

**PREVENTING THE RISE OF SOVEREIGN BORROWING COSTS
IN THE EUROZONE:
WHAT CAN THE ESM AND THE ECB ACHIEVE?**

EGMONT PAPER 56

**PREVENTING THE RISE OF SOVEREIGN
BORROWING COSTS IN THE EUROZONE:
WHAT CAN THE ESM AND THE ECB ACHIEVE?**

XAVIER VANDEN BOSCH



November 2012



ACADEMIA PRESS

The Egmont Papers are published by Academia Press for Egmont – The Royal Institute for International Relations. Founded in 1947 by eminent Belgian political leaders, Egmont is an independent think-tank based in Brussels. Its interdisciplinary research is conducted in a spirit of total academic freedom. A platform of quality information, a forum for debate and analysis, a melting pot of ideas in the field of international politics, Egmont's ambition – through its publications, seminars and recommendations – is to make a useful contribution to the decision-making process.

* * *

President: Viscount Etienne DAVIGNON
Director-General: Marc TRENTESEAU
Series Editor: Prof. Dr. Sven BISCOP

* * *

Egmont – The Royal Institute for International Relations

Address Naamsestraat / Rue de Namur 69, 1000 Brussels, Belgium
Phone 00-32-(0)2.223.41.14
Fax 00-32-(0)2.223.41.16
E-mail info@egmontinstitute.be
Website: www.egmontinstitute.be

© Academia Press

Eekhout 2
9000 Gent

Tel. 09/233 80 88

Fax 09/233 14 09

Info@academiapress.be

www.academiapress.be

J. Story-Scientia NV Wetenschappelijke Boekhandel

Sint-Kwintensberg 87

B-9000 Gent

Tel. 09/225 57 57

Fax 09/233 14 09

Info@story.be

www.story.be

All authors write in a personal capacity.

Lay-out: proexsmaes.be

ISBN 978 90 382 2058 1

D/2012/4804/254

U 1938

NUR1 754

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without the permission of the publishers.

Table of Contents

List of abbreviations	3
Introduction.....	5
1. Evolution of sovereign borrowing costs in the eurozone: a broad diagnostic	7
2. Principles of a preventive intervention in sovereign bond markets ..	11
2.1. Main benefits	11
2.2. Intervention mechanisms: primary and secondary market purchases.....	13
2.3. Economic rationale: what justifies intervening in sovereign bond markets?.....	15
A. The uncertainty about the solvency of a country	15
B. The dynamic of self-fulfilling fears of insolvency.....	16
C. Added uncertainty stemming from the ‘incomplete’ EMU.	17
D. Critique of rationale and conclusion	18
2.4. Problems and concerns: moral hazard and stigma of assistance	19
3. Preventive intervention of the ESM in primary and secondary markets	21
3.1. Main characteristics and functioning of the ESM	21
A. Functioning principles.....	21
B. Guarantee structure.....	22
C. Capacity	24
3.2. Precautionary financial assistance and secondary market interventions	25
A. Instruments	25
B. Conditionality.....	26
C. Procedure	28
D. Intervention capacity.....	29
E. Monitoring	30

4. Conditional secondary market interventions of the ECB	33
4.1. Outright Monetary Transactions.	33
4.2. Limits of secondary market purchases by the ECB	35
5. Preventive strategy: combined interventions by the ESM and the ECB	37
5.1. Design overview	37
5.2. Mitigating the risk of non activation of the preventive strategy	39
A. Overview.	39
B. Recommendations.	40
6. Eurobonds as additional instruments to prevent the rise of borrowing costs?	43
6.1. A definition of Eurobonds.	43
6.2. Economic and political issues	44
A. Redistribution effects.	44
B. Joint and several guarantees issue	46
6.3. Why Eurobonds are not a viable short term response	47
Conclusion.	49
ANNEX I: Overview of EFSF/ESM precautionary assistance instruments.	51



LIST OF ABBREVIATIONS

ECB	European Central Bank
ECCL	Enhanced Condition Credit Line
EDP	Excessive Deficit Procedure
EFSD	European Financial Stability Facility
EIP	Excessive Imbalance Procedure
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
FFA	Financial assistance Facility Agreement
IMF	International Monetary Fund
MoU	Memorandum of Understanding
OMT	Outright Monetary Transactions
PCCL	Precautionary Conditioned Credit Line
PFA	Precautionary Financial Assistance
PMSF	Primary Market Support Facility
SGP	Stability and Growth Pact
SMSF	Secondary Market Support Facility
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

INTRODUCTION

The divergence in the interest rates on sovereign bonds of eurozone countries has drawn much attention in the course of the eurozone crisis. While Greece, Portugal and Ireland lost market access early in the crisis and requested financial support, other fiscally vulnerable countries periodically see their yields approach levels deemed unsustainable. In particular, the evolution of Spain's and Italy's borrowing costs repeatedly raises much concern as these countries are generally considered 'too big to rescue'. Hence, the fate of several countries – and that of the euro – seems to hang on market views of their sustainability.

These obvious risks called for a more preemptive approach to the crisis management. It was first recognized that the rescue funds, the temporary European Financial Stability Facility (EFSF) and the permanent European Stability Mechanism (ESM), should be able to act 'ex-ante' and not 'only ex-post' i.e. before and not only after a country has effectively lost market access. Consequently, a eurozone country can now in principle request precautionary financial support from the ESM in order to prevent having to deal with refinancing difficulties in the future. Moreover, by announcing 'Outright Monetary Transactions' (OMT), the European Central Bank (ECB) committed itself to granting unlimited support to countries having first obtained the EFSF/ESM's financial assistance. Finally, despite strong opposition by some Member States, proposals for Eurobonds are being pushed forward, most notably to reduce the spread of interest rates in the eurozone.

This paper focuses on the possible instruments for 'ex-ante'/'preventive'/'precautionary' interventions which can be deployed by the ESM and the ECB in order to prevent a debt crisis in a eurozone country. The potential of Eurobonds will also be discussed in this crisis management perspective.

The first part of this paper traces the underlying trends of the evolution of interest rates in eurozone countries over the last decades. The second part discusses the principles of a preventive intervention in sovereign bond markets for the purpose of lowering borrowing costs of countries facing refinancing constraints; the limits and main issues of an ex-ante intervention will be underlined. In the third part, the properties of the ESM's precautionary financial assistance and secondary market support facility will be discussed in details. The ECB preemptive intervention policies and, in particular, the OMT will be analyzed in the fourth part of the paper. The most likely course of action – a combined intervention by the ESM and the ECB – will be discussed in the fifth part. Finally, I will point out the core challenges of introducing Eurobonds as additional instruments to mitigate the rise of borrowing costs in the short term.

Xavier VANDEN BOSCH
Research Fellow, Europe Programme, Egmont

1. EVOLUTION OF SOVEREIGN BORROWING COSTS IN THE EUROZONE: A BROAD DIAGNOSTIC

Following the Maastricht Treaty which set the course for the introduction of the Economic and Monetary Union (EMU), sovereign yields of future eurozone members converged to reach low levels by the time the euro was introduced in 1999 (see figure 1). In retrospect, this convergence appears excessive. A first possible explanation is that financial markets simply underestimated or failed to acknowledge the risks of growing imbalances in several countries. Neither did the market react to growing fiscal imbalances, nor to the deterioration of competitiveness in several ‘peripheral’ countries (e.g. in Italy, Spain, Portugal, Greece, Ireland). However, this might only seem obvious *a posteriori*: current account deficits were justified in so far as the mirroring private capital flows were believed to be financing productive investments rather than unsustainable consumption and real-estate booms. More generally, conventional wisdom at the time was that balance-of-payments were as irrelevant in the EMU as between regions within a country¹.

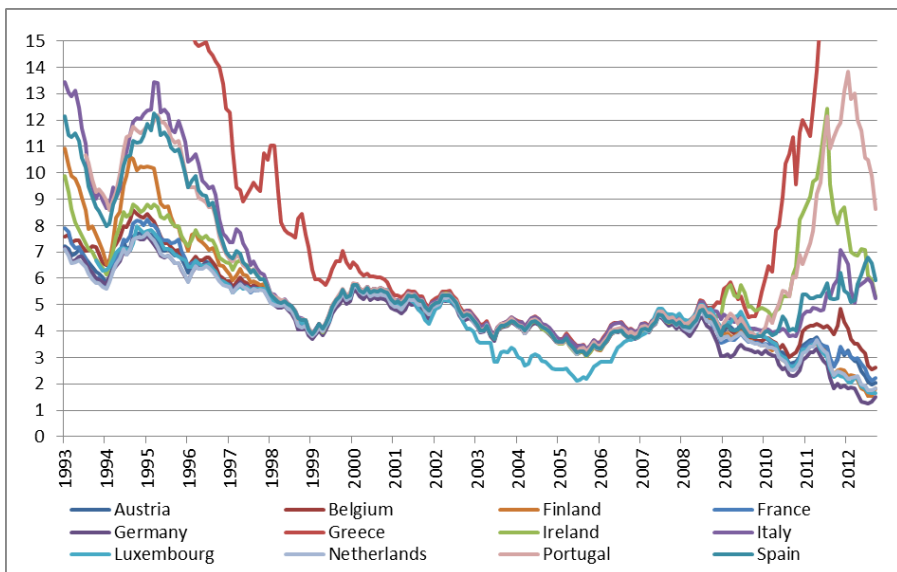


Figure 1: Evolution of 10 years government bonds' yields in the eurozone (selected countries) (in %)

1. Merler, S., Pisani-Ferry, J., (2012), "Sudden stops in the euro area", Bruegel policy contribution, Issue 2012/06, March 2012.

A second possible source of explanation for the lack of market reaction to these growing imbalances is that a genuine belief existed that a eurozone country could not fail on its debt because of implicit guarantee mechanisms within the currency area. In particular, the ‘no bail-out’ clause in the Treaty might not have been perceived as fully credible². Investors could also have believed that the ECB would ultimately stand behind eurozone countries’ debt despite its statutory prohibition to do so³. Financial markets regulation and ECB policies also tended to consider all EU sovereign bonds as equally safe⁴.

Whatever the exact explanation for the market’s complacency in the last decade, when the global economic and financial crisis hit the eurozone, excess of indebtedness and the unsustainable character of growth were revealed and accentuated. In southern eurozone countries, external economic imbalances that had built up since the introduction of the euro further accelerated due to ‘sudden stops’ i.e. massive reversals of capital inflows⁵. Economic recession and in several cases the rescue of the domestic financial sector led to an important deterioration of public finances. Sizable deficits in turn further increased debt levels. By the time the problems faced by Greece became obvious a major shift in the eurozone sovereign bond market had taken place: government bonds’ yield started to rise, incorporating the risk of default of countries which had by then lost their safe status. This ultimately led Greece, Ireland and Portugal to require a bail-out from their eurozone partners and the IMF.

At the time of writing, the market can infer from the lack of competitiveness and structural problems of several vulnerable countries that they risk not being able to adjust and redeem their debt denominated in euro, a *de-facto* foreign currency that is too expensive for their economy. Economically, socially and politically, the required internal devaluation and the burden of structural reforms might be judged too harsh. If so, it can be anticipated that public debt will ultimately be restructured: a loss imposed on private bond holders (via an ‘orderly default’ similar to the one that took place for Greece). Alternatively, a ‘disorderly default’ could also occur if some countries left the euro, restored their national currency and redeemed their debt now denominated in a devaluated currency. Hence, the general assumption that eurozone countries could not default was reversed and the irreversibility of the euro as a common currency is now doubted by the market.

2. Article 125 of the Treaty on the Functioning of the European Union, hereinafter TFEU.

3. Article 123 TFEU.

4. Financial regulation and ECB policies did not discriminate among government bonds: all were deemed as equally ‘safe’. See Kopf, C., (2011), “Restoring financial stability in the euro area”, CEPS policy brief, No 237, 15 March 2011.

5. Op. cit. footnote 1.

Consequently, interest rates on southern countries' debt arguably not only incorporate a classic 'credit' risk premium but also an 'exchange rate' risk premium (or 'redenomination'/'convertibility' risk premium) reflecting the risk of a break-up of the eurozone. In the short term, however, preventive interventions in sovereign bond markets in order to mitigate the risk of a country losing access to financial markets are conceivable. I will now turn to the principles of such interventions.

2. PRINCIPLES OF A PREVENTIVE INTERVENTION IN SOVEREIGN BOND MARKETS

This chapter discusses the principles of a ‘preventive intervention’ i.e. ‘ex-ante’ financing mechanisms aimed at preventing a country from losing market access and requesting an ‘ex-post’ bail-out. The discussion applies no matter which entity actually intervenes (the ECB or the EFSF/ESM).

I will first present the main benefits that limiting the rise of interest rates on sovereign bonds can deliver (2.1). I will then detail the mechanisms of an intervention (2.2). Thirdly, I will describe the economic rationale underlying the intervention: a complex mix of assumptions justifying the intervention (2.3). Finally, the core issue associated with ex-ante assistance – that of balancing moral hazard considerations and the stigma of assistance by setting the right conditionality – will be discussed (2.4).

2.1. Main benefits

The primary objective of an intervention is to prevent a country from losing its own access to financial markets i.e. prevent its borrowing cost from rising to ‘unsustainable’ levels at which point there is no longer a sufficient amount of creditors willing to lend to the country. An interest rate level is deemed ‘unsustainable’ or ‘unaffordable’ when it prevents a country from realistically stabilizing its debt level (see box 1). Given an initial debt level and growth perspectives, the interest rate on the debt does mechanically determine the combined size of budget cuts and extra revenues necessary to stabilize the debt level. As the interest rate on the debt grows, so does the financing gap to stabilize the debt level. Alternatively, if the interest rate decreases, so does the necessary adjustment effort. Since the size of the possible adjustment is a matter of judgment, likewise is the actual interest rate level deemed sustainable. In the current economic context, Italy’s and Spain’s respective debts are generally believed to be unsustainable with an interest rate of around 7% for bonds issued with a maturity of 10 years⁶.

6. However, it can be argued that debt would remain sustainable at those interest rate levels. See Cline, W.R., (2012), “Sovereign Debt Sustainability in Italy and Spain: A Probabilistic Approach”, Working Paper, WP 12-12, Peterson Institute of International Economics, August 2012.

BOX 1: Fiscal sustainability as criteria for solvency

When a country's debt is growing without the perspective of stabilization, the country is likely insolvent. Conversely, a country is likely to remain solvent if it manages to stabilize its debt-to-GDP ratio⁷. An essential fiscal sustainability indicator is the primary balance required to stabilize the debt-to-GDP ratio (called the debt-stabilizing primary balance). The primary balance corresponds to the general government balance excluding interest payments on government debt.

The following equation defines the debt-stabilizing primary balance p^* (expressed as a percentage of GDP) necessary to maintain the debt-to-GDP ratio d constant, where r is the real interest rate and g the real growth rate of the economy⁸:

$$p^* = \frac{r-g}{1+g}d$$

This can be simplified by neglecting the denominator on the right-hand side:

$$p^* = (r-g)d$$

The adjustment effort to stabilize debt ratio, i.e. the 'primary balance gap', reflects the necessary adjustment to stabilize debt, starting with an initial primary balance p :

$$p^* - p = (r-g)d - p$$

The term $(r-g)$ is called the 'interest-growth differential'. When $r > g$ there is rising pressure on the debt-to-GDP ratio and vice versa when $r < g$. This means that as borrowing costs rise so does the size of the adjustment effort. When r is very high, in particular given modest growth perspectives, the adjustment effort might become too large to be sustainable.

For example, a country with an initial primary fiscal deficit p of (-) 2%, debt-to-DGP ratio of 80%, a growth rate of 1% and interest rate of 4%, must fill a primary balance gap of 2.4% of GDP:

$$(4\% - 1\%) 80\% - (-0.2\%) = 2.4\% \text{ of GDP}$$

7. Blanchard, O., (1990), "Suggestions for a new set of fiscal indicators", OECD working papers, N° 79.

8. Escolano, J., (2010), "A practical guide to public debt dynamics, fiscal sustainability, and cyclical adjustment of budgetary aggregates", Technical notes and manuals, Fiscal Affairs Department, IMF, January 2010.

As long as borrowing costs remain at an affordable level, the country is able to refinance itself and can pursue its adjustment effort to stabilize and bring down its debt level. Intervening to allow a country to preserve its market access presents several advantages.

From the perspective of creditor countries, providing limited ex-ante financing might be preferable because it would be more efficient and less costly than an ex-post bail-out. By definition, if the intervention is efficient the country will at least partially continue to finance itself from private investors rather than from official public lenders in the event it loses access to financial markets. Ensuring that private creditors continue to invest in a distressed country's bonds is particularly recommendable because of the relatively limited availability of funding for an ex-post rescue. For example, a combined bail-out of Spain and Italy would be difficult to handle given the size of current financial backstops, in particular the size of the ESM⁹. Furthermore, increasing the backstops' capacity is politically challenging, notably in creditor countries such as Germany, the Netherlands and Finland, which are concerned about the risks involved.

From the perspective of beneficiary countries, the ex-ante financial assistance first and foremost lowers the risk of a default and the significant economic costs attached to it. It can also reduce the political stigma of the external support by allowing the beneficiary country to retain more independence while pursuing its adjustment. This would in turn foster social and political stability in countries where sizable efforts are required to restore their economic and fiscal sustainability. This is a crucial and somewhat overlooked factor in the longer-term crisis management perspective.

2.2. Intervention mechanisms: primary and secondary market purchases

An intervention can consist in purchasing sovereign bonds on the primary market, i.e. at issuance, or on the secondary market where bonds are traded. The announcement of a bond-buying program which precedes its actual or potential activation is also particularly relevant. As it influences interest rates in the market by shaping expectations, the commitment to intervene in the future must be considered as a crucial and integral part of the intervention mechanism.

Intervening in the primary market, by participating in auctions or syndicated transactions, amounts to directly financing a country's debt. The direct recipient of the transaction is the issuing country. In principle, only the EFSF and ESM

9. This argument will be further explored in section 3.1.C which discusses the lending capacity of the ESM.

can do so for eurozone countries as the Treaty forbids the ECB from financing countries directly¹⁰. The EFSF or ESM intervention first and foremost reduces the risk of the beneficiary country experiencing a failed auction or not raising the required funding amount. By ensuring enough demand, the intervention also seeks to lower the interest rate at issuance (i.e. raise the bond price). The presence of the EFSF or ESM in the transaction would also limit the risk of excessively high interest rates ('out of the market' prices) being posted by opportunistic primary dealers to test the needs of the country¹¹. More generally, primary market purchases also contribute to the overall liquidity in the secondary market.

A secondary market intervention consists in the purchase of sovereign bonds from private investors in the market. A secondary market intervention first and foremost ensures liquidity in debt markets. It influences the price not only in the secondary market but also in the primary market, since both are closely linked. It thus encourages private investors to further participate in the financing of the country. Moreover, although the direct recipient of the transaction is a private selling entity, such as bank or a fund, the issuing country indirectly benefits from the transaction, as some of its debt is ultimately held by the intervener (the ECB or the EFSF/ESM).

Even before any transaction takes place, the stated commitment of the ECB or the EFSF/ESM to intervene can contribute to ensuring favorable trading conditions by shaping market participants' expectations. Such an announcement produces what is referred to as the 'deterrent effect'. In principle, the deterrent effect is maximized if the commitment to intervene is credibly unlimited and unconditional. It would amount to giving full assurance to investors that a country will not be allowed to default under any circumstances. The consequence would be that interest rates would be kept to a minimum as considerations regarding solvency will be dominated by the presence of a 'lender of last resort' who commits to buy sovereign bonds if the country is unable to finance itself. In practice, a genuine lender of last resort can only be credibly endorsed by the central bank because of its ability to create money¹².

Otherwise, as a principle, if the guarantee provided by a fund or the ECB is perceived by the market as not absolute, interest rates will still reflect the possibility of a default. Thus if only limited funds are committed or conditionality is imposed, the initial positive effect of the announcement to intervene can possibly wane over time if other factors gradually undermine investors' confidence.

10. Article 123 TFEU.

11. EFSF, (2011), EFSF Guideline on Primary Market Purchases, November 29, 2011.

12. For a discussion about the role of the ECB see Buiter, W.H., Rahbari, E., (2012), "The ECB as lender of last resort for sovereigns in the euro area", Discussion paper, Center for Economic Policy Research, N°8974, May 2012.

2.3. Economic rationale: what justifies intervening in sovereign bond markets?

An intervention is essentially justified to the extent that a country suffers from self-fulfilling expectations of insolvency, in particular when these are linked to the break-up of the eurozone. Doubts about the solvency of a country which might actually be solvent can lead to its actual insolvency because debt holders fear such an event. If such is the case, markets could arguably be considered as ‘dysfunctional’ because they would overprice the risk of default above that which a country’s ‘fundamentals’ would suggest.

This self-fulfilling dynamic of insolvency can originate from a combination of different uncertainties. The first is that a country’s risk of default is intrinsically difficult to estimate (A). When a country starts experiencing liquidity constraints, it is difficult to distinguish between genuine solvency issues and mere liquidity constraints. The second is that the dominant expectation that the country will lack the necessary funding and ultimately default can lead to a self-fulfilling crisis where all investors race to sell (B). Moreover, this risk is particularly acute in an incomplete currency union such as the EMU (C). Finally, the critique of this rationale will be considered and some conclusions drawn (D).

A. *The uncertainty about the solvency of a country*

The solvency of a country is inherently difficult to assess because sovereign debt servicing is ultimately determined by the country’s willingness, rather than capacity, to pay¹³. No straightforward legal mechanism exists to enforce repayment of a sovereign debt. Moreover, creditors cannot easily coordinate to enforce repayment. In principle, a country might always choose to repudiate its debt, either for internal political reasons or following a rational estimation that the cost of default is smaller than the cost of continuing to service the debt¹⁴.

Moreover, a country’s repayment capacity depends on an inherently intangible and illiquid asset: its capacity to generate future tax revenues. The economic worth of this asset is difficult to value as it depends on the capacity and willingness of the country’s taxpayers to allow debt servicing and of its administrative capacity to raise revenue. In theory, a country could run deficits as long as what it borrows is invested in a productive capacity that will generate more tax revenues in the future which will be used to redeem the generated debt. This ‘inter-temporal budget constraint’ is, however, too loose to be of any practical

13. See for a discussion: Lucke, B., Wurzel, B., (2011), “Debt sustainability, illiquidity and insolvency”, September 2011.

14. Krugmann, P., (1988), “Financing vs. forgiving a debt overhang”, *Journal of Development Economics* 29, 253-268.

use¹⁵. Even if this path was assumed to be credible future taxation increases or cuts in spending would prove damaging for growth, negatively impacting future generations. In practice, much more practical criteria are used as indicators of solvency, such as debt sustainability criteria¹⁶.

Hence, because a country might always choose to repudiate its debt and because solvency cannot be determined but only approximated, a country's solvency is inherently uncertain. This uncertainty can in turn feed a self-fulfilling dynamic of insolvency to which I now turn.

B. The dynamic of self-fulfilling fears of insolvency

Because the solvency of a country is inherently uncertain, a shift of perception in the market can lead to a drying out of liquidities. Market participants cannot coordinate. Consequently, when market sentiment deteriorates, an investor essentially needs to guess how the market i.e. all other investors will behave, rather than assess on his own whether a country's debt is sustainable or not. When a country starts experiencing refinancing constraints, it is difficult to distinguish between a genuine solvency problem and a mere liquidity problem. A legitimate anticipation is that uncertainty and widespread lack of confidence will lead many investors to sell, thereby driving bond prices down and interest rates up. Consequently, the rise of borrowing costs will widen the financing gap and make the stabilization of debt all the more difficult¹⁷. As a result, a rational investor would also decide to sell.

Following this logic, all investors will predict the insolvency of a distressed country and anticipate a default. There is a 'race to sell' in order to avoid anticipated losses that would result from a default. Any event perceived as a signal for a future default can further fuel this dynamic. Ultimately, this self-fulfilling effect can effectively push the country out of financial markets. A liquidity crisis can thus easily degenerate into a solvency crisis, just like a shift in sentiment can lead to a bank run. Namely, a bank might be solvent but experience a liquidity crisis that degenerates into a default when the fears of depositors ultimately lead to the bank's bankruptcy, as they rush to withdraw their money. An illiquid but solvent country can similarly experience self-fulfilling crises.

The theory of self-fulfilling fears of insolvency essentially means that uncertainty generates uncertainty. If this effect dominates, the pricing of sovereign debt cannot simply be explained by indicators of the country's solvency 'fundamentals'. Once the market i.e. the aggregation of individual market participants starts to

15. Roubini, N., (2001), "Debt sustainability: how to assess whether a country is insolvent?", Stern School of Business, NYU, available at: <http://people.stern.nyu.edu/nroubini/papers/debtsustainability.pdf>.

16. See Box 1 in section 2.1.

17. *Ibidem*.

consider the possibility of a country defaulting on its debt, then a change in ‘market sentiment’ can much better explain market prices. This theory implies that once a self-fulfilling dynamic is at play due to a loss of confidence, some ‘mispricing’ by the market beyond more observable characteristics is inevitable. Market failure can thus occur as markets are not perfectly efficient.

C. *Added uncertainty stemming from the ‘incomplete’ EMU*

The risk of swing in market sentiment is arguably particularly acute in a currency union such as the EMU¹⁸. Firstly, EMU Members have abandoned their control over the currency in which their debt is denominated. They have also relinquished control over their central bank and cannot benefit from the liquidities it could provide in case of a liquidity crisis. There is no lender of last resort in the EMU that could prevent a panic.

Secondly, in a currency union such as the EMU, exchange rates between members are fixed. In a flexible exchange rate mechanism, a loss of confidence in one country would automatically result in the depreciation of its currency. This depreciation would in turn contribute to making the country more competitive and to restoring confidence. However, an EMU member can only recourse to ‘internal devaluation’ where it seeks to regain competitiveness by lowering wage costs and increasing productivity (as opposed to an ‘external devaluation’ whereby it reduces the exchange rate value). As this process is socially and politically challenging, it raises some doubt with regard to whether it can be sustained over time. Moreover, in the absence of a foreign exchange market and a flexible currency, a country in such a process must face the additional problem that available liquidities in the country as a whole will shrink as capital flies to other countries of the currency union considered safer.

Finally, there is no fiscal union backing the currency union in the EMU. In particular, no transfer mechanism within the union can act as a buffer from heterogeneous shocks among its members¹⁹. In what is essentially a heterogeneous currency area, no central budget exists that could transfer resources to members to facilitate the adjustment to such temporary shocks.

As a result, once the mood in the market becomes pessimistic, the adjustment difficulties for an EMU member are bound to be larger than had the country not been part of the EMU. The self-fulfilling run on the country is not mitigated by the country’s central bank acting as a lender of last resort; its exchange rate cannot devalue to restore part of its competitiveness and capital will leave the

18. De Grauwe, P., (2011), “The Governance of a Fragile Eurozone”, Economic Policy, CEPS Working Documents, May 2011.

19. Tommaso Padoa-Schioppa Group, (2012), “Completing the Euro: a road map towards fiscal union in Europe”, Notre Europe, June 2012.

country. These make the efforts to rebalance public finance and restore the country's competitiveness all the more challenging. In the absence of other forms of solidarity mechanisms, affected countries must essentially restore the situation on their own. Ex-ante intervention can hence be justified on this ground as well.

D. Critique of rationale and conclusion

The rationale discussed in the previous sections justifies providing liquidities to a country in order to prevent a crisis, can of course be critiqued.

In a nutshell, for opponents of preventive interventions, sovereign bond markets would not be 'dysfunctional' nor would the increase of interest rate reflect 'unfounded fears' or be 'irrational'. There would be no such thing as a liquidity crisis potentially developing into a solvency crisis because of self-fulfilling dynamics. If the market is not willing to provide the requested funding to a country, it is right to do so, estimating the country is nearing insolvency. It would hence be inefficient to try influencing the interest rates contrary to what the market is freely and effectively determining.

Perfect market efficiency is an extreme assumption but it is sensible to acknowledge that the market delivers important signals regarding solvency fundamentals. In this sense, it is pertinent to recognize that the rise in borrowing cost essentially results from major insolvency problems due to the large economic imbalances that built up in the decade following the introduction of the euro. There is no such thing as a pure liquidity crisis: liquidity problems necessarily arise jointly with solvency problems.

On the other hand, it is fair to recognize that self-fulfilling dynamics may play a significant role. Prevailing market rates might incorporate a risk premium associated with the perceived 'reversibility' of the euro. This risk in turns increases in particular because of the characteristics of the EMU, which lacks both a lender of last resort and a fiscal union. If the eurozone was 'complete', investors would not go so far as to price the risk of the country leaving the eurozone i.e. a break-up of the eurozone.

Testing for the degree of market efficiency is difficult is as difficult as testing for the degree of its inefficiency²⁰. Consequently, high unsustainable yields on sovereign bonds can either be considered as a rather 'rational' view regarding the risk of default given the fundamentals or alternatively as an 'unjustified' and

20. For an attempt see De Grauwe, P., Ji, Y., (2012), "Self-fulfilling Crises in the Eurozone: an empirical test", CEPS working document, N°366, June 2012.

‘irrational’ view of the market beyond what fundamentals would suggest (or even consist in a ‘speculative attack’).

An intermediary view – assuming markets are mostly efficient but can nonetheless be prone to self-fulfilling runs – might be the most sensible approach²¹. Following this logic, an intervention to limit the fear of a eurozone break up can be justified, but is, however, inherently limited and partly political. It is inherently limited because it should not be assumed that ‘unjustified’, ‘unfounded’, ‘irrational’ self-fulfilling dynamics are overly dominating some ‘justified’, ‘rational’ views of the market. It is partly political because in so far as fears of insolvency amount to a fear of break-up of the eurozone, an intervention to ‘remove’ those ‘unfounded’ fears cannot be justified on pure technical economic grounds.

Conclusion: interventions can only buy time for political action

The key conclusion is that interventions can only buy time for political action. First of all, the success of the intervention mostly depends on market forces. Investors need to maintain sufficient trust in the beneficiary country to keep financing it. This will depend on many variables and most notably on its growth perspectives. Bond purchases can only partially contribute to building confidence that the beneficiary country will turn out to be solvent, and that the euro is an irreversible common currency. Hence, the time or ‘breathing space’ bought by the intervention must necessarily be completed by political action to allow for a complete restoration of confidence in the long term solvency of the beneficiary country. First, fiscal and structural measures to revert the fundamental economic imbalances that built up in beneficiary countries must be adopted. Secondly, in so far as high borrowing costs reflect the risks linked to an ‘incomplete’ EMU, the economic pillar of the EMU should be strengthened in time.

2.4. Problems and concerns: moral hazard and stigma of assistance

A trade-off exists between preventing moral hazard risks and ensuring the effectiveness of the intervention. This must be considered when setting the conditions a country must fulfill in order to benefit from the pre-emptive financial assistance.

In practice, by lowering borrowing costs or preventing their rise, sovereign debt purchases remove some of the market pressure that would otherwise be exerted

21. This seems to be the approach endorsed by the ECB. See section 4.

on the country. Interventions also facilitate access to financing. Moral hazard arises in so far as the intervention negatively affects the country's effort to pursue its adjustment because the threat of losing market access decreases. Moral hazard is, however, inherent to any guaranteeing mechanism. The risk of moral hazard can be mitigated by imposing conditions on the country benefiting from the intervention.

Having few or no conditions improve the deterrent effect (or 'lender of last resort' effect) as the market can be confident that the country will not be barred from benefiting from market purchases (and the associated liquidity provisions). Moreover, it makes it politically easier for the country to request support – hence the 'political stigma' of the financial support decreases. However, when conditions are lax, there could be a moral hazard issue stemming from the intervention. In the extreme case – having unconditional access to liquidities – the country might not make the necessary effort to restore more sustainable financing conditions.

On the other hand, strict conditions make the activation of the measures more uncertain. While moral hazard considerations would be alleviated, much stigma will be associated with the use of the liquidity facility. Both for creditors' considerations (an 'economic stigma') and for domestic political considerations (a 'political stigma'), the ailing country might refrain from using the facility, as it would not want to be perceived as a country in difficulty. Since the solvency of a country cannot be exactly determined by the market, the mere granting of any support – even allegedly 'preventive' – would signal either a liquidity issue or possibly a solvency issue. Strong conditions could reinforce the impression that the country is not merely illiquid – which would justify some liquidity assistance – but is actually insolvent. Also, a government would not want to be perceived as a 'programme country' upon which reforms and austerity are enforced, as this might incur political cost as well. This stigma can be compared to the apparent stigma attached to the IMF precautionary assistance (which has been so far only requested by a few countries)²².

22. At the time of writing, only Mexico, Colombia and Poland dispose of a flexible credit line. Only Macedonia disposes of a Precautionary and Liquidity Line which is the equivalent of an ESM Enhanced Conditions Credit Line (see *infra*). For a review of the IMF's prevention tools, see Marino, R., Volz, U., (2012), "A critical review of the IMF's Tools for crisis prevention", Deutsches Institut für Entwicklungspolitik, Discussion paper, 4/2012.

3. PREVENTIVE INTERVENTION OF THE ESM IN PRIMARY AND SECONDARY MARKETS

The European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) constitute the main financial backstops for eurozone countries facing refinancing difficulties. These ‘rescue’ funds come into question when a country’s access to financial markets is lost (‘ex-post’); but they can also act to prevent such an event (‘ex-ante’), notably by intervening in primary and secondary markets. This chapter focuses on this latter possibility, with a particular emphasis on the ESM, as ultimately, it will permanently replace the EFSF.

Firstly, the functioning principles and underlying characteristics of the ESM will be addressed (3.1). I will then turn to the precise forms the preventive interventions can take (3.2).

3.1. Main characteristics and functioning of the ESM

I will first give an overview of the functioning of the ESM (A). The most important characteristic of the ESM, its guarantee structure, will then be analyzed (B). This feature fundamentally determines the fund intervention capacity to which I will then turn (C).

A. *Functioning principles*

Figure 2 (p. 22) schematically represents the key functioning steps of the ESM. Firstly, eurozone countries pool their guarantees in the ESM (step 1 – In what this guarantee consists will be further developed infra). In turn the ESM borrows by issuing bonds (the ‘common issuance’) on the market (2). Thirdly, the ESM lends the proceeds back to a recipient country (the ‘beneficiary countries’) (3). When lending, a small margin can possibly be levied above the borrowing cost so that the funds make some profit, which will be fed into a reserve fund acting as additional collateral. Fourthly, the ESM services the debt it owes to the investors in the common issuance (4). Finally, beneficiary countries reimburse the ESM (5).

By pooling their guarantees, eurozone members actually borrow collectively through the fund by issuing common debt. The ESM acts as a leveraged vehicle whose purpose is to enhance the borrowing capacity of its members, specifically by offering a lower interest rate than the one the beneficiary country would have to pay through its own national issuance. Instead of issuing its own national bond, the beneficiary country can in practice borrow at a lower cost from the market *via* the ESM.

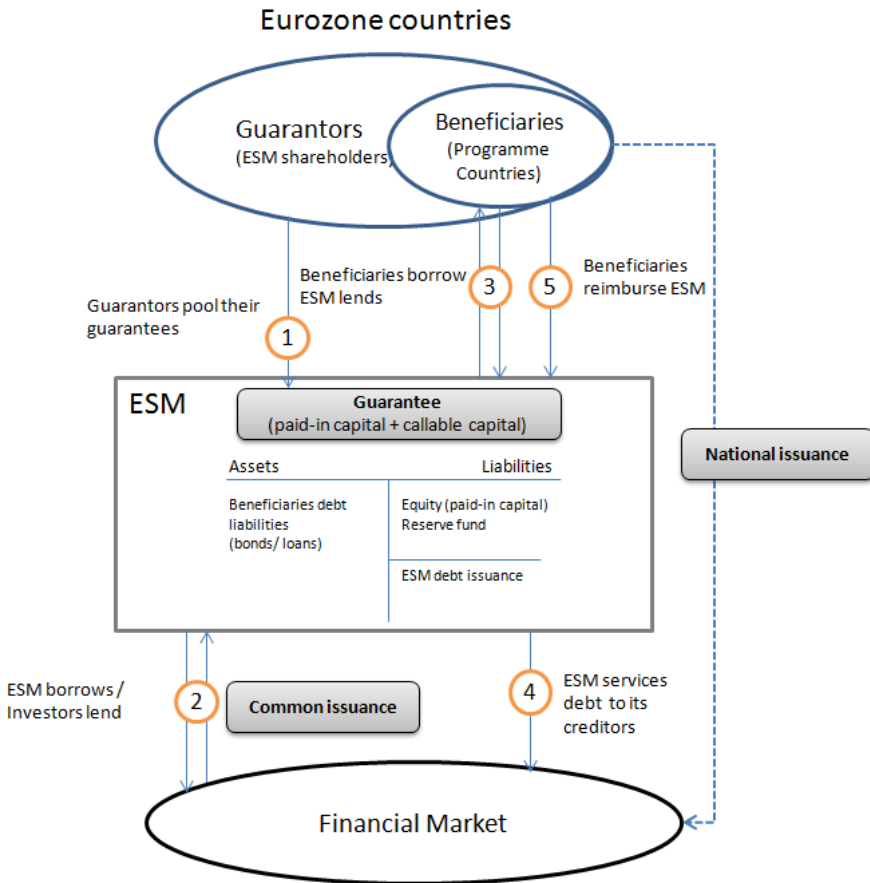


Figure 2: ESM scheme overview

B. Guarantee structure

The guarantee structure constitutes the backbone of the ESM capacity to borrow in financial markets and to lend to countries that request financial support²³. This structure essentially decides the ESM credit quality by determining how the fund’s creditors are protected from a beneficiary country’s default.

The ESM, as a permanent mechanism, unlike the EFSE, benefits from its own paid-in capital which will initially amount to EUR 80bn out of a total authorized capital of EUR 700bn²⁴. In principle, this makes it less reliant on the credit

23. I refer to the ‘guarantee structure’ rather than the ‘capital structure’ of the ESM in order to underline that the ESM globally relies on its members’ commitment to back the structure if necessary.

24. EU Council, (2012), Treaty Establishing the European Stability Mechanism, hereinafter ‘ESM Treaty’.



quality of its members acting as shareholders/guarantors. The contribution key of ESM members to the capital of the ESM corresponds to their respective share in the ECB²⁵. The payment of paid-in shares must ensure that a minimum ratio of 15% is maintained between the paid-in capital and the outstanding amount of ESM issuances i.e. the amount borrowed by the ESM²⁶.

The ESM guarantee structure is composed of three layers. In case of default of a beneficiary country²⁷, the resulting losses will first be covered by the reserve fund which essentially consists of the accumulated net income from its operations²⁸, then by the paid-in capital (initially EUR 80bn) and lastly – in order to restore the level of paid-in capital – by calling in authorized unpaid capital (initially amounting to EUR 620bn) by a simple majority of the Board of Directors²⁹. This means that the ESM equity (the paid-in capital and the potentially callable capital) and to a lesser extent its accumulated reserves function as a capital buffer that can absorb losses.

Moreover, another important disposition is that ESM loans enjoy a ‘seniority status’ (or ‘preferred creditor status’) over any other private creditors and will be junior only to IMF claims³⁰. Inspired by a similar implicit disposition of the IMF, the preferred creditor status intends to protect the ESM (and its private creditors) from a debt restructuring in a beneficiary country. It implies that if a beneficiary country defaults, the losses will first have to be borne by private bond holders and only next by the ESM followed by the IMF. This disposition should, however, not apply to instruments other than loans, in particular to primary or secondary market purchases³¹.

25. Temporarily adjusted to reflect the difference in GDP per capita among the ESM members. See Art. 42 of ESM Treaty, *ibid*.

26. Art. 41(2) ESM Treaty, *ibid*.

27. Art. 25 ESM Treaty, *ibid*.

28. Art. 24 ESM Treaty, *ibid*. and ESM, (2012), ESM Pricing policy. The ESM’s levied margin will range between 10 and 35 basis points depending on instruments. The reserve fund will also include sanctions under the excessive deficit procedure and macro-economic imbalances procedure. The ESM might also make capital gains following its bond purchases on primary or secondary markets.

29. Art. 9(2) ESM Treaty, *op. cit.* footnote 24. It is very unlikely that a simple majority decision calling for the payment of some of the remaining callable capital would not be found. Countries already committed themselves to provide their contribution up to a maximum liability corresponding to their share of the total authorized stock. Nonetheless, if they were unable to do so they would lose their voting rights (Art. 4 (8) of *ibid*.). Moreover, in case of emergency, to avoid a payment default the Managing Director of the ESM can even make capital call to ESM shareholders without the prior consent of the Board of Directors (Art 9 (3) of *ibid*.).

30. Whereas 13, preamble of ESM Treaty, *op. cit.* footnote 24.

31. This is, however, not clear-cut and might create a contention. The first version of the ESM Treaty mentioned that the ESM – as a whole – would enjoy a preferred creditor status. The final version refers only to ‘ESM loans’. Hence, in principle only ESM loans under a macroeconomic adjustment programme and recapitalization facilities will enjoy seniority status, as communicated by the ESM. See ESM, (2012), Frequently Asked Questions on the ESM.

C. Capacity

The maximum lending capacity of the ESM is fixed at EUR 500bn³². This amount is far too limited to fully bail out large and highly indebted economies like Spain and Italy³³. This ceiling can, however, be revised at any time by a unanimous decision of the Board of Governors (i.e. eurozone finance ministers): extra capital can be called in out of the total authorized capital which itself can be revised³⁴. Respecting the 15% leverage ratio³⁵, for every euro of paid-in capital, a maximum of EUR 6.6 could be raised in financial markets. However, an increase of the ESM ‘fire-power’ faces political and economic constraints.

In principle, when calling for additional capital, finance ministers would also need to unanimously agree whether the total authorized capital remains adequate³⁶. The link between the total authorized capital (EUR 700bn) and the total lending capacity (EUR 500bn) is, however, not fixed in the ESM Treaty. As it stands, the authorized capital exceeds the lending capacity by 40%. Raising the authorized capital stock in proportion to the increase of the lending capacity would ensure that the ESM maintains an optimal credit quality, allowing it to borrow at relatively low rates.

However, raising the authorized capital stock is a major political issue as it raises the potential liabilities (i.e. contingent liabilities) of ESM members. This problem was highlighted by the German Federal Constitutional Court’s September 2012 preliminary ruling over the ESM³⁷. It stated that the German commitment could not go beyond Germany’s share of the authorized capital stock (EUR 190bn) without consent from Parliament. Nevertheless, beyond clear political issues, the economic constraint on ESM members is relative. The ESM authorized capital represents 5% of the eurozone GDP, less than the total aid granted to the financial sector in the eurozone between 2008 and 2010 (9.1% of eurozone GDP)³⁸.

In order to circumvent the political issue of increasing the ESM capital, the ESM capacity could also be leveraged – basically allowing it to do more with its cur-

32. Art. 39 ESM Treaty op. cit. footnote 24. This amount more precisely corresponds to the combined fresh lending capacity of the ESM and the EFSF as up to July 2013 the EFSF may still engage in new programmes (only) if necessary to ensure a full fresh lending capacity of EUR 500bn. However, the EUR 500bn lending capacity could also be reached within this period through accelerated capital payments of the ESM.

33. See *infra*, section 3.2.D for a discussion on these countries’ refinancing needs.

34. Art 5, Art 9 and Art 10 ESM Treaty, op. cit, footnote 24.

35. Op. cit. footnote 26.

36. Art 10 ESM Treaty, op. cit, footnote 24.

37. See German Federal Constitutional Court, (2012), extract of decision of September 12, 2012, available at: http://www.bverfg.de/en/decisions/rs20120912_2bvr139012en.html.

38. Own calculation based on EU Commission, (2011), “Autumn 2011 update of the State aid scoreboard”, COM(2011)848, 01.12.2011 and EU Commission, (2011), Facts and figures on state aid in the EU Member States, Commission Staff working document, SEC(2011)1487, 01.12.2011.

rent capacity. Two options can be considered but remain very uncertain³⁹. The first consists in selling to private investors of insurance partially covering potential losses on a bond bought at a primary auction. The second consists in the establishment by the ESM of co-investment funds for private sector investors with the ESM providing first tranche loss absorption. However, neither option, both of which were initially considered as a leverage options for the EFSF seemed to attract investors' interest. Moreover, both mechanisms arguably contradict the seniority clause of the ESM: in case of default, the ESM would first have to compensate private investors for their loss⁴⁰.

In any case, from an economic perspective, financial engineering necessarily has limits. Raising the ESM lending capacity would eventually reach a ceiling because the ESM is limited by the quality of the underlying guarantees provided by the guarantors – eurozone countries – which is determined by their credit quality. The ESM cannot be indefinitely leveraged or indefinitely call capital to be transferred by its members, without either jeopardizing its own sustainability or that of its members. A more absolute approach would be for the ECB to back the ESM, for example by granting it a banking license or to back it in any other way, but this option meets strong opposition including that of the ECB⁴¹.

Due to these constraints on increasing the capacity of the ESM, a preventive programme maximizing the ESM's intervention capacity is clearly the most readily available solution to deal with eurozone countries' debt issues.

3.2. Precautionary financial assistance and secondary market interventions

The possible financial assistance instruments will first be explained (A). I will then discuss in more detail the conditionality of the intervention (B), the granting procedure (C), the capacity of the intervention (D) and, finally, the monitoring involved (E).

A. *Instruments*

The EFSF and ESM were initially designed to function strictly on an ex-post basis. The funds were meant as 'rescue funds' that would intervene as a last resort when a country would effectively have no other option than to request their assistance. However, at the Euro Area Summit on 21 July 2011, European

39. These options were initially considered for the EFSF. See EU Council, (2011), Euro Summit Statement, 26 October 2011.

40. Art 13 ESM Treaty, op. cit, footnote 24.

41. Moreover, according to the German Federal Constitutional Court, the backing of the ESM would require a Treaty change. See op. cit. footnote 37.

leaders agreed to ‘increase the flexibility [of the EFSF and ESM] linked to appropriate conditionality’⁴². In particular, concerning the flexible funding of countries, the funds were allowed to:

(I) Act on the basis of a precautionary programme;

On the basis of such a ‘precautionary programme’, the ESM can provide precautionary financial assistance (PFA), which takes the form of credit lines. Similarly to the IMF crisis prevention facilities (i.e. the Flexible Credit Line and the Precautionary and Liquidity Line)⁴³, the ESM disposes of two types of credit lines, which essentially differ in their conditionality: a Precautionary conditioned credit line (PCCL) and an Enhanced conditions credit line (ECCL). Once granted a credit line, a beneficiary country can in turn request the draw-down of funds as a loan or a primary market intervention (via a Primary Market Support Facility (PMSF)). This can be done under the agreed terms at any time during the availability of the credit line.

(ii) Intervene in the secondary markets on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability and on the basis of a decision by mutual agreement of the EFSF/ESM Member States, to avoid contagion.

Thus the ESM can also intervene in secondary markets after a Secondary Market Support Facility (SMSF) is granted to a eurozone country. This is done on the basis of an ECB analysis recognizing an exceptional market situation that could threaten the financial stability of the euro area as a whole and of its Member States⁴⁴.

B. Conditionality

Some general conditions apply to all instruments of ESM preventive assistance. As of 1 March 2013, assistance will be conditional on the ratification of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) (aka the ‘Fiscal compact’)⁴⁵. The general principle set in the ESM Treaty is that the minimum conditions correspond to a ‘continuous respect of pre-established eligibility conditions’⁴⁶. The general conditionality principle

42. EU Council, (2011), Council of the European Union, “Statement by the Heads of State or Government of the Euro Area and EU Institutions”, 21 July 2011.

43. See IMF, (2012), The IMF’s Precautionary and Liquidity Line, IMF Factsheet, available at: <http://www.imf.org/external/np/exr/facts/pdf/pll.pdf>.

44. ESM, (2012), ESM Guideline on the Secondary Market Support Facility.

45. As of October 2012, Austria, Cyprus, Germany, Spain, Greece, Italy, Portugal, Slovenia and Spain have ratified the ‘Fiscal compact’. When the Treaty enters into force, its signatories will have a year to transpose its requirements in the national law. See whereas 5, preamble of ESM Treaty, op. cit. footnote 24.

46. Art. 12 (1) ESM Treaty, op. cit. footnote 24.

reconciles “strict conditionality” – which was notably a pre-condition to create the funds⁴⁷ – with the “flexibility” required by pre-emptive financial assistance. The result is a ‘*strict but appropriate conditionality*’⁴⁸. Any intervention requires the signing of a Memorandum of Understanding (MoU) along with a Financial Assistance Facility Agreement (FFA). The former specifies the conditionality, notably the reforms to be undertaken in the recipient countries, and the latter specifies the financial terms of the support in compliance with the policy conditions.

The specific conditions for primary market intervention or the drawing of loans under a precautionary programme are specified in the conditions for obtaining a credit line⁴⁹. In principle the beneficiary of a credit line must always exhibit a sound general economic and financial situation i.e. the beneficiary must in principle always remain solvent. When granting a credit line, ex-ante conditionality is favored but if some of these ex-ante conditions are not met, some ex-post conditions are added. The ESM therefore disposes of two types of credit lines: the ‘Precautionary conditioned credit line’ (PCCL), where all eligibility criteria are met; and the ‘Enhanced conditions credit line’ (ECCL) where some eligibility criteria are not met and must therefore be compensated for by adopting corrective measures to address the vulnerabilities identified.

The ESM guidelines mention the following eligibility criteria⁵⁰:

- (i) The respect of Stability and Growth Pact commitments (although countries under excessive deficit procedure (EDP) could still access PCCL if they fully abide by the Council decisions and recommendations in the procedure);
- (ii) A sustainable public debt;
- (iii) The respect of the Excessive Imbalance Procedure (EIP) (although countries under excessive imbalance procedure could still access PCCL if they fully abide by the Council decisions and recommendations in the procedure);
- (iv) A track record of access to international capital markets on reasonable terms;
- (v) A sustainable external position;
- (vi) The absence of bank solvency problems that can pose systemic threats to the eurozone banking system. (Eurozone members under an excessive

47. As in the article 136 TFEU, as amended by EU Council decision 2011/199/EU.

48. As mentioned in EFSF, (2011), EFSF Guidelines on precautionary programmes.

49. See Annex 1 for a full overview of conditions under a primary market intervention and a secondary market intervention.

50. See ESM, (2012), ESM Guideline on Precautionary Financial Assistance.

imbalance procedure could still access a PCCL subject to demonstrating a formal commitment to address the imbalances identified by the European Council).

Concerning secondary market purchases, a country outside a macro-economic adjustment programme would in principle need to comply with the same *ex-ante* eligibility criteria. But contrary to primary market purchases under an ECCL, countries do not have the possibility of compensating unmet criteria by committing themselves to ‘enhanced’ conditions. The country would moreover need to be subject to financial markets disruptions, as assessed by the ECB.

C. *Procedure*

The procedure for granting a Secondary Market Support Facility (SMSF)⁵¹ and a Precautionary Financial Assistance (PFA)⁵² – the latter in turn allowing for a Primary Market Support Facility (PMSF) – are essentially the same.

The first step in the granting procedure is that the ESM member requests a SMSF/PFA to the Chairperson of the ESM Board of Governors i.e. the president of the Eurogroup.

Secondly, the Commission in liaison with the ECB is entrusted with key tasks that will determine the eligibility of the requesting country and conditions attached to the financial support. The Commission and the ECB will need:

- (a) to assess the existence of a risk to the financial stability of the euro area as a whole or of its Member States; for a SMSF, the ECB will also assess whether there are exceptional market circumstances;
- (b) to assess whether general government debt is sustainable. For a PFA, wherever appropriate and possible, such an assessment will be conducted together with the IMF;
- (c) to assess the actual or potential financing needs of the eurozone country concerned;
- (d) (for a PFA): to assess whether the eurozone country concerned meets the conditions for accessing a PCCL or an ECCL.

Thirdly, on the basis of the Commission’s assessment, the Managing Director of the ESM will prepare a proposal for financial assistance on the basis of which the Board of Governors may decide to grant SMSF/PFA.

51. See ESM, (2012), ESM Guideline on the Secondary Market Support Facility.

52. See ESM, (2012), ESM Guideline on Precautionary Financial Assistance.

Fourthly, the Commission in liaison with the ECB and, wherever possible, together with the IMF, will negotiate with the Member State concerned a MoU detailing the policy conditions attached to the precautionary programme. In parallel, a financial assistance facility agreement (FFA), detailing the financial terms and conditions of the precautionary financial assistance is prepared by the Managing Director of the ESM.

Finally, the Commission signs on behalf of the ESM the MoU subject to the approval of the Board of Governors, and the Managing Director of the ESM signs the FFA.

At this stage, when granted PFA, the requesting country disposes of a credit line which can be used afterwards. The activation – i.e. the draw-down of funds – can be made upon request by the beneficiary country during the availability period of the credit line according to the agreed terms. In principle, this can either take the form of a loan or a primary market purchase. When granted a SMSF, the actual activation rests solely in the hands of the ESM. Its deactivation can however be requested by the beneficiary country⁵³.

D. Intervention capacity

The size of the intervention is first of all constrained by the ESM overall lending capacity discussed previously⁵⁴. However, what matters most directly is the size of the ‘envelope’ of funds earmarked to purchases bonds in primary or secondary markets.

Concerning primary market purchases, this envelope corresponds to the amount of the credit line granted to the beneficiary country. A credit line is available for one year, renewable twice, for six months each time⁵⁵. Contrary to the EFSF guidelines, the ESM guidelines do not specify the typical size of the credit line⁵⁶. For each intervention, the ESM will in principle limit its purchase to a maximum of 50% of the issued amount. This means that the share bought at issuance by the ESM will not be larger than the share bought by the market. As a rule, the ESM will participate at the market price⁵⁷. If the primary market purchase fails to yield the necessary financing due to an insufficient private investor participation, the financing gap would be closed by a regular loan from the ESM. A failed

53. Art 5.2 of ESM guidelines on SMSF, op. cit. footnote 51.

54. See section 3.1.C.

55. ESM, (2012), ESM Guideline on the Primary Market Support Facility.

56. See op. cit. footnote 48. The EFSF specify no up-front cap, but nonetheless indicate that the ‘typical size’ of the credit line is expected to ‘vary between 2 and 10% of GDP of the Member State concerned’. This indication was dropped in the corresponding ESM guidelines.

57. At the weighted average price in an auction and at the re-offer price in a syndicated transaction, see ESM, Guideline on the Primary Market Support Facility, Art. 4. op. cit. footnote 55.

auction would however quickly raise concerns and the precautionary programme would necessarily have to be reassessed.

Ideally, the size of the credit line should be large enough to guarantee that the ESM support at issuance will last for a couple of years. For example, in 2013, the gross refinancing requirements should approximate EUR 232bn for Spain and EUR 380bn for Italy⁵⁸. This represents more than 20% of GDP in both countries. In a scenario where the ESM would buy half of the issued amounts in that year, an initial envelope of about 15% of GDP would be necessary (around EUR 200bn for Italy and EUR 100bn for Spain). Of course, ideally the fund might not need to cover half of the total issued amount. The necessary size also much depends on the tactics used by the ESM, in particular on which maturity of issuances it will focus its purchases. However, the credit line size should ideally be either large or sufficiently flexible to build trust among investors.

For secondary market interventions, while the EFSF guidelines stated that the envelope for a secondary market intervention would be equal to the remaining lending capacity of the EFSF⁵⁹, no such precisions are included in the ESM guidelines. Pro-tempore intervention caps would be set in line with a global strategy decided by the ESM and the ECB.

E. Monitoring

For both a SMSF and a PFA, monitoring of the continued compliance with the policy conditions specified in the MoU is ensured by the Commission in liaison with the ECB. Stronger monitoring under the form of ‘enhanced surveillance’ applies as soon as an ECCL is granted or a PCCL is drawn via primary market purchases or loans.

Under enhanced surveillance, the country is the object of closer scrutiny. First, stronger cooperation is expected of the beneficiary country, with the Commission acting in liaison with the ECB, the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB), and where appropriate the IMF. The beneficiary country must provide all relevant information regarding its economic and financial situation upon request. Finally, the Commission in liaison with ECB and where needed or appropriate with the IMF and ESAs will conduct regular review missions in the Member states under surveillance to verify the progress made in the implementation of the adopted measures. Accordingly, the Commission will notably assess whether further policy measures are needed.

58. Assuming the short-term debt maturing in 2012 is rolled-over in short term debt in 2013. According to IMF, (2012), Fiscal Monitor, Balancing fiscal policy risks (April 2012), Table 2, p.3.

59. See acceptance procedure in EFSF, (2011), EFSF Guideline on interventions in the secondary market.

If the beneficiary country deviates from its policy conditions or if those commitments have become clearly inadequate, or if – in the case of SMSF – it assessed that the secondary market interventions have become inadequate to contain the financial disturbance, the Board of Directors, acting on a proposal from the Managing Director, can reconsider the adequacy of the SMSF or of the PFA⁶⁰. The Board of Governors may in turn ultimately decide to discontinue primary or secondary market purchases.

60. Moreover, under PFA, after the beneficiary country has drawn funds for the first time via a loan or a primary market purchase, the Board of Directors will decide on a proposal from the Managing Director and based on an assessment conducted by the European Commission, in liaison with the ECB, whether the credit line continues to be adequate or whether another form of financial assistance is needed. See Art 7 (3) of the ESM Guidelines on Precautionary Financial assistance, *op. cit.* footnote 52.

4. CONDITIONAL SECONDARY MARKET INTERVENTIONS OF THE ECB

The ECB is at the centre of all expectations to mitigate/solve the crisis of the eurozone. Its stance is the object of much debate; some claiming it does too little, others too much. The two essential mandates of the ECB – a positive one, that of ensuring price stability; and a negative one, that of not engaging into monetization of public debt –, lie at the core of the discussions.

In practice, the ECB acts as an effective financial backstop for the financial sector and limits liquidity issues via a variety of instruments which include, in particular, the Eurosystem's TARGET 2 settlement system, Long Term Refinancing Operations and Emergency Liquidity Assistance⁶¹. Arguably, these instruments have indirectly reduced sovereign bonds' yields by maintaining the financial sector afloat.

Moreover, the ECB adopted unconventional policy instruments to directly address tensions in the eurozone sovereign bond markets, by intervening on secondary markets. I will first describe the features of Outright Monetary Transactions (OMT) (4.1), and then highlight the limits to the ECB power in this context (4.2). A global view on the strategy for preemptive intervention that OMT allows in practice will be discussed in the fifth part of the paper.

4.1. Outright Monetary Transactions

On 6 September 2012, the ECB officially announced its new programme of market purchases in secondary markets, dubbed 'Outright Monetary Transactions' (OMT). OMT in practice replace and terminate the Securities Market Programme (SMP) which was established in May 2010 to ensure a proper '*monetary policy transmission mechanism and thereby the effective conduct of monetary policy oriented towards price stability in the medium term*'⁶². The programme notably allowed for secondary market purchases of European government bonds with the aim of propping up sovereign bond yields of countries under financial pressure. Within the SMP, the ECB purchased in early 2010 and mid 2011 sovereign bonds of several distressed countries⁶³.

61. For an overview, see Bijlsma, M., Vallée, S., (2012), "The creation of euro area financial safety nets", Bruegel working paper, 2012/09, July 2012.

62. ECB, Decision of the European Central Bank of 14 May 2010, establishing a securities market programme, ECB/2010/5.

63. The ECB has not provided a detailed break-down of purchased securities. It is assumed that Italy's and Spain's government bonds benefited from the programme.

The OMT programme characteristics are the following⁶⁴:

- Conditionality: The beneficiary country must first request an EFSF/ ESM precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. Countries under an EFSF/ESM macro-economic programme are eligible.
- Coverage: No ex-ante quantitative limits exist on bond purchases i.e. intervention is potentially unlimited. OMT will concentrate on buying sovereign bonds with a maturity of one to three years.
- Decision: The decision on starting and ending OMT for a country is taken by the ECB governing council. The ECB will stop OMT in case of non-compliance with a macro-economic adjustment programme or a precautionary programme or because the objective is reached.
- No seniority: The Eurosystem has “pari passu” creditor status (unlike in the SMP programme).
- The liquidity created through Outright Monetary Transactions will be fully sterilized i.e. its effect on monetary policy will be controlled for.
- The ECB will disclose the aggregated weekly value of its purchases. The average duration of OMT holdings and the breakdown by country will be made public on a monthly basis.

The rationale of the ECB Governing Council went a step further compared to the SMP rationale. Not only would the ECB ‘safeguard the monetary policy transmission mechanism in all countries of the euro Area’, it would also address ‘severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro’⁶⁵. The ECB seems to partially endorse a lender of last resort role, by stressing unlimited purchase is in principle available. The explicit immediate intended effect is the suppression of ‘convertibility’ or ‘redomination’ risk premiums requested by investors when trading sovereign bonds. These risks are ‘unfounded’ since ‘the euro is irreversible’, as the ECB claims⁶⁶. The ECB also justifies OMT because of possible self-fulfilling expectations pushing countries into a bad equilibrium⁶⁷.

64. ECB, technical features of Outright Monetary Transactions, press release, 6 September 2012, available on the ECB website: www.ecb.int.

65. ECB, Press conference, 6 September 2012, transcript available at: <http://www.ecb.int/press/pressconf/2012/html/is120906.en.html>.

66. Ibidem.

67. See section 2.3 on the economic rationale of the intervention.

The major fundamental feature of OMT is that it makes the ECB's intervention conditional to a request for precautionary programme implying the possibility of primary market purchases. This conditionality, a fundamental distinction with previous purchases under the SMP, essentially allows the ECB to counter two types of critics. The first is that secondary market purchases, by lowering market discipline, are an invitation for wrong fiscal behavior (i.e. creates moral hazard). The second is that secondary market purchases amount to government debt monetizing (or entail 'fiscal dominance' of monetary policy). This approach limits the political dimension of the activation of OMT and covers the ECB in so far that it relies on a unanimous political decision of the Eurogroup to grant precautionary financing – under conditions – to a eurozone member requesting it.

The ECB announced no specific target interest rate but stated it would consider yield ceilings, spreads, conditions of liquidity and volatility for its interventions⁶⁸. Risks for the balance sheet of the ECB will be further limited because OMT will focus on bonds with a short maturity left. Finally, unlike in its SMP, the ECB will not have a preferred creditor status i.e. it will rank *pari-passu* with other bond holders. This disposition suppresses concerns that, with a senior status, the ECB purchases would have been detrimental to the value of bonds held by the private sector.

4.2. Limits of secondary market purchases by the ECB

In a context where the EU seems to lack the capacity to take executive decisions to manage the eurozone crisis⁶⁹, the ECB has in practice dictated a strategy for preventive financing of eurozone countries at risk of losing market access. Nonetheless, it should not justify complacency by EU political leaders. This strategy specifically calls for prompt political follow-up for two reasons⁷⁰.

Firstly, the ECB cannot guarantee that a default will not occur because it does not act as a genuine lender of last resort. While conditionality is central to the ECB approach, there is no such thing as a 'conditional' lender of last resort. By stressing it only intends to remove unfounded fears of a euro break-up and recognizing that solvency issues must be tackled otherwise, the ECB explicitly excludes the idea of supporting an insolvent country. By imposing conditions that ensure the country is mostly solvent, the ECB further excludes this possibility. Following this logic, the ECB will not, in principle, prevent an insolvent

68. Op. cit. footnote 65.

69. Veron, N., (2012), "The challenges of Europe's fourfold union", Bruegel policy contribution, issue 2012/13, August 2012.

70. This global strategy will be discussed in more details in the section 5.

country from losing market access. Thus a country might end up requesting a full bail-out of the ESM. Ultimately, a default or an exit from the eurozone is still a conceivable event. The market will take notice of this point and a country might still be pushed to default because of self-fulfilling fears of default (or be pushed into a ‘bad equilibrium’). Thus, despite the fact that the ECB has underlined its action would be unlimited, the deterrent effect of OMT will not be total. Without the right political action, the initial positive market reaction that followed the announcement would likely wane over time⁷¹.

Second, even in case it starts intervening in the secondary market, the effectiveness of OMT will much depend on the reforms implemented at the beneficiary country level, and on the extent to which the economic pillar of the EMU is reinforced at the EU level. The fate of the euro as a common currency depends on a confidence factor. The ECB can only contribute to restore trust. Market forces would ultimately decide whether to keep investing in a fragile country, whose currency is the euro, is safe enough. In principle, the ECB will stop intervening as soon as a country benefitting from OMT will lose market access. Political action is therefore needed, a fact constantly stressed by the ECB Governing Council members. In other words, the ECB can only buy time for political action as it cannot ensure that the euro is irreversible on its own.

71. This is in line with the conclusion on the economic rationale of a preventive intervention (see section 2.3.D).

5. PREVENTIVE STRATEGY: COMBINED INTERVENTIONS BY THE ESM AND THE ECB

With its OMT program, the ECB actually designed a ‘preventive strategy’ consisting in combined interventions of the ESM on the primary market and of the ECB on the secondary market of countries under financial pressure. This chapter will summarize and further discuss the implications of a combined intervention of the ESM and of the ECB action (5.1). Remaining issues, in particular related to the stigma attached to their activation, will then be discussed in more details (5.2).

5.1. Design overview

In principle, OMT would be subordinated to the granting of an EECL involving primary market purchases. Consequently, the complete set of conditions attached to the EECL will apply to the ECB’s OMT. Table 1 (p. 37) compares the characteristics of a possible combined intervention from the ESM on the primary market and the ECB on the secondary market.

Table 1: ESM and ECB respective interventions’ characteristics

	European Stability Mechanism	European Central Bank
Financial assistance Instrument	Enhanced Conditions Credit line (ECCL) with primary market purchases	Outright Monetary Transactions (OMT)
Action	Primary market bond purchases	Secondary market bond purchases
Creditor status	In principle no preferred creditor status (not an ‘ESM loan’)	<i>Pari-passu</i> with other creditors (no seniority)
Size of intervention	No upfront cap Max 50% of each issuance	Unlimited
Price	Approximation of market price: – Auction: at the weighted average price of the auction – Syndicated transactions: at the re-offer price	At market price
Maturity	No indication	Short maturities (1-3 years)
Duration	In principle: maximum two years (duration of credit line) 1 year renewable twice for six months Upon continued respect of conditions	As long as ESM credit line remains available
Precondition	Signing of TSCG Request by beneficiary Euro Area Member State Signing of MoU and FFA	De facto same as ESM

Table 1: ESM and ECB respective interventions’ characteristics (Continued)

	European Stability Mechanism	European Central Bank
Conditions criteria	Continued compliance with terms of MoU and FFA. Respect of the following criteria or corrective measures aimed at addressing criteria not met: 1. Respect of SGP commitments (or formal commitment to address the imbalances indentified) 2. Sustainable public debt 3. Respect of EIP commitments (or formal commitment to address the imbalances indentified) 4. Track record of access to financial market on reasonable terms 5. Sustainable external position 6. Absence of bank solvency problems that can pose systemic threats to the euro	De facto same as ESM

The activation of the combined bond buying is first preconditioned upon request of the beneficiary. The requesting country must sign a MoU and FFA detailing the conditions to be respected to benefit from a continued support. If eligibility criteria are not met, in particular if the requesting country cannot demonstrate a ‘sustainable external position’ and a ‘sustainable public debt’, these will have to be compensated for by other measures. This is where a political bargain can be expected about the mix of structural reforms and deficit reductions measures that will be conditional for the granting of the precautionary credit line. In principle, active involvement of the IMF will be sought in the process. The ECB has stressed this would be its preferred scenario although it does not exclude proceeding with OMT even without the IMF involvement. The beneficiary country will then have to demonstrate continuous compliance with the conditions, in particular with the corrective measures required to address the criteria not met. In principle, combined interventions should be made possible over a period of one year, twice renewable for six months.

In principle, several events should trigger an exit from the combined bond purchasing. If the countries continuously fail to implement the measures it agreed upon in the MoU, the Eurogroup could ultimately sanction the country by interrupting the programme. The continuation of bond buying not only rests on a political decision regarding continued compliance but also on market forces. Indeed, if the combined purchases fail to maintain the country’s access to the financial market, they would miss their objective and would consequently need to be interrupted. Therefore, both programmes intend to take market price sig-



nals into account. An exit from the programme would be triggered in particular by repeated auction failures, necessitating primary market purchases above 50% of the issued amount. Since this would signal the country is reaching insolvency despite the interventions, the ECB would also stop intervening. Finally, in principle if the credit line is depleted, it would either have to be extended or primary market interventions by the ESM would stop. In this case, whether the ECB would continue its intervention on the secondary market is uncertain.

While the ECB will focus its intervention on relatively short-term maturities, the ESM has no predefined strategy. Focusing on short term maturities protects the buyer from a potential default, and arguably prevents moral hazard issues, but at the same time it might tend to signal a lack of confidence on the sustainability of the country's debt, and lead to a crowding out of investors on longer maturities.

5.2. Mitigating the risk of non activation of the preventive strategy

An overview of the risk of the strategy not actually being activated is given (A) followed by some recommendations to overcome this issue (B).

A. *Overview*

What would determine the success of the strategy in the first place is whether the ailing country requests support in time to justify a precautionary programme. The alternative could ultimately be a full ex-post bail-out with the accompanying macro-economic adjustment programme. In the latter case, the ECB would not act as the country would be deemed mostly insolvent. Once a country has lost access to financial markets and is under a macro-economic adjustment programme, the ECB will only act in order to help the country regain access to financial markets i.e. when the country is exiting its adjustment programme.

Trying to avoid requesting preventive support for too long is risky. From a market perspective, given the uncertainty of the activation of primary market purchases and the attached OMT, the market might start anticipating a full bail-out rather than a preventive financial assistance. Once it has lost market access, it will be too late for a country to benefit from the 'big bazooka', the combined ESM/ECB intervention was intended to be⁷².

72. In the course of the global financial and economic crisis, the 'big bazooka' became a popular expression referring to the deterrence effect of a large intervention. After an original quote by Hank Paulson, former US Treasury secretary, before the US Congress, on 15 July 2008: 'If you have a bazooka in your pocket and people know it, you probably won't have to use it'.

As underlined previously, relying on the announcement effect could only prove itself to be a mistake. The more the country delays the request, the more likely it is that market pressure will intensify. And the closer the country will be to a potential default, the more difficult it will be to obtain relatively low conditions from its eurozone partners. Moreover, by then, the eventual request for support will signal a solvency problem rather than a liquidity problem. In sum, as time passes, political and economic stigma might actually rise to the point where preemptive financial assistance is never activated. Complacency and indecisiveness could jeopardize the preventive strategy suggested by the ECB.

B. Recommendations

While distressed countries should not unnecessarily delay requesting support, other partner countries need to be sufficiently accommodating. It is in the interest of all eurozone countries to facilitate assistance requests and the resulting opening of precautionary credit lines from the ESM. This would truly load ‘the big bazooka’ that so far only exists on paper. Therefore the main issue revolves around what ‘appropriate’ conditions should be attached to the precautionary programme. In principle, these should be light enough to encourage the country to request assistance and strong enough to prevent moral hazard risks⁷³.

Events repeatedly highlighted the issue surrounding the conditionality attached to precautionary assistance. At the European Council on 28-29 June 2012, the request by Italy that the EFSF/ESM should be ready to support the Italian debt with lower conditionalities than under a macro-economic adjustment programme was followed by an agreement subject to much ambiguity, both in its content and its possible implementation. Then, following the OMT announcement by the ECB, Spain, most in need of assistance, has appeared to attribute much stigma to the use of the ex-ante EFSF/ESM facilities.

Several recommendations can be formulated. First, moral hazard concerns should not dominate discussions. The objective of precautionary assistance is precisely to – temporarily – facilitate continued access to the financial market. The market will therefore still discipline the country under a precautionary programme. This discipline will be effective as the market would fear the country would slip from its adjustment path, stop respecting elementary conditions and ultimately risk losing the benefits of both primary and secondary market interventions.

Secondly, prior clarification and agreement regarding the conditionalities of support would be a strong signal that political brinkmanship will not dictate

73. See section 2.4 for the general discussion on this dilemma and the economic rationale of preventive financial assistance.

crisis management. The Commission, in liaison with the ECB, should inform eurozone countries in advance of the eligibility criteria to facilitate requests.

Thirdly, while at the time of writing the focus is on Spain, other countries with relatively sound economic situations, but which are still under the threat of a sudden deterioration of their sovereign bond market, should also ideally request the opening of stand-by credit line. They should do so even if they do not plan to activate the assistance under the current relatively favorable circumstances. This would prevent future difficulties in case support is one day needed and would have a strong deterrent effect. Italy should in particular consider doing so⁷⁴.

Fourthly, there is a possibility that the question of the seniority of ESM will arise. I argued that, in principle, there is no *de jure* status attached to the bond the ESM will hold on its books. However, investors might still anticipate that a *de facto* seniority applies. That ambiguity should be lifted as the ECB did for its OMT programme.

Finally, beyond the most crucial question of setting the right conditions, the size of the credit line granted under the precautionary programme should not be overlooked. The credit line should ideally be larger than 10% of GDP, or allow for some flexibility, to ensure the coverage of two years of refinancing needs⁷⁵.

74. Cline, W.R., (2012), "Interest rate shock and sustainability of Italy's sovereign debt", policy brief, PB12-5, Peterson Institute of International Economics.

75. See section 3.2.D for a complete discussion.

6. EUROBONDS AS ADDITIONAL INSTRUMENTS TO PREVENT THE RISE OF BORROWING COSTS?

I will first briefly describe what Eurobonds are (6.1). As I will argue, their characteristics lead to economic and political issues rendering the introduction of Eurobonds unrealistic in the short term (6.2). I will then summarize why, when strictly considered as a short-term crisis management tool, Eurobonds present downsides compared to mechanisms readily available i.e. EFSF/ESM and ECB (6.3).

6.1. A definition of Eurobonds

Many proposals for the introduction of Eurobonds gained much attention in the course of the eurozone crisis⁷⁶. Eurobonds schemes can vary greatly but nonetheless share some common principles. Eurobonds are commonly issued bonds whose proceeds can partially serve to cover eurozone countries' financing needs. In practice, Eurobonds are issued by an entity (e.g. a 'debt agency') backed by guarantees of eurozone countries. Since the outbreak of the eurozone crisis, Eurobonds schemes were mostly being discussed as a short-term crisis management tool that would especially benefit countries under market pressure.

The case for a short term introduction of Eurobonds basically follows the same logic than pre-emptive interventions discussed in this paper. This should not come as a surprise as the bonds issued by the ESM are basically 'Eurobonds' themselves: these are also commonly issued and backed by the guarantees of eurozone countries. In terms of conditionality, Eurobonds present a similar tradeoff between stigma and moral hazard issues that arise under a precautionary programme of the EFSF/ESM⁷⁷. There are two major differences between the two mechanisms though. Firstly, while the ESM provides financing to a limited selection of countries, the entity issuing Eurobonds generally provides funding to all eurozone members systematically. Secondly, and as a consequence, the guarantee structure underlying the scheme should in principle be stronger to allow for a much larger lending capacity.

76. Most notably: the Blue bond proposal (Delpla, J., von Weizsäcker, J., (2010), "The Blue Bond proposal", Bruegel policy brief, Issue 2010/03), the European Redemption fund proposal (German Council of Economic Expert, (2011) "Euro area in crisis, Annual report 2011/12", annual report of GCEE, chapter 3), the Eurobills proposal (Hellwig, C., Philippon, T., (2011), "Eurobills, not Eurobonds", available at: <http://www.voxeu.org/article/eurobills-not-euro-bonds>). For a broad overview and comparisons see Claessens, S., Mody, A., Vallee, S., (2012), "Paths to Eurobonds", Bruegel Working Paper, 2012/10.

77. For an overview of conditionality considerations, see section 2.4. It should be noted that for the same conditionality level, financing via Eurobonds would probably present a lower stigma than under a precautionary programme of the EFSF/ESM.

6.2. Economic and political issues

A. *Redistribution effects*

In so far that financing via the common issuance is mandatory, i.e. all guarantors in the scheme are at the same time beneficiaries⁷⁸, Eurobonds would have a direct redistribution effect. Less creditworthy countries would likely benefit from the lower interest rates on the common issuance while fiscally strong countries would likely pay a higher borrowing cost than previously. Seen from this static perspective, the scheme would only create winners and losers: ‘high-yield’ countries would benefit at the detriment of ‘low-yield’ countries as illustrated in BOX 2 (p. 45).

Whether this relative loss for fiscally strong countries can potentially be offset mostly depends on the absolute gains that could be achieved (in BOX 2: the extent to which the actual common interest rate would be below the weighted average interest rate r^*). As liquidity gains would most probably be limited⁷⁹, this would only be possible if current interest rate levels were much above normal levels. If this is due to fears of a break-up, Eurobonds introduction would arguably contribute to breaking these expectations, and lower interest rates⁸⁰. However, it is clear that in so far that this dynamic is detrimental in some fiscally vulnerable countries; it benefits fiscally strong countries, as capital flight from fiscally weak to fiscally strong countries tends to lower their interest rates. While some absolute gains are likely, one should thus not expect that the common borrowing cost of the eurozone would decrease below that of fiscally strong countries when Eurobonds are introduced.

Nonetheless, absolute gains could be distributed unevenly among eurozone countries by allowing a differentiated interest rates allowed by a bonus/penalty system⁸¹. However, whether countries currently benefiting from low yields would benefit still depends on the expected absolute gains which are inherently uncertain. Moreover, in a dynamic perspective, it is arguable that the compensation might only add to the distressed countries’ indebtedness and thus ultimately have no value to the healthy ones accepting a future liability in exchange⁸². This uncertainty and the complexity of the scheme might make the proposal excessively difficult to negotiate.

78. (in figure 2 p. 22), where the ‘debt agency’ substitutes for the ESM as the issuing entity, guarantors and beneficiaries circles coincides.

79. See European Commission, (2011), “Green Paper on the Feasibility of Introducing Stability Bonds”, COM (2011)/818, 23 November 2011.

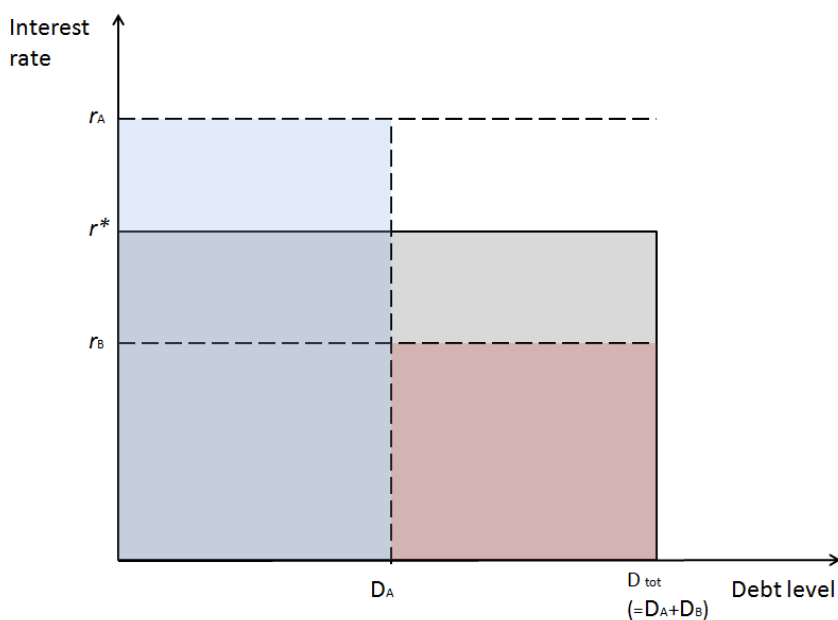
80. In a similar way as ‘ex-ante’ or ‘preventive’ financing, in particular primary market interventions discussed supra.

81. For a proposition involving differentiated interest rates, see for example Artus, P., Cuillère, T., El Moutawakil, B., (2011), “What bonus/penalty system for the eurobond?”, Natixis, Flash economics, N°613, 22 August 2011.

82. Tirole, J., (2012), “The euro crisis: some reflexions on institutional reforms”, Banque de France Financial Stability Review, N°16, April 2012.

BOX 2: Eurobonds redistribution effects (under full substitution of national issuance)

The effect on interest rate is illustrated in the following figure where two countries A and B pool their entire debt which we assume are of equal size ($D_A = D_B$). Initially, country A has a borrowing cost of $r_A D_A$ (blue area) and country B of $r_B D_B$ (red area). If A and B simply pool their debt together, they now both pay the interest rate r^* which is lower than r_A but higher than r_B (assuming it is the weighted average of the two). Hence, in a simple pooling scheme A wins while B loses: A's interest rate is lowered and B's interest rate is now higher. The overall borrowing cost for A and B taken together is the grey area ($r^* D_{TOT}$).



Although this scenario assumes the full substitution of national issuances by Eurobonds, partial substitution would face similar redistribution issues.

The EFSF/ESM' loans or primary market interventions are not implying a direct impact on the interest rates of the strongest guarantors. Their beneficiaries are specific countries that requested support rather than all of the eurozone countries that might be 'forced' to partially finance themselves via Eurobonds.

B. *Joint and several guarantees issue*

Eurobonds proposals differ significantly from the EFSF/ESM scheme since all guarantors of the scheme are at the same time beneficiaries (see figure 2, p. 22). This necessitates a larger funding capacity and consequently a stronger guarantee structure than that of the ESM. Accordingly, most ‘Eurobonds’ proposals consider ‘joint & several guarantees’ as an absolute necessity to ensure the robustness of the scheme. In principle, the guarantors would be liable not only for their own share, but also for the others’ share in case the latter default. In practice, if a beneficiary country defaults on its obligation to redeem its debt, other countries would be requested to compensate for the loss incurred by the issuing entity (e.g. the ‘debt agency’). In other words, eurozone countries would collectively commit to insure each others’ debt.

Joint-and-several liability emerges more naturally in an environment in which countries are behind a ‘veil of ignorance’ i.e. commitments are not made in a context where suspicion of cross-subsidies looms large⁸³. Once lifted, it becomes difficult to find a consensus on proposals likely implying significant risk-sharing between creditworthy and less creditworthy countries. Moreover, the success of Eurobonds would depend on how the market will react and on the beneficiary countries’ ability and willingness to stabilize and reduce their debt level. Both are inherently uncertain, which increases the difficulty in reaching an agreement.

In this difficult context, joint and several guarantees tend to be perceived as dangerous and incredible because of the sizable commitment they imply. *In extremis*, creditors could request that a small guarantor (like Estonia or Cyprus) pay up for the debt of Spain or Italy⁸⁴. Doubts about the capacity and willingness of guarantors to pay such large amounts might induce the market to believe joint and several guarantees are not really credible, thereby jeopardizing the Eurobonds’ scheme.

In comparison to the ESM, eurozone countries would need to agree to expose themselves to much larger contingent liabilities. In this sense, the difficulty of introducing Eurobonds can be measured comparatively with the potential difficulty of increasing liabilities under the ESM in order to boost its lending capacity⁸⁵. Political opposition is particularly vocal in countries perceived as fiscally strong, most notably Germany, the Netherlands and Finland⁸⁶.

83. *Ibidem*.

84. Gros, D., (2011), “Eurobonds: wrong solution for legal, political and economic reasons”, 24 August 2011, available at: <http://www.voxeu.org/article/Eurobonds-are-wrong-solution>.

85. While the ESM has EUR 700bn of committed guarantees, Euro-bills would require EUR 940bn, the Redemption pact about 2.250bn, Blue Bonds about EUR 5.600 bn.

86. In *extremis*, and strictly speaking, contingent liabilities for Germany (as percentage of GDP) would amount to 36% for Eurobills, 117% for the Redemption Pact, 215% for Blue Bonds compared to 7.3% for the ESM. Calculated as the German maximum liability under the scheme divided by Germany’s GDP (2011).

6.3. Why Eurobonds are not a viable short term response

Eurobonds and the EFSF/ESM's precautionary financing schemes share the same core functioning principles. As such, Eurobonds do have the potential to lower the borrowing cost of countries currently under strong market pressure. However, they would almost certainly imply higher interest rates for countries perceived as fiscally strong. Moreover, by design, Eurobonds almost necessarily assume joint and several guarantees. This implies that eurozone countries accept a significant and almost unlimited exposure in the event that a beneficiary country defaults. This makes their introduction, in the current crisis context where liabilities are precisely accounted for, extremely unlikely.

ESM precautionary programmes do not present these problems. Financing is targeted at specific countries most in need. This requires a lower funding capacity and lighter guarantee structure than with Eurobonds. Politically problematic contingent liabilities are hence kept to a minimum. The ESM in particular is a readily available vehicle, with a credible capital structure implying limited liabilities, and which is better designed to provide liquidity assistance. If its size proved to be too limited, eurozone countries would still have the possibility of increasing its capacity, which would in any case be more politically palatable than a short-term Eurobonds introduction.

Of course, Eurobonds design could actually resemble the ESM design to limit these core issues. The scheme could be based on 'several' guarantees (instead of 'joint and several') and make financing with Eurobonds facultative. If so, one could therefore question the need to have a second instrument very similar to the ESM. The only difference might be that it would be strictly dedicated to ex-ante financing. There is no obvious advantage to creating a separate entity. It would be simpler to increase the ESM ceiling if needed.

This conclusion does not however preclude of the major benefits that forms of Eurobonds could deliver within a reinforced EMU architecture. They could evolve towards a common safe asset rivaling US Treasury Bonds and reinforce the international role of the euro as a reserve currency. They could structurally prevent the emergence of disruptive financial flows within the eurozone. They could also insure the financing of a significant proportion of new solidarity mechanisms which would act as buffers against cyclical regional shocks in the EMU, notably facilitating the correction of external position imbalances.

However, even a limited Eurobonds scheme necessarily implies as a prerequisite a political commitment towards a fiscal union, one crucial missing building block in the EMU. This commitment, which would ultimately have to take the form of a new Treaty, is unavoidable as the mutualisation of risks/debts calls for

the mutualisation of control⁸⁷. Whether EU countries manage to agree to the transfers of sovereignty that such a major integration leap requires remains far from certain, and will in any case and inevitably require some time.

87. This paper hence does not discuss potential legal implications. For a brief overview, see Vanden Bosch, X., Verhelst, S., (2012), "A briefing on Eurobonds", Egmont Institute, European Policy Brief, N°10, June 2012.

CONCLUSION

There are several compelling benefits arising from an intervention in sovereign bond markets to prevent a country's borrowing cost to reach unsustainable levels. In general, well designed pre-emptive purchases in a country's primary and secondary sovereign debt markets would be more efficient and less costly than allowing this country to be bailed-out. In a scenario where large countries such as Spain and Italy must simultaneously be rescued, full-scale bailout programmes that were used for Greece, Ireland and Portugal, would either require more funding or involve a large debt restructuring. Since it is unlikely that more funds will be committed in the ESM and that a default is precisely what should be avoided, effective ex-ante financial assistance becomes a necessity to ensure an efficient management of the eurozone crisis.

The original design of the EFSF/ESM was therefore reviewed to allow the funds to act preemptively by intervening in primary or secondary sovereign bond markets for countries requesting support under a precautionary programme. In this context of raising uncertainties regarding the future of the euro, the ECB suggested a comprehensive and bold strategy preventing countries from losing access to markets. For a country requesting preventive support, the ECB would purchase the beneficiary countries' bonds on an unlimited basis in secondary markets (via OMT) while the ESM would impose the conditions and intervene in primary markets. Given their respective firepower, this combination is without doubt the most efficient path and allows for a political backing of the ECB interventions.

Although some countries, notably Spain and Italy, have experienced threatening pressure by financial markets, they so far refrained from requesting such support, notably because of the uncertainty regarding the attached conditions which might prove stigmatizing. The eurozone should not however rely on the market relief the ECB announcement has created because it can only wane over time. Since the ECB made its intervention conditional, it does not fully endorse the role of a lender of last resort and cannot guarantee on its own the irreversibility of the euro. To be potentially activated the combined interventions by the ECB and the ESM most importantly require the signing of a memorandum of understanding setting the conditionality attached to them.

Taking notice of this, countries that regularly experience strong market pressure should request the opening of a credit line while their situation on financial markets still allows for it. Hesitation to do so only risks bringing them on the edge of a financial precipice, as markets will start questioning whether the activation of the preventive strategy, including OMT, will ever take place. Once in this situation, it will be even more complicated for the Eurogroup and the coun-

try on the verge of default, to agree on the conditions of a precautionary programme, if not on the justification for a precautionary programme instead of a regular bail-out. In this case, the benefits of secondary market purchases by the ECB will be sorely missed as it would be too late to give a chance to the ECB to intervene in secondary markets.

Other eurozone countries should facilitate the negotiations, by not requesting unnecessarily strong conditions. The strategy is indeed ‘preventive’ as it aims to encourage the market to keep financing the beneficiary country. In any case, it is by design a temporary intervention. Market pressure will not be switched off because the combined intervention is switched on. Consequently, excessive moral hazard considerations should not jeopardize the whole strategy. Once an agreement on the conditions is reached, the credit line should be large enough to cover two years of primary market interventions. In sum, the success of preventive crisis management suggested by the ECB crucially depends on political action: the ‘big bazooka’ is now available – on paper – but it will only be loaded by granting ESM precautionary credit lines to countries necessitating it.

However, once properly activated, the preventive strategy can only buy some time. Investors’ confidence in the irreversibility of the euro and in the solvability of all its members cannot be restored by preventive crisis management mechanisms, no matter the effectiveness of their design. This is a fundamental part of the underlying rationale of the ECB’s strategy, as it assumes that while markets can be prone to self-fulfilling expectation of insolvency, interest rates in sovereign bond markets convey important price signals. In this sense, the ECB’s claim that ‘fears of the reversibility of the euro are unfounded’ is necessarily political: investors’ fears might well be founded in so far as the fate of the euro rests on political decisions upon which the ECB has no control.

To make sense and effectively buy time, preventive interventions must, hence, necessarily be accompanied by political action. At the country level, time should be used to pursue adjustment efforts. At the EU level, time must allow European leaders to decide how the monetary union should be completed with political, economic, fiscal and banking unions. As part of this comprehensive future design, by reinforcing the economic side of the EMU, properly designed Eurobonds could structurally limit financial markets’ volatility that currently threaten the common currency. However, as several countries have repeatedly stressed, even partial Eurobonds cannot be introduced before eurozone members jointly agree on the future design of the EMU. Without such a commitment, it would be elusive to believe an agreement on the introduction of Eurobonds can be reached in the short term. In the meantime, a combined intervention by the ESM and ECB is the most effective mechanism to mitigate the eurozone crisis.

ANNEX I: OVERVIEW OF EFSF/ESM PRECAUTIONARY ASSISTANCE INSTRUMENTS

Intervention type	Primary market purchases (or loan) under a Precautionary Conditioned Credit Line (PCCL)	Primary market purchases (or loan) under an Enhanced Conditions credit line (ECCL)	Secondary market interventions
CONDITIONS			
Preconditions	Ratification of TSGC (ESM). Request by beneficiary country. Signing of MoU and FFA.	Ratification of TSGC (ESM). Request by beneficiary country. Signing of MoU and FFA.	Ratification of TSGC (ESM). Request by beneficiary country. Signing of MoU and FFA. ECB assess the need for intervention. (Analysis determining the potential existence of exceptional financial circumstances and risks to financial stability).
Ex-ante conditions (eligibility criteria)	1. Respect of SGP commitments (or formal commitment to address the imbalances indentified). 2. Sustainable public debt. 3. Respect of EIP commitments (or formal commitment to address the imbalances indentified). 4. Track record of access to financial market on reasonable terms. 5. Sustainable external position. 6. Absence of bank solvency problems that can pose systemic threats to the euro.	Same criteria as under a PPCL but for those not met -> ex-post conditions	1. Respect of SGP commitments (or formal commitment to address the imbalances indentified). 2. Sustainable public debt. 3. Respect of EIP commitments (or formal commitment to address the imbalances indentified). 4. Track record of access to financial market on reasonable terms. 5. Sustainable external position. 6. Absence of bank solvency problems that can pose systemic threats to the euro.
Monitoring of ex-ante conditions	Continuous respect of the eligibility criteria monitored by the Commission.	Continuous respect of the eligibility criteria (that were met when the credit line was granted) monitored by the Commission.	Continuous respect of the eligibility criteria monitored by the Commission.
Ex-post conditions		The beneficiary country must adopt corrective measures aimed at addressing remaining vulnerabilities (criteria not met).	
Enhanced surveillance	Commission in liaison with ECB from the moment the credit line is drawn (activated).	Commission in liaison with ECB from the moment the credit line is granted.	Commission in liaison with ECB. Deviation can lead to revision condition in MoU or termination of programme.
Activation	At the initiative of the beneficiary country.	At the initiative of the beneficiary country.	At the initiative of the Euro Working Group/Board of Directors Technical Subcommittee including the ECB, on the basis of the ECB analysis.

INTERVENTION SIZE			
Total reserve	No upfront cap. Typical size to be expected 2-10% of GDP (EFSF).	No upfront cap. Typical size to be expected 2-10% of GDP (EFSF).	EFSF: all remaining capacity ESM: not specified.
Intervention Limit (per issuance/ over time)	Primary market purchases: in principle max 50% of final issue amount. Loan: maximum tranche size set in FFA (of credit line).	Primary market purchases: in principle max 50% of final issue amount. Loan: maximum tranche size set in FFA (of credit line).	EFSF/ESM and ECB sets pro-tempore intervention caps. Reports only on weekly volume.
Price	Primary market purchases: (Auction) at the weighted average price of the auction or (Syndicated transactions) at the re-offer price. Loan: same conditions as for regular loans.	Primary market purchases: (Auction) at the weighted average price of the auction or (Syndicated transactions) at the re-offer price. Loan: same conditions as for regular loans.	At market price.