LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

WILL MERKEL CALL FOR EUROBONDS?

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Quite unexpectedly, the next months might provide new momentum for Eurobonds. Although political coordination in the euro area is dismal and the spirit for constructive proposal is less than optimal, a specific financial fallout of the current economic crisis – the exceptionally low level of interest rates in Germany - might play in the hands of proponents of mutual issuances of government bonds in the euro area and be a game-changer for the future of Europe. Contrary to what is sometimes assumed, the German economy does not reap only benefits from a historically low level of interest rates. In fact the current exceptional monetary circumstances represent a severe challenge for part of the German financial system and reverberates on the efficiency of the domestic savings allocation.

The idea of mutual issuance is very controversial and politically sensitive. The very word Eurobonds has become epitome of strong divergence of interests among the 18 member states. However the issuance of securities representing multinational debt might emerge as the only solution at hand to bring domestic interest rates at a level consistent with an efficient rate of savings and investments. Renewing today the proposal for Eurobonds would also benefit from the weakness of the alternative policies. Quantitative easing in particular, would solve the main factor behind low interest rates in Germany - the uncertainty about the future integrity of the euro area – but would aggravate the problem itself increasing the demand for German government securities and lowering its market remuneration. The problems behind quantitative easing leave little other option than Eurobonds.

A change in the equilibrium level of interest rates

Real interest rates worldwide have declined substantially since the 1980s and are now in negative territory. Since the late 1990s, three factors appear to account for most of the decline. First, a steady increase in income growth in emerging market economies during 2000–07 led to substantially higher saving rates in these economies. Second, the demand for safe assets increased, largely reflecting the rapid reserve accumulation in some emerging market economies and increases in the riskiness of equity relative to bonds. Third, there has been a sharp and persistent decline in investment rates in advanced economies since the global financial crisis. Some factors work in the direction of keeping rates persistently low: long-lasting negative effects of the global financial crisis on economic activity, persistence of the "saving glut" in key emerging market economies, and renewed declines in the relative price of investment goods.

The equilibrium real interest rate is the price that equilibrates the desired demand for and supply of funds. Factors affecting the equilibrium real rate shift or tilt the demand or supply schedules. A reduction in the equilibrium real rate would be produced by an outward shift in the supply schedule of funds or an inward shift in the demand schedule. The supply of funds may come from private

saving, public saving (the budget surplus), or monetary policy actions.

real rates can be approximated by the difference between the nominal interest rate and inflation expectations over the relevant time horizon:

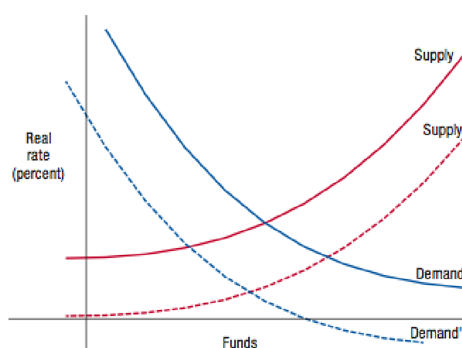
$$r_t^{[n]} = i_t^{[n]} - E_t\, p_{\tau,t+n}$$

in which $i_t^{[n]}$ is the nominal yield of a zero coupon bond of maturity n at time t, and Etπt,t+n is the expected consumer price inflation over the life of the bond.

The European Central Bank has a major and obvious role in determining short term interest rates, it also affects the expected consumer price inflation, which, as we have seen, computes into the real rates. However, the current major policy problem of the ECB concerns the functioning of the transmission mechanism of monetary policy in the periphery. Credit crunch is still depressing the economy in several countries and reverberating into expectation of instability for the whole euro area. This has been one of the main causes behind investors' flight toward safe assets that has depressed the yields of German government bonds.

Quantitative easing might aggravate the problem

In the standard interpretation of monetary policy, a neutral monetary policy (that is, keeping output at its potential) does not contribute to the determination of the real interest rate, which is then at its natural level. However, deviations of monetary policy from a neutral stance should lead the real rate to move away from its natural level. Loosely speaking, monetary policy easing can be represented as an outward shift in the supply of funds and in the lowering of interest rates.



The ECB is now expected to deploy quantitative easing as a last resort to counter credit problems, recessionary forces and ultimately deflationary threats. However quantitative easing – in particular if it has to be enacted without privileging the purchase of government bonds of single weaker countries – implies a reinforced demand for government bonds in Germany as well. It might thus aggravate rather than solve the problem of low interest rates in Germany.

Serious "permanent income" effects of projected low interest rates

Currently, the German government is seriously concerned with the low level of remuneration provided by of its federal bonds. German state bonds represent the safe haven asset par excellence

and their attractiveness has been magnified by the doldrums in the rest of the Euro area countries. A low cost for debt service has amounted to huge savings for the public accounts. Different calculations estimate the lower cost up to120bn euro since the beginning of the crisis. However, an environment characterized by exceptionally low interest rates is not entirely beneficial for the country. The pattern of household consumptions is severely affected by the projection of low interest rates on the future income: In the years preceding the European crisis, German households were convinced that they could offset the cuts German lawmakers had made to government-mandated pensions by saving more money on their own. Consequently, households invested heavily in insurance policies and so-called Riester retirement plans, purchased shares in securities funds and paid portions of their salaries into company pension plans.

Over the decades, they have accumulated €5 trillion in monetary assets, along with more than €6 trillion in real estate and tangible assets. Because Germans tend to be risk-averse, they invest most of their money in savings deposits, life insurance and fixed-income products. Now they are forced to look on as the euro crisis and the central banks' low interest-rate policies eat up the gains they had envisioned and darken the prospects of a comfortable retirement, especially at the lower levels of the income scale. Part of the recent slowdown suffered by German domestic demand – which surprised most economists - seems due to the effect of interest rates on projected income as explicitly reported in the letters that pension plans regularly send to their subscribers.

Life insurance companies in the crossfire

An even more troubling fallout of the new environment affects, in particular, German insurance companies that are struggling to survive with portfolios that bear negative real yields and nominal yields that are close to zero. Together with pension plans, insurance companies account for more than €1.8 trillion of German monetary assets. Most of this money is invested in government bonds, which means that the returns on life insurance policies are declining from one year to the next. Guaranteed interest rates, which were at 4 percent in 2000, had dropped to 1.75 percent by 2012.The record-low interest rates that have been a boon for borrowers are becoming a major problem for insurance companies, which are warning of lower profitability if rates stay at current levels through next year or beyond. According to the last EIOPA's Financial Stability Report, the current low interest yield environment represents the most prominent risk for life insurers, which are currently struggling to pay guaranteed rates of return and to maintain strong profitability in the long term. Similarly the Bundesbank, the German central bank, maintains that the prevailing low interest rates constitute the greatest individual source of risk for life insurance companies. Typical life insurance products are sold with a long-term minimum return guarantee, which is set at the inception of the contract and remains unchanged until redemption. Such contracts usually have maturities above 20 or 30 years which implies that life insurers still hold in their underwriting portfolio contracts sold in the past when bond markets yielded a relatively higher rate of return. There is the risk that, in the event of unfavorable market developments or after a sudden increase in risk perception, income from investments may be insufficient to make contractually guaranteed payments to policyholders and to fulfill any additional profit participation commitments. This risk can increase considerably when funds are continuously invested in a low-interest rate environment. Inevitably, life insurance companies must examine the level of distributions and bolster their equity capital. But the stability of the industry ultimately depends on the fact that interest rates remain higher than the real growth rate of the economy, as it had been customary in the past decades. The consequence are of macroeconomic dimension.

Life insurers' portfolios are geared towards loans, fixed income securities, and investment in

funds. The total investment portfolio amounted to €936 bn (or 35 percent of GDP) at end-2012. The weight of fixed income securities has been trending up over the past several years while the weight of units in unit funds (together with shares and other variable-yield securities) has been stable.The coverage ratio i.e., the ratio of own funds to the regulatory minimum, is significantly higher than one but is lower than most European peers' while profitability is poor. The coverage ratio has been on a declining trend since 2007 and stood at 169 percent at end-2012, which looks poor in international perspective. Profitability measured by profits over total assets has been stable but low since 2005.

More than one third of life-insurance companies might go underwater by 2023

According to the analyses of the International Monetary Fund, The German life insurance industry stands out in international perspective for its heavy exposure to low interest rates. Interest rates have fallen to the lowest levels in a generation which has brought down investment income. Weak economic conditions across the euro area and an inflation rate projected to remain below the ECB's target over a three year horizon imply that monetary conditions are likely to remain very accommodative for the foreseeable future. Although large insurers are in general well diversified in geographical and business terms and many have also already significantly adjusted their business models to the new environment, some life insurers may be squeezed by a thin or even negative margin between investment returns and minimum guarantees made to policyholders in the past. A similar phenomenon took place in Japan in the late 1990's and led to several failures. Low yields also constitute a key medium-term solvency risk through liability valuation.

More specifically, the vulnerability of German insurers to prevailing low rates is due – among other peculiar and distinctive characters - to high historic guarantees relative to reinvestment yields. Reinvestment yields have been declining over the past several years and hover now around 3 percent. German life insurers provided guarantees to their policyholders above 2.75 percent until 2006. Although guarantees on policies underwritten since 2007 have fallen substantially, the average guaranteed rate on the in-force business remains high, at 3.2 percent at year-end 2012. Other factors that enhance German vulnerability are: the high duration gap between assets and liabilities; the weight of deferred profit participation reserves and of capital in the balance sheet; the risk and expense results.

Stress tests suggest that several life insurers could face difficulties in coming years. The Financial Stability Review 2013 released by the Deutsche Bundesbank reports the results of stress scenarios conducted on German life insurers. According to the report, persistently low interest rates would be deleterious for the solvency situation of a subset of insurers. Particularly under the most severe scenario, more than one-third of all life insurers operating in Germany would not be able to meet the regulatory capital requirements by 2023. The Bundesbank estimated in November 2013 that in a severe stress scenario with a prolonged period of low interest rates, more than ten percent of life-insurers would breach regulatory own funds requirements (under Solvency I) by 2018, and more than one third by 2023. Measured in terms of their premium revenue, this latter group holds a market share of 43 percent. Separately, Moody's (2013) estimates that the German life insurance industry would ultimately suffer economic losses on in-force business if reinvestment yields remained permanently below 2.6 percent. A small number of companies closed their new business operations and are in run-off mode.

Several gimmicks and Deutschland-Bonds in the pipeline

It should not be surprising thus that the German Finance ministry is mulling over possible ways to increase the level of interest rates paid on public bonds. One of the proposals for instance was to grant a hefty premium to insurance companies that would underwrite a bond issued by the Federal government that would be used to finance infrastructural investments in Germany.

However the most interesting initiative seems to be the rediscovery of “Deutschland Bonds”: the Bundes-Laender Anleihe (also Germany Bond) issued together by the federal and the state governments of Germany. Since their very inception “Deutschland bonds” have been highly controversial as they had been widely seen as a possible door opener to Eurobonds, or common issuances by Euro-area countries. In the Deutschland Bond, the federal government together with a number of federal states, issues debt securities on the capital market and the funds raised through the bonds are shared between federal and the single state governments in the amount of their respective share of the emission volume. Analogously the federal and the regional governments respond of the repayment and of interest payments in amounts that are proportional to their share of issued debt. As in many Eurobonds proposals, each participant-issuer is liable for interest and principal payments at fixed, pre-determined in proportion to the respective emission volume.

Since its early discussion, the German Federal Minister of Finance Wolfgang Schäuble had openly rejected a joint and several liability attached to the bond, because, in addition to constitutional concerns, the design of the Germany-Bonds could be seen as a blueprint for the euro bonds: The German Bond is obviously intended to reduce funding costs for weaker Laender, bringing it closer to the one that is acknowledged to the credit merit of the federal government. Inevitably, as soon as Deutschland Bonds were announced, in mid 2012, they were seen as a template for the possible development of Eurobonds.

The origins of the D-Bond go back to June 2012, when the German government needed to get the German parliament to approve the eurozone's “Fiscal compact”, which aimed to enshrine budget discipline in national constitutions, paving the way for a permanent euro-wide bailout fund, the European Stability Mechanism – partially bankrolled by Germany. At the same time a number of proposals were advanced in Germany for the design of Eurobonds, in particular through the concept of a Redemption Fund. The momentum for common bond issuances became stronger as Chancellor Merkel needed to assuage the dissenting voices of some of the regional prime ministers needed to pass the new ESM at the Bundesrat. Against that backdrop, Finance minister Wolfgang Schaeuble designed the D-bonds.

In the German system of public finance, joint issuance by federal and state governments was a fundamentally new concept. The first Bund-Laender bond was issued on June 26, 2013 in the amount of three billion euros and running seven years (to 15 July 2020). The value-added that the federal government promised the regions was access to international investors, increased size and liquidity and better regularity. However, the political effect was muted, since larger German Laender quickly cooled on the idea, realizing that the credit enhancement to an already existent scheme - the 'joint-Laender' model, under which a collection of regions fund together - was negligible. Significantly, Laender whose leaders had been staunch opposers also of debt mutualization for the Euro-area had ducked out of the first issuances in 2013: Baden-Wuerttemberg, Bavaria, Hesse, Lower Saxony, Saxony and Thuringia.

Berlin had been doing its utmost to hype up its new-fangled regional funding initiative, the Deutschland Bond, but that had not stopped bank strategists calling the product a political charade

and investors cursing its complexity. If investors don't want to just rely on the fact that all entities are interconnected, have to do very detailed analysis on each of the regions in the deal. The less that enthusiastic acceptance put the bonds on a back-burner.

However just recently, according to the German financial daily "Handelsblatt", Finance Minister Wolfgang Schäuble (CDU) negotiated with his regional colleagues on the relaunch of common bonds. "The federal and state debt management could be merged. Purpose common bonds could be issued," it says, according to the newspaper, in a position paper by Schäuble and Hamburg's First Mayor Olaf Scholz (SPD). Both leaders coordinate the negotiations on the federal-state financial relations.

The initiative by Schäuble and Scholz is surprising because common federal-state bonds are still criticized by some Laender. Apparently a significant relaunch and a formalization of the joint issuances might require a constitutional amendment. In addition, federal and state governments want to sort the social responsibilities fundamentally new. Schäuble and Scholz write that the states should be given "a limited legislative powers" in welfare that finance them. The consequences would be drastic: This could be the future in the individual federal states, different social standards. At the same time Schäuble is willing to take on additional tasks. "The federal government assumes after 2020 Housing Benefit completely", says the paper by Schäuble and Scholz. It is about the accommodation costs for Hartz IV recipients. In return, the countries should waive agent. In what is still open.

Proposals of “new bonds” are connected with the problems of insurance companies

The coincidence between the problems of the German insurance companies and the study of new safe assets – as the Deutschland Bonds - is noticeable since today, given the exceptionally low interest rates, the problem seems to resurface. In 2012, exactly when the idea of the Germany bonds saw the light of the day, insurance companies had just started piling on risky assets in their struggle to compensate somehow for the already declining domestic yields. The level of riskiness implicit started to worry the country regulators. German insurers are traditionally risk-shy. While subprime and financial crisis-related losses at German banks totaled almost $105 billion, losses at the country’s insurers, including Allianz and Munich Re, were less than $7 billion, according to data compiled by Bloomberg. The stability of the insurance sector is a factor of major relevance for the German economy. In a country with a pronounced role of insurance companies, an insurance sector that functions properly can both help to provide that specific risks are allocated efficiently and contribute to economic growth. Empirical studies reveal a positive correlation in Germany between insurance services and economic growth. However, when interest rates recede and a sustained low-interest rate environment ensues, the bonus and rebate provisions (which serve to finance policyholders’ profit participation shares) shrink, as they originate principally from investment income. A decline in investment income could lead to withdrawals from the bonus and rebate provisions in excess of allocations. As a result the bonus and rebate provisions would shrink weakening the life insurers’ capital base as part of the provisions are recognized as own funds. Furthermore, policyholders’ profit participation shares would be at risk. The most important adverse effect of the diminished capital base, however, would be a reduction in the insurance companies’ resilience.

In such situations it is tempting to search for yield by investing in lower-quality and consequently riskier credit, extending duration and increasing balance sheet leverage. This is by no

means a hypothetical consideration and has already occurred in the United States. According to the IMF's Global Financial Stability Report, between the fourth quarter of 2008 and the end of 2012, U.S. insurance companies increased risky assets as a percentage of overall assets from about 22.5 per cent to roughly 24 per cent. At the same time, the net interest margin of U.S. insurers declined from about 3.4 per cent to 3 per cent. According to insurance sector analysts, financial markets are currently not pricing in any meaningful rise in interest rates. This leads to complacency and a considerable mis-pricing of risk. Again, cursory evidence indicates that insurers increased the share of corporate bonds (including high-yield bonds), thus investing in an asset class where currently compressed spreads no longer appear commensurate with underlying risks. Market corrections are bound to create appreciable losses. These developments raise concerns that insurers are vulnerable to sudden spikes in yields and the attendant financial market volatilities, triggering a disorderly adjustment and potentially creating outsized financial risks.

But not a permanent solution

BaFin required life insurers to build a *Zinszusatzreserve*, i.e. create additional reserves that prevent non-realised capital gains from being distributed to current policyholders at the expense of future policyholders. It is increasingly evident that German life-insurers are finding it difficult to generate investment yields that are sufficient to cover the benefits guaranteed in policies sold in the past. At the same time, the current low interest rates are creating often substantial valuation reserves for bonds with high coupons in life insurers' portfolios. German legislators have passed the Life Insurance Reform Act to address this situation. Under this new legislation, allowance is made for hidden losses when determining policyholders' participation in the valuation reserves. Other notable measures in the Life Insurance Reform Act include restrictions on dividend payments to shareholders and a lowering of the maximum technical interest rate from 1.75% to 1.25%. The Act also raises the minimum threshold for policyholders' participation in the risk surpluses from 75% to 90%. The aim of the Life Insurance Reform Act is to improve the resilience of life insurers and thus the stability of the life insurance segment as a whole. It therefore restricts outflows of funds, eg in the form of policyholders' participation in the valuation reserves.

According to the Bundesbank, all in all, the measures considered could help to improve the stability of German life insurers in a persistent low-interest-rate environment. The restrictions on policyholders' participation in the valuation reserves are likely to play a particularly important role in practice. However, insurers' long-term guaranteed return commitments and much shorter-term investments mean that the planned measures alone will not provide a permanent solution to the problems created by a prolonged phase of low interest rates.

The decline of German debt and the need for European debt

According to the government's plans, the German Federal debt should decline regularly in the coming years. Originally, Schaeuble expected the debt-GDP ratio to buck the 60% threshold in 2020. Should this ambitious goal be achieved, the supply of high-quality federal paper would further decline. Because long-term rates are a weighted average of expected future short-term rates, expectations of future fiscal surpluses will tend to decrease today's long-term real bond rate. Insurance companies, as well as the other agents of pension plans for most individuals in Germany, would face serious problems in raising yields without investing in much riskier assets.

Should the worrying scenario materialize in Germany, or simply become of public awareness,

pension-recipients might feel uncertain about their future incomes. This in turn would depress actual domestic demand as a direct consequence of consumption functions based on life-cycle or "permanent income" considerations. The depressed demand would bring interest rates even lower and possibly trigger a downward deflationary spiral.

Before this scenario becomes self-fulfilling, Germany will need to find a new safe high-quality asset class that is not currently existing. Low asset returns or, more generally, poor investment opportunities are simply one of the many manifestations of a deep recession. In the case of the euro area, the crisis and the lack of good investment opportunities are strictly related. One could even maintain that the lack of a quality security for the euro area is the main problem behind the uncertainty suffered by most of the economic agents. In such an environment, looser monetary policy conditions are not the *result* of a desire to favor borrowers, but rather the necessary *response* to bring the economy back on to a sustainable growth path in an environment of price stability. Eurobonds are the only way to increase interest rates without depressing the economy further, delaying the recovery and contributing to downside risks to price stability. Far from helping borrowers, a new quality asset for the euro area would favor savings rich countries and the European economy as a whole.