The ELEC "Euro T-Bill Fund"

A proposal for a two-year refinancing for all € bills/optional refinancing of bond maturities until 2015

27th January, 2012

This note updates the November 2011 proposal from some Members of ELEC in the light of the agreements made by the euro area Heads of State or Government (HOSGs) on 9 December, 2011, and subsequent discussions on a TREATY ON STABILITY, COORDINATION AND GOVERNANCE IN THE ECONOMIC AND MONETARY UNION. *ELEC has supported this report to assist discussion and it is issued by a number of members of the Monetary Panel of ELEC – acting in their personal capacity. It does not necessarily represent the official views of ELEC, or any of its members.*

Executive Summary

Our proposal is for a temporary "Euro T-Bill Fund" once the proposed "Treaty" on fiscal discipline is signed:

- After a euro area State's economic policies have been approved by ECOFIN in the European Semester as both economically effective and politically durable.
- Then all such States would pool all their short-term borrowing via a Fund that would only last four years. The Fund would borrow in the markets for, at most, a two year term – to match closely the borrowing profile of its client States.
- The borrowings of the Fund would enjoy a "joint and several" guarantee involving all participating euro area States.
- After the Fund's termination, each Member would have to borrow in the markets in its own name and on terms determined by its own credibility in the light of the success of its own reform programme.
- The fund's capacity would be large enough to fund for at least the next two years all the maturing bonds of euro area States that may temporarily be unable to access the capital markets on normal terms.
- Variable interest surcharges would be applied to those States that the Ecofin Council has determined to have an excessive deficit (i.e., to have breached the Stability and Growth Pact (SGP)); any money built up from these surcharges would be used as a "first loss" buffer and the unused buffer that could remain at the end of the Fund's life would be passed to the ESM for enhancing its capital base.
- Any revenue resulting from the implementation of euro area-wide taxes (such as the possible financial transaction tax) could be earmarked to build an additional cushion.
- States that became subject to sustained SGP sanctions would cease to be eligible to borrow further from the Fund in the future.

Our modest proposal is designed to provide a degree of mutual support that will be sufficient to allow adequate time to States that are themselves trying to restore their competitiveness and the sustainability of their public finances. Then they can demonstrate to their creditors that the first fruits of good policies are visible, and that the policies are entrenched into their political structure in a way that limits the risk of sudden reversal.

If the eurozone demonstrates that it is on track to meet these initial economic (and political) goals of renewed competitiveness and sound public finance, then its individual Members will have a compelling story to tell the investors of the world.

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Introduction

The euro area Heads of State or Government (HOSGs), at their 26 October 2011 Euro Summit, reaffirmed that the euro is at the core of the European project. They committed themselves to strengthen the economic union to make it commensurate with the monetary union. On 9 December, they made a series of historic agreements on (i) a new fiscal compact and strengthened economic policy co-ordination and (ii) a development of the two stabilisation tools, involving an acceleration of the ESM and some improvement to the EFSF.

We now propose a third stabilisation tool that will assist Member States who are experiencing the difficulties of higher interest costs, rather than needing an immediate financial rescue that might involve the need for funds from external providers such as the IMF. With such an anchor for a Member State's borrowing costs in the short-term, the ECB's Securities Market Programme could be left to run off as there would be no need to attempt to influence secondary market yields.

This report does not seek to debate the wider solutions to the current crisis. Instead, it focuses only on the narrow question of designing a third stabilisation tool: a temporary programme of issuance of "Euro T-Bills" that would achieve the practical objectives that might be expected if the political decision is taken in the near future to issue securities jointly. We consider such Euro T-Bills to be a step that merits serious consideration in the light of the European Commission's Green Paper. Such a Fund could be one component in solving the crisis, and encouraging the fiscal discipline and enhanced competitiveness that should prevent new ones in the future.

We propose to introduce joint financing of some public debt of euro area Member States for a period of four years through a Euro T-Bills Fund. This would be done via a completely simple, transparent fund so the fragmentation of the euro area's national public bond markets would start to be eliminated. This would be a step to strengthen the euro area's financial architecture to defend us better against financial crises – though only internally at this stage. But the difficulties that the US and Japan are experiencing in tackling their much bigger debt and deficit problems suggests it would be prudent to create such defences even today.

Essentially, there are three reasons:

1. To complement the existing package of measures (included in the 'six-pack') to strengthen fiscal discipline and competitiveness in the eurozone. Moreover, these are about to be re-inforced by the Commission's proposals of 23rd November – the "two-pack".
2. To protect euro area Member States from sharp swings in market sentiment that – through spill-over effects via highly integrated financial markets – hurt not only the 'weak' and 'misbehaved'. Member States of a monetary union issue debt in a currency over which they have no control. That is why they are so sensitive to movements of distrust that have self-fulfilling properties even though, i**n aggregate, euro area public finances are in relatively good shape. Moreover, the euro area's external balance is close to equilibrium, underlining that it does not need outside help.**
3. To create deeper markets in public securities of euro area States, bringing about increased liquidity and thus lower funding costs.

The introduction of Euro T-Bills will be based on the guarantees of all participating Member States for the Euro T-Bills Fund. The scheme has to be well designed, e.g. it should bring benefits for all States,

both weak and strong. Above all, it is essential to exclude risks of moral hazard. For that reason, we propose to start with Bills with up to two year maturity. Our concept is that the Fund would cease to issue new securities after four years. However, we would leave the door open to designing and implementing either a new temporary scheme or a more permanent mechanism in the light of experience and progress achieved towards a fiscal union. A future scheme could include longer maturity Euro T-Bills after fiscal discipline is demonstrably embedded in all euro area States. But the whole process must avoid moral hazard or the creation of a "transfer union" in the euro area.

Given the commitment to balanced budgets in the future, debt ratios should decline steadily though it will still be many years before the euro area average drops to the 60% goal. This proposal is entirely complementary to the European Redemption Fund proposal from the "German Council of Economic Experts"[1]. Our plan could well be seen as something of a limited – both in time and volume - experiment in joint and several liabilities. If all goes well during the limited life of our Euro T-Bills Fund, then Member States might have the confidence to go forward with much larger and long-lasing guarantees, if they were still felt necessary.

The combination of great liquidity and being the "safest" haven in the eurozone (reflecting the fact that the Fund's bills will be the only short-term haven) should make the Fund's yields close to the lowest of all so that most participating States would see an interest cost saving. Naturally, any solution to the crisis will automatically remove the current "safe haven" discount in German/Dutch yields. For Germany and the Netherlands, the real question is not a few basis points of interest cost on a small part of their debt but the economic benefits of a vibrant and transparent single market with over 300 million customers using the single currency so with no foreign exchange risk for doing business.

As the bills would be manifestly the best possible credit of the eurozone, they will have a high rating. For investors, the key will not be some commercial rating but the simple fact that these bonds would genuinely approach the "risk-free asset" concept that underpins current bank and insurance regulation. That risk assessment would flow from observation of economic reality, rather than the HOSGs/regulators statements. As such, they would be eligible collateral at the ECB and the NCBs of the Eurosystem and be a natural asset for banks to hold. Accordingly, they would be expected to be very actively traded and become the most marketable financial instrument in the eurozone, with ultimate liquidity flowing from both the short maturity and collective strength of the guarantors.

During the life of the Fund, there would be no doubt that all participating States would not experience any difficulty in rolling over maturing bonds at the very lowest interest costs, thus underpinning their debt dynamics. The Fund must be given enough headroom in size so that all bond redemptions and the deficits in the next four years could be accommodated, as well as maintaining the size of existing bill programmes.

Sixty years ago, Robert Schuman made his famous Declaration that "concrete achievements would build a *de facto* solidarity" Such a fund would be a concrete achievement and, indeed, an expression of solidarity amongst the euro area Member States. But solidarity is a two-way street. The stronger nations would support the weaker in return for the weaker undertaking reforms that should strengthen them in the future. If such a State resiled from its reforms, then correspondingly it resiles from any expectation of further support from the stronger.

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[1] [1] See: http://www.sachverstaendigenrat-wirtschaft.de/a-european-redemption-pact.html.

The Proposal

Objective

The proposed scheme should be seen as a way to stabilize the monetary union, strengthen monetary integration and complement the Treaty on the Functioning of the European Union (TFEU) and the SGP with both an incentive and disciplinary mechanisms – a powerful "carrot and stick" approach. **A key benefit of the whole scheme is that markets can be sure that, at a minimum, ALL bond maturities due in the next four years for participating States can be rolled over for two years at the lowest possible interest rate – as well as deficits.**

1. **Incentives:**
    - The ability to borrow at the then-lowest rate available in the euro area
    - The certainty of being able to borrow at all.
2. **Discipline:**
    - An interest rate surcharge for States in the Excessive Deficit Procedure;
    - Exclusion from new issuance for those subjected to continuing SGP sanctions.
3. **Pre-condition:** Signing of the TREATY ON STABILITY, COORDINATION AND GOVERNANCE IN THE ECONOMIC AND MONETARY UNION

Outlining the three Elements

1. **A new legal entity will be established** - initially by separate Treaty and perhaps ultimately through amendment of the Treaty on the Functioning of the European Union (TFEU). It shall be called the Euro T-Bills Fund and will finance a modest part of its Members' public debt.
2. **The Euro T-Bills Fund would function under guarantees from all its Members, and will finance itself by issuing short term "Euro T-Bills"**. Its bills would match closely the financing needs of the Members, so there would be no mismatch of assets and liabilities that might require financial engineering. It would be the epitome of simplicity and "plain vanilla" financing.
3. **Participating Member States would be subject to a graduated series of automatic sanctions** if their fiscal performance fell below target**.**

The Proposal in Detail

1. Borrowers

The only borrowers from the fund would be Members of the euro area not in receipt of special assistance and whose overall economic policies have been accepted by the ECOFIN - initially during the second European Semester in the first half of 2012. Such agreed economic policies should normally **entitle** a State to borrow from the EFSF - if needed due to market conditions. Our proposal assumes that ECOFIN will only accept policy proposals from States where it has also examined (and publicly explained) the political process that will ensure the policies are implemented - both effectively and durably. Borrowers from the Euro T-Bills Fund must not be subject to continuing sanctions under the SGP.

2. Initial Participation

In the light of the HOSGs agreement of 9 December, participation by all euro area Members is expected eventually but those three States in receipt of special assistance would not be eligible in the first instance. We believe it is essential that at least Germany and France participate at the outset, presumably with Italy and Spain. However, the strong assumption is that all euro area States would participate to gain maximum benefit. The initial launch should be accomplished quickly – preferably under the normal budget procedures of each Member State. But we recognise that lawyers may advise a more specific legal framework once the immediate crisis has passed that necessitates urgent action.

If a State fails to implement the agreed policies, the ultimate sanction is removal from the Fund. Of course, this is not a decision taken lightly and it is the intention to keep the group together. However, it would be quite understandable that the other euro area States would no longer be willing to offer any guarantees to a member that, after a significant period of intense advice and pressure from fellow euro area Ministers, fails to implement the agreed policies. The suspension of a State from the fund would be a very serious sanction for that State. However, contagion from such a step to other States will be minimal, given the fact that the others remain within their own cross-guarantee.

3. Treaty amongst the Members

There would be a Treaty between the eurozone Members to ratify the detailed arrangements so that the binding nature of the commitment is quite clear. This would be similar in nature to the original Schengen Treaty and might in the fullness of time be absorbed into the main Treaty on the Functioning of the European Union. It would commit Members to agree to use "enhanced co-operation" as necessary to enable the machinery of the European Union to be utilised to achieve financial and economic stability within the eurozone. This may require an amendment to Article 136 TFEU to allow further inner coordination among eurozone States than is thus far permitted.

But perhaps more usefully, any changes to the TFEU that are underway could also be used to clarify the position of this Fund under Article 125 – the "no bail out rule". A possible text for a third paragraph is set out below and the background is explained in some detail in Appendix II, with much further background in our original working papers.

'3. The joint and several guarantee by Member States, or of the Union, of the issuance of debt instruments by Member States whose currency is the euro, and the joint issuance of such debt instruments shall be permitted, provided this issuance ensures strict compliance by participating Member States to the prohibition of excessive government deficits.'

The founding document should provide for the exclusion of a Member/inclusion of a new Member so that the joint and several guarantees for subsequent issues would be crystal clear and legally water-tight so that investors would have no doubt about the ease of enforcing their claim.

4. Life of the Euro T-Bills Fund

The Fund will terminate after four years as that should have given weaker States some more breathing space. We expect that, during this period, Members should (i) get enough time to restore order to their public finances (i.e. restore market trust) and (ii) start seeing the positive effects of their structural reforms on their competitiveness. Depending on the issuance profile, it could be a further two years before the last obligations of the Fund are redeemed.

Euro area Members have decided to make far-reaching Treaty commitments about closer economic integration and financing, as well as agreeing to enact rapidly the Commission's November 23rd proposal (now dubbed the "two-pack"). This scheme builds on those solemn commitments. After the Fund's termination, each Member would have to borrow in the markets in its own name and on terms determined by its own credibility in the light of the success of its own reform programme.

If the experiment in policy reform supported by limited joint and several financial guarantees had proved successful, then the political leaders of the day could choose to renew the scheme for another period. They could broaden the experiment to start the European Redemption Pact, though that could happen at any stage.

5. Size and Liquidity

- **All participating Euro area Member States would be obliged to use the Euro T-Bill Fund** to finance all short term borrowings. Simply re-financing all such existing bills would give the Fund a €600 billion size.
- For example, if all the participants also re-financed the bonds maturing in 2012 and 2013 via the Fund, then its size would be just short of €2,200 bn, or 23% of the participants' GDP. (For reference, a corresponding re-financing by the US would be about 39% of its GDP)
- Naturally, all participants would also have the option of not using the facility to roll over maturing bonds. However, they would have to issue longer–dated bonds that would not compete with the Fund's short-term Bills. If Germany, France, Austria, Finland and Netherlands do not re-finance their maturing bonds in this way, then the ceiling could be under €1,500 bn – or 15% of all participants GDP.
- Financing of new deficits consistent with Treaty obligations would be permitted. However, the expectation is that future deficits will be modest.
- There are good reasons to expect that any State that can easily maintain its market standing in the longer term bond markets would certainly do so.

  i. First, it would be costly to re-build the investor base since economies that do not tap the market usually suffer from greater political instability. These economies are also more vulnerable to external shocks, so their incentive to maintain the access to credit markets is high.

  ii. Second, an excessive reliance on short term debt should be avoided so as to minimize the amount of debt that has to be rolled-over once the Fund has expired.

  iii. Third, convergence trades should also contribute to diminish the interest rates charged to peripheral States, thus making long-term issuance for beleaguered States a little more appealing. Once the market returns to levels consistent with debt sustainability, other investors will pump cash into the market.

  iv. Fourth, the mere fact of guaranteed market access through the Fund should reduce substantially the risk that the State is further downgraded by a rating agency, reducing the likelihood of additional outflows.

- The new Treaty proposes (currently in Article 6) that the Members report their debt issuance plans to the Commission in advance. This requirement will facilitate our plan as basic concepts of financial stability suggest that the maturity structure should be monitored to ensure that there is not an over-use of short term financing. Perhaps there should be a corridor with the bottom designed to ensure sufficient short term paper to guarantee great marketability. Breach of the upper boundary of the corridor would give a warning signal about a Member's finances – or the market's perception of rising longer term risks.

- The data in Appendix III show that the gross annual issuance is likely to be well over €1000 bn so there should be no doubt at all about the marketability of the securities. Moreover, the short maturities make them inherently liquid. We expect that many "primary dealers" in Member State's sovereign debt would be attracted to become dealers in these new securities.
- We expect that the Fund's securities would be classed as "zero risk weighting" if held by banks and insurance companies – under CRD IV and Solvency II. There should be no impediment to them being held by UCITS, especially money market funds. If any regulatory restrictions are discovered, then the European political institutors have the capability to remove impediments very rapidly.

6. Up to two-year Issues

The Fund would issue bills with up to two year maturities. Each security issued by the Euro T-Bills Fund would be a "full faith and credit" obligation of the Fund and thus undoubted falling under a full guarantee from all participating euro area Member States.

On a technical note, issues for less than one year might take the traditional form of a discount bill. Longer dated issues could take the form of a security with a coupon. But the Fund manager would respond to market requests about the optimum format.

The maximum maturity of two years should be seen as a protection for the guarantors. If a State failed to honour its commitments in such an egregious way that other Members felt obliged to exclude it from future borrowings, then their guarantees would expire at the latest in two years.

At the end of the four-year life of the Fund, all euro area States should have complied with their Stability Plans (to be approved in the 1H 2012 European Semester) and be well on the way to drastically reduced deficits. Moreover, they should have fulfilled their commitments to insert a "constitutional" type of balanced budget rule. That combination should enable them to borrow for much longer maturities at sensible rates.

7. Interest Rate payable by the Member States to the Fund

The normal interest rate payable on loans to participating euro area States would be the Fund's own cost of borrowing plus a fee to cover the administration costs. Such an interest rate will not trigger an unsustainable surge in borrowing costs. Indeed, for many States it will offer a significant benefit. However, we propose that there will be surcharges for States that are running an excessive deficit (under the Excessive Deficit Procedure - as determined by the ECOFIN Council pursuant to the TFEU and the Stability and Growth Pact (SGP)). – see paragraph 9 below.

8. Guarantees

- **Recent experience has proved that partial guarantees do not work. It is essential that the Euro T-Bills Fund would be the subject of joint and several guarantees of all the participants order to realise the full advantages of the scheme.** Only then the average figures become relevant and EMU can benefit from the simple fact that it is financially stronger than the other major developed economies. We believe that the historic agreement by the euro area HOSGs on December 9th 2011 now makes this a politically feasible proposal, given the time and volume limits of the Fund.
- Under international law, once the euro area participating States sign the Treaty – currently expected in early March – they are bound to one another to bring the Treaty into operation, subject to ratification. Accordingly, this simple fund can be started up swiftly on that basis, and bring immediate relief for many States. If a State later fails to ratify the Treaty, then it would be excluded from further borrowing from the Fund and the provisions for excluded Members would be used to modify the guarantees for the future.
- Once a Member State decides to participate in the guarantees, it is not possible to abandon those guarantees on existing issues if it were excluded from future issuance. If a State were suspended from access to the Fund, then a new series of bills would be initiated after such a suspension with the new pool of guarantors.

9. Penalties and Sanctions

a. *Interest rate surcharge:* **Participating States would pay a surcharge to the fund that increases when they are in "excessive deficit"** - as determined by the ECOFIN Council pursuant to the TFEU and the Stability and Growth Pact (SGP). As many States are presently subject to SGP requirements for improvement and they would be subject to a variable surcharge. These surcharges will be based

on an automatic formula and not be subject to any negotiation. States entering the scheme should agree up-front to the surcharge mechanism pay an interest rate to the central agency ('the Fund') that is composed of the following component:

1. The borrowing costs of the fund in the market
2. A fixed fee of 2 basis points to cover operational expenses of the fund
3. A variable surcharge which vary with the relative performance of the State concerning its public finances. **But this element will have to be based on a simple straightforward formula.**

Some initial thoughts on the mechanics of the surcharge are set out in Appendix IV. These surcharges would be used to create buffers in the fund and act as an insurance premium against future financial problems -a "first loss" buffer. The capital remaining at the end of the Fund's life would be passed to the ESM for addition to its capital base.

b. ***Exclusion:*** A State may be suspended from the arrangement if it fails to continue meeting the criteria for participation – having its economic policies accepted by the Eurogroup (see Section 1 above). Presumably, the State would not then be eligible for funding from the EFSF (or the ESM if it were operational at that stage). So the Eurogroup would already have taken the effective decision to push that State to the very brink.

   That step would be a political choice, but one that would have enormous implications for the application of market discipline as bond buyers would have received a very powerful signal about the potential borrower's creditworthiness. The euro area would then be in roughly the same position as today if a major State were to be at imminent risk of default. However, give the simple fact that the other States remain within their own cross-guarantee; the potential for contagion is minimized. Moreover, the euro area would have provided a four year period of grace for the State to put its house in order. If it has failed to take the opportunity, then default was inevitable anyway.

   To re-iterate our introductory comments: the Euro T-Bills Fund would be an expression of solidarity amongst the eurozone Member States, but solidarity is a two-way street. The stronger nations would support the weaker in return for the weaker undertaking reforms that should strengthen them in the future. If such a State resiles from its reforms, then correspondingly it resiles from any expectation of further support from the stronger.

10. Administration

This would be provided jointly by the debt offices of participating States – modelled along the lines of the Euro System of Central Banks. Supervision, calculation of the surcharges and balance sheet management of the system will take place at the central level in the Euro T-Bill Fund, but would be mainly a light, co-ordinating role that could be supplied for example by the European Commission's Finance Office in Luxembourg.

Timeline of Political and Fund Developments: Three Scenarios

Date	Euro T-Bills Fund	Political Developments
2012		
Feb	ECOFIN requests Commission to flesh out the idea, and Commission to prepare the technicalities of administration	
March	• EBA, EIOPA, ESMA confirm that the Fund's securities would be eligible for 0% risk weighting and no obstacles for EU investors to purchase. (If any difficulties, Commission to propose rapid legislation to remove them) • ECB confirms repo eligibility on "best terms"	HOSG sign new Treaty [and send to European Parliament: for consent to avoid an IGC, or for agreement - depending on type of Treaty]
April	2nd European Semester (2ES) approves Stability Plans (SPs) of Germany, France, Netherlands, Austria, Finland and Luxembourg.	National Parliaments of the participating States approve time and volume limited "joint and several" guarantees for the Fund.
May	Euro T-Bills Fund launched – to expire mid - 2016	A required minimum number of Member States have ratified Euro T-Bills Fund agreement – Fund is established
June	2ES: ECOFIN approves remaining SPs of participating States	European Parliament approves the new Treaty, if necessary - national ratifications to be completed for entry into force 1 January 2013
July	First series of bills issued on behalf of all participants – including an Italian bond maturity refinanced for 21 months. The launch must be subject to the requirement for a quorum of Member States to have ratified the Treaty.	
Autumn	Full array of bills/bonds issued	
Dec	• Euro T-Bills Fund exceeds €400 billion outstanding (€300 bn of bills of participants corresponding to half of the year + at least €100 bn of 2-yr bond maturities and all the deficit funded through the Fund) • Arbitrageurs have brought interest rates down for all MS at the short end of the yield curve.	

Scenario I : Good news		
2013		
Spring	3 ES: ECOFIN approves SPs of all participants and none subject to SGP sanctions	
Dec	Euro T-Bills Fund could exceed €1 trillion outstanding as Italian/Spanish maturities are re-financed	
2014		
Spring	• 4ES: ECOFIN approves SPs of all participants and none subject to SGP sanctions • Commission Spring forecasts show growth firmly established as improved competitiveness of participating States shows through clearly. Debts ratios declining noticeably	
March		Spring HOSG Summit: In light of the good developments, Euro T-Bills Fund could become permanent and maturities could even be extended to [5 years]
May	Second anniversary of Fund	
June	ECOFIN sets new rules to encourage restoration of longer debt structure of MS	
During the year	Ireland and Portugal cease to be recipients of aid and become eligible to borrow via Fund	

Scenario II: Some Difficulties Persist		
2013		
Spring	3 ES: ECOFIN approves SPs of most participants but say [Italy] subject to mild SGP sanctions	
During year		Ratification of new Treaty not yet complete
Dec	Euro T-Bills Fund exceeds €1.5 trillion outstanding as Italian/Spanish maturities [+others?] are re-financed	Ratification deadline missed
2014		
Spring	• 4ES: ECOFIN approves SPs of most participants but say [Italy] still subject to significant SGP sanctions • Commission Spring forecasts show growth firmly established in most States as improved competitiveness of participating States shows through but concerns remain about [Italy]	
May	• Second anniversary of Fund • Italy rolls over its initial bond refinancing for 24 months	Treaty in force a year late
June	All MS except [Italy]are able to fund longer terms bonds at “normal” yield spreads	HOSG decide that Fund should terminate on schedule in May 2016 – unless all participating MS are cleared to use it by then.
July	• New bills only permitted that mature before May 2016 • Effectively [Italy] put on notice that bigger effort required or it will lose access to the facility in May 2016 • [Italy] re-doubles efforts	
2015		
Spring	• 5ES: ECOFIN approves SPs of all participants and none now subject to SGP sanctions • Commission Spring forecasts show growth firmly established as improved competitiveness of participating States shows through clearly. Debts ratios declining noticeably	
March		Spring HOSG Summit: In light of the good developments, Euro T-Bills Fund could become permanent and maturities could be extended to [5 years]
May	Third anniversary of Fund	
June	ECOFIN sets new rules to encourage restoration of longer debt structure of MS	

Scenario III: Worst Case		
2013		
Spring	3 ES: ECOFIN approves SPs of most participants but say [Italy] subject to mild SGP sanctions	
During year		Ratification of new Treaty encounters substantial difficulties
Dec	Euro T-Bills Fund exceeds €1.5 trillion outstanding as Italian/Spanish [+others?] maturities are re-financed	
2014		
Spring	• 4ES: ECOFIN approves SPs of most participants but say [Italy] now subject to maximum SGP sanctions • Commission Spring forecasts show growth firmly established in most States as improved competitiveness of participating States shows through but great concerns about [Italy]	
May	• Second anniversary of Fund • [Italy] rolls over its initial bond refinancing for 24 months • [Italy] now excluded from future borrowings from Fund	
June	All MS except [Italy]are able to fund longer terms bonds at “normal” yield spreads	• HOSG decide that Treaty cannot be ratified. • Fund should terminate on schedule in May 2016 – unless all participating MS are cleared to use it by then. • Require all financial institutions to take account of the problems of [Italy]
July	New bills only permitted that mature before May 2016. Member States may re-start some borrowing in own name.	
2015		
Spring	5ES: ECOFIN approves SPs of all participants except [Italy] – which remains excluded from borrowing from Fund	
March		Spring HOSG Summit: Recognised extreme seriousness of situation in [Italy]
May	Third anniversary of Fund	
2016		
April	Recognition that: • all participating States except [Italy] are able to borrow from markets on normal terms • That [Italy] will choose to default on [50%] of its [€600 bn] obligations to the Fund • **That the guarantors collectively will have to pay [€300 bn] to cover maturities.**	

Appendix I: About ELEC

ELEC is a network of European entrepreneurs of goodwill, aimed at putting timely intellectual pressure on European decision makers to further economic integration in Europe. It acts in complete independence from national or private interests, public authorities or any pressure group.

Established in 1946, ELEC was one of the founding Members of the European Movement in 1948. Its mission includes the mobilisation of its Members in support of projects that embody the European common interests through the circulation of information, the organization of debates and the publication of papers on important European themes.

ELEC is built as a federation of national sections present in a number of European States. The Membership of its national sections is drawn largely from economic and financial circles; but it also maintains close contacts with senior national and European civil servants as well as academics and policy makers, whose expertise and influence stimulate the exchanges and broaden their scope and quality.

NOTE: ELEC has supported this report to assist discussion and it is issued by a number of Members of the Monetary Panel of ELEC – acting in their personal capacity. It does not necessarily represent the official views of ELEC, or any of its Members.

Appendix II: Legal constraints for joint issuance of Euro T-bills?

(For detailed discussion, please contact Professor René Smits rs@renesmits.eu)

Article 125 Treaty on the Functioning of the European Union (TFEU)[*] excludes liability for the debts of another Member State. Among the provisions underlying the 1990s thinking behind EMU, the 'no bailout clause' makes public authorities of the Member States rely on markets for funding deficits. It is intended to enforce market discipline on governments. Joint issuance of Eurobonds - or Euro T-Bills - sits uncomfortably with the no bailout clause.

The realisation that the 1990s Treaty provisions did not properly address a situation in which the stability of the euro area as a whole would be in danger because of excessive deficits of individual States, led Member States to establish two 'rescue funds', the EFSF and the EFSM. The establishment of the ESM, the successor to these funds, will be given firm legal footing through the introduction of a new TFEU provision which specifically permits its establishment by Euro Area States. Article 136 TFEU will be amended by the addition of a third paragraph, reading as follows:

'The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality.'

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[*] ***Article 125***

(ex Article 103 TEC)

1. The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

2. The Council, on a proposal from the Commission and after consulting the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 123 and 124 and in this Article.

Member State practice during the evolution of the sovereign debt crisis has been evidence of a less strict interpretation of Article 125 TFEU than previously adhered to. This means that joint issuance of Eurobonds or Euro T-bills must not necessarily be considered to be in direct conflict with Article 125 TFEU.

In the interests of legal certainty, and to avoid any potential conflict with the interpretation of EU law by national constitutional courts, it would be preferable to add a third paragraph to Article 125 TFEU, as well, reading as follows:

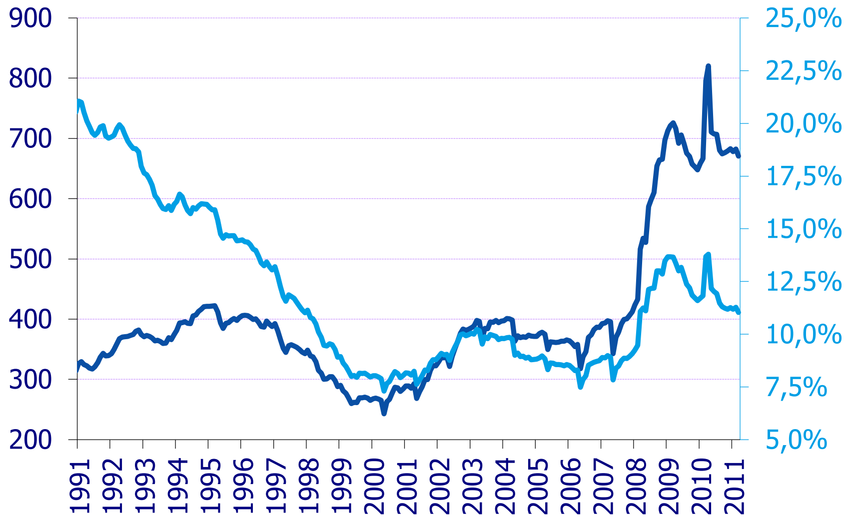
'3. The joint and several guarantee by Member States, or of the Union, of the issuance of debt instruments by Member States whose currency is the euro, and the joint issuance of such debt instruments shall be permitted, provided this issuance ensures strict compliance by participating Member States to the prohibition of excessive government deficits.'

The Treaty amendment undertaken in preparation for the establishment of the ESM, and the constitutional changes envisaged to embed fiscal discipline in national legislation provide a golden opportunity to introduce an additional Treaty amendment and, thereby, to discard any doubts on the legality of the issue of Eurobonds and Euro T-Bills.

René Smits (Professor of the Law of the Economic and Monetary Union, University of Amsterdam), 22 January 2012

[For a more elaborate discussion of the legal constraints for the joint and several guarantees between Member States, and for the issuance of Eurobonds or Euro T-Bills, see the Outline of the legal chapter on Eurobonds, 21 November 2011, written for *An "EMU Bond Fund" Proposal*, 21 November 2011, available at: [**add website**].]

Appendix III: History of short-term debt issuance in euros (Source: ECB)



Source: ECB

Source: ECB

Appendix IV: the Surcharge Mechanism

(For detailed discussion, please contact Wim Boonstra: W.W.Boonstra@rn.rabobank.nl)

States that borrow under the proposed Euro T-bill programme pay an interest rate to the central agency ('the fund') that is composed of the following component:

4. The borrowing costs of the fund in the market
5. A fixed fee of 2 basis points to cover operational expenses of the fund
6. A variable surcharge which vary with the relative performance of the State concerning its public finances.

The surcharge as mentioned under 3 will have to be based on a simple straightforward formula such as the following.

R(i) = α [DEF(i) - DEF(m)] + β [DEBT(i) –DEBT(m)]

Where:

- R(i) = the margin payable by State i over the funding costs of the EMU fund
- DEF(i) = the government deficit of State i, as a % of GDP
- DEBT(i) = the government debt of State i, as a % of GDP
- The variables DEF(m) and DEBT(m) represent the SGP criteria for government deficit (3%) and government debt (60%)
- 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.

Under this formula, a State will pay a surcharge if its public deficit and/or its public debt exceed the SGP ceiling. It is essential that this formula is fixed ex-ante and so is not subject to ad hoc negotiations. States that participate in the scheme will have to agree ex-ante to pay the surcharge without renegotiations.

As said, the parameters α and β are coefficients that determine the size of the surcharge and the relative weight of the performance on government deficit and government debt respectively. The value of these parameters is rather arbitrary and should be fixed before the scheme can start. The following considerations are of importance:

1. The size of the surcharge should be sufficient to play a constructive role in disciplining policymakers
2. States participating under the scheme should on the whole be better off inside than outside
3. The surcharge should above all be sensitive for changes in public deficits. In that case, both deteriorations and improvements quickly translate into increases or declines respectively in the surcharges - giving the right incentives to policymakers.
4. The total of paid surcharges should be substantial enough to create over time a sizeable financial buffer. This should be large enough to deal with States facing serious problems with their public debt.

Obviously, variables can be added to this equation, such as the level of public investment, the share of the public sector in the economy and balance of payments indicators like the current account balance. However, as the scheme aims at consolidating public finances, it makes sense to keep it as simple as possible and link it directly to the criteria from the SGP. Moreover, the attraction of the variables

selected here is that they do justice to both current developments (relative performance on government deficit) and the legacy of the past (existing government debt).

Just for illustration, we have calculated two surcharge scenarios for the years 2000 – 2010. In scenario 1, the calculation of the surcharge is relatively heavily based on the debt level and to a lesser extent on the deficit. In scenario 2, the debt parameter is halved, but the deficit parameter is increased by 50%. As a result, in the second scenario the average spread is substantially lower but much more sensitive for changes in the deficit. This scenario may be more effective in disciplining policymakers.

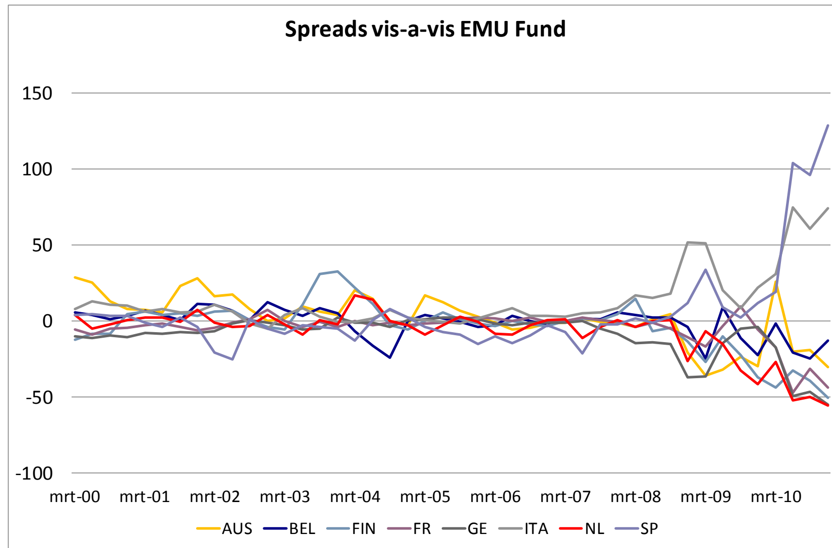
If we compare the average surcharge of the individual States during this period with the actual spread over a synthetic 2 year Euro T-bill rate (calculated as the debt-weighted average of 2 year government bond yield of the participating States) it becomes clear that the average surcharge is higher than the actual spreads (see table). This is partly due to the fact that the actual spread also can have negative values, which the surcharge by definition cannot. The picture will certainly be different if we could include 2011 in the analysis, which unfortunately is not possible. This is due to lack of data at the time of writing. However, if we take into account that the issues of Euro T-bills will benefit from their huge liquidity and include a liquidity effect (LE) premium of just 25 basis point, all States are better off using central funding.

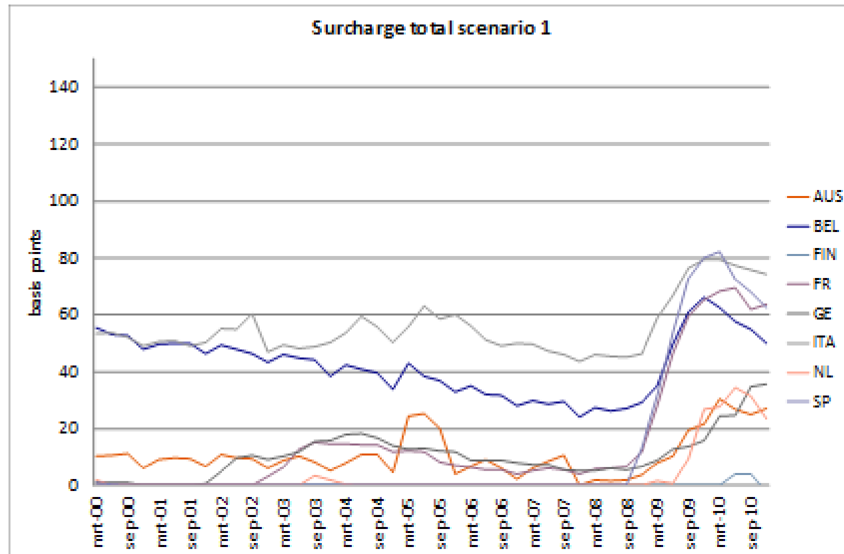
Summary table

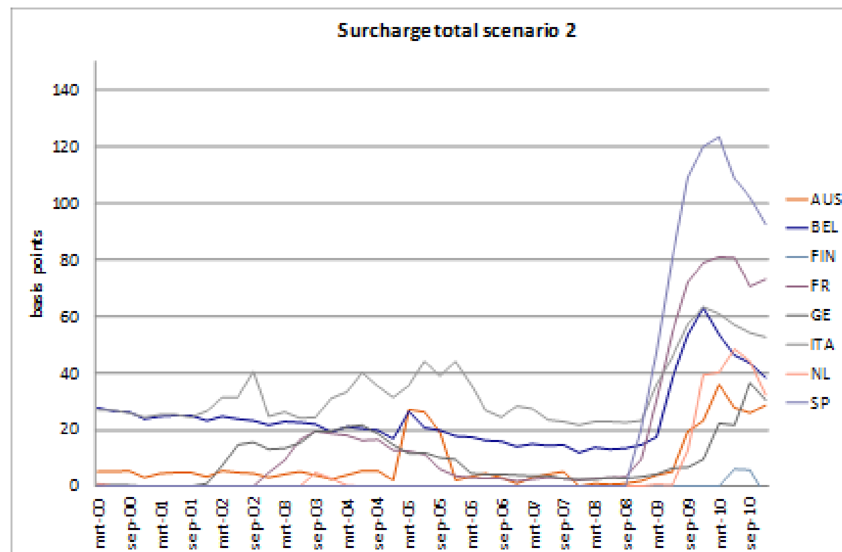
	AUS	BEL	FIN	FR	GE	ITA	NL	SP
average spread on 2 year bonds	2	-1	-4	-5	-10	13	-8	6
average surcharge scenario 1	11	42	0	16	11	56	4	12
average surcharge scenario 2	8	24	0	17	10	34	5	18
average surcharge scenario 1 incl LE	-14	17	-25	-9	-14	31	-21	-13
average surcharge scenario 2 incl LE	-17	-1	-25	-8	-15	9	-20	-7

The following figures compare the surcharges with the actual spreads over time. Next, the composition of the surcharge is illustrated for both scenarios. Off course, these are just examples for illustration and any other scenario can be chosen, as long as it deals with the considerations above and it is fixed ex-ante. Setting the parameters α and β will therefore also to a large extent be a political process. But this process has to be non-recurrent and take place at the inception of the fund. After initial setting, computing the spread is a straightforward process of calculation. Again, this is an improvement over the current situation in which every breach of the European budget agreements leads to new negotiations.

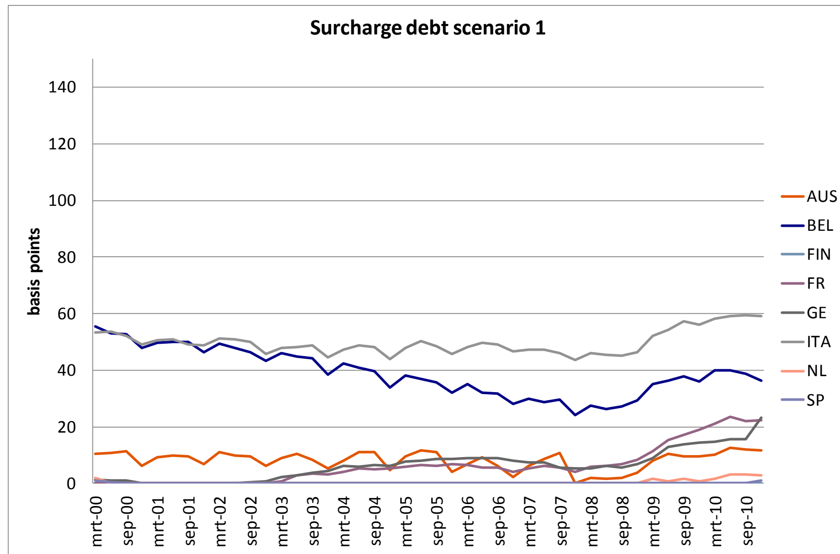
Two surcharge scenarios compared with market spreads 2000 – 2010

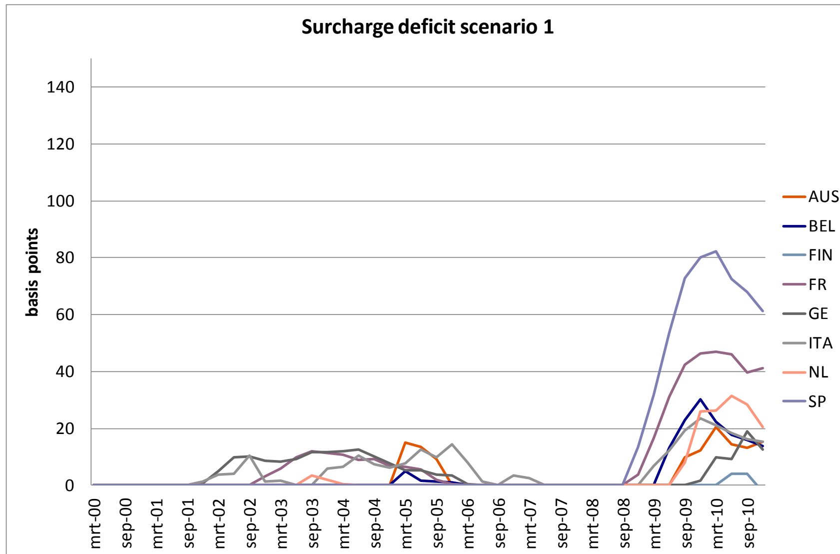


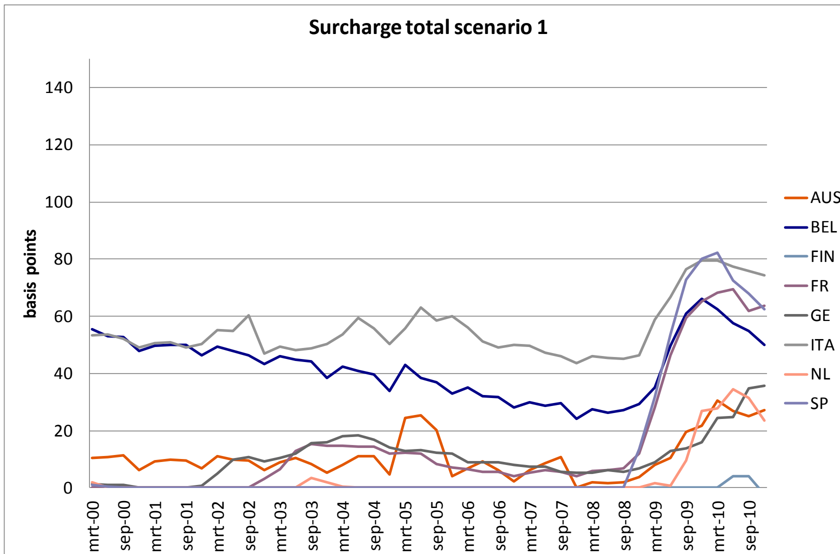




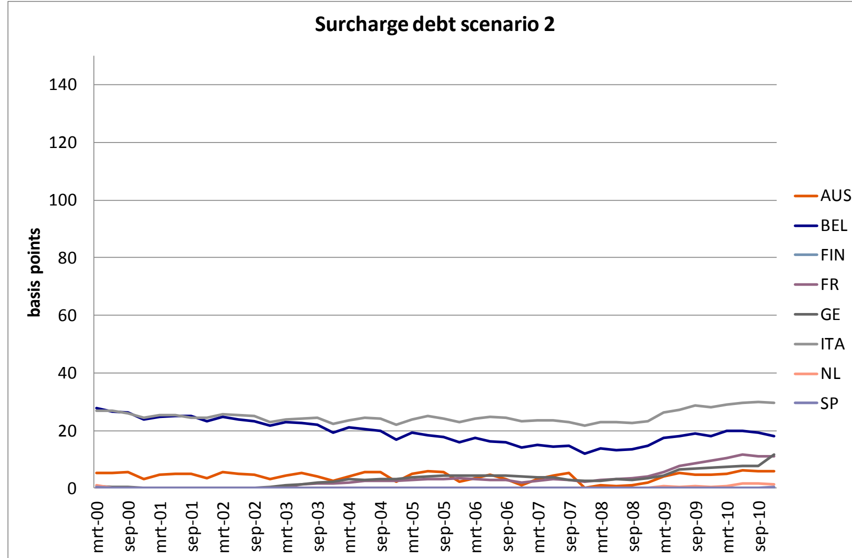
Scenario 1: α = 0, 10 and β = 0,010

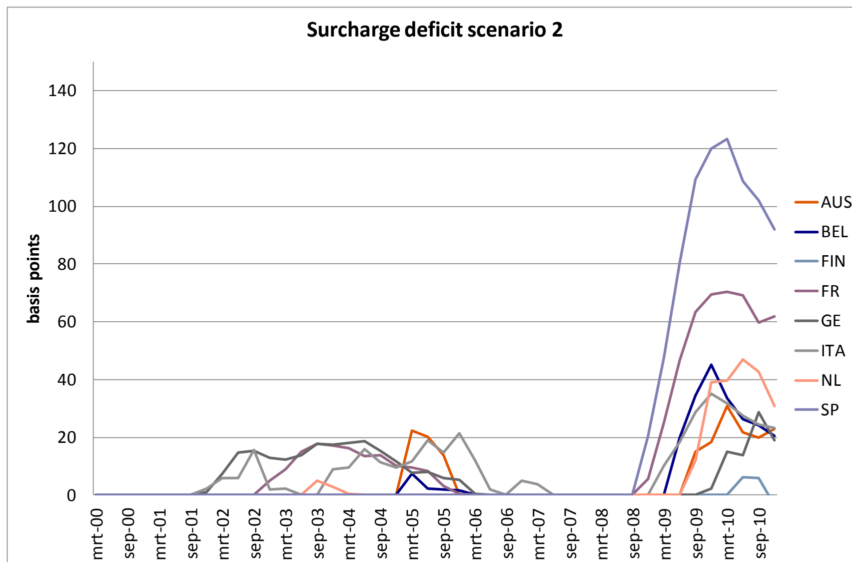


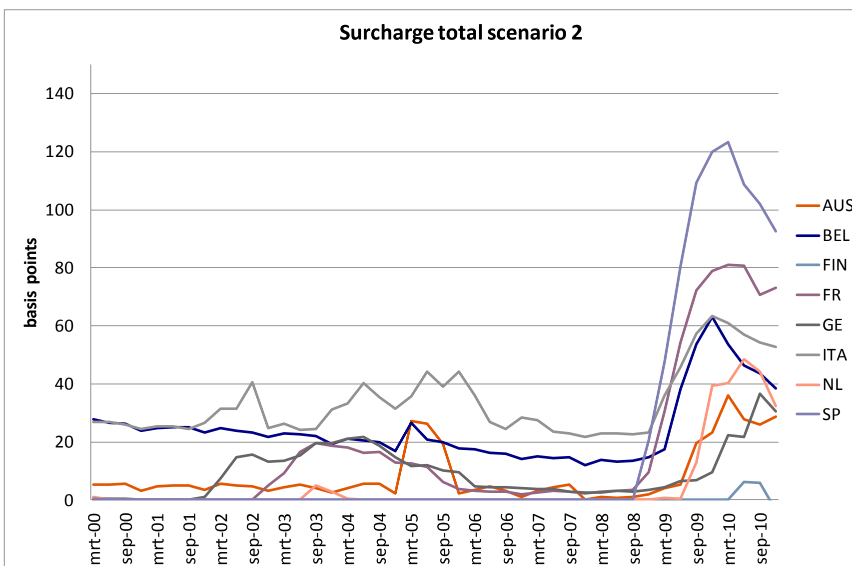




Scenario 2: α = 0, 15 and β = 0,005







Appendix V: Participants in the Working Group

All Members participated in their personal capacity and do not represent the views of their institution. Naturally, not all Members agree with every aspect of the scheme. We are grateful to others who contributed to the discussions and provided illuminating insights.

The participants came from Austria (Franz Nauschnigg, OeNB), France (René Karsenti, ICMA), Spain (Nicolás Trillo Ezquerra, BBVA), UK (Graham Bishop) and the Netherlands (Niels Gilbert, DNB; René Smits, University of Amsterdam; Wim Boonstra and Shahin Kamalodin, Rabobank; Marko Bos, European Movement, Netherlands; Alman Metten, former MEP.)

Wim Boonstra acted as Chairman and Graham Bishop as Rapporteur.

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