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On perpetual bonds

Interview by **Marcin Kuchciak,** Reporter, Redakcja PAP Biznes, Polska Agencja Prasowa S.A. to **Giancarlo Corsetti**, Professor of Macroeconomics, University of Cambridge, **Aitor Erce**, Visiting Scholar, UPNA (Navarra Public University), **Antonio Garcia Pascual**, Visiting Scholar, Johns Hopkins University

Question: *In your article of May 14th published on www voxeu.org website you focused on the idea of issuing a consol under the EU Recovery Fund at a supranational level. Therefore, I am curious whether similar conclusions about the consol, in your opinion, also apply to the issue of perpetual bonds at the level of EU member states? Do consol issues at the level of EU member states make more sense than at the supranational level?*

Answer: Investors will demand a higher coupon from consols than from a regular bond, making consols a particularly costly way to raise funds in the market for any Treasury, this is even more so for member states with low sovereign ratings. Moreover, although principal is never repaid, states would be "on the hook" for high coupon payments forever. This strategy may prove not only costly, but also inflexible.

Question*: The article was published on 14 May. Some time has passed since that date. Are your arguments from the article still valid? For example at that time the European Commission announced more details about the recovery plan. Does this change anything?*

Answer: The European Commission (EC) seems to have abandoned the idea of issuing consols to finance the Recovery Fund. The plan has not yet specified how the Fund will be financed: whether financing would match the maturity of the loans; or, instead, the Fund will be allowed to engage in maturity transformation by borrowing short and lending long. In the former case, the Fund will be issuing longer-term deb. In the latte, it will be issuing proportionally more short-term debt, which will have to be rolled over for the entire maturity of the loans. There are strong financial arguments to go for the latter especially with low-for-long interest rates.

Question: *I understood from the article that the consol issues would, in your opinion, be more expensive than short-term bond issues and the expected interest rate of 0.5% according to the supporters of the idea is very optimistic. How much do you estimate the real coupon for the consol? Giavazzi and Tabellini suggest issuing consols for 50 or 100 years, even perpetual. How many base points do you think the cost of the coupon for these three interest periods would change?*

Answer:There is an important difference between issuing a consol, which does not mature, and a 50 year bond. Just to give you an idea, there is about a 100 basis points (bps) yield difference between 50-year bond and 10-year bond for highly-rated European countries. Based on current market conditions, a consol would probably require an additional 100-200 bps to be attractive to market investors. This means a yield of about 2 to 3%, vs. a yield of approximately zero for a 10-year bond.

Question: *Another argument to the detriment of perpetual bonds is that if they were purchased by insurance companies or pension funds, given sensitivity of their fixed coupon to interest rates changes, this could undermine the stability of the financial system. What if the ECB were to buy them, as proposed by Giavazzi and Tabellini? This would probably mean limiting the Recovery Fund to EU member states that are also members of the euro zone.*

Answer: Insurance and pension funds generally hold longer dated debt, but consols are risky investments, even for such longer-term investors.

As for the ECB buying very long-term debt there are complications. The ECB may choose to reduce its balance sheet over the longer term. With finite maturity bonds, it can do so by not reinvesting them as they mature. For consols, this is not possible, the ECB will have to sell at the market price, potentially incurring losses. In addition, in the context of the recent German Constitutional Court ruling, the ECB buying perpetual debt may be challenged with the claim that it could be considered monetary financing, which is not permitted.

Question: *Doesn't the financing by Recovery Fund of issuance of debt with shorter maturities and passing these low interest rates onto member states by using of loans with low margins and very long maturities increase the risk of moral hazard?*

Answer: This depends on whose incentives we consider. It is true that by providing a subsidy (through maturity transformation) the mechanism can elicit moral hazard, as is the case for any insurance mechanism. The traditional way to deal with that concern has been to impose conditionality but this, in turn, can generate market and political stigma.

Question: *If so, what conditions should be attached to low-margin loans from the Recovery Fund to EU member states in order to minimize this risk?*

Answer: The uncertainty about the recovery is very high. It will require to mend economic and social links that are eroded by the crisis and the lockdown. This is vastly uncharted territory for policy.

For conditionality to work, it must be both well-designed and credible. Where markets consider that policy plans are not consistent with stability and solvency, they will demand higher interest rates. This is why governments will have to make every effort to clarify what their own policy priorities are.

Question: *Why is that makes sense for the EC to borrow short term but pass on those funds as long-term loans to member states?*

Answer: This is the core or our recommendation. There are important benefits for the Recovery Fund to act as a financial intermediary: borrowing from markets and on-lending the proceeds to countries. We argue that the two sides of the Recovery Fund balance sheet — debt issued to markets and loans to member states — should be seen as two separate policy instruments. Using them as we propose, pursuing interest rate saving by borrowing at relatively shorter maturity relative to the terms of its loans, the EC would deliver a powerful maturity transformation to the benefit of lower-rated member states.

Question: *How long do you think short-term bonds issued at supranational level would mature?*

Answer: When issuing short debt to finance a longer-term position, the issuer faces the need to rollover it over time. Rollover needs make the burden of debt very sensitive to market conditions: a hike in risk premia pass through very quickly on interest costs. This is where the high-rating of the EC comes in, as it has low risk-uremia and good market access throughout the financial cycle.

Question: *What are the maturities, you think about, when you use the term 'very long maturities'? Would these maturities be different for each EU member state?*

Answer: One size may not necessarily fit all. Countries should be able to choose, conditional on a good explanation for the preferred maturity. Longer maturities could carry somewhat higher lending rates.

Question: *Would the interest rates on loans from the Recovery Fund also vary between EU member states?*

Answer: By issuing joint debt at low interest rates that can be passed on to every member state at the same lending rates, Europe delivers an essential service to its member states, especially those that need it the most. This is also in line with other international institutions, such as the IMF, where countries are offered the same loan rates. However, if we accept that countries choose loans with different maturities, it would then be reasonable to link the loan cost to the maturities---this also help catering for moral hard concerns. Some countries may go for 10 other for 30 year loan.

Question: *Would these loans be for a specific, well-defined purpose, or for any use that is strictly related to the recovery of the coronavirus affected economy? Who would control the use of these loans?*

Answer: Looking at the Commission proposal, the recovery fund is supposed to target public investments, focusing on better health infrastructure, IT, clean energy, etc. with the final objective of elevating productivity and growth. This is a reasonable plan, but as with any public investments, it is critical that the use of funds is designed carefully and monitored closely to make sure they are put to good use.