From Euro Crisis to Covid Pandemic: The Changing Universe of Safe Public Debt in Europe

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Overview

The initial market perception of euro area governments as issuers of risk-free assets was vulnerable to an abrupt change in market sentiment about their creditworthiness during the euro crisis.

The regime switch from safe towards risky sovereigns for several countries led to a sharp drop in the stock of government debt securities with a high credit rating.

The European policy response to the Covid-19 pandemic in 2020 unexpectedly gave way to a much higher issuance of supranational public debt and expanded the universe of safe sovereign assets.

This paper discusses the changes in the European universe of safe public debt and assess the recent increase in common public debt issuance.

Conclusion: At present, the potential ‘float’ of supranational safe debt is too small and too transitory. The post-pandemic challenge for euro area leaders is to create a permanent supply of a safe sovereign asset for EMU.

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1. The split between safe and risky euro area sovereigns

A safe sovereign asset is anchored in a country's creditworthiness (or solvency): given its high intrinsic quality, investors expect a full payoff. As it is information-insensitive, the market value (or liquidity) is high.

The safety and liquidity of a sovereign asset presumed to have a high intrinsic value may in fact be fragile, i.e. an adverse shock can suddenly make the debt claim information-sensitive, of questionable safety and thus illiquid.

The Maastricht Treaty set out to promote the intrinsic quality of national public debt, grounded in market-based and rule-based fiscal discipline. Meanwhile, EU financial regulation manufactured market integration and market liquidity.

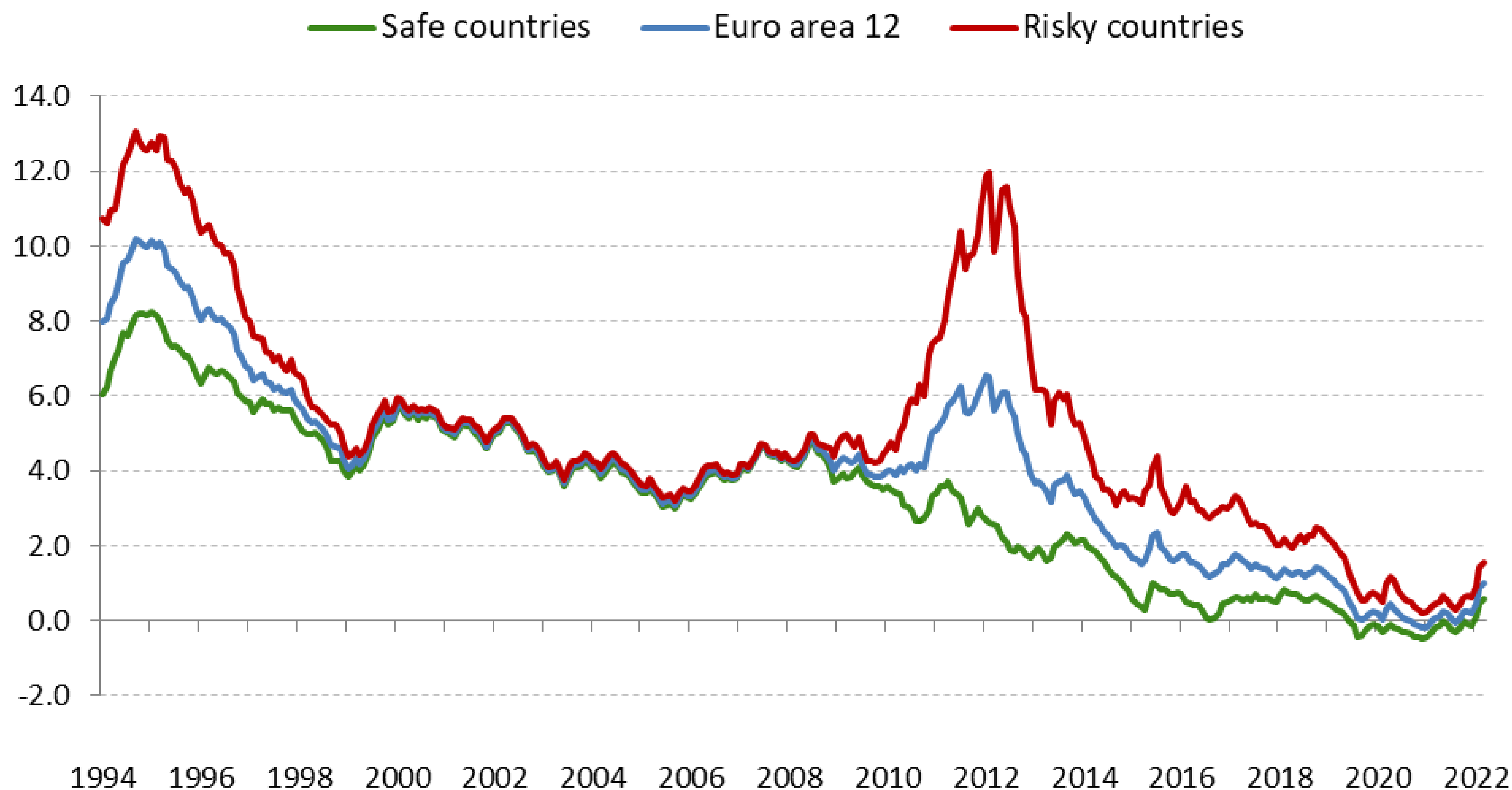
Also thanks to 'EMU bonus' a nearly single sovereign yield curve emerged.

The euro crisis (2008-2013) revealed the rise of macro and financial imbalances. Investors demanded higher risk premia in interaction with falling credit ratings. The split between safe and risky sovereigns showed the systemic fragility of EMU

From convergence to divergence of long-term interest rates

Government bond yields of the first 12 euro area countries, 1994-2022

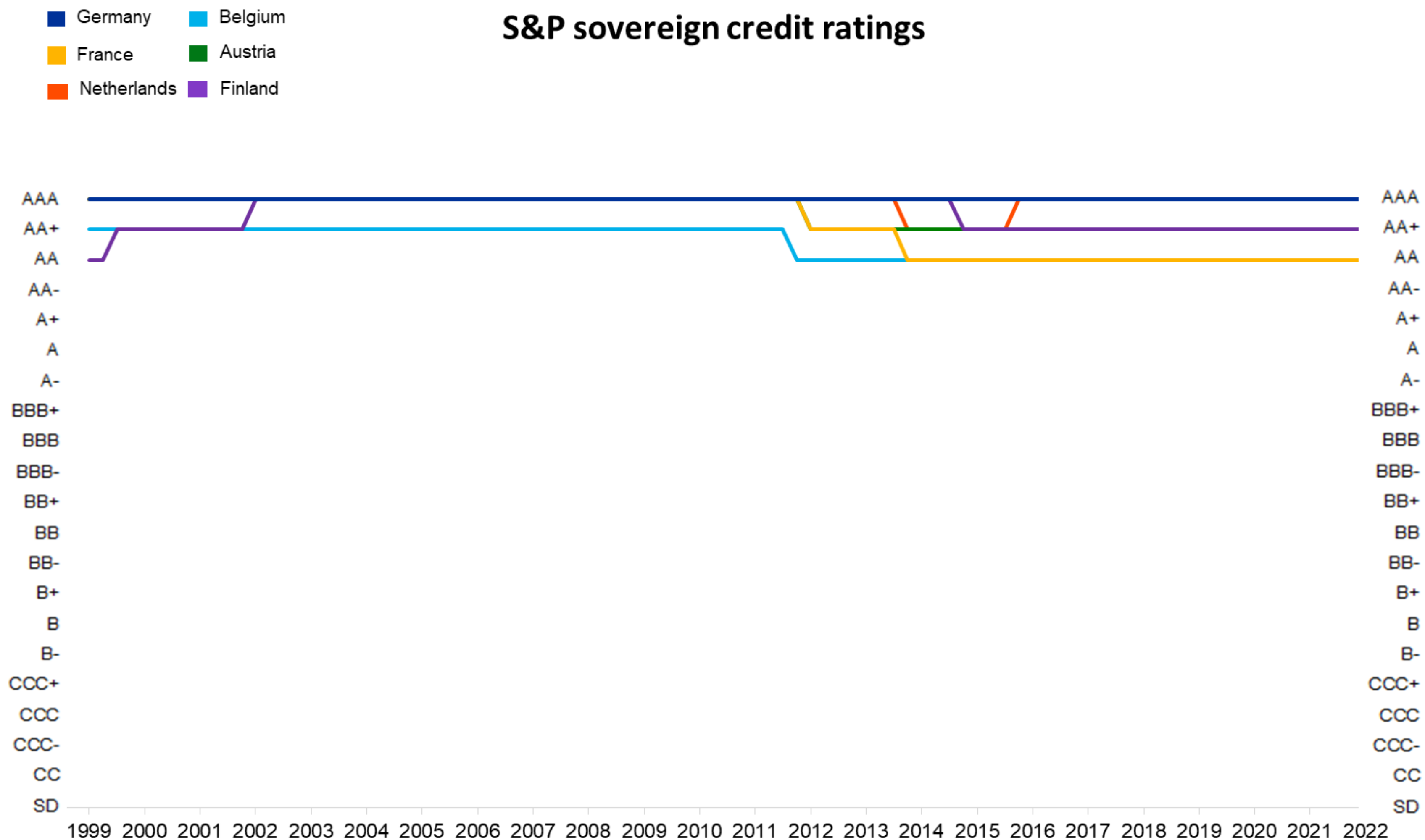
(monthly data in percentages)



Notes: Long-term interest rate for convergence purposes, 10-year maturity. Euro area 12 = Simple average of the first 12 EU countries that adopted the euro. Safe countries = Simple average of Germany, France, Netherlands, Belgium, Austria, Finland, Luxembourg. Risky countries = Simple average of Italy, Spain, Ireland, Portugal, Greece.
Source of data: ECB-SDW. Latest observation: March 2022.

Narrow range of high credit ratings for safe sovereigns

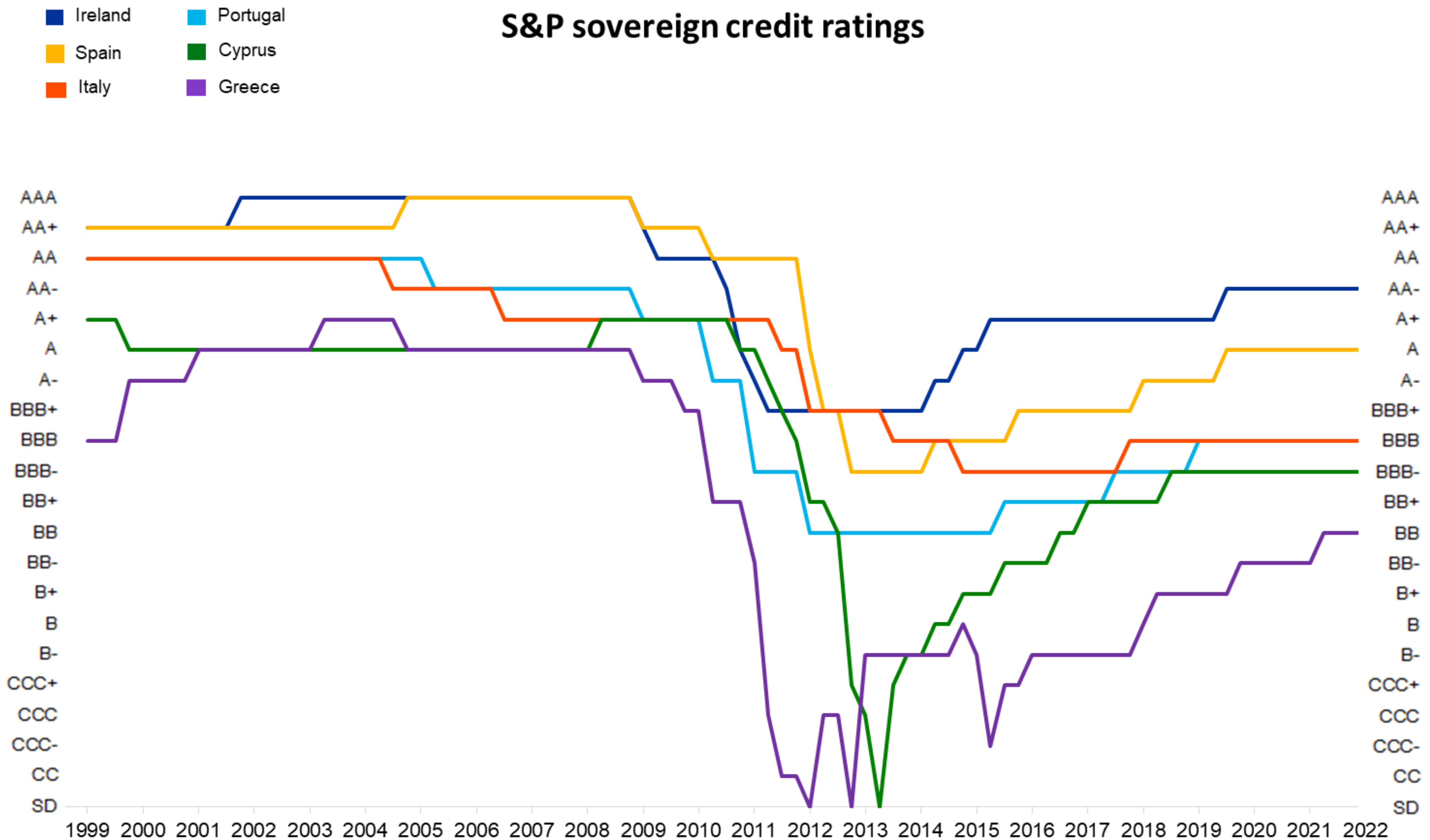
Sovereign credit ratings of safe countries, 1999-2022



Source of data: Standard & Poor's Global Ratings. Last observation: 2022 Q1.

Falling credit ratings for risky sovereigns

Sovereign credit ratings of risky countries, 1999-2022



Source of data: Standard & Poor's Global Ratings. Last observation: 2022 Q1.

2. A persistent segmentation of the euro area capital market

European leaders first hesitated but then provided conditional financial assistance to crisis-hit countries and built a stronger EMU framework for sovereign safety.

Market trust gradually returned after ECB commitment of mid-2012 to undertake conditional but unlimited interventions in distressed government bond markets. The ECB's collateral eligibility waivers and its quantitative easing from 2015-2019 compressed all sovereign yields and created perception of fiscal sustainability.

Yet, the split safe/risky sovereigns is persistent in terms of yields and ratings.

The re-assessment of sovereign strength has led to a sharp drop in the stock of national government debt securities denominated in euro with the highest (AAA) credit rating, from nearly € 4 trillion to € 2 trillion. This is still the current level.

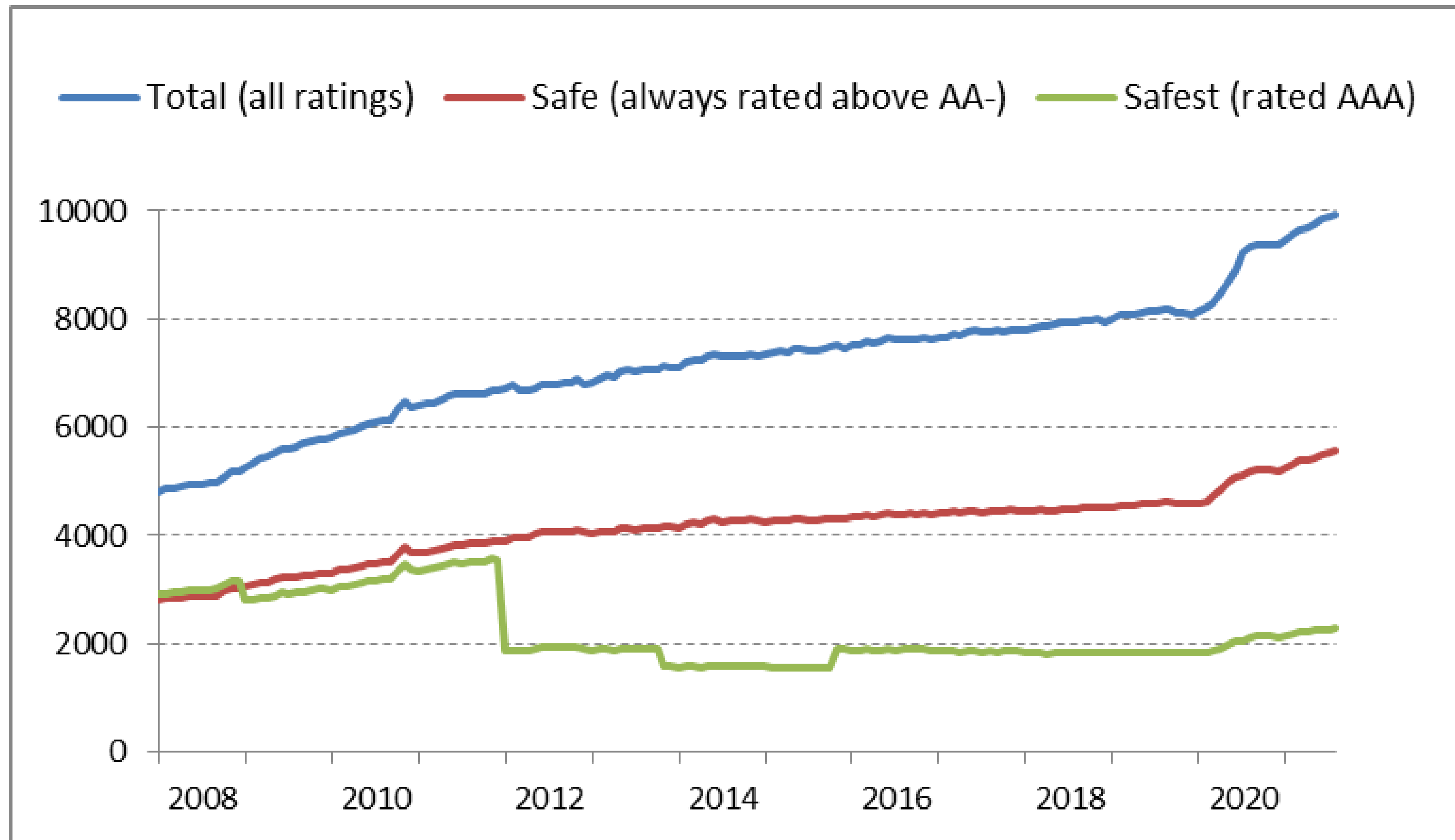
Only 7 euro area countries were always rated above AA- and qualify as safe.

A new crisis in one or more of the risky euro area countries and contagion to other weak nations remains an ever-present threat to euro area stability.

The credit rating composition of euro area government debt

Euro area government debt securities by credit rating, 2008-2021

(stock of euro-denominated debt securities in € bn. for 19 euro area countries)



Note: Based on S&P ratings.
Source of data: ECB-SDW and Standard & Poor's Global Ratings. Latest observation: August 2021

3. European sovereign bond markets in the pandemic

EMU systemic fragility returned with the Covid-19 crisis, as risky sovereigns saw a stronger and more persistent rise in bond yields than safe sovereigns.

- The general escape clause of the SGP was activated to suspend normal procedures, with little attention to the condition that medium-term fiscal sustainability must be maintained
- EU supervisors applied a prudential filter to make it easier for banks to continue lending to the private sector while absorbing the large issuance of government bonds
- The capacity for EIB, EU and ESM to borrow in the capital market during the Covid-19 crisis was enlarged to establish common safety nets for firms, workers, and sovereigns
- Large-scale EU borrowing funded a 'Next Generation EU' recovery facility providing for grants and loans to the Member States, in particular to the hardest-hit EU countries
- The ECB accepted Greek government bonds as collateral and said it would grandfather (sovereign) collateral downgraded below the investment-grade threshold
- The ECB's flexible pandemic emergency purchase programme (PEPP) including Greek debt helped to control the euro area sovereign yield curve and national sovereign spreads

Thanks to the ECB's flexible monetary policy and the evident public risk-sharing, the credit ratings of risky countries were mostly stable during the pandemic (even rising for Greece) and government bond yields uniformly declined.

4. The potential of European supranational safe debt

EU/EMU public policies in fact seek to address the lack of a central fiscal capacity and the missing single sovereign asset for the eurozone to anchor the euro.

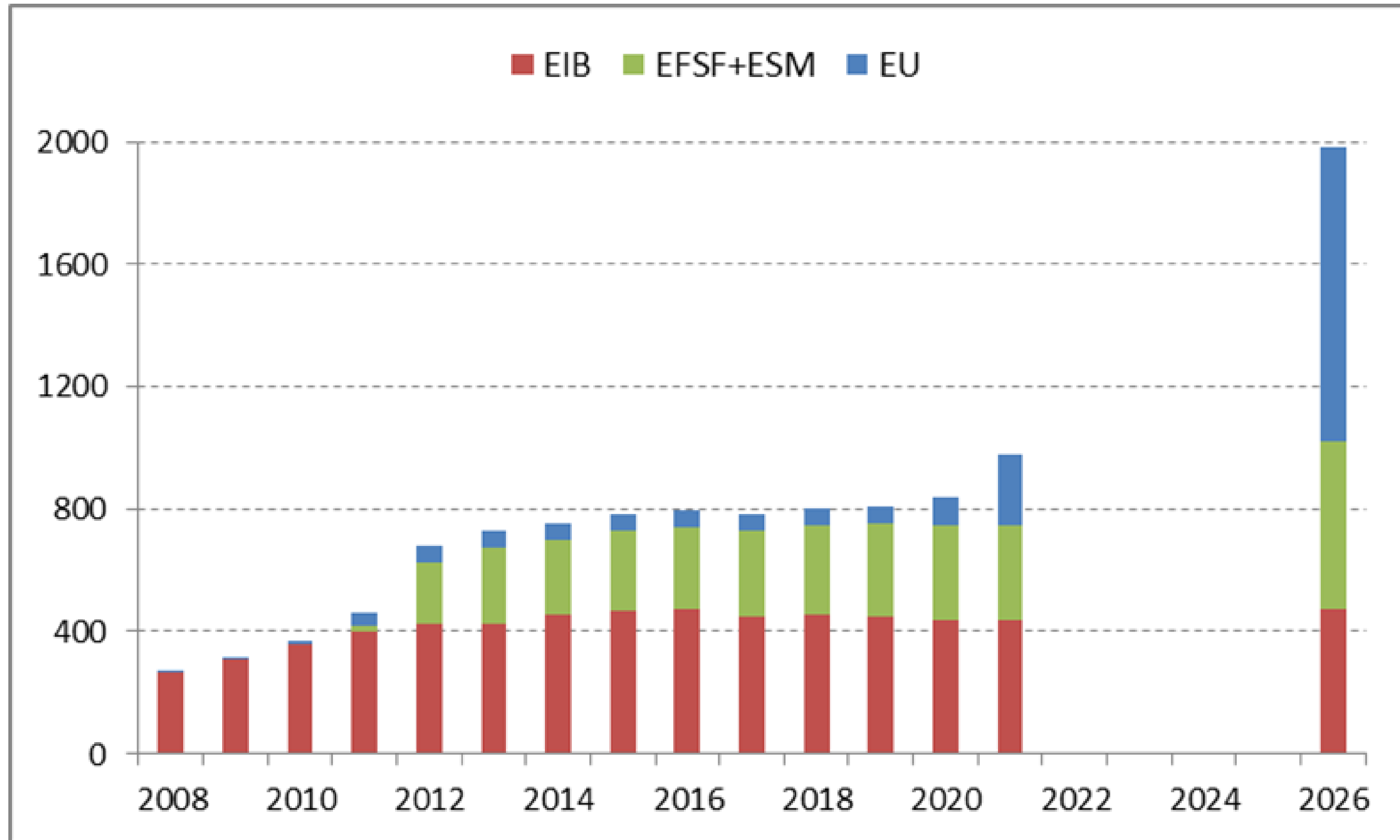
Could supranational safe debt of the EIB, EU and ESM – which is backed by subscribed capital, reserves, guarantees or own resources – offer an alternative?

- They enjoy very high credit ratings and the stock of their supranational debt securities in issue at end-2019 was €805 bn. (o/w €590 bn. issued in euro).
- The Covid-19 borrowing plans of the EIB (€40 bn.), ESM (€240 bn.) and the EU (€100 bn. for SURE and €806 bn. for NGEU) add up to €1186 bn.
- If fully realised, the total stock of European supranational debt securities would rise to almost €2 trillion in 2026.

The growing supply of supranational debt securities in Europe

European supranational debt securities from 2008 to 2026

(actual and potential amount in € bn.)



Source of data: Annual financial accounts from the EU, EFSF, ESM and EIB. Latest observation: August 2021

5. A hybrid model of large-scale public borrowing

At present, the potential ‘float’ of European supranational safe debt is too small.

- Maximum lending capacity of the EIB, EU and ESM – including the pandemic-related increases – adds up to €2.2 trillion.
- But it comprises transitory investment projects and temporary financial support.
- ECB bought €4 trillion of public sector bonds of variable risk from 2015-2021.
- Many financial institutions are eager to buy and hold safe sovereign debt.
- Draghi: make large-scale EU borrowing permanent to fund common public goods via grants and loans to Member States and to assist them with specific challenges (‘pragmatic federalism’).
- ESM: proposal to host a loan-based fiscal stabilisation fund of €250 bn.

Overall, a hybrid model could be emerging with large-scale public borrowing both at the national and the European level.

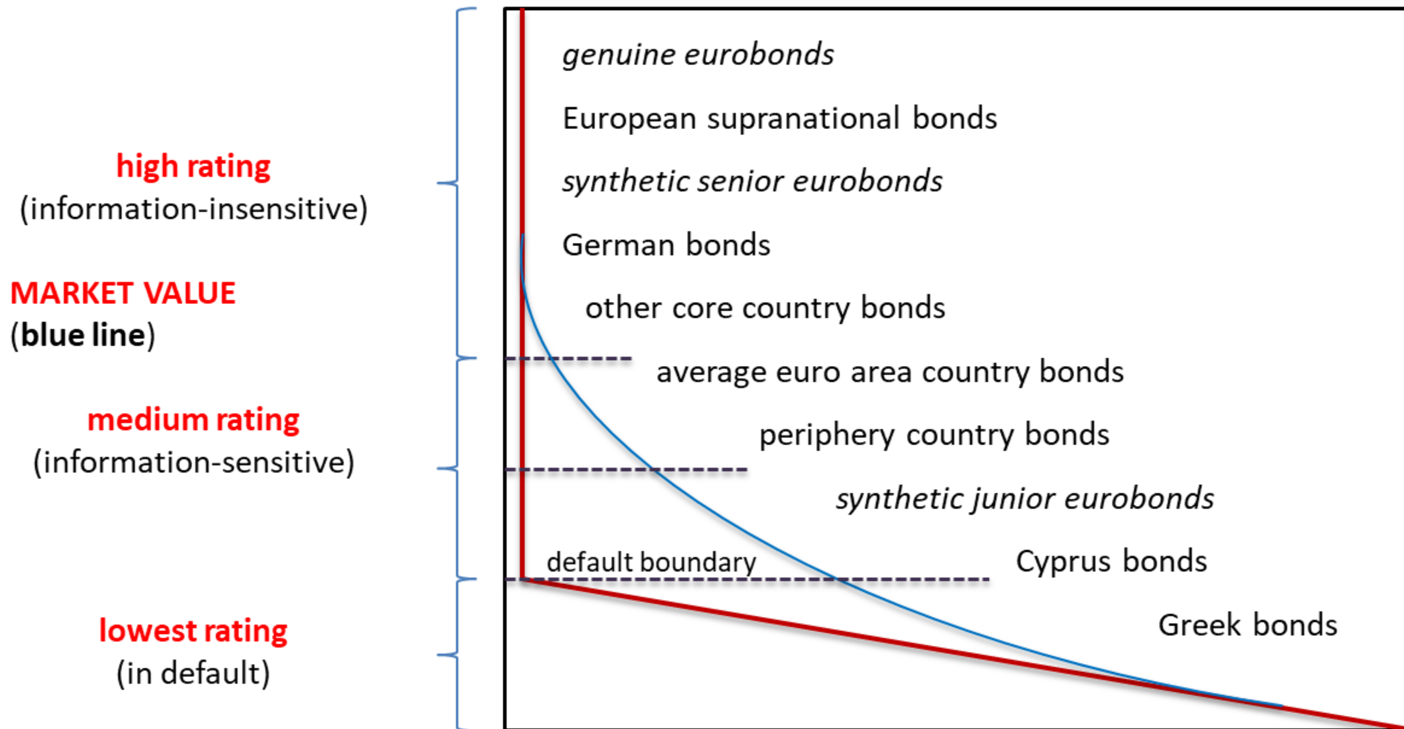
A hybrid universe of safe and risky public debt in Europe

Public debt securities by expected return and market value

(non-existent options in italics)

EXPECTED RETURN
(**red line**)

high payoff (always) | **fragile high payoff** (outside crises) | **low payoff** (in crises)



Source: Own presentation, inspired by Holmström (2015) and Golec and Perotti (2017)

6. Conclusions

European leaders assumed that the EU/EMU legal framework would be effective in making national government bonds equally safe and liquid financial instruments and secure financial integration. The sovereign debt crisis proved they were wrong.

A safe asset concentrated in the German bund is incompatible with having free capital mobility and a stable monetary union. EMU needs a single safe sovereign asset to anchor euro area money and finance.

The European response to the Covid-19 pandemic showed the benefits of public risk-sharing in stabilising sovereign bond markets and securing financial integration, together with the ECB's public sector asset purchases as a monetary backstop.

The post-pandemic challenge for euro area leaders is to enrich the European universe of public debt with a permanent supply of a safe sovereign asset for EMU.

Thanks for your kind attention!

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