Why a Debt Redemption Fund / Pact?

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Background

More than three years ago, when sovereign debt crises were spreading across the Eurozone, and spreads were widening rapidly, the German Council of Economic Experts proposed a debt redemption fund and pact (GCEE 2011). The idea was twofold: (1) to provide the Eurozone with a temporary instrument that would insure against roll-over crises while eliminating the public debt overhang and (2) pave the way for a permanent regime of fiscal discipline through a debt restructuring regime. A temporary mutualisation of debt was to secure that in the long run the Euro area could do without mutualisation of national debt.

In the meantime, the threat of a roll-over crisis has diminished and spreads on sovereign bonds have come down significantly from their peaks, mainly due to the actions of the ECB. But the debt overhang in many countries of the Euro area looms even larger and is endangering growth prospect and raising the specter of lost decades. Therefore the basic idea of a debt redemption pact remains relevant, albeit a less ambitious design than in the original proposal might be considered.

Design

1. The Debt Redemption Pact is a temporary mechanism that consists of a pact and a funding scheme.

   The **Redemption Pact** entails (i) a country specific plan for structural reforms and fiscal adjustment that mimics the consolidation demands set out by the TSCG and, (ii) safeguard against moral hazard and to secure repayments.

   The **Redemption Fund** allows participating countries to refinance public debt in excess of 60% of GDP (in the original proposal). Repayment obligations are set as a percentage of nominal GDP to provide some automatic stabilization and backload redemption of debt when growth picks up. By design, the countries with the largest participation would be those which now have the highest debt burden.

   Alternative designs of the fund could envisage a higher threshold for mutualisation (e.g. 75% of GPD) or more equal participation, e.g. setting an equal share of joint issuance at 20% of GDP of every participating country.

2. **Fund dynamics and size.** The redemption fund first accumulates during the "roll-in" phase and is then gradually drawn down. A fund for all debt above 60% would reach a maximum size of 2,85 trillion after 5 years and the repayment phase (with sustainable

primary surpluses) would be 20 years. The equal share of 20% of GDP version would mutualize about 1.9 trillion Euro and could be designed to expire after about a decade.

3. **Guarantee structure:** the original proposal envisaged joint and several guarantees, which would deliver the highest benefits for the vulnerable countries but also the highest risks for the highly rated countries. Under a pro rata scheme both risks and benefits would be smaller.

4. **Maturity of debt:** the scheme targets long term refinancing, i.e. maturities over 2 years. The reason is that countries under pressure face spiraling spreads at the long end of the yield curve. They can usually have fewer difficulties to refinance at short maturities and thus they shorten the maturity structure during time of pressure, increasing their vulnerability.

5. **Membership:** in principle only countries in good standing should join a redemption scheme because it assumes full redemption of the debt (albeit at lower interest rates) and does not foresee any haircuts. Thus the original proposal only included countries that are not under a *macroeconomic* adjustment program (ESFS or ESM). Countries that successfully complete an adjustment program might be able to join at a later stage; however, allowance would have to be made for the outstanding ESM debt.

6. **Safeguards:** Any scheme of joint issuance causes moral hazard. The largest risk is that governments deviate from the fiscal adjustment path once the scheme is set in motion. Therefore there need to be safeguards:

   During the roll-in phase a serious breach would lead to the suspension of the country; after the roll-in phase, non- compliance would lead to a mark-up on the interest rate of the jointly issued debt. The mark-up system could also be devised as an incentive scheme with an automatic reduction for achieving lower debt levels.

   Collateral could be posted to protect repayments and lower the overall refinancing rate in any joint and several scheme. The original proposal called for posting 20 % of usage of the fund. In addition, repayments would be secured through earmarking and possibly a mark-up on specific taxes. It should be noted, that these are not additional taxes above the commitments undertaken under the TSCG, they would make them more binding though. Under a pro rata scheme, different safeguards could be envisaged, in particular paid in capital as in the case of the ESM.

   A debt restructuring regime was part of the original proposal to discourage any renewed accumulation of public debt (or assumption of private debt) in the future. In particular, the proposal set an upper debt threshold above which the access to ESM financing would be conditional on a restructuring. This mechanism would only be activated once participating countries' debt levels had fallen below the threshold (plus a safety margin) but this was to be agreed as integral part of the overall deal.

   At any time a participating country will be exposed to financial markets, with varying intensity though: During the roll-in phase only short-term debt and after that all debt needs to be refinanced. Therefore, besides the pact as a major safeguard against moral hazard, marginal refinancing costs of governments also penalize or reward economic policy pursued by the respective government.

Rational

7. The main difference between a DRF/P and other joint issuance schemes is that it is a **one-time operation** with the aim of restoring sustainable finances and smoothing the path into a new regime.

8. Compared with some other proposals that target the debt stock, a DRF/P is a **flow operation** which avoids possibly disruptive restructuring of outstanding debt and secures their refinancing.

9. The Pact part of the scheme is designed to **enhance the credibility** of fiscal adjustment and structural reforms and thus should help reduce overall financing costs for highly indebted countries (i.e. in addition to a direct effect from the joint issuance there is an indirect effect of a credibility premium). Also, the five year roll-in period (before countries are again fully reliant on market financing) would buy time to clean up the financial sector and for the positive effects of structural reforms to materialize.

10. The aim is to ensure that in the long run a **"no bail out regime"** in the Euro area prevails. There are two variants of a "no-bail" out regime and there were different opinions on this in the expert group. Some experts favor achieving such a state through strongly increased central powers over national budgets, other experts favor a debt restructuring regime as disciplining device for the long run.

11. Any scheme of joint issuance would provide a **"safe asset"** which may offer liquidity services and benefits for the diversification of bank balance sheets. But any asset seen as safe for investors will carry residual risk for governments participating in the joint issuance. Also any scheme of joint issuance would have limited impact on the degree of financial market integration unless the structural weaknesses in the banking sector are addressed. Joint issuance could therefore only buy time to clean up.

12. A DRF/P scheme as originally proposed was to be implemented through an intergovernmental agreement. Treaty amendments would be necessary to implement any joint and several liability as well as some protections against moral hazard (such as central powers over national budgets). To pass muster of the German Constitutional Court any scheme would have to be unambiguously temporary, liabilities may not endanger debt sustainability or the budgetary autonomy of Germany and is combined with a precise legal framework ensuring fiscal discipline.

Conclusion

The Redemption Pact combines temporary European solidarity between member states in times of crisis with national responsibility for fiscal consolidation and structural reforms. While the ECB had to build a monetary bridge to overcome an acute crisis, the debt redemption pact could present a fiscal bridge both for crisis resolution and for anchoring reform, removing the main growth obstacle and establishment of a new stability regime.