



# **The EU's Response to the COVID-19 and Ukraine Crises: A Game Changer for the International Role of the Euro?**

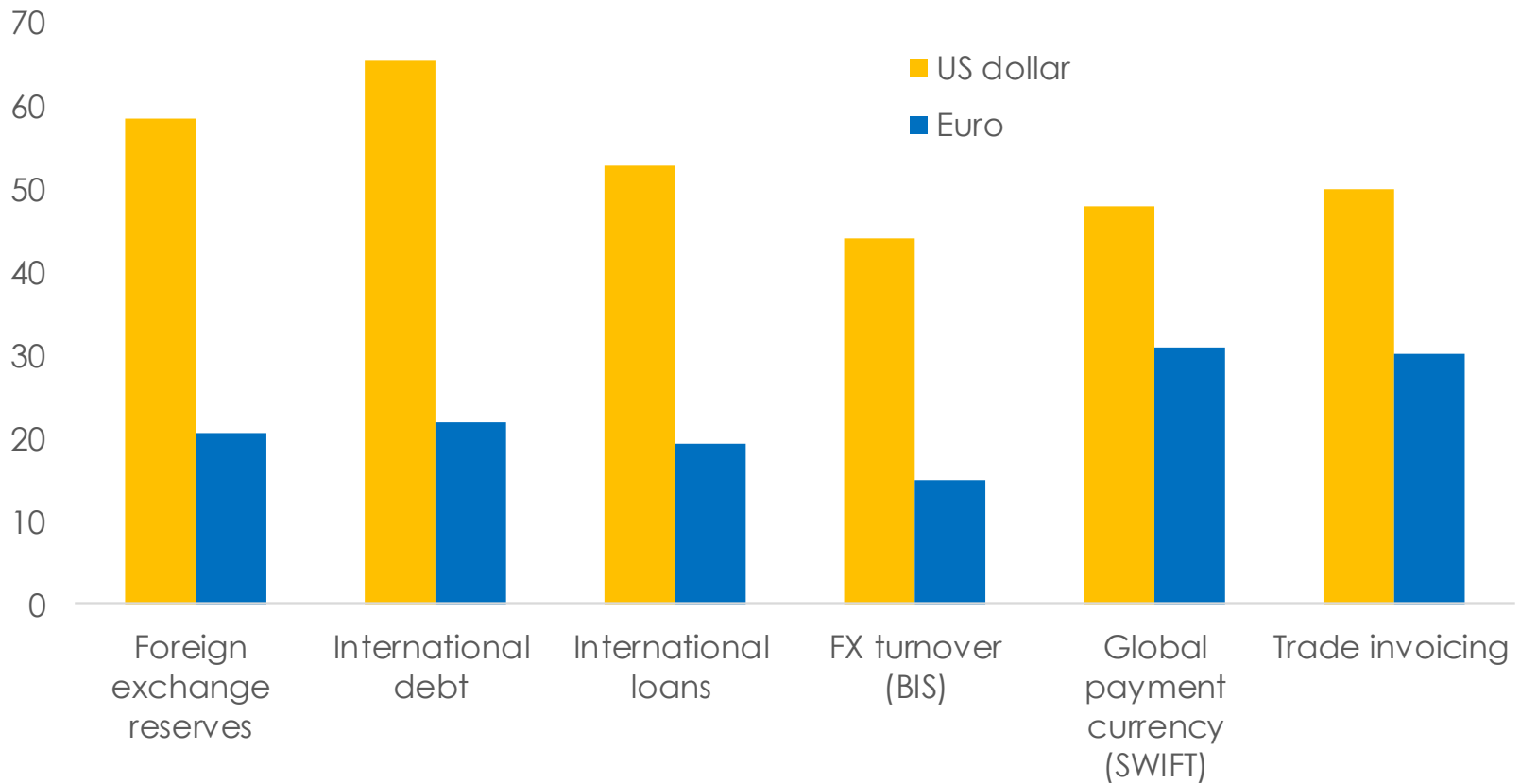
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***Workshop on Recent Developments and Future Prospects for the  
International Monetary System***  
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## International roles of the euro and the US dollar: a snapshot

(% of world's total; data for Q4 2022 or nearest available date) (1)



Sources: BIS; ECB; IMF; SWIFT; and Boz et. al (2020), "Patterns in Invoicing Currency in Global Trade," IMF WP/20/216.

(1) FX turnover data are for April 2022. SWIFT data are for December 2022. For trade invoicing, annual data for 2019

## Key characteristics of major economies, 2020

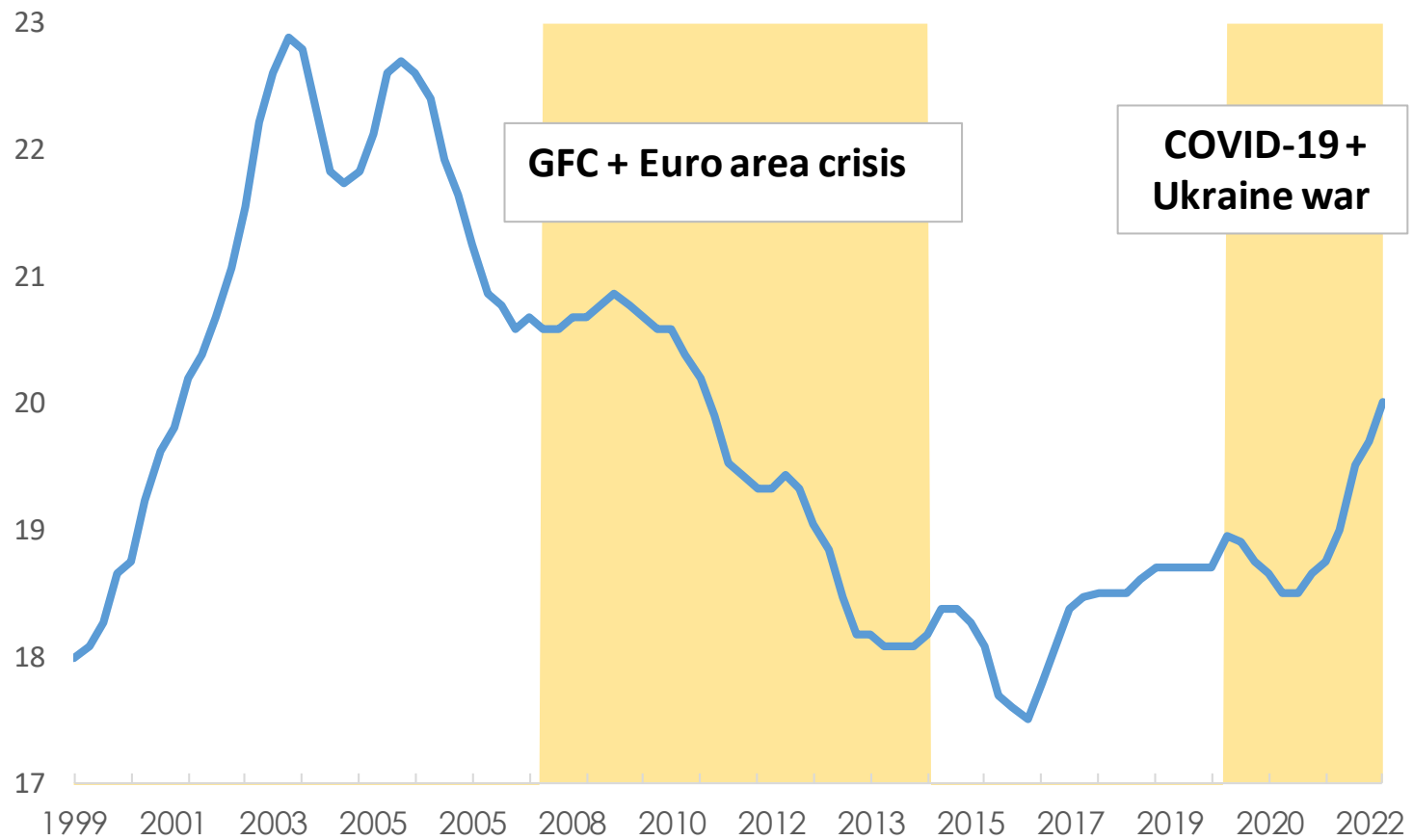
	Population (millions)	Share of world GDP (%)	Share of world trade in goods and services (%) (1)	Size of financial system (2)	
				USD billions	% of GDP
Euro area	340	15.3	15.8	40336	318.3
US	329	24.6	12.9	79251	406.8
China (4)	1414	17.5	15.3	41198	335.9
Japan	126	5.9	4.2	25253	527.0
UK	67	3.2	3.3	14043	527.0

Sources : IMF (WEO 10/2021; IFS); World Bank Financial Development and Structure Dataset; BIS; World Federation of Exchanges.

(1) Excluding intra-euro area trade.

(2) Sum of stock market capitalisation, stock of debt securities and deposit money bank assets. Data for 2017.

## Composite Index of the International Role of the Euro (at constant exchange rates; four-quarter moving average)



Source: ECB.

## Factors behind the euro's disappointing international performance

- **Incumbency advantages.** An exaggerated argument, according to the “new view on international currencies” (Eichengreen, Mehl).
- **Insufficient depth, integration and efficiency of EA's capital markets.**
- **Insufficient supply of euro area safe assets\***
- **Complementarities between different assets and currency functions** (e.g. Gopinath and Stein, 2018).
- **Lingering doubts about EMU architecture and macro-financial stability** (EMU is an uncompleted project).
- **Foreign and security policy:** including the fact that the EA is still not capable of speaking with a single voice in the global economic and financial arena.

## The EU's evolving policy towards the IRoE

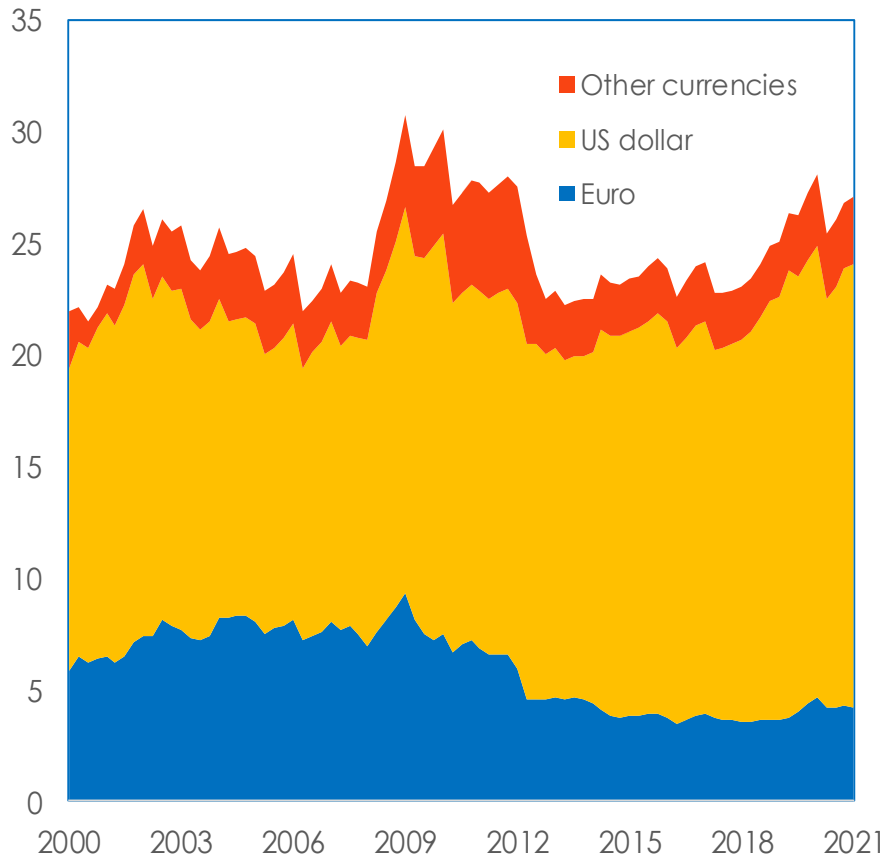
- **First 10 years of EMU:** the ECB pursued a **neutral policy** (“neither promote nor hinder”) the international role of the euro (IRoE) inherited from the German Bundesbank.
- **EMU@10 Communication and Report (2008):** a first attempt to change this policy, but EA crisis refocused attention on addressing EMU's internal challenges and the Commission's proposals were not adopted by the Council and the European Parliament.
- **2018 Communication on Strengthening the IRoE:** a real quantum leap towards a policy of promoting the IRoE. Followed by 2021 **Communication on the European Economic and Financial System.**
- And this time around, the **Council and the European Parliament did explicitly endorse the new strategy**, which includes **supporting the issuance of euro-based safe assets.**

## **The European, and global, safe asset problem**

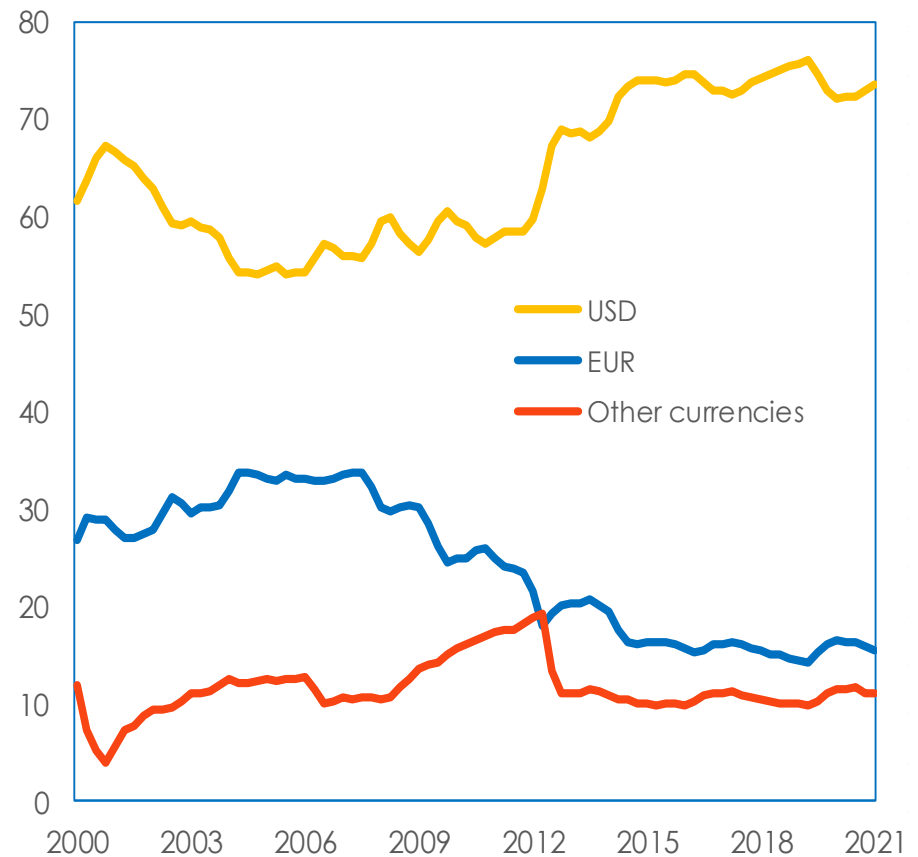
- The euro accounts for a much lower share of the global supply of AAA assets than the US dollar.
- And most of the decline in the world's safe assets seen since 2009 has been driven by the fall in euro-denominated assets, reflecting the credit downgrade of many EA sovereigns.
- This also means that if EA manages to supply part of the unsatisfied global demand for safe assets, this could help boost the IRoE, as well as help mitigate the global safe asset shortage

## Market capitalisation of Bloomberg Barclays Global Aggregate of AAA assets

Percentages of GDP



Percentages of total market capitalisation



Sources: Bloomberg, IMF and author's calculations.



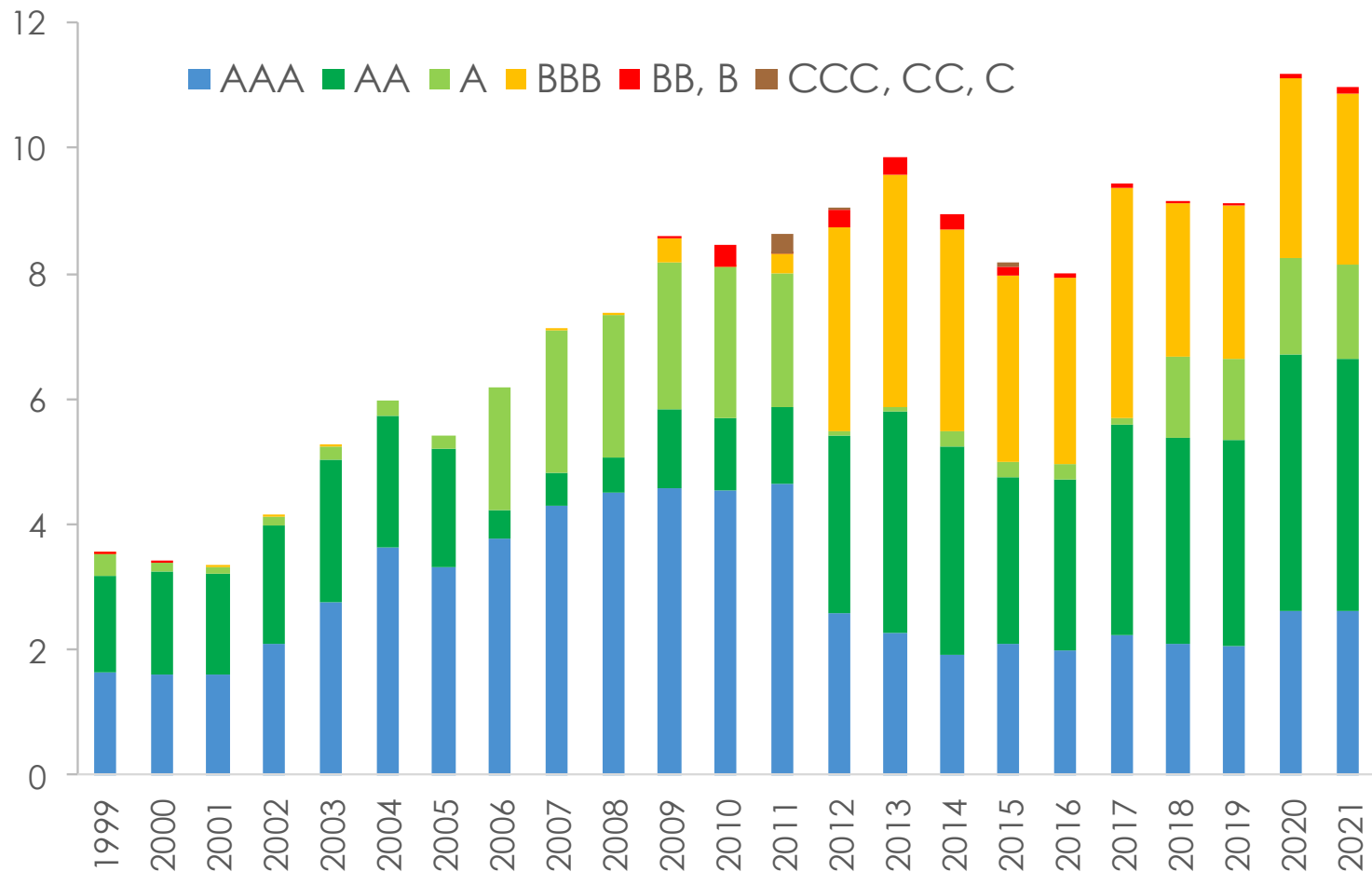


**Table 1: Euro area sovereign credit ratings**  
(long-term ratings, end of period)

	2005			2014			September 2022		
	S&P	Moody's	Fitch	S&P	Moody's	Fitch	S&P	Moody's	Fitch
Germany	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA
Luxembourg	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA
Netherlands	AAA	Aaa	AAA	AA+	Aaa	AAA	AAA	Aaa	AAA
Austria	AAA	Aaa	AAA	AA+	Aaa	AAA	AA+	Aa1	AA+
Finland	AAA	Aaa	AAA	AA+	Aaa	AAA	AA+	Aa1	AA+
France	AAA	Aaa	AAA	AA	Aa1	AA+	AA	Aa2	AA
Ireland	AAA	Aaa	AAA	A	Baa1	BBB+	AA-	A1	AA-
Spain	AAA	Aaa	AAA	BBB	Baa2	BBB+	A	Baa1	A-
Belgium	AA+	Aa1	AA	AA	Aa3	AA	AA	Aa3	AA-
Slovenia	AA-	Aa3	AA-	A-	Ba1	BBB+	AA-	A3	A
Italy	AA-	Aa2	AA	BBB-	Baa2	BBB+	BBB	Baa3	BBB
Portugal	AA-	Aa2	AA	BB	Ba1	BB+	BBB+	Baa2	BBB
Estonia	A	A1	A	AA-	A1	A+	AA-	A1	AA-
Slovakia	A	A2	A	A	A2	A+	A+	A2	A
Malta	A	A3	A	BBB+	A3	A	A-	A2	A+
Lituania	A	A3	A	A-	Baa1	A-	A+	A2	A
Latvia	A-	A2	A-	A-	Baa1	A-	A+	A3	A-
Cyprus	A	A2	A+	B+	B3	B-	BBB	Ba1	BBB-
Greece	A	A1	A	B	Caa1	B	BB+	Ba3	BB

Sources : Standard & Poor's, Moody's, Fitch, and Trading Economics.

## Stock of euro area sovereign debt securities, 1999-2021 (USD trillions)



## The European debate on creating a common safe asset

- It has been driven by considerations other than the IRoE, notably:
  - Reducing the banks-sovereigns nexus by limiting the home bias in banks' portfolios, which had exacerbated the EA crisis (the “doom loop”).
  - Fostering financial integration and risk-sharing.
- There has been a proliferation of safe assets proposals since 2009, with intriguing names (ESBies, SBBS, E-bonds, Blue Bonds...).
- The debate has moved overtime, reflecting political feasibility considerations, from proposals involving debt mutualisation to some that do not. (1)
- But none of them has been adopted and this debate is currently relatively dormant.

## Estimated Impact of Selected Common Safe Asset Proposals on the Supply of Safe Assets

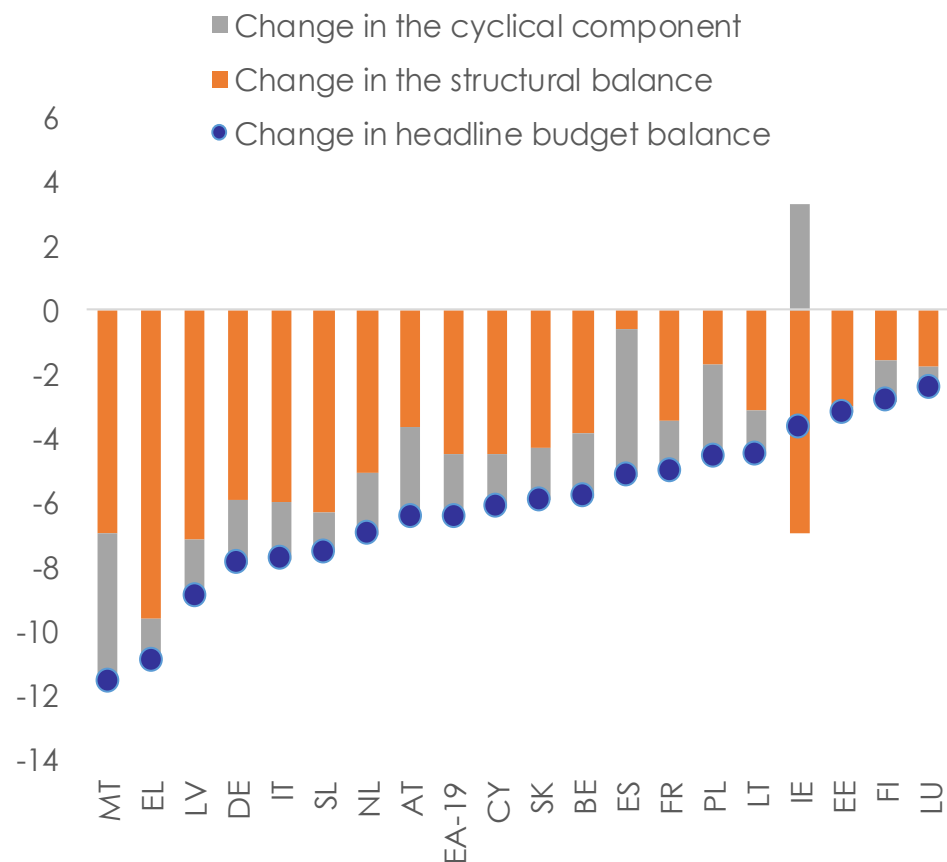
Proposal	Authors	Volume of safe assets issued		
		% of GDP	EUR trillions (based on 2021 GDP)	% of euro area public debt (2021)
Blue Bonds	Delpla and Weizsäcker (2010)	60%	7.3	60%
Redemption Fund	German Council of Economic Experts (2011)	40%	4.9	40%
E-bonds	Giudice et al. (2019)	15%-30%	1.8-3.7	15%-30%
E-Bonds	Leandro and Zettelmeyer (2019)	19%-21%	2.3-2.5	19%-21%
SBBS	European Commission (2018)	13%	1.6	13%
SBBS	Leandro and Zettelmeyer (2019)	6%-21%	0.7-2.6	6%-21%

Sources: Authors of the proposals and estimates.

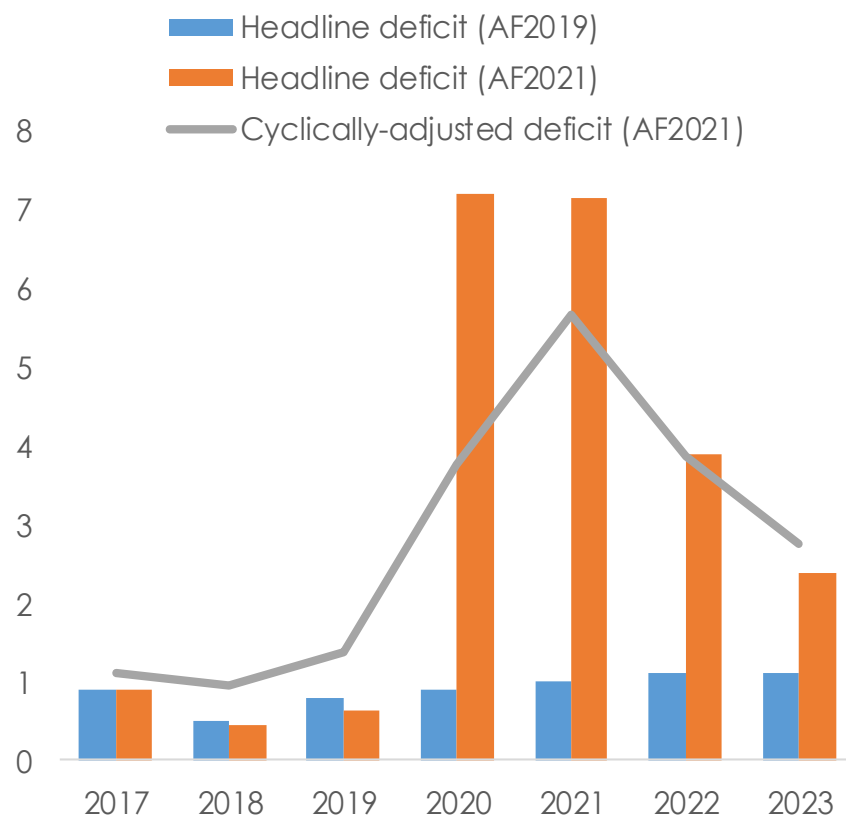
# The EU's response to the COVID-19 crisis

- **The fiscal response at national level.**
- **The new financial facilities (NGEU, SURE, MFA, ESM's Pandemic Crisis Support, EIB's Pan-European Guarantee Fund).**
- **Issuance of green bonds.**
- **The ECB's response (PEPP, swap and repo agreements with non-EA central banks).**

## Fiscal response to COVID-19 crisis, 2020-2021 (% of GDP)



## General government deficit, euro area (% of GDP)

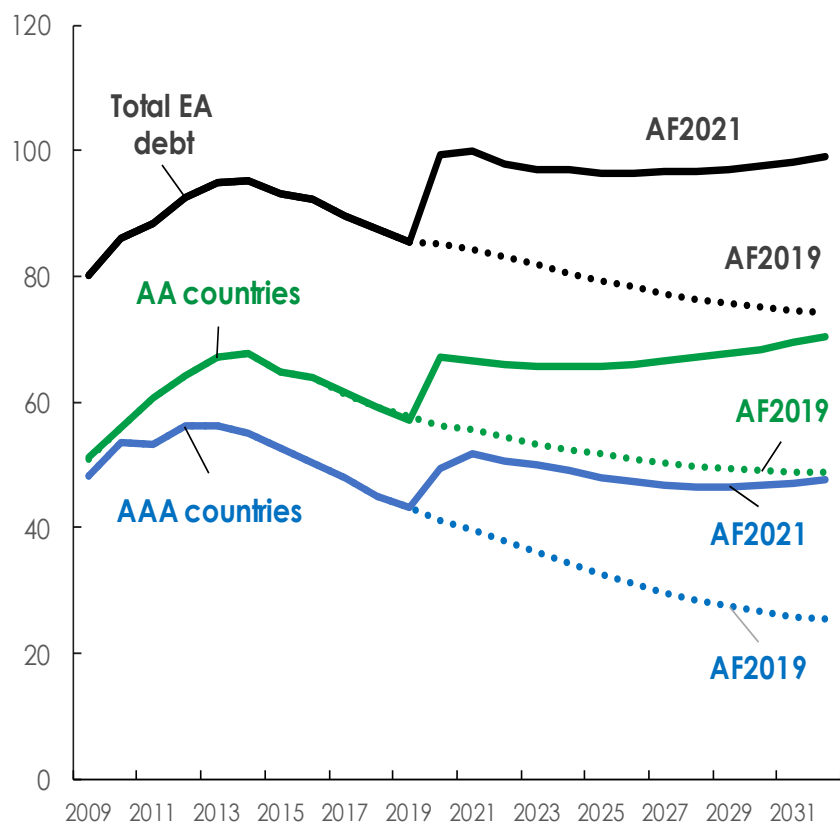


Source: EC, Autumn 2021 forecasts.

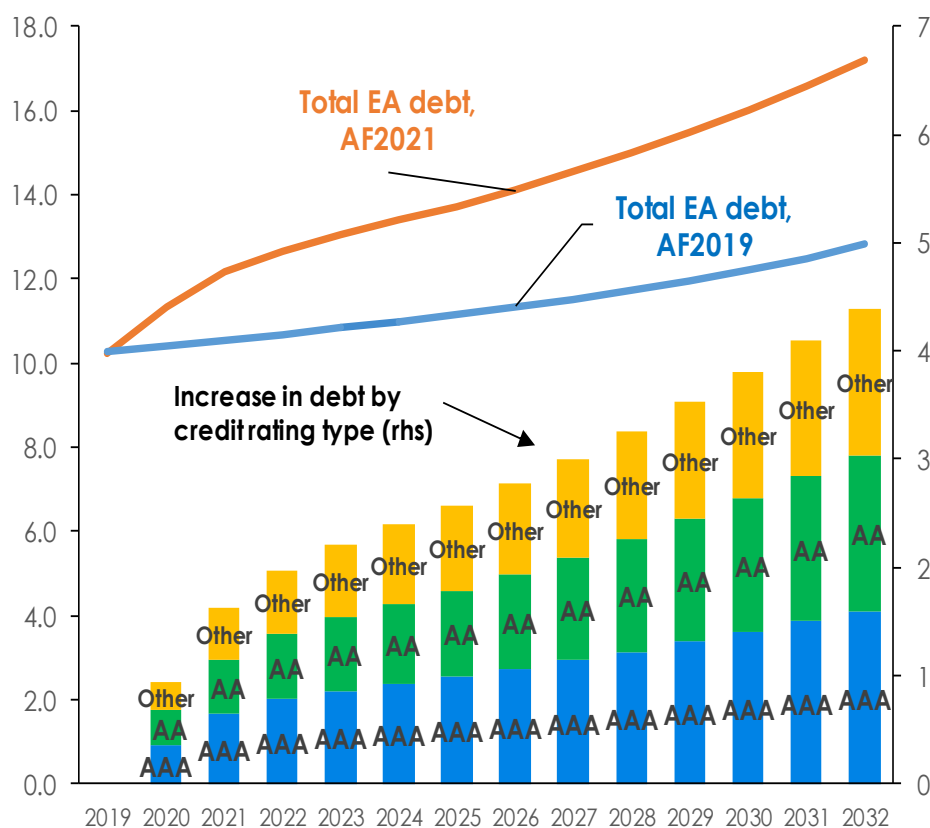
Sources: EC, Autumn 2019 and Autumn 2021 forecasts

## Trends in euro area public debt prior to and after the pandemic

In percent of GDP



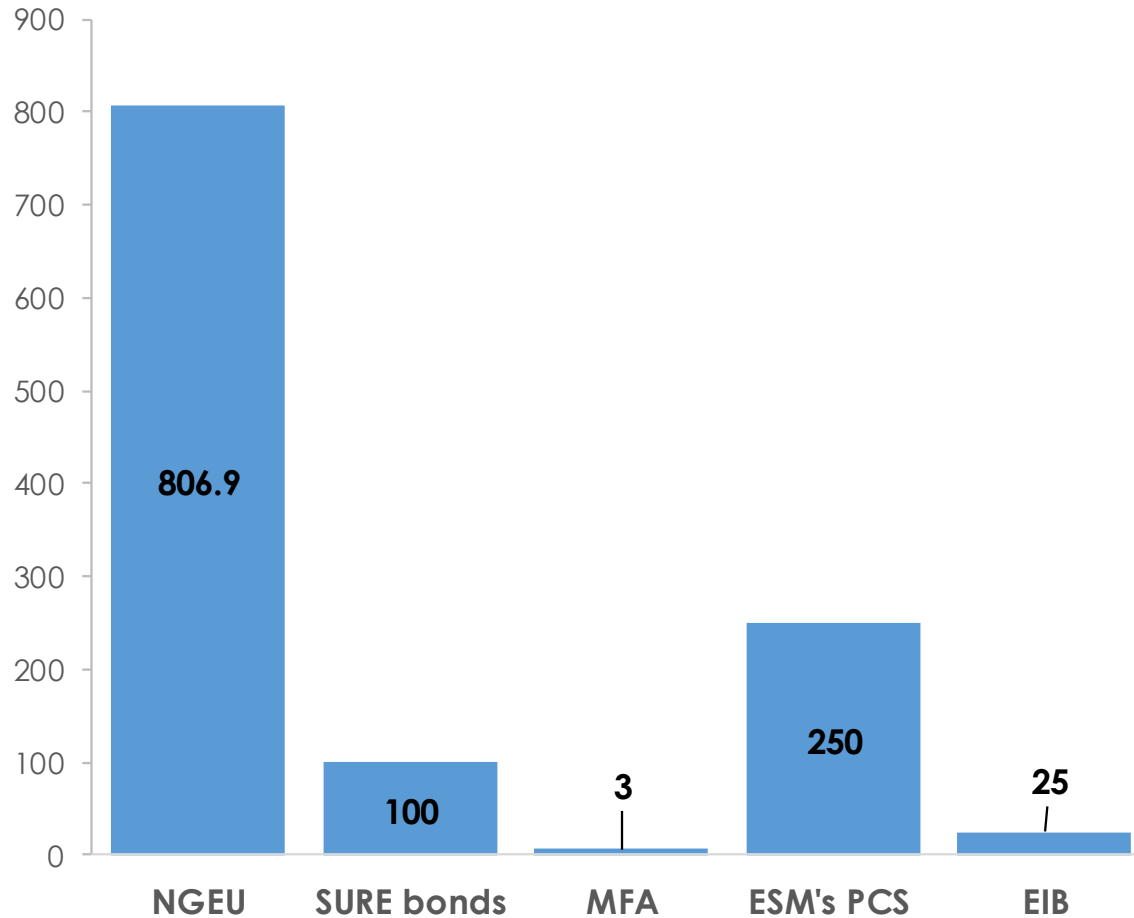
In EUR trillions



Sources: European Commission (Autumn 2019 and Autumn 2021 Forecasts and medium term fiscal projections; Standard & Poor's.



## Potential issuance under pandemic-related facilities (EUR billions)



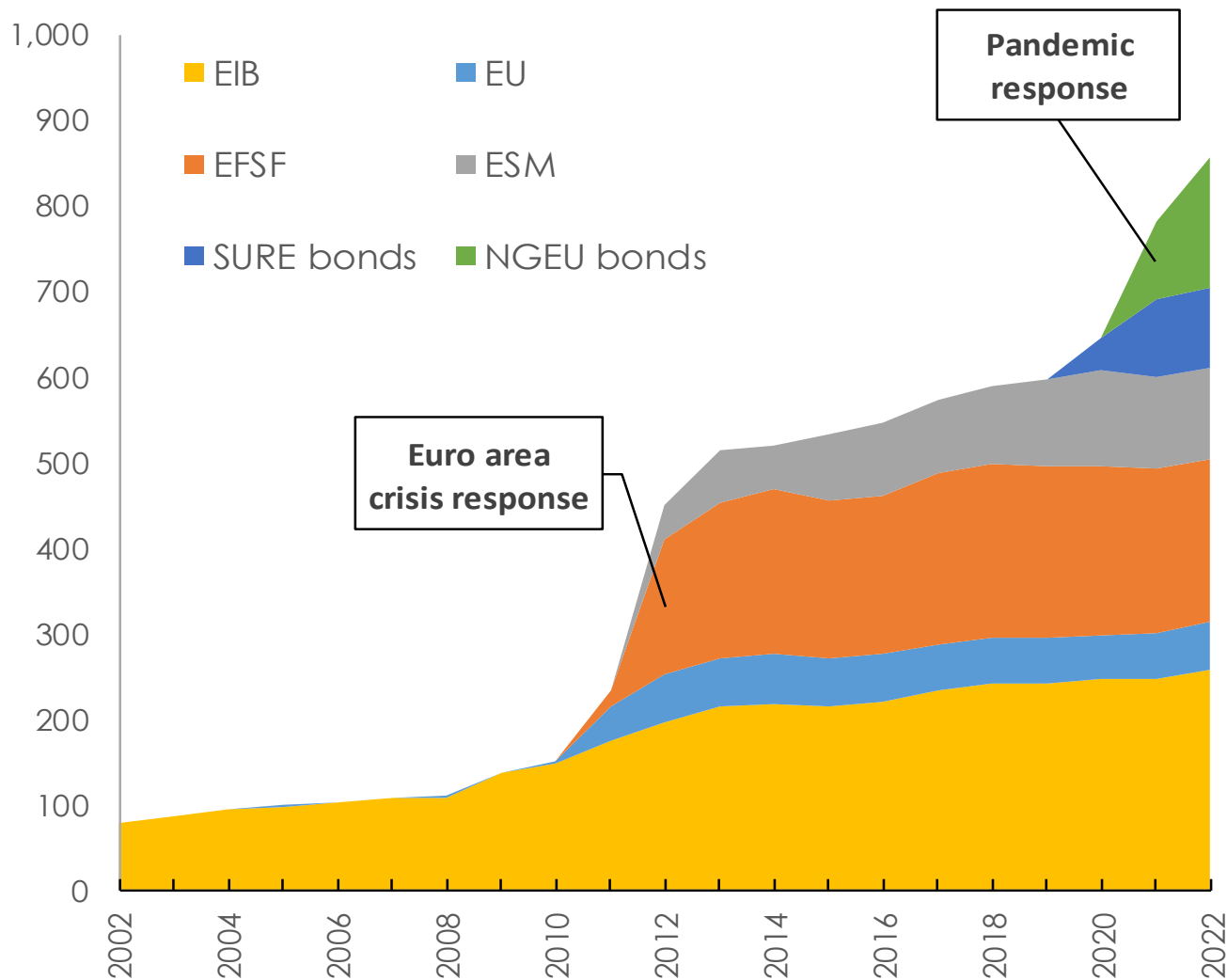
Sources : European Commission, ESM and EIB.



## The New Generation EU (NGEU) Instrument

- Commission empowered to borrow up to EUR 806.9 bn at current prices between 2021 and 2026.
- At least 30% of this amount in the form of green bonds.
- The bulk of the funds (EUR 724 bn) will go to finance the RRF to support reforms and investment identified in National RRPs (focus on green and digital transitions).
- Funds can be borrowed both in bond market and through issuance of short term bills.
- Disbursed through loans + grants. Loans to be fully repaid by 2058.
- Guaranteed by EU Budget Headroom and new “own resources” for the EU Budget.\*

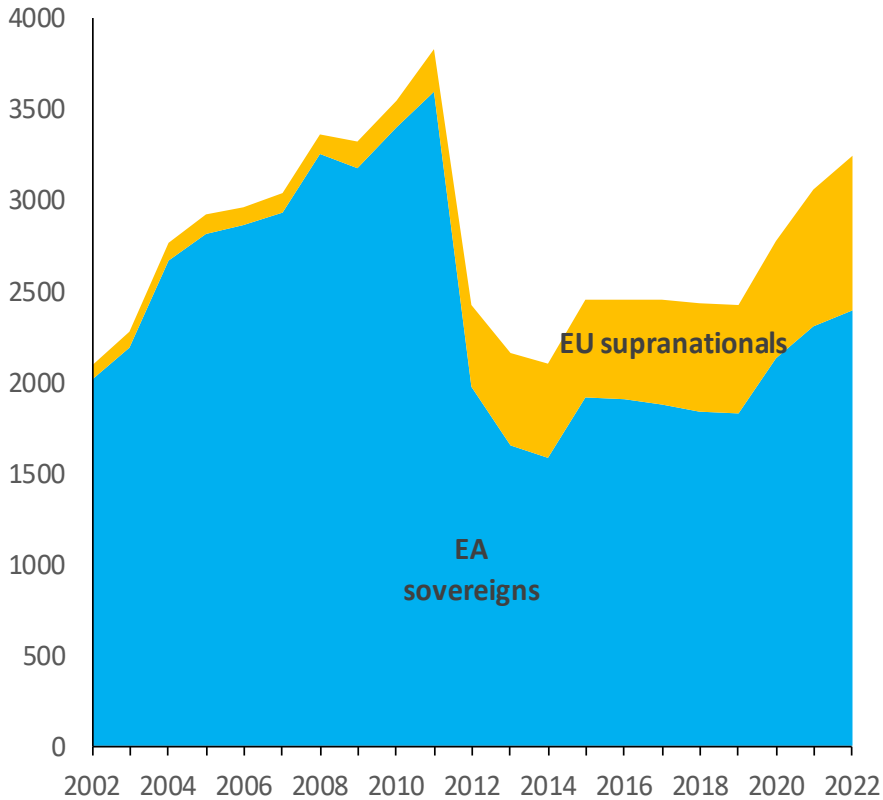
## EU supranational debt denominated in euro (EUR billions, end-of-year stocks)



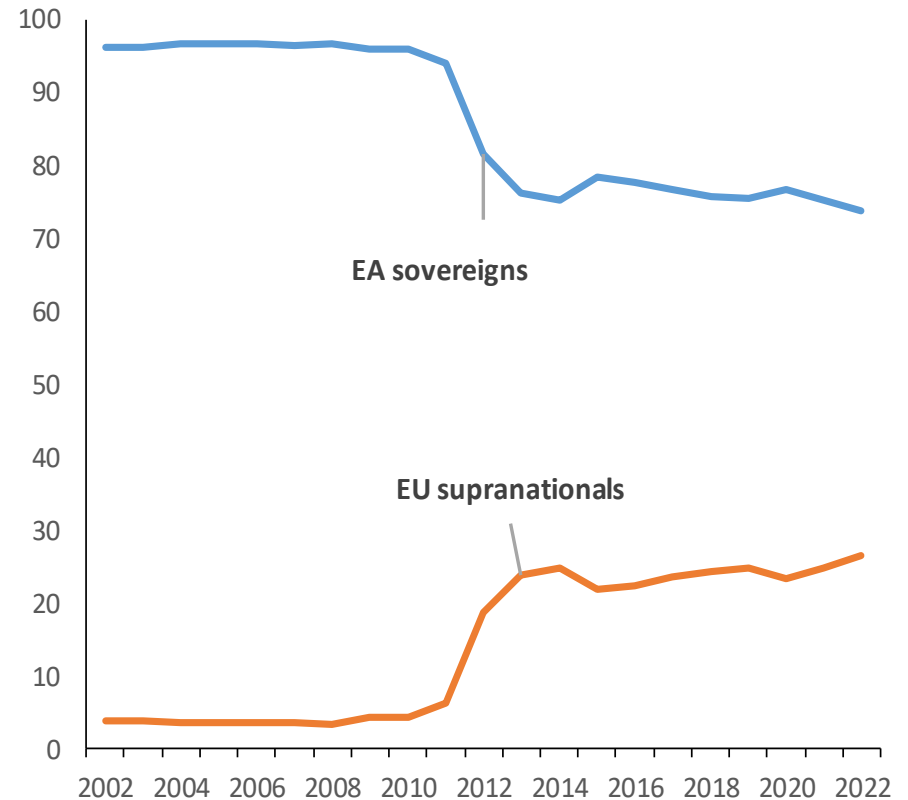
Sources: European Commission, ESM, EIB and authors calculations.

# Sovereign versus supranational safe assets in euros, 2002-2022

## Stocks in EUR billions



## In percent of stocks of euro-based safe assets



Sources : European Commission, ESM and EIB.

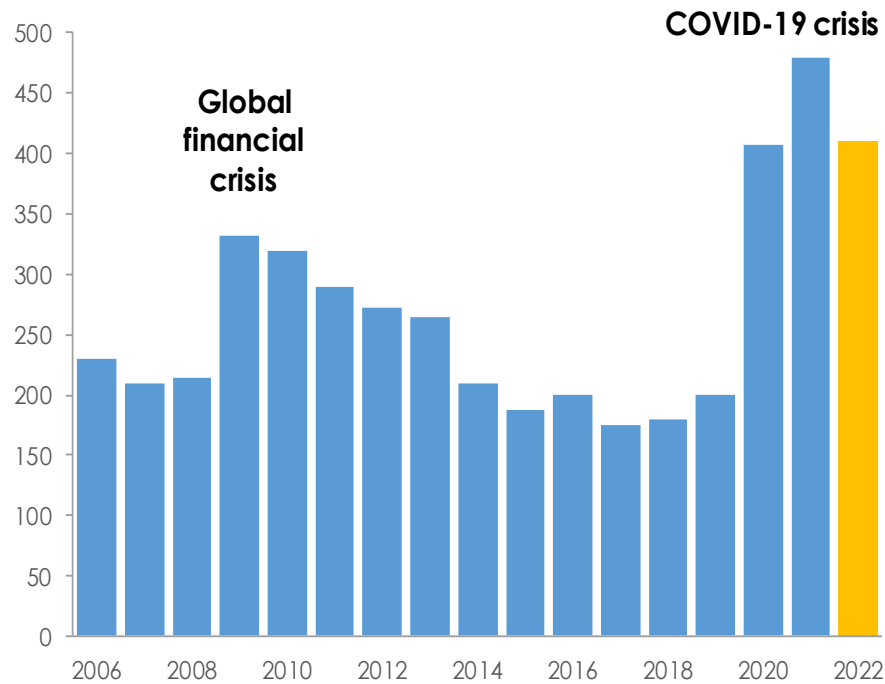
## How big are the NGEU and SURE programmes?

(in EUR billions and in percent; outstanding stocks at end-2019)

Indicator	Stocks EUR billions	Share of NGEU + SURE (EUR 906.9 bn)
<b>Euro area safe assets</b>	2427	37.4 %
AAA sovereign bonds	1829	49.6 %
Supranational bonds	598	151.6 %
<b>Triple A bonds issued by other G-7 sovereigns</b>	18709	4.8 %
<b>International debt securities</b>		
Narrow definition	14073	6.4 %
of which: denominated in euros	3060	29.6 %
BIS' broad measure	22128	4.1 %
of which: denominated in euros	8386	10.8 %
<b>Global official foreign exchange reserves</b>	10528	8.6 %
of which: allocated and in euros	2029	44.7 %

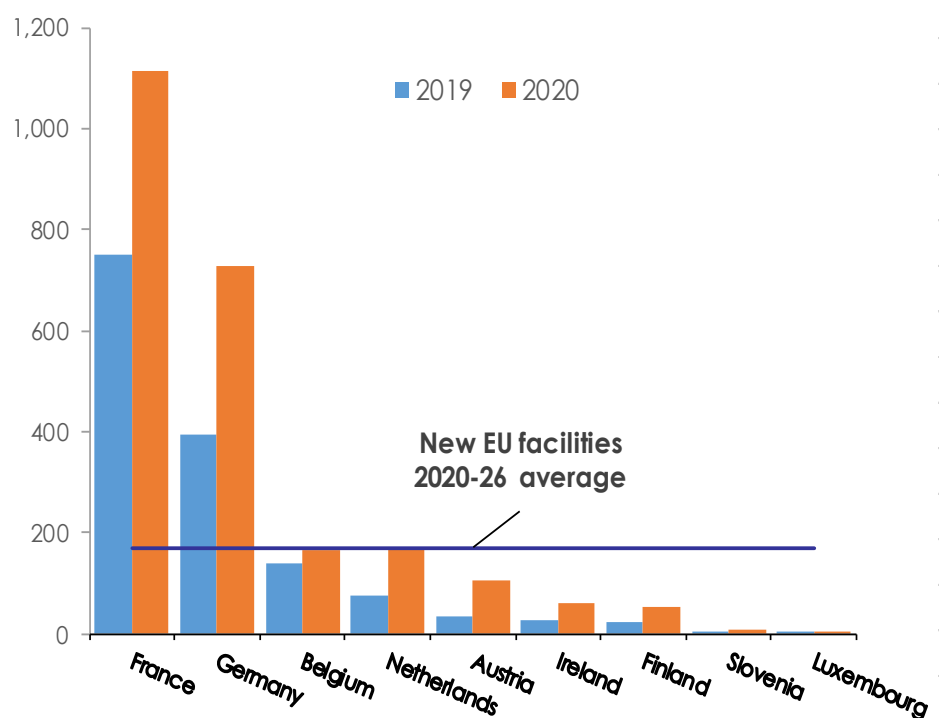
Sources : European Commission, BIS, Eurostat, ECB, IMF, and author's calculations.

## Gross issuance by German federal government (EUR billions)



Source : Germany's Finance Agency.

## Gross issuance by AAA/AA euro area governments (EUR billions, annual issuance by the general government)



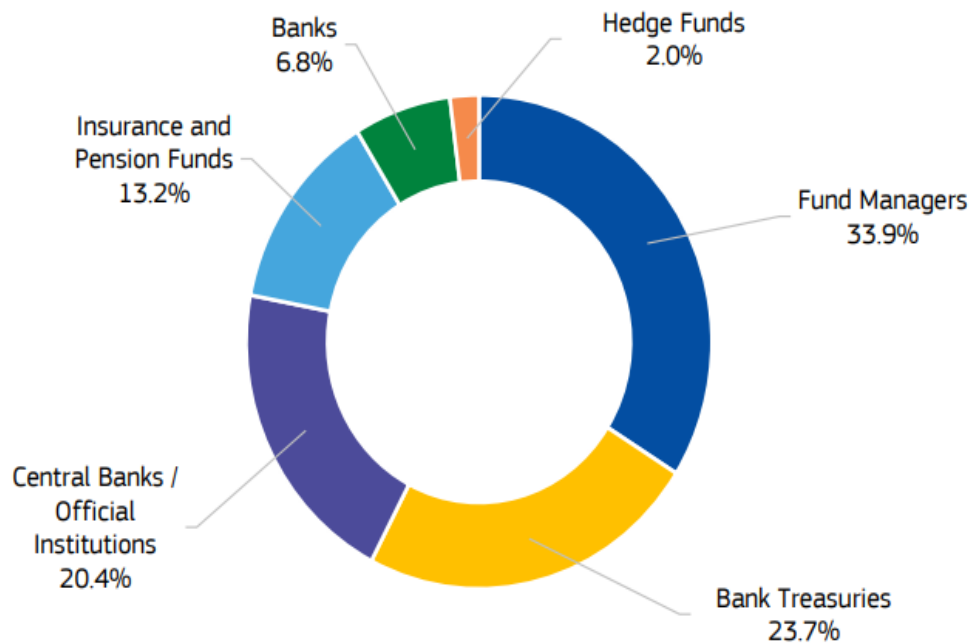
Source : ECB.

## Implementation of NGEU and SURE: an enthusiastic reception by the markets

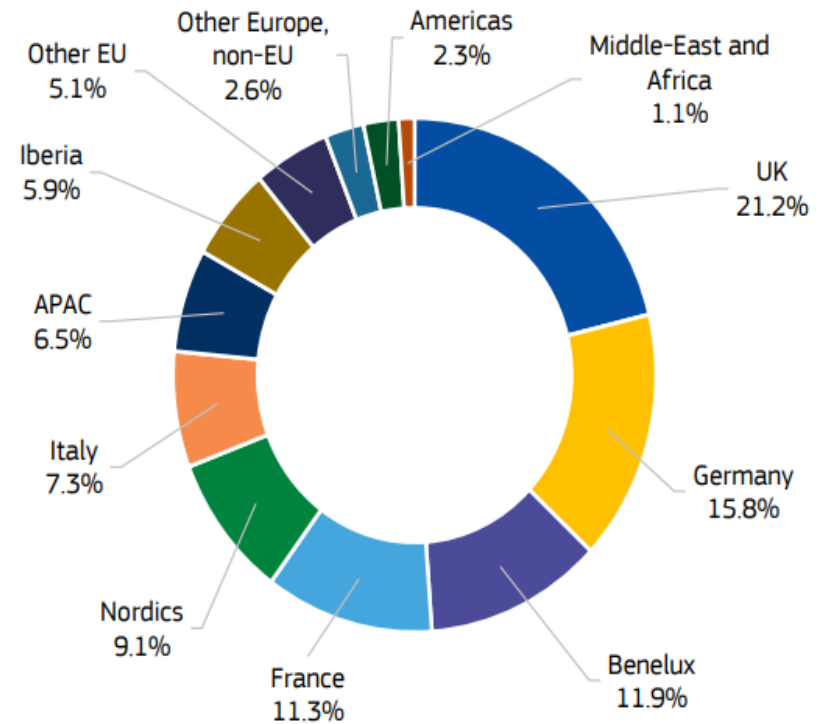
- By end-2022, the outstanding stock of bonds and bills issued under the NGEU and SURE facilities had reached EUR 350 bn. If we add the issuance for MFA+ operations for Ukraine, all of which are integrated since 2023 under the so-called EU's Unified Funding Approach, the stock had risen to **EUR 462 bn by mid-August 2023**.
- Some issues have been vastly oversubscribed, with several bond market records having been broken.
- NGEU and SURE bonds have been trading at spreads over German bunds lower than those of previously issued EU supranational bonds.
- International investors have shown strong interest, suggesting the existence of substantial latent global demand for safe assets in euros.

## A Diversified Investor Base (EU Bond Syndications, January 2020 - June 2023)

**Investor distribution by investor type**



**Investor distribution by country / region**



Source : European Commission

## The EC's debt issuance strategy has been overhauled

- The good reception by foreign investors is partly explained by the increased liquidity and tradability of the new bonds (evidence of lower bid-ask spreads: Monteiro, 2022).
- Far-reaching changes in the EC's debt management strategy are increasing liquidity and predictability (decoupling lending from borrowing operations, publication of issuance calendars, development of a full benchmark yield curve and a network of primary dealers).\*
- The positive implications of the new facilities for the IROE are, therefore, not limited to their impact on the volume of safe assets issued in euros. As significant is the fact that they are contributing to the modernisation of the EC's approach to debt issuance.



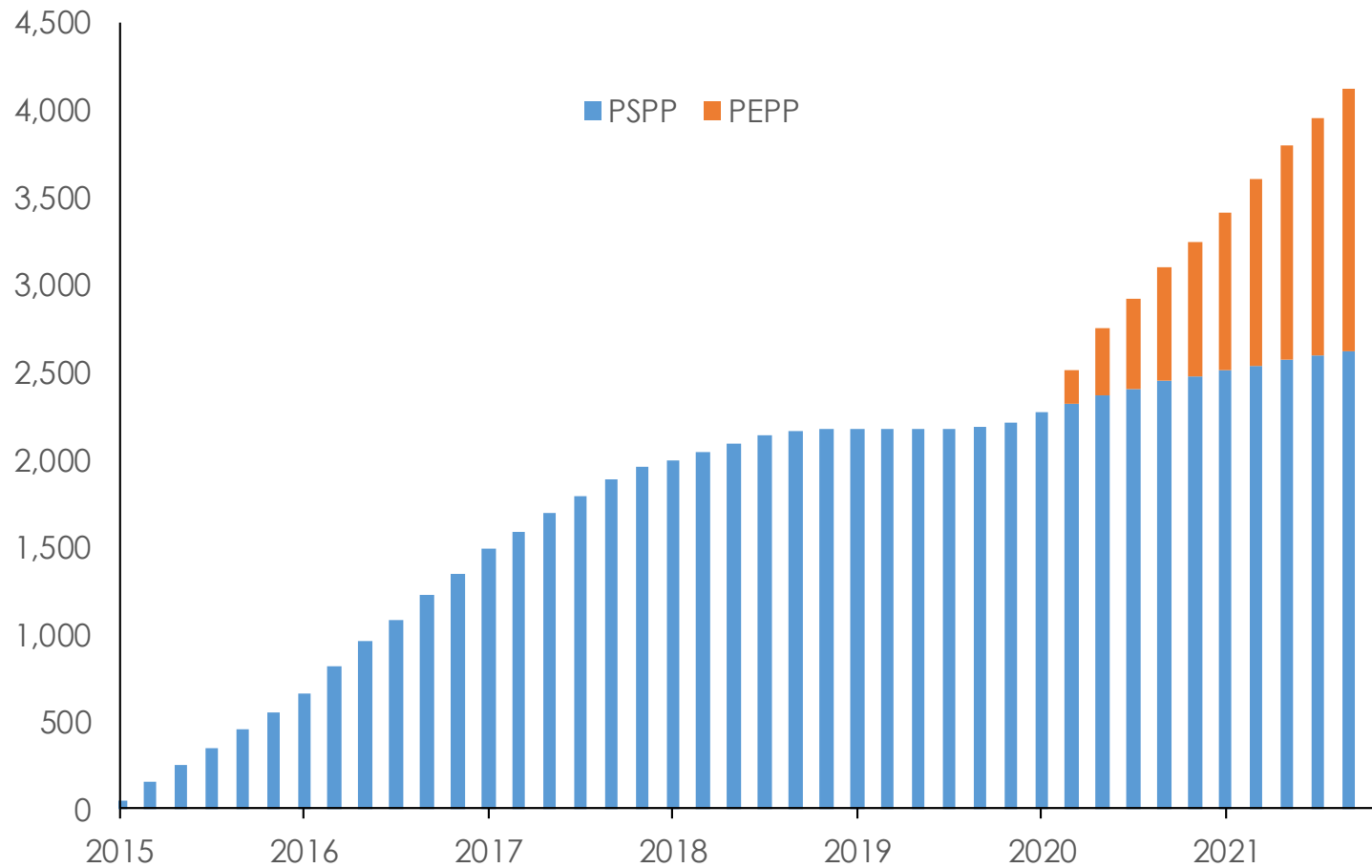
## The case of green bonds

- Although incumbency advantages favour USD, the emergence of new segments of the capital markets where the dollar's supremacy has not yet been established provide a window of opportunity for the euro (or other currencies) to strengthen its international role.
- The green bond market, where euro already played leading role, is a case in point.
- Moreover, 30% of NGEU to be raised through green bonds. By mid-August 2023, EUR 44.2 bn of green bonds had been issued, including largest ever green bond (EUR 12 bn, October 2021).
- Supported also by EU's leading international regulatory role in green finance (Taxonomy, Green Bond Standard) and the RRF Regulation.\*

## A less optimistic view

- The NGEU and SURE **facilities are temporary** (the SURE programme has been completed and NGEU net issuance must end by 2026, though refinancing will continue and bonds can be traded until 2058). \*
- **Actual issuance may fall short of maximum available amounts** for lack of interest (for example, the ESM PCS facility has never been used) or weak reform implementation (RRF).
- The increased supply of safe bonds via the NGEU and SURE instruments has been partly offset by the **ECB through its asset purchase programmes** (PEPP, PSPP). This has diminished the stock of safe bonds available to the market, including international investors, thus limiting impact on the euro's global role (Eichengreen and Gros, 2020).

## Cumulative purchases of public securities under the PSPP and PEPP (EUR billions)



## **Four developments that may support the IROE in the future**

1. The unwinding of the ECB's purchases under the PEPP/PSPP.\*
2. Financing needs created by the war in Ukraine.
3. Possible upgrades of euro area treasuries boosting the supply of national public safe assets in euro
4. Ongoing changes in the world economy, financial technology and the geopolitical environment.

# 1. Unwinding of ECB purchases under PEPP/PSPP

- The unwinding, under the current inflationary environment, of previous purchases under the PEPP/PSPP, will increase the amount of safe assets in euro available to the market.
- In March 2022, the Eurosystem discontinued net asset purchases under the PEPP and in July 2022 under all APPs, including the PSPP. But it continued to reinvest redemptions fully until February 2023 and partially until June 2023. In July 2023, it discontinued all reinvestments.
- The stock of public sector assets in euro held by the Eurosystem has therefore been declining since March 2023, as assets mature.

## 2. Implications of the war in Ukraine

- The war in Ukraine is likely to further boost the supply of EU supranational assets to finance **stabilisation and reconstruction**, as well as support for refugees, security and energy sector reform.
- The latest **needs assessment**, based on the reconstruction and recovery needs estimated as of 24 February 2023 (1), puts the costs at USD411 bn (EUR 383 bn), or almost 2 times Ukraine's GDP. And these needs are growing by the day, particularly as Russia increasingly targets civilian infrastructure.
- In response, the EU has adopted unprecedented packages of **Macro-Financial Assistance** loans – of more than €7 bn in 2022 and up to €18 bn in 2023 – to help cover Ukraine's short-term funding needs.
- And in June 2023, the European Commission proposed the creation of a “**Ukraine Facility**,” amounting to EUR 50 bn for 2024-2027, to address Ukraine's stabilization and reconstruction needs, while supporting reforms to accompany the country's European path.(2) This facility will entail the issuance of euro-denominated bonds

## 2. Implications of the war in Ukraine (c'td)

- However, an increase in supranational issuance to support Ukraine is unlikely to remedy, on its own, the scarcity of euro-denominated safe assets. Although Ukraine's financing needs are, as noted, very large in terms of its GDP, their potential implications for the issuance of EU supranational bonds **should not be exaggerated**.
- Only a **larger EU financial initiative**, perhaps aimed at dealing with the economic fallout of the energy crisis provoked by the war in Ukraine, or at ramping up EU defence expenditure, might require the issuance of bonds at an order of magnitude comparable to NGEU, but such initiatives are not currently on the table. (1)
- It is too early to tell, but it all points towards a new important source of common euro-based safe assets, which bodes well for the IRoE, although not as large as the NGEU/SURE instruments.

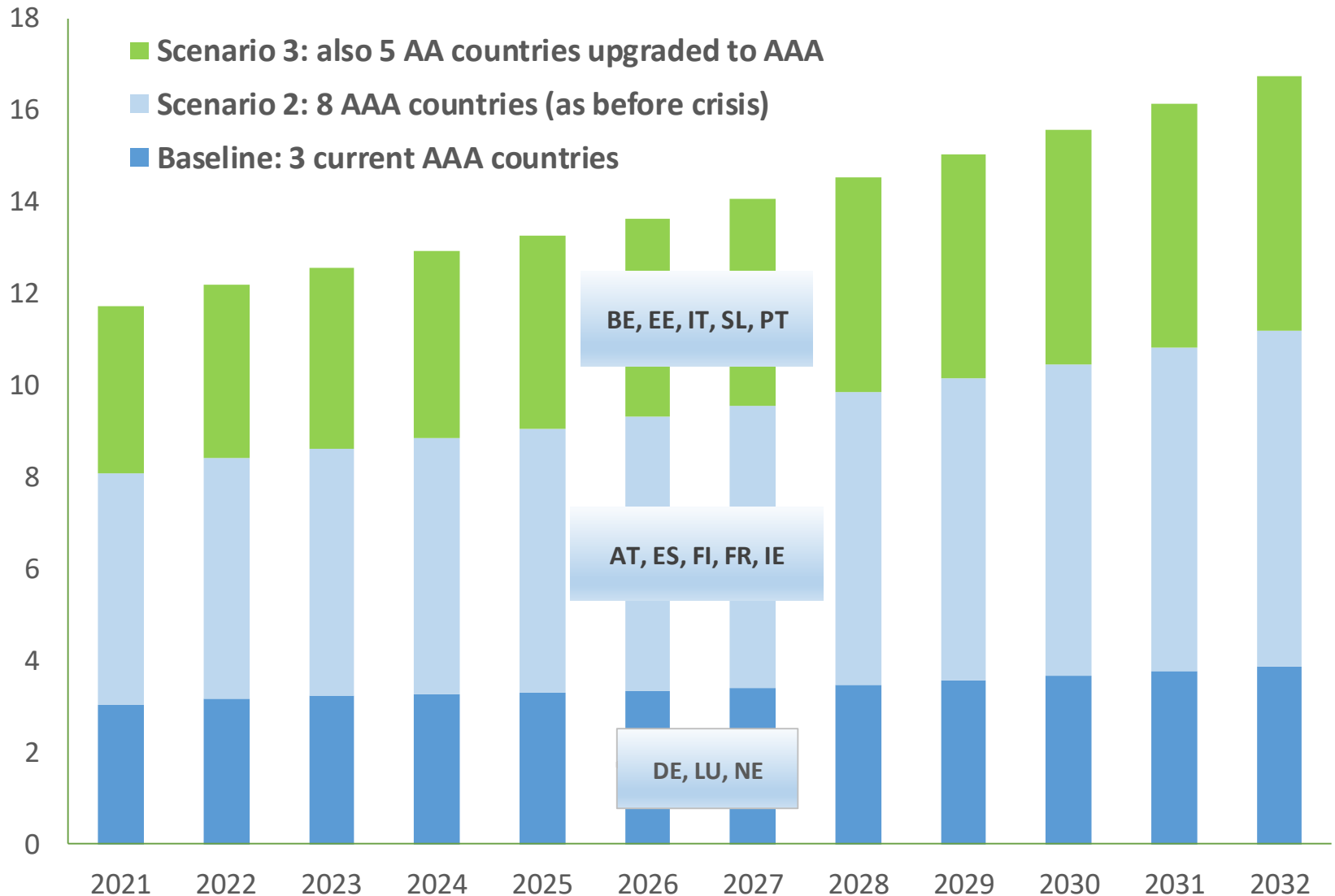
### 3. Possible upgrades in EU sovereign ratings \*

- Much of the decline in EU (and global) safe assets since the GFS was caused, as noted, by the downgrade of EA sovereigns.
- Should some of these countries manage to restore their AAA credit ratings in the coming years, this could boost national safe assets in euro.
- The upgrade to AAA of at least some of the EA treasuries currently rated AA could produce substantially more safe assets than most common safe asset proposals and that the NGEU/SURE facilities (Papadia and Temprano-Arroyo, 2022; next slide). (1)



# Supply of euro area sovereign safe assets under different rating scenarios

(In EUR trillions; end-of-year)



Source : Papadia and Temprano-Arroyo (2022)

## 4. Structural changes and geopolitics

- Ongoing structural changes in the world economy, financial technology and the geopolitical environment create a more propitious context for the EU's new facilities and a proactive strategy on the IROE to make a difference.
- They make it more plausible that the world will move towards a true multi-polar currency system (“new view on international currencies”).

## Conclusions

- While the NGEU and other programmes are boosting the stock of supranational safe bonds in euro and contributing to the modernisation of the EC's debt issuance strategy, they are unlikely to act, on their own, as a real game changer for the IRoE.\*
- But some developments are likely to support the IRoE in the future:
  - ✓ First, the unwinding of the ECB's APPs, EU bond issuance related to the war in Ukraine and its ramifications, and possible upgrades of euro area sovereign issuers might further increase the supply of euro-denominated safe assets, partly compensating for the phasing out of the NGEU and SURE facilities.
  - ✓ Second, structural changes in the world economy, including financial technology, and geopolitical factors might facilitate the transition to a multi-polar currency system.