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Saving EMU:

Central funding of public budgets as the next step?

Europese Beweging Nederland
European League for Economic Cooperation

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Content

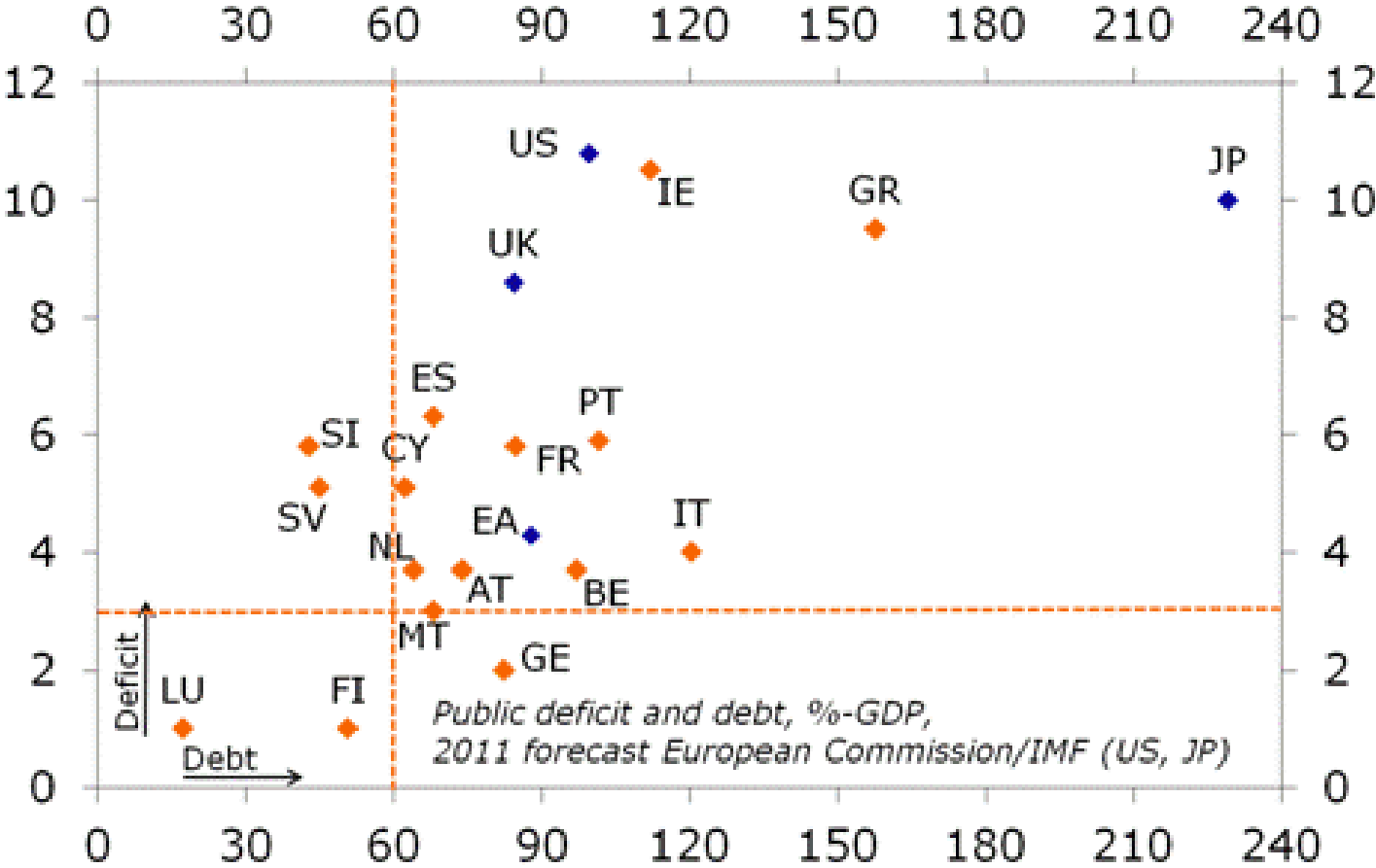
- The problem with EMU
- The results
 - Doubt about future of euro
 - Volatile interest rates differentials
 - EMU is in danger
- Can the issuance of 'eurobonds' be (part of) the solution?
- A workable eurobond-design
- Practical issues
 - Political
 - Implementation
- Conclusions

The problem: monetary integration is incomplete

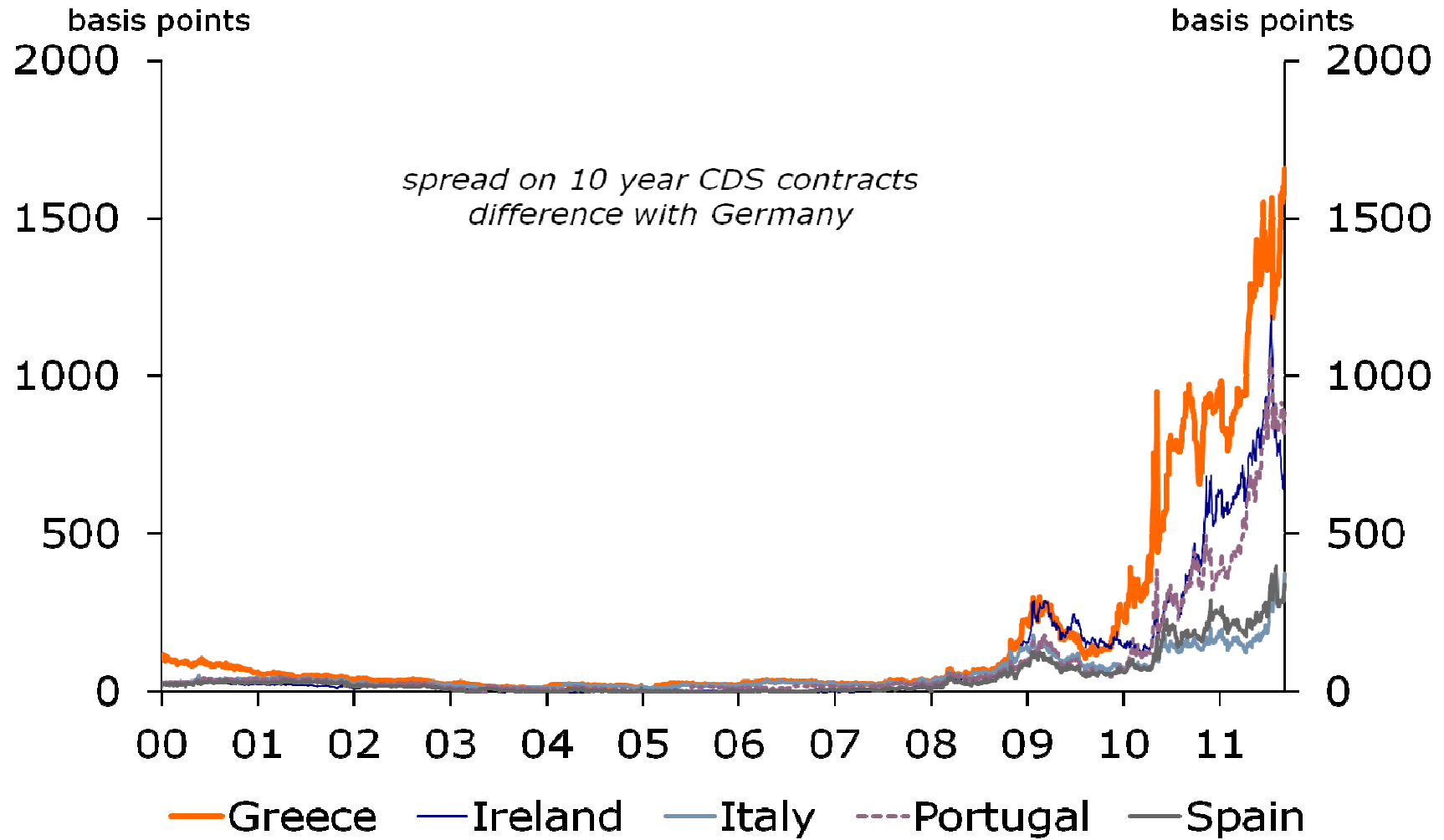


- Completed:
 - Euro
 - Common monetary policy
 - Integrated money market
- Not completed
 - Political Union
 - Integration of public bond market
- The result: EMU is unstable
 - In EMU: it is the margin that determines the sentiment
 - Instead of the average

On average, EMU is relatively sound



Financial markets have failed to discipline





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Unexpected?

- “De verschillen in de rente op de staatsleningen van de verschillende lidstaten zullen bij afwezigheid van wisselkoersrisico dan ook marginaal zijn”
- “In feite heeft de volledige vrijheid van kapitaalverkeer, in combinatie met vaste wisselkoersen, als eerste effect dat overheden die omvangrijke tekorten realiseren deze eenvoudiger en vooral goedkoper kunnen financieren dan voorheen. **De marginale kosten van een onverantwoord begrotingsbeleid nemen af**”
- “In feite krijgen de financiële markten met het voortbestaan van een gesegmenteerde kapitaalmarkt een breekijzer aangereikt om de kracht van de EMU uit te proberen.
- Citaten uit ESB, 6 december 1989
- Noot: op dat moment was nog geen sprake van een gemeenschappelijke valuta

The consequences



- Markets can still speculate against the euro by driving up intra-EMU interest rate differentials → weaker countries can be kicked out (see for example pressure on Greece)
- Bond yields could be lower for all members of EMU once liquidity could be improved → beneficial for all, both weak and strong countries
- Liquidity of bond markets within eurozone is much smaller than liquidity of US market, in spite of huge size of total market in EMU
- There increasingly doubts in the market whether the euro will survive as a currency in the long run, because investors fear (or politicians think) that:
 - Countries may be kicked out
 - Countries may opt to leave
 - Politicians are too slow in their actions
- It is a dangerous mistake that EMU would get stronger if weaker countries were to leave under market pressures.
 - Probability of serious recessions will increase
 - How to prevent contagion?



Many 'solutions' are offered

- Very recent: European Monetary Fund → will add to fragmentation
- Strengthening of SGP → essential, but not enough (see Ireland, Spain)
- Removal of weak countries from EMU → recipe for disaster
- All have the same problem:
 - Improvisation in reaction to acute crisis situation
 - Temporary and/or partial but not definite solutions
 - Some are straightforward stupid ideas
- Almost all fail to tackle the fundamental problem: EMU is incomplete and still vulnerable for attack → we should remove the design flaws of the euro



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The eurobond cacophony

- There are many so-called eurobond proposals. They have one thing in common: the word 'eurobond'. The differences are huge.
- Successful eurobonds should bring:
 - Stability in the markets
 - Improved fiscal discipline
 - Clear benefits for all countries (weak and strong)
 - A self-financing and pro-active crisis mechanism (via an insurance premium)
- Most proposals bring at best some benefits for the weaker countries
- Benefits for strong countries might be:
 - Lower funding costs due to liquidity premium. This is strongly dependent on the exact design. Here things can go seriously wrong
 - Self-financing crisis mechanism



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The eurobond cacophony (2)

- De Grauwe & Moesen (2009)
Proposal guarantees access to finance. No sheltering from market sentiment. No benefits for strong countries
- Delpla & Von Weizäcker (2010)
Blue and Red bonds. Core of debt is guaranteed. Market sentiment limited to Red bonds. Still vulnerable for strong swings in market sentiment
- Tremonti & Juncker
No advantage for stronger countries

The challenge

- **Improve (market or regulatory) discipline in 'normal' times**
 - Different qualities of fiscal policies should translate into differences in funding costs
 - Sound financial policies should be rewarded
- **Institutional strengthening of the euro**
 - Elimination of all possibilities to speculate against the very existence of the euro
 - Shelter countries from sudden swings in financial market sentiment
- **Deepening of eurozone bond markets**
 - Improved liquidity translates into lower funding costs for all
 - Stronger 'competitive position' of the euro against the dollar
- **Create a framework for countries that fail on their public debt**
 - History tells us that countries do fail from time to time
 - Countries should be able to fail without derailing the whole system



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Three solutions

- Most probable solution: 'muddling through'. This will not work in the end, as any individual problem threatens to translate into a new 'eurocrisis'. The best to be hoped for is that it will buy time.
- Most fundamental solution is introduction of common EMU-wide budget => politically out of the question (at least for the time being)
- Second best solution: central funding using eurobonds, but:
 - Cross-guarantee (not a partial guarantee) between all participating countries
 - Strengthening of fiscal discipline by more effective SGP
 - At least cost-effective, but preferably beneficial for stronger countries as well
 - Self-financing insurance mechanism



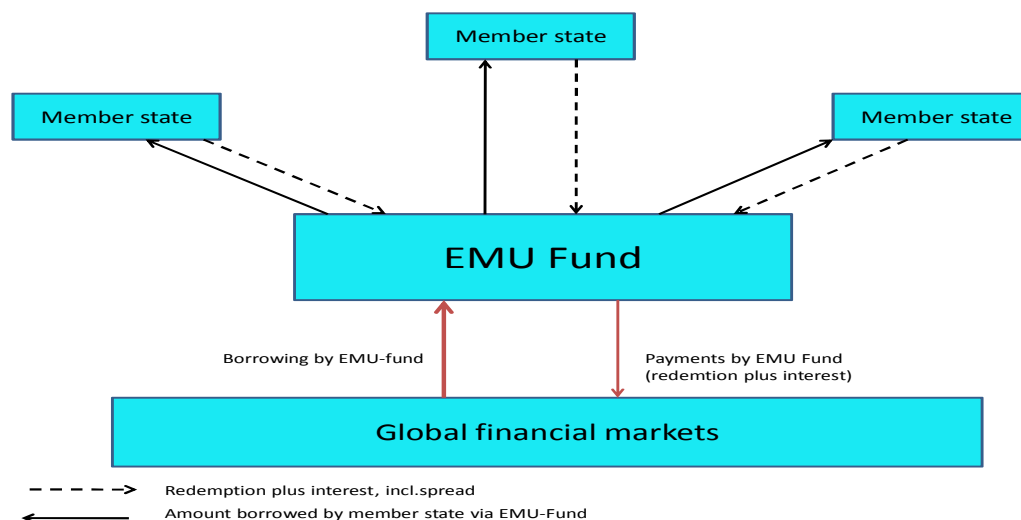
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Central funding of all public debt

- Common funding on a voluntary basis. Countries can choose not to enter, but 'once in, you can't go out'
- Central funding via a new institution: the EMU Fund. Which also means that the ECB can stop its Securities Markets Program
- Countries that participate give up their right to directly tap the financial markets
- Weaker countries pay a spread over the funding costs of the EMU Fund
- Spread is based on a formula, determined by:
 - Public debt ratio
 - Deficit ratio
- Boonstra (1989)(1991)(2005)(2009)

Central funding via the EMU fund

- EMU fund issues (euro)bonds and pays market rates → high rating is extremely important
- Redistributed to the member states
- Countries pay spread to the Fund over funding costs, depending on fiscal performance
- Self-financing mechanism ('insurance premiums')
- Cross-guarantee essential (not partial guarantees)



Pros and cons of this approach



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- Advantages
 - Flexibility in debt management (maturities etc.)
 - Diverging fiscal policies translate into diverging funding costs (restoration of failing market discipline)
 - Countries are sheltered from sudden swings in market sentiment
 - Creation of huge and liquid pan-EMU bond market
 - Weaker countries pay premium to EMU Fund, instead of higher interest rates to markets → financial buffer against future problems
 - Using cross-guarantee → the average counts, not the problem in the margin → lower funding costs
- (Possible) problems
 - Potential tensions with no-bail out clause → we already have crossed this line
 - Difficulties in calculation of spread → see below
 - Practical implementation
 - Lack of political willingness → voluntary participation
 - We can start without Germany. Any pair of countries can start and scale up.



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Computing the spread

- A simple straightforward formula will suffice:
- $R(i) = \alpha [O(i) - O(m)] + \beta [S(i) - S(m)]$
- Where:
 - $R(i)$ = the margin payable by country i over the funding costs of the EMU fund
 - $O(i)$ = the government deficit of country i , as a % of GDP
 - $S(i)$ = the government debt of country i , as a % of GDP
 - The variables $O(m)$ and $S(m)$ represent the acceptable levels for debt and deficits. They could be the criteria from the SGP.
 - The parameters α and β are coefficients, used to determine the weight of the relative performance on government deficit and government debt respectively in setting the mark-up.



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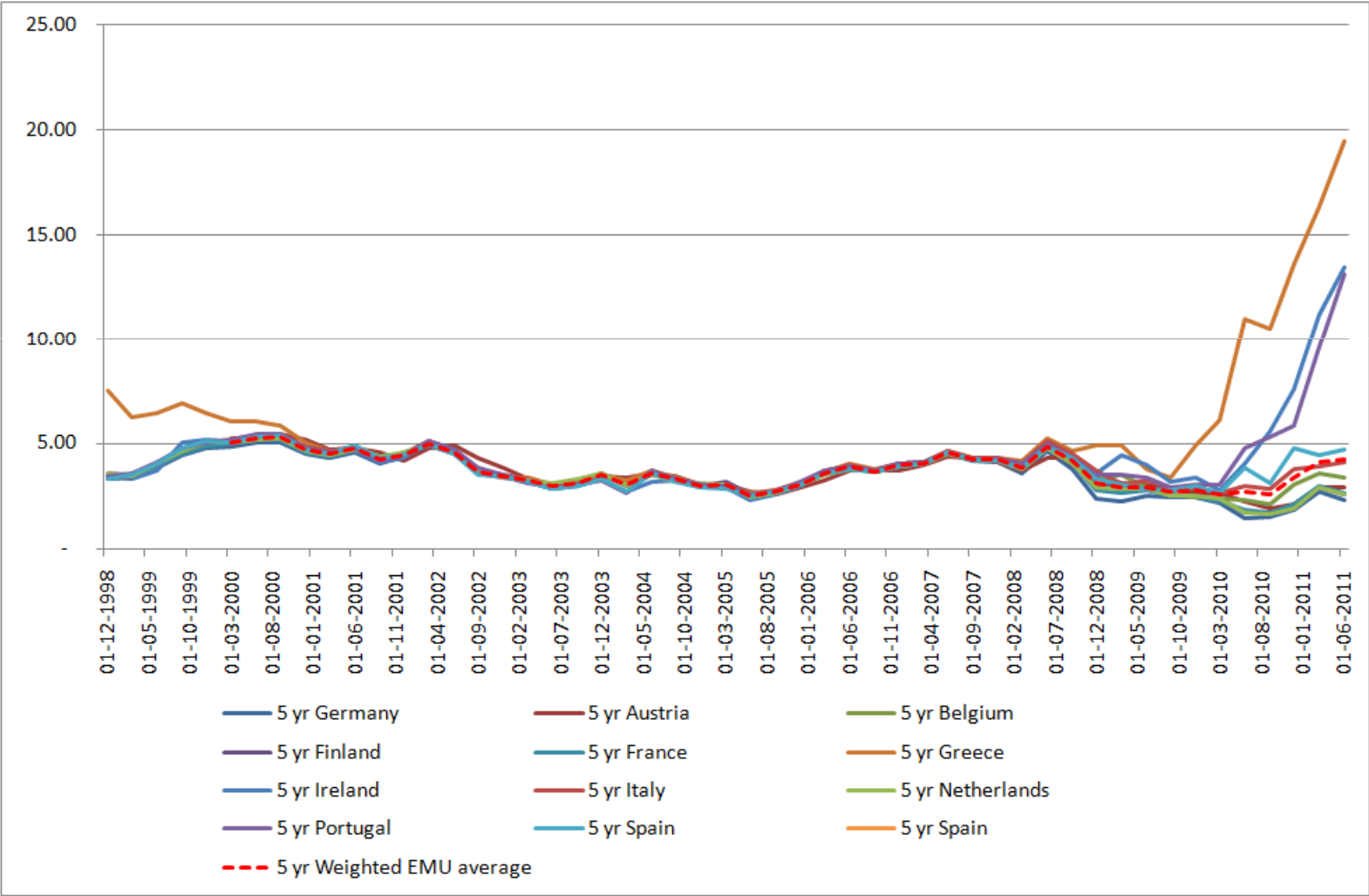
Funding costs: what are the effects for the stronger countries? Two scenario's

- Convergence towards the best stronger (Germany) or even lower (due to improved liquidity) → everybody better off
- Most likely: convergence towards a weighted average of yields of participating countries
 - EMU average respectively 28 (5 yr) and 34 (10 yr) bp higher than German funding costs
 - But: what is the relevant period?
- These estimates are excluding liquidity effects
- Including moderate liquidity premium of 25 bp German funding costs hardly rise.

5 year public bond yield EMU member states plus debt-weighted average



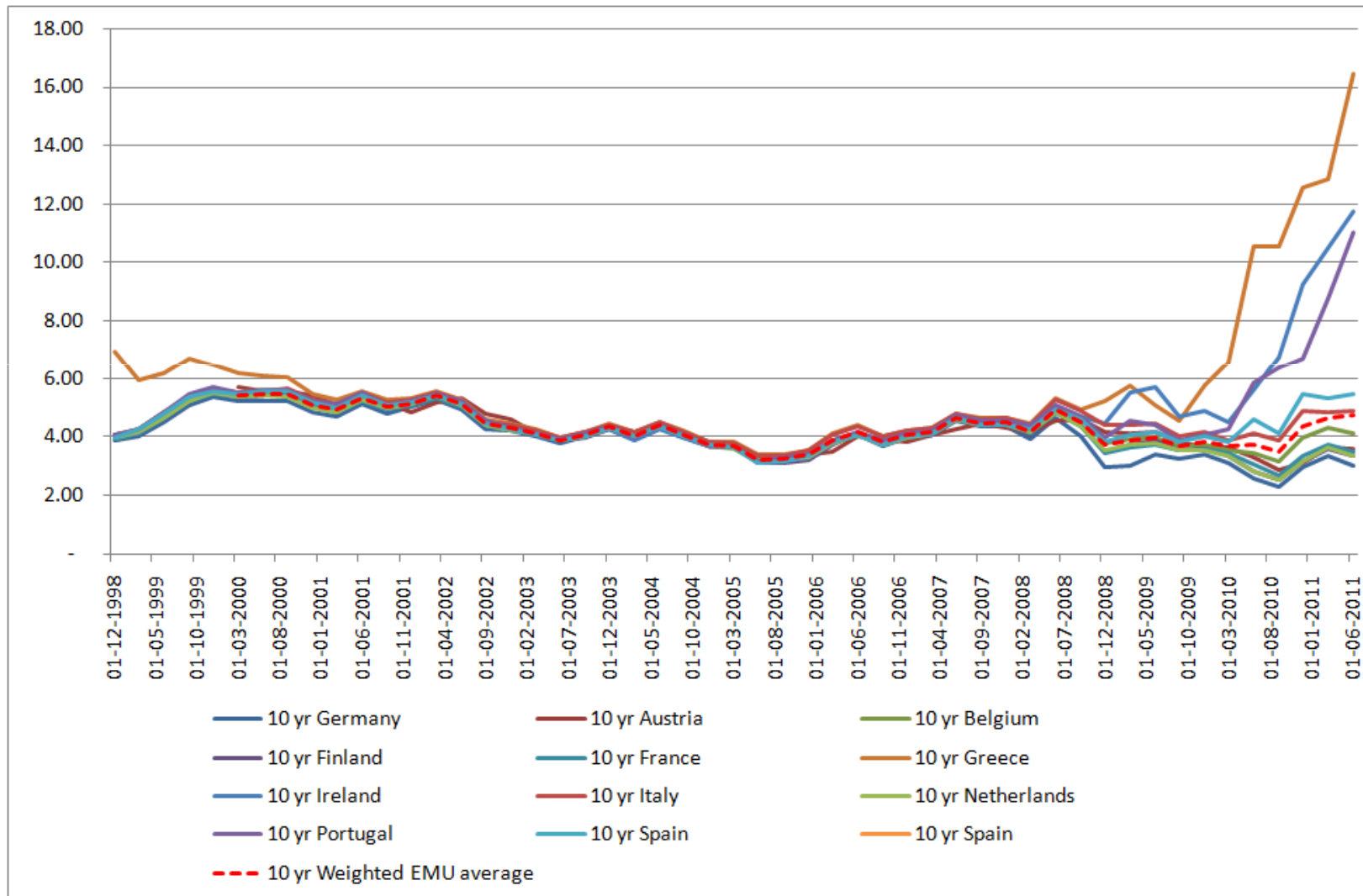
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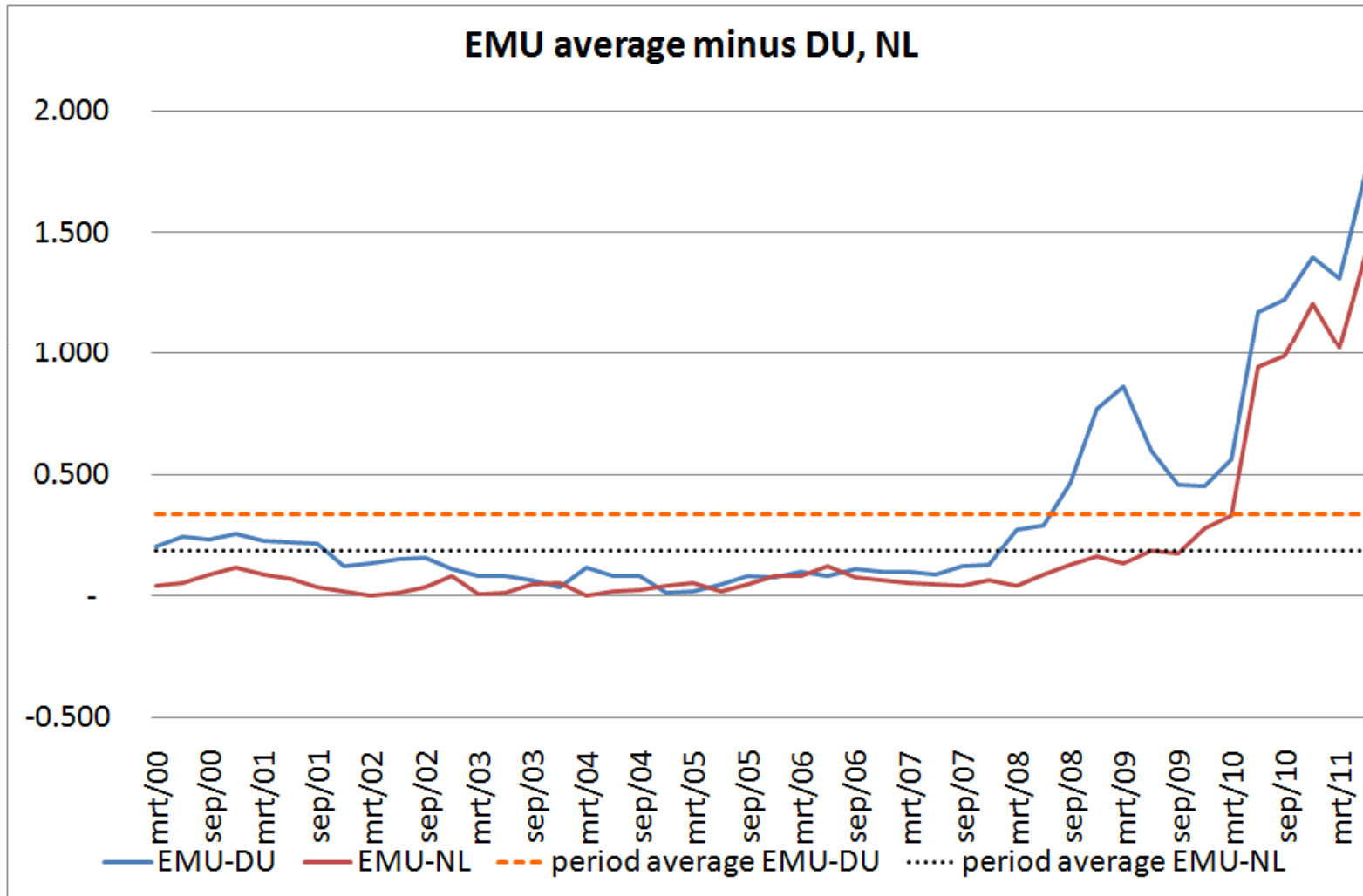
10 year public bond yield EMU member states plus debt-weighted average



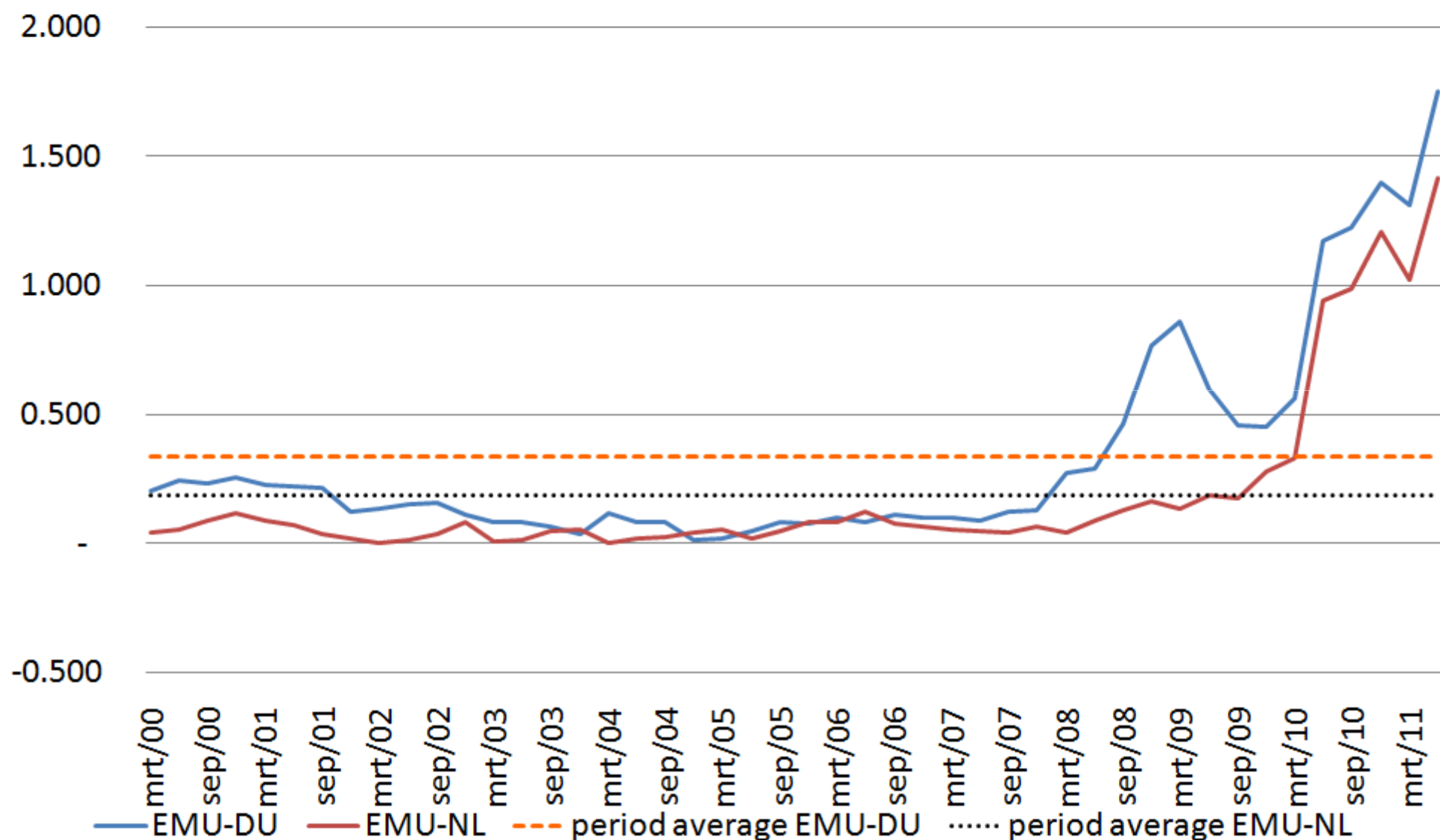
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A closer look at German and Dutch funding costs

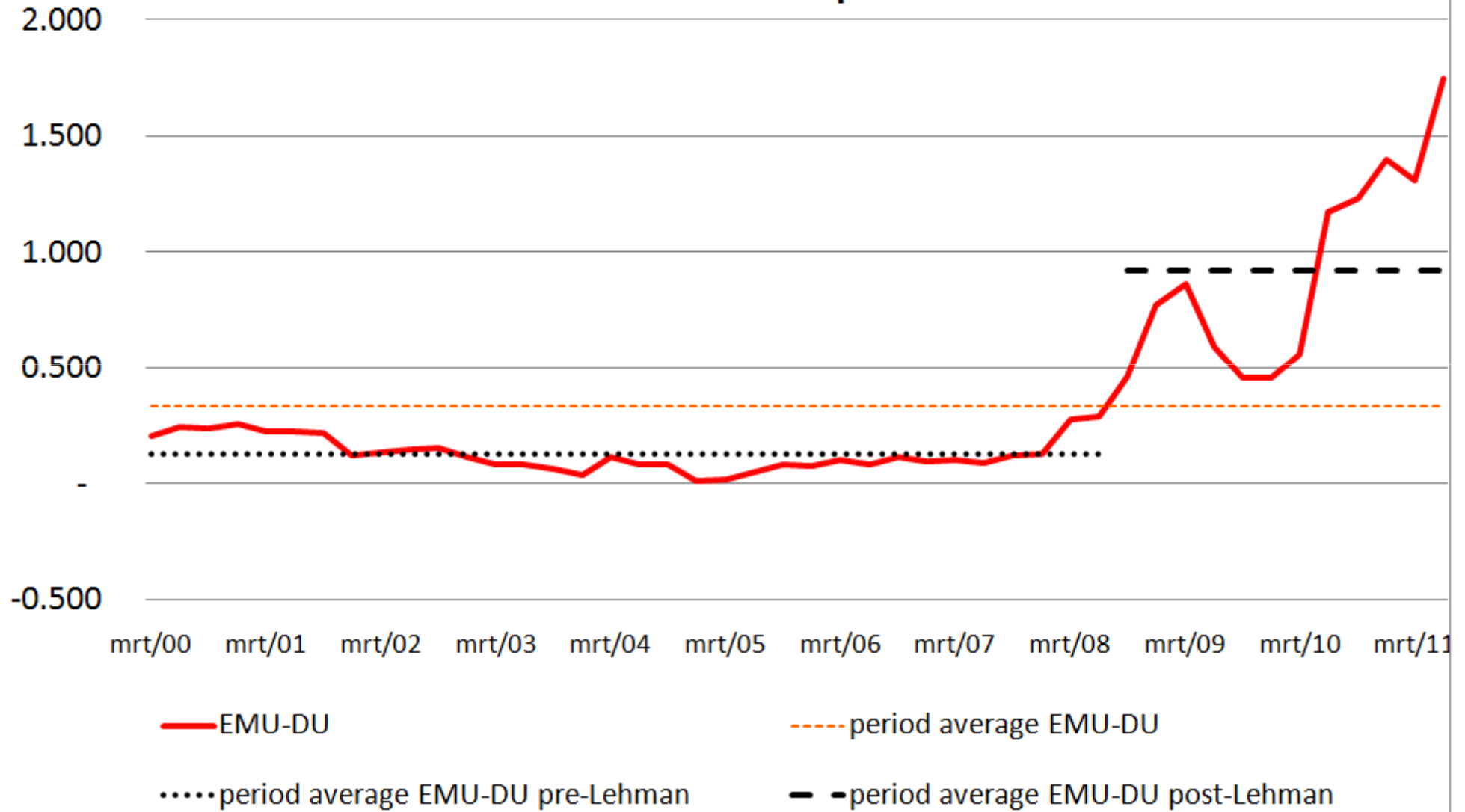


EMU average minus DU, NL



EMU average minus DU

What is the relevant period?



Funding costs: what are the effects for the stronger countries? Additional remarks



1. Even in a pessimistic scenario the average extra funding costs for Germany are low.
2. Costs of rescue packages are much larger!
3. Caveat 1: margins fluctuate heavily from year to year.
4. Caveat 2: funding advantage of stronger countries only exists in times of crises! In normal times non-existent!
5. In times of crisis huge costs of rescue packages and market volatility. EMU fund scheme is self-financing.

Two tentative calculations, based on French/German anchor



	Scenario 1	Scenario 2
Total margin paid to fund (=profit EMU Fund)	€ 946 bn.	€ 1.840 bn.
Contributed by (share in % between brackets):		
- Austria	€ 7 bn. (0.8)	€ 14 bn. (0.7)
- Belgium	€ 80 bn. (8.5)	€ 194 bn. (10.5)
- Greece	€ 163 bn. (17.3)	€ 223 bn. (12.1)
- Ireland	€ 18 bn. (1.9)	€ 11 bn. (0.6)
- Italy	€ 616 bn. (65.1)	€ 1361 bn. (74.0)
- Netherlands	€ 2 bn. (0.2)	€ 1 bn. (0.1)
- Portugal	€ 16 bn. (1.7)	€ 10 bn. (0.5)
- Spain	€ 44 bn. (4.6)	€ 26 bn. (1.4)

Note: based on the following assumptions:

- EMU fund introduced per January 2000
- Scenario 1 (a = 0,25; b = 0,02)
- Scenario 2 (a = 0,15; b = 0,05)
- Based on actual debt and deficit figures



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Concluding remarks

- Only a pan-EMU federal budget or central funding using eurobonds tackles a fundamental flaw in EMU's design: the fragmentation of markets.
- If fragmentation of national bond markets is not eliminated, EMU will remain vulnerable and may in the end not survive.
- Central funding bring advantages for all participating countries:
 - Deeper markets bring increased liquidity → lower funding costs
 - Weaker countries benefit from cross guarantee
 - Self-financing insurance mechanism → no need for additional rescue packages
- Cross-guarantee may initially bring a slight increase funding costs for Germany



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More information?

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