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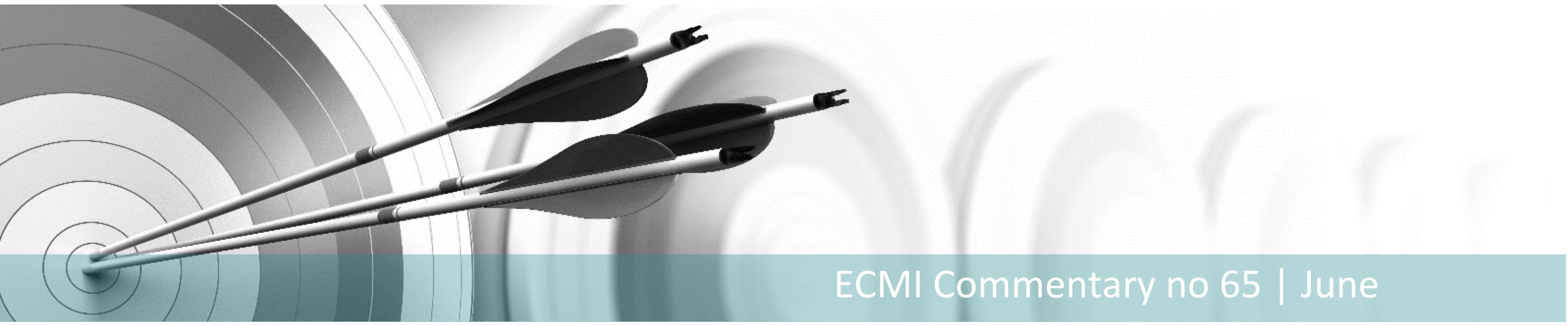

A common euro-bond market in sight

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The 'Next Generation EU' budget proposal has brought a common eurozone bond market suddenly and unexpectedly much closer. To fund the recovery, the EU Commission will go directly to the markets in the next two years and raise €750 billion. This will give an enormous boost to a common euro-bond market, a *conditio sine qua non* for long-term stability in the eurozone, the European capital markets, and the international role of the euro. It also is an impetus for further joint work on government bond issuance and settlement procedures, and for expanding maturities coverage.

Debates about creating a eurozone sovereign bond market or a European safe asset have been ongoing for at least one decade. Unlike in the US where the federal state is at the centre of a vast government bond market, in Europe, eurozone countries have no common Treasury and issue debt separately, while having different ratings and consequently different degrees of safety.[1] Complex proposals were made to stabilise *euro* government bond markets, such as the Blue-Red bonds,[2] or the Sovereign Bond-Backed Securities (SBBS)/European Safe Bonds (ESBies) with junior and senior tranches of sovereign bonds, but they had partial joint liability or too much financial engineering.[3] A more recent proposal, based on the principle of seniority of European debt issued without mutualisation, has not yet been officially discussed.[4]

[1] Only Germany and the Netherlands have a triple-A rating.
[2] See Delpla, J. and J. Von Weizsäcker (2010), "The Blue Bond Proposal", Bruegel Policy Brief, Issue 2010/03, May. Bruegel.
[3] See Brunnermeier, M., S. Langfield, M. Pagano, R. Reis, S. Van Nieuwerburgh and D. Vayanos (2017), "ESBies: safety in the tranches", Economic Policy, 32(90): 175-219.
[4] Leandro, A. and J. Zettelmaeyer (2018), "Safety Without Tranches: Creating a 'real' safe asset for the euro area", CEPR Policy Insight n. 93, June.

The urgency of the Corona crisis changed views, and the acceptance is now there that the EU Commission can directly borrow in the markets to address an unprecedented economic situation, following Art. 122 of the Treaty on the Functioning of the European Union (TFEU).[5] This basis was already used for the Support to mitigate Unemployment Risks in an Emergency (SURE) regulation,[6] which allows the EU to raise €100 billion to support national unemployment schemes in the EU. It creates a contingent liability for the EU-27 based upon the guarantees of the member states in line with their respective share in the total Gross National Income of the Union, on a *pari passu* basis. The same basis will now be used for the €750 billion recovery fund in the context of the EU's next 7-year budget, the Multiannual Financial Framework (MFF).

The Recovery Bond issued by the Commission, if approved by the European Council, will represent a sea change in European policies and will be a big improvement for Europe's bond markets, and create a large long-term debt security for institutional investors. The plans are that the maturities could last until 2058, or about 30 years, and that the first repayment would only happen from 2028 onwards. Together with the about €500 billion of outstanding borrowing from the European Investment Bank (EIB),[7] the €90 billion outstanding from the European Stability Mechanism (ESM), and the €47 billion outstanding under the European Financial Stabilisation Mechanism (EFSM), this makes at least €1.4 trillion in triple A assets.[8]

Between 2007 and 2019, the borrowing needs of euro area governments surged drastically and outstanding general government debt grew by 69% in nominal terms from €4.9 trillion to €8.2 trillion (Figure 1).[9] With the Covid-19 crisis unfolding since the beginning of the year, the total outstanding amount of government debt securities stood at €8.5 trillion in April-2020, with four countries (France, Italy, Germany and Spain) accounting for almost 80% of that. Although about 75% of these government bonds are rated A or above, only 23% are AAA-rated bonds.

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[5] According to Article 122 of TFEU: "where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.".

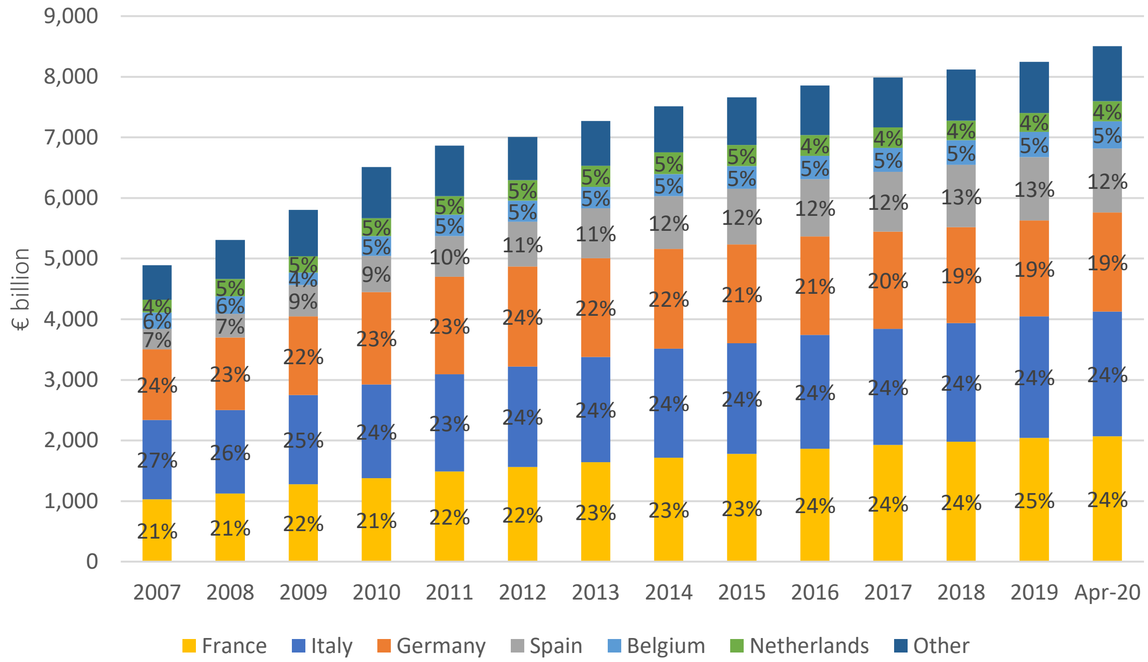
[6] Regulation (EU) 2020/672 was adopted on 19 May 2020.

[7] EIB has also created a Pan-European Guarantee fund in response to COVID-19 of €25 billion. This fund aims to mobilise up to €200 bilion of additional financing. However, it remains to be seen whether the ceiling of €200 billion will be reached, and whether the guarantees will lead to activation and payments that would imply the EIB having to issue debt to finance those payments to the amount of €200 billion.

[8] Importanly, about half of that amount (€850 billion) is one-off operation linked to this extraordinary crisis with a 30-year maturity. This means that coverage of different maturities is not assured. In addition, issuance of 'safe debt' by the various European institutions is not really harmonised, or traded in an integrated way.

[9] As a result, the debt-to-GDP ratio rose from 52% to 69% over that period.

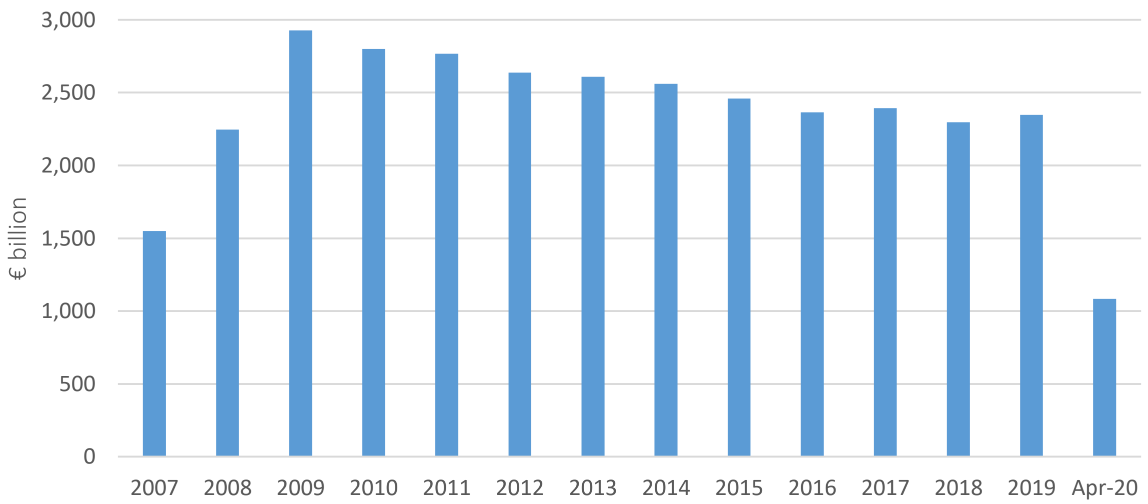
Figure 1. Nominal outstanding amounts of euro area government debt securities (€ billion)



Note: Data refer to debt securities issued by the general government (i.e. central, state and local government plus social security funds). Other includes: Austria, Cyprus, Estonia, Finland, Greece, Ireland, Latvia, Lithuania, Luxembourg, Malta, Portugal, Slovakia, Slovenia.
Source: European Central Bank.

As for the new debt issuance of euro area governments, it is expected to increase well above the €2.3 trillion in 2019, given that at the end of April was already at €1.1 trillion (Figure 2).

Figure 2. Issuance of euro area government debt securities (€ billion)



Note: Data refer to debt securities issued by the general government (i.e. central, state and local government plus social security funds).
Source: European Central Bank.

The big increase of budget financing requirements as a result of the unavoidable response to the coronavirus crisis constitutes an opportunity to discuss forms of European debt without mutualisation that creates a new European safe asset. A larger euro denominated bond market allows for a more complete yield curve over different maturities, which is used as a benchmark for other issuers and for derivative markets. It also provides for a more liquid market in euro-bonds, that reduces spreads and issuance costs as compared to the very fragmented national bond markets (certainly for the many smaller EU countries). Although it is a temporary measure, the maturities create long-term liabilities for the EU, which also create expectations of more to come (e.g. new common revenues). Moreover, this is essential to really foster the role of the euro as a global currency, attract international investors, respond to the present geopolitical environment, and promote the European sovereignty.

From a prudential perspective, an additional advantage is that a larger European asset class emerges for financial institutions, not linked to a sovereign. This reduces the sovereign nexus, or the dependency of banks upon rating of the sovereign for the pricing of credits, a splitting factor for European banking markets. It also makes the discussion about the limitations of large exposures to sovereigns – or the introduction of a risk weighting for sovereigns – less prominent, as financial institutions will automatically redistribute their assets.

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