



Food for
Thought

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The French National Bond Issue

What Methodology? Which Priorities?



This article is the result of Paul Goldschmidt's reflection, a former director at Goldman Sachs International and former director at the European Commission, and member of the Advisory Board of the Thomas More Institute, which led to two working papers during the summer on issues regarding the methodology and the priorities to give to the French National Bond Issue that President Sarkozy wished for. These working papers have been sent to Michel Rocard and Alain Juppé, both of them former Prime Minister and co presidents of the Commission tasked with determining strategic sectors to benefit from the National Bond Issue, as well as to all the members of the Commission.

Within the scope of the financial crisis, which has led to the most severe recession since the 1930's, the proposal of a large scale "National Bond" issue aimed at financing investments and/or underpinning the revival of economic activity, falls within the parameters of a well established tradition. However, one should not lose sight of the fact that the three such large scale borrowings, issued since WWII, turned out to be particularly onerous for the French tax payer because of the attendant repayment conditions. These terms had been selected, at the time of issue, with the aim of raising the largest amount of funds possible and therefore geared to meet the expectations of subscribers, without giving much thought to the coherence of the terms with the purposes to which the issue's proceeds were to be allocated. Henceforth, the repayment of the "Pinay" and "Giscard" bond issues, both indexed on the price of gold, was burdened by successive devaluations of the French franc (the fear of which was the basis for the indexation) but mainly by the abandonment by the United States of the fixed price of USD35 per ounce of gold in the early 70's, an event that was largely unforeseeable at the time of issue.

This article, drawn from two working papers that were sent to the main actors and deciders in charge of the project, aims, in the first instance, to define a general methodological framework to ensure the success of the issue followed by recommendations of priorities that could, among others, be selected to benefit from this privileged source of financing. Bearing this in mind, the recommendations relative to the purpose of the proposed loan, entrusted by President Sarkozy to former Prime Ministers Juppé and Rocard, should include a framework of relevant terms and conditions so as to ensure coherence with the aims defined.

Is the Issue Justified?

A preliminary question needs however to be addressed: is a large National Bond issue justified in the current economic and budgetary context? There are indeed grave doubts, expressed by no less eminent personalities as President Trichet of the ECB, as to its pertinence, estimating that the stimulus measures already decided have not yet fully worked their way through the system and that, consequently, priority should be given to budgetary discipline, including limiting indebtedness so as to better control inflation expectations linked to a future economic upturn. Others, confronted with rising unemployment and – in the best of outcomes – facing only a slow economic recovery, are strong supporters of the President's initiative.

It is true that it may seem paradoxical to recommend a significant increase of the national debt when the severity of the crisis is specifically ascribed to the excess indebtedness of the international financial system. This excess indebtedness was largely hidden through the use of complex financial instruments, structured on flawed economic models which, when challenged in the particular sector of the American "subprime" market, initiated a domino effect that came close to destroying the entire world financial system in the aftermath of Lehmann Brothers failure.

However, when considering the merits of increasing the French national debt, one should also take into account the current situation: the crisis has created specific responses at the level of consumers, investors and financial intermediaries. The former have, when they were able to do so, reduced their indebtedness and increased their savings rate which has led to a lower level of consumption (limited in France by the high level of social protection and a close to zero inflation rate). Entrepreneurs were inhibited in their investment projects by two factors: the decrease in demand attributable to the crisis on the one hand, a significant and often dissuasive increase in financing costs despite credit availability on the other. As to financial intermediaries, mainly banks, they were requested to provide the market with the considerable resources made available (or guaranteed) to them by the State. This did not prevent banks from increasing significantly their margins in order to restore their impaired capital base but also to take into account the deterioration of the quality of borrowers induced by the crisis that increased their risk profile.

In such an environment, the transformation of consumer savings into credit facilities underpinning the financing of the economy does no longer take place through normal market mechanisms. The intervention of the State, through the issuance of a large National Bond issue, can therefore be justified in order to stimulate activity and provide financing at a reasonable cost for investment projects needed to ensure the competitiveness of the economy and thereby foster employment. This appears all the more desirable that, in the absence of a vigorous upturn, budget deficits will continue to increase leading to higher indebtedness but without the countervailing benefits.

How Should the Modalities be Selected?

Having attempted to validate its appropriateness, as well as its incidence on the national debt, let us now consider more closely the terms and conditions of such an issue. They will undoubtedly be dictated in part by the market in light of the level of economic activity and inflationary expectations that shall be "objective" factors at the time of issue early 2010. Authorities will, nevertheless, have a certain degree of flexibility which allows them to structure the loan so as to make it more attractive to subscribers while limiting its cost. To avoid the kind of bad "surprises", such as in the "Pinay" loan, it is important to link conditions to variables that are directly function of the use of proceeds rather than to references which are uncorrelated.

Therefore, even before considering the merits of numerous potential "beneficiaries", which are already expressing interest, it is necessary to make a fundamental "political" determination: should the proceeds of the loan finance "public goods" (infrastructure – education – healthcare – fundamental research etc.) or alleviate failures of the private sector (SME financing – recapitalisation of the banking system – applied research and development expenses of private enterprises, etc.)?

Indeed, even if both types of investment share the similar ultimate purpose of an improvement of the competitiveness of the French economy over the long term while stimulating activity in the short run, the former reaches its aims through difficult to measure secondary or tertiary effects while the latter aims at defined objectives impacting specific beneficiaries and leading to eminently measurable outcomes.

This "political" decision that must imperatively be made at the outset should be a determining factor concerning the loan's ultimate structure, unless one recommends a two phase issue with distinct

characteristics, with the aim of offering the choice to the investor as well as maximising the amount raised. These important questions are developed here under.

Indeed, if the choice is directed towards financing of public goods, loan terms should be closely related to conditions prevailing, at the time of issue, in the secondary market for classical government loans. The rationale of such a loan is based on the following type of considerations: in the current sluggish economic environment, there is a strong demand for securities offering an attractive yield in relation to low prevailing inflationary expectations, coupled with the safety provided by the quality of the issuer. In addition, the liquidity provided by an active secondary market (underpinned by the size of the issue), provides the investor with the reassurance that he will be able to adjust his position as a function of his personal needs and/or the evolution of the market over the life of the issue. The amount raised can be easily adjusted by modulating the premium offered relative to secondary market levels. In such a configuration, it would appear unwise to succumb to the temptation of adding additional advantages, such as indexation on inflation, even if it allowed raising a larger amount and/or reducing the initial interest rate (thus reducing the immediate drain on the budget). The budgetary risk over the 20/30 year life of an indexed loan is very significant and would be shouldered by future generations.

If, on the other hand, the initial determination favoured the support of private sector investment, it would be possible to consider a "participative" structure for the loan. This implies, of course, that the participation offered to subscribers is linked directly to the conditions under which the loan is disbursed: one can envisage a broad spectrum of instruments such as loans (subordinated or not) to which warrants are attached, convertible debentures, direct equity stakes or royalties tied to specific research projects (such as the electric car). Such a structure, in which the potential financial rewards would be set aside for to the bondholders, would reduce significantly the budgetary cost of servicing the loan without any additional risk above a reduced guaranteed rate of interest and the repayment of principal. The management of such a loan could be entrusted to a competent existing institution (Caisse des Dépôts) who could in turn farm the proceeds to specialised organisations responsible for SME support or financing of research projects.

By defining at the outset a coherent framework which integrates the aims of the Government, the legitimate returns anticipated by investors and prevailing market conditions, one will facilitate immeasurably the difficult priority choices to be satisfied. It will be possible to avoid the temptation of ineffective compromises while limiting the criticisms and disappointment of those that cannot be satisfied.

What Priorities Should the Issue Finance?

Let us now turn to concrete suggestions concerning priorities to be financed by the National Bond issue. In so doing we have deliberately aimed at ensuring coherence between our proposals and political choices frequently expressed by the President. A second concern was efficiency, avoiding excessive dispersal of efforts, therefore focusing on the considerable financial resources envisaged on a limited number of specific objectives. Thirdly, recognising the importance of the task, we have not hesitated to challenge a number of commonly accepted ideas that are deeply embedded in society's consciousness at the risk of seeing the proposals rejected out of hand.

We have selected two specific areas for consideration: first education which represents a choice of financing "public goods" within the meaning discussed in the first part of our analysis, and, second, the dual environment/employment pillar aiming at underpinning "private sector" activity, which fits the alternative approach described for the issue's structure. Each of these domains is among the highest priorities which have been identified within the framework of fighting the unprecedented severity of the economic and financial crisis. Without in any way contesting the validity of other worthy causes, we believe that a clear and focused selection of objectives is capable of gaining public opinion support while offering an opportunity to implement reforms whose necessity has become only too obvious.

A last important preliminary remark: even though the proposals are aimed at a "National" bond issue, it should be clear that, aiming at policies affecting education, the environment and employment, they should be conceived and integrated in the broader context of the European Union. France should initiate bold initiatives that can serve as "pilot projects" and constitute examples of "best practices" in these areas, which in turn can be extended throughout the EU. By seizing this opportunity, France will be in a position to influence and shape decisively the future orientations of Community policies.

First Priority: Education

In the face of globalisation, the only way for the EU in general and for France in particular to maintain (and - why not - improve) existing economic and social standards, is to invest massively in education. This fact is widely recognised but implies accepting important changes, in particular the reinforcement of citizen's own responsibilities, and a willingness to challenge sometimes century old educational structures. Education consists in the transmission of "knowledge": it can be of an academic nature that we will refer to as "instruction", have a practical content designated as "training" but also encompassing ethics, meaning the transmission of "values", including "social responsibility". Together they form a complementary but indissociable single entity. It is commonly accepted that education is one of the "fundamental human rights". As is the case for every "right" it entails both obligations and responsibilities. These rights and obligations have undergone profound changes with the passage of time. The acceleration of these changes, among the most spectacular of which is probably the realisation that education has become a lifelong process, has not been accompanied by corresponding structural reforms. If one addresses the question afresh, one can divide education in three distinct periods in which the responsibilities and obligations of the actors are distributed in significantly different ways.

The first period covers infancy up until 16 year old (age of legal responsibility in many countries). During this period, responsibility for education is divided between parental authority (exclusive to start with) transmitting values and behavioural standards, and the State. The State undertakes mainly instruction and secondarily values. The "right" to education is evidenced by the legal obligation of "schooling" which, in turn, justifies the fact that its financial burden is shared by society as a whole. As it is widely recognised, this first period is crucial for the future of any child. Therefore the highest quality standards are required. A first area that could be financed by the National Bond issue would be to strengthen the partnership between those who exert parental authority and teachers.

Proposition 1 – Financing at school the strengthening of partnership mechanisms between those who exert parental authority and teachers

This partnership could be developed in part on the basis of the proposals, contained further on in the paper, concerning "lifelong training", aiming at improving the ability of participants to better exercise their joint and several responsibilities. A specific aspect could be to encourage awareness of the children of their own responsibility for success, allowing them to become fully accountable at the next stage.

The practical modalities of such training should be left to the competent specialists, but participation could be made compulsory for parents whose children were experiencing difficulties or for teachers whose results were considered insufficient by inspectors. It is quite likely that the very existence of a structured parent/teacher partnership would considerably reduce the need for remediation which in turn would considerably reduce the costs induced by a high rate of "failure".



The second period starts at 17 years of age, continuing until the acquisition of a qualification which allows for an independent livelihood. It covers both the continuation of "instruction" (end of high school through university) and "training" in professional technical skills. At this level, the State has the key responsibility of providing appropriate instruction and training services (in conjunction with private sector actors: industry-foundations-alumnae etc.). However, the privileged partner of the State is the student himself. It is at this stage that it seems appropriate to challenge the current "economic" structure of education. Let us first make forcefully the point – to avoid any ambiguity – that education remains during this period a "right", and that no student should find himself barred from access because of a lack of financial resources. This being said, the student who chooses to pursue further education in the immediate aftermath of his basic "instruction" aims at acquiring skills to improve his career. Insofar as society provides him with the means to satisfy this ambition, it would seem fair that the beneficiary assumes corresponding obligations and responsibilities. First of all there is an obligation to "achieve": a key to encourage success is assistance to the student in finding the appropriate orientation.



Proposition 2 – Financing an ambitious career advising program for the students

This could be the subject of a specific "program" to be financed by the National Bond issue, aimed at aligning the wishes of the student and the necessary competencies needed to follow successfully the chosen path. Such an approach would allow Institutes of higher education to set up entry exams, thus reducing significantly failure rates due to a bad orientation and its associated exorbitant costs.

Another aim could be a considerable reinforcement of "apprenticeships" as an alternative route to academic studies for a successful integration into society. In addition, a decision aimed at reinforcing responsibility should include a significant increase in tuition fees so that students become more aware of the true costs associated with their education.



Proposition 3 – Financing a program of compensation for a necessary increase of tuition fees

The sine qua non counterpart to such a policy would be the simultaneous availability of financing options, easily accessible to a candidate, so as to ensure the effectiveness of the principle of "universal access". The National Bond issue could finance a "Guaranty Fund" which would encourage banks to make "riskless" loans.

Such a system would, by its nature, be particularly well suited to be extended to EU level through implementation of an ad hoc "global loan window" to the EIB's classical model. Default risk could be transferred to the Community budget or counter-guaranteed by the "shareholder States", each underwriting their own nationals. Particular attention should be given to the terms and conditions of such loans which must be sufficiently flexible so as not to discourage applicants. Amortisation could be based on long periods and tied to earning capacity. Fiscal incentives could be appended to the system which might be extended to "employers" who would be attracted by the possibilities of recruiting qualified personnel.

The significant increase in tuition fees should allow, in turn, educational institutions to hire better qualified teachers, to make the necessary investments in buildings and materials as well as to finance research projects maintaining and improving the competitiveness of the European education system. Thus a virtuous circle of excellence would gradually be put in place. With regard to "fairness", it is not unreasonable to ask beneficiaries of a costly education that opens the way for remunerative employment to assume the greater part of this cost rather than spreading the burden on the ordinary taxpayer. This proposal, that will certainly be shocking to many, should be considered within the framework of opportunities that are to be offered within the context of "lifelong training" discussed hereunder.

The third period covers all tuition aimed at individuals who have interrupted their education after their basic instruction, those who are confronted with the need of retraining or those who, for professional or private reasons, wish to improve their knowledge. Bronislaw Geremek, in one of his very last texts recommends: "a European Fund could ensure for every European citizen the possibility of an apprenticeship or further instruction, outside of the normal period of schooling or university studies in order to update his professional qualifications and adapt to new work requirements, a sort of "Erasmus" aimed at workers" ¹. Adequate financing mechanisms should be put in place: In addition to loans, as mentioned above, co-financing by employers could be part of employee "rights" in case of restructuring or dismissal.

However, the main innovation concerning the structuring of lifelong training which has become a vital necessity would be based on the following concept: considering that employees of companies or institutions are holders of knowledge and experience that are often definitively lost when they retire, should one not consider amending – by law and after extensive consultation – the organisation of career planning aiming at preserving this "wealth" for the benefit of society, improve the quality of life of retirees, while, at the same time, finding a partial solution to the problems of ageing and financing of retirement benefits?

¹ Michel Rocard and Nicole Gnesotto (dir.), *Notre Europe*, Paris, Robert Laffont, 2008 p.252.



Proposition 4 – Financing an innovating life-long learning program

Could one not envisage making available to companies and institutions in every sector, qualified persons who, from 55 years onwards, would dedicate an increasing part of their time to training their fellow citizens? These part time endeavours could be extended well beyond normal retirement age; they would be remunerated and contribute to an improvement in retirement benefits.

To supply such a system with both the necessary quantity and quality of “teachers”, one could also recruit younger participants who could, for instance, be compensated on favourable terms by a credit against the indebtedness they may have contracted during their earlier education. Part of the funds collected by the National Bond issue could be used to set up a “National Service for Lifelong Learning”, charged with implementing the system which would become a cornerstone of the competitiveness and employment policies pursued by the Government.

Second Priority: The Environment/Employment Pillar

Nearly every stimulus program elaborated in connection with the crisis devotes significant attention to these twin priorities. Their coupling is a recent trend as for a long time environmental protection was seen as incompatible with economic growth. However, the fight against global warming entails behavioural changes whose adoption is only conceivable to the extent that technological progress allows continued satisfaction of “needs” that are deeply ingrained. It would be naïve to count on solidarity alone, either at national or global level, to allow for a fair sharing mechanism.

Happily, expectations of further technological progress offer solutions that, while being respectful of the environment, are capable of both improving the quality of life as well as offering significant employment prospects. Europe is ideally placed to benefit from this conjunction that can initiate a virtuous circle. The sector is, indeed, particularly well suited to generate a rapid “return on investment” while contributing to the protection of the environment. Citizens are offered the opportunity to reduce their current expenditures, shielding them from price fluctuations of raw materials such as oil and gas, and improving simultaneously their disposable income. Environmental upgrading of publicly owned real estate not only creates employment opportunities but also reduces structurally the recurring operating expenses of the administration. Furthermore, the impact on employment is largely immune to delocalisation as it is directly linked to the real estate infrastructure.

Europe, whose research capacity is widely recognised, should be at the vanguard of innovation in these promising sectors including the “clean” car, thermal isolation, renewable energies, energy efficiency etc. Support for applied research in these domains opens up opportunities for creating high added value jobs, particularly suited to maintain and improve competitiveness within a global world.

If financing of this type of activities were to be selected as a priority use of the funds collected by the National Bond issue, the following options should be considered:



Proposition 5 – Cofinancing “applied” research together in partnership with companies stretching from SMEs to multinational companies

Co-financing of applied research projects in partnership with companies stretching from SMEs to large multinational corporations. The instrument could be low interest bearing loans, without additional guaranties, but including a sharing mechanism of the financial rewards derived from the successful innovations (royalties).



Proposition 6 – Financing a program of direct equity stakes or shareholdings acquired through specialised investment vehicles in SMEs active in the sector concerned

Direct equity stakes – or shareholdings acquired through specialised investment vehicles – in SMEs active in the sectors concerned aimed at financing their growth and, consequently, their employment capacity. Instruments could include ordinary shares, convertible subordinated debentures, loans with warrants etc., the aim being to reduce as far as possible the cost of financing in exchange for equity related benefits. The chosen instrument should increase in parallel the autonomous financing capacity of the beneficiary through the strengthening of its equity base or the subordination of the debt incurred.

The purpose of the National Bond issue would therefore be direct support for the private sector activity in areas linked to the environment, considered in its broadest sense. It constitutes one of the most promising avenues leading to the substitution by new highly profitable industrial activities, having a long term future, of those who are no longer able to sustain competition in a globalised economy and in which the “protectionist” option must be avoided at all costs.

The structure of the proposed financial instruments to be deployed would allow for the possibility of transferring the financial rewards linked to the investments to the National Bondholders. This “risk” incentive would be translated into a lower interest rate level guaranteed by the State. The budgetary impact will be reduced or - in the best of cases – nil, limited to the difference, if any, between the repayments and/or distributions related to the initial investments and the nominal amount of the issue and the guaranteed rate of interest. The minimum guaranteed rate should take into account that the financial rewards derived from the investments will be deferred, which could be dissuasive for investors requiring a guaranteed income; it could also affect the liquidity of the issue in the secondary market in light of the complexities of assessing periodically the underlying value of the investments.

Another important factor will be the management of the loan in terms of selecting investment projects and the ongoing monitoring process. France operates several highly qualified institutions, specialised in research and SME support, which could be solicited as “sub-contractors” for these tasks, avoiding the need of setting up new bureaucratic and costly entities. Partnerships with EU institutions such as the EIB/EIF or the Community Research Program could also be rewarding.

Nothing should prevent the Government from complementing these arrangements by adding fiscal incentives aimed at the beneficiaries of the investments or the purchasers/users of the products concerned. Their financing should, however, derive from the ordinary budget rather than from the proceeds of the issue. Their impact could have a significant impact on the terms and conditions of the issue by increasing its amount and/or reducing the interest rate.

Conclusion

The recommendations here above are not mutually exclusive but are aimed at investors having differing objectives regarding income, risk profile, liquidity preferences etc. The recommendations are complementary insofar as development of the environmental sector will require a significant investment in the training of its actors. This offers interesting possibilities in terms of retraining of staff, often highly qualified, who are the victims of restructurings in sectors that have become obsolete. We recommend, therefore, either to make a deliberate choice between the two suggested priorities, or to consider two bond issues, with different characteristics, which would be marketed either simultaneously or consecutively in light of market conditions prevailing in early 2010.

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