

## THE OUTLOOK FOR A EUROPEAN SAFE ASSET

The availability of a euro-denominated safe asset issued jointly at European level is key to the full integration of EU financial markets. The issuance of these instruments – in sufficient and regular volumes across the entire term structure – would become another benchmark for market participants, would serve as an underlying asset for derivative contracts, and would smooth the way for the implementation of the common monetary policy in the euro area.<sup>1</sup>

In Europe, supranational bonds, commonly referred to as eurobonds, have been issued by European institutions for the most part in exceptional circumstances, such as bonds issued by the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF) in response to the euro-area debt crisis. More recently, the European Commission has issued other supranational bonds to finance initiatives linked to the pandemic crisis, such as the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) and the NextGenerationEU (NGEU) programmes.<sup>2</sup> The total amount of securities issued thus far by the Commission is however very small compared with the size of the combined public debt of the Member States (€458 billion at end-2023, or 3.3 per cent) and around 40 per cent of the securities are held by the Eurosystem.<sup>3</sup> In addition, these securities are not included in the main bond benchmark indices, cannot be used as underlying assets for derivatives, cover only certain maturities and are largely kept in the portfolios of market participants who hold them until maturity for institutional reasons.

Between 2018 and 2023, yields on eurobonds issued by the Commission were between 20 and 40 basis points higher than rates on overnight indexed swaps (OIS) with the same maturity (Figure A).<sup>4</sup> Over the same period, the yield spread relative to corresponding German government bonds (Bund), commonly regarded as the major euro-denominated safe asset, averaged 50 basis points for the ten-year maturity. This spread was particularly wide (up to 90 basis points) during periods of higher demand for Bunds (see panel (b) of Figure A). As the credit ratings assigned by rating agencies to Bunds and eurobonds are similar,<sup>5</sup> most of the yield spread between the two bonds appears to be related to the liquidity premium demanded by investors to hold eurobonds.

<sup>1</sup> This instrument should be issued by an existing (i.e. the European Commission) or a newly established (i.e. a European Debt Agency) high-profile European institution (see M. Amato, E. Belloni, C.A. Favero, L. Gobbi and L. Priviero, 'European Sovereign Debt Risk Management: the Role of a European Debt Agency', 2023).

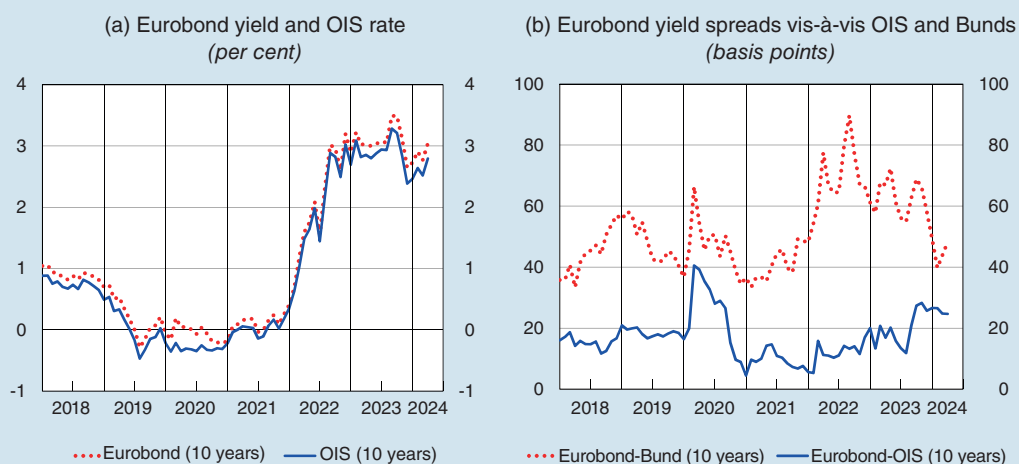
<sup>2</sup> Prior to the pandemic, the European Commission mainly issued debt to finance three lending programmes to provide support to countries in financial difficulty, specifically: the European Financial Stabilisation Mechanism (EFSM) for euro-area countries, the Balance of Payments (BoP) assistance facility for non-euro-area EU countries, and Macro-Financial Assistance (MFA) for non-EU countries.

<sup>3</sup> Other holders are foreign investors (20 per cent), banks and money market funds (16 per cent), insurance companies and pension funds (15 per cent) and financial institutions and investment funds (8 per cent).

<sup>4</sup> OIS rates reflect the expected average level of the interbank overnight rate over the duration of the swap contract.

<sup>5</sup> Moody's assigned its highest rating (AAA) to the EU, noting its Member States' commitment to ensuring the continued soundness of the Union's finances, given the high credit profile of the EU members with a higher rating. However, Standard and Poor's gave the EU a long-term issuer rating of AA, its second highest rating.

### Yields and spreads of eurobonds issued by the European Commission (1) (monthly data)



Source: Based on LSEG data.

(1) Panel (a) reports the ten-year zero-coupon yield obtained from an estimate of the term structure of eurobonds using the methodology explained in Pericoli M. 'Real Term Structure and Inflation Compensation in the Euro Area', *International Journal of Central Banking*, 10, 1, 2014, pp. 1-42. Panel (b) shows the spread between the ten-year zero-coupon yield on eurobonds compared with the OIS rate and the zero-coupon yield on the German Bund.

Looking ahead to any future joint issuances of bonds, it would also be useful to reflect on the two methods of sharing guarantees between EU countries. The first method is to provide several but joint guarantees (SJGs) where all EU countries are jointly liable for the default of each country. Such guarantees are similar to those used for the eurobonds issued by the European Commission that are currently in circulation.<sup>6</sup> The second consists of several but not joint guarantees (SNJGs), in which each debtor country is liable only for its share of the joint issuance. Financing costs would be significantly lower for SJG bonds than for SNJG bonds (which would be close to the weighted average of the costs of each country),<sup>7</sup> because the credit rating of the bonds issued would be higher due to the participation of countries with low debt and high GDPs.

According to a multi-country credit risk model that allows theoretical yields to be estimated for the two guarantee schemes, the yield spread vis-à-vis the Bund of hypothetical SJG bonds averages around 20 basis points (green dots, Figure B), while the spread for SNJG bonds (blue dots, Figure B) is similar to the euro-area average (around 60 basis points).<sup>8</sup>

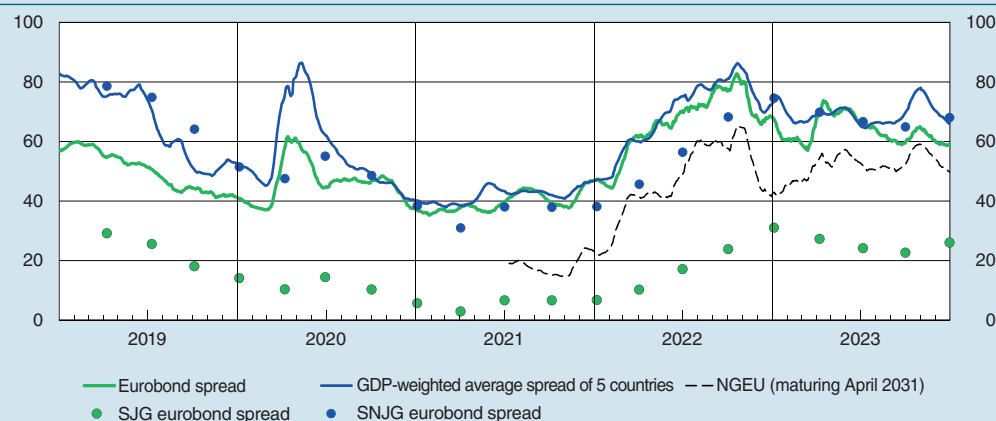
<sup>6</sup> With regard to the first issuance of NextGenerationEU bonds, Moody's stated that: 'The multiple layers of debt service protection, including explicit recourse to extraordinary support [...] create the equivalent of a joint and several undertaking and obligation on the part of EU Member States to provide financial support to the EU'.

<sup>7</sup> It is reasonable to assume that the rating agencies would assign SJG bonds a rating no lower than that of existing eurobonds, which in turn is similar to that of German and Dutch government bonds.

<sup>8</sup> See K. Pallara and J-P. Renne, 'Fiscal limits and the pricing of Eurobonds', *Management Science*, 70, 2, 2024, pp. 1216-1237. The estimation of the yields associated with the SJG and SNJG bonds is based on the yields of the national bonds of Belgium, France, Germany, Italy, the Netherlands and Spain. These countries in aggregate account for around 80 per cent of the EU's public debt. Under the joint issuance schemes, their relative weight is based on the (relative) size of the participating country's economy as measured by GDP.

Figure B

**Yield spreads vis-à-vis the Bund of Commission-issued eurobonds  
and of both SJG and SNJG eurobonds (1)**  
(daily and quarterly data; 10-year maturity; basis points)



Sources: Based on Eurostat and LSEG data.

(1) The chart shows the yield spread vis-à-vis German ten-year government bonds of Commission-issued eurobonds, and of SJG and SNJG eurobonds. The green and blue dots indicate, respectively, the spreads of hypothetical SJG and SNJG eurobonds calculated based on the methodology described by K. Pallara and J.P. Renne, 2024, op. cit. The blue line is the national GDP-weighted average of government bond yield spreads for Belgium, France, Italy, the Netherlands and Spain vis-à-vis German bonds. The green line is the spread for eurobonds issued by the European Commission. The dashed black line represents the spread on the ten-year zero-coupon bond issued by the Commission under the NGEU programme in June 2021 (maturity April 2031).

On the whole, SJG bonds, assuming that their liquidity is at least equal to the average liquidity of the national sovereign bonds, would benefit from funding costs that are lower than the euro-area average. However, the yield on eurobonds issued by the European Commission is similar to that of SNJG bonds, according to the model. This dynamic suggests that the downward impact of high credit ratings on yields is more than offset by the upward impact associated with low liquidity and uncertainty over future eurobond issuance programmes.<sup>9</sup> If eurobonds were issued regularly, for different maturities and in large amounts, their yield would be close to that of SJG bonds.

For countries with a stronger fiscal position, such as Germany and the Netherlands, the funding costs associated with the joint issuance of bonds would however be higher than those of domestic government bonds. Their participation in the issuance of such bonds should therefore be accompanied by a plan for redistributing the overall savings so as to ensure that each country benefits.<sup>10</sup> This plan could also

<sup>9</sup> K. Pallara, M. Pericoli, and P. Tommasino, 'The advantages of issuing European safe assets', Banca d'Italia, *Questioni di economia e finanza* (Occasional Papers), forthcoming.

<sup>10</sup> For example, based on the model's estimates for the last quarter of 2023, if around 5 per cent of the government debt of Belgium, France, Germany, Italy, the Netherlands and Spain had been financed by SJG-type eurobonds and if a redistribution plan based on the relative size of the GDPs of the countries participating in the issuance had been adopted, the financing cost for each country would have been around 40 basis points lower than their individual national issuances.

link the post-distribution costs borne by individual countries to developments in their national debts in order to discourage opportunistic behaviours.<sup>11</sup>

The European Commission's recent issuances of eurobonds can be seen as the first step towards the creation of a European safe asset that could complement national government bonds. These bonds are currently penalized by the lack of a stable and regular supply, which can only be ensured through the establishment of a permanent central fiscal capacity, which is needed to appropriately manage the aggregate demand of the EU (alongside national fiscal policies and monetary policy) and to finance some important European public goods.<sup>12</sup>

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<sup>11</sup> These could include excessive debt and a strategic default. For more details on how to avoid these risks by using suitable institutional mechanisms, see also M. Cioffi, P. Rizza, M. Romanelli and P. Tommasino, 'Outline of a redistribution-free debt redemption fund for the euro area', Banca d'Italia, *Questioni di Economia e Finanza* (Occasional Papers), 479, 2019.

<sup>12</sup> See 'The future of Europe's economy amid geopolitical risks and global fragmentation', *Lectio Magistralis* delivered by Fabio Panetta, Governor of the Bank of Italy, on the occasion of receiving an honorary degree in Juridical Sciences in Banking and Finance from the University of Roma Tre, 23 April 2024.