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Creating a common safe asset without eurobonds

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Europe needs a capital market that is sustainably integrated and as single as possible. This will not be achieved without a broad and solid foundation. The international position of the euro is stagnating close to historical lows, while the lack of a European-wide common safe asset highlights the fragmented nature of national government bond markets. Although collective issuance of government debt by member states through eurobonds seems to be unattainable for political reasons, there are other ways to arrive at a common safe asset. Debt issuance by the European Central Bank (ECB) and the European Union could play a constructive role here. By financing the European budget through bond issues and at the same time allowing the ECB to issue short-term money-market paper, Europe could tackle multiple challenges in one fell swoop.

Since the beginning of the euro crisis, Europe has taken several steps to strengthen its monetary union. These have led to numerous initiatives that have brought much more coherence to the eurozone, even though not all of them have been complete. Two of the most important ones are the Banking Union (BU) and the Capital Markets Union (CMU). Although the former – an indispensable step to a full and deep Economic and Monetary Union (EMU) – is on the right track, the latter – the only path towards a fully integrated European capital market – seems to have lost its way (Lannoo and Thomadakis, 2020).

The EU capital markets are the sum of various national and un-harmonised capital markets, with the number of supervisors for capital markets activities exceeding that of member states. On top of that, important elements are still missing (e.g. the harmonisation of taxes on financial products; the convergence of company law, including on bankruptcy; and the creation of a single rule book). As a result, the financial system is overwhelmingly bank-based, and the role of capital markets in the financing of economic activity is negligible compared to the Anglo-Saxon countries.

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The creation of a CMU would give businesses more opportunities to meet their financing needs (e.g. issuance of shares and bonds), make them less dependent on bank credit, increase their shock-absorbing capacity, while allowing investors to safely invest and participate in capital markets. Having in place a European safe asset would be a step closer towards that target. Such an asset would not only provide more diversified and liquid capital markets of both debt and equity, it would also support further portfolio diversification in the financial sector and provide a new source of high-quality collateral for cross-border financial transactions. More importantly, it would render sovereign bonds issued in otherwise small and less liquid markets more attractive for international investors. Moreover, the safe asset would increase the range of available instruments on capital markets, thus contributing to deeper and more integrated European capital markets.

The European capital market is fragmented

CMU is having trouble getting off the ground, which is more difficult now with the UK's departure from the EU. One of the reasons is the lack of a large EMU-wide and highly liquid market for government paper. The EMU clearly has a large government bond market, but this is fragmented along national lines, which affects liquidity and quality. Triple-A (AAA) paper is scarce, and until recently the supply was waning as important AAA-rated issuers (e.g. Germany and the Netherlands) were running fiscal surpluses. What is more, the ECB's Asset Purchase Program (APP) that started in 2015 has led to a further contraction in the volume of tradable triple-A paper.[1]

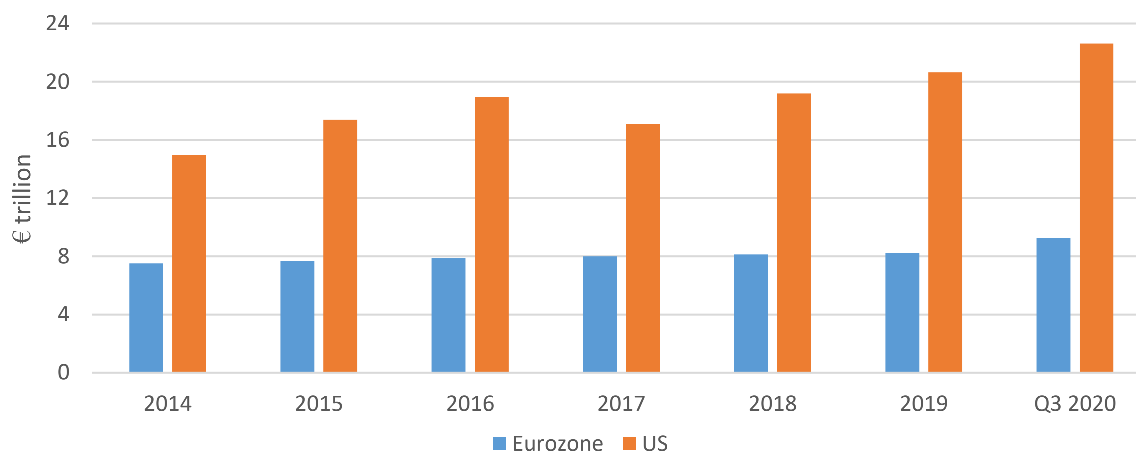
In most of the well-developed capital markets, the government is the most important issuer of risk-free bonds. In particular, where the government debt is ultimately secured by the population as a whole (i.e. the taxpayer), government bonds are seen as the safest investment and form the basis of the market. Normally, these markets are substantial, with large volumes of debt paper outstanding across the entire yield curve and large amounts traded. In times of turbulence, when investors turn to low-risk investments, the risk curve steepens, meaning that the yield on government bonds falls while for more risky bonds it rises.

The eurozone's problem is that there is no deep market in high-quality EMU-wide securities. A comparison between Europe and the US reveals a couple of notable points.

First, while the absolute size of the total market for government debt in the eurozone reached an all-time high of €9.3 trillion in Q3 2020, it is substantially smaller than the €22.6 trillion in the US (see Figure 1). This is also reflected when looking at relative terms. In the euro area debt levels reached 114% of GDP in Q3 2020 (up from 90% of GDP in 2019), while In the US 160% (up from 92% of GDP in 2019).

[1] The European Investment Bank (EIB) – the largest multilateral investment bank – is another large issuer of AAA paper, which had more than €240 billion in euro-denominated bonds outstanding at the end of 2019. In particular, at year-end 2019, it had issued a total of €449 billion securities, €242 billion of which were denominated in euros, in addition to approximately €112 billion in US dollars and nearly €46 billion in British pounds. By comparison, the other issuers of AAA-rated government paper in the eurozone are Germany (€2,053 billion), the Netherlands (€395 billion) and Luxembourg (€14 billion).

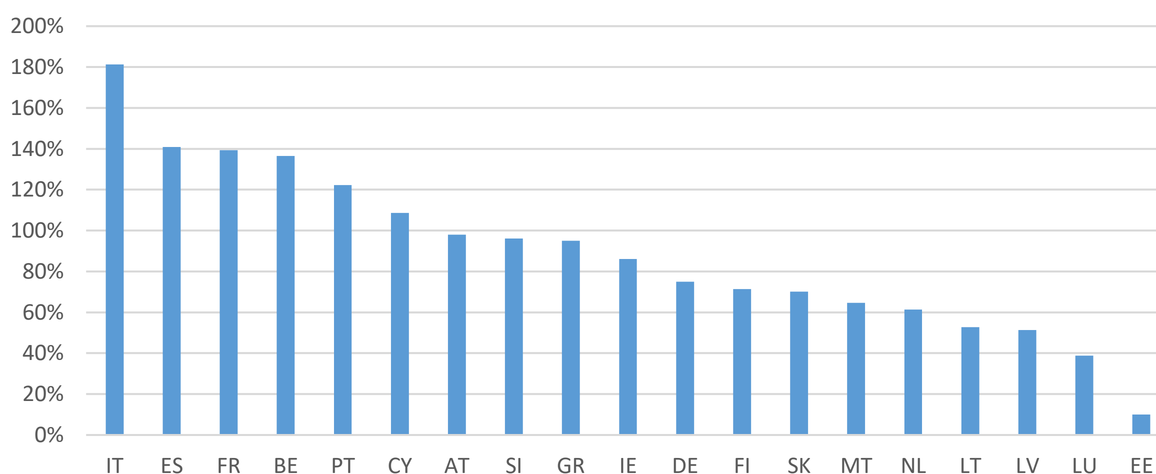
Figure 1. Outstanding government debt in eurozone and the US (€ trillion)



Note: Data refer to debt securities issued by the general government (i.e. central, state and local government plus social security funds).
Source: authors' own calculations based on data from the ECB, the FRED Economic Data, and the Eurostat.

Second, while the US market for federal government bonds is highly homogeneous, in Europe the market is fragmented along national border lines with four countries (France, Italy, Germany and Spain), accounting for 81% of the total outstanding amount of government debt securities in Q3 2020 (at the same level as at end-2019). Looking at relative terms, in countries such as Belgium, France, Italy and Spain, debt securities issued by the government are two to three times more than those issued in Finland, Germany and the Netherlands (see Figure 2).

Figure 2. Outstanding government debt of euro area countries (% of GDP, Q3 2020)

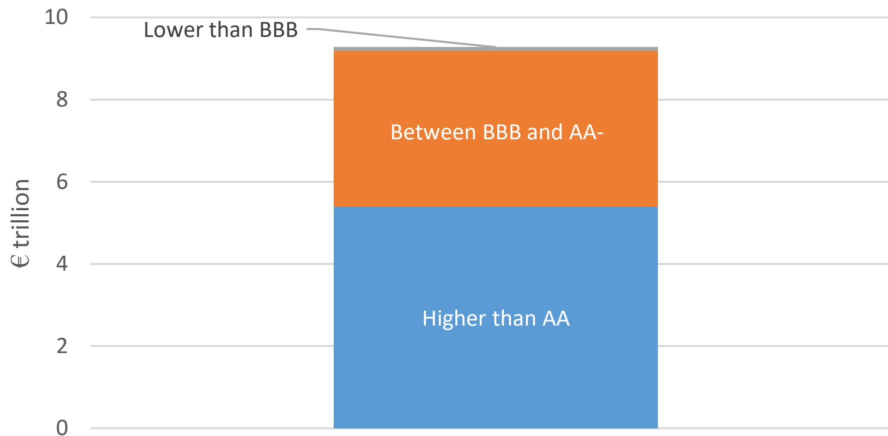


Note: Data refer to debt securities issued by the general government (i.e. central, state and local government plus social security funds).
Source: authors' own calculations based on data from the ECB, the FRED Economic Data, and the Eurostat.

Third, there are wide variations in the quality of these bonds (see Figure 3). While Dutch, German and Luxembourg government bonds are rated AAA, at the other end of the spectrum the highest-rated Greek bonds are rated no higher than BB-. The AA or higher segment in the eurozone has a volume of €5.4 trillion, which is less than a fourth of the American government

debt (€ 22.6 trillion, rated AA+). As a result, the high-grade market in Europe is small and fragmented, and offers a much lower level of liquidity than the market in the US.

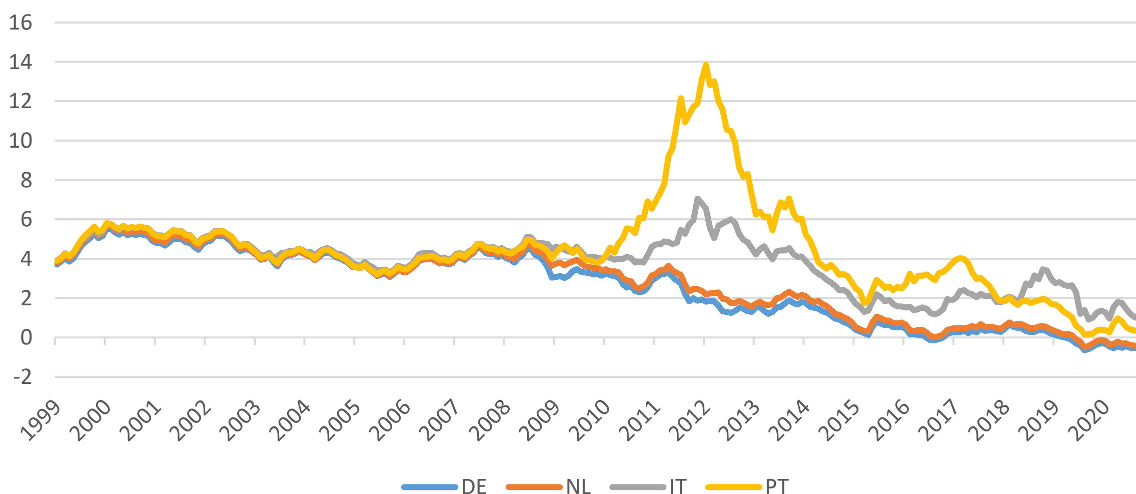
Figure 3. Eurozone public debt as rated by S&P (€ trillion, Q3 2020)



Notes: Data refer to debt securities issued by the general government (i.e. central, state and local government plus social security funds). The category 'Higher than AA' includes: AT (AA+), BE (AA), FI (AA+), FR (AA), DE (AAA), LU (AAA), and NL (AAA). The category 'Between BBB and AA-' includes: EE (AA-), ES (A), IE(AA-), IT (BBB), LT (A+), LV (A+), MT (A-), PT (BBB), SI (AA-), and SK (A+). The category 'Lower than BBB' includes: CY (BBB-) and EL (BB-). As an entity, the EU is rated AA.
Source: authors' own calculations based on ECB and Standard & Poor's data.

Fourth, another complicating factor is the fact that a flight to quality in times of uncertainty could lead to direct and serious tensions between eurozone member states. This was for example the case after the great financial crisis, as well as the subsequent European sovereign debt crisis. The yield differential between government bonds from countries rated AAA and countries with a lower rating widened substantially at that time, which led to significant tensions in the eurozone (see Figure 4).[2]

Figure 4. Yields on 10-year government bonds (AAA versus BBB)

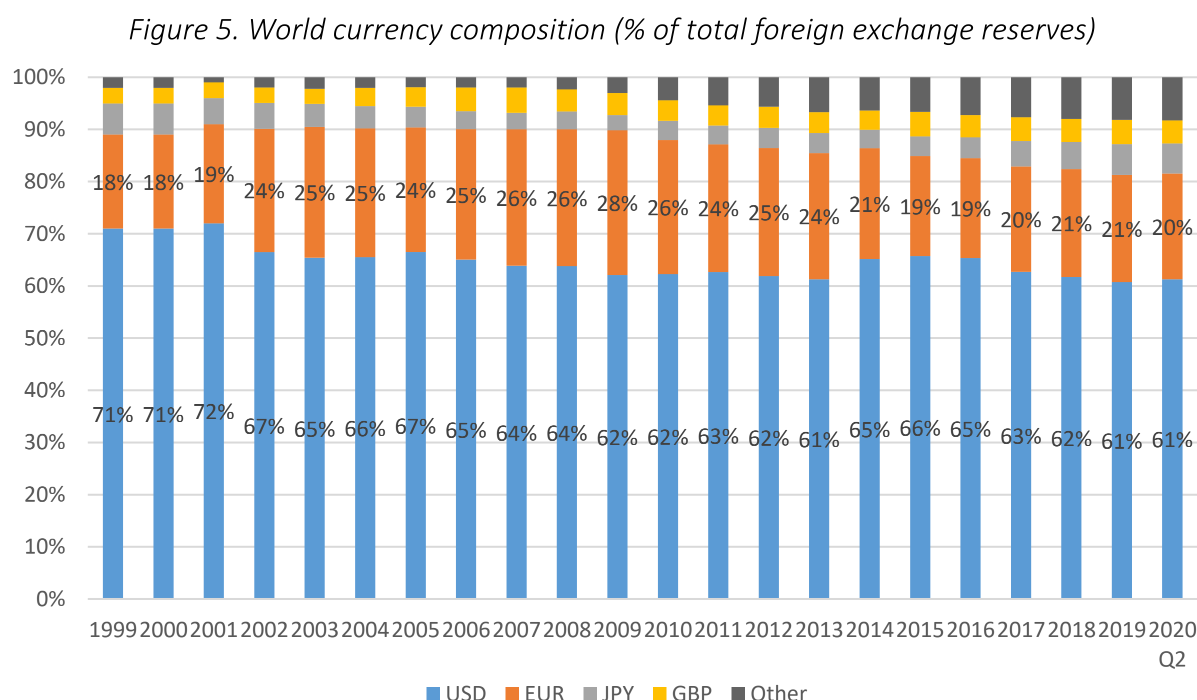


Source: FRED Economic Data.

[2] Since then, the ECB's interventions helped to reduce government long-term yields.

The fragmentation of the EMU's bond markets is one of the main reasons why the euro is not developing much further as an international currency. International investors looking for a safe haven see the European capital market as too small, fragmented and not sufficiently liquid. The creation of a common safe asset would substantially benefit the CMU, as it would strengthen the international position of the euro (ECB, 2019; Lannoo and Thomadakis, 2019). The importance of the euro in the global financial markets is far less than that of the US dollar. Since its peak in 2009 when it represented 28% of the world foreign exchange reserves, it has steadily declined to 20% at Q2 2020 (see Figure 5).

Figure 5. World currency composition (% of total foreign exchange reserves)



Source: IMF.

Communal debt issuance is needed

The problem is that the formation of a collective debt instrument is a hugely sensitive political issue. Countries such as Germany and the Netherlands are very much opposed to collective debt issuance, due to fears that this would inevitably lead to the dreaded European transfer union. However, this fear is not necessarily justified as the initial ideas relating to communal debt issuance were actually intended to impose greater discipline on member states through communal issuance of government bonds in the form of eurobonds (Muellbauer, 2013). But it is indeed true that communal debt issuance without conditionality would introduce substantial moral hazard issues. The fact that several member states failed to keep their public deficit and or public debt below the criteria defined by the Stability and Growth Pact (SGP) has not helped to strengthen mutual trust either. For this reason, the conditional eurobond variant is currently not politically feasible, despite the great benefits it could bring.

The question that naturally arises is how the eurozone can have a common safe asset without the use of Eurobonds. There are various possible options, some of which might be politically attainable. It what follows, we will briefly consider these options.[3]

Option 1: Issuance of ECB bonds

The first option involves the ECB converting some of its liabilities into tradable debt paper, which will then be used by governments and central bank to issue EMU-wide securities. The ECB's balance sheet has ballooned over the last years as a result of its asset purchases. The asset side of its balance sheet includes a huge item of purchased bonds, most of which are government.[4] As a result, part of the government debt issued by member states has in fact already been mutualised. On the liability side, the largest item is the reserves held by financial institutions (mostly banks) with the ECB, currently at around €2.5 trillion. The ECB could convert part of these reserves into tradable bonds, in which European, as well as international banks and financial institutions would invest. Although the ECB has not yet started to issue its own securities, other European central banks have long tested this path (e.g. Sweden, Switzerland).[5]

The issuance of securities by central banks is one of the most market-friendly forms of open market policy (Rule, 2011; Gray and Pongsaparn, 2015).[6] Central banks issue bonds to further develop their financial markets, as well as to remove surplus liquidity from them (Filardo, *et al.*, 2012; Vajs, 2014).[7] In fact, the potential creation of active secondary market trading in such securities can have the benefit of helping to develop wider financial markets, particularly in countries where there may not be an active government bond market, or where there is little or no issue of long-dated government bonds (Gray and Talbot, 2006). From a CMU perspective, the pricing of such securities can be used to form a default risk-free yield curve which market

[3] There are also alternatives in which existing government debt issued by member states is repackaged and reissued as a new investment product secured by the underlying asset. These structured products, also known as European Safe Bonds (ESBies), have no real guarantees from the member states and/or the EU. In this respect therefore, they are inferior to paper issued directly by member states or European institutions. For this reason, we do not consider them further here, even though they could be a viable way forward for creating high quality debt paper (Ji, 2018).

[4] Only as part of its purchase programme has the ECB bought government debt amounting to around 30% of EMU GDP.

[5] Since 2008 the Swedish central bank (Riksbank) has been issuing certificates with maturities from 1 to 360 days, in an effort to absorb the surplus of liquidity that the banking system has in relation to the Riksbank. These certificates, which do not count as banking liquidity, are interest-bearing, but they do not bear a coupon (Riksbank, 2020). Similarly, the Swiss National Bank (SNB) aiming to reduce liquidity resulting from inward capital flows, regularly issues SNB bills with maturities ranging from a few days to several months, as one of its open market instruments (SNB, 2020).

[6] These securities are the only instruments that fulfil three criteria: i) operations are not constrained in size; ii) instruments are tradable; and iii) instruments permit an equitable distribution of liquidity across the system in situations where interbank markets are not developed.

[7] Short-term repurchase agreements of domestic currency assets act as means of fine-tuning the quantity of reserves available to commercial banks by offsetting movements in other components of their balance sheet. In Asia, issuance of bonds by central banks is relatively common practice. The Bank of Thailand for example has been issuing tradable securities with maturities ranging from two weeks to three years since 2003 (BoT, 2017). But even earlier, since 1961 the Bank of Korea has issued its own securities known as Monetary Stabilisation Bonds (MSBs) and has since 1998 used them as the primary means of absorbing the excess of liquidity in the market (BoK, 2020).

participants will use as a benchmark to price other securities. Thus, the existence of such a default risk-free curve would encourage the development of other fixed-income securities, including a corporate bond market.

Option 2: Funding the European budget by issuing EU bonds

For the 2021-27 Multiannual Financial Framework (MMF) government leaders have formulated an EU budget of €1.8 trillion. Part of this budget is a recovery fund of €750 billion, which will be financed by issuing a series of EU loans secured by all member states. This implies that the costs of the recovery fund will not put pressure on member states' budgets, at least for now. But more importantly, it paves the path for the creation of a European capital market, given the creation of a common safe asset of €750 billion (Constâncio *et al*., 2020).

As for the remainder of the budget, around €1,074 billion, the intention is to fund it through payments from member states and from the direct income of the EU. However, an alternative option could be to fund it – fully or partially – from bonds issued by the EU. These bonds would have to be guaranteed pro rata by EU member states, meaning that their annual contributions to the EU budget for the next seven years would not be needed. After seven years, an EU-wide government debt market with a volume of more than €1.8 trillion would have been created. If it turns out that there is good demand for such loans (when the issue takes place), government leaders could decide to accelerate further issuance and actually fund the budget for the coming years in advance.

The advantage of such approach, given that it does not involve a transfer from one country to another, is that the member states would remain responsible for their own government debt and no moral hazard would be created. All member states would have an immediate financial benefit in proportion to their contribution, as their contribution to the EU budget would lapse partially or even entirely. Of course, interest and repayments on this issued debt would be due, but these would be minimal given the current level of interest rates and the fact that the issued bonds could be extended on the due date. The debt issued by the EU would indeed serve an important function as the cornerstone of the CMU.

Option 3: Issuance of conditional eurobills or eurobonds

A third option entails the financing of member states government debt through the issue of communal debt paper. This could be structured in a way that avoids the possibility of moral hazard (e.g. with conditionality) and gives strong incentives for the participating countries to fulfil their budgetary agreements (Boonstra, 1991). Moreover, it can be combined with the formation of an insurance fund that could secure the outstanding debt should a member state nonetheless default (Boonstra, 2012).

Although this option is currently politically sensitive, it would still not be sensible to dismiss it entirely. If it is successful, it will not only show that there is strong demand for such securities, it will also contribute to a more developed capital market and a stronger international position for the euro. Thus, the issuance of communal government debt could become a politically feasible option. Last but not least, it is actually the only way that a market volume could

ultimately be achieved relatively quickly to rival the US Treasury market – the biggest, deepest and most essential bond market in the world.

Option 4: A combination of options one and two

Once an EMU-wide common debt issue takes place, one can expect the new paper to be extremely popular. Indeed, this was the case with the overwhelming demand for the first issue of €17 billion 'corona-bonds' under the EU Support to mitigate Unemployment Risks in an Emergency (SURE) instrument on 17 October 2020. In particular, demand exceeded supply by a factor of almost 14, which illustrates the potential for common debt issuance by the EU.

However, a disadvantage of that approach could be the fact that the new debt paper will probably be immediately included in the portfolios of institutional investors and other large market participants (which will hold this paper for longer periods). For a well-developed capital market, there needs to be trading in large volumes in the secondary market across all maturities. If most of the paper is held in portfolios, this will negatively affect the liquidity of the market. Size is important. But currently, the market for EMU-wide government paper is too small to offer the necessary liquidity across the whole yield curve.

To overcome this issue, one idea could be to have the central bank issue short-dated bonds (e.g. all marketable maturities up to one year) [Option 1], while longer dated bonds would be issued by the EU [Option 2]. This has been the situation for some time in countries such as Thailand and South Korea (Gray and Pongsaparn, 2015) and also has the advantage that governments and the central bank would not get in each other's way with their issues. The possibility of a flexible approach to the condition of the money market would be a further advantage for the central bank. In the EMU therefore, the EU could start with maturities of one year or more and gradually increase these as its issue volume increases.

Conclusion

In order for the CMU project to get off the ground, European capital markets should have a strong foundation. A Europe-wide common safe asset could deliver an important contribution to the CMU foundation. This asset has to fulfil at European level the role that government bond markets play in the national level. The quickest way to create such a market would of course be to bundle new and existing government debt from member states and replace it by the issuance of conditional eurobonds. Today, however, this is not a feasible option for political reasons.

An alternative way, one that will create a fully integrated European bond market and allow the euro to be developed into a full-fledged currency, would be a common issuer or pooling of riskless debt. One of these alternative options would be to fund the entire EU budget for the next five years with bonds issued by the EU. This would provide an immediate benefit for member states, in that their contributions to the EU budget (for that period) would be much lower or even lapse altogether. In addition, if the ECB issues short-term money-market paper at the same time, then with one stone Europe can hit two birds: remove the surplus liquidity in the European banking system, and create a market for highly liquid short-term bonds.

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