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How to make EU bonds a safe(r) European asset

Moritz Kraemer

Summary

If the European Commission's proposal for a €750bn recovery fund is approved by member states, the EU would become the biggest supranational issuer in the world. To uphold the EU's extremely high creditworthiness under a massively enhanced borrowing envelope, the Commission proposes that member states transfer up to 0.6% of GNI to the EU budget per year until 2058, when the last bonds would be repaid. This amount will exceed the EU's plausible annual debt service costs. But member states' pledges of future transfers to the EU budget are effectively unenforceable promises.

An EU break-up scenario may appear unlikely today, but so did Brexit a decade ago. A deeper political crisis within the EU could lead to promised payments being withheld, immediately jeopardising the EU's timely debt service. If the bonds are to be rated AAA, the probability of such an adverse turn of events must be almost zero. It is difficult to make this assertion with confidence decades into the future. Investor doubts about the EU's long-term survival, however exaggerated they might be, could lead to higher than necessary funding costs, which will have to be borne by European taxpayers.

To remove all doubt, member states should provide more robust financial support. The most straightforward form would be unconditional guarantees with cross-default clauses (as in the cases of the EFSF or the SURE programme); providing the EU with a capital cushion (as in the cases of the EIB and ESM); granting the EU a stable and meaningful own-resource tax base, in line with the Commission recommendations, or providing collateral in the form of government bonds to guarantee the EU's debt service on a rolling basis.

Moritz Kraemer is Chief Economic Advisor at Acreditus and teaches at Frankfurt University and the Centre International de Formation Européenne.
Until 2018 he was sovereign Global Chief Rating Officer at S&P Global.

1. Introduction

If the European Commission gets its way, the EU will soon enter the capital market at the deep end. For the first time the EU will borrow large amounts under its own name. If approved by member states, the EU will raise €750 billion of unsecured bonds to finance the Next Generation EU recovery fund. Some €500 billion of the receipts will be used to fund grants to member states hit particularly hard by the pandemic. The remaining €250 billion will be on-lent to member states, which will be responsible for paying them back to the EU (European Commission, 2020a). Nevertheless, all EU members will be collectively responsible for making sure the EU always has sufficient resources to secure the debt service on its bond programme.

The final contours of the recovery fund are still under discussion. A decision is possible at the Council summit on 17-18 July 2020. It is conceivable that the final envelope of the EU's borrowing capacity will be reduced, maybe back to €500bn, which was the original proposal put forward by Chancellor Merkel and President Macron. It is also possible that the share of grants will be reduced, and more funds will be on-lent as loans rather than handed out as grants. This is what the Netherlands and its 'frugal four' allies appear to be pushing for. The proposed formula to distribute the funds across countries is also still to play for.

Whatever the final agreement, one thing seems certain: the EU's presence on the capital markets will surge. It is set to become the biggest multilateral issuer globally. That monumental shift from dwarf to giant calls for a reassessment of the factors underpinning the EU's creditworthiness. With the stakes growing commensurately with the increased liabilities it is opportune to ask what could be done to strengthen the EU's creditworthiness in a financially and politically sustainable way.

The first section of this paper describes the EU's so far limited exposure to capital markets. The second lays out the factors that have underpinned the EU's extremely high creditworthiness until now, investigating whether those supporting factors will be sufficient to uphold the EU's strong credit credentials under a dramatically enlarged issuance environment. The third section will underline why the unconditional financial support of the most highly rated member states is particularly critical for the EU's own creditworthiness. The fourth and final section offers recommendations to make EU bonds safer and the institution a more resilient issuer.

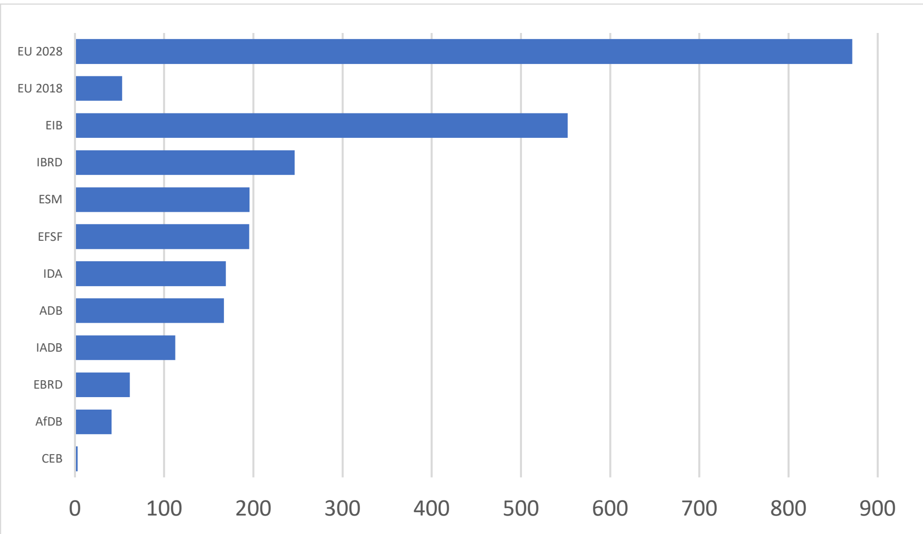
2. A short history of the EU in the capital market

The EU has issued bonds ever since the mid-1970s when the Community Loans Mechanism (CLM) was implemented. It was introduced with a view to supporting the member countries most affected by the oil crisis, especially Italy (Horn, Meyer, & Trebesch, 2020). The loans were reimbursable by the borrowing countries and intended to alleviate balance of payments pressures. As such the CLM was effectively an alternative to IMF programmes. Member states guaranteed 200% of the credit limit (set at $3 billion in 1974). This was done to ensure that the CLM-bonds issued could be serviced even if the borrowing member defaulted and one or several guarantors were unable or unwilling to pay up. The funds raised and on-lent to member states in economic distress were significant: Italy received 1.7% of its GDP between 1974 and 1976, Ireland almost 4%. The CLM was later converted into the Balance of Payment Facility, which is now restricted to EU members outside the euro area (since its creation in 2012, the European Stability Mechanism, ESM, is now the institution of choice when lending to financially stressed euro area sovereigns). Under the Balance of Payments facility, the EU borrowed and on-lent during the financial crisis a total of €18 billion to Hungary, Latvia and Romania.

Until now, the receipts of every single EU bond issue have been on-lent back-to-back to member states (and to a limited extent to non-members through the Macro-Financial Assistance window). All bonds have therefore been secured by the repayment obligation of the borrowing member state. Over 90% of the EU's current exposure is to Portugal and Ireland. These loans were made in the context of the EFSM (European Financial Stability Mechanism), a €60bn facility introduced in 2010 to provide financial support to euro area governments with shaky or no market access. For that purpose, the EU issued €45 billion worth of bonds in 2011 and 2012. Since then, issuance volumes have dwindled to a trickle, to average some €3 billion annually. The EFSM has been superseded by the creation of the ESM. As of today, the EU has outstanding bonds of around €50 billion. For all intents and purposes, compared to the big fish multilateral lending institutions, the EU has been a minnow (see Figure 1).

If Brussels has its way, that is about to change, and in a big way. If fully implemented, the Next Generation recovery plan would increase the EU's financial obligations over fifteen-fold in the coming years (see Figure 1). It would be a bigger debtor than the European Investment Bank (EIB), which until now has been the most prolific supranational issuer globally. Two-thirds of EU-bond receipts will fund grants. For the first time, the EU would issue liabilities that are not secured by back-to-back loans to member states. Instead, EU debt servicing would be backed by the promises of all member states to provide sufficient resources.

Figure 1. Total assets (€ billion, 2019)



Source: own calculations, based on 2019 balance sheets of issuers.

3. The factors supporting the EU's creditworthiness

Credit ratings are a common and widely understood shorthand for creditworthiness. Currently, as an issuer, the European Union enjoys a top-notch AAA credit rating from Moody's, Fitch, DBRS and Scope. Standard & Poor's lowered the rating in two steps (2013 and 2016) to AA, both times coinciding with downgrades of sovereign member states, including that of France. While rating approaches differ somewhat across agencies, the S&P downgrades underscore the fact that the EU's own creditworthiness is ultimately tied to that of its members, especially the most highly rated ones. All agencies currently assign a stable outlook to their respective ratings. That is their way of indicating that they consider further downgrades unlikely during the next two to three years.

But will this constructive view survive contact with the new reality of massively ramped up EU-debt? Brussels thinks so. When releasing its recovery fund plan, the Commission confidently stated that this huge borrowing programme will be supported by its "very strong credit rating". The Commission's confidence may be well-placed: some rating agencies have already signalled that the EU's rating is unlikely to change under the larger borrowing envelope. Moody's stated that the recovery fund would have "limited credit impact" for the EU, as the larger debt burden would be offset by a commensurate increase in member state support. Moody's also makes the case that the creation of the Fund would be a strong signal regarding EU cohesion, presumably a credit positive (Moody's, 2020). Similarly, Fitch indicated that it considers the comfort of additional EU-budget resources sufficient to offset the risks of higher debt service outlays (Fitch Ratings, 2020). Earlier, Scope Ratings, the largest Europe-based rating agency stressed that it uses a mandate-driven approach to assessing supranationals. Scope therefore believes the recovery fund to be a "critical step in the right direction". In essence, Scope considers the EU AAA-rating to be resilient to a significant balance sheet increase (Scope Ratings, 2020).[1]

The EU's credit ratings have been underpinned by a similar set of factors at all agencies. Rating companies use discretion to weigh them differently; hence the split rating from S&P, for example. But fundamentally, they are all looking through similar lenses at the same picture. This section sets out the factors that have supported the EU's rating. It also raises the question whether those strengths may be diluted once the EU's ambitious plan becomes a reality. There have been several layers of protection safeguarding the EU's debt service capabilities.

Repayment of loans granted. The first line of defence for debt service has been the repayment by the sovereign member state to which the receipts had been on-lent. This credit support will be absent for the share of the EU bonds that will fund the grant component (up to €500 billion). The recipients of grants are by definition under no obligation to pay them back to the EU. This line of defence will therefore not hold in the future.

[1] Disclosure: the author is an Independent Non-Executive Director at Scope Ratings GmbH. This role does not involve any analytical work at the firm.

Budgetary flexibility. The EU has the flexibility to re-prioritise spending towards debt-servicing over all other programme expenditure. In the past this flexibility would have been used if a member state defaulted on its obligations to the EU. To date, no such default has ever occurred. Up until now the amounts on which a member state could have defaulted vis-a-vis the EU have been modest relative to the size of the EU budget. The average amount of existing EU debt maturing between 2022 and 2030 is €2.6 billion per year. This is dwarfed by the envelope of the current multiannual financial framework (MFF) 2014-21 of over €1 trillion. Reprioritising expenditure would have been sufficient under most plausible circumstance to cover the receipts shortfall caused by the member's default. With average debt redemptions increasing tenfold post-2028, budgetary flexibility will be greatly diminished when serving as a meaningful defence to underpin EU debt service payments. Dependence on extraordinary member support will therefore become even more important.

Own resources. The EU's so-called own resources are somewhat of a misnomer. The largest part of those revenue streams are member states' transfers based on the size of their economies and a share of their value-added-tax receipts. The EU 'owns' them insofar as member states have committed to making those contributions in the binding MFF agreements.

To always ensure sufficient repayment capacity, the Commission proposes to increase the own-resources ceiling – the maximum amount the Commission can request from member states to finance EU expenditure – to 2% of gross national income (GNI). Between 2028 and 2058 an amount equivalent to 0.6% of GNI will be reserved exclusively for the debt service of securities issued to finance the Recovery Fund's operations (European Commission, 2020c). Based on an estimate of 2028 GDP of the EU27 of €16.3trn (25% above 2020 level), 0.6% would amount to almost €100 billion. Assuming an EU27 average nominal growth rate of 2.5% per year thereafter, this amount will roughly double to be close to €200 billion in 2058. The proposed regulation on the EU own resource system also includes an annual debt repayment limit of 7.5% of the debt (Art. 3b(2) of (European Commission, 2020b)), which translates into a maximum €56 billion annually. A linear amortisation schedule would result in a much lower €24 billion per year (still a tenfold increase from the status quo), of which €16 billion would account for the portion that will have funded non-reimbursable grants. Hence, under the EC proposal, the annual debt repayments would be comfortably covered by member states' promises of increased budgetary contributions in the future.

Even so, financial indicators of the EU as an issuer would weaken compared to the status quo. The EU holds no equity as traditional multilateral lenders do. Equity is a buffer that protects creditors from deterioration in an issuer's credit portfolio. The only other relevant institution without a meaningful capital cushion is the European Financial Stability Facility (EFSF, see Table 1, last column, from (S&P, 2019)). However, the EFSF benefits from explicit, unconditional and timely guarantees. Members' guarantees for the EFSF have a cross-default link. If the payment under guarantee is refused, the guarantor itself would be placed in default by rating agencies. That acts as a strong incentive to honour the guarantee and makes them effectively self-enforcing. The EU does not benefit from comparably strong financial support. It can count on large, but less binding future budget commitments, as described above. Not making good on such commitments does not constitute a member state default under prevailing default definitions. It would therefore be less financially damaging to the supporting government.

The EU's liquidity position would also weaken when its borrowing programme is rolled out. We can consider the so-called fiscal headroom as the EU's main liquidity buffer. The EU budget has always been designed with a safety margin. The fiscal headroom is the difference between the own resource ceiling (the maximum amount for which member states are on the hook) and the expenditures appropriated in adopted budgets. The fiscal headroom can be used to ensure timely debt service and is akin to callable capital in multilateral lending institutions like the EIB. Should it become necessary (which has never happened), the EU can demand that member states pay up to the resource ceiling to secure debt service. In 2020 the fiscal headroom stands at 0.19% of GNI (European Parliament, 2020). This is equivalent to 59% of the EU's outstanding debt (see Table 1, penultimate column).

Table 1. The EU and its multilateral peers: key financial ratios

The EU and its multilateral peers: key financial ratios

	Institution	Rating Moody's	Rating S&P	Total Assets 2019 (€ bn)	Liquid assets/gross debt (%)	Shareholder equity/assets (%)
	EU 2018	Aaa	AA	53	57%	0,0%
	EU 2028 (0,6% of GNI headroom, current proposal)	tbd	tbd	872	13%	0,0%
	EU 2028 (0,4% of GNI headroom, hypothetical)	tbd	tbd	872	9%	0,0%
EIB	European Investment Bank	Aaa	AAA	554	22%	12,8%
IBRD	World Bank (IBRD)	Aaa	AAA	246	36%	14,9%
ESM	European Stability Mechanism	Aaa	N.R.	196	59%	42,4%
EFSF	European Financial Stability Facility*	Aa1	AA	195	5%	0,4%
ADB	Asian Development Bank	Aaa	AAA	193	35%	26,6%
IDA	World Bank (IDA)	Aaa	AAA	169	323%	86,4%
IADB	Inter-American Development Bank	Aaa	AAA	119	36%	25,4%
EBRD	European Bank for Reconstruction and Development	Aaa	AAA	68	71%	26,3%
AfDB	African Development Bank	Aaa	AAA	41	52%	21,3%
CEB	Council of Europe Development Bank	Aa1	AAA	3	42%	12,4%

Note: Data for all peers is for 2018 except for total assets (2019). "Liquid assets" for EU 2018 is equivalent to the difference between own resource ceiling and total payment appropriations. "Liquid assets" for EU 2028 is equivalent to 0,6% of EU27 GNI (as per Commission proposal for a Council decision on the system of Own Resources of the European Union, Article 3c), or a lower 0.4% in a hypothetical compromise scenario). Liquidity for peers does not include callable capital. If it did, the ratio would increase very significantly for most peers.

Assumption: EU27 GDP in 2028 €13.4 tr (25% above 2020 level) and equalized with GNI.

EU 2028 assumes full usage of borrowing for SURE (€100 billion) and EU Next Generation (€750 billion) and a technical assumption that all EU bonds maturing through 2028 (€31.5 bn) will be retired.

* EFSF debt securities are backed by several (but not jointly), irrevocable, unconditional and timely guarantees by Euro area member

Sources: own calculations, Issuer financial reports, S&P Global "Supranationals Special Edition, Oct. 2019 for last two columns (2018 data)

From 2028 onwards the EU budget will, as described above, contain an earmarked annual 0.6% of GNI in commitments to cover service of the debt to be issued under the recovery programme. While this is a large increase from the current headroom, it is rising by less than the outstanding debt. The liquidity buffer would drop to 11% of gross debt in 2028, which is well below the liquidity cushions typically recorded for AAA-rated supranationals. Only the EFSF has a lower liquidity ratio, as it does not need much liquidity of its own: through the timely cross-default guarantees it can rely on drawing on the liquidity of member states themselves. As the debt will continuously fall through 2058 and the denominator (GNI) of the 0.6% ratio continues to rise, it is not implausible that member states will negotiate a lower ratio than 0.6% at some point in the future. Otherwise the annual earmarked amount in, say, 2038 (€125bn=6% of GNI of €20.8 tr) would exceed the average annual amortisation (€25bn) fivefold. That seems excessive by almost any measure. Renegotiation to set a lower contingent contribution in the future for purely political reasons is therefore a possibility. Should the proposed earmarked large contribution of 0.6% of GNI be reduced faster than the reduction of the outstanding debt it is meant to support, the liquidity position would come under additional pressure (see third line in table for an example of 0.4% of GNI earmarked headroom).

4. Member states' support promises are subject to imponderable political risks

In the light of more stretched financial indicators, the ability and willingness of highly creditworthy member states to support the EU budget will, more than ever, be the decisive factor backing the EU's own extremely high creditworthiness. In the EU's case this extraordinary support is particularly important: the EU is the only European multilateral institution issuing debt that does not enjoy either a cushion of paid-in capital, or explicit member state guarantees. Until now, those support mechanisms have never been necessary. The EU's borrowing was minor, and its existing financial flexibility was considered sufficient. Now its borrowing will become significant and financial flexibility more constrained. Without a capital buffer or legally enforceable guarantees, uninterrupted and unwavering AAA-member support will be more critical than ever.

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There is currently no reason to believe that highly rated member states would renege on any promises made. This constructive view is not materially tarnished by the fact that one of the largest net contributors, the UK, has now left the Union. Britain is believed to honour all financial obligations towards the EU that it has contracted during its membership (the so-called Brexit bill). Should other countries decide to leave the EU as well, it would be a fair assumption that those departing members would also stand by their legacy obligations. That includes the commitments that are about to be made now to support funding of the recovery programme.

Nevertheless, through negotiations over successive EU multiyear financial frameworks (MFF) net contributors have a track record of pushing back hard to minimise their own obligations towards the Union. Three of the five remaining EU AAA-members are part of the so-called frugal four (the Netherlands, Denmark and Sweden), with Austria at AA+ being the fourth. They have been looking at the Commission proposal with a distinct lack of enthusiasm. Germany has shown a more constructive approach lately and the more federalist inclination recently displayed by Berlin seems to be supported by the German public. Luxembourg, the remaining AAA member, is financially insignificant. These five are the countries that matter most for the EU's AAA rating.

Lasting trust in those member states' promises is pivotal for the pricing and rating of the approaching wave of EU bonds. Under the plan, paying up is an obligation under European law. But such obligations are effectively unenforceable. The sovereign is, well, sovereign. Remember Boris Johnson telling EU peers in 2017 to "go whistle" when confronted with Britain's obligation to pay the Brexit bill? Short of gunboat diplomacy, forcing a recalcitrant state to fulfil its promise is in practice impossible. That inevitably raises the question of how much store to put in commitments to add to future EU budgets. And since the promise to make good on funds to the EU budget do not carry a cross-default clause, as explicit guarantees would, members can renege on them almost with financial impunity. Brussels might secure a favourable ruling from the European Court of Justice. But nothing stops a sovereign from just shrugging it off and ignoring it.

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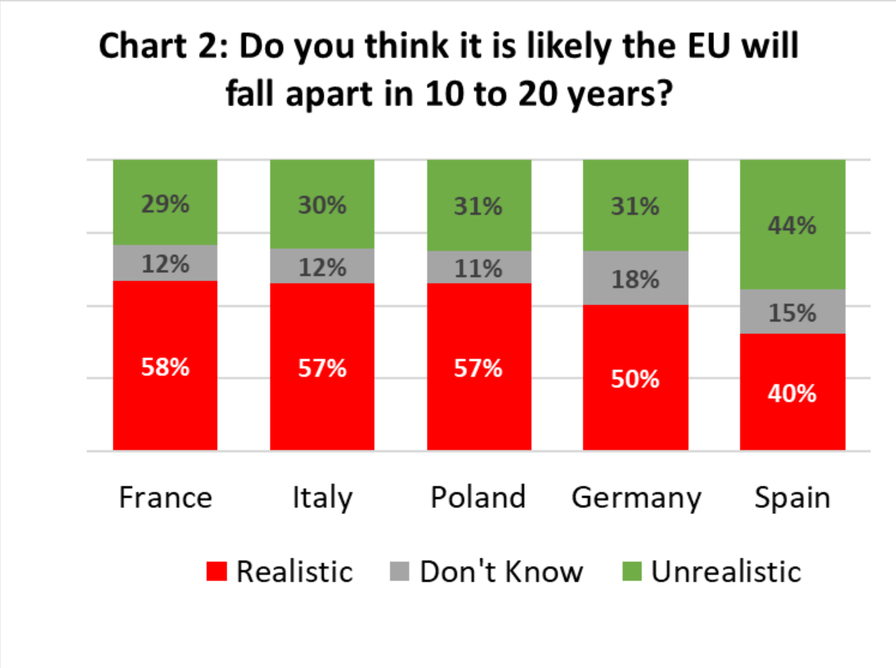
Most observers currently think a traumatic EU-break up scenario is implausible. I would agree. Yet again, when Tony Blair entered 10 Downing Street and seemed to move his country closer to Europe, Brexit appeared equally inconceivable. Sentiments can change swiftly. An IPSOS poll recorded a halving of Italians' trust in the EU between 2010 and 2017. By that time, a mere 38% of Italian respondents held a positive view of the EU (Politi, 2017). According to Google Trends, the search term 'Italexit' spiked in Italy in the spring of this year. It has come down from the peaks, but is still at an elevated level, comparable to a previous peak in 2018 when some members of the populist government of the time were publicly toying with the idea of Italy leaving the euro area (Google Trends, 2020). On balance, Europe's citizens (still) hold the EU in high regard. But despite their own overall positive view, they are gloomy about Europe's future: a poll commissioned by the European Council on Foreign Relations in 2019 (see Figure 2) suggests that more than half of the citizens surveyed considered a collapse of the EU likely in the next one or two decades (European Council on Foreign Relations, 2019). This popular view seems unduly defeatist. Yet, Brexit, Trump and coronavirus have taught us to expect the unexpected. And to prepare for it better.

Figure 2. Poll by European Council on Foreign Relations, 2017



Source: European Council on Foreign Relations, "Seven days to save the European Union", May 16, 2019.

A situation where one or several of its large members turn their backs on the EU would be a huge, possibly mortal, blow to Europe's institutional integrity. Before such a cataclysmic collapse of cohesion, the Union would have gradually slid into political disarray and mutual distrust. The economic backdrop would almost certainly be equally unfavourable. The very future of monetary union could be at stake. In such a fraught political environment, imagine a distrusted Brussels administration demanding the fulfilment of commitments made a long time ago. National leaders might be reluctant to subordinate immediate domestic spending priorities to legally unenforceable promises to the perceived benefit of an institution, from which electorates would by then have become increasingly alienated. If one government delays or refuses payment, others might follow. A dwindling band of loyalists will eventually resist offsetting the emerging financial shortfall. The EU would become an ever-*loser* union and its debt service could be at acute risk. Let us be clear: judging from the summer of 2020 this turn of events looks highly unlikely. But where in the shades of grey of unlikeliness does it fall?

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If the EU bonds are to be rated and priced AAA, it is not enough to believe that the probability of such a default scenario is low. It must be extremely low. Specifically, it must be AAA-remote. This means that its occurrence should be as unlikely as an AAA issuer defaulting on its own debt. Moody's data shows long-term AAA default rates a little above 0.1% (Moody's, 2019). Investors believing that the EU will, for decades to come, stick together as a cooperative club motivated by mutual solidarity with a 99.9% probability will happily add EU bonds to their portfolio at negative AAA-yields.

It seems more likely, however, that EU bonds will trade at a higher yield than other AAA-rated issuers. Bond markets already show higher yields for the EU than for AAA-rated European issuers such as Germany or the EIB. The EU yield curve looks more like that of AA-rated France than of AAA-rated Germany. In early July, the EU traded 15 basis points wide of EIB at the 10-year tenor and over 40 with respect to Germany. The discount may be due to the lower liquidity of EU bonds that come with a smaller size. The liquidity will surely increase in line with issuance size going forward. This could lead to spreads versus Germany and AAA supranational peers narrowing, other things being equal.

But as has been described in this section, other things will be far from equal. A further widening of the spreads from today's situation is therefore quite possible once the EU bond supply takes off. In fact, EU bonds have already begun to underperform some of their institutional peers in the last few weeks (European Commission, 2020d). Higher yields translate into higher costs for European governments, and ultimately taxpayers. Governments should therefore have every incentive to do whatever it takes to reduce the perceived risk and interest cost of the bonds.

5. How to make EU bonds safer

What can be done to underpin the credit strength of the EU as an institution? Creditworthiness cannot be created out of thin air. Without a reliable and sizeable resource base of its own, the EU's respect with investors and rating agencies will rely on the financial support of member states, especially the highly rated ones. What are the chances that in the coming decades, political controversies will erupt that may throw into question the EU-edifice as we now know it? A Brexit-squared, just more acrimonious? And will those solemn promises made during the then distant 2020 corona crisis still be considered good enough by investors holding the debt decades from now? While the bulk of the EU's gross issuance would occur within the next few years, the bonds would most likely have to be refinanced between now and 2058, in line with the EU's practice of rolling over debt issued in the past so as to optimise the cost of funding (European Union, 2010). It is therefore important that the trust in the institutional set-up of the EU will be maintained beyond the short term.

George Soros looks like an unlikely buyer of EU bonds. The investment legend recently ruminated that the EU might "not survive the coronavirus crisis" if it cannot find a joint approach to assist the most-afflicted countries (Faulconbridge, 2020). That seems overdone. But it reflects the fact that many investors, especially outside the EU, harbour lingering doubts about the EU's long-term future. A view shared by many EU citizens, as has been shown above. What can be done to entice Mr Soros and his fellow-sceptics to buy EU bonds at AAA-yields? Sweet talk about ever-closer union is unlikely to do the trick.

What will make a difference are tangible commitments to strengthen the credit quality of the bonds. To achieve this, the bonds must benefit from some credit enhancements. Luckily, the EU already has longstanding experience with such credit enhancements. All that is required is the will to apply tried and tested tools.

Guarantees: the most straightforward way to strengthen the bonds' credit credentials would be to let guarantees take the place of unenforceable promises. Sovereign guarantees have been the instrument of choice ever since the Community Loan Mechanism of the 1970s. As recently as May 2020 the EU-Council approved the SURE-Facility aimed at financially supporting member states in their fight against pandemic-related unemployment (European Council, 2020). It was also the support mechanism chosen to underpin the creditworthiness of the EFSF in 2010. Unconditional and timely guarantees are stronger commitments because they entail cross-default clauses. Failure to fulfil the obligations under the guarantee count as a default of the guaranteeing member state itself. The cost of a sovereign default is immeasurably higher than reneging on an unenforceable promise. In the absence of cross default clauses, the deterrent to withhold EU budget contributions are largely limited to reputational consequences.

Sovereign guarantees have been the instrument of choice since the Community Loan Mechanism of the 1970s.

Member states' provision of guarantees has become ever stingier. When the Union issued the Community Loans in the 1970s, members guaranteed 200% of the underlying bonds. The securities issued by EFSF a decade ago were secured by member guarantees of up to 165% of the bonds' face value (Moody's, 2020). With the SURE facility earlier this year, over-collateralisation with guarantees turned to under-collateralisation (25% of total). The up to €750 billion of bonds under the EU recovery fund would enjoy no guarantees at all under the current plan.

So far only a few investors have begun to question why a borrowing programme that will be unusually large will benefit from protections that are unusually weak. But when the next political crisis hits the EU, or the current sea of euro liquidity recedes, investors may well become more selective. Imagine Le Pen and Salvini rising to power, toying with exit. A sell-off or rating downgrades would only exacerbate the sense of crisis and could become self-reinforcing. It should be avoided.

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Why have member states retreated from issuing guarantees? After all, they make firm assertions that they will support the EU budget in the future to ensure timely debt service. In principle, a guarantee would be nothing more than a legal manifestation of that promise. If member states are convinced that their payment promises are indeed non-negotiable, underwriting the bonds more formally would not incur any additional cost. On the contrary, it could lower the EU's borrowing cost and therefore save European taxpayer money. What is holding them back, then?

One reason for their reluctance could be as mundane as accounting. Eurostat, the European statistics agency, decided in 2010 that member state guarantees supporting EFSF issues should be included in the calculation of guarantors' debt ratios in proportion to their guarantee commitment (European Commission, 2011). Equalising contingent liabilities with outright debt seems questionable on substance, but the rule stands. Concerns that it might also apply to the much larger debt now going to be issued may caution member states already weary of rising public debt in the wake of the crisis. That concern is unwarranted. Eurostat took the EFSF-decision based on the fact that it was effectively an empty shell without any decision-making power and not under the control of existing European institutions (the Eurogroup is only a working group of the Council). This argument cannot plausibly be made with respect to the EU itself.

But if it is not the fear of the accounting treatment of guarantees, what is it that keeps member states clearly stepping up to the plate to support the EU's debt with guarantees? This is a question that will have to be answered. If not now, then in more turbulent times ahead. The answer must not be appropriation risk in national parliaments. If today, at a time of high solidarity and collective pandemic trauma, governments were to harbour doubts that their national legislatures would approve large amounts of guarantees, why should investors be confident that appropriations to make good on the less firm promises will be reliably approved in the distant future?

If no compelling answer is forthcoming, the risk of investors taking a more cautious approach should not be dismissed. To rely on the ECB to step into the breach is a risky assumption, unless one believes implausibly that QE will extend all the way to 2058, which would signal an existential crisis of the euro. In sum, there is no good reason why member states have so far shied away from guaranteeing EU bonds. It is not too late to do so to mitigate the risk of a confidence crisis down the road.

Collateral. An alternative to guarantees would be to pledge collateral, for example in the form of government bonds. This has been the mechanism applied by the Brady Plan, which brought an end to the Latin American debt crisis in the 1980s (Trade Association for Emerging Markets). Back then bank loans taken out by Latin American governments were converted into tradeable bonds with US-Treasuries as credit support. As in the 1980s, the EU bonds' debt service would be secured by a collateral pledge, held in an escrow account. That pledge could cover all future debt service, in which case it would be equivalent to a guarantee. It could also be partial and revolving, undergirding only a certain share of the EU's overall debt service. Defaulting on a bond used as collateral would clearly be a default of the member state itself. Cross-default holds once again, making the pledge highly credible. Pledging collateral would therefore be the cleanest solution, unambiguously equalising the support pledge with member states' own full faith and credit obligations. In bond market parlance EU bonds would be unambiguously *pari passu* with member states' obligations.

At current interest rates this issuance of government bonds used as collateral would be affordable, although that could change in the period up to 2058. The collateral solution would, however, have one obvious disadvantage compared to guarantees. They would immediately increase the debt of national governments one-for-one. This enhancement is therefore even more unlikely to be considered than the guarantee option.

Give the EU taxation power. When releasing its recovery fund plans, the Commission itself proposed to give the EU several new own revenue sources independent of transfers from member states. Specifically, the proposal refers to a digital tax, resources from the EU's Emissions Trading Scheme and a Carbon Border Adjustment Mechanism (European Commission, 2020a). These fees or taxes would go to the EU budget straight away, with no detour through member states' finances. Together they could fund the EU budget to an annual amount of approximately €20 billion (European Commission, 2020c). This is not far from the average €25 billion annual net amortisation between 2028 and 2058. If implemented, this could bolster the EU's finances and mitigate the risks to its creditworthiness, especially if those new own resources receipts were to be truly additional. To the degree that they would be offset by lower transfers from member states' budgets, the beneficial impact would of course be proportionally smaller. But even then, it would still underscore the value member states attach to the EU as an institution, providing a powerful signal for fiscal integration in Europe. Investors and rating agencies should take comfort from such a step. If member states were to agree to give the EU more financial autonomy now, chances are that more would follow in the decades to come, further propping up the credit quality of the EU bonds without dependence on members' transfers.

Unfortunately, while a final decision is still outstanding, the discussion on raising own resources seems to have stalled. In times of their own burgeoning deficits, member states seem wary about giving up on tax bases in what is effectively a zero-sum situation. A tax base is either attached to the Union or member states. Ultimately the member states will decide who gets the tax base. They should consider the Commission proposal. Strengthening the EU's finances will make it financially more independent. This may provide member states with more national fiscal flexibility in the future, as the need for budgetary contributions will fall correspondingly. In a situation where the future seems further away than normal and time preference is especially high, the prospects for the Commission's proposal to be adopted seem modest. Rejection would not help the EU's creditworthiness.

Remove the grant element. A radical way to improve the financial safety of EU bonds is to remove the grant element (currently up to €500 billion, or two-thirds of the total). According to media reports this modification has been propagated by the Netherlands and Austria. Removing the grants and converting them into loans would make the EU loans stronger: all would be secured by the payment obligations of borrowing member states, to whom the raised funds would be on-lent. Other members would only be obliged to contribute should one of the borrowers default on loans from the EU. But enhancing EU creditworthiness through this channel would be a pyrrhic victory. It would fly in the face of political intent to display solidarity across societies in times of unprecedented challenges.

With the grant genie now out of the bottle, pushing it back in could raise serious questions about the viability of the EU as a political project in the long term. Investors and rating agencies would likely react in an adverse way to such a U-turn on European integration. The risk of this radical 'solution' being adopted appears small. Most member states, led by heavyweights France and Germany, appear steadfast in their preference for a sizeable grant element. But even a drawn-out acrimonious discussion about this subject could be harmful to investor sentiment. It would accentuate fault-lines inside the EU that could still break open in the future. That is not conducive to market confidence.

All things considered, none of the abovementioned credit-enhancement mechanisms will be adopted. At this point, the issuance of EU bonds should be possible at attractive rates even without enhancements. Investors will talk about the reassurance of the ECB being there as a de facto backstop. They will also take comfort from the belief that the bonds will be sought after by central banks across the globe as a reserve asset. But that belief is still to be tested. In a world with ample supply of outright government bonds, some may prefer to stick to their established portfolio. In any case global foreign exchange reserves have stopped growing for almost a decade now, effectively capping demand for reserve assets.

Issuing such an unprecedented amount of bonds without additional safeguards carries risks. Comparable to driving without a seatbelt. Today, we face an open road, the sun is shining and driving conditions are ideal. But if you are about to embark upon a 38-year journey, unanticipated accidents can happen. You may yet face bad weather and unforgiving traffic. Or maybe you make an error of judgement yourself. Most of the time we do not really need the seatbelt when driving, because accidents happen so rarely. Nevertheless, we still habitually use seatbelts without even thinking about it, and for good reason. The EU should buckle up as well.

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