Improving Fiscal Governance with Amortizing Sovereign Bonds

The better alternative to the European Redemption Fund, and a possible fiscal reform route for the United States, is to mandate all new government bonds issued to be amortizing

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Maximum moral hazard in the interest-only sovereign bond world

Europe, despite her travails, is arguably more advanced in making a serious assault at sovereign debt levels than the United States, where nevertheless the issue is on every policymakers mind.

As on the old continent one discussion after the other of the elusive 'European Redemption Fund' ERF comes through the wires, perhaps a good approach would be to step back and ask the simple questions again.

The first and most important is: why do we need a Redemption Fund for government finance?

Why is it that we ask mortgagors that fund a house with a 2% physical depreciation rate with a self-amortizing mortgage and not governments that fund a road with a 2% physical depreciation rate?

Unless you're still doing your computations with an abacus and are thus unable to technically address this question, the answer will be: moral hazard.

The sad reality of our democracies is that governments prefer to live in a permanent interest-only world, implying minimal debt service and a bet on rolling over the outstanding. Consumed by relentless rent seeking via debt mutualization, including 'firewalls' by others and central bank stealth bailouts via inflation, in such a world regular amortization has no place.

A first implication is that the amortization profiles of the projects that government has funded do not matter for the debt profile either. Public consumption leads to the same public debt profile as a long-term investment in education or infrastructure. This raises serious intergenerational equity issues.

A second implication is that if outstanding is simply rolled over and not amortized, the fairly optimistic motto that 'government does not die' has to hold. We know, however, that investor perceptions that it could may easily arise and blow up the planned roll over. This is then the time for an international bailout, a 'Redemption Fund' – and its cash flow equivalent, the 'Debt Brake' - as investors go on strike. The last exit is financial repression of the investors you can still get hold of.

Option ARM with recast quick fixes is not a model for sovereign finance

There were products developed during the exuberance of U.S. mortgage finance, causal for the collapse of the system in 2007/8, that operated exactly like we do now in sovereign finance. One such product was called 'option ARM'; Sheila Bair dubbed it 'pick your pay'. Initial debt service was conveniently low for the borrower, who funded investment at excessive cost with it, and the product predictably accumulated debt very fast. Yet, it had a 'recast' provision, which said that when a certain debt ceiling trigger was hit faster amortization would automatically kick in. We know what happened to this portfolio. When recast finally kicked in, affordability was down as a result of crisis factors (cash flow and balance sheet), defaults ballooned, and the belatedly scheduled amortization could not be forced on borrowers. Many analysts of the U.S. crisis regard option ARMs products as the worst of a bad lot, worse than Subprime, because they engulfed relatively solvent borrowers in an unaffordable sea of debt.

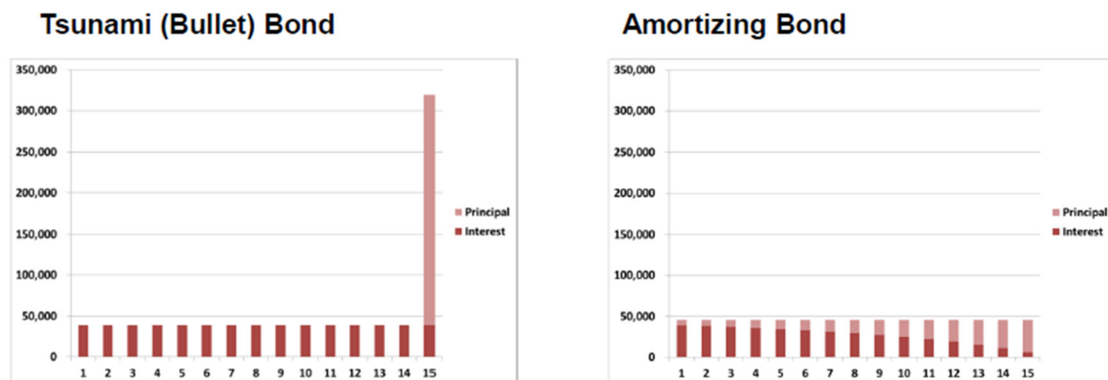
Option ARM's recast provisions are de-facto the European medicine after exuberance has led to ballooning public debt. U.S. experience suggests that the chances for success of such an aggressive amortization concept are slim. Importantly, there are no safeguards against the problems not repeating themselves for the portion of debt that does not enter the Redemption Fund. This debt in totality is expected, but by no means guaranteed, to remain under 60% of GDP and to be backed by the individual Eurozone country only. The result of this construction is a distorted incentive structure: borrowers with high debt levels benefiting strongly from the mutualized ERF will not only face lower average cost of funds than more disciplined borrowers. They will also have no incentive for accelerated amortization of the debt that was placed into the ERF, which will be their cheapest funding option. This is the precise opposite of what the ERF rules would demand. Adding to this the general difficulty to discipline sovereigns, failure to enforce rules will be the inevitable outcome.

Attacking the roll-over tsunami upfront through instrument change

The road forward seems to be to develop the long-term system before applying quick fixes to the short-term debt issue. If we want to start getting serious about government finance, we must – as one important aspect of reforms – ensure that the debt becomes regularly amortized, ideally allocated to the specific projects that it funds. That would imply that consumption expenditures do not lead to new debt, an automatic version of the 'Debt Brake'. Debt for long-term investments such as a road or a hospital, in contrast, can amortize over perhaps as much as 50 years. In other areas, such as defense, the right amortization schedule would be a subject of debate, but still reasonable assessments can be made.

There are two essential options for implementation of amortization: the annuity concept, with increasing amortization over time under a fixed payment (shown in the chart), and the serial amortization concept with constant amortizations. Both already substantially reduce government liquidity risk, which – if the entire stock of debt would be converted to amortizing – would be essentially limited to issuing new debt for new investment projects. For highly indebted nations, the annuity loan profile – and long maturities - could be chosen to make the amortization initially more affordable. Average amortizations would remain slow in the first years for those countries. Yet, a start would be made.

Current ‘Tsunami’ Bond Standard and Amortizing Bond Alternative



Notes: cash flow profiles of two 15 year bond with identical present values.

An instrument change will impact aggregate sovereign debt management

Making sure that *all* new government debt would have amortization embedded would mean an immediate regime change for the government bond market. In the context of the Eurozone, it would discipline not only the proposed ERF portion of debt (above 60% of GDP), but all debt issued. Greater public spending discipline would be enforced through the automatic deduction of amortization above interest paid from budgets. As gross redemptions rise, in order to inflate gross debt levels as much as in the past, finance ministers would have to justify strongly increased gross issuance in front of parliaments vs. the status quo. This would increase the political stakes and add pressure to select uses of funds more carefully.

Flexibility is surely needed in reality. Interest-only debt should ideally be outlawed, as many jurisdictions have done more recently for mortgage finance, but can in practice be limited in size, e.g. to total debt. Partial amortization and roll-over could be accepted for shorter term bonds, within additional limits. Both moves would also address the increasing short-termism in government funding strategies, another major financial stability risk. Governments that need to lump multiple investment projects to fund them via single debt issues could chose an average amortization profile. Despite all this necessary fine-tuning, the principle of regular amortization should be firmly established.

Clearly, the intention of the proposal would not be to eliminate government debt. The dangers of this approach has been shown in the United States in the final years of the Clinton administration, when mortgage (agency) debt started to take over central stage for investors from sovereign debt, with the known consequences. Rather, amortizing bonds would help to regain investment capacity for the modernization of depreciated public assets and degrees of freedom for future generations. And it would help to credibly reduce debt to more sustainable levels over the mid-term.

Instrument change could be the beginning of broader sovereign finance reforms

In the context of the Eurozone, where debt mutualization is hotly debated, the amortization proposal can be easily combined with a bond insurance scheme. Eurozone members would in this scenario invest some of the rate advantages gained from debt mutualization into amortization.[1]

The United States is lacking an explicit debt mutualization option and would have to incentivize herself to greater discipline as long as investors are willing to roll over her debt. The fear that the day when they would rather not might not lie in a too distant future should be motivation enough. The country might want to remember that the approach to give preference to radically reformed financial instruments has been used in history successfully. The prime example here is the National Housing Act of 1934, a crucial New Deal legislation, that changed the mortgage market from variable and bullet to the fixed-rate and amortizing regime still prevailing today.

An examination of this particular case in the context of the recent mortgage market crisis reveals that the amortizing fixed-rate products experienced significantly both lower default rates than the former, not to speak of eliminated liquidity/interest rate risk. The same case surely also would suggest that amortization can only be one element in a broader strategy to better manage sovereign debt levels. However, given the potential of the instrument to introduce automatic discipline, it could very well be a central one.

[1] For detail on a partial insurance scheme – full insurance seems both financially and politically infeasible - see http://finpolconsult.de/mediapool/16/169624/data/PB_No_252_Duebel_on_Partial_Bond_Insurance_by_the_Eurozone.pdf.