

**Olli Rehn**

Vice-President of the European Commission and member of the Commission responsible for Economic and Monetary Affairs and the Euro

## **Eurobonds: Stability and Growth for the Euro Area**

Check Against Delivery  
Seul le texte prononcé fait foi  
Es gilt das gesprochene Wort

**ALDE New Year Seminar**

**Brussels, 10 January 2011**

Ladies and Gentlemen, Dear Friends,

This New Year marked the 10th anniversary of the Euro. We may have seen no fireworks for this event. Nevertheless, despite some doomsday scenarios we have read in the press, the Euro remains intact. And – despite some systemic shortcomings – it remains our prime political project and the foundation of economic stability in Europe.

But this year will also mark a profound transformation of EU economic governance, precisely in order to rectify those shortcomings. This is absolutely essential if we want to restore confidence in the European economy. This year marks a turning point. It will be the year when the future governance of the Euro will be determined. And it will be the year when strong monetary union will finally be complemented by an ever closer economic union.

And there is a compelling reason for that. The crisis that has ravaged the European economy, and affected the jobs and welfare of millions of Europeans, is by no means behind us.

The time has come for a new and deeper understanding of interdependence and accountability within an economic and monetary union. The time has come for a new and deeper approach to economic integration.

This implies striking the right balance between responsibility and solidarity in our economic policy-making. In fact, we are facing a dual challenge. On the one hand, euroarea Member States have to speed up structural reforms to live up to the requirements of sharing a common currency. On the other hand, at European level, we need the right instruments that reflect the reality and requirements of the single currency.

Against this scenario and before dwelling deeper into the pros and cons of Eurobonds, let me make a few remarks on fiscal consolidation, economic growth and financial firewalls.

The financial and economic crisis that struck in 2008 was first tackled by massive fiscal stimulus. Together with major monetary easing, it managed to prevent a replay of the 1930s. However, the stimulus also increased deficits. As the state of public finances was vulnerable in several member states and as the collapse of activity drastically reduced tax revenues, it was obvious that fiscal policy had to switch from stimulus to consolidation - sooner rather than later.

For this reason, over the past two years, we have promoted gradual and differentiated consolidation. Almost all developed countries face a sovereign debt crisis: confidence in the ability of governments to service debt has been shattered. As a result, they have seen high interest rates and weakened trust in the banking sector. This is holding back investments they badly need.

It is true that further stimulus would add to demand as such. But let's not forget, it would also weaken confidence even further. At the very most, it would provide temporary relief. In some countries it would provide not even that – as it weakens the basis for sustained growth and job creation. This is why there is no alternative to growth-friendly consolidation.

While fiscal consolidation is unavoidable, active public policies to promote sustainable growth are equally important. We now have to turn words into action. The economic dynamism of Europe and its capacity to create jobs is at stake.

In the joint statement of European Liberal Democrat leaders in London yesterday, we clearly said, "Complementing the single market in the services and digital sectors alone could add hundreds of billions of Euros to the European economy and generate thousands of Euros in extra annual income for the average European household."

For most Member States, reforms aimed at improving the functioning of labour markets remains the prime and pressing priority: increased labour mobility and wage flexibility is absolutely key to bringing people back into work and increasing productivity.

We should embrace competition and structural change. The only "protectionism" we favour is that of protecting PEOPLE. This means ensuring that all our citizens have the skills needed in a modern economy and society.

In fact, spelling out what it takes to get growth going is not too difficult. What is difficult is getting decisions done and implemented. Of course, many decisions are politically painful at first and it will take a long time to feel their full positive impact.

Thankfully, we have many encouraging examples that show that restoring confidence in public finances and implementing ambitious structural reforms does work.

If you want examples, just have to look at Denmark and the Netherlands in the 1980s, Finland and Sweden in 1990s, and Germany in the first decade of this century.

In the current crisis, Estonia, Latvia and Ireland have taken very bold measures, and there are now clear signs that these measures are paying off.

What I have just outlined is, in fact, a profoundly liberal agenda; that is, a firm commitment to fiscal prudence and economic reform, while empowering individuals to use their potential in full, with equal opportunities and social fairness.

Ladies and Gentlemen,

Bringing down debt, deleveraging, takes time. Similarly, structural reforms take long, often several years, to give their full results.

Markets, however, tend to be impatient. This impatience can push solvent sovereigns or banking institutions into a liquidity crisis that could eventually endanger financial stability in the euro area and the union as a whole. To avoid this, sufficient mechanisms to ensure the liquidity of member states and key financial institutions are necessary. Building such firewalls and doing so without creating detrimental incentives, or moral hazard, has been a key challenge of our crisis management.

While we have been chasing a moving target, significant progress has recently been made. Leveraging the EFSF is about to be completed, even if the additional firepower is likely to remain less than what was speculated at some point. The start of the permanent mechanism, ESM, will be advanced to mid-2012 from a year later, and, in March, the euroarea member states will assess whether the combined financing capacity of the EFSF and ESM is appropriate. Good progress is being made on expanding IMF resources.

We should also note the very significant steps taken by the European Central Bank to ensure the liquidity of the banking sector. Together with the recapitalisation measures overseen by the European Banking Authority, the actions of the European Central Bank are greatly contributing to stabilise banking system.

Let me emphasize another important point. Financial firewalls imply pooling risks among the member states. For this pooling to be economically and politically feasible, strong mechanisms need to be in place to prevent free-riding by any member states. In the case of the financial assistance from the EFSF/ESM, very strict policy conditionality is the essential prerequisite for this.

In the case of a wider pooling of sovereign risk through joint bonds, strong governance mechanisms have to be created to prevent imprudent behaviour.

The Commission presented the Green Paper on Stability Bonds at the same time with the proposals based on the euroarea-specific Treaty article 136 for further strengthening economic governance. This was obviously not a coincidence: we see the strengthening of governance and addressing the funding challenges in the euro area as intrinsically linked. The six-pack, the 136-proposals and the now Fiscal Compact are all important steps in this direction.

The basic principle is clear: Any step in the further sharing of risk would have to be balanced by provisions that ensure sustainable public finances and minimise the moral hazard. Stability Bonds would have to go in parallel, hand in hand, by a substantially reinforced fiscal surveillance and policy coordination, as an essential counterpart.

Ladies and Gentlemen,

Joint issuance of Member States' debt would fundamentally alter the structure of European financial markets. The potential advantages seem clear and large:

Joint bonds would act as a driver of integration and efficiency of European bond markets. They could lower transaction costs and the cost of government borrowing.

Stability Bonds would strengthen financial stability by allowing member states a secure and stable access to refinancing. And lower debt-servicing costs would give member states the time and breathing space necessary for economic reform and fiscal consolidation.

For the banking system, Stability Bonds would be a source of robust and equitable collateral and an ideal instrument for liquidity buffers.

In short, Stability Bonds can provide substantial benefits, also for countries with currently high credit standing. Yet, there are serious challenges to make them work, economic, legal, and technical ones. And we need to be equally clear about these, as well.

First and foremost, Stability Bonds should not lead to a reduction in budgetary discipline. An unlimited ability to borrow on capital markets with the help of credibility of other Member States would weaken incentives for responsible fiscal behaviour, unless this was ensured by a rock-solid rules-based governance.

Furthermore, Stability Bonds must be very safe and reliable instruments. Otherwise they would lack market acceptance and political credibility in all Member States.

Finally, Stability Bonds must be consistent with the Treaty.

The Green Paper presents three broad, rather generic, approaches to a possible design of Stability Bonds. They are based on two basic features of such bonds: first, the degree of substitution of national issuance, which can be either full or partial; second, the nature of the underlying guarantee.

The first option would be equivalent to a full substitution of euroarea government bonds issuance by the Stability Bond. Such bonds would be backed by common guarantees provided jointly by all euro-area Member States.

This option would very effectively deliver the benefits of a common bond. A very large, homogenous and liquid market would emerge, providing the global financial system a safe-haven comparable to the US Treasury market. The new bond would serve as high-quality collateral and improve the resilience of the euro-area financial system.

Yet, this approach would need to be accompanied by very robust budgetary discipline, requiring significantly deeper economic, financial and political integration. It is also very likely that bonds with joint and several guarantees would not be compatible with Article 125 of the Treaty.

Under the second approach, Stability Bonds would also benefit from joint and several guarantees, but they would replace only a certain part of national debt financing. As a result, the euro area government bond market would consist of two parts: Stability Bonds, for example up to a certain percentage of GDP, and national government bonds, issued at the national level under national guarantee.

This option would also enhance euro-area financial stability and improve, monetary policy transmission and the international role of the euro, but somewhat less so than under the full approach. The common issuance would pose little credit risk, and its yield would probably be comparable with the yields on current triple-A euro area government bonds. Conversely, the national bonds would carry higher credit risk and be less liquid. Therefore, their yields would likely be accordingly higher.

A robust rules-based framework of fiscal discipline would be required, although market discipline on the national issuance implies perhaps a less far-reaching transfer of sovereignty than under the full approach. With this option, too, Treaty compatibility is a major issue.

Finally, the third option would be a partial substitution of national issuance by Stability Bonds, backed with several but not joint guarantees. The difference between this approach and the second one is that Member States would remain liable for their respective share of Stability Bond issuance, as well as for their national issuance. This option is thus an extension of the current EFSF financial backstop to regular financing of the EA sovereigns.

The risk of moral hazard would be much lower, as Member States could not benefit from a possibly higher credit quality of other Member States. Moreover, interest rates on national issuance would serve as a disciplining tool. Stability Bonds based on this approach could be more rapidly deployable, could deliver advantages in terms of more secure access to funding, and could facilitate the conduct of monetary policy.

However, this approach would obviously deliver fewer benefits in terms of financial market efficiency and stability. The yield advantage would be considerably lower than in the case of issuance backed with the joint and several guarantees, as the credit quality of the issuance would at best be the weighted average of the credit qualities of the euro-area Member States. Furthermore, without significant further credit enhancement, such a bond might be very difficult to sell to capital markets.

Dear Friends,

As I have already stressed before, the Green Paper aimed to open the debate on Stability Bonds. Our event today is a prime example of such debate, which is essential in order to reflect appropriate further steps. We are still evaluating the feedback that we have received in our public consultation which ended just a couple of days ago.

We have carefully listened to various proposals for enhanced stability tools made over the past weeks or months. This includes the proposal made by the German Council of Economic Advisors who [Professor Schmidt and Mr Weigert may correct me later on] suggest a joint issuance of bonds, which would be limited in time and size to bring public debt in all Member States to below 60% of their GDP. While I would not mix this with Eurobonds proper, I find the proposal smart and potentially doable, and certainly worth exploring further.

Let me sum up, we believe that at this juncture of the global economy and the financial crisis we must have a serious debate on how to further develop and govern the economic and monetary union. The debate launched by the Green Paper on Stability Bonds is a crucial part of it.

If we can discuss dispassionately and decide responsibly, the potential gain is tangible for all of us: sounder economic policies across Europe, more integration of financial markets, and economic and financial stability for our economies at large.

It won't be easy to achieve this, but it is definitely possible. With these thoughts, let me wish you a very Happy New Year.

Thank you very much.