Finanzgruppe
Deutscher Sparkassen- und Giroverband

Stabilisation Bonds for Europe

15th of April 2020

Authors:
Dr. Reinhold Rickes
Reinhold.Rickes@dsgv.de

Dr. Sonja Scheffler
Sonja.Scheffler@dsgv.de

Dr. Holger Schulz
Holger.Schulz@dsgv.de

The finance ministers of the Eurogroup have agreed on a first fiscal rescue package before Easter. The European Stability Mechanism (ESM) should ensure the financing of health care systems. “Sure" is intended to support the funding of workers on short-time work and, via the European Investment Bank (EIB), small and medium-sized enterprises. At the same time, further negotiations on a reconstruction fund have been announced, but the structure of this fund is entirely open.

For the next few weeks, the critical question remains if this rescue package is considered to be comprehensive in perspective of the financial markets. With concern, attention is focused on the forthcoming rating assessments of Italy, for example, on April 24. The crisis of the real economies could become an overall problem for the Euro area if the coountry ratings in southern Europe are downgraded. Although the stock markets have recently recovered, this recovery is on shaky ground and could result in a downward spiral again.

The chief economists of the Savings Banks Finance Group propose a new additional way with "stabilisation bonds" to avoid new turbulence on the financial markets: Countries with very sound finances would provide guarantees, limited in time, to countries with less stable finances. This could be a core element of a reconstruction fund without providing comparatively expensive equity capital. Stabilisation bonds strengthen the resilience of the euro financial markets. They are a sign of solidarity in Europe and of Euro coherence.

Europe: action and solidarity

- ➔ In Europe, the number of people infected with corona continues to rise. Some countries have already announced initial measures for a cautious and gradual relaxation of contact restrictions. But it is becoming apparent that the crisis, which originated in the real economy, can only be overcome in prolonged steps over some time. The inevitable effects on the economy and finances must be addressed. The consequences of insolvencies or further turbulence must be avoided to spill over to the financial sector.
- ➔ Based on close German-French cooperation, the European Finance Ministers in the Euro area have finally found a way to send a signal of solidarity for Europe as a whole. The European Investment Bank, through the national development banks, in particular KfW in Germany, will provide 200 billion Euro to support small and medium-sized enterprises. Furthermore, 100 billion Euro should be made available on a loan basis "as soon as possible" to cope with short-time working during the pandemic. Last but not least, the European Stability Mechanism provides a "lending capacity" of 410 billion Euro.
- ➔ In contrast to self-inflicted emergencies, loans can now be made available on a comparatively unconditional basis according to macroeconomic standards via a separate "Pandemic Crisis Support". Here, the EU finance ministers have made it possible for each country to quickly draw loans of up to two per cent of its GDP for direct and indirect corona measures. This is a vital sign of European solidarity.
- ➔ However, the volumes of aid for individual countries are comparatively small. This is compared, for example, with the number of government bonds held by the banks themselves in the respective country. For example, Italy could draw down 39 billion Euro, but according to LBBW estimates, it would need around 45 billion Euro in the event of a rating downgrade.
- ➔ It certainly helps that the ECB has already acquired more than 80 billion Euro in March 2020 with the new PEPP purchasing program and the regular program together. Monetary policy thus provides sufficient support for fiscal policy. However, fiscal policy, in particular, is still called upon to take even more far-reaching precautions in this crisis.
- ➔ For example, solidarity should be further strengthened by fiscal support if the pandemic lasts. In particular, the health sectors in many countries in southern Europe need more assistance than has now been agreed.
- ➔ Solutions must be weighed and enforceable. At present, full communitarisation via corona bonds, if they mean permanently introduced Euro bonds, is not possible to reach a consensus and would not make sense. The pan-European rescue package may need to be stretched even further. Additional fiscal instruments should be included.
- ➔ As a realisable compromise, the chief economists of the Savings Banks Finance Group propose stabilisation bonds with a limited term - new issues only until 31 December 2021 with a maximum time of 5 years. Such stabilisation bonds would strengthen solidarity. They would be

placed on the markets by the respective country - for example, Italy - with a guarantee for example from the Federal Republic of Germany.

- ➔ This instrument could be used in many bilateral guarantee relationships between countries with high and low contry ratings. Such a solution would not burden the equity of the ESM as it would be the case with Corona- or Eurobonds. The bilateral guarantee relationships could then form the nucleus for a European reconstruction fund.
- ➔ In particular, a later transfer to the ESM (quasi in function as the European Reconstruction Fund) should make it clear that the bilateral character of the stabilisation bonds is primarily due to the speed currently required. Bilateral guarantee relations should not call into question the European idea of joint growth and joint responsibility, but rather supplement it in the current crisis in the sense of a quicker ability to act.
- ➔ In principle, it should be examined whether the premium for the guarantee could be awarded as a grant, depending on the due date. This offers the possibility to repay debts or invest in the respective guarantee beneficiary country. Also, it could be agreed that repayments would only be scheduled after certain GDP growth thresholds have been reached (analogous to the measures in the course of the support for Greece). Insofar as the amounts are generated in the growth process before the start of repayments, they could also be used in the time perspective as a stimulus package to revitalise Europe.
- ➔ The main advantages of stabilising bonds compared to corona bonds is that they are bonds of the respective country. The guarantor facilitates refinancing and pricing for a limited time. The management of the issuing activity, the choice of instrument and also the marketing remain under the sovereignty of the individual country. This means that responsibility clearly lies with the respective issuing country.
- ➔ The Chief Economists of the Savings Banks Finance Group expect that the raising of the guaranteed funds will also improve the conditions for the other issues and thus provide significant relief during the crisis phase. Furthermore, it is expected that the probability of default by the country claiming the guarantee will be comparatively lower. A positive side effect of a corresponding guarantee by the Federal Republic of Germany would be that the Deutsche Bundesbank would be able to purchase these guaranteed bonds for the Eurosystem. In addition, rating reviews of the countries in Southern Europe are likely to follow on a much stronger basis.
- ➔ Financially sound countries could use this instrument to demonstrate solidarity and strengthen crisis resilience in the Euro area for the Community as a whole. This would once again demonstrate the financial markets that Europe stands together and, in contrast to many other currency areas, is also keeping an eye on effective ways of reducing the increased debt levels caused by the crisis.
- ➔ In summary, we see the following key advantages of stabilisation bonds:

1. stabilisation bonds are limited in time (until the end of the pandemic, maximum term 5 years). This means that the default risk is lower than with Corona- or Eurobonds.
2. Corona- or Eurobonds have to be settled via the ESM and, in opposite to the guarantee solutions, they are a burden on the ESM's equity capital. They are therefore relatively expensive.
3. the new and regular ECB buy-up programmes reduce the risks for the guarantors of the stabilisation bonds.

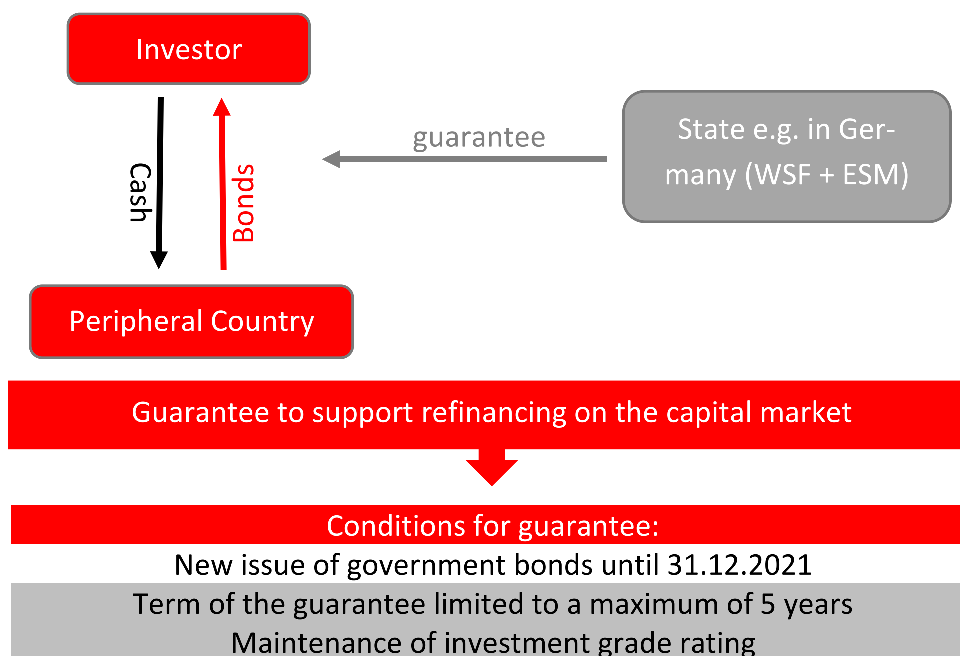
➔ The core elements of the proposal are set out in the appendix.

Appendix: The proposal for Euro area stabilization bonds: Breakdown by category and schematic presentation

Countries that had a high degree of stability before the crisis, help Euro area periphery

Possible volumes using the example of Germany

Bn. Euro	Use
400	Euro area stabilisation bonds (included in Economic Stabilisation Fund, [WSF coupled with ESM]) possibly with conversion of the premium for guarantee as a grant + thresholds (GDP growth) for start of amortization Targets: Solidarity, debt repayment and investment



Emissions:

April/May 2020 - 31.12.2021

Due to the date:

Max. 5 years from start of issue, i.e. max. 30.03.2025-31.12.2026

Source: LBBW

Disclaimer

The present positions of the Chief Economists do not necessarily reflect the position of DekaBank or the position of the respective Landesbanken and savings banks. This paper was prepared with the help of the following eight institutions:

LBBW
Berliner Sparkasse
Haspa
DekaBank
NORD/LB
BayernLB
Helaba
Kreissparkasse Köln

Imprint

Publisher
German Savings Banks and Giro Association
Department of Economics, Financial Markets
and Economic Policy
Charlottenstrasse 47
10117 Berlin
Phone: 030 20225-5303
DSGV-Volkswirtschaft@DSGV.de
www.DSGV.de

Editorial Deadline
14th of April 2020

Design
Franz Metz, Berlin

Responsible
Pia Jankowski – DSGV
Director
Head of Economics, Financial Markets and Economic Policy
Pia.Jankowski@DSGV.DE
Dr. Reinhold Rickes - DSGV
Director of Department
Head of Economics
Reinhold.Rickes@DSGV.DE

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