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European Commission Green Paper on the feasibility of introducing Stability Bonds - Official Version

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This Green Paper released today (23 Nov 2011) assesses the feasibility of common issuance of sovereign bonds among the Member States of the euro area.

Brussels, 23 November 2011

European Commission Green Paper on the feasibility of introducing Stability Bonds

The Green Paper published by the European Commission today structures the political debate in the EU on the rationale, pre-conditions and possible options of financing public debt through Stability Bonds. Such common issuance of bonds by the euro-area Member States would imply a significant deepening of Economic and Monetary Union. It would create new means through which governments finance their debt, by offering safe and liquid investment opportunities for savers and financial institutions and by setting up a euro-area wide integrated bond market that matches its US Dollar counterpart in terms of size and liquidity. The fiscal framework underlying EMU would similarly undergo a substantial change, as Stability Bonds would need to be accompanied by closer and stricter fiscal surveillance to ensure budgetary discipline. Some of the options for the design of Stability Bonds considered in the Green Paper might require a Treaty change. Regardless of any necessary time for implementation, agreement on common issuance could have an immediate impact on market expectations and thereby lower average and marginal funding costs for those Member States currently facing funding pressures.

What is the main intention and content of this Green Paper?

This Green Paper assesses the feasibility of common issuance of sovereign bonds among the Member States of the euro area . Sovereign issuance in the euro area is currently conducted by Member States on a decentralised basis, using various issuance procedures. The introduction of commonly issued Stability Bonds would mean a pooling of sovereign issuance among the Member States and the sharing of associated revenue flows and debt-servicing costs. The Green Paper does not indentify any preferred option or way forward. Instead, the documents open and structure a wide public debate on appropriate next and possibly more concrete steps in this matter.

Why did the Commission choose to issue this Green Paper?

There has for many years been a lively debate in academic and financial spheres on the possible pooling of sovereign issuance in the euro area and many reports have been published on this subject. The sovereign debt crisis in the euro area, meanwhile, has significantly raised the focus on join issuance, which is seen by many observers as a tool for not only boosting integration and the efficiency of financial markets in the euro area, but also as a potentially powerful instrument to tackle the crisis.

Through this Green Paper, the Commission aims to structure and better inform this important debate.

What are the main options for such Stability Bonds?

The many possible options for common issuance of Stability Bonds can be categorised in three broad approaches, based on the degree of substitution of national issuance (full or partial) and the nature of the underlying guarantee (joint and several or several) implied. The three broad approaches examined in the Green Paper are:

- the full substitution by Stability Bond issuance of national issuance, with joint and several guarantees: this approach would seem the most ambitious option of all, as it would replace the entire national issuance by Stability Bonds and as each Member States would be fully liable for the entire issuance. This option would accordingly have strong potential positive effects on stability and integration. But at the same time, it would, by abolishing all market or interest rate pressure on Member States, pose a relatively high risk of moral hazard and it might need significant Treaty changes.

- the partial substitution by Stability Bond issuance of national issuance, with joint and several guarantees: this approach would essentially be the same as the option mentioned above, but Stability Bonds under this option would only cover parts of national financing needs. Therefore, Member States would continue issuing their own bonds, although at an accordingly lower volume due to the parallel issuance of Stability Bonds. Hence, Member States would still need to tap financial markets on their own and would be subject to market and financing conditions that would vary across Member States and might reflect their different credit quality. Hence, the risk of moral hazard would also exist under this option but in a more reduced form. As this approach would only partly cover financing needs of Member States, under this approach, as under the third one, one would have to decide about the specific volume or share of financing needs for a Member State to be provided by the issuance of Stability Bonds.

- the partial substitution by Stability Bond issuance of national issuance, with several but not joint guarantees: This approach is the most limited one of the three options, as it would only partially cover Member States' financing needs (as Approach No. 2 above) and as it would only be covered by several guarantees. This option would therefore probably have only smaller effects on stability and integration, and the risk of moral hazard for the conduct of economic and fiscal policies in Member States would seem very limited. This option would be relatively rapidly deployable, as the need for measures to counteract such moral hazard would be limited and as the instrument seems also otherwise fully compatible with the Treaty. To ensure a sufficient creditworthiness of such instruments, some additional safeguards, i.e. "credit enhancements" might be necessary, for example in the form of collateral provided by Member States. This approach would have certain similarities to bonds issued by the European Financial Stability Facility (EFSF). However, whereas the latter are meant to step in and help financing vulnerable Member States in the context of the sovereign debt crisis, Stability Bonds would be instruments available to all euro area Member States and also outside any crisis context. Their volume and potential effect on market efficiency and integration would be accordingly much larger.

These options present different trade-offs between the expected benefits and pre-conditions to be met (see Table 1 in the Annex).

Why does the Commission use instead of the term Eurobonds that of "Stability Bonds"

The public discussion and literature normally uses the term "Eurobonds". The Commission considers that the main feature of such an instrument would be enhanced financial stability in the euro area. Therefore, in line with President Barroso's State of the Union address on 28 September 2011, this Green Paper refers to "Stability Bonds".

What will be the difference between Stability Bonds and project bonds?

Stability Bonds would be an instrument designed for the day-to-day financing of euro-area general governments through common issuance. In this respect, they should be distinguished from other jointly issued bonds in the European Union and euro area, such as project bonds, which aim to enhance the credit standing of private entities that need to raise private funds for the large-scale infrastructure projects they promote.

What would be the main advantages of joint issuance?

The Green Paper finds that the common issuance of Stability Bonds has significant potential benefits.

- The prospect of Stability Bonds could potentially quickly alleviate the current sovereign debt crisis, as the high-yield Member States could benefit from the stronger creditworthiness of the low-yield Member States. Even if the introduction of Stability Bonds could take some time, prior agreement on common issuance could have an immediate impact on market expectations and thereby lower average and marginal funding costs for those Member States currently facing funding pressures.

- Stability Bonds would make the euro-area financial system more resilient to future adverse shocks and so reinforce financial stability. Stability Bonds would provide a source of more robust collateral for all banks in the euro area, reducing their vulnerability to deteriorating credit ratings of individual Member States. Similarly, other institutional investors (e.g. life insurance companies and pension funds), which tend to hold a relatively high share of domestic sovereign bonds, would benefit from a more homogenous and robust asset in the form of a Stability Bond.

- Stability Bonds would improve the effectiveness of euro-area monetary policy. Stability Bonds would create a larger pool of safe and liquid assets. This would help in ensuring that the monetary conditions set by the ECB would effect financing conditions on bond markets, which is a precondition for monetary policy to have an effect on the borrowing costs of enterprises and households and ultimately on aggregate demand and inflation.

- Stability Bonds would promote efficiency in the euro-area sovereign bond market and in the broader euro-area financial system. Stability Bond issuance would offer the possibility of a large and highly liquid market, with a single benchmark yield in contrast to the current situation of many country-specific benchmarks. The liquidity and high credit quality of the Stability Bond market would deliver low benchmark yields, reflecting correspondingly low credit risk and liquidity premiums. A single set of ?risk free? Stability Bond benchmark yields across the maturity spectrum would help to develop the bond market more broadly, stimulating issuance by non-sovereign issuers, e.g. corporations, municipalities, and financial firms.

- Stability Bonds would facilitate portfolio investment in the euro and foster a more balanced global financial system. The larger issuance volumes and more liquid secondary markets implied by Stability Bond issuance would strengthen the position of the euro as an international reserve currency (see also the table 2 in the Annex).

What would be the main challenges or conditions for introducing Stability Bonds?

The introduction of Stability Bonds would indeed pose significant challenges and requirements to be met. The Green Paper identifies the more technical ones in this respect. The main issues are the following:

- In particular, the need to guard against any weakening of market discipline. Any type of Stability Bond would have to be accompanied by a substantially reinforced fiscal surveillance and policy coordination as an essential counterpart, so as to avoid moral hazard and ensure sustainable public finances. Whereas the EU's fiscal surveillance framework has already been strengthened with the recent reform of the Stability and Growth Pact including new enforcement mechanisms (the so called "six pack"), the Green Paper elaborates on means to reinforce fiscal surveillance beyond the recent proposals. While Stability Bonds would not transfer sovereignty from Member States to capital markets, they imply a step towards shared fiscal sovereignty among the euro-area Member States. The implications for fiscal sovereignty call for a substantive debate in euro area Member States.

- Stability Bonds should be designed and issued such that investors consider them a very safe asset. Stability Bonds would need to have high credit quality to be accepted by investors and by those euro-area Member States that already enjoy the highest credit rating. High credit quality would also be needed to establish Stability Bonds as an international benchmark and to underpin the development and efficient functioning of related futures and options markets, which are key for the provision of liquidity on bond markets.

- Stability Bonds must be compatible with the EU Treaty. While the issuance of Stability Bonds under a system of several guarantees would not require Treaty change, Stability Bonds issued with joint and several guarantees would a priori be incompatible with the current 'no bailout' provision.

How would Stability Bonds be implemented in practice?

Numerous technical issues would need to be decided with respect to the organisation of Stability Bond issuance. The implementation issues analysed in the Green Paper cover the organisation of debt issuances through debt management offices, the relationship with the ESM, the legal regime governing issuance, documentation, market convention and accounting questions. These operational and practical issues, of which others may be highlighted in the forthcoming debate, would have to be solved once a decision was made on the principal idea and its basic shape.

What is the follow up to this Green Paper?

All these issues on the possible advantages, challenges, options and operational terms require careful reflection

. The views of key stakeholders in this respect are essential. In particular, Member States, the European and national parliaments, financial market operators, financial market industry associations, academics, within the EU and beyond, and the wider public should be adequately consulted.

A ccordingly, the Commission has decided to launch a broad consultation 1 [1] on this Green Paper , which will close on 8 January 2012 2 [2] . The Commission will seek the views of all relevant stakeholders as mentioned above and seek the advice of the other institutions. On the basis of this feedback, the Commission will indicate its views on the appropriate way forward.

For more information:

President Barroso's website [3]

IP/11/1381 [4] New action for growth, governance and stability

MEMO/11/821 [5] The 2012 Annual Growth Survey: Frequently Asked Questions

MEMO/11/822 [6] Economic governance: Commission proposes two new Regulations to further strengthen budgetary surveillance in the euro area

Annex

Table 1: Overview over the three main options

	(Option 1)	(Option 2)	(Option 3)
Main features			
• Degree of substitution of national issuance by Stability Bonds	Full	Partial	Partial
• Guarantee structure	Joint and several	Joint and several	Several (not joint) with enhancements
Main effects			

• on average funding costs 1/ for Stability Bond as a whole 2/ across countries	1/ Medium positive effect from very large liquidity compensated by strong moral hazard. 2/ Strong shift of benefits from higher to lower rated countries	1/ Medium positive effect, from medium liquidity and limited moral hazard 2/ Smaller shift of benefits from higher to lower rated countries. Some market pressure on MS with high level of debt and subprime credit ratings	1/ Medium positive effect, lower liquidity effect and sounder policies prompted by enhanced market discipline 2/ no impact across country. Stronger market pressure on MS with high level of debt and subprime credit ratings
• on possible moral hazard (without reinforced governance)	High	Medium, but strong market incentives for fiscal discipline	Low, strong market incentives for fiscal discipline
• on financial integration in Europe	High	Medium	Medium
• on global attractiveness of EU financial markets	High	Medium	Medium
• on financial market stability	High	High, but some challenges in case of unsustainable levels of national issuance	Low, but it may help to deal with the current crisis thanks to its rapid implementation.

Legal considerations	Probably Treaty change	Probably Treaty change	No Treaty changes required. Secondary legislation may be helpful.
Necessary minimum implementation time	Long	Medium to long	Short

Table 2: Basic figures on government bond markets

Member State	General government debt			Central govern-ment debt
	EUR billion, end 2010	% of GDP, end 2010	% of euro area, end 2010	% of GDP, end 2010
Belgium	340.7	96.2	4.4	87.7
Germany	2061.8	83.2	26.4	53.2
Estonia	1.0	6.7	0.0	3.3
Greece	329.4	144.9	4.2	155.6
Spain	641.8	61	8.2	52.3
France	1591.2	82.3	20.3	67.8
Ireland	148.0	94.9	1.9	94.3
Italy	1842.8	118.4	23.6	111.7
Cyprus	10.7	61.5	0.1	102.6

Luxembourg	7.7	19.1	0.1	17.4
Malta	4.3	69	0.1	68.9
Netherlands	369.9	62.9	4.7	57.3
Austria	205.6	71.8	2.6	66.2
Portugal	161.3	93.3	2.1	91.2
Slovenia	13.7	38.8	0.2	37.3
Slovakia	27.0	41	0.3	40.1
Finland	87.0	48.3	1.1	43.9
Euro area	7822.4	85.4	100	71.6
p.i.: USA	10258	94.4		

1. :

Feedback can be provided via all normal means,
including to a dedicated mailbox: ECFIN-Green-Paper-Stability-Bonds@ec.europa.eu [7];
(webpage: http://ec.europa.eu/economy_finance/consultation/index_en.htm [8])

2. :

Tags: bond [10], Commission [11], ECFIN [12], EFSF [13], Eurobonds [14], Rehn [15], Stabilisation Bank [16]

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