Policy Contribution
Issue n˚25/22 | December 2022

Don’t look only to Brussels to increase the supply of safe assets in the European Union

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The views expressed in this document are solely those of the authors. The authors thank Annika Eriksgaard and Jeromin Zettelmeyer for their valuable comments.

Executive summary

A sufficient supply of safe assets denominated in euros is critical if the European Union is to achieve full banking and capital markets union while fostering the euro’s international role. The European debate on developing the supply of safe assets has so far focused on the possible creation of a common safe asset. This has tended to underplay the potential contribution of sovereign assets. Expanding the supply of national safe assets, notably through the gradual implementation of fiscal and growth-oriented structural policies in euro-area countries, leading to upgrading of their sovereign ratings, provides a promising, and perhaps more feasible, option. An upgrade to triple A of those euro-area countries that are currently rated double A could produce substantially more safe assets than most common safe asset proposals, including those based on the development of ‘synthetic’ safe assets.

There has been a remarkable increase in the share of supranational assets in the stock of euro-based safe assets since 2008, reflecting downgrades in sovereign ratings and the EU’s financial responses to the euro-area crisis and the pandemic. However, safe assets in euro remain dominated by those issued by euro-area governments.

Although common safe assets have certain advantages over national safe assets, reflecting their built-in risk diversification properties, there is currently not much political appetite for such proposals. Meanwhile, sovereign safe assets already offer many of the advantages of common safe assets.

Sound fiscal policies and growth-stimulating reforms, which are in any case desirable, should be implemented to improve the credit ratings of euro-area sovereigns. This might not be politically feasible in the short-term, given the difficult economic environment currently faced by the EU, but it should be a key component of the EU’s medium-term safe asset strategy. Should the political consensus be found to create a common safe asset, such an asset could be incorporated into the euro area’s existing safe asset system, reinforcing its positive effects.

Recommended citation
Papadia, F. and H. Temprano-Arroyo (2022) ‘Don’t look only to Brussels to increase the supply of safe assets in the European Union’, Policy Contribution 25/2022, Bruegel

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risk[2]. But, as highlighted by Alogoskou s and Lang eld (2017), these reform proposals may not, in all cases, tackle both concentration and credit risks. Attempts to reduce concentration witnessed since the global nancial crisis has been explained by the decline in euro-denominated assets, mainly re ecting the credit downgrades su ered by a number of euro-area sovereigns (Temprano Arroyo, 2022, pp. 16-17). Because the world su ers from such a shortage of safe assets, if the EU managed to supply part of the world's unsatis ed demand for such assets, it could both increase the international attractiveness of the euro and help alleviate the global safe-asset problem.

1: AAA

Source: Bruegel based on Bloomberg, IMF. Note: The Bloomberg Global Aggregate – AAA Index includes a series of triple A fixed-income securities issued by treasuries, other government-relating institutions and corporations. Quarterly data.

Since 2008, the attitude of EU authorities towards the international role of the euro has changed from a neutral policy, which was still in uenced by the cautious attitude of the Bundesbank (Papadia and Efstathiou, 2018), to one that actively promotes this role. Of course, the international use of a currency depends on a host of factors, but there is signi cant consensus that the lack of an adequate supply of euro-denominated safe assets is a key constraint on its international development. Again, the comparison with the contribution of US safe government securities to the dollar's global role is telling. e increase in safe assets issued at EU level in response to the pandemic, in particular under the NextGenerationEU (NGEU) instrument, goes in the right direction but is not quantitatively su cient (nor su ciently durable in time) to mark a decisive step in the euro's international status (Claeys and Wol , 2020; Temprano Arroyo, 2022). A more comprehensive strategy, including the deepening of EMU, is needed.

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Euro-denominated public safe assets in the EU can be issued by euro-area governments and by EU supranational institutions, including the European Commission, the European Investment Bank (EIB) and the European Stability Mechanism (ESM), which has now also integrated the European Financial Stability Facility (EFSF).

While the supply of euro-denominated safe assets remains dominated by those issued by euro-area governments, there has been a remarkable trend towards an increase in the share of supranational assets in the outstanding stock of euro-based public triple A assets. e share of supranational bonds in the stock of euro-denominated safe assets has gone up from only 3 percent in 2008 to 26 percent in August 2022, a phenomenal increase (Figure 2).

2: , 2002-2022

Source: Bruegel based on European Commission, ESM, EIB. Note: For 2022, the chart shows: end of August data for supranational assets; and for sovereign assets, projections for end-2022 based on the European Commission medium-term debt projections (European Commission, 2022a).

is re ects two separate developments. e main factor is that credit downgrades during the euro-area crisis reduced the number of triple A-rated euro-area treasuries from eight to only three: Germany, Luxembourg and the Netherlands (Table 1). Figure 3 illustrates the overwhelming e ect this has had on the supply of sovereign safe securities in euro.

Second, the issuance of supranational bonds increased sharply in response to the euro-

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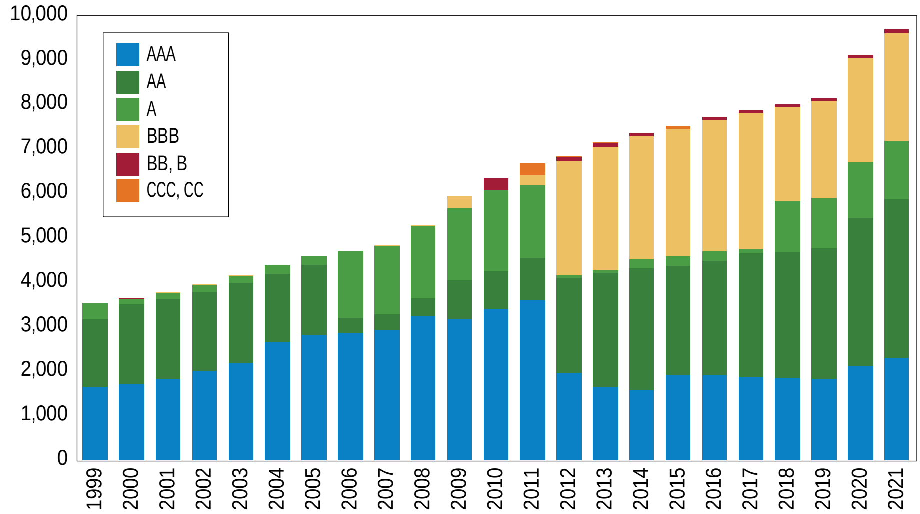

Sources: Bruegel based on Eurostat, S&P and Trading Economics. Note: Includes securities issued by the current 19 euro-area sovereigns.

4:

Source: Bruegel based on European Commission, ESM, EIB.

Figure 4 shows the trend in the stock of supranational EU securities, most of which enjoy a triple A rating from the main international rating agencies and can therefore be considered safe assets. It shows a big jump in 2011-2013, coinciding with the euro-area crisis, and again in 2020-2022, coinciding with the pandemic.

While the trends just described illustrate the potential importance of supranational institutions as a source of euro-denominated safe assets, they are also a reminder of the dominant in uence of national issuance and, therefore, underline the huge scope for increasing the availability of high-quality assets in euro through the upgrade of sovereign ratings.

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e supply of euro-denominated safe assets can be increased in three main ways[6]:

- More issuance at EU level, including through the possible creation of a common safe asset;
- More issuance at national level from countries with the highest credit ratings;
- Credit upgrades for countries with sub-triple A ratings.

is section examines the potential contribution of each of these sources of safe assets.

4.1

ere are two di erent approaches to expanding the issuance of safe assets at EU or euro area level. e rst and most obvious one is to boost bond issuance by existing EU supranational institutions and facilities, or to create new supranational facilities funded through international borrowing. e second option brings us back to the academic and policy debate of the past decade on the creation of a European common safe asset. We look at each of these two approaches in turn.

Increased issuance by EU supranational institutions and facilities

e EU increased supranational issuance when it created the EFSF and ESM in response to the euro-area crisis, and the SURE and NGEU instruments in reaction to the pandemic. As noted in section 3, EU supranational borrowing has increased rapidly over the last 10 years and its share in the stock of total euro-denominated assets has risen markedly. e SURE and NGEU facilities, if fully used, could put into the market a volume of new safe assets comparable to those that could be created under some of the best-known common safe asset proposals (Temprano-Arroyo, 2022, pp. 27-29). But with the euro-area sovereign debt crisis over, there is not in the foreseeable future a clear need for new programmes funded under the EU's macroeconomic stabilisation facilities. And with the COVID-19 crisis seemingly under control in Europe, there is currently not much political inclination to make the SURE or the NGEU instruments permanent.

More fundamentally, the expansion of supranational borrowing must be backed by prudent national scal policies. All supranational facilities are, in one way or another, ultimately guaranteed by EU countries, requiring tight common control over national scal policies. Without such control, a rapid expansion of supranational borrowing could result in the downgrade of the supranational entities managing those facilities. It is thus of paramount importance to ensure the creditworthiness and high-quality ratings of the sovereign guarantors behind these facilities.

A possible source of increased supranational issuance of safe bonds by the EU stems from the need to provide nancial support to Ukraine, which faces huge macroeconomic stabilisation and reconstruction needs. e World Bank, the government of Ukraine and the European Commission (2022), in their needs assessment study published on 9 September 2022, estimated that the cost of the war in terms of reconstruction and recovery needs amounted, as of 1 June 2022, to $349 billion, or more than 1.6 times the GDP of Ukraine. is estimate is probably on the low side as it does not take into account the impact of Russia's more recent strategy to redouble attacks on energy and other critical civilian infrastructure. But it helps illustrate the orders of magnitude involved.

In response, the Commission has proposed two unprecedented packages of MFA loans – of up to €9 billion and up to €18 billion – to help cover Ukraine's short-term funding needs in 2022 and 2023, respectively, the rst of which has already been partly disbursed (European Commission, 2022a and 2022b). e Commission has also proposed the creation of a new facility, to be called RebuildUkraine, to address Ukraine's longer-term reconstruction needs (European Commission, 2022a). While the details of this new facility remain to be spelled out, it could potentially lead to the issuance of a new type of supranational bonds in euro. If one adds to this the expected continued issuance of MFA bonds in support of Ukraine and other neighbouring countries a ected by the war, and increased bond issuance in euro by the EIB and the EBRD to fund the reconstruction of Ukraine, it is hard to escape the conclusion that addressing the consequences of the war is likely to lead, sooner or later, to a signi cant (oner or l)1.1 (a)7 (e)1 (a(t)1 ()1511 (yU)11 (an)7 (a)7 (ti

Creation of a 'European common safe asset'

Another approach to increasing the supply of safe assets at EU level would be the creation of

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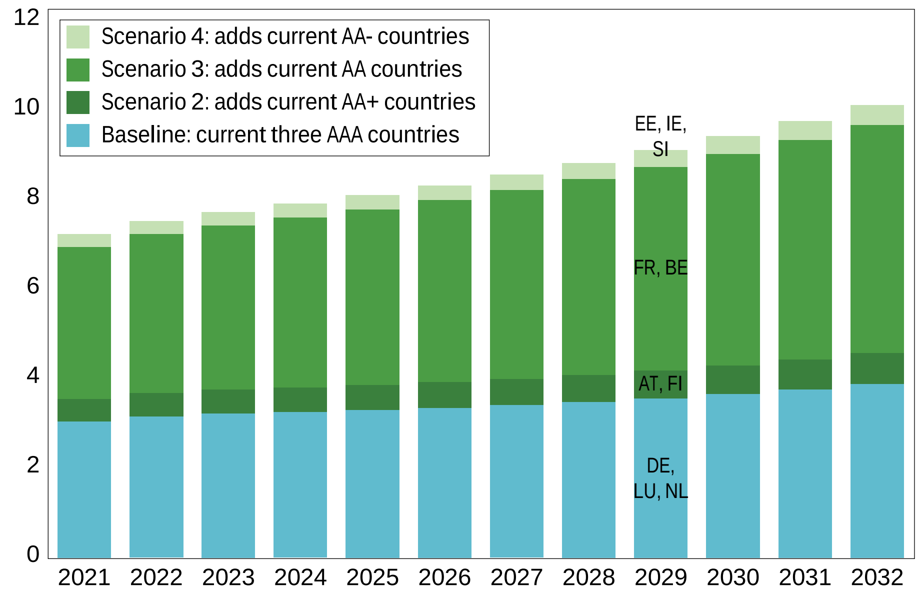

Sources: Bruegel based on European Commission medium-term debt projections (European Commission, 2022c), Standard & Poor's.

ese potential increases in safe assets also fare well in comparison with those estimated by some of the best-known proposals for a new European common safe asset, which are summarised in Table 2. ese proposals entail an issuance volume of common safe assets, scaled up using the euro area's 2021 GDP, ranging between €0.7 trillion, for certain variants of the SBBS proposal, and €7.3 trillion, for the Blue Bonds proposal (Delpla and von Weizsäcker 2010), with most proposals yielding a volume of common safe assets within the €1.5 trillion to €3.7 trillion range. Even the most cautious of the upgrade scenarios mentioned above would be close to the lower bound of this range, while other scenarios would expand the supply of euro-based safe assets well above the upper bound of that range.

e positive e ects of an upgrade of some euro-area countries to the triple-A level would be enhanced if it was accompanied by an improvement in the ratings of those that are still below the double A credit category (including Italy, Portugal and Spain), even if it is not realistic to assume that they can reach the triple-A notch in the foreseeable future. Improved

a few national safe bond markets. Moreover, an approach in which euro-area banks are encouraged to hold massive amounts of the bonds of just a few highly-rated euro-area treasuries might not be politically acceptable, as the latter could be seen to benefit disproportionately from efforts to reduce the home bias in banks' portfolios.

Similarly, for international investors, supranational assets in euros might be particularly attractive because they provide them with an exposure to the euro area rather than to individual member countries. This allows them to diversify risk in a simple manner, reducing the information and transaction costs associated with building a diversified portfolio of euro-area national government bonds. This should enhance the positive impact of an increased supply of safe assets on the euro's international role, compared with the effect of an equivalent amount of national safe assets.

That said, an expansion of sovereign safe assets would already bring, as noted, many of the advantages of safe assets. It would facilitate the diversification of banks' portfolios across national jurisdictions, thus lessening the risk of a vicious circle between banks and sovereigns. And, if accompanied by general improvements in the ratings of sub-triple A euro-area countries, any increase in contagion and credit risk that could result from such diversification would be mitigated. Moreover, as argued by Véron (2017), the diversification of bank holdings of government securities across countries would also facilitate the introduction of a common deposit insurance scheme, another key aspect of the banking union project. Indeed, for as long as the home-bias problem persists, there will always be the suspicion that deposits protected by a European deposit insurance scheme could be used by banks, under moral suasion by their home-country government, to increase excessively their exposure to domestic public

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e expansion of the supply of euro-area safe assets remains critical for completing EMU, in

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