

## Policy Paper

# Don't change horses in midstream

How to make NGEU bonds the euro area's safe asset

23 August 2021

Sebastian Mack, Policy Fellow

#SafeAsset  
#NGEU  
#Eurozone



The bonds financing the European Union's recovery remain short of being the much-hoped-for safe asset of EU monetary union (EMU). However, with the right reforms they could well turn out to be just that. To earn safe asset status, the volume of EU debt should increase, EU borrowing made permanent, and the ECB treat supranational EU bonds in a more favourable manner. The flaws associated with failing to be a eurozone-only instrument are offset by remarkable fiscal and democratic benefits. If NextGenerationEU (NGEU) proves successful, then member states should seize the opportunity to create the long-awaited safe asset and put EU borrowing on a permanent footing before debt is repaid as of 2028.

## Executive Summary

The eurozone needs a common safe asset to foster EMU stability and to address the shortage of safe euro-denominated assets. The European sovereign debt crisis highlighted the vulnerability of euro countries lacking a common safe asset and nearly pushed EMU off the cliff. To remedy this problem, several proposals have been put forward, but it took the coronavirus pandemic to make debt issuance possible at EU level. Under NGEU, the EU will issue debt up to EUR 807 billion and pay it back by 2058.

Against the multitude of objectives that academics and political decision-makers have linked to a euro area safe asset, there are four functions that it can realistically fulfil. First, it should provide a high-quality, liquid collateral for financial transactions. Second, it should prevent adverse shocks from triggering a ‘flight-to-safety’ as observed in the European sovereign debt crisis. Third, it should support the decoupling of private sector borrowing costs from those of domestic sovereigns. And fourth, it should facilitate the diversification of banks’ sovereign portfolios.

The EU bonds financing Europe’s recovery already fulfil important functions. They address the scarcity of safe euro-denominated assets and mitigate the home bias in banks’ sovereign exposures. The launch of NGEU has increased investor confidence in European financial architecture and EU bonds could now reduce the fragmentation visible in euro area sovereign bond markets. However, the EU bonds’ safe asset status is hampered by insufficient liquidity, the temporal limitation of NGEU, and an unfavourable treatment in ECB’s monetary policy framework.

Making NGEU bonds the euro area’s safe asset therefore requires three things: First, the EU needs to substantially increase its borrowing up to a level comparable to the largest eurozone sovereign issuers. Second, the temporary NGEU programme must be turned into a permanent common fiscal facility to ensure long-term market presence. And third, the ECB needs to apply to EU bonds haircuts that are no higher than those applied to national government bonds and abandon its caps on supranational EU bond purchases.

NGEU bonds backed by the EU-27 are not the ideal solution for the euro area. However, operating outside an intergovernmental eurozone setting also offers advantages: the Union method adds greater democratic control and NGEU does nothing to raise national debt levels. If NGEU proves successful, political decision-makers should seize the opportunity to create the long-awaited safe asset and put EU borrowing on a permanent footing before debt repayment begins in 2028.

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## Introduction

**The lack of a common safe financial asset is a key deficiency in European monetary union.** In recent years, academics have come up with a whole host of proposals to remedy this problem. However, so far none has ever gained political traction. Now, reality has overtaken the theoretical debate. Under NextGenerationEU (NGEU), the EU is raising common debt in significant volumes on capital markets – and the eurozone could finally get its safe asset: a common high-quality, low-risk and liquid debt instrument issued at the European level.

**The new EU bonds are clearly not the safe asset that you would have drafted as the ideal solution for the eurozone.** The NGEU programme is first and foremost designed to fight the pan-EU economic fallout from the coronavirus pandemic. Delivering a safe asset for the eurozone is not the primary objective of the recovery fund. Still, the bonds financing NGEU are creating a new reality in financial markets. So, the question is can these bonds nevertheless fulfil the functions of the much-hoped-for safe asset of the euro area?

**This policy paper argues that the bonds issued under NGEU have yet to fulfil all functions of a safe asset for the eurozone.** However, they do provide the EU's best shot at getting such an instrument off the ground in the foreseeable future. Therefore, it is politically sensible to aim at turning these bonds into that safe asset. This requires three things: First, the EU needs to substantially increase its borrowing. Second, the temporary NGEU programme must be turned into a permanent common fiscal facility. And third, the ECB needs to make its policy framework more favourable towards supranational EU bonds.

**“The bonds issued under NGEU provide the EU's best shot at getting a safe asset in the foreseeable future.”**

## 1 Old debates and new reality

**The eurozone has a particular interest in a common euro-denominated safe asset.** Safe assets are a cornerstone of daily operations on international financial markets. Banks and other financial institutions provide safe assets as high-quality collaterals in transactions. Central banks use safe assets for both conventional and unconventional monetary policies. Investment funds refer to safe assets as a benchmark to price riskier assets and rely on them as a store of value. The eurozone needs a common euro-denominated safe asset for two reasons: to address the general scarcity of safe assets and to foster EMU stability.

### 1.1 The need for a common safe asset and ideas for creating it

**The lack of a common safe asset seriously threatens EMU stability.** This danger became painfully obvious during the European sovereign debt crisis in the wake of the great recession around late 2009. In the absence of a common safe asset, market participants fled into German Bunds – the only asset perceived as safe – which, in turn, rendered borrowing costs for crisis countries soar sky-high. This flight-to-safety also damaged the balance sheets of banks that were highly exposed to their respective governments through domestic sovereign bond holdings. The vulnerability of individual euro countries to speculative attacks nearly pushed EMU off the cliff.

**The scarcity of euro-denominated safe assets is problematic for financial markets.**

When the European sovereign debt crisis struck, several euro area economies saw their debt downgraded.<sup>1</sup> So, the supply of euro-denominated safe assets decreased. On the other hand, regulatory changes following the global financial crisis pushed banks, insurance firms and pension funds to hold more and higher-quality assets to prepare for the next crisis. Hence, the demand for safe assets increased. All in all, safe assets denominated in euro have become scarce and this is an impediment to the proper functioning of European capital markets.

**Several proposals for a common euro area safe asset have been put forward since 2010.**<sup>2</sup> Early suggestions aimed at ensuring funding for countries in distress whereas subsequent ideas concentrated on reducing the vicious circle (“doom loop”) between banks and national governments. More recently, the goals of promoting the euro’s international role and supporting the development of a capital markets union have won favour. However, until the coronavirus pandemic struck, none of these proposals obtained sufficient political support to see the light of day. With NGEU the terrain of this debate has now fundamentally changed.

## 1.2 NextGenerationEU is creating a new reality in financial markets

**The EU is not a newbie at capital markets.** Even before NGEU, the European Commission began borrowing from capital markets to lend money to neighbouring countries through the Macro-Financial Assistance (MFA) programme, to EU member states through its Balance of Payments (BoP) and the European Financial Stabilisation Mechanism (EFSM) programmes, and since 2020 under the Support to mitigate Unemployment Risks in an Emergency (SURE) programme. To finance the MFA, BoP and EFSM programmes, the outstanding volume of EU bonds amounted to EUR 52 billion in 2020. The SURE programme with issuances mainly in 2020–2021 is adding another EUR 100 billion. For these programmes, the Commission has used a back-to-back funding approach, meaning it issued bonds and transferred the proceeds directly to the beneficiary country on the same terms (interest rate, maturity) that it received. All lending activities to date have been funded through dedicated borrowings and not via the EU budget.

**NGEU marks a new era for EU debt issuance.** During the NGEU spending phase between 2021 and 2026, the EU will borrow up to EUR 150–200 billion annually and EUR 807 billion (in current prices) in total. The EU will, thus, raise capital amounting to 5% of EU GDP to support member states with loans and grants. Moreover, 30% of the entire NGEU debt will be issued as green bonds providing investors with additional transparency on the sustainable use of proceeds. Putting NGEU borrowing on top of existing EU programmes (EFSM, MFA, BoP and SURE), the total outstanding volume of EU bonds could peak close to EUR 1 trillion in 2026 (Figure 1). This will make the EU per se one of the largest bond issuers in Europe. From 2028 onwards, NGEU debt will be repaid by member states either directly (for loans) or through the EU budget (for grants) and by 2058 at the latest. To partly repay NGEU grants, the Commission is set to propose additional own resources for the EU.<sup>3</sup>

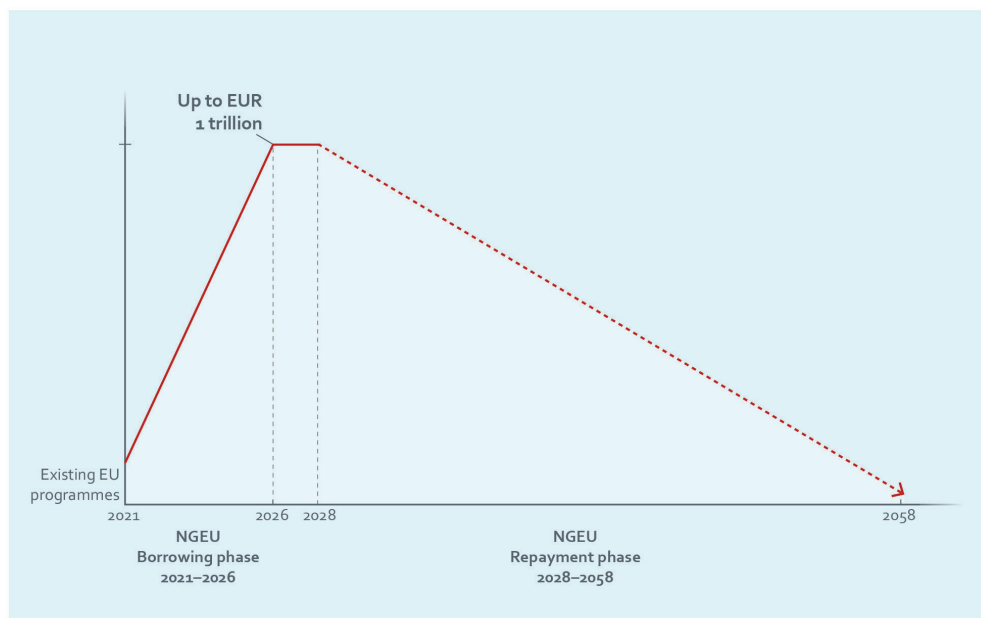
**“The total outstanding volume of EU bonds could peak close to EUR 1 trillion in 2026.”**

<sup>1</sup> ECB, *The international role of the euro*, June 2021.

<sup>2</sup> Eurobonds, red/blue bonds, purple bonds, Sovereign Bond-Backed Securities (SBBS) and E-bonds, just to name the most prominent examples.

<sup>3</sup> European Commission, *Potential new sources of revenue*.

Figure 1: Schematic representation of the projected outstanding volume of EU debt: NGEU issuances on top of already existing EU programmes (EFSM, MFA, BoP and SURE).



Source: Own illustration. Design: Burak Korkmaz.

**The Commission will behave more like other large and frequent issuers.** The Commission will no longer rely on rigid back-to-back lending but move to pool funding. It will issue long-term EU-Bonds and short-term EU-Bills backed by the EU budget. Building on a newly minted Primary Dealer Network of 39 EU banks, the Commission will make use of auctions and syndications.<sup>4</sup> The Commission will annually publish a borrowing decision defining the maximum amount that it is authorised to borrow during a specific year. To communicate with the markets, the Commission will outline the borrowing calendar in six-monthly funding plans. All of this means that NGEU is fundamentally changing the role of EU debt in financial markets. Will it also bring about the long-awaited common safe asset?

<sup>4</sup> European Commission, *Primary Dealer Network*.

## 2 Functions that a euro area safe asset can realistically fulfil

Past debates have evolved over a multitude of economic and political objectives that a safe asset for the eurozone should achieve. Before assessing whether the bonds issued by the EU to finance the recovery deliver a safe asset, this section outlines the functions that such a safe asset can realistically fulfil and derive from there its required characteristics. This paper argues that four functions are especially important:

1. A European safe asset should **serve the proper functioning of financial markets** by providing a high-quality euro-denominated collateral for financial transactions.
2. It should **prevent adverse shocks from triggering a capital ‘flight-to-safety’** that threatens individual member states with losing access to financial markets.
3. It should **support the ECB in implementing its monetary policy** by providing a common benchmark for a euro area term structure of risk-free interest rates.
4. It should **sever the financial link between national governments and banks** by facilitating the diversification and de-risking of banks’ sovereign portfolios.

### 2.1 Serve the proper functioning of financial markets

**To be attractive as collateral in various financial transactions for a broad range of investors from across the globe, a safe asset first needs to fulfil certain technical characteristics.** Safe assets are marketable financial claims, commonly in the form of debt securities and preferably on public sector entities, that offer special conveniences in terms of safety to investors.<sup>5</sup> Since they can easily be turned into cash, investors are willing to pay a “money premium” for them. Safe assets need to be issued with a wide range of maturities to build a yield curve that financial market participants can refer to as a benchmark for the term structure of risk-free interest rates.

**Safe assets require deep markets and ample liquidity.** To be easily and always exchangeable, safe assets must circulate in a high-volume market generating large transaction volumes. The issuer must ensure that there is always sufficient supply of new bonds so that investors are not subject to roll-over risk, i.e. they can easily replace old bonds reaching maturity.

**Credit quality in all situations is key.** To count as risk-free, secure store of value, a safe asset must be of the highest credit quality. It must show low price volatility and information sensitivity under normal circumstances and even in a sudden and extreme crisis. Only if the asset has no or very low default risk, do investors consider it as safe harbour. This is what Markus Brunnermeier calls the “good friend analogy”: it is around when you need it.<sup>6</sup>

“Safe assets must circulate in a high-volume market generating large transaction volumes.”

<sup>5</sup> For a good overview, see for example ESRB, *Addressing the safety trilemma: a safe sovereign asset for the eurozone*, Working Paper Series No 35 / February 2017, pp. 6–12.

<sup>6</sup> Brunnermeier, Markus et al., *A Safe-Asset Perspective for an Integrated Policy Framework*, 29 May 2020.

## 2.2 Mitigate the flight-to-safety

**A safe asset for the euro area must reduce fragmentation in the eurozone sovereign bond market.** Since the outbreak of the global financial crisis, euro-denominated safe assets have become scarce. As a result, prices for triple A rated sovereign bonds such as the German Bund have skyrocketed pushing interest rates to historically low levels. The establishment of a eurozone safe asset would boost supply and could raise interest rates of high-rated sovereign bonds, thereby reducing fragmentation of the zone's sovereign bond market. This in turn would mitigate the flight to safety in times of crisis and prevent intra-euro imbalances from exacerbating. To have an appreciable impact on financial markets, the euro area safe asset would probably need to reach a volume comparable to that of the (so far) largest eurozone sovereign issuers.

**The introduction of a common safe asset must, however, not crowd out demand for national euro area sovereign debt.** As long as the euro area lacks a single treasury with common taxes and expenditures, each euro country needs to find buyers for its own debt. If investors started to disregard sovereign bonds offering less favourable risk-return-ratios, this would pose severe difficulties to the funding of some national governments. To avoid the crowding-out of national sovereign bonds, close coordination among national debt management offices and the EU in its role as new, large-scale issuer as well as communicating planned issuances to investors well in advance will be key.

## 2.3 Support the implementation of monetary policy

**A euro area safe asset must build the risk-free benchmark yield curve for the eurozone.** Although the 19 euro countries share the same currency and the ECB sets the reference interest rate for the entire eurozone, financial markets still use national sovereign bonds as a reference when calculating funding costs of private borrowers located in different member states. As a result, the cost of borrowing for the private sector is very different for each euro country and reflects fragmentation in the eurozone's sovereign bond market.<sup>7</sup> This amplifies the private sector's vulnerability to changes in national sovereign ratings and hampers the smooth and symmetric transmission of euro area monetary policy, particularly during periods of market stress.

**To decouple the private sector's borrowing costs from the sovereign's funding costs, the safe asset would need to be the benchmark for pricing other assets in the eurozone.** This would reduce national differences in lending and borrowing conditions and facilitate the ECB's conduct of monetary policy. To serve as the new anchor point for the eurozone, the safe asset would ideally be issued by members of the euro area. Such eurozone-only bonds would provide a truly euro area benchmark yield curve. To exploit the full stabilising potential of the euro area safe asset, the ECB would need to include it in the list of assets eligible for both regular open market operations and extraordinary asset purchases.

**“The safe asset would need to be the benchmark for pricing other assets in the eurozone.”**

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<sup>7</sup> ECB, Euro area statistics, *Composite cost of borrowing*.



## 2.4 Help break the sovereign-bank doom loop

**A safe asset can help mitigate risks spilling over from sovereigns to their domestic banking sector and vice-versa.** The eurozone crisis revealed the vulnerability of the bank-sovereign nexus, with euro area banks holding disproportionately high volumes of debt instruments issued by their home sovereign. Banking union promised to sever this doom loop but has so far failed to do so. By contrast, the coronavirus pandemic has inflated banks' holdings of domestic sovereign debt.<sup>8</sup> A common safe asset may facilitate potential risk-mitigating measures aimed at reducing the nexus between sovereigns and banks in the banking union. Banks could use the EU safe asset as collateral for interbank loans and ECB funding instead of national sovereign bonds. This would help break the vicious circle between banks and their domestic government where the downgrade of a sovereign triggers haircuts on sovereign bonds on banks' balance sheets. This in turn raises their funding cost and interest rates on loans, perhaps driving the economy into a recession and ultimately aggravating the problems of the downgraded sovereign. While a common safe asset alone cannot force banks to diversify and de-risk their sovereign portfolios, it does offer the means to break the infamous doom loop.

**“A common safe asset offers the means to break the infamous doom loop.”**

**For European banks to buy EU debt and hold fewer of their domestic sovereign bonds, the EU safe asset must match three conditions.** First, the EU safe asset must offer a risk-return-ratio that is at least as attractive as the bonds issued by the bank's home sovereign. Only if a bank sees economic value in buying the common safe asset, will it reduce its domestic sovereign exposure. Second, prudential regulation must not treat the common safe asset less favourably than existing national sovereign debt. Today, EU banks can invest at unlimited volumes in EU national sovereign bonds denominated in the currency of the respective member state and without the need to back the exposure with capital. Hence, banks will buy the EU safe asset only if it benefits from the same preferential treatment as national sovereign bonds. Third, the EU safe asset must be eligible as collateral for open market operations conducted by the ECB. To be able to borrow central bank money, banks need to deposit securities at the ECB. So, banks will purchase the EU safe asset only if they can use it as collateral to receive fresh money from the ECB. And again, the ECB's collateral framework should not treat EU bonds less favourably than national EU sovereign bonds.

## 3 Does NGEU debt deliver the safe asset for the euro area?

With NGEU, the EU will for the first time borrow money to finance budgetary expenditures. This is a different way of creating a safe asset than under previous theoretical proposals. The core question therefore is whether EU bonds can fulfil the functions of a safe asset for the eurozone.

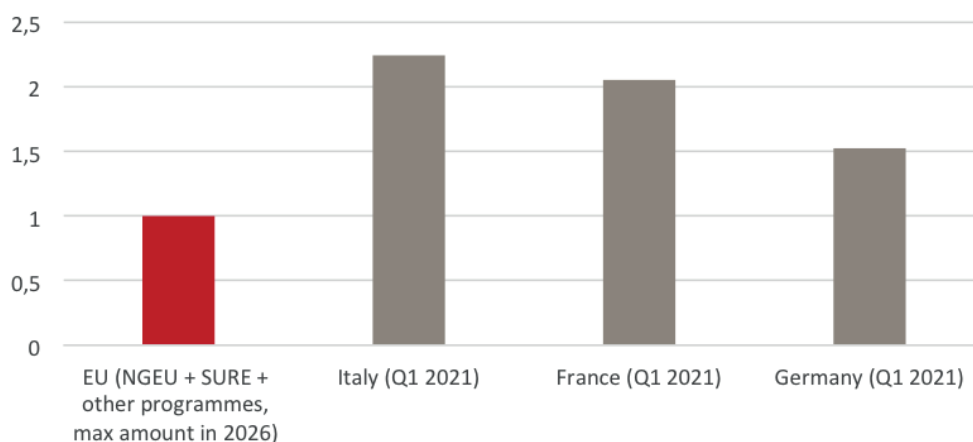
<sup>8</sup> European Commission, *European Financial Stability and Integration Review 2021*, May 2021

### 3.1 Serve the proper functioning of financial markets

To contribute to the proper functioning of financial markets, the common safe asset needs to be highly liquid, have no roll-over risk, and be of highest creditworthiness.

**NGEU bonds will not provide the liquidity necessary to create a safe asset.** Taking NGEU and existing EU programmes together, outstanding volume of EU debt will be close to EUR 1 trillion when all NGEU bonds are issued in 2026. Compared to national EU government bonds (see Figure 2), this is slightly below the current Eurozone benchmark bond, i.e. German Bunds adding up to EUR 1.5 trillion, and remarkably lower than French OATs (EUR 2.1 trillion) or Italian BTPs (EUR 2.2 trillion). Moreover, the fact that the EUR 100 billion SURE bonds are issued as social bonds and 30% of NGEU debt, i.e. up to EUR 225 billion, will be issued in green bonds significantly fragments the already small market in EU debt. For the time being, this reduces the liquidity and market depth of conventional EU bonds. However, it might pay-off in the long-term because investors increasingly prefer sustainable investment and thus liquidity in conventional bonds is expected to shrink. So, if EU bonds are to stay, it will be a trump card if they are already present in the market for sustainable bonds with a proven track record.

**Figure 2: Outstanding volume of bonds issued by EU (projected) and selected national government bonds (actual).**



Source: AFME<sup>9</sup> and European Commission.

**The liquidity of the EU safe asset also suffers from the current distribution of investors in EU bonds.** While the Commission's plan is to ensure a regular presence on all parts of the curve with as liquid as possible EU-Bonds,<sup>10</sup> the reality looks rather different. The NGEU bond issuances seen so far have been oversubscribed, but more than 90% of EU bonds ended up in the pockets of central banks, fund managers, insurers and pension funds as well as bank treasuries (Table 1). In practice, this means that less than 10% of the bonds issued are actively traded and available for use as underlying security in financial transactions. The bulk of them is just put into the safe. While it is premature to draw definitive conclusions given that the issuances have just started and investor trust has yet to be built, the distribution by investor types indicates that EU bonds are attractive to certain investors as their high rating offers a positive yield, but they are not (yet) perceived as

<sup>9</sup> AFME, *Government Bond Data Report Q1 2021*, 29 Jun 2021.

<sup>10</sup> European Commission, *The EU as a borrower*.

a safe asset. In any case, it is fair to say that if the proportion of hedge funds and banks in EU bond purchases remains flat, the transaction volume of EU bonds will fall short of what is required to create a safe asset that can always be bought and sold in the secondary market.

**Table 1: Distribution of investors by type.**

	<b>NGEU 10-year 15 June 2021</b>	<b>NGEU 5-year 29 June 2021</b>	<b>NGEU 30-year 29 June 2021</b>	<b>NGEU 20-year 13 July 2021</b>
Central Banks / Official Institutions	23%	30%	15%	17%
Fund Managers	37%	33%	41%	37%
Insurance and Pension Funds	12%	10%	18%	18%
Bank Treasuries	25%	21%	19%	24%
Banks	2%	4%	5%	2%
Hedge Funds	1%	2%	2%	2%

Source: European Commission.

**The temporal limitation of NGEU is hampering the safe asset status of EU bonds.**

As of now, NGEU is due to end by 2058 at the latest. So, if EU member states leave NGEU as a one-off exercise and decide against turning it into a permanent fund, then investors will at some point have difficulties in replacing old bonds reaching maturity. Again, the limited interest of banks and hedge funds in the first NGEU issuances (see Table 1 above) tends to suggest that some investor groups do not consider the EU bonds to be a safe asset and this could partly be because of their temporary nature.<sup>11</sup> With no change in the EU own resources decision, NGEU debt will be paid back from 2028 onwards and thus the outstanding volume of EU bonds will constantly decrease which ultimately will make it impossible for investors to roll over EU debt instruments reaching maturity.

**The EU has been awarded the highest creditworthiness by credit rating agencies.**

The EU is rated AAA/Aaa/AAA/AAA (outlook stable) by Fitch, Moody's, DBRS and Scope and AA (outlook positive) by Standard & Poor's.<sup>12</sup> The EU debt is backed by the EU budget revenues and the member states' commitment to meet their EU repayment obligations before all other liabilities and to provide extra funding to the EU in the unlikely event that a member state does not repay. The extra funding exceeding member states' initial budget contributions is capped at 0.6% of each member state's Gross National Income (GNI) during the NGEU's lifetime. So, the liability for each member state is limited.<sup>13</sup> However, in the worst case, the EU can count on the economic strength of the five triple A rated member states (Germany, the Netherlands, Sweden, Denmark and Luxembourg) providing additional support of up to 0.6% of their GNI. Although this is not as safe as a joint and several

**“The transaction volume of EU bonds falls short of what is required to create a safe asset.”**

**“Some investor groups do not consider the EU bonds to be a safe asset because of their temporary nature.”**

<sup>11</sup> Global Capital, *No such thing as a temporary safe asset*, 15 April 2021.

<sup>12</sup> European Commission, *EU's credit rating*.

<sup>13</sup> Council of the European Union, *Opinion of the legal service, Proposals on Next Generation EU*, 24 June 2020.

liability applying to all member states, the safety net seems strong enough to earn the EU the highest creditworthiness.

**To contribute to the proper functioning of financial markets, NGEU borrowing should be extended.** First, the volume of outstanding EU debt should substantially increase to create a deep and liquid market for EU bonds. Second, joint borrowing should be expanded under a more permanent mandate to guarantee the EU's long-term presence in capital markets. If the next two to three years prove that the pilot project of common debt and investment achieves its objectives – raising funds at very low cost without running undue risks and delivering on green and digital investment, generating higher growth, and ultimately avoiding any increase in divergences among member states – this would be a convincing argument to replicate this exceptional derogation from the normal ways of funding and use NGEU as a template also for future crises.

#### Box 1: Do EU bonds contribute to the proper functioning of financial markets?

**Function:** To contribute to the proper functioning of financial markets, a safe asset needs to be highly liquid, have no roll-over risk, and enjoy the highest creditworthiness.

**Diagnosis:** The EU bonds fall short of fulfilling this function. Regarding **liquidity**, the volume is insufficient to make a real difference for financial markets. While outstanding EU debt will peak close to EUR 1 trillion towards the middle of this decade, it would need to reach at least EUR 1.5 trillion to be at par with the German Bund and increase to more than EUR 2 trillion to play in the same league as the current biggest issuers, Italy and France. In terms of **roll-over risk**, without extending the one-off programmes SURE and NGEU launched during the coronavirus pandemic, EU debt is set to constantly decline over time and so will its status as potential safe asset. As far as **creditworthiness** is concerned, the EU has been awarded top ratings by credit rating agencies. NGEU does not create a joint and several liability for the member states. However, in the worst case, the EU can count on the economic strength of the five triple A rated member states providing additional support of up to 0.6% of their GNI.

**Recommendation:** To contribute to the proper functioning of financial markets, two things need to change. First, **the volume of outstanding EU debt should substantially increase** to create a deep and liquid market for EU bonds. Second, **time-limited joint borrowing should grow into a more permanent mandate** to guarantee the EU's long-term presence in capital markets.

### 3.2 Mitigate the flight-to-safety

To mitigate a capital flight-to-safety, the safe asset would need to help address the scarcity of highly rated euro-denominated assets and reduce fragmentation in the eurozone sovereign bond market while at the same time avoid crowding out demand for national euro area sovereign bonds.

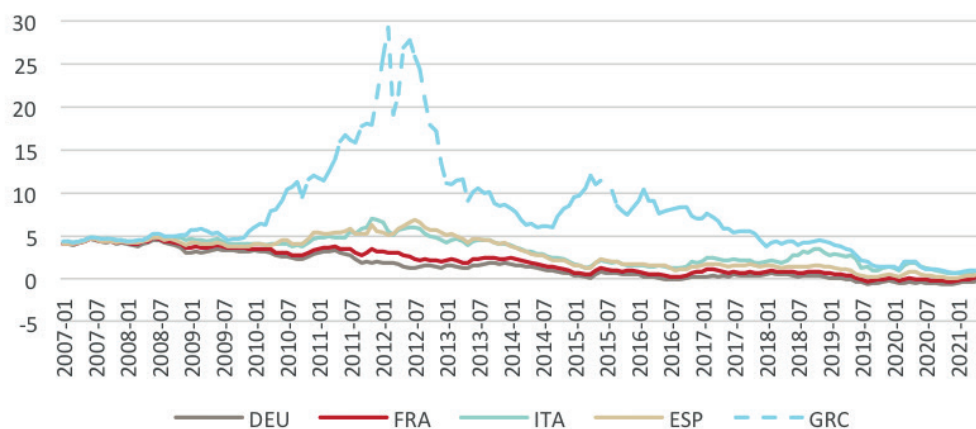
**It is not likely that EU bonds will crowd out national debt issuances.** Indeed, NGEU will put up to EUR 807 billion in additional debt instruments on the market. But given the current shortage in euro-denominated safe assets, the market seems ready to absorb an additional supply of annually EUR 150–200 billion in EU bonds. To avoid major collisions, the European Commission is coordinating its issuances close-

ly with member states. Furthermore, investors enjoy planning security through the Commission’s six-monthly funding plans outlining the borrowing calendar for the next half-year. Latest evidence underlines that the NGEU issuances are well coordinated and managed: Italy (EUR 10 billion)<sup>14</sup> and Spain (EUR 2.2 billion)<sup>15</sup> issued new bonds just before and after the first NGEU issuance (EUR 20 billion) on 15 June 2021 and financial markets showed absolutely no problem at all in digesting this combined volume.

**EU bonds have the potential to make the eurozone sovereign bond market less fragmented.** The announcement of NGEU in 2020 alone brought down risk premia for EU sovereign bonds (Figure 3). This suggests that investors perceive the EU’s financial architecture to have improved thanks to European solidarity in the coronavirus pandemic and, consequently, they rate national sovereign bonds safer and feel encouraged to buy more of them. Going forward, EU bonds could make sovereign bond yields converge even further because they make foreign investors pay more attention to EU capital markets; this, in turn, boosts interest in other European issuers. So, instead of crowding-out demand for national sovereign bonds, the so-called portfolio effect could crowd them *in*. By increasing the universe of highly rated bonds denominated in euro, EU bonds allow investors to accumulate more national sovereign bonds and build bigger portfolios.

“Going forward, EU bonds could boost interest in other European issuers.”

Figure 3: Long-term interest rates of selected euro countries.



Source: OECD.<sup>16</sup>

**Foreign investors’ appetite for EU bonds has yet to grow.** While market experts expect the EU swiftly to become a must-have name for international investors,<sup>17</sup> the geographical distribution of investors in the first NGEU bond issuances reveals that the share of foreign investors has been relatively small so far (Table 2). Purchases by investors located in Asia and the rest of the world, including the US, were rather limited, although this picture is somewhat blurred because the UK (home to the City of London) serves as an important investment hub for international investors and soaked up close to a quarter of all EU bonds. Still, if the aim is to make EU bonds the common safe asset and promote the international role of the euro, then non-EU demand will clearly have to increase. While it is too early to draw definitive conclusions, EU bonds will attract more foreign investors if they

<sup>14</sup> Ministero dell’Economia e delle Finanze, *Syndicate placement results: BTP 10 Years*, 8 June 2021

<sup>15</sup> Tesoro Público, Resultado de últimas subastas, *Bonos del Estado*, Settlement date 06/22/2021

<sup>16</sup> OECD, *Main Economic Indicators, Long-term interest rates*.

<sup>17</sup> Tradeweb, *EU Issuance and the Evolution of European Bond Markets*, 28 April 2021.

match the technical characteristics of a safe asset, i.e. ample liquidity and permanent market presence. As highlighted in the section before, this would require the EU to increase borrowing volume and abandon time limits on EU debt.

“EU bonds will attract more foreign investors if they provide ample liquidity and permanent market presence.”

Table 2: Distribution of investors by geography.

	NGEU 10-year 15 June 2021	NGEU 5-year 29 June 2021	NGEU 30-year 29 June 2021	NGEU 20-year 13 July 2021
UK	24%	30%	21%	24%
Benelux	15%	6%	13%	11%
Germany	13%	8%	27%	19%
Nordics	10%	12%	7%	12%
France	10%	8%	10%	9%
Italy	5%	6%	7%	7%
Other Europe	10%	11%	13%	15%
Asia	10%	18%	1%	3%
Rest of World	3%	1%	1%	0%
Total	100%	100%	100%	100%

Source: European Commission

### Box 2: Do EU bonds mitigate a capital flight-to-safety?

**Function:** To mitigate a capital flight-to-safety, the EU safe asset would need to help address the scarcity of safe euro-denominated assets and reduce fragmentation of the eurozone sovereign bond market while at the same time not risk crowding-out demand for national EU sovereign bonds.

**Diagnosis:** The issuance of up to EUR 806 billion in NGEU bonds does not seem to crowd out national sovereign bonds. On the contrary, the additional supply of safe euro-denominated assets might even crowd in sovereign bonds. EU bonds thus have the potential to make sovereign bond yields converge and reduce the current fragmentation in euro area sovereign bond markets. However, the demand for EU bonds from outside the EU remains scant.

**Recommendation:** To increase its attractiveness for international investors, EU bonds’ safe asset status would benefit from ample liquidity and permanent market presence. As highlighted in the section before, this would require the EU to **increase borrowing volume** and **abandon the temporal limitation of EU debt**.

### 3.3 Support the implementation of monetary policy

To support the implementation of monetary policy, the safe asset would need to be the benchmark for pricing other assets in the euro area and be eligible for ECB monetary transactions.

**NGEU is not a eurozone instrument.** The EU debt issued under NGEU is denominated in euro, but it also embraces eight EU member states with their own national currency. In addition, two out of five countries contributing to the triple A rating of the EU are not part of the euro area: Denmark and Sweden. Therefore, the EU bonds issued on the back of the EU-27 budget will hardly be able to create the fully constituted eurozone yield curve that the ECB could use for monetary policy purposes.<sup>18</sup> Albeit an imperfect proxy for the eurozone, the EU bonds' yield curve might still serve as a complementary reference yield curve and support the euro area in decoupling private sector borrowing costs from sovereign funding costs. The economic weight of the eurozone is already dominant in the EU-27 and is set to further grow with the imminent accession of Bulgaria and Croatia to the club of currently 19 euro countries.<sup>19</sup> So, the importance of the new "European yield curve"<sup>20</sup> as a benchmark for the pricing of other euro area assets will rise over time.

**EU-27 bonds are an imperfect solution for the eurozone but applying the Union method to NGEU is fiscally and democratically beneficial.** An important benefit of debt owed by the EU-27 budget is that it does not translate into national debt which could impair member states' debt sustainability and access to financial markets. Eurostat does not allocate the EU debt to the different member states as the exact repayment modalities will only be determined at a later stage. Beyond this financial aspect, the decision to anchor NGEU borrowing in the EU budget is highly advantageous in terms of parliamentary control, democratic accountability and checks and balances, all of which would not be available within an intergovernmental eurozone setting.

**The ECB has integrated EU bonds in the conduct of its monetary policy, but regulatory barriers remain.** The ECB is accepting EU bonds as collateral in open market operations and buying them in the course of its extraordinary asset purchases. However, the ECB does not treat EU bonds as the European safe asset. Under the ECB's collateral framework,<sup>21</sup> the supranational EU bonds face a higher haircut than national sovereign bonds, making them less attractive for banks who want to use them as collateral for receiving fresh money from the ECB. With regard to asset purchases, the ECB has limited itself to holding no more than 10% of all assets purchased in supranational bonds and to buy no more than 50% of the bonds of one supranational issuer.<sup>22</sup> However, to exploit the entire stabilising potential of the EU bonds and have full flexibility in conducting its monetary policy, the ECB would need to apply to EU bonds haircuts similar to national sovereign bonds and abandon its current purchase limits.

“The importance of the new ‘European yield curve’ for the pricing of other euro area assets will rise over time.”

“The ECB does not treat EU bonds as the European safe asset.”

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<sup>18</sup> ECB, *Euro area yield curves*.

<sup>19</sup> European Commission, *Commission welcomes Bulgaria and Croatia's entry into the Exchange Rate Mechanism II*, Press release, 10 July 2020.

<sup>20</sup> IPE, *Commission to use rescue plan to create ‘European yield curve’*, 7 October 2020.

<sup>21</sup> Guideline (EU) 2016/65 of the European Central Bank.

<sup>22</sup> Decision (EU) 2020/188 of the European Central Bank.

### Box 3: Do EU bonds support the implementation of monetary policy?

**Function:** To support the implementation of monetary policy, the safe asset would need to be the benchmark for pricing other assets in the euro area and be eligible for ECB monetary transactions.

**Diagnosis:** The bonds issued on the back of the EU-27 budget will hardly be able to create the fully constituted eurozone yield curve. Although an imperfect proxy, they might still support companies in getting their financing costs priced more in line with the European safe asset than with the borrowing costs of the domestic sovereign. In addition, tying the bonds to the EU budget comes with economic and political advantages which would be unavailable in an intergovernmental eurozone setting. The ECB has integrated the EU bonds in the conduct of its monetary policy but does not treat EU bonds as the European safe asset.

**Recommendation:** To exploit the whole stabilising potential of the EU bonds and have full flexibility in conducting its monetary policy, the ECB would need to treat them like the European safe asset. Therefore, the ECB should apply to EU bonds haircuts similar to national sovereign bonds and abandon its current purchase limits in their regard.

### 3.4 Help break the sovereign-bank doom loop

To help break the sovereign-bank doom loop, the EU safe asset needs to have a risk-return ratio attractive to banks and benefit from the same treatment as national EU sovereign bonds with regard to prudential regulation and the ECB collateral framework.

**NGEU bonds have the potential to reduce the doom loop between banks and their national sovereign.** Looking at the first NGEU issuances, bank treasuries have been actively buying EU bonds to the tune of 20–25% in volume (see Table 1 above). Given that demand for EU bonds is concentrated in Europe (see Table 2 above), it is likely that banks located in the eurozone have been purchasing EU bonds to diversify their sovereign portfolio away from their home government. EU bonds rated with AAA are attractive to banks as they carry only marginal risk but offer a slightly higher return than the German Bund. However, banks headquartered in countries with lower credit ratings might be less interested in replacing the bonds of their home government by EU bonds since the latter's yield is lower.

**Prudential regulation could encourage banks across the eurozone to buy EU bonds.** For the time being, EU bonds benefit from the same preferential treatment in prudential regulation as national sovereign bonds: banks are not required to hold capital for them. However, EU bonds on their own will not ensure that banks throughout the euro area purchase them in significant amounts rather than national sovereign bonds. In the light of the risk-return-profile of EU bonds compared to central government bonds issued by non-triple A countries, it might thus be necessary to provide banks with additional incentives to make them replace substantial parts of their home sovereign debt holdings with EU bonds. One way to achieve this would be to introduce positive risk-weights for national sovereign bonds and to attach the zero risk-weight only to EU bonds. However, given long-standing political opposition and short-term economic constraints, amending the prudential treatment of sovereign exposures has proven difficult in the past.



**The ECB should help make EU debt more attractive for Eurozone banks.** Another way to incentivise eurozone banks to buy EU debt is to amend the ECB's collateral framework. Currently, the ECB accepts EU bonds as collateral for open market operations but applies a higher haircut to EU bonds (L1B = Category II) than to debt instruments issued by central governments (L1A = Category I). This means that banks get less money from the ECB when depositing EU bonds as collateral. However, to encourage banks outside triple A rated eurozone countries to buy EU bonds, the ECB should amend its collateral framework and apply similar or even more favourable haircuts to EU bonds than to debt instruments issued by central governments. The ECB strategy review<sup>23</sup> concluded on 8 July 2021 touched on the collateral framework but only with regard to climate-related risks. So, if EU bonds are to become the common safe asset, the ECB should amend its collateral framework accordingly.

**“To encourage banks to buy EU bonds, the ECB should amend its collateral framework.”**

#### **Box 4: Do EU bonds help break the sovereign-bank doom loop?**

**Function:** To help break the sovereign-bank doom loop, NGEU bonds need to have a risk-return ratio that is attractive to banks and benefit from the same treatment as national EU sovereign bonds as regards prudential regulation and the ECB collateral framework.

**Diagnosis:** NGEU bonds benefit from the same zero risk-weight as national sovereign bonds. Eurozone banks have thus heavily bought NGEU bonds which is promising when it comes to diversification and de-risking of banks' balance sheets. However, due to their risk-return ratio, NGEU bonds are less attractive to banks located in high-yield countries. In open market operations, the ECB applies higher haircuts to EU bonds than to national EU sovereign bonds which is making EU bonds less attractive as collateral for banks.

**Recommendation:** The ECB should make its collateral framework more favourable towards supranational EU bonds and apply the same haircuts as to national sovereign bonds to encourage banks from all euro countries to reduce their exposure towards their domestic sovereign.

<sup>23</sup> ECB, *Strategy review*.

## Conclusion

**The EU bonds financing Europe's recovery already fulfil important functions of a euro area safe asset.** An additional supply of up to EUR 807 billion in high quality bonds addresses the current shortage in euro-denominated safe assets. Their high credit rating makes EU bonds attractive for many investors and might well lead to increased demand for national EU sovereign bonds at the same time. European banks are buying EU bonds and thereby diversify and de-risk balance sheets currently biased towards domestic sovereigns. The launch of NGEU has already increased investor confidence in European financial architecture. EU bonds could now make sovereign bond yields converge further and thus reduce the fragmentation visible in euro area sovereign bond markets.

**NGEU bonds are the best shot at getting a safe asset in the foreseeable future.** The flaws associated with failing to be a eurozone-only instrument decline with each new country that joins the euro. So, over time, EU bonds may well help to decouple private sector borrowing costs from those of domestic sovereigns. Crucially, operating outside an intergovernmental eurozone framework offers remarkable fiscal and democratic benefits. Common borrowing channelled through the EU budget does nothing to raise the debt levels of individual member states and applying the Union method has the benefit of adding greater democratic control. It is, therefore, politically sensible to take advantage of NGEU bonds and make them the euro area's safe asset.

**With the right reforms, NGEU bonds can be made the much-hoped-for safe asset.** This would first and foremost require the political will to increase the volume of EU borrowing and to introduce a permanent common fiscal facility. It would also require the ECB to amend its provisions for the treatment of supranational EU bonds to fully exploit their potential for enhancing the implementation of monetary policy in the eurozone and for mitigating the home bias in banks' sovereign exposures.

**EU member states have until 2027 to decide whether to extend the pilot project of common EU debt with regard to volume and time.** If the negotiations for the next multi-annual financial framework do not amend the current plan, NGEU bonds will gradually be withdrawn from the market. So, if the coming years prove that common borrowing and investing are beneficial to the whole Union, political decision-makers should seize the opportunity to create the long-awaited safe asset for the eurozone and put EU borrowing on a permanent footing before NGEU debt starts being paid back from 2028 onwards.

**“Decision-makers should seize the opportunity to create the safe asset before NGEU debt starts being paid back.”**

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This policy paper is part of the Resilient Recovery Project funded by the European Climate Foundation (ECF).

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