institutions in these countries to increase significantly their borrowing from the European Central Bank as recently as July and August 2010. Moreover, as part of its emergency programme begun in May at the height of the Greek crisis to purchase euro area sovereign bonds, the ECB announced on 12 August that it would purchase short-dated Irish bonds in an effort to reduce growing volatility in the Irish bond market based on investor concerns that the government will have to continue massive public support for Ireland's weakened banking sector. These developments suggest that volatility is returning to EU sovereign debt markets and that investor concerns have not been allayed by the much-heralded bank stress tests and the creation of the EFSF.

3. Reforming Sovereign Debt Restructuring in the EU

This chapter argues that a reformed institutional structure at the EU level to oversee sovereign debt restructurings and, in exceptional circumstances, sovereign defaults should be established based on a coherent set of principles that are linked to a new decentralised EU institutional structure with clear lines of responsibility and decision-making to facilitate negotiations between creditors and sovereigns during periods of financial distress. The desirability of a level playing field in the EU internal market suggests that such an approach can be based on a harmonised set of principles and guidelines across EU states that govern the application and operation of this sovereign debt restructuring process.

3.1 A Decentralised EU Institutional Approach

The recent sovereign debt crisis and ongoing financial turbulence in global and European financial markets demonstrates the need for a more coherent and rational sovereign debt default and restructuring process. Such a process could reduce the uncertainty and thus the moral hazard for states to reach unsustainable debt levels by creating a more predictable sovereign debt restructuring process. A clearer procedural framework and set of principles applicable throughout Europe would lead to improved and more timely sovereign debt management decisions, thus reducing the likelihood of crises occurring and mitigating the associated costs. The aim for creating a more orderly sovereign debt restructuring process in Europe would be to increase the incentives that sovereigns have to pay their debts in full and on time. This will allow sovereigns to have continued access to capital at reasonable interest rates. To achieve this, a clearer EU legal and institutional framework should be established to reduce the uncertainty that now surrounds sovereign defaults and restructurings.

Recent proposals as discussed above for a European Monetary Fund or the creation of a new EU agency with powers to arbitrate and resolve sovereign debt disputes would probably require amending the EU Treaty, which may not be a feasible political proposition at present.⁷⁰ Instead, this section suggests that EU policymakers should consider the following principles and rules to provide more certainty to sovereign debt risk management for both sovereigns and investors. These would not necessitate Treaty changes, but would be feasible within the existing legislative instruments.

⁷⁰ See discussion in Häde, 'Legal Evaluation of a European Monetary Fund', above n. 53.

3.1.1 Collective Action Clauses (CACs)

CACs – also known as majority action clauses - allow a super majority of, for example, bondholders holding a particular class of bond contracts to vote to restructure the financial or repayment terms of the bond.⁷¹ The bond contract could provide, for instance, that 75% of creditors – rather than 100% - of a certain creditor class vote to restructure the financial and repayment terms (ie., lower the interest rate or extend the maturity of the debt, respectively). The super-majority's decision would bind the minority bondholders of the same class, thus preventing a small minority from delaying or otherwise disrupting a restructuring agreement, thereby making the restructuring process more predictable.⁷²

First, sovereign debtors and investors should agree henceforth to incorporate CACs into sovereign bond contracts or sovereign loan contracts (ie., bank loans) governed under the law of an EU state. Although investors and sovereigns are increasingly using CACs in their sovereign bond contracts following the Argentine default, significant differences in the structure of these contracts still exist, thus increasing uncertainty regarding the renegotiation of repayment terms and how the overall restructuring process would operate. Sovereign bond contracts issued by EU states should have harmonised legal templates governing their overall structure but would allow the parties to agree on some of the specific repayment terms.

Although a growing number of EU sovereign bond contracts contain CACs, the majority does not, which means that for most EU sovereign bond contracts the consent of 100% of the bondholders of a particular class of bonds are necessary to change the repayment terms of the bond.⁷³ As a result, a small minority of bond holders can prevent a restructuring that the majority believe to be in their best interests. Rather, EU directives and regulations should require that all sovereign bond and loan contracts contain majority action clauses, but allowing the parties to agree on certain repayment terms, such as specifying the percentage of creditors holding a certain value of the debt (eg., 85%, 75% or 65%) to approve a change in payment terms (eg., lower interest rate). EU law should also require that sovereign bond or loan contracts contain a clause describing the process through which sovereign debtors and creditors negotiate if a restructuring event were to occur. This clause would specify how the creditors would be represented and by whom and on what date, or within what period of time, the debtor must provide financial and other information to the creditors' representative. The representative would be authorised to act on behalf of the creditors in the negotiations and have discretion to act based on the instructions of creditors with a specified percentage value of claims.⁷⁴

Another important area concerns how the sovereign would initiate a restructuring. EU law could require that this could be provided in a clause describing what period of time – for example, four weeks— for creditors to come together to obtain the relevant information regarding the sovereign's financial situation, choose a representative, and decide a timeline for the negotiation process. The notion of a 'cooling off' period or automatic stay on creditor action against non-sovereign corporate or individual debtors is already recognised

⁷¹ The financial terms of the contract would generally include the rate of interest (the coupon rate), the amount of the principal, and related financing terms, while the repayment terms would include the date of periodic payments and the means and place of payment, the loan's maturity date, and in some cases what amount of interest and principal would be included in each payment.

⁷² CACs are in all sovereign bonds issued under English law and are increasingly being used under New York law sovereign bond contracts, which by tradition required unanimity or 100% of creditors of the same class to vote to restructure the financial or repayment terms of the bond contract.

⁷³ See Elmar B. Koch, *Challenges at the Bank for International Settlements: An Economist's (Re)view*, pp.56-60, stating '[t]raditionally, CACs were included in sovereign bonds governed by English, Japanese and Luxembourgian law. Sovereign bonds issued under US, German, Italian and Swiss law did not include CACs' and thus required unanimous approval by bondholders of a particular class of bonds to change repayment terms. Ibid, pp. 60-65, providing data of the value of sovereign bond issuance with CACs.

⁷⁴ The specified percentage value of claims would be provided in the repayment terms of the contract. Moreover, the representative, and not individual creditors, would have the authority to initiate litigation for breach of the bond or loan covenants, but only with the approval of creditors with a specified value of claims.

in the insolvency laws of some countries, such as Chapter 11 of the US Bankruptcy Code.⁷⁵ The contract would be required to state when the 'cooling off' period would begin, for example, the date when the sovereign notifies its creditors that it wants to restructure its payments and/or the date that the creditors appoint their representative. The duration of the cooling off period would be mandated by EU law at, say, 60 or 75 days. During this period, a temporary suspension or deferral of payments would be required and enforced by an EU court of law. EU law should mandate that the bond or loan contract should provide for the possibility of a suspension or deferral of payments and provide for damages or penalties for any creditor who violates the provision by seeking to enforce its claim without prior court approval.

3.1.2 Implementation

The decentralised approach that relies on regulating EU sovereign bond and loan contracts so that they contain CACs is not the only option that has been proposed for reforming the sovereign debt restructuring process. Of course, the IMF staff had proposed an international sovereign debt restructuring mechanism (SDRM) in 2002 that attracted much attention but was not approved because of US opposition. The SDRM would have provided a more centralised approach that would have involved amending the IMF Articles of Agreement in order to create a legally binding arbitration process in which a designated IMF tribunal would have mediated and approved any disputes regarding the restructuring of sovereign debt.⁷⁶ The IMF's SDRM was criticised on the grounds that it was insufficiently market-oriented and required too much centralised authority at the international level by concentrating too much power in the IMF. These same criticisms are perhaps also applicable to recent proposals to create an EU Monetary Fund (1.3) that would provide guarantees on sovereign debt and liquidity assistance for ailing EU sovereign debtors while negotiating creditor claims, or the creation of the EFSF, which also provides liquidity support and issues guarantees for euro area sovereigns having financial difficulties.

On the other hand, one can question the viability of the decentralised approach on the grounds that there are multiple legal systems of contract law in the EU and that this might be difficult to harmonise in order to facilitate sovereign debt negotiations and restructurings. Another question concerns what is the scope of the debt subject to the CACs. In theory, there would be no reasonable justification on economic grounds to restrict the scope of such clauses to bond contracts. For instance, Taylor (2002, 4) observes that '[i]t would be appropriate, for example, to include such clauses in bank debt along with bonded debt'. It is observed that such clauses are already incorporated in many syndicated bank loans.⁷⁷ Another question concerns whether during a restructuring all the claims of different bond issues should be consolidated into a single class of creditors or, alternatively, whether all the claims of bondholders should be consolidated with the claims of other creditors (ie., bank loans). Market-based practitioners appear to prefer an approach that consolidates the CACs and other clauses into debt on an issue-by-issue or loan-by-loan basis. Any inconsistency in legal terms or requirements created by different types of issues or jurisdictions should be resolved by arbitration provided in the contracts or by an EU agency established (as discussed below) to apply the EU principles and guidelines governing sovereign debt restructuring.

⁷⁵Although Chapter 11 of the US Bankruptcy Code does not apply to sovereign debt default or restructuring, Chapter 9 of the US Bankruptcy Code does provide insolvency proceedings and an automatic stay against creditor claims against a municipal or county government debtor while the sovereign debtor is formulating a repayment plan for judicial and creditor approval. While the automatic stay is in effect, secured creditors can petition the court for adequate protection of their collateral rights in eligible property owned or possessed by the debtor. In chapters 9 and 11, the automatic stay can remain in effect for up to a six month period to allow the debtor an opportunity to negotiate with creditors and devise a comprehensive payment plan.

⁷⁶ Anne Krueger, 2002, 2002, *A New Approach to Sovereign Debt Restructuring*, Washington DC, International Monetary Fund (Apr. 16, 2002)

<<http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf>>("SDRM - April version", 11-14

⁷⁷ See Steven L. Schwarcz, 2000, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 *CORNELL Law Review*, 975, 982-84, and 'Facing the Debt Challenge of Countries that are Too Big To Fail', Duke Law Working Paper, pp. 1-7.

Finally, the EU must have the institutional capacity to monitor the implementation of such debt contracts to ensure that vital data is communicated to creditors and debtors and that the parties negotiate terms and conditions with full access to relevant information. An EU sovereign debt agency could be created by regulation to exercise such a function and would have authority to collect data and perform surveillance of sovereign debt markets and report market developments to the European Commission, Parliament, and market participants. The responsibilities of a EU sovereign debt agency could include overseeing EU Member State sovereign debt practices and providing data to the market regarding the risks that certain bond and loan contracts pose and to make recommendations and, if necessary, 'name and shame' states which appear to be developing unsustainable debt positions.

The agency could also exchange information with the ECB, the European Supervisory Authorities, and the European Systemic Risk Board regarding financial stability issues in the sovereign debt markets. Moreover, it would clarify the process how market participants could enforce their rights and obligations under the debt contracts in a court of law of an EU state, especially to ensure that any restructuring process is occurring according to contractual requirements.

3.2 EU Financial Stability Fund

The proposed EU sovereign debt agency with responsibility for overseeing the implementation of the CAC approach to sovereign debt restructuring based on harmonised EU principles and guidelines could also administer the establishment of a EU 'stability' fund to which EU states experiencing short-term funding problems would have access for short-term funding during financial distress and crises until they regain access to capital markets. The EU 'financial stability' fund would be paid for by a small transaction tax on all sovereign bond sales.⁷⁸ The tax could be imposed at a very low level – ten basis points/0.10%, or five basis points/ 0.05% - so as not to distort significantly the sovereign bond market and it would be easily implemented by requiring the intermediary banks who execute the transactions to deduct the tax at the point of purchase and sale and pay on to national treasuries who would then have an obligation to pay the sums into the fund. The tax could also apply to sovereign debt derivative instruments (ie., sovereign credit default swaps) or other instruments which use sovereign debt as a referenced asset. The tax would apply uniformly to all EU sovereign bond issuance and could even be extended to include a tax on bank loans to EU governments. The tax could provide a sustainable source of finance to assist EU sovereigns experiencing sovereign liquidity problems and help assist the implementation of any restructuring plans. In return for accessing the fund, states would be required to implement appropriate fiscal adjustments in order to bring their sovereign debt to sustainable levels over the medium term.

If instead the country is not merely illiquid, but insolvent, more drastic measures should be taken and the EU stability fund would continue to be available, but needs to be supplemented by a mechanism for determining collective guarantees.⁷⁹ These should be offered on the basis of strict conditionality, in which the state in question may be required to undertake significant structural reforms to, for example, the fiscal system, the structure of macro-economic management, or the labour market. Short-term austerity measures may be a necessary component of a rescue package. But their impact should always be assessed against the needs of medium term recovery. This also means that the rules of the Growth and Stability Pact that have so conspicuously failed should be reconsidered and possibly replaced.

⁷⁸ See Kern Alexander et al., 'Crisis Management, Burden Sharing and Solidarity Mechanisms in the EU' (May 2010), Brussels, European Parliament, p. 43.

⁷⁹ This means that EU authorities should adopt criteria for determining whether a state is either illiquid or insolvent; or, if it is illiquid, at what point does it become insolvent?.

The approach suggested above would involve a major re-think of the political economy of the EU in general and the euro area in particular. It would require a significant change of direction in fiscal policy, including a harmonised EU framework consisting of principles and guidelines to govern the restructuring and default of a sovereign debtor. The absence of an EU regime governing the restructuring of sovereign debt has resulted in an under-pricing of the true costs of sovereign debt, as it creates a moral hazard for investors to take on too much sovereign debt because they perceive that euro-area states in particular will always bail them out to prevent a collapse of the euro area. This has led to an under-pricing of sovereign debt which means that the full cost of sovereign debt has not been internalised by those who invest in it, thereby resulting in too much of it being issued. Moreover, investors would be able to price sovereign debt more efficiently if they had more certainty regarding the rules of debt renegotiation and the ability to coordinate their claims collectively with other creditors in a crisis and to obtain relevant information from sovereigns. Whether such an EU agency could be constructed to facilitate such negotiations and generate relevant information for creditors is a policy matter and legal issue that is beyond the scope of this brief study.

Conclusion

This paper argues that any institutional or legal reform for a more orderly EU sovereign debt default process should not be further centralised in EU institutions but rather should be based on a set of harmonised principles enshrined in EU legislation **(3.1)** and implemented by EU states with verification of implementation confirmed by an EU sovereign debt agency **(3.2)**.

Although EU bank stress tests reported in July 2010 calmed concerns about the health of EU banks by showing generally that EU banks were not inadequately capitalised nor dangerously exposed to sovereign debt, EU financial markets remain fragile. The renewed troubles with Ireland's state-owned banks and Greece's persistent sovereign debt problems suggest that the results of the stress tests have not sufficiently eased investor concerns about EU financial institutions and by extension have rekindled fears about the solvency of some deeply indebted EU sovereigns, especially Greece, Ireland, Portugal and Italy. **(2.1)**

These developments suggest that volatility is returning to EU sovereign debt markets and that EU policymakers should consider whether Europe needs a formal EU sovereign default process to incentivise states to manage more effectively their sovereign debt and to promote a more orderly resolution of creditors' claims. This paper examined a number of options, including the newly-created European Financial Stability Facility **(2.2)**, and suggests that European policymakers should focus reform efforts on adopting a decentralised sovereign debt restructuring process that emphasises the use of collective action clauses to facilitate negotiations and information flow between creditors and sovereigns regarding sovereign debt risks. EU directives and regulations, not necessitating Treaty changes, should harmonise the principles and guidelines that govern the operation of CACs, but parties should be permitted some freedom to decide the parameters of CAC negotiations and some aspects of the restructuring process. **(3.1)**

An EU sovereign debt agency should be created to facilitate such negotiations and to serve as an information warehouse for creditors and sovereigns to obtain data on market developments relevant to the pricing of sovereign debt risk. **(3.2)** The EU sovereign debt agency could also administer a European Financial Stability Fund that would be created to provide liquidity to states experiencing financial distress and undergoing a restructuring if the state in question fulfils the requisite conditions for obtaining support. **(3.2)** The EU Financial Stability Fund would be financed by a transaction tax on all EU sovereign bond issuance, credit default swaps and other derivative transactions that reference EU sovereign bonds. The tax would be at a very low rate so as not unduly to limit the market and to raise adequate revenue to assist states with temporary liquidity problems.

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Annex A – Selected results of EU stress tests

(mln Euros for all except the UK which is mln Pounds)	Germany		France		Italy	
	DEUTSCHE BANK AG	HYPO REAL ESTATE HOLDING AG	BNP	SOCIETE GENERALE	UNICREDIT	INTESA SANPAOL O
Total Tier 1 Capital after Benchmark	41527	6211	71769	39415	45918	33934
Total Tier 1 Ratio after Benchmark (%)	13.2%	7.8%	11.4%	11.9%	10.0%	9.8%
Total Tier 1 Capital after Adverse	38987	4898	66932	36520	38334	33326
Total Tier 1 Ratio after Adverse (%)	10.3%	5.3%	9.7%	10.2%	8.1%	8.8%
Total Tier 1 Ratio after Adverse+Sovereign (%)	9.7%	4.7%	9.6%	10.0%	7.8%	8.2%
-Additional Impairment losses	-411	-184	-988	-576	-1200	-928
-Additional losses on sovereign exposures in the trading book	-2812	-362	-425	-941	-1608	-1915

(mln Euros for all except the UK which is mln Pounds)	Netherlands		Spain		UK	
	ING Bank	RABOBANK GRP	SANTANDE R	GRUPO BBVA	BARCLAYS	LLOYDS BANKING GROUP
Total Tier 1 Capital after Benchmark	40366	37211	63869	32028	63209	56522
Total Tier 1 Ratio after Benchmark (%)	11.2%	14.8%	11.0%	10.6%	15.8%	10.8%
Total Tier 1 Capital after Adverse	37836	35732	59473	29994	58295	51042
Total Tier 1 Ratio after Adverse (%)	9.1%	12.7%	10.2%	9.6%	13.9%	9.4%
Total Tier 1 Ratio after Adverse+Sovereign (%)	8.8%	12.5%	10.0%	9.3%	13.7%	9.2%
-Additional Impairment losses	-733	-510	-2255	-1505	-740	-1396
-Additional losses on sovereign exposures in the trading book	-445	-100	-907	-1223	-473	-23

Source: CEBS (<http://www.c-eps.org/EuWideStressTesting.aspx>)

3.2 MARKET IMPACT OF ORDERLY SOVEREIGN DEFAULT

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Abstract

This contribution is an opinion to the ECON Committee on the market impact of (orderly) sovereign default in the EU. The Committee specified that this opinion should clarify: a) what would be the impact on the global financial system of a (partial) Greek default or that of any other (peripheral) country in the euro zone; b) whether European banks' balance sheets could currently or in the near future withstand a (partial) sovereign default with a haircut without recourse to further state aids; c) whether an orderly default procedure would be compatible with the European Financial Stabilization Mechanism and Facility as decided on 9 May 2010; d) what form could an orderly European sovereign default procedure take. This briefing paper endeavours to offer a view on this complex issue. Paragraph 1 provides an introduction. Paragraph 2 illustrates why, to my mind, a Greek or other peripheral EMU country default would not trigger a systematically relevant banking crisis which could entail the need of additional (substantial) state aids. Paragraph 3 briefly comments on the indirect, but relevant, costs associated with a sovereign default in the EMU area. Paragraph 4 considers the May 2010 sovereigns' rescue package and whether it is compatible with an orderly default procedure. Paragraph 5 calls for the swift introduction of a European statutory sovereign default procedure also to reconcile properly the May 2010 initiatives with their legal basis. Paragraph 6 lists a series of statutory provisions which should be incorporated into the European sovereign default procedure. Paragraph 7 concludes, briefly commenting on the idea of a European Monetary Fund and its legal basis under the current TFEU.

Contents

- 1. A brief introduction81**
- 2. On the expected direct effects of a Greek default on the European banks' capital81**
- 3. Sovereign defaults and (likely) indirect effects on the European banking system82**
- 4. The May 2010 sovereigns' rescue package and its legal basis83**
- 5. A call for the swift introduction of a European statutory sovereign default procedure.....84**
- 6. A few examples of statutory provisions which should be incorporated into the European sovereign default procedure.....85**
- 7. A provisional conclusion.....87**

1. A brief introduction

History shows that big financial crises are often followed by sovereign defaults. Thus, there is very little new in the feared (and threatened) Greek default in this respect; what is new is however that:

(i) this would have been the first sovereign default of a western European country since the interwar period and, obviously, the very first of a EMU member (entailing yet unknown implications for the common currency);

(ii) the Greek default could potentially inoculate contagion to other EMU members (notably Portugal, Ireland and Spain, and, to a lesser extent, Italy), leveraging the risk of a currency crisis;

(iii) the magnitude of the economic resources devoted by the EMU members and the IMF to avert (or at least tame) the risk of default through official sector intervention is unprecedented. Suffice to say that the rescue package adopted in May 2010 totals more than one trillion USD in loans available for countries with funding problems: an amount significantly above that committed by the US under the TARP in 2009.⁸⁰

2. On the expected direct effects of a Greek default on the European banks' capital

Sovereign defaults are historically related to banking crises; often in the sense that sovereign defaults weaken the banks' balance sheets and, in the extreme, could even create the threat of a bank run. In the current financial crisis the circle has been perhaps even more vicious.⁸¹ Indeed, the financial crisis and, to some extent even banks' rescue packages adopted in 2008-2009 (the case of Ireland seems to be quite illustrative in this respect), contributed significantly to the worsening of the debt to GDP ratio of many sovereigns bringing about the risk of a sovereign crisis.⁸²

However, in the current scenario a risk of contagion from EMU peripheral sovereigns back to the European private banking sector should not be overestimated either. The Greek example seems quite exemplary. Greek outstanding national debt is reported to be around € 300 billion, roughly equivalent to about 125% of the country GDP. The country's budget deficit is estimated at about 12.7% of the GDP. The Italian, German and French banking system exposures to Greek sovereign debt calculated at the end of the third quarter of 2007 and at the end of 2009 were as follows:

Lenders' country	Exposure in 2007	Exposure in 2009
France	41,3	52,2
Germany	25,6	31,2
France	41,3	52,2

Note: data expressed in € billion;

Source: Bank of Italy (briefing note of the hearing of Dr. Fabio Panetta at the Italian Parliament, Rome, 8 June 2010)

⁸⁰ D.Gros, T.Mayer, *How to deal with sovereign default in Europe: Create the European Monetary Fund now!*, CEPS Policy Brief, 17 May 2010, at 1.

⁸¹ Compare recently B.Candelon, F.C.Palm, *Banking and Debt Crises in Europe: The Dangerous Liaisons?* in *De Economist*, 158, no. 1, 2010, where they quote at p. 81 the warning of Kenneth Rogoff in the Korean Times, 30 November 2009 "essentially there is still a risk that the financial crisis is simply hibernating as it slowly morphs into a government debt crisis".

⁸² See IMF, *Global Financial Stability Report*, April 2010, p. 3-10.

This finding is plainly confirmed by the recently published (23 July 2010) banks' stress test performed by the ECB, which contemplates haircuts on sovereign debt but does not consider sovereign default in the exercise.⁸³ The same holds true, according to a different (albeit less sophisticated) stress test performed by a leading investment bank, also in a worst case scenario, where the severity of the test contemplates several sovereign defaults of peripheral EMU countries occurring at the same time and an haircut of 30% of the face value of the sovereign bonds. Indeed, a Bank of America/Merrill Lynch Report of 10 May 2010 ("*Sovereign fears: direct impact manageable*") shows, albeit with several cautionary warnings (in very few cases there were available the exposure to peripheral European sovereign debt, and not all banks had disclosed their total holdings of government debt) an attempt to quantify the impact on European banks if Portugal, Ireland, Italy, Greece and Spain all restructure their debt applying an "haircut" of 30%. The report estimates that the "first order impact would be a fall in the Core Tier 1 ratio of the banks covered in the exercise (33 leading European banks) from 9,3% to 8,4%" and it concludes therefore that "the European bank sector would still have twice the minimum level of regulatory capital in a scenario whereby every peripheral sovereign restructured its debt. Admittedly, most of the Greek banks and a number of Italian banks would need additional capital in such a scenario". More in general, in such a scenario – which is described by the reporters themselves as "flawed in that it treats the risk of an Italian restructuring the same as a Greek restructuring and it also assumes that no other actions (i.e. disposal) are taken by banks (two assumptions which are overly simplistic)" – it is estimated that "the European bank sector could need to raise an additional EUR 22 billion". This number should be confronted with the over EUR 200 billion raised by the sector since the start of 2007⁸⁴ and can be considered, hence, quite manageable.

In turn, according to a staff note of an Institute of International Finance, Greek government debt represents (only) 2,4% of international bank equity capital (2,2% of Italian bank regulated capital according to the Bank of Italy); Ireland debt 0,7%, Portugal 1,9% and Spain 4.0%. *As to the question whether European bank balance sheets could withstand a sovereign default without recourse to further state aid, to my mind the answer should therefore be affirmative.* Data suggest that a Greek default, albeit negatively affecting the balance sheets of European banks, could not be credibly considered, *per se*, as a trigger of a European systemically relevant banking crisis.

3. Sovereign defaults and (likely) indirect effects on the European banking system

This is not to say a sovereign default of a EMU member would be without significant impacts on the global financial system of the area. Although direct effects of a sovereign default on banks' balance sheets could prove manageable, *its indirect effects could have a negative longer term impact both on funding and economic growth.* The impact on funding could, on one hand, derail the bank funding recovery still underway and, on the other hand, make funding costs higher and more differentiated within the euro area on country-specific fundamentals. On the other hand, as it has been recently observed by Hui and Chung⁸⁵ "the onset of the European sovereign debt crisis in late 2009 called into question the grand experiment of pooling 16 countries into a monetary union".

It results indeed that "sovereign credit risk is an important determinant of the prices of deep out-of-the money dollar-euro put options" and that, therefore, "the creditworthiness of the euro-area countries could affect market expectations on the stability of the euro".

⁸³ Compare ECB, *EU Stress Test Exercise – Key Messages on Methodological Issues*, 23 July 2010, p.7, footnote 8.

⁸⁴ According to the ECB stress test published on 23 July 2010, from October 2008 to the end of May 2010 EU governments injected 236 billion euro in the capital of EU banks (ECB, *EU stress exercise – Key messages on methodological issues*, p. 3).

⁸⁵ C.H.Hui, T.K.Chung, *Crash risk of the euro in the sovereign debt crisis of 2009-2010*, working paper, 28 June 2010.

In other terms “the atmosphere of collective safety provided by a common currency in the first 10 years of its existence is gone (probably for good)”.⁸⁶ This is due to the fear of a chain reaction; and such a chain reaction was considered as a real possibility by the market, since currency traders and hedge funds reportedly betted nearly USD 8 billion against the euro, amassing the biggest ever short position since the monetary union was formed.⁸⁷ The weakness of the euro signals also the deep deterioration of the debt to GDP ratio of all EU members: rating agencies expect that by the end of 2010 sovereign debts in the EU area will increase of 760 billion in respect to end 2009; of these, 490 billion concern EMU countries: an amount six times bigger than the increase experienced in 2007.⁸⁸ As Willem Buiter, Citi’s chief economist wrote in a recent note⁸⁹

(i) “the public finances of advanced industrial countries are in a worse state today than at any time since the industrial revolution, except for wartime episodes and their immediate aftermath;

(ii) “most of the industrialized nations are on unsustainable fiscal trajectories;

(iii) “fiscal unsustainability problems have been driven by (1) pro cyclical fiscal behavior in the boom years; (2) direct fiscal costs of the financial crisis; (3) the impact of the recession on taxes and spending; and (4) lower post bubble revenues from real estate and the financial sector”;

(iv) unsustainable public finances are not just an issue for Greece and disproportionate attention has been placed on euro periphery countries. The deterioration in the structural (or cyclically adjusted) fiscal balance of the US and the UK is larger than in Greece, Portugal or Spain”;

(v) “Markets, commentators and analysts will in due course realize that fiscal sustainability is not just a problem of a handful of euro Area members. Unless the US, the UK, France, Japan and even Germany change course quite radically, there may not be a single AAA rated sovereign left five years from now”

4. The May 2010 sovereigns’ rescue package and its legal basis

All the foregoing – probably coupled also with a strong, albeit undemonstrated, official belief (transmitted also to the market) that the euro area cannot endure a single sovereign default among its members⁹⁰- should help in understanding the reasons beneath the adoption:

a) on May 3, 2010, of the 2010-2012 program of financial support for Greece up to 110 billion, 80 of which extended as bilateral loans by other EMU members; note that in some cases the financial effort required by a single EMU member is quite disproportionate in respect to the threat posed by the Greek sovereign debt held by its national banking system (Italy, for example, made available through Decree no. 67 of 10 May 2010 up to 14,8 billion euro, an amount three times higher than the exposure of its banking system to the Greek sovereign risk); the same day the ECB – in order to prevent disruptions on the side of liquidity, especially for the Greek banks, derogated to the rating requirements for the Greek sovereign bonds used as collateral in liquidity transactions;

⁸⁶ M.Dabrowski, *The global financial crisis: Lessons for European integration*, in *Economic Systems* 34 (2010) 38-54, at p. 45.

⁸⁷ C.H.Hui, T.K.Chung, *Crash risk of the euro*, p. 4.

⁸⁸ F.Panetta, *Briefing note, Hearing at the Italian Parliament*, 8 June 2010, p. 5.

⁸⁹ *Global Economic Views – Sovereign Debt Problems in Advanced Industrialised Countries*, 26 April 2010.

⁹⁰ Calling for a change of such official doctrine J.Méltiz, *Eurozone Reform: A proposal*, CEPR Policy Insight no. 48, May 2010, p. 2, where the conclusion that “there is little reason why Eurozone should view government defaults with any greater alarm than any other central bank management in the world would view government defaults within its territory. To the contrary, the Eurozone is particularly well armed to deal with such defaults since its own central bank has no large central government to contend with, the Maastricht Treaty guarantees the central bank’s independence and member governments are explicitly forbidden to bail out one another”. Note that, consistently with the official doctrine, also the ECB stress test recently conducted did not consider in the exercise, under the adverse scenario, sovereign default.

- b) on May 10, 2010 of the European Financial Stability Facility, through which EMU Members, in a final attempt to prevent sovereign defaults in the EMU and the correlated risk of contagion, decided to put at stake (although indirectly: enabling the Facility to extend conditional loans to EMU members facing exceptional circumstances up to 500 billion and undertaking, at the same time, to guarantee the euro bonds to be issued by the Facility to fund such loans) an unprecedented amount of their taxpayers' money; the same day the ECB adopted the Securities Market Program to support failing euro denominated government bonds in order to prevent new disruptions in such markets;
- c) on May 12, 2010 of the joint Communication on "Reinforcing Economic Policy Coordination" (COM 2010 250 final).

In turn, the foregoing should also help in making clear that, despite all these efforts and programs, one or more EMU members could eventually end up confronted not simply with a liquidity crisis - which can be overcome through the extension of the loans made possible by the newly adopted European programs - but with a true solvency crisis. *This means, to my mind, that an orderly default procedure could eventually follow the European Financial Stabilization Mechanism and Facility and should be considered compatible with it.* For Greece, an insolvency scenario has been recently predicted, for example, by Nouriel Roubini⁹¹, who believes that it is now time to admit that Greece is not just undergoing a liquidity crisis but is going to face a solvency crisis and calls therefore for a prompt debt restructuring and an orderly default procedure. Not surprisingly, a recent JP Morgan Report⁹² puts it this way: "one way or another Greece, Spain, Portugal and Ireland will all reach a position of debt sustainability. In practical terms, this means being able to access capital markets at a borrowing cost that is not too far from the country's nominal growth rate. The only uncertainty is how this destination will be reached and to what extent the burden of adjustment is shared between domestic residents (via fiscal tightening), *creditors* (via *debt restructuring* or inflation), other residents (via fiscal transfers) or trading partners in the rest of the world (via a weaker euro)"

5. A call for the swift introduction of a European statutory sovereign default procedure

In this context it is worth questioning:

- (a) *whether it makes sense that the EMU does not provide any orderly European sovereign default procedure and what form this procedure could take;*
- (b) *whether there is sufficient legal basis in the Treaty for the measures adopted on 9 May 2010 setting up the European Financial Stabilization Mechanism and Facility and for the adoption of an orderly European sovereign default procedure.*

On this latter point, it is well known that all the measures adopted in the last months to face the feared sovereign default must be assessed against the so called "no bail out" provision of Article 125 TFEU, taking into account, though, also the enabling provision of Article 122 TFEU which entitles the Council, on a proposal from the Commission, to "grant under certain conditions Union financial assistance" to a Member State where it is "in difficulties or is seriously threatened with severe difficulties caused by (...) exceptional circumstances beyond its control". It is apparent that European institutions stretched quite a bit the enabling provision of Article 122 and at the same time construed in a very restrictive way the "no bail out" provision of Article 125 to find a sufficient legal basis in the Treaty for the measures recently adopted.

⁹¹ N.Roubini, *Niente pasticci in salsa greca*, Il Sole 24 Ore, 30 June 2010, p. 14.

⁹² JP Morgan, *Euro area sovereigns: the long journey back to solvency*, Economic Research Global Data Watch, 9 July 2010.

The underlying idea was that the extension of conditional loans does not amount to the “assumption of the commitments of central governments” (as prohibited by Article 125 of the Treaty) and that the current sovereign difficulties, albeit deriving from lax fiscal and budgetary policies of the Member States concerned, could nonetheless be characterized – in consideration of the extraordinary effects derived from the on going global financial crisis and, to be true, using also a discreet amount of hypocrisy – as “exceptional circumstances beyond the control” of the Member State concerned. The impression is very strong, however, that EMU countries, having failed to prepare in advance a mechanism capable of managing an orderly default and debt restructuring within the EMU, acted to prevent any sovereign failure in the strong belief that such a failure could be too dangerous for the EMU.

Watering down the “no bail out” provision (as well as Article 123 TFEU) could prove very dangerous also. It does not come as a surprise, thus, that markets reacted negatively on the currency, “fearing that impaired government bonds would end up on the balance sheet of the ECB undermining the long term stability of the euro”⁹³ and that the ECB, at the extreme, could become the “bad bank” of the area. I agree therefore with those who advocate as a key policy aim for the future to restore market discipline by making sovereign default possible. To this aim it is necessary to preemptively put in place a European orderly default procedure. *To my mind such a procedure should come along with the enforcement of the measures adopted with the 3-10 May 2010 rescue package, so as to ensure adequate priority to the claims related to all loans extended under the plan and in this way reconcile the program with its legal basis* (diminishing, if not averting, the risk that bridge loans operate in practice as assumption of the commitments of the sovereign in default). In other words, the legal basis which supported the adoption of the rescue plan, not only authorizes but, to my mind, *also requires that an orderly default procedure is adopted*, so as:

- (i) to set a rule based deterrent threat to national fiscal profligacy⁹⁴;
- (ii) to make the application of the rescue package more stringently directed at tackling a liquidity crisis and not an insolvency and
- (iii) to ensure a higher level of safety (through the higher priority) to the claims related to the loans extended under the new facility, in this way making the intervention more compliant with the no bail out provision.

6. A few examples of statutory provisions which should be incorporated into the European sovereign default procedure

How then to devise a proper European or EMU default procedure? Reliance can be made both on international experience and on some recent proposal calling for the setting up of a European Monetary Fund. As to the former point, in my view there is here a very strong case for a European *statutory* procedure based on a EU regulation (under the existing TFEU), which should set out in detail *mandatory rules* aimed at making the restructuring process more orderly, more predictable and more rapid. The reasons that supported the attempt to introduce such a process in the international setting⁹⁵ – an exercise which failed so far, despite the IMF 2002 proposals and the authoritative support that this project received by leading scholars⁹⁶ – are even more compelling within the EMU⁹⁷.

⁹³ D.Gros, T.Mayer, *How to deal with sovereign default in Europe*, p. 2.

⁹⁴ R.Goldbach, C. Fahrholt, *Burying the Stability Pact: The Reanimation of Default Risk in the Euro Area*, GFinM working paper, no. 10, April 2010, p. 25.

⁹⁵ For an accurate account compare M.C.Malaguti, *Sovereign Insolvency and International Legal Order*, in *International Community Law Review* 11 (2009), 307-326; Banco de Espana, *Recent Episodes of sovereign debt restructuring: a case study approach*, no. 804/2008, passim.

⁹⁶ See, for a thorough and convincing discussion of the matter, N. Roubini, B. Setser, *Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions and a Roadmap for Reform*, paper presented at a conference on “Improving the Sovereign Debt Restructuring Process”, Paris, March 9, 2003.

In my opinion, pure contractual solutions do not adequately respond to European needs. As to the form that an orderly default procedure should take, the economic literature indicates that statutory provisions should comprise at least the following (the list is purely indicative and in no way comprehensive):

- a) a timely suspension on re-payment to prevent a rush to exit from the sovereign debt, applicable once the default is declared; default should be made possible both on a voluntary basis (i.e. the sovereign declares the default starting the procedure) and on an involuntary basis (i.e. the creditors call the default, starting the procedure), since the economic literature convincingly demonstrated that involuntary bankruptcy would alleviate the sovereign's reputational concerns in calling for a more timely voluntary procedure and would also provide a mechanism for creditors to block new debt issues which could dilute their outstanding claims⁹⁸;
- b) a "fair" priority rule, according to which creditors should be divided into different classes with different rights depending on a set of criteria preemptively defined. To my mind, "first-in-time absolute priority" – i.e. the principle whereby bonds issued first would have priority over those issued later and higher priority creditors would be paid up in full before lower priority creditors receive anything – might prove too harsh and may even lack fairness⁹⁹; a differentiation in the amount of the haircut depending on the time of the issue, the type of collateral and other relevant circumstances (if any) could prove a more viable and "fair" solution. In any event, what is important is that the priority structure for the sovereign own debt is clearly set in advance so as to settle questions of equity and facilitate the enforcement of the default procedure¹⁰⁰;
- c) a reasonable differentiation, in the structuring of the creditors' classes, between domestic and external debt. Economic literature indicates that "domestic debt and external debt are likely to be restructured at different times, using different restructuring processes and on different terms"¹⁰¹. In my view, since, unlike corporate defaults, sovereign default does not bring about, *per se*, a change in the management of the country and only domestic creditors vote to that end, a reasonable discrimination against domestic creditors could make sense to better correlate risk and governance, to prevent moral hazard and by this way also to indirectly prompt the removal of the incumbent political élite if it were to be blamed for the default¹⁰²;
- d) majority *mandatory* restructuring *clauses*, whereby the restructuring proposed by the sovereign is made binding also for minority creditors if the majority accepts the contractual change: such a rule has obviously to be carefully crafted so as to take into account the differentiation of claims deriving from a multi-class structure of the restructuring and is needed to overcome "hold out" problems, that is the risk that creditors willing to exacerbate conflict and resist the restructuring also where the majority of creditors approves it might take advantage of the unanimity principle applicable to the amendment procedure of many existing bond covenants (e.g. those governed by the US law) to "green mail" sovereigns and get by this way a preferential treatment;

⁹⁷ This is even more so if we consider that there is no safe legal basis in the TFEU for the expulsion of a EU or EMU member: compare P.Athanassiou, *Withdrawal and Expulsion from the EU and EMU*, ECB working paper series, no. 10, December 2009, *passim*. On the intricacies of the re-establishment of one or national currency after the adoption of the Euro, H.Scott, *International Finance*, Foundation Press, NY, 2005, p. 200-204.

⁹⁸ P.Bolton and D.A.Skeel, *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?* 53 *Emory Law Journal*, p. 763.

⁹⁹ A solution advocated by P.Bolton and D.A.Skeel, *Inside the Black Box*.

¹⁰⁰ N. Roubini, B. Setser, *Improving the Sovereign Debt Restructuring Process*, p. 6.

¹⁰¹ N. Roubini, B. Setser, *Improving the Sovereign Debt Restructuring Process*, p. 15.

¹⁰² Economic research indicates that this is actually an outcome often determined by sovereign default: E.Borensztein, U.Panizza, *The costs of sovereign default*, IMF working paper, WP/08/238, at p. 22.

- e) super-seniority rank for all loans extended to the sovereign after the default is declared or in the months preceding the default in so far as these loans are needed to prevent a liquidity crisis and/or the contagion of the default to the banking sector. Absolute priority should be given to those loans made available by the public sector under a conditionality policy. As it has been correctly noted, "the strongest negotiating asset of a debtor is always that default cannot be contemplated because it would bring down the entire financial systems"¹⁰³; measures capable to minimize such risk and the unavoidable disruptions which come along with a sovereign default deserve, therefore, a preferential treatment;
- f) express derogation to the sovereign immunity defense¹⁰⁴, although in the context of a better regulated framework for creditors' litigation, including also provisions on claw back on payment made in the months preceding the default;
- g) new disclosure principles, whereby the sovereign should be expected to provide full and accurate information on its debt profile and restructuring plans; as noted by Roubini and Setser, this should include "publishing a full accounting (detailed and disaggregated) of its outstanding debts soon after defaulting and informing creditors of any significant changes to its debt stock"¹⁰⁵.

7. A provisional conclusion

Is there merit, in the current circumstances, for a further advance of the regulatory framework, so as to set up, as advocated by some commentators, a European Monetary Fund?¹⁰⁶ To my mind, probably there is. But only through the enhanced cooperation procedure: a procedure which, so far, has never been followed. And not surprisingly so.

¹⁰³ D.Gros, T.Mayer, *How to deal with sovereign default in Europe*, p. 4.

¹⁰⁴ A defence whose applicability is debated and unevenly admitted in different jurisdictions: for the applicability in Italy of such defence, in respect of the Argentinean debt restructuring, see the judgement of the Supreme Court of 27 May 2005 no. 6532.

¹⁰⁵ N. Roubini, B. Setser, *Improving the Sovereign Debt Restructuring Process*, p. 14.

¹⁰⁶ T.Meyer, *The Case for a European Monetary Fund*, *Intereconomics*, May/June 2009, p. 138; D.Gros, T.Mayer, *How to deal with sovereign default in Europe*, rightly claiming that "recently events have vividly demonstrated that in the absence of a mechanism to manage an orderly sovereign default, adjustment programmes lack credibility and the balance sheet of the ECB is put at risk. Indeed, without a fiscal agent like the EMF in times of crises, the ECB becomes the fiscal agent of euro area governments by default. This role, if maintained, will destroy the institution in the intermediate future".

4. EUROBONDS - AN ADDITIONAL DEBT ISSUANCE INSTRUMENT?

4.1 EU PUBLIC DEBT MANAGEMENT AND EUROBONDS

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Bocconi University and Università degli Studi di Milano

Abstract

A common Eurobond making each participating issuer liable only for its own share could be agreed upon by the Member States with the lowest credit risk premia: Finland, France and Germany. However, the efficiency gains from this weak form of cooperation in terms of market integration and liquidity would be limited if not offset by the higher costs of an inflexible debt management. To reap the liquidity benefits of a unified market, the Eurobonds should be issued by all euro-area Member States or by an EU Institution. But only a common bond jointly guaranteed by all euro-area Member States could reach the "safe-haven" status and the size needed to compete with the US Treasury market. The mutualisation of credit risks faces however strong political opposition, because of fears of relaxed fiscal discipline and inequitable sharing of its benefits and costs. Although solutions to these problems can be found, more evidence is needed on the benefits and costs of a common Eurobond to convince potential issuers. This paper makes a first step in this direction.

Contents

- 1. Introduction 91**
- 2. Stylized Facts 91**
 - 2.1 The Interest-Rate Spreads on German Bunds..... 91
 - 2.2 Contagion 95
 - 2.3 The interest rate differential between German Bunds and US Treasuries 96
 - 2.4 The interest rate on Eurobonds issued by the EIB 97
- 3. What Type of Eurobond? 98**
 - 3.1 - A commonly issued Eurobond with country-specific shares backed by several guarantees 98
 - 3.2 - A commonly issued Eurobond backed by joint guarantees..... 98
 - 3.2 - An EU Eurobond issued by an EU Institution 100
- 4. The Arguments for a Eurobond..... 101**
 - 4.1 The efficiency gains from further integration; greater liquidity and lower borrowing costs..... 101
 - 4.2 A "safe-haven" alternative to US Treasuries and the use of the euro as a reserve currency 101
 - 4.3 Risk insurance, market access and crisis prevention..... 102
- 5. The Arguments Against a Eurobond 103**
 - 5.1 Creating a thick market is costly and requires a permanent and credible issuance program 103
 - 5.2 Centralized funding makes debt management inflexible..... 103
 - 5.3 Lower incentives for fiscal discipline and moral hazard..... 104
- 6. Feasibility..... 105**
 - 6.1 Legal obstacles 105
 - 6.2 Political Feasibility 106
- 7. Concluding Remarks..... 108**
- References 109**

1. Introduction

Notwithstanding the important steps taken towards market integration and greater efficiency, euro-area government bond markets remain fragmented as witnessed by persistent and, more recently, widening interest-rate differentials. This has led economists to reconsider the possibility of a European government bond jointly issued by euro-area Member States.¹⁰⁷ While the timing of the new proposals reflects the pressures on weaker and/or smaller sovereign issuers who have found their funding costs increase as a result of the US financial and euro-area crises, the potential benefits from a common issuance program are known since the Giovannini Group Report (2000). A common Eurobond is a strong form of debt management cooperation with the potential of promoting further market integration, greater liquidity and lower borrowing costs. New proposals also contend that a common Eurobond would satisfy the global demand for a risk-free asset and better compete with US Treasuries for the global financial flows in search of a “safe-haven”, thereby strengthening the use of the euro as a reserve currency. The argument that Eurobonds could provide insurance and continued market access to weaker Member States during crises is instead rarely made, but Eurobonds could reduce exposure to crisis transmission from contagion and interdependence. In this paper, we first investigate the determinants of interest-rate differentials between euro-area Member States and between US and Germany in order to provide the relevant stylized facts needed to evaluate the rationale for a common Eurobond. Then, we discuss the benefits and the costs of three possible types of Eurobonds that encompass the various proposals. Finally, we consider the legal obstacles and the political opposition to a common issuance program.

2. Stylized Facts

In this section we provide the relevant stylized facts to assess the potential benefits from a European government bonds issued by euro-area Member States. First, we assess the degree of integration in the European government bond market by examining the behavior of interest rate differentials. Second, we examine the potential for a larger European market to better compete with the US market, by estimating the liquidity premium on German relative to US bonds. Finally, we look at the interest rate on bonds issued by the European Investment Bank (EIB) to evaluate the performance of a bond issued by an EU Institution.

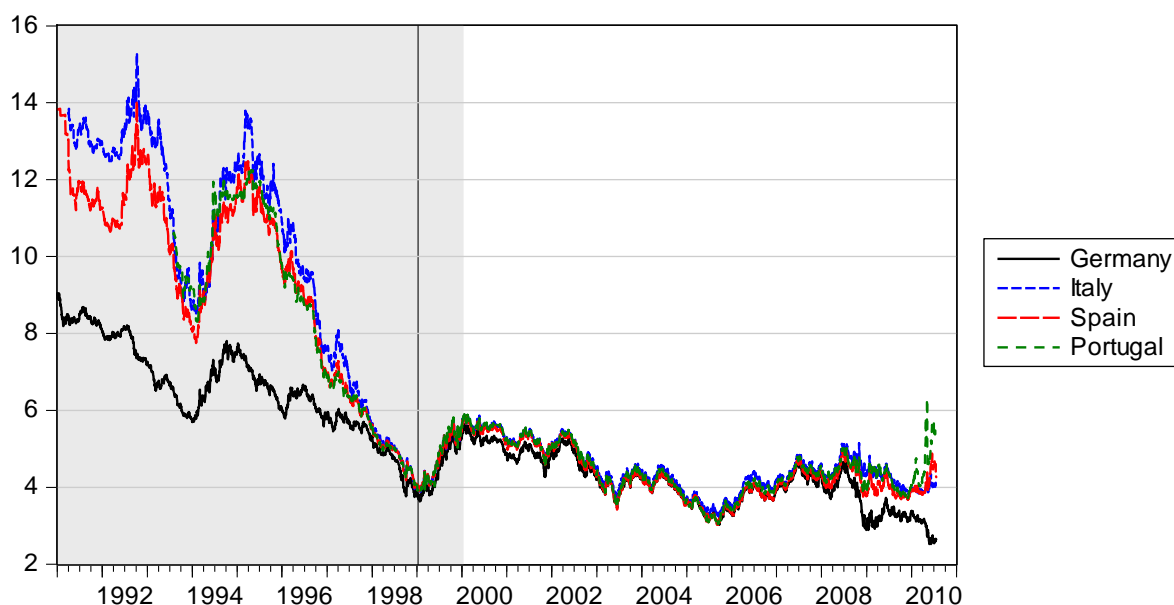
2.1 The Interest-Rate Spreads on German Bunds

The European Monetary Union (EMU) brought to life an integrated market for fixed-income government securities in the euro-area. Common euro denomination made bonds issued by euro-area Member States close, but not perfect, substitutes. Figure 1 reports the yields to maturity on 10-year bonds issued by Germany and by high yield Member States: Portugal, Italy, and Spain. The Figure shows that 10-year yields converged significantly, narrowing from highs in excess of 300 basis points in the pre-EMU period to less than 30 basis points about one year after the introduction of the euro. Yet, bonds issued by euro-area Member States have never been regarded as perfect substitutes by market participants: non-negligible interest rate differentials have remained and become sizeable during the course of 2008, 2009 and especially 2010.

¹⁰⁷ See, e.g. Gros and Micossi (2009), Mayordomo et al. (2009), De Grauwe and Moesen (2009), ELEC (2010), Jones (2010).

Figure 1:

Yields convergence after monetary union



There are two possible explanations for these interest rate differentials. The first one is **credit risk**; sovereign issuers that are perceived as having a greater solvency risk, must pay investors a credit risk premium. The second explanation is **liquidity risk**, that is, the risk of having to sell (or buy) a bond in a thin market and, thus, at an unfair price and with higher transaction costs. Small issuers with low volumes of bonds outstanding and thus small markets must compensate investors with a liquidity premium (see the BOX at the end of this section).

Distinguishing the credit risk premium from the liquidity premium is important because, while the former results from a low credit standing due to weak fiscal fundamentals, the latter reflects an inefficient national market. To solve this identification problem we use the Credit Default Swap (CDS) as a proxy of the credit risk premium. A CDS is a swap contract in which the protection buyer of the CDS makes a series of premium payments to the protection seller and, in exchange, receives a payoff if the bond goes into default. The difference between a CDS on a Member State bond and the CDS on the German Bund of the same maturity is a direct measure of the credit risk premium of that State relative to Germany.

Figures 2 and 3 report interest-rate differentials for euro-area Member States (blue line) - i.e. the spreads of 10-year government bond yields on German Bund yields- along with the associated CDS spreads (red line); their difference is a measure of the liquidity premium differential. We group the interest-rate spreads on Bunds and the associated CDS into high yielders (Figure 2) and low yielders (Figure 3).¹⁰⁸

The following facts emerge from the data:

- i) There is a clear tendency of all spreads on Bunds in the euro-area to comove (i.e. move in parallel) but, as shown in Figures 2-4, the nature of the comovement is not constant over time;
- ii) The liquidity premium component of the interest-rate spread is very small for all Member States with only few exceptions: Finland, France and, perhaps, the Netherlands;

¹⁰⁸ We do not present data for Cyprus, Malta, Slovenia and Slovakia because times series are not long enough given the short spell of time these countries have spent within the EMU. Data for Luxembourg are also not reported.

iii) The case of Finland where the credit risk premium is always close to zero, makes it clear that in a crisis the liquidity premium rises to determine a positive comovement between the Finnish spread and all other euro-area spreads.

Figure 2:

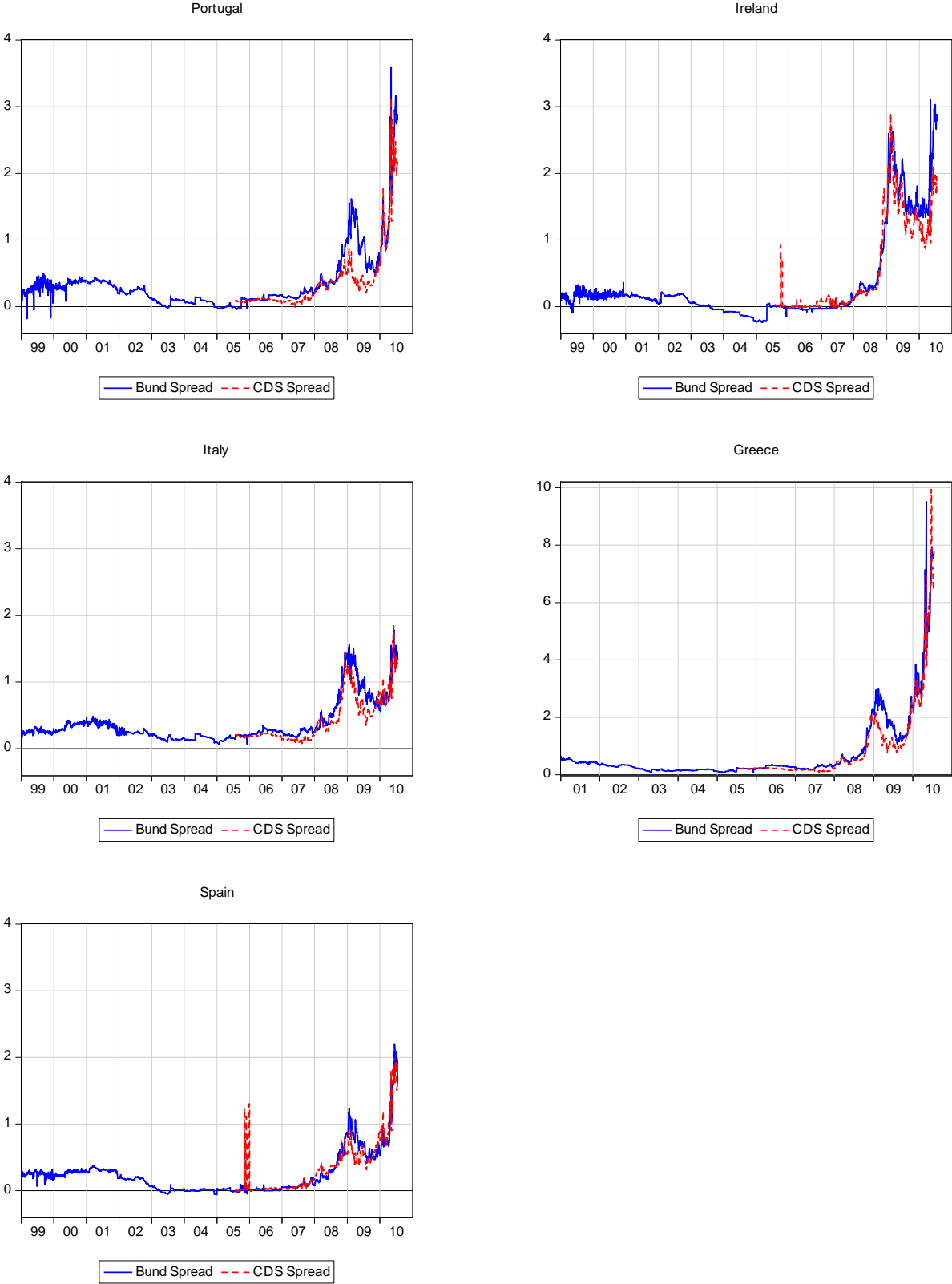
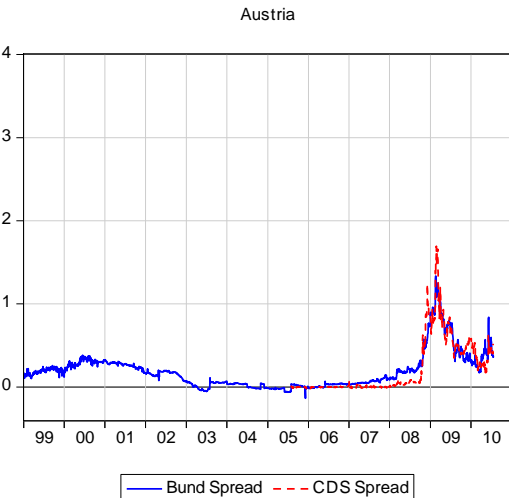
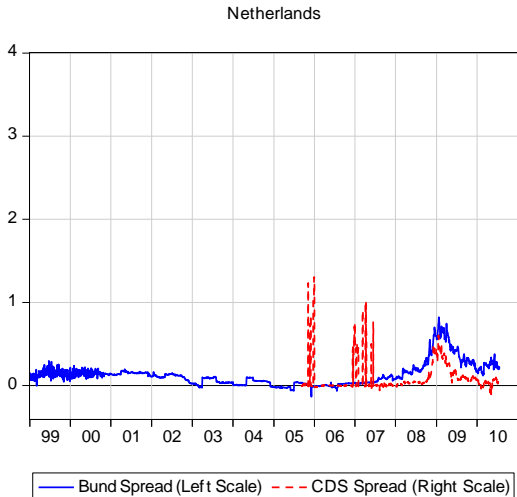
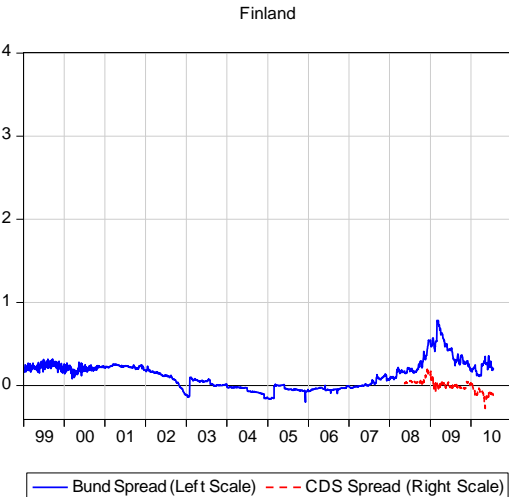
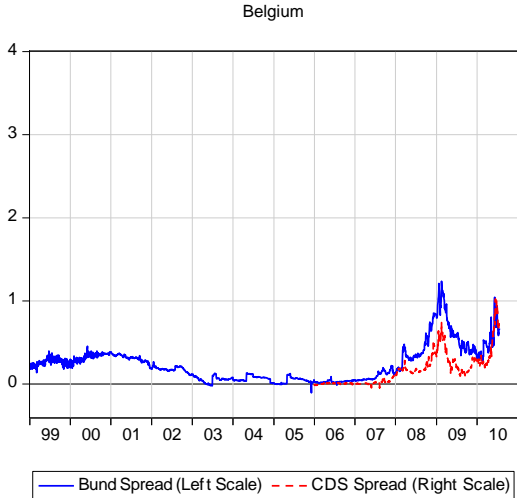
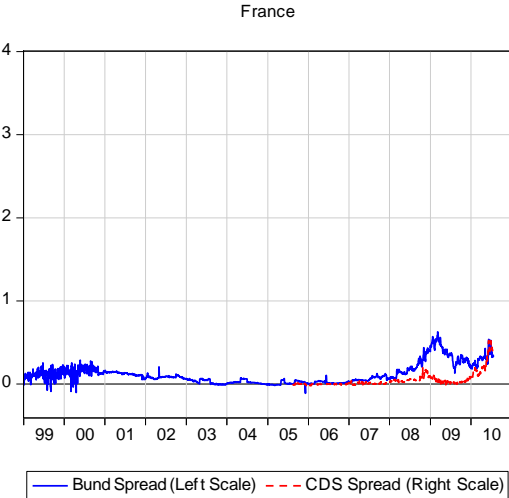


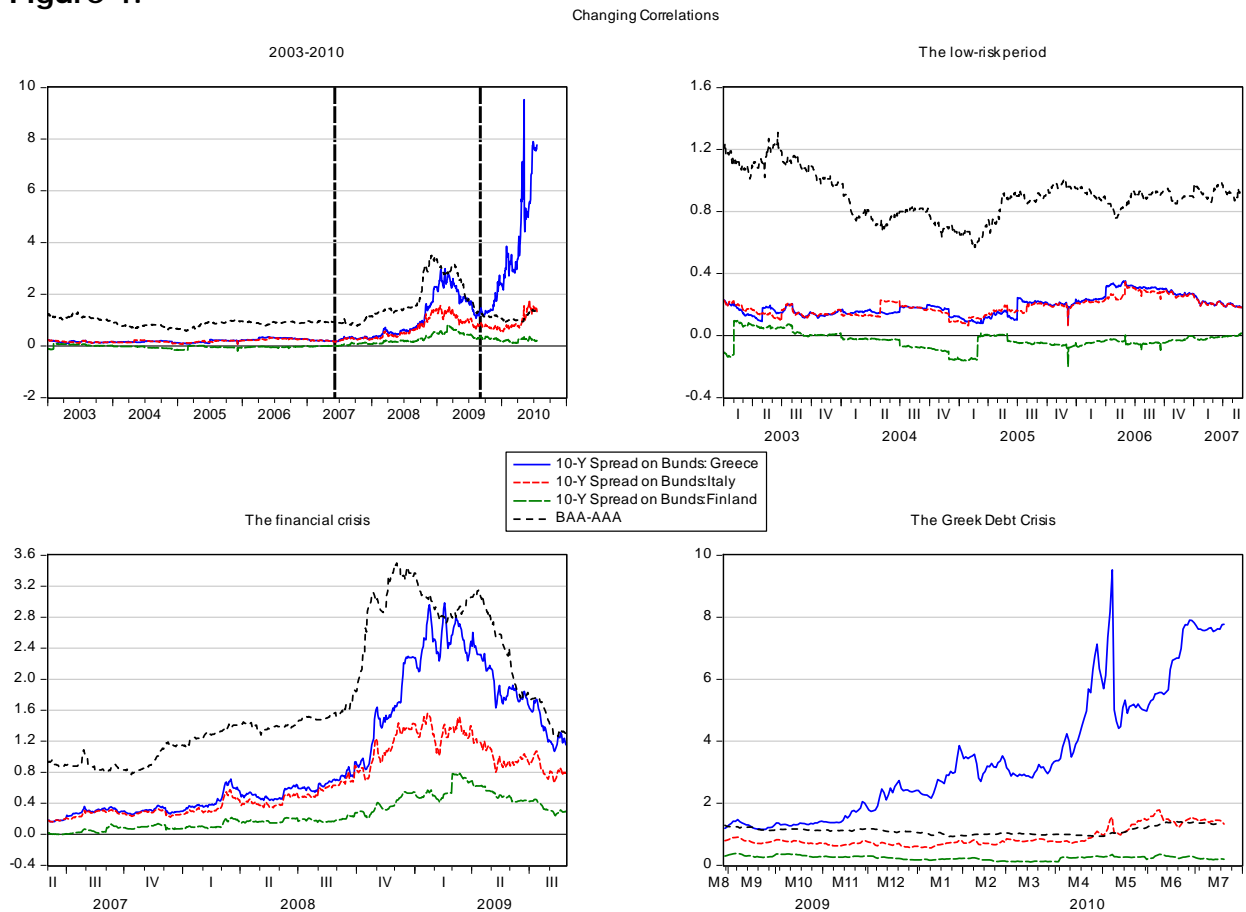
Figure 3:



2.2 Contagion

There is an important fact about the comovements of interest-rate spreads in the euro area: their interdependence is not constant over time but it is subject to structural breaks, a phenomenon often referred to as “contagion”. To illustrate this phenomenon we consider two high-yielders, Greece and Italy, and one low-yielder, Finland. We report in Figure 4 the Greek, the Italian and the Finnish 10-year spreads on Bunds along with the spread between yields on US BAA and AAA corporate bonds, a variable often used to describe the market attitude toward risk. We consider the full sample 2003-2010 and three subsamples, the low-volatility period (2003-2007), the Financial Crisis (May 2007-August 2009) and the Greek Debt Crisis (September 2009-July 2010).

Figure 4:

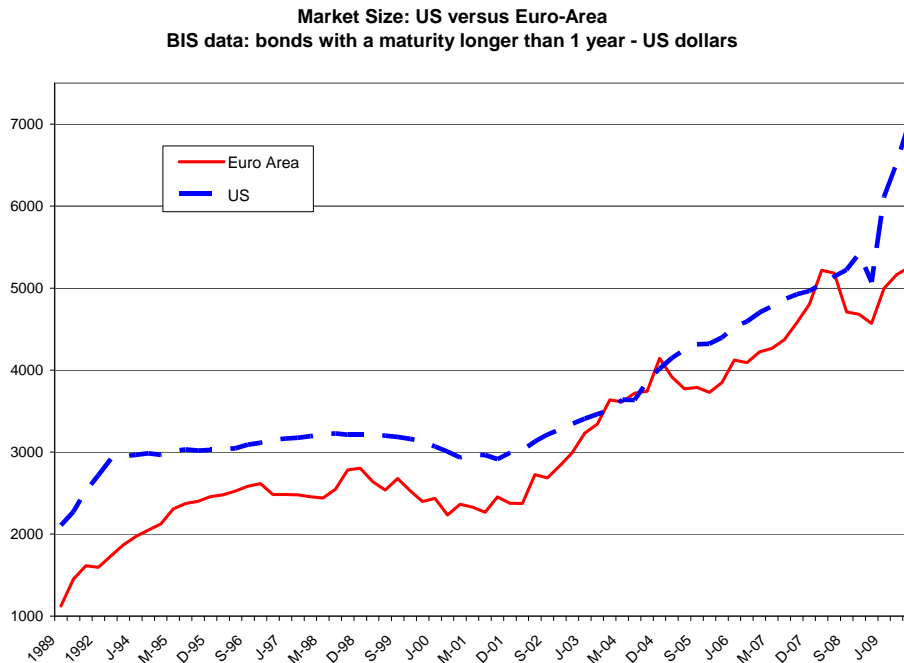


A changing correlation pattern clearly emerges from the data. Over the low-volatility period Italy and Greece are placed in the same class of risk by the market and their spreads on Bunds are very highly correlated. During the financial crisis the credit risk of the two high-yielders diversify. In fact, both the Italian and the Greek spread positively react to the increase in the BAA-AAA spread but their response is different; the Greek spread reaches a peak of about 300 basis points, while the Italian spread peaks at 150. Interestingly, during the financial crisis also the Finnish spread on Bunds responds slightly to international risk because of an increase in the liquidity premium. Finally, during the Greek crisis, the surge in the interest rate on Greek bonds, not only leads the Greek spread to a value of nearly one-thousand basis points, but, strongly affects the Italian spread that even rises above the US BAA-AAA spread to reach almost 200 basis points. This evidence clearly points to a significant “contagion” effect.

2.3 The interest rate differential between German Bunds and US Treasuries

The euro-area bond market is very close in size to the US market; Figure 5 shows that the difference in the volumes of bonds outstanding with a maturity longer than one year is negligible until the end of 2008. However, the German Bund market represents only 23% of the euro-area market and is thus much smaller than the US one. A natural question arises on the possibility that German Bunds have to pay a liquidity premium due to their smaller market size and the lack of international benchmark status enjoyed by US Treasuries.

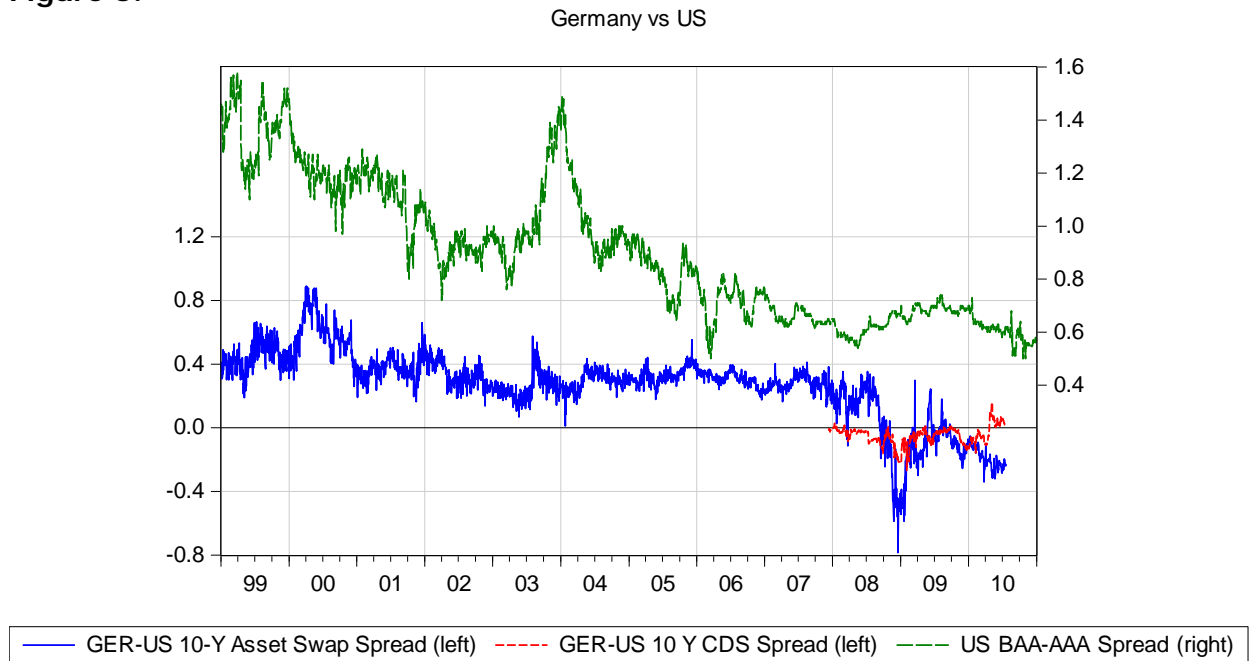
Figure 5:



Answering this question is made easier by the fact the CDS swap differential between US and Germany is negligible, and so is their relative credit risk premium, but is made more difficult by the existence of a fluctuating euro-dollar exchange rate. To filter out exchange-rate expectations from the interest rate differential between German and US bonds, we use the difference between the 10-year Fixed Interest Rate Swaps in euro and in US dollars that is immune from sovereign liquidity and credit risks. We report in Figure 6 three series: the 10-year German US Asset Swap Spread (defined as the difference between the interest rate spread and the difference between the 10-year Fixed Interest Rate Swaps), the difference between the CDS on German Bunds and US Treasuries and the US BAA-AAA spread.

We note first that before the financial crisis a common Eurobond would have enabled the euro-area market to better compete with the US market as the most liquid market globally. In the pre-crisis period the CDS differential is negligible and the asset swap spread can be taken as an indicator of the liquidity premium on German Bunds. It points to a sizeable liquidity premium, around a mean of 40 basis points.

Figure 6:



However, when the crisis hits the markets and the BAA-AAA spread starts fluctuating away from its low-risk period mean, the liquidity premium paid by German Bunds on US Treasuries disappears, and in fact is reversed as a consequence of the “flight to quality” towards German Bunds and a perceived higher relative credit risk of the US, as witnessed by the CDS differential. The increase in the relative supply of US Treasuries, shown in Figure 5, is also consistent with this interpretation. This pattern persists during the Greek debt crisis, probably due to a portfolio shifts towards German Bunds away from bonds issued by Member States with lower credit standings. Hence, in the pre-crisis period US Treasuries did enjoy the status of the most liquid benchmark globally, but they appear to lose this role thereafter.¹⁰⁹

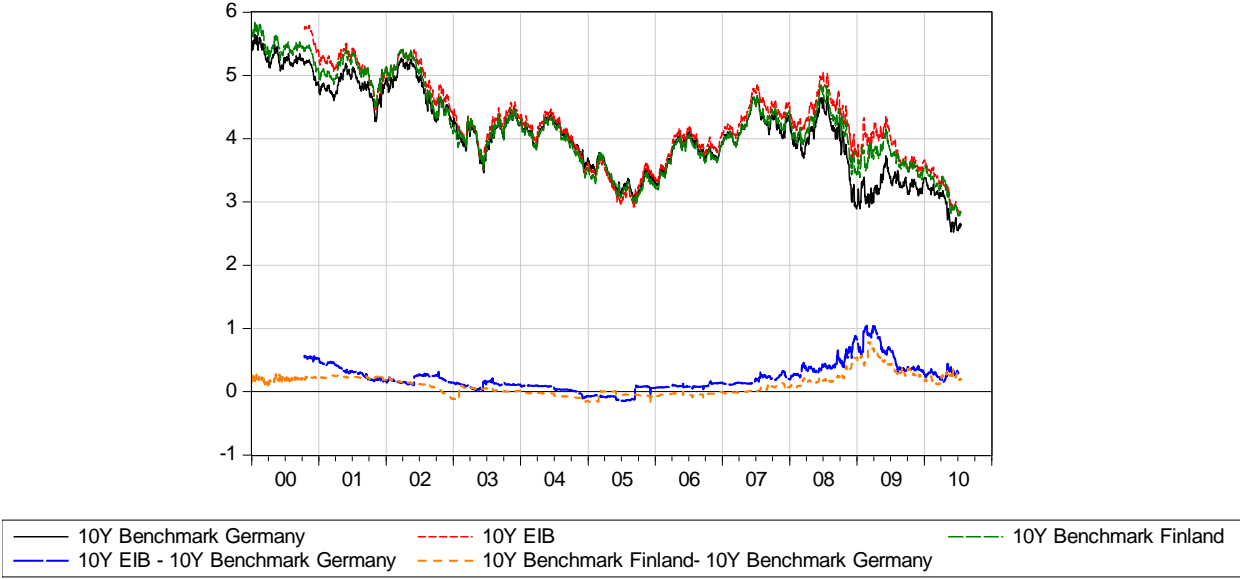
2.4 The interest rate on Eurobonds issued by the EIB

To assess the performance of a bond issued by an EU Institution we construct, from various EIB bond issues, the interest rate on a synthetic EIB bond with residual term to maturity as close as possible to 10 years. Figure 7 reports the yields on 10-year EIB bonds along with the yields on 10-year German Bunds and the yields on 10-year Finnish bonds. We note first that the yield differential between the EIB bonds and German Bunds climbed from near zero to 100 basis points over the course of the financial crisis, to return to a level of around 30 basis points thereafter.

Although the pre-crisis level has not been restored yet, the impact of the euro-area debt crisis on this differential is clearly much smaller than that of the financial crisis. Interestingly, Figure 7 also shows that the interest rate on EIB bonds follows closely that on 10-year Finnish bonds, paying only a small premium over it. As Finnish bonds have no credit risk but very low liquidity, this evidence suggests that the illiquidity of EIB bond is the most likely explanation for their interest rate differential with German Bunds. This evidence is consistent with the idea that a common Eurobond issued by a EU Institution would have the same credit quality of German Bunds.

¹⁰⁹ While it would worth looking at traded volumes to better understand the apparent reversal in international benchmark status, data are difficult to find because US Treasuries and German Bunds are mostly traded over the counter (Bunds as well as other euro-area bonds are also traded on regulated markets).

Figure 7:



BOX: Credit Risk, Liquidity Risk and Interest Rate Differentials

The interest rates on government bonds with the same currency denomination and maturity can differ because of different credit and liquidity risks. The credit risk depends on the creditworthiness of the issuer; if there is a positive, even small, probability that a government may not honor its obligations and default on its debt, investors will ask for a credit risk premium (or a default risk premium) to hold its bonds. As the probability of default that investors perceive increases, so does the credit risk premium and the interest rate. The credit premium depends on the government’s domestic fiscal fundamentals (deficit and debt) and economic growth, but also on international factors, such as the investors’ attitude to (or perception of) global risk, flight to quality effects and the level of interest rates. The liquidity of a bond depends on how easily it can be traded without incurring into losses and transaction costs. In a thick market with large volumes traded, the risk that selling (or buying) a bond may move the price adversely is reduced because the probability of a matching order increases. A thick and efficient market also reduces transaction costs. It follows that the liquidity premium (and the interest rate) that investors ask to hold a bond should decrease with the volume traded and thus with the stock of bonds outstanding; governments with smaller economies and lower amounts of bonds should pay a higher liquidity premium. Liquidity is also enhanced by the availability of a futures contract to hedge investors’ positions; German Bunds may pay a lower liquidity premium because they are the bonds on which the Eurex futures contract is based.

This discussion suggests the following simple representation for the interest rate differential:

$$R^M - R^B = \Delta C(d, g) + \Delta L(v, g)$$

where the difference between the interest rate on a Member State bond, R^M , and the interest rate on a benchmark bond, R^B , i.e. the German Bund, is equal to the sum of the credit risk premium differential, ΔC , and the liquidity premium differential, ΔL . As discussed above, the credit risk premium depends on the domestic fundamentals, d , and global factors, g . The liquidity premium depends on the volumes of bonds outstanding, v , and on global factors. One reason for including global factors as determinants of the liquidity premium differential is that a perceived higher global risk is often associated with higher interest-rate

volatility and thus an increased cost of illiquidity; i.e. of having to trade in a thin market at an uncertain price. Moreover, portfolio shifts by international investors towards safety and liquidity, i.e. flights to quality, may affect both the credit risk premium and the liquidity premium. We take the difference in credit default swaps (CDS) as a proxy of the credit risk premium differential, ΔC , and report in Figures 2 and 3 the spreads on Bunds, $R^M - R^B$ (blue line), and the CDS spread (red line); their difference is a measure of the liquidity premium differential, ΔL .

3. What Type of Eurobond?

Several arguments have been put forth in favor of a common European government bond. All proposals stress that Eurobonds would promote further market integration, greater liquidity and lower borrowing costs due to a reduction in liquidity premia. Recent proposals also contend that Eurobonds could reach the status of a “safe-haven” benchmarks competing with US Treasuries for global financial flows and strengthen the use of the euro as an international reserve currency. The politically sensitive argument that Eurobonds could provide insurance and continued market access to weaker Member States is instead rarely made, but Eurobonds could reduce exposure to crisis transmission from contagion and interdependence. Whether some or all of these potential benefits would arise from common issuance depends on the type of debt instrument. It is then worth considering three hypotheses:

3.1 - A commonly issued Eurobond with country-specific shares backed by several guarantees

The first hypothesis is a single debt instrument issued by a group of euro-area Member States, through an independent agency, with funds raised and obligations divided between participating issuers in specific fixed proportions (how to determine these shares is discussed below). Each participating Member State would guarantee only its share of the joint instrument. While the Eurobond would trade as a single debt instrument, each participant would be liable only for the interest payments and principal redemption corresponding to its share of the bond, and not for the debt of the other issuers. The credit standing of this bond would likely emerge and be perceived by investors as the average of the credit standings of the participating Member States (weighted by their relative shares), while its liquidity could be greater than that of the national bonds of the participating issuers depending on the size that its market would reach.¹¹⁰

3.2 - A commonly issued Eurobond backed by joint guarantees

The second hypothesis is a single debt instrument issued by a group of euro-area Member States backed by several and joint guarantees: each participating issuer would guarantee the totality of the obligations of the common instrument, thereby making it an indivisible legal object. The issuing entity could be an independent agency or, as suggested by Boonstra (2010), a newly created EMU Fund for on-lending to a group of participating euro-area Member States. The debt-service obligations of each participating issuer would be specified in relation to the amount of funding obtained, but the cross-default nature of the joint guarantees would give an investor legal recourse to all the participating issuers, in case that not all the obligations of any issuer were fully met. Thus, the credit standing of this instrument would tend to reflect the creditworthiness of the participating Member States with larger economies. Participation by Germany and France would ensure a lower credit risk premium than the weighted average of the participating Member States even if some of them were of lower credit standings.¹¹¹

¹¹⁰ This type of instrument has been studied by EPDA (2008) and is consistent with the proposal by De Grauwe and Moesen (2009).

¹¹¹ This type of instrument is the third hypothesis considered in the Giovannini Group Report (2000) and is consistent with the proposals by Boonstra (2010), Delpla (2010) and Jones (2010).

3.2 - An EU Eurobond issued by an EU Institution

The third hypothesis is a debt instrument issued by an EU Institution for on-lending to Member States. This institution would lend the funds raised with EU bonds to Member States at an interest rate reflecting funding costs plus, eventually, a margin possibly different across States. EU bonds would be backed by the several and joint guarantees of the 27 EU Member States; these guarantees would not be explicit but derive from the EU legal order. If the common bond were issued by the European Commission (EC) the guarantees would derive from the legal obligations of the Member States under the EU Treaty.¹¹² If the bonds were issued by the EIB, it would be backed by the capital subscribed by EU Member States.¹¹³ In both cases, EU bonds would be of the highest credit quality and their risk premium should be close to zero.¹¹⁴

Table 1: Summary of Main Characteristics of the three Types of Eurobond

Characteristic	Type 1	Type 2	Type 3
Issuing Entity	Independent Agency	Independent Agency or EMU Fund	EU Institution EC or EIB
Participation	Open	Open	27 EU Member States
Fixed Shares of each Country	Yes	No but limits on debt of each participant	No but limits on debt of each EU Member
Guarantees	Several	Several and Joint explicit	Several and Joint from EU Treaty
Mutualisation of Default Risk	No	Yes	Yes
Credit Rating	Weighted Average of participants	Reflect Rating of larger participants. Highest (AAA) if all euro-area Members join	Highest (AAA)
Liquidity	Conditional on Market Size and Participation	Conditional on Market Size and Participation	Conditional on Market Size
Management	Inflexible	Flexible	Flexible
Legal Obstacles	None	Change in TFEU Art.125 No-Bailout	Change in TFEU

¹¹² The European Commission already borrows on capital markets to fund its Balance of Payments Facility and its bonds have a AAA rating.

¹¹³ The EIB already borrows on capital markets to finance investment projects and its bonds have a AAA rating.

¹¹⁴ This type of instrument is the fourth proposal in the Giovannini Group Report (2000). Issuance of a common bond by the EIB has been considered by Majocchi (2005) for funding projects envisaged in the Lisbon Strategy and by Gros and Micossi (2009) for the purpose of financing a European Financial Stability Fund.

4. The Arguments for a Eurobond

4.1 The efficiency gains from further integration; greater liquidity and lower borrowing costs

The main argument for a common European government bond is that it would promote further market integration, especially on the supply side, and greater debt management coordination. The efficiency gains from a unified bond market could be substantial: liquidity could be enhanced by larger outstanding volumes and the more so if the common Eurobond would become eligible for delivery into a futures contract. Greater liquidity would, in turn, reduce liquidity premia and, thus, the costs of borrowing for Member States, with greatest advantage for smaller and medium sized issuers. Finally, to the extent that issuance of national bonds would come to an end, some Member States with smaller funding needs would save the costs of maintaining their national primary markets and dealer systems.

These benefits could be obtained, in various degrees, with all the three types of debt instruments considered, to the extent that: issues were sufficiently large and regular; the outstanding volumes of the Eurobond reached sufficiently high levels and; its market replaced the national markets of, at least, the Member States with smaller funding needs.

The evidence in section 2 suggests that the argument has some merit and mostly appeals to small issuers with high credit standings, such as Finland and The Netherlands, but also to a benchmark issuer like France, which all appear to have borne a high cost from illiquidity since the start of EMU.¹¹⁵ Interestingly, this cost increased over the course of the US financial crisis by up to 30 basis points, either because of greater interest-rate volatility or a portfolio shift toward German Bunds. In fact, liquidity premia for these countries seem to respond to the surge in measures of risk, thereby displaying a positive correlation with credit risk premia. Indeed, the higher interest-rate volatility, associated with a perceived higher risk, could increase the cost of illiquidity; i.e. of having to trade in a thin market at an uncertain price. Moreover, a portfolio shift by international investors towards safety and liquidity, i.e. a flight to quality, may affect both the credit risk premium and the liquidity premium.

4.2 A “safe-haven” alternative to US Treasuries and the use of the euro as a reserve currency

Recent proposals contend that a common European government bond would satisfy the global demand for a risk-free asset and better compete with US Treasuries for the global financial flows in search of a safe investment. The “safe haven” argument is based on the idea that, since safe German Bunds are in scarce supply, a common Eurobond with similar credit risk characteristics, but greater liquidity, would attract the demand by international investors and thus would reduce the borrowing costs for the euro-area sovereign issuers. A single debt instrument would also strengthen the use of the euro as international reserve currency.

Indeed, even German Bunds appear to suffer from a lack of liquidity or international benchmark status compared to US Treasuries: before the financial crisis, they have been paying a premium as high as 40 basis points, though their credit risk is practically zero. This suggests that, even benchmark issuers, such as Germany and France, for which the gains from further integration have always been thought to be small, could benefit from greater liquidity if the common issuance market approached the size of the US market. Liquidity is, however, not enough; for a common Eurobond to achieve the status of a “safe haven” international benchmark, its credit standing should be as high as that of German Bunds. Indeed, evidence from the global financial crisis is consistent with a flight to credit quality more than liquidity. As shown in Section 2, the widening of interest-rate spreads on the bonds with lower credit standings is completely explained by their higher credit risk as

¹¹⁵ For France this argument applies only to 10-year bonds.

measured by CDS spreads. Higher liquidity premia, or portfolio shifts towards German Bunds, can account for an increase in bond spreads only in a few Member States: Finland, France and The Netherlands. However, even the French spread during the euro-area debt crisis is mainly explained by an increase in credit risk as measured by the CDS spread.

Whether the demand for a "safe haven" asset of high credit quality and liquidity can be satisfied by a common Eurobond depends on the type of the guarantees and/or the credit standings of the participating Member States. Participation to a Eurobond that makes each issuer liable only for its own share (as under hypothesis 1) would have to be restricted to Member States with a credit standing as high as that of Germany and France, since it would be equivalent to a diversified portfolio of national bonds. The latter countries should also join for such a bond to reach a sufficient liquidity. Whether participation to a Eurobond backed by joint guarantees (hypothesis 2) had to be equally restricted is an open question. Evidence on the credit quality of EIB bonds (which are implicitly backed by the joint guarantees of all EU Member States) can however shed light on this issue. As shown in section 2, EIB bonds are priced by international investors in the same way as safe but illiquid Finnish bonds; indeed the interest rate differential between the two bonds is practically zero. This suggests that a Eurobond issued by an EU Institution (and probably by all euro-area Member States) would be perceived as of the highest credit quality and could reach the "safe haven" status if its market size approached that of US Treasuries.

4.3 Risk insurance, market access and crisis prevention

In principle, common European government bonds could provide insurance against credit risk and ensure continued market access during crises to sovereign issuers under distress. However, for this to be the case, the common Eurobond should have to be backed by the joint and cross guarantees of the issuing Member States (hypothesis 2) or it should be issued by an EU Institution (hypothesis 3). The risk insurance argument is rarely made in the policy debate and in the economic literature. This probably reflects political considerations but also economic reasons. Indeed, evidence that movements in interest-rate spreads (a proxy for credit spreads) have a strong common component mainly driven by changes in international risk factors suggests a limited scope for insurance.

Notwithstanding the lack of risk-diversification opportunities, a debt instrument guaranteed by France and Germany, that together account for 46% of the euro-area debt, would be of similar credit quality to their national bonds and thus greater than the weighted average of the credit standings of the participating Member States. Evidence on the EIB bond interest rate closely tracking that of Finnish bonds is consistent with this hypothesis. However, there would be no economic rationale for a common Eurobond if its better credit quality and lower risk premium emerged from the assumption of risk by larger and safer issuers rather than from risk sharing opportunities. What needs to be argued is that country-specific shocks have negative spillovers to other Member States' creditworthiness. In this case, a common debt backed by joint guarantees (or issued by an EU Institution) would reduce exposure to crisis transmission from contagion and interdependence. If the occurrence of a debt crisis in a Member State increases the probability of a crisis in other States and, thus, their credit risk premia, then providing insurance to the State with the weakest fundamentals would work as an insurance for all; it would benefit all participating Member States except, perhaps, the most virtuous one. This would be the case if a debt crisis originating in a Member State were likely to propagate to other Member States through their financial links. One main channel of crisis transmission is through cross-border holdings of national bonds and increased vulnerability of the European banking system. Another channel works from a worsening of market sentiment and increased risk aversion. The euro-area debt crisis triggered by the fiscal problems of Greece is a case in point. As shown in section 2, the surge in the credit risk premium of Greece clearly affected the Italian interest-rate spread that even rose above the US BAA-AAA corporate spread to reach nearly 200 basis points. Even the credit risk component of the French spread that was muted until then reached almost 40 basis points in the euro-area debt crisis.

5. The Arguments Against a Eurobond

5.1 Creating a thick market is costly and requires a permanent and credible issuance program

A main argument against a commonly issued bond is that the launch of a Eurobond would add a new market to the existing national markets and thus increase rather than reduce fragmentation. In fact, to promote market integration, enhance liquidity and provide a safe-haven international benchmark, the outstanding amount of Eurobonds should be substantial and, more importantly, Eurobonds should replace national bonds on a large scale. This implies that the success of the program will critically hinge on the decision of participating Member States to rely on the new instrument for their funding needs. Smaller size issuers, in particular, should quickly move to Eurobonds and close their national markets. Commitment to a permanent issuance program will then be crucial. To create a thick market, Eurobond issues would have to be sufficiently large, regular and predictable, i.e. based on an issuing calendar specifying minimum offered amounts. More importantly, issuance should not be discontinued.¹¹⁶ This may prove to be difficult to the extent that the transition process will involve high initial set-up costs and uncertain benefits in the future.

5.2 Centralized funding makes debt management inflexible

The Eurobond issuing program would have to accommodate the different needs of participating issuers, from rolling-over maturing debt to achieving the desired maturity structure, to early redemptions. The problem is now less compelling than at the start of EMU because of the substantial convergence in the type of (medium- and long-term) instruments and in the maturity structure of public debt across Member States. Interest-rate swaps can also be used to fine tuning the duration of the debt. It is however a fact that centralized funding would raise coordination issues and would reduce flexibility in the pursuit of country-specific debt management objectives that would have to be accommodated on national bond markets. This could add complexity to the management of each Member State's total debt and run against full market integration.

The "inflexibility" problem is different depending on the type of Eurobond. A debt instrument with country-specific shares backed by several but not joint guarantees (hypothesis 1) would prove to be the most inflexible. In order to enhance liquidity and facilitate the pricing of risk, subsequent bond issues would have to be comparable over time and this could only be ensured by keeping both the set of participating Member States and their shares in the common bond constant over time. A trade off would then emerge in the choice of these shares; they could either reflect the debt levels (or securities outstanding) of the participating issuers or the sizes of their economies in terms of GDP. The latter solution would restrict the use of the common instrument by the Member States with highest debt levels and might be instrumental to impose fiscal discipline, but the former would be preferable to promote market integration and liquidity and could be defended on the basis that each Member States would remain liable for its own share.

A Eurobond underpinned by joint guarantees (hypotheses 2 and 3) allows for a greater flexibility in accommodating debt management needs because the risk characteristics of each single bond issue would not depend on the amount of funds that each Member State would obtain from that issue. However, limits on the maximum amount of debt that each participating Member State could possibly incur over time (and across maturities) would have to be agreed upon and communicated before the start of the program.

¹¹⁶ The use of Eurobonds for temporary programs, such as the funding of the European Financial Stability Fund as proposed by Gros and Micossi (2009), would thus fail to reduce market fragmentation and enhance liquidity.

Because of the assumption of risk by all participating issuers, these limits would have to be set in relation to their taxing power and thus GDPs. Moreover, in order to preserve the comparability of different issues over time, the Member States participating in the program should not change.

Issuance of Eurobonds by an EU Institution can also ensure flexibility in that the Institution could deal with specific needs in lending to Member States. Even in this case a limit should be set to the maximum amount of debt that each State could possibly incur over time (and across maturities). Constant participation would also be a problem (on top of participation *tout court*) to the extent that new states joined the EU.

In all cases, joint issuance would require a high degree of coordination: amounts, maturity and timing of bond issues would have to be decided by the issuing entity in close co-operation with the Member States.

5.3 Lower incentives for fiscal discipline and moral hazard

The most forceful argument against a common European bond is that it undermines fiscal discipline by removing incentives for sound budgetary policies. At worst, it could create a moral hazard problem in that a Member State may be tempted to free ride on other Members' legal obligations to assume its debt in case of default. In particular, a common Eurobond prevents financial markets from exerting their disciplinary effects through higher interest rates and undermines the no bailout clause that prohibits a Member State to be liable for or assume the debt obligations of another government. Then, with lower costs of default and deficit financing, Member States would be encouraged to run lax fiscal policies and take up more debt. This would weaken the credibility of the euro-zone as an area of stability and fiscal soundness.¹¹⁷

A first argument that applies to all types of Eurobonds is that they will reduce the credit risk premium and thus the interest rate that weaker Member States have to pay on their debts. However, the case for relying on the disciplinary effects of widening interest rate spreads is weak. Experience shows that market signals, i.e. interest rate spreads, not only are dominated by swings in market sentiment but, more importantly, can remain weak for a long time and change violently when it is too late to prompt fiscal adjustment.

A stronger case can instead be made against Eurobonds with mutual guarantees based on the fact that the cross-default nature of the guarantees would undermine the no bailout clause (Article 125 TFEU), and heighten the risk of moral hazard. However, to assess the impact of Eurobonds on fiscal discipline one has to ask how effective the no bailout clause is in preventing irresponsible or even opportunistic behavior. In fact, there has always been skepticism as to whether governments would adhere to the no bailout clause given the close financial and economic ties within the euro-area and the threat of contagion. After the rescue of Greece, these doubts have been reinforced and the deterrent role of the no bailout clause has lost much of its credibility.¹¹⁸ Summing up, bailout expectations and moral hazard will always be a problem. It has to be seen whether it would be wise to further weaken the no bailout principle. For instance, with a jointly guaranteed debt the possibility of imposing strict conditionality on financial support to a country with fiscal distress would partly be lost.

In the end the problem of moral hazard created by the mutualisation of risks would always emerge, as it is inherent in any insurance contract. The important question to ask is whether a common Eurobond can reduce exposure to crisis transmission and whether this benefit can compensate for the risk of moral hazard.

¹¹⁷ See Issing (2009) for a stand against Eurobonds, Becker (2010) and Berrigan (2010) for a discussion.

¹¹⁸ The debate on strengthening the Stability and Growth Pact offers further evidence that fiscal discipline cannot rely on the no bailout clause.

Moreover, bailout and moral hazard problems can be limited, for instance by fixing the maximum amount of debt obligations that each Member State could have in the form of Eurobonds (see Depla 2010 and Jones 2010).¹¹⁹ Any borrowing need beyond this ceiling would have to be funded with national bonds. This would set a limit to the obligations that the other Member States would have to guarantee and be liable for in the event that a Member State would default. Moreover, Eurobonds could be made senior with respect to the national bonds issued after the start of the program (see Depla 2010). While Eurobonds would be risk free, any debt exceeding the ceiling would have to be issued at higher interest rates on the national market. This solution is simple and set incentives for fiscal discipline that are closely related to the amount of outstanding debt, a feature that is still missing in the Stability and Growth Pact.

6. Feasibility

Is the issuance of a Eurobond feasible? Debt underpinned by joint guarantees is not only against the spirit but most likely violates the no bailout clause of the EU Treaty. A common Eurobond also faces strong political opposition. These issues are addressed in what follows.

6.1 Legal obstacles

Legal obstacles depend on the nature of the guarantees underpinning the common Eurobond. A debt instrument that makes each participating Member State liable only for its own share (hypothesis 1) would not face legal impediments. Common issuance could be agreed outside the EU legal framework; participating issuers would only be required to abide by common rules on technical issues.

More advanced arrangements implying the cross-guarantees of the participating Member States may require changes in the legal infrastructure, either in the Treaty, or in EU legislation. For instance, a common Eurobond backed by the several and joint guarantees of the participating euro-area Member States (hypothesis 2) violates the no bailout clause, i.e. the letter of Art 125 of the Treaty on the Functioning of the European Union (TFEU).

Legal obstacles related to the possible violation of the no bailout clause would be technically different in the case of a bond issued by an EU Institution because the cross guarantees, would not be explicit but derive from the EU legal order. On the other hand, providing the European Commission with the power to raise funds for deficit financing would likely require a change in the Treaty, unless it could be based upon Article 352 TFEU (conferring the Council the power to adopt actions necessary for the attainment of the Treaties' objectives), as the Balance of Payment Facility under regulation 302/2002. A possible alternative to be explored could be to give the Commission power to raise funds under Article 122.2 TFEU, whose scope is restricted to financial assistance by the Council in case, *inter alia*, of difficulties caused by exceptional circumstances, as for the European financial stabilization mechanism recently adopted on May 9, 2010. A similar problem arises if the mandate of EIB were to be extended to finance the deficit of the Member States, as Article 309 TFEU should be modified.

Finally, and importantly, if an EU Institution, such as the EC or the EIB, were to become the single issuer, the question of non-participating Member States which would *de facto* cross guarantee the debt of the participating States would have to be addressed (see Goldschmidt 2009).

¹¹⁹ EPDA (2008) also concludes that debt limits should be preferred to the creation of a Guarantee Fund given market aversion to structured products.

6.2 Political Feasibility

Political opposition has two motivations. The first is that a common Eurobond relaxes fiscal discipline and creates a moral hazard problem, as already discussed in the previous section. The second, perhaps, more compelling issue is the equitable sharing of the benefits and costs of the program. While all Member States participating in the issuance of a Eurobond (or borrowing from an EU Institution) would benefit from greater liquidity, those with the highest credit standings might lose from the mutualisation of credit risk. If the joint bond did not reach the safe-haven status, Member States with sound budgetary policies and low debts could even face higher credit risk premia and borrowing costs. In any case, they would end up subsidizing Member States with weaker fiscal fundamentals.¹²⁰

In the case each participating Member States were liable only for its own share of the joint instrument (hypothesis 1), the latter would be equivalent to a diversified portfolio of national bonds and the credit risk component of its interest rate would likely emerge as an average of the credit risk premia paid by participating issuers on their national bonds. The risk characteristics of a common Eurobond backed by joint guarantees (hypothesis 2) would depend on the participating Member States. In the best case scenario, the credit quality and the risk premium of a Eurobond jointly guaranteed by all euro-area Member States would be as good as those of French and German national bonds. But the latter States, while sharing the benefits of enhanced safe-haven status and, perhaps, greater euro-zone financial stability, by assuming the credit risk of the other States, would see their risk exposure increased. Issuance by an EU Institution would also be problematic and even more so because EU Member States outside the euro-area would guarantee the Eurobond without sharing its benefits.

As the discussion makes clear, the lack of participation incentives is a serious obstacle to the implementation of any common issuance program. Why should a Member State pay a higher interest rate or agree to guarantee the debt of other States if it did not obtain a proportionate share of the benefits? This explains why Eurobond proposals usually come along with suggestions on how to relax the participation constraint.

A first solution is to restrict participation to the Member States with the highest credit rating or to restrict issuance to a short-maturity low-risk type of instrument: Treasury bills (see EFDA 2008, Münchau 2009). These solutions cannot be applied to a Eurobond issued by an EU Institution, limit the scope of market integration and may not be effective because, as shown in section 2, the credit risk component of interest rate spreads may differ substantially even within the same class of high rated bonds.

A second solution relies on a compensation scheme based on the indexation of the interests paid by each Member State either to measures of its credit risk premium or to fiscal parameters. For instance, each Member State could pay on its share of the Eurobond a margin equal to the credit risk premium, as measured by CDS, on its national bonds, while the remaining interest payments would be proportional to the share of the Eurobond (see Mayordomo et al. 2009).¹²¹ This scheme could be applied to any type of Eurobond. For instance, an EU Institution could charge Member States with different interest rates. The main problem with this solution is that, for the compensation scheme to work, the markets for national bonds (on which CDS are quoted) have to be kept alive contrary to the objective of reducing fragmentation. Making Eurobonds depend on the national markets that they should replace is a self-defeating strategy.¹²²

¹²⁰ See Berrigan (2010) for a further discussion.

¹²¹ Similarly, De Grauwe and Moesen (2009) propose to link payments to the interest rates on national bonds. Interest rates are however worse proxies for credit risk than CDS spreads.

¹²² Furthermore, if a common Eurobond backed by joint guarantees reduced the exposure to crisis transmission then the risk premium measured by CDS on national bonds would tend to overstate the credit-risk contribution of the participating issuers.

If anything, Member States with smaller funding needs would not be able to issue Eurobonds and at the same time maintain a liquid market for their national bonds. A different compensation scheme, that overcomes these difficulties, is to index the interest payments to fiscal parameters such as the deficit and/or the public (and private) debt relative to GDP (see Boonstra 2010 and Gros 2010). This solution offers a shield from the sudden swings in sentiment on financial markets, and may provide incentives for fiscal discipline based on EU most preferred indicators of fiscal sustainability but agreement on technical details on the indexation mechanism could be difficult to reach.

The only viable solution, as already discussed in the previous section, is to define the maximum amount of debt obligations that each Member State could have in the form of Eurobonds. Any additional borrowing would have to be funded with national bonds. This would set a limit to the obligations that the participating Member States would have to guarantee and be liable for in the event that one of them would default. If Eurobonds were also made senior with respect to the national bonds issued after the start of the program, they would be risk free (see Depla 2010). This solution would ensure a safe-haven status for Eurobonds, set incentives for fiscal discipline and appears equitable to Member States with strongest fiscal fundamentals. Whether it could receive political support is however unlikely.

7. Concluding Remarks

In this paper we have provided the relevant stylized facts to assess the potential benefits from a European government bond issued by euro-area Member States or by an EU Institution. We have found that credit risk premia are the main drivers of interest-rate differentials of euro-area Member States relative to Germany, a fact suggesting little scope for a Eurobond with country-specific shares that leaves each participating issuer liable only for its own share. Indeed, only few Member States, Finland, France and, perhaps, the Netherlands appear to have borne a high cost from illiquidity. Moreover, the efficiency gains from a Eurobond backed by several but not joint guarantees in terms of market integration and greater liquidity would be limited and possibly offset by the higher costs of an inflexible debt management.

The potential benefits of combining credit quality with liquidity are suggested by the evidence on the interest-rate differential between German and US bonds. Indeed, we find empirical support to the "safe haven" argument that a common Eurobond with the same credit standing of German Bunds, but greater liquidity, would attract the demand by international investors and strengthen the use of the euro as a reserve currency. In fact, before the US financial crisis, German Bunds appear to suffer from a lack of liquidity or international benchmark status compared to US Treasuries. After the crisis they even appear to be perceived as a safer investment. This findings together with the evidence of a zero credit risk premium on EIB bonds suggests that a Eurobond issued by all euro-area Member States could reap the liquidity benefits of a unified market approaching in size that of US Treasuries. However, to reach a "safe-haven" status the common bond would have to be jointly guaranteed by all euro-area Member States. A Eurobond backed by joint guarantees could also reduce exposure to crisis transmission and contagion that appear relevant factors affecting interest-rate spreads over the course of the euro-area debt crisis.

A Eurobond issued by an EU institution would also provide these benefits but participation of non-euro Member States would be problematic as they would assume the risk of a jointly guaranteed debt without fully sharing its benefits. This suggests the creation of a new EMU issuing entity for centralized funding of euro-area Member States. Full participation by euro-area Member States should also be ensured since the start of the program; a gradual approach with sequential participation is bound to fail because a common issuance program has high initial set-up costs while its success critically hinges on the potential market size for the new instrument and thus on the number of participating issuers and their credible commitment to the program.

Issuance of a jointly guaranteed Eurobond requires, however, a change in the no bailout clause (Article 125 TFEU) and, more importantly, the political will to implement it, which is lacking at present. Indeed, a mutualisation of credit risk faces strong political opposition especially by Member States with sound fiscal fundamentals because of fears of relaxed fiscal discipline and inequitable sharing of the benefits and the costs from the program. Although solutions to these problems can be found, it is difficult to think of a Member State willing to assume another State's risk in the absence of an EU common fiscal policy. Indeed, one may even wonder whether a common debt will ever exist without a stronger fiscal integration.

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4.2 THE FEASIBILITY OF COMMONLY ISSUED GOVERNMENT BONDS

by the Association of Financial Markets Europe (AFME)

Abstract

In September 2008, AFME's European Prime Dealers Association (EPDA) published a research paper exploring the benefits and drawbacks of a common European bond from a market perspective. The paper was based on a survey of Primary Dealers' views on the pricing of possible European common debt instruments and consisted of both a qualitative and quantitative analysis. From the results of this paper, the EPDA published a briefing note in March 2009 on the specifics of a possible common European T-bill. This paper summarises the results of earlier studies and places them in the context of current market developments. Matters relating to common issuance are discussed, addressing the arguments for and against the introduction of such an instrument; the results of a survey detailing Primary Dealers' estimates of the pricing of a possible European common bond or bill are presented to provide some guidance on the preferred shape of a common bond programme; and the follow up to the outcome of the market survey provides an exploration of a common T-bill.

The **Association for Financial Markets in Europe** (AFME) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

The **European Primary Dealers Association** (EPDA) advocates with relevant government and regulatory bodies on behalf of eurozone government bond primary dealers through dialogue and market best-practices recommendations. A subdivision of the Rates Division, AFME/epda promotes integration and efficiency within the European government bond market and addresses primary and secondary issues by facilitating consultation with key market participants, including primary dealers, European Debt Management Offices, the European Commission (EC), the European Central Bank (ECB), and trading platforms.

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Contents

Introduction 1154

1. Impacts of Common Issuance 115

2. The EPDA Market Survey 116

3. The Common T-bill further explored 121

Conclusion..... 122

Introduction

As a result of the global financial crisis, Europe has seen an unprecedented amount of government bond issuance over the past two years. The funding capacity of many European countries was further tested in the months following the sovereign debt crisis in Greece, which led first to the foundation of the €60 bn European Financial Stabilization Mechanism (EFSM) and then the €440 bn European Financial Stability Facility (EFSF). In this context, the idea of a common European bond has been discussed by regulators, policy makers and in the financial press¹²³.

In September 2008, AFME's European Prime Dealers Association (EPDA) published a research paper exploring the benefits and drawbacks of a common European bond from a market perspective¹²⁴. The paper was based on a survey of Primary Dealers'¹²⁵ views on the pricing of possible European common debt instruments and consisted of both a qualitative and quantitative analysis. From the results of this paper, the EPDA published a briefing note¹²⁶ in March 2009 on the specifics of a possible common European T-bill.¹²⁷

This paper summarises the results of both studies and places them in the context of current market developments. Matters relating to common issuance are discussed, addressing the arguments for and against the introduction of such an instrument; the results of a survey detailing Primary Dealers' estimates of the pricing of a possible European common bond or bill are presented to provide some guidance on the preferred shape of a common bond programme; and the follow up to the outcome of the market survey provides an exploration of a common T-bill.

¹²³ See: – 'The benefits of a single European bond', Financial Times, Wolfgang Munchau, 26 January 2009; – 'The Eurozone needs a Government bond market', Financial Times, George Soros, 18 February 2009; – 'Fight the crisis with Eurozone bond market', Financial Times, Romano Prodi, 25 February 2009; – 'Merkel seeks bond co-ordination', Financial Times, Chris Bryant and David Oakley, 26 February 2009; – 'German debt chief snubs a joint European bond', Financial Times, David Oakley, 26 February 2009; – 'Emergency Eurozone aid signalled', Financial Times, Tony Barber, 3 March 2009.

¹²⁴ "A common European Government Bond", published in September 2008.; http://www.sifma.org/research/pdf/EPDA-SIFMA-Common-Bond-Report_0810.pdf

¹²⁵ AFME defines Primary Dealers as 'A group of dealers in government securities designated by the authorities to play a role as specialist intermediaries between the authorities and the market, in government securities markets. Primary Dealers usually have special rights to deal with central bank in open market operations and/or privileges in bidding at primary auctions of government securities. In exchange Primary Dealers are usually obliged to participate in the primary market and perform market-making functions in the secondary market, in addition to maintaining minimum capital and staff proficiency standards.'

¹²⁶ 'Towards a Common European T-bill'; <http://www.afme.eu/document.aspx?id=2684>

¹²⁷ A T-bill is a debt instrument with a maturity at issuance of less than 1 year.

1. Impacts of Common Issuance

Fragmented sovereign debt issuance in the euro area can be a source of inefficiency and may be partly responsible for high liquidity premiums in the European government bond market. Investors demand a liquidity premium when a security can not be easily converted into cash at the fair market value. When the liquidity premium is high the asset is said to be illiquid, which causes prices to fall and interest rates to rise. All other things being equal, the liquidity premium is generally negatively correlated with the outstanding volume of a bond. The prospect of common issuance creates scope for much larger volume issues and the potential to establish area-wide benchmark loans along the yield curve. This could lead to lower liquidity premiums and lower interest rates and therefore reduce the costs of borrowing for Member States and, in turn, the burden on taxpayers. Presently, the liquidity premium is greatest for smaller issuers. For benchmark issuers - Germany and France - the gains from further integration are believed to be more limited but potentially overall liquidity premium benefits could be realised by all issuers if the common issuance market could approach the size of the US Treasury market.

Another cost reducing factor of common issuance is that the increased liquidity would likely remove the need for national Debt Management Offices (DMOs) to enforce market making obligations on Primary Dealers, which is a large cost for those that participate in the market¹²⁸.

Furthermore, common issuance could lead to more efficient hedging¹²⁹ of positions for market participants, thereby reducing transaction costs. Currently, the Eurex German bund futures contracts have become the benchmark against which dealers hedge the exposures on their bonds (either German or bonds from other European countries). For that reason, liquidity in the secondary market in the wholesale futures segment is much larger than that for the underlying German bund or any other European government bond. This can be problematic as to be an effective "hedge" an instrument needs to be correlated closely with the instruments against which it is to be hedged. Since the onset of the credit crisis, correlation among European countries has decreased significantly due to the volatility between the yield spreads of the underlying German bund and the various other euro area European government bonds. Market makers pass the resulting larger costs of hedging on to end investors, which leads to higher transaction costs for the industry.

A commonly issued European government bond would likely see the Eurex bund futures contracts replaced by a euro-area-wide futures contract based on the underlying common issuance bond. This instrument would have the same liquidity, if not greater, than the current German contract. As the underlying bond would be the common issuance bond, it would be perfectly correlated and therefore eliminate the risk of volatility between the products, thereby making the new futures contract a much more effective hedge and, in turn, significantly reducing transaction costs in European government bonds.

A common European government bond would also create possibilities for a larger and more liquid repo market, enabling dealers to take short positions more easily and enhancing liquidity in the cash market. The cash, repo¹³⁰ and futures market could work in a virtuous circle each enhancing the others liquidity, leading to lower costs of borrowing.

¹²⁸ Most issuers impose market making obligations to their Primary Dealers. Under this obligation, banks are obliged to quote to each other two way prices, within a certain spread and for a number of hours per day. Prices that are formed here, serve as an important benchmark for end investors. This helps liquidity.

¹²⁹ Hedging is a technique designed to reduce or eliminate financial risk; for example, taking two positions that will offset each other if prices change. Hedging is a crucial part of market making.

¹³⁰ A repurchase agreement (also known as a repo or Sale and Repurchase Agreement) allows a borrower to use a financial security as collateral for a cash loan at a fixed rate of interest. For traders in trading firms, repos are used for example to finance positions and cover short positions in securities. The repo market is therefore of great importance to the functioning of the bond market.

Finally, a common European government bond would better enable Europe to compete with the US Treasury market as the most liquid market globally and could aid the development of the euro as a reserve currency. If commodities and other products were to be priced in euro in world markets, this could permit European Monetary Union (EMU) members to purchase them at more competitive rates as they would not incur the foreign exchange risk arising from the dollar conversion.

On the downside, it could be argued that investors and financial intermediaries might see some investment options and arbitrage possibilities reduced following the creation of a common European government bond, while the sell-side could see business opportunities shrink through less derivative and syndication advice to governments.

However it can be argued (at least by reference to the theoretical instruments developed for this paper's market survey) that, as sub-AAA issuers would still need significant separate sovereign issuance, this would retain other opportunities for investors, relative value trading for intermediaries/hedge funds, and business opportunities for sell-side firms.

2. The EPDA Market Survey

The EPDA performed a market survey to investigate the appropriate form that common issuance could take. Thirteen primary dealers in European Government bond markets were asked to price six theoretical debt instruments which were given a best estimate, fair market value price as at the end of the trading day on Monday 23 June 2008.¹³¹ The prices were compared across the different theoretical instruments and with the pricing of government bonds of the individual European countries. In this way, it was possible to quantify the benefits of a common bond and single out the most favourable alternatives for its creation.

Development of theoretical common bonds

Credit rating

These six theoretical scenarios for a common bond were developed in cooperation with the three major international credit rating agencies¹³², as well as a range of academics and investors,.

In order to draw maximum benefits, any common debt instrument should be structured to attract the highest possible credit rating, preferably AAA. The majority of instruments assessed in the survey have been devised with this in mind. Factors singled out by credit ratings agencies as relevant to a credit rating assessment for a common bond include:

1. an enforceable legal obligation on participating Member States to ensure that common debt is senior to any debt issued in their own name following the introduction of common issuance;
2. an issuing entity that is free from political interference;
3. all issuers being liable for a proportionate share of each maturity; and
4. a liquidity cushion or "guarantee fund" to ensure sufficient liquidity to meet upcoming bond redemption payments where participating issuers carry different credit ratings.

The first three factors are incorporated in all six debt instruments, while the fourth factor is incorporated in three of the six instruments.

¹³¹ The date was chosen at random, within the timeframe available for the market survey.

¹³² Fitch, Moodys and Standard & Poors.

The “guarantee fund” would be administered by the issuing agency and is assumed to be of sufficient size to ensure that bond payments would be met in the event of default by a participating issuer or issuers. Precedents for this type of structure include the International Financing Facility for Immunisation and Nordic Municipal Bonds¹³³. The guarantee fund would be established with contributions from non AAA-rated participating issuers and its structure could, in principle, be designed to achieve an AAA rating, although the actual rating would depend on the precise details of the fund including its size

Alternatively, the percentage of debt that could be issued through the common vehicle by non-AAA issuers could be limited and the remainder of their issuance subordinated. This could help to ensure that the common bond achieves AAA status by offsetting the probability and duration risk of non-payment to the debt agency by non-AAA issuers. An independent agency, which would be the “best buyer” for most of the outstanding issuance, could be incorporated to pool all these assets into a AAA product backed by the underlying independently issued government bonds. In this latter case governments would still issue independently, with most (if not all in the case of AAA issuers) of their issuance directly purchased by this agency.

Appropriate mechanisms incorporated into the structure of the common debt instrument could respond to credit upgrades or downgrades of a participating sovereign so that the credit rating of the common bond would not be affected. Taking the example of the guarantee fund, the downgrading of a AAA-rated issuer would require that issuer to advance cash collateral towards the Guarantee Fund.

Six scenarios

The range of the six theoretical debt instruments was intended to reflect variations on the following factors:

- participation of only some or all 15 euro-area issuers;
- Program size; total annual sovereign bond issuance or 50% annual issuance or T-Bill only; and
- the existence (or not) of a “Guarantee Fund” to ensure payments would be met in event of an issuer default and raise the credit quality of the bond.

Other elements of the theoretical bonds remained constant. As discussed above, to obtain the best credit rating, these were:

- An independent issuing agency, free from political interference.
- Each Member State set a specific percentage of the liability for all bonds correlated to their overall funding requirements. To be effective, an agency would need to be flexible in satisfying the funding requirements during the course of a year of a particular Member State, although the overall percentage of the total for that year would remain fixed.
- European debt instruments are assumed senior to any subordinated debt issued by euro area sovereign issuers. However, following the implementation of common issuance a transition period, during which outstanding sovereign debt would mature or be bought back by issuers, would be needed. Commonly issued debt could not therefore be expected to realise its full value or credit quality until the end of this period.

¹³³ For more information on these precedents please see page 43 of the 2008 AFME paper “A common European Government Bond”.

Another constant factor was the several liabilities of participating issuers. Consistent with the terms of the EU Maastricht Treaty (the so called "no bail-out" clause), each participating issuer would be liable for its share of total debt only, and not for the debt of other issuers.

The six theoretical debt instruments surveyed were as follows (please note that the data on which the scenarios are based is from June 2008 and that numbers and credit ratings have changed):

- I. **15 euro area sovereign issuers, comprising their total annual issuance.** Based on advice from international credit ratings agencies, the rating of this instrument would likely be that of the lowest rated participating issuer (Greece) and therefore A/A/A1 (now: BB+/BB+/Ba1). Nearly half (47%) of this bond's total issuance would derive from the (at that time) eight AAA rated sovereign issuers within the euro area¹³⁴, with Italy accounting for half of remaining issuance.
- II. **15 euro area sovereign issuers** comprising their total annual issuance, with a "guarantee fund" administered by the issuing agency. The Fund would justify a bond credit rating of **AAA**.
- III. **15 euro area sovereign issuers comprising 50% of their annual issuance** (remainder issued by sovereigns as sub-ordinated debt), with a "guarantee fund" administered by the issuing agency. The Fund would justify a bond credit rating of **AAA**.
- IV. **12 euro area sovereign issuers (excl Fra, Ger, Ita)** comprising their total annual issuance, with a "guarantee fund" administered by the issuing agency. The Fund would justify a bond credit rating of **AAA**. At the time of research, 30% of the bond's total issuance would derive from AAA-rated sovereign issuers, with Belgium accounting for the majority of remaining issuance. Since the three largest European issuers are not included, the liquidity would arguably be less.
- V. **6 AAA-rated euro area sovereign issuers excluding Fra & Ger (i.e. Aut, Fin, Ire, Lux, NL, Spn)**, comprising their total annual issuance. (Currently, only 4 of those AAA countries remain due to downgrades of Ireland and Spain). Because only AAA-rated countries were involved in this scenario, no guarantee fund would be necessary to obtain a credit rating of **AAA**.
- VI. **6 Month T-Bill for 15 euro area sovereign issuers comprising their total annual T-Bill issuance.** Of the six models under examination, this bond would constitute the third largest issuance, despite being for T-bills only, as at the time of research, 13 out of 15 countries had the highest possible short term rating, T-Bill credit rating could be as high as **A-1+/P-1/F1+**

Execution of the Market Survey

The six theoretical debt instruments were given a best estimate, fair market value price by the 13 participating Primary Dealers as at the end of the trading day on Monday 23 June 2008. In addition to the characteristic of the theoretical bonds described above, survey participants were asked to take the following assumptions into account in pricing the theoretical debt instruments:

- each of the six Common Bonds is politically possible;
- they are fungible instruments with a common structure;
- any transition phase required in order to fully implement the common bond would have lapsed;

¹³⁴ This is based on ratings awarded by the three major international agencies, Fitch, Moody's and Standard & Poors. Each of these agencies in June 2008 rated the following Member States as AAA: Austria, Finland, France, Germany, Ireland, Luxembourg, Netherlands and Spain. (Note that in August 2010, Spain and Ireland have lost their AAA rating).

- bond ratings are not affected by sovereign credit rating changes; the credit rating of the common bond would not be affected as appropriate mechanisms will be incorporated into the structure to take care of such eventualities. Any credit downgrading would have implications for the Guarantee Fund which is incorporated into options II-VI. The downgrading of a AAA-rated issuer would require that issuer to advance cash collateral towards the Guarantee Fund, and the downgrading of a non AAA-rated issuer would likely lift the level of cash collateral it is required to advance to the Guarantee Fund.
- independent legally binding obligations are in place between issuers and debt agency;
- in the options where it is incorporated, a "Guarantee Fund" of sufficient size to ensure that bond payments are satisfied in the event of an issuer default;
- a highly liquid repo market, as the common bond will replace the various European Government Bonds as the repo instrument of choice; and
- a highly liquid common bond futures market.

Results of the market survey

The market survey results endorsed the options that embraced simpler structures and did not incorporate a guarantee fund. The most competitively priced options (which would lead to the lowest borrowing costs for issuers) were therefore the common 6 Month Treasury Bill (Option VI) and the option of bonds issued jointly by a group of small/medium sized AAA issuers (Option V)¹³⁵.

The 6 month T Bill scenario is of modest ambition compared to the other structures and its credit risk was limited, due both to the limited duration of debt and the relative uniformity of issuers' short term credit ratings at that time. It would incentivise issuers to prudently manage their debt due to the possible impact on their sovereign coupon issuance. Option V, on the other hand, could enable smaller AAA issuers to reduce the liquidity premiums on their debt whilst demonstrating the feasibility of a common bond.

Although the market survey showed benefits for most euro area members, the theoretical bonds (with the exception of the 6 month T Bill) were deemed unlikely to trade at more competitive levels than a German government bond (Germany normally borrows at the most attractive levels of all European issuers).

Many survey participants noted the difficulty of pricing bonds aggressively in the market conditions at the time of study. Market volatility, coupled with the number of assumptions that dealers were asked to take into account, contributed to more conservative pricing. In spite being specifically asked not to, many dealers doubted the possibility of the bonds coming to fruition and follow-up feedback suggests this doubt crept into their pricing of the bonds. This being said, the value of the survey lies primarily in the value of the various options evaluations; rather than as a comparison to current market instruments that are free from ambiguity.

It is important to consider that some of the conditions that were incorporated in the six scenarios are no longer valid. Ireland and Spain have lost their AAA rating; Greece has been downgraded to below investment grade, while Portugal now rates A-/A-/Aa2. Overall, the assumptions on credit risk of European sovereigns that were made by investors at the time of the study have changed drastically. While a default of a European government was considered almost unthinkable, in the minds of investors it became very real in 2010. Only the establishment of the €440 bn EFSF, the €60 bn EFSM and the ECB bond buying programme steadied the markets. These events have changed the perception of both individual country risk and European "solidarity".

¹³⁵ For the exact prices that resulted from the survey, please consult the 2008 AFME paper "A common European Government Bond".

The results of the study and the following discussions with the Primary Dealers have brought to light some general lessons that could be useful for the development of a common bond, regardless of the changed circumstances.

General aversion to structured products

The participating Primary Dealers recognised that investors would need to be comfortable with any common European debt instrument, and it might take some time for its acceptance by the market. Options incorporating the "Guarantee Fund" were viewed as a structured product for which current investor appetite is poor. One participant remarked that the recent crisis had shown that the offloading of risk by issuers into common structures could leave issuers with fewer incentives to manage risk effectively. This issue would need to be addressed in further work.

Senior/Subordinated Debt Preferred to "Guarantee Fund"

From a pricing point of view, many dealers commented that instead of a guarantee fund they would have preferred a structure within which the volume of issuance placed by non AAA-rated issuers was:

- (i) capped on the basis of objective criteria; and
- (ii) senior to subordinated debt issued outside of the common structure.

It is unclear whether the recent foundation of the EFSF (which could be seen as having a guarantee fund-like structure) would have changed their opinion.

This preference of the dealers was subject to the provisos that a mechanism could be developed to prevent issuers offloading risk into the common structure and also that the structure could be seen to be free from "political interference". However subordinated debt would carry a credit premium and, in some cases, could carry lower credit ratings than presently for debt issued by the issuers in question. Alternatively, the case could be made that subordinated debt would not carry a credit premium. From use of the common bond, the issuer would benefit from a significant reduction in its overall cost of borrowing thereby making it less likely to default in its subordinated debt portfolio than it otherwise would be in current circumstances. Nevertheless, dealers were not asked to price subordinated debt but such pricing would be necessary in order to more clearly demonstrate costs and benefits for individual participating Member States.

Simplicity a virtue

Feedback from the market survey indicated a preference for simple and transparent products that would be easy for investors to understand. Option V and VI share the advantages of being simple and palatable options.

Investor consultation

A clear consideration for all survey participants was the preference of their clients. For all the qualitative and quantitative benefits of a common issuance, its success will stand or fall on investor demand so when common issuance is considered at the official level, both the buy and sell sides should be closely involved in discussions at key stages in the process.

3. The Common T-bill further explored

Based on the outcome of the 2008 paper, the EPDA published a briefing note in March 2009 elaborating on the specifics of a possible common European T-bill.

The common T-bill would create a shared issuance program for all euro area Treasury paper (debt that generally has a maturity of less than one year at issuance). The estimated size of the programme would be €800-900 bn. Bond issuance (i.e. maturities of > 1 year) would be issued separately by each issuer as per the current model.

Any European T-Bill instrument would be senior to any other debt issued by euro area sovereign issuers. Furthermore, the level of issuance to be permitted in the common T-bill would be capped at an agreed debt/GDP ratio (proposed percentage $\leq 20\%$). Member states would be free to issue their own T-bills outside the structure provided they were subordinated.

This isolates the credit risk in Member State bonds issued outside the common T-bill structure. Therefore, country spreads between issuers will still exist in the bonds portion of the market (as they do now) to underpin fiscal discipline for Member States. Issuers will be punished by investors if they are seen to be too economically lax.

It is likely that the combination of the cap and the seniority to individually issued debt would lead to the highest possible credit rating for the product.

Optionally, an independent euro debt body may wish to have a direct claim on tax receipts of participating Member States equivalent to the state's total funding requirements in the common T-bill structure. This would be enforceable at the European Court of Justice level.

As with the six scenarios in the 2008 study, the debt would be issued by an independent euro debt body, free from political influence.

Also, in order to not undermine the "no bail out" clause, each participating issuer would be liable for its share of total debt only, and not for the debt of other issuers (so called 'several liability'). The liability of each issuer for each bill would reflect the percentage of the overall funding requirement apportioned to each issuer for the total T-bill program (e.g. if Issuer A is 10% of the total funding for the T-Bill program, Issuer A has an outstanding commitment of 10% for each outstanding bill issued in the common T-bill.).

To be effective, the issuing body would need to be flexible in satisfying the funding requirements of a particular Member State during the course of a year (perhaps agreed on a quarterly basis), although its maximum participation level for that year would remain fixed.

As T-bill issuance is by its nature short-term, phasing in should be fairly straightforward as all outstanding issuance would need to be rolled over on an annual basis. Subordination is more difficult as outstanding bonds could not be made junior to common T-bills. Nevertheless, if all new bonds were subordinated, this would effectively phase it in over time as old bonds are redeemed or even bought back. Some subordination implementation program for bonds would need to be agreed with issuers as part of the common T-bill.

Conclusion

The two studies discussed in this paper suggest there are important benefits for both governments and taxpayers from a common European Issuance Programme. Smaller liquidity premiums, more effective hedging and the removal of the market making obligation would lead to lower interest rates.

While market conditions have changed since the time of study, the survey results point to general lessons that are useful for the development of a common bond. Investors prefer simple solutions that exclude a Guarantee Fund. A common T-bill programme, which caps individual nations' participation at a percentage of GDP, is senior to all other debt and follows the principle of several liability, would support the Stability and Growth pact, encourage fiscal discipline and drive down interest rates for participating countries.

Given the importance of investor demand in the consideration of the different issuance strategies, it is recommended that both the buy and sell sides be closely involved in discussions at key stages in the development process.

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