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"Expert group reflects on debt mutualisation in the EMU"

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As part of their effort to construct a genuine economic and monetary Union (EMU), policymakers are pondering the prospect of debt mutualisation.

The findings of an expert group set up by the European Commission on two debt mutualisation instruments, a debt redemption fund (DRF) and eurobills, were presented in front of the European Parliament in early April 2014. As of yet, no concrete actions towards debt mutualisation are on policymakers' near term agenda and the exchange of views on the group's findings served mainly as food for thought for future discussions.

The expert group was set up by the Commission in March 2013, following a commitment made to the European Parliament, as part of the overall agreement on the Two Pack of economic governance (a set of policy measures meant to enforce fiscal discipline and clarify financial assistance provisions for eurozone member states). The group aimed to analyse the possible merits, risks, requirements and obstacles of partial substitution of national issuance of debt through joint issuance.

The experts thus presented the pros and cons of the two instruments, the needed precautionary measures which would limit their moral hazard and the legal constraints that they currently face. They concluded that for the moment it is best to wait for recent economic governance and financial sector reforms to kick in, before concrete steps towards debt mutualisation are taken. This would ensure that policymakers have more certainty about the European economic landscape and would maximise the success of the new debt mutualisation tools.

The need for debt mutualisation in the context of the EMU

The idea of issuing debt jointly is part of a broader attempt to gradually complement the monetary union with a fiscal layer. Joint issuance is ultimately one of the latter's defining elements, alongside a eurozone ministry of finance, with a taxation capacity and a strong euro area budget.

While monetary policy is indeed centralised in the EMU, fiscal policies are merely under a rules-based European surveillance, while remaining national in nature. Asymmetric shocks are thus dealt with through national fiscal stabilizers. The crisis episode put an emphasis on the imperfections of the common currency area on a number of fronts. It quickly emerged that the EMU was lacking mechanisms to ensure sustainable public finances, that one size fits all monetary policy could easily coexist with wide disparities in competitiveness between North and South (lacking other well-functioning adjustment tools) and that in spite of sharing one currency, market risk was perceived differently across the different member states, leading to a wide disparity in borrowing costs both for sovereigns as well as for private sector actors.

At the same time, a missing integrated EU-level framework to deal with financial sector regulation also led to the emergence of a strong connection between banks and their sovereigns, which implied that once one of the two links faced difficulties, the other could also come under pressure.

The crisis gave policymakers the needed push to take action. Broad ranging economic governance and financial sector reforms were put in place. The six-pack and two-pack of economic governance as well as the fiscal compact are pushing for fiscal discipline and a better check and tackling of macroeconomic imbalances. The European banking union, currently in the making, together with the bank recovery and resolution directive (the BRRD) have made headway in severing the banking-sovereign loop and increasing EU financial integration.

Unfortunately, the problems of accumulated debt and market access for debt burdened sovereigns, remain as of yet unresolved. A number of euro area member states are still dealing with a severe debt overhang, accumulated in the years prior the crisis and amplified by the crisis episode. Moreover, member states are also suffering from a growth crisis, with only a modest recovery in sight, which does not promise impressive growth in the short run. This disappointing growth performance has further burdened debt to GDP ratios. Finally, wide cross-country differences in borrowing costs exist, making it nearly impossible for some debt burdened member states to access markets at a competitive rate. Debt mutualisation promises to provide the cure for these ailments.

With these concerns at heart, the expert group on debt mutualisation put the spotlight on a DRF and eurobills. The idea to mutualise eurozone debt is certainly no novelty. It had been on the discussion table prior to the crisis and perceived as a means towards deepening EMU integration. In 2011, the topic made a comeback. It was taken up by the Commission Green Paper, as well as by a number of think tanks and academic institutions. The efforts of the expert group complement these initiatives and use as inspiration some of the ideas which were already on the table.

The DRF

The DRF is a temporary mechanism meant to deal with the overhang of public debt. It aims to reduce the debt legacy of the public sector and is envisaged to be temporary, with an estimated lifespan of 25 years. It entails the reduction in public debt exceeding 60% of GDP and debt restructuring rules kicking in once the debt overhang has been cleared. Debt in excess of this threshold would be transferred by participating member states into the fund during a roll-in phase (which would be no longer than 6 years). The proceeds obtained from the issuance of bonds would be used to refinance national bond with a maturity no longer than two years on the day that the scheme is introduced.

At the end of the roll-in phase, the fund's volume would be limited to 2.85trillion EUR. The sum of all amounts of debt transferred to the fund would add up to 3.1trillion

EUR. The participating member states would then redeem the transferred debt over a 20-25 year period. Each member state would make payments to the fund as a percentage of their GDP.

To make the repayment possible, a steady primary surplus would be required. It is assumed that interest savings, together with a reduction in the liquidity premium would make it possible for most participating member states to achieve a primary surplus.

Various options for designing the Fund were considered by the expert group. Under one scenario, the liability of the fund would be 'joint and several', implying that each bond issued under the DRF umbrella would have a guarantee given by each member state up to its full amount. If there were problems in the repayment of DRF bonds, an investor could ask the country of its choice to make the repayment. This would of course entail a substantial transfer of sovereignty during the fund's lifetime.

A DRF with such a guarantee structure would reduce the need for financing through the ESM or through unconventional monetary policy measures provided by the ECB. The DRF financing costs would under this scenario be similar to those of the best-rated participating member states.

An alternative to the 'joint and several' model would be a 'pro rata' scheme, similar to the model used already by the European Stability Mechanism (ESM, the eurozone's permanent rescue fund which draws on paid-in as well as on callable capital, which can be called in under certain circumstances). Under a pro rata scheme, the DRF would have a small fraction of paid-in capital and a larger fraction of committed callable capital, subscribed by each participating member state pro rata based on a key reflecting their share in transferred debt.

The joint and several scheme would be more effective than the pro rate one, but would also require more trust and commitment from the side of the member states participating in the scheme.

Eurobills

While the DRF would deal with debt legacy, eurobills would be a means of stabilising government debt markets in times of stress and offer a safe and liquid asset which would foster financial integration. Unlike the DRF, eurobills could potentially become a permanent mechanism of joint issuance. The asset would aim to reverse the trend towards market fragmentation and help with the monetary transmission channel. While eurobills could contribute to the diversification of sovereign debt holdings in bank balance sheets and reduce the bank-sovereign loop, they could not become a substitute for structural reforms.

In terms of functionality, eurobills would entail the joint issuance of short-term government debt by the euro area member states, backed, as in the case of the DRF, either by a joint and several or by a pro rata guarantee. An issuance limit would be set in advance. Eurobills would have maturities up to one or two years.

Under joint and several guarantees, each member state would be liable for the share of any other member state.

As in the case of the DRF, a pro-rata design for the eurobills can also be envisaged. Under the latter system, each participating member state is liable for its share in eurobills issuance. It would once again follow the example of the ESM's capital structure, and would thus encompass a small fraction of paid-in capital and a larger fraction of committed callable capital, subscribed by each participating member state pro rata in line with a key set in advance. While such a pro rata system would indeed create a large bills market, the effects in lowering financing costs would be significant only in times of market stress and not normal times of low stress.

Worries and risks

Both instruments considered by the expert group come with corresponding concerns. They include moral hazard risks, as well as legal and scope reservations.

Moral hazard

Both the DRF as well as eurobills are susceptible to serious moral hazard risks. The latter refers to one entity making decisions about the risk to take and another entity bearing the cost, if the risk materializes. The hazard is directly related to guarantee structure, the volume of joint issuance in relation to debt left at national level, the duration of the scheme, the maturities of the instruments chosen and political constraints set on governments.

To address moral hazard, various mechanisms were considered by the expert group. They include prior conditions for entrance into the debt mutualisation scheme (a period of probation and restricting eligibility for participation), reinforced competences of the European level over member states' fiscal and economic policies in cases of non-compliance (the introduction of debt brakes into national constitutional law, structural reforms, the earmarking of national tax revenues for the payment of DRF obligations, depositing of collateral corresponding to a certain percentage of the debt transferred into the DRF), financial incentives and sanctions (the calling in of collaterals, stopping the debt transfer during the roll-in phase of the fund in the case of the DRF, increasing interest rates and earmarking tax revenues; as a last resort, the suspension and eventual exclusion of a member state from the DRF or eurobills scheme).

Unfortunately, concerns exist also when considering the preconditions and sanctions and the extent to which they are credible and enforceable.

Legal limits

Both instruments face not only moral hazard worries but also legal constraints. Within current Treaties, nu guarantees for joint and several liabilities are possible. Pro-rata commitments on the other hand could, under certain conditions, be envisaged, according to the expert group (modelled to some extent after the ESM).

The experts thus suggest that it could be possible to set up a temporary eurobills scheme through a combination of a regulation based on Article 352 involving enhanced cooperation and an intergovernmental agreement.

Naturally, this comes with its own shortcomings. On the one hand, eurobills will not address debt legacy, a DRF would still be needed further down the road. On the other, the Union would be reaching out yet again to an intergovernmental agreement, as was the case of the ESM, putting into doubt the democratic legitimacy of the initiative. If the latter course of action is pursued, appropriate accountability mechanisms, foreseeing a close involvement of the European Parliament and of the national parliaments of the member state participating in debt mutualisation, are needed.

Scope

Finally, the question of whether the two debt mutualisation instruments would be accessible to all euro member states or only to those who are not under a programme (although arguably the latter are most in need of assistance) also remains open. The experts hinted in their report at the possibility of welcoming former programme countries into the schemes, once their programme is complete.

Looking ahead

Having considered both the DRF as well as eurobills, the experts hint at the need for a joint use of the two, with the aim of tackling both the debt overhang, as well as existing sovereign funding difficulties. With a number of open questions and alarm bells still hovering over the prospect of debt mutualisation however, the expert group is cautious about advocating policy measures towards it now. They advise to wait until the effects of the new economic governance and financial sector reforms kick in. With more certainty about the macroeconomic and financial landscape they are operating in, policymakers would be better equipped to design a successful and sustainable scheme for debt mutualisation.