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Stability Bonds for the Euro Area

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After pulling back from an almost existential crisis, the euro area is growing again. However, it remains the worst economic performer of the major advanced economies, barely reaching its precrisis level of GDP (figure 1). Meanwhile, public opinion on the euro has recovered, but it remains vulnerable to another shock (figure 2). The rules and buffers created in the last few years to enable the euro area to withstand another sudden stop of credit and market-driven panic in one or more of its member states are welcome steps, but they are widely recognized as inadequate. As Finance Minister Emmanuel Macron of France has said, "Without any change, the euro zone cannot survive."[1] Mario Draghi, president of the European Central Bank (ECB), has also declared that a "minimum requirement" for survival of the euro area is for its member states to "invest" in "mechanisms to share the cost of shocks," so that "all countries can retain full use of national fiscal policy as a countercyclical buffer" (Draghi 2014).

But what kinds of "mechanisms" are appropriate—or politically feasible—in a region where many people are skeptical about any sort of mutualized backstop for countries that get into financial trouble? The diversity of European economic cycles, economic structures, and political dynamics is both a strength and a weakness of the euro area as it struggles to achieve a true monetary, fiscal, and financial union. It will not be easy to put in place arrangements that distribute risks and ensure that all countries can use fiscal policy to cushion economic downturns (Ubide 2015b). Yet such arrangements are necessary and urgent to ensure that, when the next recession arrives, markets don't force countries to adopt the fiscal policies—raising taxes and cutting spending while in a recession—that inflicted so much economic and political damage during the recent crisis.

Detailed proposals for joint euro area issuance of bonds have emerged in recent years, but they all present some shortcomings that the stability bonds described here would try to overcome.

A step toward addressing these concerns, this *Policy Brief* argues, would be the creation of a system of stability bonds in the euro area, to be issued by a new European Debt Agency (EDA) to partially finance the debt of euro area countries, up to 25 percent of GDP. These stability bonds should be initially backed by tax revenues transferred from national treasuries, but ultimately by the creation of euro area–wide tax revenues, and used to fund the operations of national governments. They could also be used for euro area–wide fiscal stimulus, to complement the fiscal policies of the member states. Such bonds would strengthen the euro area economic infrastructure, creating incentives for countries to reduce their deficits but not forcing them to do so when such actions would drive their economies further into a downturn. They would permit the euro area to adopt a more flexible or expansionary fiscal policy during recessions.[2]

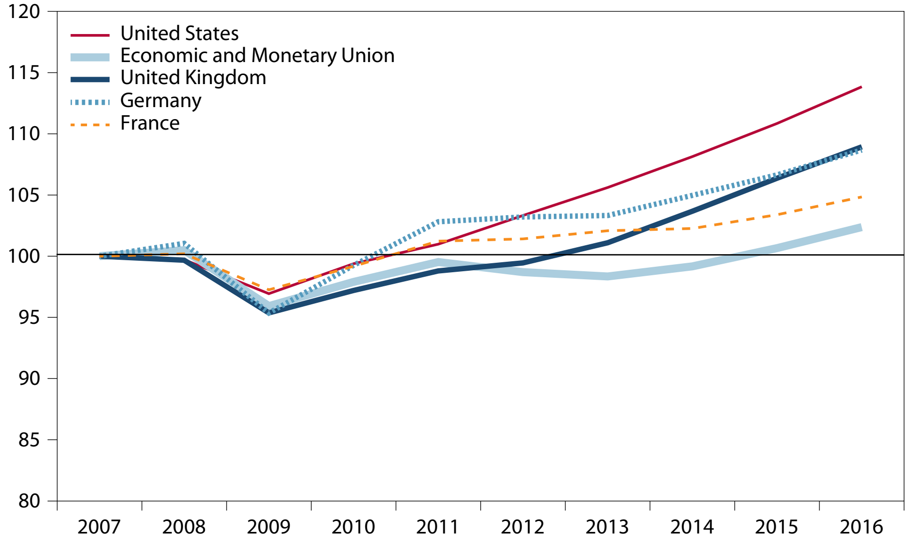
Detailed proposals for joint euro area issuance of bonds have emerged in recent years, but they all present some short-

1. Ferdinando Giugliano and Sarah Gordon, "Macron calls for radical reform to save euro," *Financial Times*, September 24, 2015, www.ft.com.

2. See the extensive discussion in Posen and Ubide (2014).

Figure 1 GDP levels, 2007–16

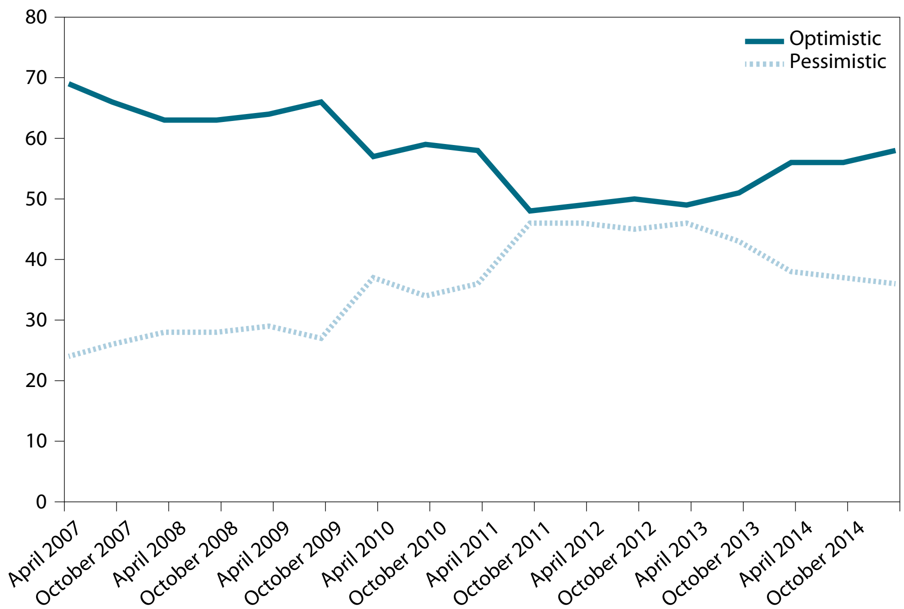
index, 2007 = 100



Sources: Bloomberg and author's calculations.

Figure 2 View of the European Union's future, 2007–15

percent



Source: Eurobarometer, http://ec.europa.eu/public_opinion/archives/eb/eb83/eb83_first_en.pdf.

comings that the stability bonds described here would try to overcome. The European safe bonds (ESBies) proposed by Brunnermeier et al. (2011) are based on financial engineering, which can't constitute a durable policy solution. The PADRE framework proposed by Paris and Wyplosz (2014) is a debt restructuring mechanism funded by the securitization of future ECB profits, which would fundamentally dent the ECB's independence. The debt redemption fund proposed by Bofinger et al. (2011) is a temporary mechanism to ease sovereign funding costs in the near term, but with a return to the rules-only framework afterward. The eurobills proposed by Phillipon and Helwig (2011) limit joint issuance to one-year maturity, thus truncating the yield curve. The blue and red bonds proposed by Delpla and Von Weizsacker (2010) are the closest to an ideal framework, but they are backed by guarantees, not revenues, and the share of joint bonds (60 percent of GDP) is too large for the current stage of euro area fiscal and political integration.

It will not be easy to establish stability bonds, especially if some countries such as Germany feel they would be tantamount to giving a free credit card to misbehaving euro area members. Accordingly, certain rules should accompany their use to discourage abuses. For example, because each country's debt would be subordinated to the stability bonds, a strong incentive would remain for all countries to continue to undertake the reforms needed to improve the resilience and sustainability of their economies. Skeptics in Europe should see the system of stability bonds as a way of reducing the rollover risks of member states' debt and of minimizing the disastrous impact of sudden stops, all while keeping market discipline at the center of fiscal and economic policy. Rather than encouraging bad behavior, stability bonds could be structured to minimize moral hazard, improve governance, and ensure that fiscal policy can support growth during the next recession. They would serve as a risk-free asset that would support the diversification of the balance sheets of euro area banks, strengthen the financial union, and catalyze the creation of cross-border banking groups, thereby promoting private risk sharing. They can be part of a means of resolving the vicious sovereign-bank link, which has devastated the euro area economy, and of creating the environment for a credible enforcement of the no-bailout clause, completing the economic infrastructure of the monetary union and fulfilling the spirit of the Maastricht Treaty. The result of such a step would be higher potential growth for all countries in the euro area—including Germany itself.

THE EURO AREA ECONOMIC POLICY FRAMEWORK IS INCOMPLETE

The economic policy framework of the euro area was created as a combination of centralized monetary policy and decentralized national fiscal policies based on common budgetary rules set out in the Stability and Growth Pact (SGP). It was coupled with surveillance tools and coordination of national economic policies, which included national financial supervision. A central fiscal capacity was explicitly ruled out because it was considered that if countries were complying with the SGP and achieving a fiscal situation of close to balance or small surplus, they would be able to deal with asymmetric country-specific shocks with national fiscal policies. The euro crisis revealed that this hypothesis was false.[3]

The framework for euro area economic policy was reinforced during the crisis along three pillars. The first pillar is the integration of the various components of the economic, budgetary, and structural surveillance procedures in the European Semester, the European Union's annual cycle of economic policy surveillance and coordination. Within this framework, the European Commission analyzes national economic policies over the first six months of each calendar year and issues country-specific recommendations to be taken into account by member states in the second half of the year. During the crisis, two new legislative packages were introduced. The "six-pack" includes a new Macroeconomic Imbalance Procedure to detect imbalances and competitiveness problems in member states at an early stage. It reinforces the SGP by introducing the possibility of sanctions early in the procedure, with stronger enforcement tools based on a new reversed qualified majority rule. The "two-pack" obliges euro area member states to submit their annual draft budgetary plans for the following year to the European Commission ahead of parliamentary adoption. The Commission issues opinions (not legally binding) that may ask for a revision of the budget plans.

The second pillar is the strengthening of the surveillance of the financial sector. This strengthening began with the establishment of an EU-wide system of financial supervisors composed of three supervisory authorities and a macroprudential watchdog, followed by the creation of a single centralized mechanism for the supervision and restructuring of banks (the so-called banking union).[4] The main elements are (1) the Single Supervisory Mechanism, which places supervision of the main

3. See the discussion in Ubide (2013b).

4. See Ubide (2013a, 2015a) and Véron (2015) for a comprehensive discussion of the banking union and European financial markets.

European banks under the European Central Bank; (2) the Bank Recovery and Resolution Directive, which provides a toolkit for the resolution of nonviable banks via a new power to bail in shareholders and certain creditors and the option of transferring assets to a bridge bank; (3) the establishment of a Single Resolution Mechanism, including a Single Resolution Fund and the possibility of recapitalizing banks directly as a last resort; and (4) the introduction of the fourth Capital Requirements Directive and the Capital Requirements Regulation (CRD4/CRR).

The third pillar is the development of a crisis resolution mechanism to address financial market fragility and mitigate the risk of contagion across member states. The European Stability Mechanism (ESM) is an intergovernmental instrument with a prorata guarantee structure backed by paid-in capital of €80 billion and an irrevocable and unconditional obligation on ESM member states to provide their contribution to the authorized capital stock (total €700 billion). It provides for a financial firewall of €500 billion and raises the funds needed for its financial assistance by issuing debt securities with maturities of up to 30 years. The ECB contributed to the crisis management framework with the creation of the Outright Monetary Transactions (OMT) program in the secondary markets for sovereign bonds with a maturity of less than three years, conditional on an ESM program.

These are welcome improvements, but they do not solve the fundamental gap in the economic infrastructure of the euro area—that is, the ability to ensure that fiscal policy will be able to cushion economic downturns. The euro crisis has shown that a system of rules without money to back them up is not enough.

Some have argued that the euro area sovereign debt is unsustainable and, therefore, the best solution would be a debt restructuring program (see, among others, Mody 2013). This is unlikely to be successful, however. A large share of the euro area debt is held by residents, and therefore the amount of debt relief would be very limited, in addition to undermining the confidence in the sovereign bond market and bankrupting the banking sector. Furthermore, after the ECB's quantitative easing (QE) program a large share of the debt will be on the balance sheet of the ECB. Under the Maastricht Treaty, the ECB cannot participate in any debt restructuring because it would be at risk of violating the monetary financing prohibition. Thus the haircut applicable to the private sector would be even larger.

The SSM and the European Systemic Risk Board (ESRB)[5] have proposed severing the link between banks and sovereigns by introducing nonzero risk weights for sovereign bonds and imposing limits to geographical exposures in banks' balance sheets. These proposals, while understandable from a narrow supervisory standpoint, are worrisome. The increase in risk weights would have a negligible impact on the extent of carry trades, but it would discriminate euro area bonds versus global bonds. Limiting exposure by the use of geographical quotas would introduce an arbitrary distortion into banks' portfolio decisions.[6] Overall, these proposals would increase funding costs for the weaker sovereigns and the vulnerability of their debt markets, introduce undesirable (and impossible to hedge) break-up and currency risks into euro area banks' balance sheets, reduce the availability of high-quality collateral, and generate regulatory confusion. Instead of introducing differential credit risk in euro area bonds, it would be better to implement the institutional changes needed to ensure the debt sustainability of the euro area.

The so-called Five Presidents' Report by Juncker et al. (2015) sets out a long-term vision for the euro area, including a medium-term (2017–25) objective of creating a fiscal stabilization function for the euro area, coupled with further steps toward reinforced central powers over budgetary and economic policy matters. Such steps would pave the way toward a long-term fiscal and economic union with a central budget and fiscal capacity, the power to tax and issue debt, and a treasury for the Economic and Monetary Union (EMU), all coupled with the transfer of more national sovereignty to the EMU.

The proposals in the Five Presidents' Report are welcome, but they are too vague, and the euro area cannot wait until the medium term. The debate on eurobonds failed during the crisis because they were perceived to be a way to share the cost of the crisis and relieve euro area periphery countries from their need to reform. These two problems are now largely solved. With the exception of Greece, all periphery countries have market access at reasonable rates, and reform programs are well advanced. But the global economy is fragile, and the probability of a global downturn during 2017–25 is very high. Europe's economy and societies are too weak to endure another recession in which fiscal policy cannot adequately respond to cushion the downturn. The work toward a fiscal stabilization function must start before the next recession hits.

The Five Presidents' Report identifies three principles that should guide the stabilization function: (1) it should not lead to permanent transfers; (2) it should not undermine incentives for sound fiscal policymaking at the national level; and (3) it should improve the economic resilience of the EMU and of individual member states. The system of stability bonds proposed here is a way to start the process of completing the EMU while meeting these three principles and addressing the shortcomings of the proposals described earlier.

5. See Transcript of interview with Danièle Nouy, *Financial Times*, February 9, 2014, www.ft.com; and ESRB (2015).

6. Banks that have most of their liabilities in a country should not be forced to introduce a geographical mismatch in their balance sheets.

STABILITY BONDS AS A NECESSARY CONDITION FOR FINANCIAL STABILITY IN THE EURO AREA: THE ROAD TO A EUROPEAN TREASURY

The EMU was created as a "stability union," defined by a no-bailout clause and the individual responsibility of each state, and the German government and the Bundesbank continue to defend that view (see, for example, Weidmann 2014). However, the euro crisis demonstrated the contrary: A stability union can be achieved only by means of a joint fiscal capacity. The crisis revealed that the EMU was incomplete and lacked mechanisms for efficient risk sharing, both public and private. The reforms introduced since 2010 attempt to address the lack of risk sharing via bail ins and last-resort rescues, which expose euro area countries to market panics and require very frontloaded fiscal adjustments that imply a very steep GDP cost at times of crisis.[7] This arrangement is inefficient and suboptimal, and it is not sustainable in the long run. A better arrangement is to create a robust insurance mechanism that provides stability during bad times.

A fiscal capacity would fulfill several roles. It would facilitate the servicing of the existing debt and reduce the debt overhang effect;[8] complete the financial union by providing a credible backstop to the bank resolution fund and the needed deposit guarantee; create an asset that European banks can use to efficiently diversify their portfolios and reduce their exposure to their home country; help avoid a situation in which fiscal policies would have to act in a procyclical fashion again during a financial crisis; and ensure that euro area countries would not become vulnerable again to a sudden stop. These improvements would add resilience to the euro area economy, facilitate the development of private risk sharing mechanisms such as the creation of true pan-European banks, and increase potential growth.

How Would a Fiscal Capacity Work?

Because of the idiosyncrasies of the euro area and the need to rebuild trust among member states, a fiscal capacity must combine some joint issuance of bonds with mechanisms to ensure national fiscal discipline, avoid moral hazard, and guarantee political legitimacy. These mechanisms have to go beyond legal rules—which experience shows have been overruled in times of stress—and incorporate a strong component of market surveillance.

Therefore, this *Policy Brief* proposes the creation of a system of "stability bonds" to partially finance euro area debt up to 25 percent of GDP along the full spectrum of maturities of the yield curve. These bonds would be issued and managed by a European Debt Agency in close cooperation with the national debt agencies, and they would be supported by tax revenues. These revenues could be composed initially of transferred national tax revenues, such as shared value-added tax (VAT) proceeds, a tax that should in the future become, at least in part, a European tax.[9] These revenues could also be combined with a new euro area–wide tax, such as a carbon tax.[10] Ideally, over the years the bulk of revenues supporting stability bonds would be euro area–wide revenues.

In practice, after the EDA has formulated the issuance plans, the draft budget of each member state would include a line that allocates its mandated contribution to the debt service of the stability bonds for the next year, in a manner similar to the way in which the contributions to the European budget are managed. For example, it could be a percentage of the VAT base.[11] Making a contribution proportional to the VAT base would allow for cyclical divergences across countries. The contribution of each country would cover expected debt service needs as well as enough of a reserve to achieve an AAA rating. Unused funds from this mandated contribution would be liberated at the end of the year for free disposition by each member state. The EDA would have the legal authority to request at any time an extraordinary transfer of revenues to meet unexpected debt service needs. The EU budget could serve as an additional guarantee if needed. Member states would use the funds raised by the stability bonds to finance their budgets, together with taxes and funds raised by national bonds.

Stability bonds would be senior to national bonds from a debt service standpoint, and thus they would likely enjoy an AAA rating. The standard AAA requirement that debt service be below 10 percent of revenues would be fulfilled in view of the low interest rates and the seniority of stability bonds.

Because of the expected funding needs of euro area countries, the transition to stability bonds could be completed in three to five years as the debt coming due in the member states

7. If fiscal multipliers are large, frontloaded fiscal consolidation can hurt growth and exacerbate debt levels in the short run. If financing allows, adjustment should be conducted at a pace that balances the need to improve structural primary balances against the need to not unduly undermine growth.

8. The negative impact of high debt/GDP ratios on growth.

9. See the discussion in Mauro (2014) of the transfer of VAT revenues.

10. German finance minister Wolfgang Schäuble has been making suggestions along these lines. See "Berlin und Brüssel erwägen eigene Euro-Steuer" ["Berlin and Brussels consider Euro Area Tax"], Euractiv.de, July 26, 2015, www.euractiv.de.

11. The European budget is financed from three main sources: custom duties, a contribution based on a percentage of a virtual VAT base (because the VAT base is different across countries, the calculation is based on a homogenous, theoretical tax base), and transfers to balance the budget if needed.

is gradually replaced by stability bonds. During this transition period, if a country were to suffer a speculative attack and risk losing market access, it could accelerate its adoption of stability bonds toward the target of 25 percent of GDP.

All euro area members would be required to participate in this system. They would have to meet three requirements to join it: (1) pass a constitutional amendment that grants seniority in debt service to the stability bonds; (2) authorize the transfer of revenues every year to the EDA to service the stability bonds (with an explicit commitment to transfer additional revenues in case of emergency to avoid a default of the bonds); and (3) change legislation to transfer authority over national accounts and fiscal data to a new, independent Euro Area Statistical Agency.[12]

Limiting stability bonds to 25 percent of GDP strikes the right balance between providing stability and containing moral hazard.

The creation of such an agency is a critical step toward rebuilding mutual trust and avoiding a repetition of the Greek fiscal fraud. It could be set up in a manner similar to the Single Supervisory Mechanism for the banking sector, building on existing national statistical services but transferring authority and management to the new agency in order to harmonize statistical methodologies and improve the quality and reliability of macroeconomic data. This is another example, like the banking union, of how deeper integration and risk sharing contribute to better governance of the euro area.

These three requirements would be the "political down payment" to participate in this stabilization mechanism. The EDA could be integrated into the ESM and therefore be governed by the Eurogroup. All changes suggested here could be incorporated into the ESM Treaty, thereby avoiding initially a wholesale treaty change.

A special parliamentary committee, composed of representatives of the participating member states and the European Parliament, would assume political oversight of the EDA. Every year, the EDA would make a proposal on the issuance plan for the next calendar year. The plan would have to be approved by this special parliamentary committee.

Participating countries could not be expelled from the system, even if they were to enter into an Excessive Deficit Procedure. The enhanced system of fiscal rules, the new Euro Area Statistical Agency, and market pressure on domestic bonds should deter flagrant misbehavior.[13] A system in which countries would have to be reconfirmed each year as a participant in the issuance scheme would be unworkable and unstable.[14] In the same spirit as the euro, participation in the stability bonds should be irreversible.

Stability bonds would support the financing of national government activities, so that even during country-specific market panics a portion of a government's funding would be guaranteed and economic stabilization could be achieved. This is a better option than the proposals[15] to use a euro area fiscal capacity to fund the cyclical component of national unemployment insurance systems, for several reasons. First, because it would unduly delay the introduction of such a scheme by requiring a long period of harmonization of labor market structures in order to avoid what could be perceived as transfers due to lack of labor market reforms. Second, because it would require estimating an unobserved variable (the nonaccelerating inflation rate of unemployment [NAIRU]), which would complicate its monitoring and management.[16] And, third, because by earmarking funds for a specific use it deprives countries of the flexibility to deal with unexpected events.

Limiting stability bonds to 25 percent of GDP strikes the right balance between providing stability and containing moral hazard. This structure would be similar in spirit to the German federal system, which tries to reconcile the principles of independence of the budget process at the *Länder* (state) level with some equalization of services across *Länder*. But this structure would not create a permanent transfer system because the equalization across countries would only be in output gap terms, not in output level terms, by providing the instruments for fiscal stabilization during downturns.[17]

In the event of a large euro area–wide negative shock, stability bonds could also be issued by unanimous decision of the Eurogroup and approved by the special parliamentary committee in order to finance a euro area–wide fiscal stimulus

12. This agency could initially be part of Eurostat in order to accelerate the process.

13. Since the SGP has been in operation, fiscal policy deviations have certainly occurred, but they have been minor in a macro sense and corrective measures have been broadly effective. The case of Greece was qualitatively different because it involved data fraud.

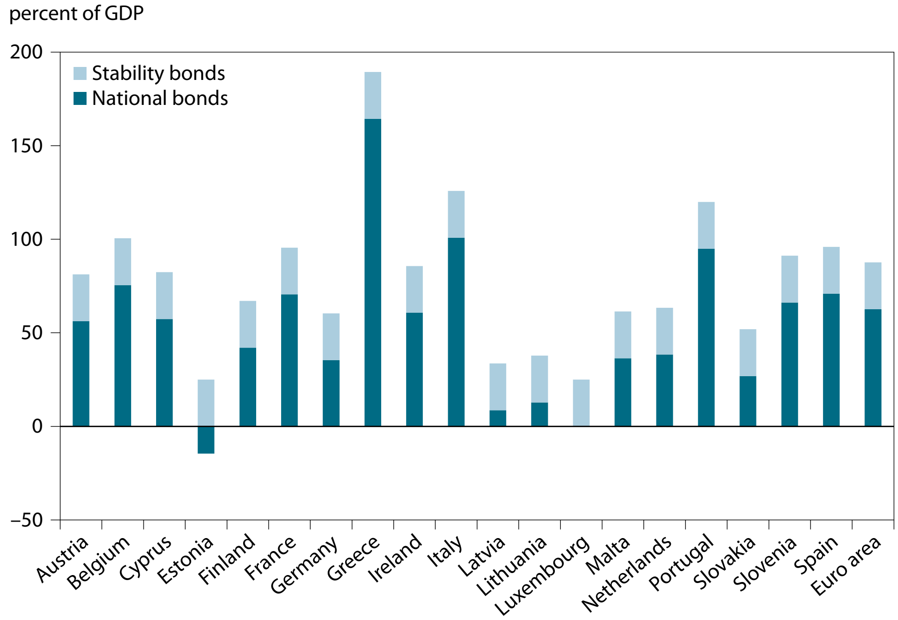
14. This was a major flaw of the blue bond/red bond proposal of Delpla and Von Weizsacker (2010).

15. See *Contributions from the Sherpas of the Five Member States to the Five Presidents' Report*, Italian contribution, May 2015, http://ec.europa.eu.

16. The need to estimate an unobserved variable, the output gap, has created plenty of confusion, with fiscal rules based on the cyclically adjusted deficit, and it has led to calls for simpler rules such as expenditure rules.

17. According to IMF (2013), a "rainy day fund," for example, set up in 1970 would have benefited all euro area countries, including Germany, over its existence.

Figure 3 Illustrative distribution of bonds, 2019



Sources: IMF (2015); author's calculations.

package.[18] This would contribute to solving another problem of the current economic infrastructure of the euro area: the absence of a mechanism to design the euro area fiscal stance when a more expansionary fiscal policy is needed.[19] This asymmetry inflicts the euro area with a deflationary bias that the stability bonds could correct.[20]

Under this structure, countries would have to fund the domestic debt in excess of 25 percent of GDP, which would average about 60 percent of GDP by 2019 in a hypothetical case of introducing the program over the next four years (see figure 3 based on the debt/GDP projections of the International Monetary Fund [IMF 2015]). This national debt would provide market discipline and control over moral hazard while retaining ample liquidity in national bonds to avoid an excessive liquidity premium. Successful countries that reduce their overall debt levels toward the 60 percent of GDP targets would still have 35 percent of GDP in national debt. Because stability bonds would increase the stability of the euro area as a whole and of each country, the combined cost of debt would likely decline for all countries, even if the yield on the national bonds could increase marginally because of the seniority of the stability bonds.[21] Introducing stability bonds now, while inflation is very low and the ECB is undertaking QE, would facilitate the process, because the scarcity effect generated by QE on domestic bonds would contribute toward keeping rates low during the transition period.

Stability bonds would contribute to a deeper, more resilient financial union. They would create a risk-free curve for the euro area, which would allow euro area multinationals to price their bonds while preserving the domestic yield curves from smaller, domestically oriented firms.[22] Meanwhile, they would provide banks with an asset to further diversify their portfolios, facilitating the efforts to limit the exposure to domestic assets and further contributing to the breaking up of the bank-sovereign link. In addition, by generating a more stable euro area economy, with smaller ex ante divergences across countries and, importantly, a sharply reduced break-up risk, they would encourage the creation of cross-border banks that deliver effi-

18. If this were to happen after the initial transition period, it would likely imply going temporarily above the 25 percent of GDP limit. In this case, the EDA would plan to gradually return the level of stability bonds to the 25 percent level by not rolling over some of the bonds as they come due.

19. Because fiscal policy in the euro area is created by the aggregation of each country's fiscal policy, with asymmetric rules designed to reduce deficits, there are no rules to generate a euro area fiscal stimulus if individual countries refuse to participate.

20. This is similar to the finding that military alliances undersupply defense when compared with common defense mechanisms because of free riding. Rules are never a perfect substitute for a common framework (see Spaolore 2012).

21. In principle, the cost of debt for each country should a priori be unchanged unless new risk premia are created or reduced.

22. The lack of a full yield curve was the main flaw of the eurobills proposal by Philippon and Hellwig (2011).

cient private risk sharing via equity holdings, one of the key missing pieces of the current framework.[23] Disappearance of the break-up risk should allow supervisors to incentivize cross-border equity holdings via lower capital charges that reflect the diversification benefit. Overall, by creating a more stable euro area, stability bonds would contribute to reducing risk premia in euro area assets and therefore ease financial conditions over the medium term. By reducing the cost of capital, the end result would be higher potential growth.

Stability bonds provide a policy option...to accelerate recovery from the euro crisis and an environment in which to experiment safely and move toward a full-fledged fiscal union.

Both stability bonds and national bonds would be eligible for repo at the ECB. Once the program reaches its 25 percent of GDP target, the ECB would prioritize stability bonds in its QE programs but would not be forbidden from buying a capital key-weighted basket of national bonds if the QE program were to become large enough to impair market functioning in stability bonds. The stability bonds would allow termination of the politically conflictive OMT program because the stabilization function of individual countries would now be performed by the stability bonds.

Because national bonds would now represent a smaller part of domestic banks' portfolios and of the ECB balance sheet, the no-bailout clause would become more credible. If in the future a euro area country, despite the enhanced surveillance and market discipline, ended up in a truly unsustainable situation, its financial system should be more diversified and better able to handle an eventual restructuring of its debt. This restores the balance between liability and control, which opponents of joint issuance often mention, and it eliminates the need for an ex ante debt restructuring mechanism.[24]

This system of stability bonds could become the embryo of a future European Treasury. It is impossible to foresee all the difficulties adoption of a European Treasury will face, but this system will create a mechanism to gradually address these difficulties. A fiscal union can be created only in small steps. Stability bonds would provide a policy option to ease financial conditions in the euro area in order to accelerate recovery from the euro crisis and create an environment in which to experiment safely and move toward a full-fledged fiscal union.

23. This would allow supervisors to grant capital credits to banking groups that would diversify equity holdings across euro area countries. See Farhi and Werning (2014) for a theoretical discussion of this catalyzing effect of public risk sharing for private risk sharing.

24. See, for example, Weidmann (2014), who argues in favor of clauses that trigger automatic maturity extensions in bonds of countries that request ESM assistance.

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