

VoxEU: Perpetual bonds are not the best way to finance the European Recovery Fund

The cheapest way to finance the European Recovery Fund would be to issue joint EU debt at shorter maturities, then pass those low-interest rates onto member states through loans at low margins over funding costs and with very long maturities, writes Giancarlo Corsetti, Aitor Erce, Antonio Garcia Pascual for VoxEU



French President Emmanuel Macron and German Chancellor Angela Merkel during a joint video press conference as they propose a 500-billion-euro European programme to support the economic recovery following the coronavirus crisis.

Source: Shutterstock

Perpetual bonds could boost EU stability...

A number of prominent voices have put forward the idea of funding a large investment package (€1.5-2 trillion) to support the EU recovery from Covid-19 by issuing EU perpetual bonds (consols). Such a joint recovery plan is seen as vital for the stability of the EU.

One argument in favour of using consols is that committing to joint perpetual debt delivers a high degree of mutualisation. However, by borrowing through perpetual bonds, the EU would stand in sharp contrast with the recent practice of countries like the US or Germany that, when facing

unexpectedly large financing needs, have relied heavily on the shorter part of the curve.

How come the Debt Management Offices (DMOs) in Germany and other European countries prefer not to issue perpetual bonds or very long-term debt? What are they (we) missing?

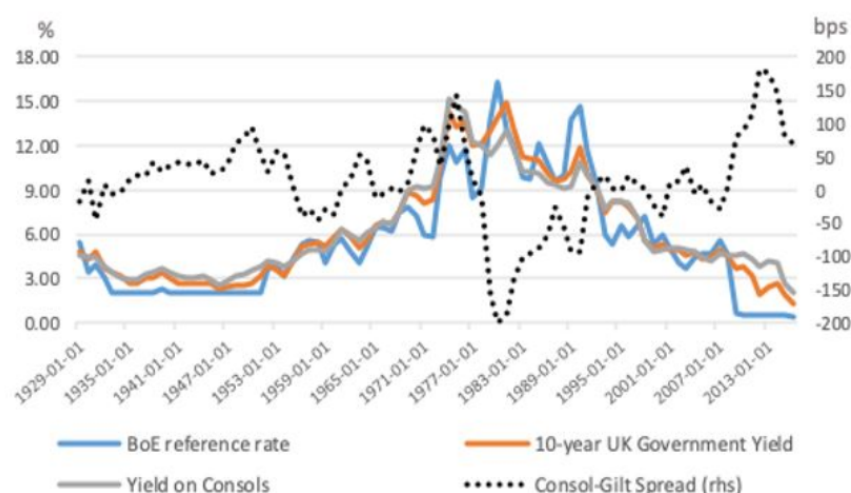
...but are they the most cost effective option?

There is one essential problem with financing the current crisis issuing consols.

In a world of ultra-accommodative monetary policy, not taking full advantage of ultra-low rates de facto amounts to working against the efforts of the monetary authorities which try to keep down the interest burden weighing on private and public debtors. Why would AAA-rated treasuries that can issue debt at negative interest all the way up to 10 years want to pay comparatively higher coupons by issuing consols? When the UK announced the redemption of the last consols in 2014, the head of multi-asset allocation at Threadneedle Asset Management argued "I hope that this move is the first of many to cut the interest bill and save taxpayers money" (Financial Times 2014).

This divergence in funding costs is exemplified in Figure 2, which uses data provided by the Bank of England.

Figure 2 One century of Gilt, Consols and Bank of England Rates



Source: Bank of England

A key quote from the article:

"Strong issuers can afford to borrow short term at very low rates and engage in debt roll-over as debt matures, reducing the term premium they pay. The picture is different for weaker issuers. Weaker issuers face both higher borrowing costs and more uncertain future access to capital markets.

For these issuers, using long maturity debt to finance long-term projects makes more sense. Matching the duration of assets and liabilities is a sound practice when refinancing risks are non-negligible. The question is hence whether there is a way for Europe to allow all countries to benefit from matching long-term investment spending with shorter term liabilities? We argue that there is.

The EU is a strong issuer which can use the asset and liability side of its balance sheet as two

separate policy levers. European loans given to member states for support should be long maturity in order to improve debt sustainability and reduce near-term gross financing needs. Instead, the financing of the loans, through the issuance of EU bonds, should rely more on the front-end of the yield curve to take full advantage of ECB's accommodative monetary policy.

In other words, by using the two sides of its balance sheet wisely, the EU can deliver powerful 'maturity transformation' on behalf of its member states. Crucially, this exercise of maturity transformation is financed by borrowing countries, hence it does not rely on transfers or use of taxpayers' money from other countries."

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