# Ifo Viewpoint

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# Accountability Bonds*

Progress has been made in overcoming the economic crisis in the euro area, even though further adjustments are needed. Efforts to restructure public finances, however, are flagging and meeting with increasing political resistance. There are serious shortfalls in the governance and coordination of fiscal policy. The European Fiscal Compact stipulates that member states reduce their budget deficits towards the upper ceiling of a structural deficit (corrected for cyclical effects) of 0.5 percent of GDP. In reality, however, the structural deficits in many countries are rising. Yet no serious efforts are being made on the part of the European Commission and Council to enforce the debt rules. Implicit joint liability through the ESM and the ECB bond purchasing programmes undermines incentives for sound fiscal policies.

This is why it is necessary to reform fiscal policy governance in Europe. The introduction of an additional instrument would make it far more effective: a new class of junior government bonds, called **accountability bonds**. These bonds have the following properties: If the government debt ratio exceeds 120 percent, interest payments of these bonds are frozen, and the maturity of the bonds is automatically extended until the debt ratio falls back below this threshold. If a country applies for an ESM Programme, accountability bonds lose their value. If there are defaults on 'normal' bonds, accountability bonds lose their value. The ECB does not buy accountability bonds. Bank regulation is adjusted so that banks can only hold accountability bonds with appropriate equity backing.

Eurozone member states are required to issue accountability bonds under the following circumstances. Member states with a current (structural) budget deficit that exceeds the upper ceiling of 0.5 percent of GDP have to finance this excess debt via accountability bonds. In 2015, for example, Spain posted a structural public budgetary deficit of 2.5 percent. According to the reform concept presented here, the country would have financed new debt totalling 2 percent of GDP in the form of accountability bonds. An intertemporal equalisation account for accountability bond issues is used to deal with later revisions of the structural deficit. States that comply with the jointly agreed deficit rules would not have to issue any accountability bonds.

It should be noted that this proposal includes no changes for the existing stock of debt. All member states including those with higher debt to GDP ratios than 60 percent would be allowed to roll over their existing stock of debt in the form of 'normal' government bonds.

Accountability bonds would prevent individual member states from passing on the costs of excessive debt to the community of European States via collective liability in the framework of ESM programmes or bond purchases by the ECB. If a country runs a deficit above the jointly agreed level, it would be held accountable for the costs – hence the name accountability bonds.

To prevent states from having to issue subordinate bonds in economically difficult times, precautions could be taken in better times via the build-up of a 'reserve'. For states currently running high budget deficits, transition rules could be applied, whereby binding and falling ceilings for public budget deficits to be financed with conventional bonds are agreed.

This concept differs from others based on junior and senior government bonds or elements of partial collective liability in two key ways: firstly, the concept of accountability bonds is not based on debt stocks, but on flows (current deficit). This prevents large stocks of government bonds from suddenly becoming subordinate, sustaining high price losses and questioning their rollover. Secondly, the concept of accountability bonds features no new elements of collective liability for government debt.

The fact that accountability bonds have higher default risks than conventional government bonds begs the question of whether investors may be prepared to buy such bonds. This point is open to speculation, since the bonds do not exist yet. There are, however, other types of bonds with more or less high default risks such as, for example, convertible bank bonds (Cocos) or comparatively risky SME bonds (*Mittelstandsanleihen*). The saleability of accountability bonds will definitely depend on the country issuing the bond. If Germany or France were to issue the bonds, there would certainly be investors who would purchase them at correspondingly higher rates of return. Countries with higher debts may have difficulties finding investors, but these countries would then be forced to take measures to once again comply with European fiscal rules. That is precisely the goal of accountability bonds. Alternatively, they could apply to an ESM programme, but this programme would presumably also stipulate a very swift return to compliance with the jointly-agreed rules.

What could accountability bonds achieve?

1. The incentives for excessive debt financing caused by existing elements of collective liability (the ESM, the ECB's OMT programme) would be, at least partly, corrected. The costs of debt contracted beyond the jointly agreed limits would be borne by its contractors, rather than being passed on to the taxpayers of other countries.
2. European fiscal governance would be strengthened. It would be considerably less attractive harder for member states of the Eurozone to overstep or ignore European fiscal rules.
3. Taxpayers in the Eurozone would be protected from paying for the excessive debts of either their own or other countries.
4. Investors would have to bear at least part of the costs of debt crises.
5. Fears that the introduction of explicit investor bail-in will lead to a destabilisation of the entire market for government bonds would be allayed because accountability bonds would only be a small segment of the government bond market.
6. Investor bail in for accountability bonds would not increase (but probably reduce) the financing costs of the existing stock of debt which needs to be refinanced.

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