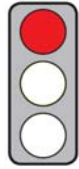


MAIN ISSUES

Objective of the Green Paper: The Commission presents its ideas regarding how to shape Eurobonds.

Parties affected: All.



Pros: –

Cons: (1) Eurobonds suspend market disciplining, thereby reducing budgetary discipline and the willingness of Member States to reform. The policy processes proposed by the Commission cannot compensate this.

(2) Eurobonds of option 1 infringe the German Bundestag's budget responsibility which is protected by the Basic Law's guarantee of the permanence of basic principles.

CONTENT

Title

Green Paper COM(2011) 818 of 23 November 2011: Green Paper on the feasibility of **introducing Stability Bonds**

Brief Summary

► Background

- The declining creditworthiness of several Member States and the accompanying increase in interest rates has triggered a debt crisis which is affecting a growing number of Member States. Several politicians and scientists are calling for the introduction of Eurobonds in order to solve the crisis.
- “Eurobonds” – the Commission uses the term “Stability Bonds” – are sovereign bonds issued by Member States of the euro area through a common debt management office. Thereupon, the debt management office distributes the proceeds to Member States.
- The Commission puts up for discussion:
 - the pre-conditions for the introduction of Eurobonds;
 - the potential advantages of Eurobonds;
 - three options regarding the designing of Eurobonds. The options differ in that they:
 - provide either the full or partial substitution of national bonds through Eurobonds and
 - provide either a joint and several or several but not joint guarantee.

In the case of a several but not joint guarantee, each Member State is liable only for its own share in the issuance of Eurobonds. The issuance share of a Member States either corresponds to the contribution key to the EU budget or to the capital key of the European Central Bank (ECB). In the case of a joint and several guarantee, each Member State is liable not only for its own share but also for the share of any other Member State failing to comply with its obligations. However, in such circumstances, participating liable Member States would have a claim on the defaulting Member State.

► Pre-conditions for the introduction of Eurobonds

- Any “inappropriate behaviour” (“moral hazard”) in Member States, in particular in the form of deficient budgetary discipline, is to be addressed.
 - “Moral hazard” is created by the very fact that the Eurobonds reduce the incentives for budgetary discipline. Member States can run up debts at the expense of the budgetary discipline of other Member States, without this having an affect on their financing costs. Market disciplining is reduced.
 - In order to balance out the lowered incentives for budgetary discipline, the Commission proposes to:
 - strengthen the surveillance of budgetary discipline by planning ex ante reserves in national budgets and by carrying out “costly new measures” only on on-track execution;
 - strengthen the monitoring of macro-economic imbalances, such as the loss of national competitiveness in several Member States, and where necessary correct them, as such imbalances can have a negative impact on national budgets (cp. [cepAnalysis](#));
 - put in place a “system” that ensures the full debt service of each Member State. To this end, an “institution” should be granted “extensive intrusive power”, including the possibility of putting the failing Member States under some form of “administration” (p. 22);
 - undertake compensation payments between states with high and low creditworthiness; and
 - permit the issuance of Eurobonds only if Member States comply with the macro-economic and fiscal rules, in particular the requirements of the Stability and Growth Pact.
- A reinforced fiscal and macro-economic surveillance to avoid moral hazard is subject to changes to the EU Treaties and complementing secondary legislative provisions, as well as amendments to national legislation in many Member States.

- Eurobonds must have a high credit quality, as otherwise:
 - there is a risk that investors acquire only very few Eurobonds and
 - Member States with high creditworthiness reject Eurobonds as they increase financing costs.
- Eurobonds with a joint and several guarantee infringe the bail-out prohibition (Art. 125 TFEU), hence the EU Treaties must be changed.

► **Advantages of Eurobonds**

- Eurobonds alleviate the debt crisis, as the “high-yield Member States” could benefit from the creditworthiness of the “low-yield Member States”.
 - High-yield Member States are Member States with a lower creditworthiness, such as Greece.
 - Low-yield Member States are Member States with a higher creditworthiness, such as Germany.
 Bail-out packages would no longer be necessary, or at least only on a small scale.
- Eurobonds stabilise the European banking system, for the typically large amounts of national sovereign bonds held by inland banking systems lead to the reduced creditworthiness of inland banks where the creditworthiness of the Member State concerned is reduced. As a consequence, the refinancing of banks is impeded. This interdependence is broken by Eurobonds.
- Eurobonds increase the liquidity of the market for sovereign bonds.
 - A market is deemed liquid if a large amount of sovereign bonds can be sold without affecting the market price. Therefore, the liquidity of a market increases in relation to market size and increases in sales and purchases.
 - In less liquid markets, the sale of large amounts of sovereign bonds leads to a reduced price. Therefore, investors are calling for a liquidity premium in the form of an interest surcharge. In other words, increased liquidity leads to reduced liquidity premium. Through Eurobonds, the liquidity premium for Germany would sink by 0.07 percentage points and for the Euro states on average by 0.17%.
- Eurobonds improve the efficiency of the monetary policy decisions made by the ECB. For the sovereign bonds of several Member States the market was no longer liquid. Liquid markets, however, are a precondition for monetary policy decisions – such as the reduction of the interest rate – penetrating to enterprises and private households.

► **Option 1: Full substitution of national sovereign bonds through Eurobonds with joint and several guarantees**

- Government financing is fully covered by Eurobonds. There are no national sovereign bonds.
- This option involves “the greatest risk of moral hazard” (p. 13).
- This Eurobonds approach can be “most effective” in delivering benefits (p. 13).
- Government costs for Germany increase between 0.5 and 2 percentage points (p. 6).
- The introduction of option 1 might take “a considerable amount of time” (p. 19) due to the need for changes to the EU Treaties.

► **Option 2: Partial substitution of national issuance with Eurobonds with joint and several guarantees (“Blue-Red-Approach”)**

- “Blue Bonds” are Eurobonds with joint and several guarantees.
- “Red Bonds” are national government bonds issued in the case of additional government financing and are junior to Blue Bonds.
 - The ECB does not permit their use for refinancing as their creditworthiness is too low.
- A limit is defined for Blue bonds, e.g. 60% of the GDP for each single Member State.
- In case of non-compliance with the requirements of the Stability and Growth Pact, the ceiling is lowered.
- Moral hazard occurs only during the introduction phase, as Member States with a low creditworthiness can benefit from a higher creditworthiness of other Member States until they reach the ceiling of 60%. Where the ceiling is reached, a Member State issues only Red Bonds, the interest of which depends on the national default risk.
- Once a ceiling is defined, it must be maintained and must not be adjusted under political pressure. Otherwise, the sanctioning effects of Red Bonds are not achieved.
- The degree to which Eurobonds create benefits depends on the chosen ceiling: the higher the ceiling, the greater the benefits. The debt crisis is contained in the introduction phase, in which Member States issue only Blue Bonds. Thereupon a payment default is possible.
- The yields on Blue Bonds are low and comparable to the yields on the current AAA government bonds. The yields on Red Bonds differ among Member States. They are oriented towards country-specific liquidity and credit criteria.
- The introduction of option 2 takes “a considerable amount of time” (p. 19) due to the need for changes to the EU Treaties. The rules for fiscal and macro-economic surveillance require lower changes than option 1, as the sanctioning function of the market is maintained.

► **Option 3: Partial substitution of national issuance with Eurobonds with several but not joint guarantees**

- Eurobonds can – as in option 2 – be issued up to a predefined ceiling. Any exceeding financing needs must be covered by national government bonds.

- The single Member State is liable only for its own share which corresponds to the contribution key to the EU budget or to the capital key of the ECB.
- Due to the several – but not joint – guarantee, moral hazard would be low. Moreover, the sanctioning function of the market would be maintained due to the national issuance.
- The benefits created by Eurobonds would be less than is the case with option 1 and 2. The debt crisis can hardly be contained.
- Eurobonds with a several but not joint guarantee have at best an average credit quality. Therefore, the Commission proposes a credit enhancement, in particular the underpinning by gold, cash or shares of public companies, as well as earmarking specific tax receipts to servicing Eurobonds.
 - Improved credit quality leads to reduced yields on Eurobonds and increased yields on national bonds. The interest payment for the total debts of a Member State is not changed.
- The introduction of option 3 can be carried out quickly, as no changes to the treaties are necessary.

Policy Context

In its decision of 6 July 2011 on the financial, economic and social crisis, the European Parliament called upon the Commission to examine the introduction of Eurobonds and to identify the conditions under which they could be of benefit to all participating Member States.

Options for Influencing the Political Process

Leading Directorate General: DG Economic and Financial Affairs

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

There is no doubt that Eurobonds trigger **moral hazard issues**. However, contrary to what the Commission hopes, these **cannot be avoided by means of political processes**. **The sanctioning function of the market is indispensable. For with political processes** such as the proposed increased surveillance of budgetary discipline and macro-economic imbalances, **sanctions can be undermined, or at least delayed, through exceptions or political exchange deals**. The experience gained from the Stability and Growth Pact clearly demonstrates this.

Moreover, a Member State which is jeopardised by sanctions could also threaten to cease the interest and principal payments for Eurobonds. Although powers of intervention into national budgets are supposed to prevent such threats, it is questionable whether the empowered institution will actually be willing and in the position to enforce such powers without regard to internal political repercussions.

Compensation payments that reflect credit standing between Member States with a low and those with a high credit standing **will not be enforceable**. If a Member State is sufficiently highly indebted and the threat to cease servicing debts for Eurobonds seems sufficiently credible, the compensation payments are to cease immediately, too. Moreover, if one assumes that investors estimate the default risk correctly, compensation payments would have to be equal to the current interest differences. This is no help for high-interest Member States. Therefore, low compensation payments are agreed upon when introducing the Eurobonds. **The ceasing and low fixation of compensation payments means that a transfer union is introduced through the back door.**

As the pressure from the market is diminishing and moral hazard cannot be avoided, the willingness for reform will slacken in many Member States. Already during the introduction of the Euro, the southern Member States benefited for a decade from the low interest rates. The resulting fiscal leeway, however, was not used for a reduction of debts. Instead, the low interest rates meant that it was cheaper to get into debt and states increased their debts. Also in the case of Eurobonds, it can be expected that interest earned will be consumed and that necessary reforms will not be taken. It is **particularly in times of crisis that governments can enforce real economic and fiscal reforms which were hardly possible during 'normal' times. Just the discussion about Eurobonds aggravates the enforcement of such reforms and therewith a solution of the debt crisis.**

Many Member States must now make up for reforms which they missed before and after the introduction of the Euro. Reducing this pressure for reforms that comes from Eurobonds would mean that the euro area will continue to suffer from macro-economic imbalances and a lack in budgetary discipline. The containment of the crisis, which the Commission expects to happen, will at best be achieved for a short period only. In the long run, problems will grow. The stabilisation of the banking system can be reached more efficiently if banks are given incentives to increase diversification. To this end, it is necessary to cover government bonds with risk-adequate own capital. Moreover, the too-big-to-fail issue must be solved.

The positive effects of increased liquidity is not in proportion to the increased interest costs and the dangers arising from moral hazard.

The options presented by the Commission are to be assessed as follows:

State debt financing completely through Eurobonds (option 1) maximises the moral hazard problem. Single Member States can rely on the bail-out through other Member States. Budget consolidation and real economy

reforms to increase competitiveness do not take place. For Germany, the interest rate increase entails two negative effects: on the one hand, private credits and loans become more expensive as the interest for risk-less German government bonds are an interest rate floor. If the interest rate floor is raised, all other interests are increased too. Thus investments are impeded. In order to finance higher interest rates, taxes must be raised or expenses be cut.

Eurobonds with a joint and several guarantee (option 2) involve massive moral hazard problems. The Commission's hope that the ceilings for Eurobonds could be immutably defined is naïve. The fear of state insolvencies, which today is created by the political pressure to introduce Eurobonds, will tomorrow create political pressure to increase the ceilings. Furthermore, the Commission's proposal to reduce the ceiling where the Stability Pact is infringed will not be politically enforceable, as in this way the fiscal problems of the Member State concerned are increased once more.

As moral hazard can therefore not be avoided, it cannot be expected that the Member States will use the savings gained from the introduction of Blue Bonds for debt reduction.

Eurobonds with a several but not joint guarantee (option 3) do not create the intended interest rate reduction. For that to happen, improvements in credit quality would be necessary, but that cannot be delivered by Member States with lower creditworthiness. Instead, it is much more likely that Member states which already have a high creditworthiness must improve their credit quality in order to balance out the creditworthiness of other Member States. Hence, option 3 does not really differ substantially from option 2.

Legal Assessment

Competency

The EU Treaties do not contain any express competence basis for the introduction of Eurobonds. Hence, only the so-called "flexibility clause" (Art. 352 TFEU) might serve as a legal basis. This provides that the EU is entitled to take action where this is necessary, in order to attain objectives set out in the Treaties. However, Eurobonds with joint and several guarantees cannot be based on the flexibility clause either, as they are in conflict with the bail-out prohibition (Art. 125 TFEU). For with joint and several guarantees the Member States are also liable for the shares of other Member States. Art 352 TFEU can serve as a competence basis for Eurobonds with a several but not joint guarantee, as each Member State is liable only for its own shares and is therefore not subject to the bail-out prohibition.

Compatibility with EU Law

Eurobonds with joint and several guarantees infringe the bail-out prohibition (Art. 125 TFEU), as even the Commission itself admits (p. 11). **In order to introduce option 1 or 2, an amendment to the Treaty would be necessary.** Option 3 would be in line with the bail-out prohibition due to the several but not joint guarantee.

Compatibility with German Law

Eurobonds with a joint and several guarantee according to option 1 are not in line with the German Basic Law, which obviously also the Commission understands (p. 11, FN 14): The basic decisions on revenue and expenditure form an essential part of the democratic process and shaping function in the constitutional state (cf. German Federal Constitutional Court, BVerfG „Lissabon“, Rs. 2 BvE 2/08 et al., para. 252, BVerfG „Euro-Rettung“, Rs. 2 BvR 987/10 et al., para. Tz. 122). The German Bundestag must not delegate its budget responsibility on the basis of undetermined budget policy authorizations (cf. BVerfG „Euro-Rettung“, Rs. 2 BvR 987/10 et al., para. 125). Further inadmissible is the justification of permanent mechanisms which might result in the assumption of liability for voluntary decisions of other states, in particular if incalculable consequential effects are related (cf. BVerfG „Euro-Rettung“, Rs. 2 BvR 987/10 et al., para. 128). Germany must not subject itself to an uncontrolled automatism of a joint liability (cf. BVerfG „Euro-Rettung“, Rs. 2 BvR 987/10 et al., para. Tz. 137).

Option 1 serves the ongoing financing without quantitative or temporal limitations. Thus it represents a permanent mechanism in which liability depends on the payment defaults and budgetary decisions of other Member States. **The liability exposure of option 1 is neither controllable nor foreseeable**, due to the uncertain number and volume of payment defaults. **The German Bundestag loses its influence on budget responsibility.** Budget responsibility forms part of the democratic principle, which is protected against changes by the guarantee of permanence of basic principles (Art. 79 (3) GG). Therefore, **Eurobonds of option 1 cannot be brought in line with the Constitution by way of a Basic Law amendment, only by a new Constitution** (Art. 146 GG).

With regard to option 2, there are concerns as to its compatibility with the Basic Law. The consequence of liability can be calculated more easily due to the ceiling, yet this option also establishes a permanent mechanism which might result in an assumption of liability for the voluntary decisions of other states.

With the Eurobonds of option 3, the budget responsibility remains with the Bundestag. Due to the several but no joint guarantee, the consequences of liability are foreseeable and there is no infringement of the Basic Law.

Conclusion

Moral hazard problems cannot be avoided through political processes. Market disciplining is indispensable. Eurobonds of option 1 infringe the German Bundestag's budget responsibility, which is protected by the Basic Law's guarantee of permanence of basic principles. With regard to option 2, there are concerns as to its compatibility with the Basic Law.