Rabobank

The ELEC temporary Euro T-Bill facility

Sovereign Bond Markets in State of Flux
Brussels, 06 March 2012, CEPS

Wim Boonstra
Chief Economist,Rabobank, Utrecht
President of the Monetary Commission of ELEC, Brussels

The ELEC approach to eurobonds (1)

- Temporary (4 years) conditional Eurobond programme (under cross-guarantee)
- Covers all liquidity needs (debt redemption and deficit)
- Only open for solvent countries (currently not for GR, IRE and PT) that fully implement new fiscal rules
- Maximum maturity of Bills: 2 years
- Conditional bonds ➔ surcharge depending on performance of public finances

The ELEC approach to eurobonds (2)

- Temporary programme: acceptable for constitutional courts
- Big stick at the end: misbehaving countries can be removed without contamination of the system (thanks to the cross-guarantee)
- A four year facility buys time to implement adequate policies
- Cuts link between domestic banking systems and national public debt ➔ failing governments don't contaminate domestic banks
- Creates a "risk-free asset"

The ELEC approach to eurobonds (3)

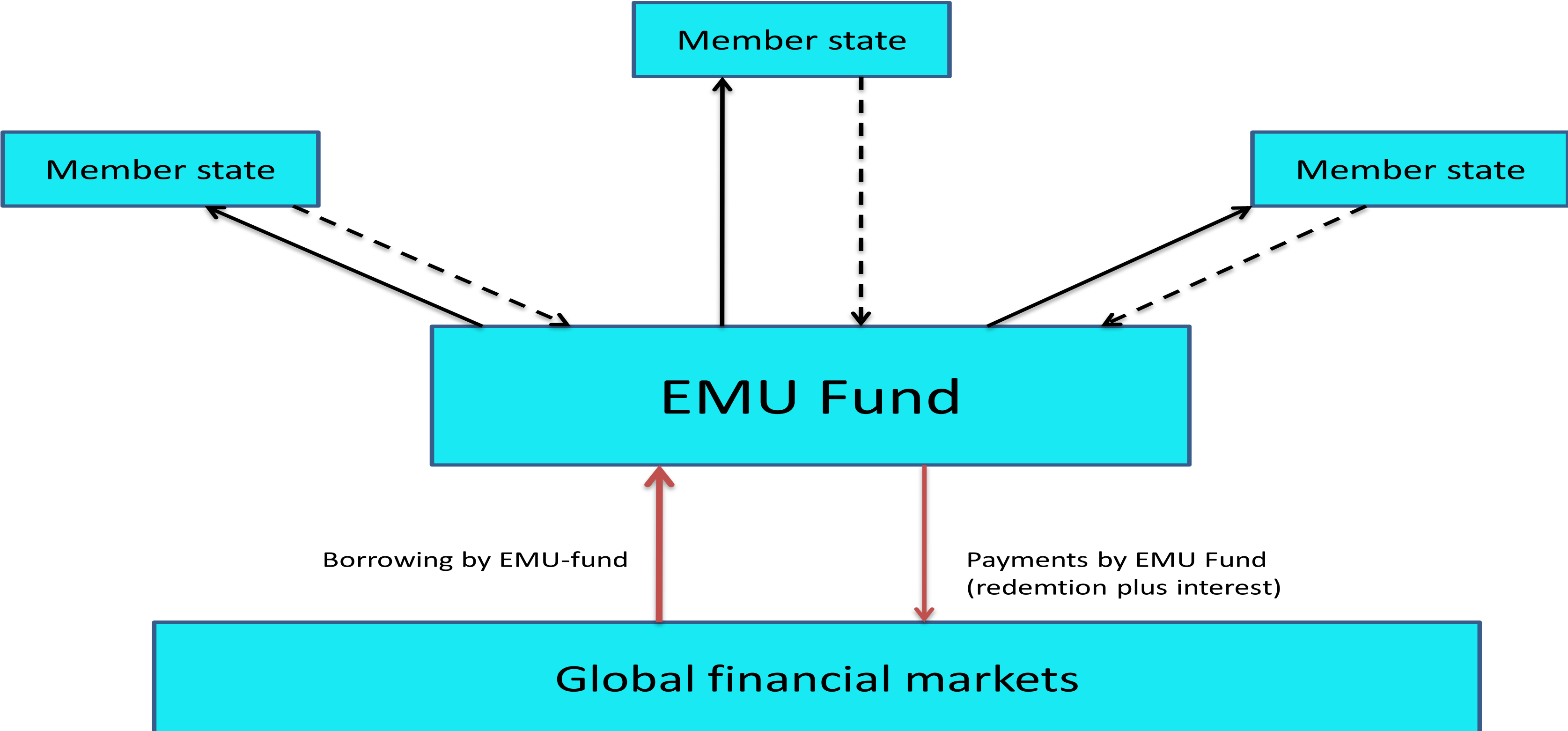
- Common funding with a cross guarantee, open for all countries that don’t draw on the EFSF and comply to the new budget rules
- Central funding via a new institution: the EMU Fund.
- ECB can stop its SMP. EFSF enlargement is not necessary
- Countries that participate give up their right to directly tap the financial markets in the short term maturities
- Countries that fail to meet the SGP criteria pay a spread over funding costs of the Fund, determined by public debt and deficit ratios (see below)

The ELEC approach to eurobonds (4)

- EMU Fund issues short term bonds, paying market rates
- The issued bonds are covered by a full cross-guarantee
- The money raised is distributed to the participating member states
- Participating countries pay market rates plus surcharge (see below)
- The surcharges are added to the reserves of EMU Fund, creating buffers for future mishaps
- Cross-guarantee in combination with good governance (budget rules with effective supervision and automatic and effective sanctions) will result in a very high credit rating

Central funding via the EMU fund

Rabobank



Advantages of this approach (1)

- Better discipline as diverging fiscal policies translate into diverging funding costs (restoration of failing market discipline)
- Countries are sheltered from sudden swings in market sentiment
- Creation of huge and liquid pan-EMU market for short-term bonds
- Weaker countries pay premium to EMU Fund, instead of higher interest rates to markets ➔ financial buffer against future problems

Advantages of this approach (2)

- Using cross-guarantee ➔ the EMU average counts, not the problem countries in the margin ➔ lower funding costs for all?
- Non-performing countries can be removed without danger of contagion
- Link between national public sector and domestic banks is cut: “risk free assets’ are covered by a cross-guarantee.
- Stability of banking sector improves because of more stable markets and cut of link between banks and governments.

Consequences for investors

Rabobank

- In the short maturities (< 2 year) for public debt there will be only one relevant issuer: the EMU fund
- In the longer maturities (> 2 year) there will only be public bond issues from the stronger countries
- The liquidity of the EMU market for public T-Bills will improve enormously and match the market for short term US Treasuries
- The competitive position of the euro as a major reserve currency will improve enormously
- The euro will probably appreciate substantially

Possible problems of this approach

- Potential tensions with no-bail out clause ➔ we already have crossed this line
- Anchoring the system and calculation of the spread ➔ see below
- Lack of political willingness ➔ voluntary participation, but one you're in, you cant go out (unless you are removed……)
- Uncertain impact on funding costs for stronger countries.

Computing the spread

Rabobank

- A simple straightforward formula will suffice:

- $R(i) = \alpha\,[O(i) - O(m)] + \beta\,[S(i) - S(m)]$

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

Concluding remarks

- Only a pan-EMU federal budget or Eurobonds tackles a fundamental flaw in EMU's design: the fragmentation of markets.
- If fragmentation of national bond markets is not eliminated, EMU will remain vulnerable and may in the end not survive.
- A vulnerable EMU results in vulnerable banks and unstable markets
- Eurobonds will only help if they deliver advantages for both strong and weak countries
- However: Eurobonds are a fundamental redesign of EMU and need time to implement
- The ELEC temporary scheme of conditional euro T-Bills delivers most, if not all of these benefits

More information?

www.rabobank.com/kennisbank