EconPol
POLICY BRIEF

03
2017

November
Vol. 1

# Accountability Bonds – Reconciling Fiscal Policy Based on Market Discipline with Financial Stability

*by Clemens Fuest and Friedrich Heinemann*

EUROPE
econPOL
European Network for Economic and Fiscal Policy Research

headed by

ifo INSTITUTE
Leibniz Institute for Economic Research
at the University of Munich

EconPol POLICY BRIEF
A publication of EconPol Europe
European Network of Economic and Fiscal Policy Research

Publisher and distributor: ifo Institute
Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 89 9224-0, Telefax +49 89 9224-1462, email Abentung@ifo.de
Editors: Daniela Abentung, Clemens Fuest
Reproduction permitted only if source is stated and copy is sent to the ifo Institute.

**EconPol Europe: www.econpol.eu**

# Accountability Bonds – Reconciling Fiscal Policy Based on Market Discipline with Financial Stability

*Clemens Fuest and Friedrich Heinemann**

## 1. Introduction

Reforming the Eurozone is a top priority on the European policy agenda. France and Germany are expected to launch a joint initiative to reform the institutions of the currency union. To be successful, this initiative will have to be acceptable not only to Germany and France, but to all member states including those plagued by high debt levels and sluggish economic growth. The issue of market discipline in national fiscal policy and sovereign debt restructuring dominates the debate over Eurozone reform. While the German government emphasizes the role of market discipline and the no-bailout-rule, the French government is more skeptical, arguing that sovereign debt restructuring may give rise to financial instability. Public debt levels are high (over 130 percent of GDP in Italy, for example), banks are holding large quantities of government debt, and their ability to absorb losses from a debt restructuring is limited. In this situation, reforms that make debt restructuring more likely could undermine investor confidence and trigger a financial crisis.

There is nevertheless a growing awareness that fiscal governance in the Eurozone will not work without credible forms of public debt restructuring. Such restructuring can only be avoided with far reaching mutualization of government debt. This, however, would be incompatible with preserving national sovereignty in fiscal policy. European control over national fiscal policies is weak and will remain so for the foreseeable future. At the same time, the no-bailout-rule and plans for public debt restructuring can only remain credible if their implementation does not lead to a financial crisis. Highly-indebted countries are unlikely to support fiscal policy reforms dominated by market discipline either, especially if they massively raise debt servicing costs or make it harder to roll over existing debt.

* Clemens Fuest: ifo Institute, Munich, Friedrich Heinemann: ZEW, Mannheim

Two years ago we published a proposal[1] for a new form of government bonds called Accountability Bonds aimed at reviving market discipline into the Eurozone without endangering fiscal and financial stability. This paper revisits the concept of accountability bonds in the light of current developments and responds to criticism of it.

## 2. Accountability Bonds: how do they work and what can they achieve?

Accountability bonds are government bonds that differ from today's standard bonds in the following ways:

1. If a member state's structural budget deficit (not the stock of debt) exceeds the level of 0.5 percent of GDP specified by the European fiscal compact, its excess debt is issued in the form of accountability bonds.[2]
2. Accountability bonds are junior government bonds, i.e. they lose their value as soon as the issuing government defaults on 'regular' bonds.
3. If a country starts an ESM program, its accountability bonds lose their value.
4. If a country's debt to GDP ratio including accountability bonds exceeds 120 percent of GDP, redemption and interest payments on accountability bonds are suspended until the debt ratio falls below that level, even if the issuer does not default on other government bonds. Countries with a current debt to GDP ratio of 120 percent or more are subject to a transitionary arrangement.
5. The ECB cannot buy accountability bonds.
6. Banking regulation and supervision treats these bonds as risky, in other words banks can only hold these bonds if they are underpinned with equity and subject to diversification restrictions.
7. Countries are allowed to refinance their existing stock of regular bonds with newly issued regular bonds.

[1] Fuest. C., F. Heinemann, C. Schröder (2015): Reformen für mehr fiskalische Eigenverantwortung der Euro-Staaten, Das Potenzial von „Accountability Bonds“, Studie für die Vereinigung der Bayerischen Wirtschaft, see also Fuest, C (2016): Accountability Bonds, ifo Viewpoint No 171.

[2] An alternative and less restrictive approach would be to use the three percent rule of the European Stability and Growth Pact. The key point is that the concept does not refer to debt stocks.

The economic logic underlying the proposal is *not* to 'punish' member states if they overstep European fiscal rules. The main objective is to ensure that, if individual member states issue new debt that exceeds the jointly-established limits set out by common fiscal rules, this excess debt is not covered by any form of solidarity, be it through ECB bond purchases or financial help from the ESM.

This ensures that the cost of this debt is borne exclusively by those involved in its creation – namely the country issuing the debt and the private investors who buy it. The new bonds will foster accountability in the Eurozone – if member states want to overstep European fiscal rules by borrowing more than jointly agreed, they and their creditors are held accountable if things go wrong and their debt cannot be serviced. Most importantly, investors who buy this debt need to understand that it will *not be repaid by taxpayers in other member states*. This does not imply that there is joint liability for government debt below the limits set by European fiscal rules. The No-Bailout Rule is a general rule of the Eurozone. ECB bond purchases and ESM credits, however, do imply that all taxpayers in the Eurozone are held liable for the debt of individual states that receive support.

Accountability bonds have a number of additional advantages. They strengthen European fiscal governance and fiscal policy coordination by highlighting the need to respect European fiscal rules. Allaying fears that the taxpayers of less indebted countries will be held liable for the debt contracted by higher spending member states may even make it easier to garner political support for more elements of fiscal solidarity, including a possible Eurozone fiscal capacity. Introducing accountability will represent a stronger commitment to fiscal consolidation. This should foster investor confidence regarding both the existing stock of debt and newly issued normal government bonds. It will also reduce borrowing costs for highly indebted governments.

# 3. Accountability bonds: Q&A

In this section we discuss a number of issues that have been raised in the debate about accountability bonds, their economic implications and their political viability.

**a) How do accountability bonds differ from previous proposals involving senior and junior government bonds like the Red Bond-Blue-Bond Plan (Delpla and von Weizsäcker[1]) or the debt redemption pact (Council of Economic Advisers[2])?**

The key difference is that these earlier proposals refer to the *stock* of government debt, while the accountability bonds concept leaves the stock of debt untouched and focuses on the *flow* of debt, i.e. the current and future yearly budget deficits. The Blue-Bond-Red Bond proposal, for instance, implies that there will be joint liability for national debt up to a level of 60 percent of GDP. The excess stock of debt will not be covered by joint liability and will potentially be subject to restructuring. This raises issues regarding the stability of the market for this debt. The accountability bond concept implies that countries are allowed to roll over the entire stock of debt existing at the point in time when accountability bonds are introduced. This implies that countries that comply with European fiscal deficit rules will never be obliged to issue accountability bonds, even if their current stock of debt is far higher than 60 percent.

**b) Could accountability bonds destabilize the public finances of highly-indebted countries?**

No. Since all countries are allowed to roll over their debt as it exists when accountability bonds are introduced and banks may continue to hold these bonds under the same conditions as today, there is no danger of the reform destabilizing financial markets. If, in the future, accountability bonds lose their value because a country applies for an ESM program, or its debt level including accountability bonds exceeds 120 percent of GDP, the loss of value of outstanding accountability bonds will increase the likelihood that the country can service its outstanding regular bonds. In this sense, accountability bonds limit the "debt dilution problem", whereby new debt lowers the quality of old debt. Investors financing the excessive deficits of a euro area country by buying an accountability bond would no longer impose a negative externality on earlier investors. Banking sector stability will not be affected because banks have no particular incentives to hold accountability bonds. If they do so, they are required to underpin

[1] Delpla, Jacques and Jakob von Weizsäcker (2010), The Blue Bond Proposal, Bruegel Policy Brief No 2010/03, May 2010.

[2] Bofinger, Peter, Feld, Lars, Franz, Wolfgang, Schmidt, Christoph and Beatrice Weder di Mauro (2011), A European Redemption Pact, VOX, 09 November 2011.

their investments with sufficient equity, so that they can absorb losses. Their holdings of regular debt will even benefit from reduced debt dilution.

**c) What happens when the existing stock of public debt needs to be refinanced?**

All countries are allowed to refinance their existing stock of regular outstanding debt with new regular bonds. The stock of outstanding accountability bonds would be refinanced through new accountability bonds. If a country's debt stock were to fall below a specified level (e.g. 60 percent of GDP), countries could be allowed to replace maturing accountability bonds with regular bonds.

**d) Won't the owners of accountability bonds be bailed out just like 'normal bondholders' were in the last crisis?**

The bail-in of private creditors (loss of value of the bonds) would be an integral part of the conditions under which accountability bonds are issued and acquired. Banks are unlikely to hold large quantities of accountability bonds because they need to provide equity for their financing. If banks nevertheless opt to hold accountability bonds, this equity will available to absorb losses. EU member states may still jointly decide to bail out the owners of accountability bonds for political or other reasons, but there will be far lesser incentives to do so than in the case of regular bonds.

**e) Who will want to buy accountability bonds? Aren't they too risky?**

Since accountability bonds are more risky than regular bonds by the same issuer, the return on them will also be higher. Is it conceivable that nobody will want to buy accountability bonds? This may prove the case with very highly indebted countries, but generally it is unlikely. There is a large market for junior bonds issued by banks, for instance, and there is also a sizeable junk bond market.

**f) Do accountability bonds undermine fiscal discipline by further questioning the binding nature of fiscal rules?**

Since the introduction of the Euro, compliance with fiscal rules has been relatively poor. Accountability bonds will underscore the relevance of existing fiscal rules, and impose a cost for violating them. This will make it far less attractive for member states to break the rules, and will draw the public's attention to any such violations. In other words, accountability bonds will reinforce European fiscal rules, not undermine them.

**g) Will accountability bonds have a pro-cyclical effect, i.e. will they make it harder for countries to access credit when they most need it?**

Prudent fiscal policy remains well within deficit limits in order to leave enough leeway for fiscal stabilization in the event of a downturn. If the issuance obligation for accountability bonds is based on the structural deficit, scope for deficit spending will automatically increase in downturns.

**h) The structural deficit is difficult to forecast. What happens if the structural deficit is revised and it turns out that too few or too many accountability bonds were issued?**

There should be an equalization account that allows countries to adjust their bond issuance if it was inappropriate. Existing fiscal rules like the Swiss or the German "debt brakes" offer examples of how this can be put into practice.

**i) Wouldn't countries merely ignore the obligation to issue accountability bonds just as they have violated fiscal rules in the past?**

The issuance of accountability bonds can be enforced by the ECB alone. If a country issues too much debt, the ECB can simply declare that certain bonds have the status of accountability bonds. European banking supervision can then inform banks about of this new bond status.

**j) Why should highly indebted member states agree to the introduction of accountability bonds?**

In the long term all Eurozone member state have an interest in sound fiscal governance. Introducing accountability bonds will make announcements of future fiscal consolidation more credible and mitigate the debt dilution problem. This will reduce borrowing costs. Insofar as there are differences in national economic interests among member states with different levels of debt and different economic situations, introducing accountability bonds may be one element of a larger compromise package, which may include elements where the benefit to highly indebted countries is larger, like a fiscal capacity.

# 4. Conclusions

Accountability bonds address various concerns from different sides. Since the issuance obligation is detached from the existing stock of debt, the transition to accountability bonds will not trigger a new bond market run or destabilize European banks. On the contrary, this new type of junior bonds will improve the quality of outstanding debt by alleviating the debt dilution problem. This, in turn, should make it acceptable for countries with high stocks of existing debt and fragile banking systems. Countries which – independent of their past performance – fully comply with the European rules will not face any shocks to their financing conditions, but will even earn a credibility premium in future refinancing operations.

At the same time, these new instruments introduce a credible element of market discipline *at the margin,* as they activate market surveillance for the specific part of a structural deficit that exceeds jointly agreed limits. Accountability bonds represent a response to growing concern that public deficits resulting from non-compliance with European rules should not be encouraged by collectivizing debt, either explicitly or implicitly (for instance through central bank bond purchases). With the accountability bond issuance obligation firmly in place, it may also be easier for fiscally healthier countries to accept new risk sharing mechanisms that insure euro member countries against large asymmetric shocks. Accountability bonds can be regarded as a signal that insurance mechanisms will not be abused to bail out the creditors of insolvent countries in the future.

Overall, accountability bonds strike a good balance between two different schools of thought prominent in the euro area reform debate: "Southern Europe", which stresses the risks of capital market instability and destructive vicious cycles; and "Northern Europe", which emphasizes the need for credible bail-in-mechanisms and market discipline. Accountability bonds respect the key concerns of both sides; they are an innovative instrument that stands a real chance of building a consensus.

## EconPol Europe

EconPol Europe - The European Network for Economic and Fiscal Policy Research is a unique collaboration of policy-oriented university and non-university research institutes that will contribute their scientific expertise to the discussion of the future design of the European Union. In spring 2017, the network was founded by the ifo Institute together with eight other renowned European research institutes as a new voice for research in Europe.

The mission of EconPol Europe is to contribute its research findings to help solve the pressing economic and fiscal policy issues facing the European Union, and thus to anchor more deeply the European idea in the member states. Its tasks consist of joint interdisciplinary research in the following areas

1) sustainable growth and ‘best practice’,

2) reform of EU policies and the EU budget,

3) capital markets and the regulation of the financial sector and

4) governance and macroeconomic policy in the European Monetary Union.

Its task is also to transfer its research results to the relevant target groups in government, business and research as well as to the general public.