SUPRANATIONAL DEBT AND FINANCING NEEDS IN THE EUROPEAN UNION

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Abstract

The COVID-19 pandemic has substantially affected the financial trajectory of governments, which have seen their financing needs increase significantly. Against this background, the European Union has launched a series of programmes to smooth this financing in the short term, through the activation of credit lines to cover direct or indirect health expenses and temporary unemployment scheme-related expenditure. Further, it has approved a recovery fund (dubbed Next Generation EU), which will transfer resources from the European budget to the Member States for investments that enhance competitiveness and social and environmental sustainability. In this connection, this paper firstly estimates the increase in financing needs at the European level. Secondly, it sets out the supranational measures adopted to address the consequences of the pandemic, to be financed with debt issued by the European Commission, on behalf of the Member States. Finally, it characterises the starting point of this situation, i.e. it provides the main figures on euro-denominated supranational debt currently in circulation and reviews the arguments in favour of the importance of increasing this type of debt and pan-European safe assets.

Keywords: public debt, European Union, public financing needs, European Recovery Fund.

JEL classification: E62, F36, F45, H63.

Resumen

La pandemia de Covid-19 ha afectado sustancialmente la trayectoria financiera de los Gobiernos, que han experimentado un aumento significativo de sus necesidades de financiación. En este contexto, la Unión Europea (UE) ha puesto en marcha una serie de programas para facilitar esta financiación en el corto plazo, mediante la activación de líneas de crédito para cubrir los gastos sanitarios directos o indirectos y los gastos de esquemas de desempleo temporal. Además, se ha aprobado un fondo de recuperación *(Next Generation EU)*, que transferirá recursos del presupuesto europeo a los Estados miembros para inversiones que mejoren la competitividad y la sostenibilidad social y ambiental. Ante este contexto, en este documento, en primer lugar, se estima el aumento de las necesidades de financiación a escala europea. En segundo lugar, se exponen las acciones supranacionales adoptadas para hacer frente a las consecuencias de la pandemia, que se financiarán con deuda emitida por la Comisión Europea, en nombre de los Estados miembros. Finalmente, se caracteriza el punto de partida de esta situación, esto es, se proporcionan las principales cifras sobre la deuda supranacional en euros actualmente en circulación y se revisan los argumentos que apoyan la importancia de aumentar este tipo de deuda y los activos seguros a escala europea.

Palabras clave: deuda pública, Unión Europea, necesidades de financiación públicas, Fondo Europeo de Recuperación.

Códigos JEL: E62, F36, F45, H63.

Contents

1 The COVID-19 crisis and the financing needs of European Union Governments

Prior to the coronavirus crisis, the public debt of the euro area economies was on a declining trajectory. In its autumn 2019 projections, the European Commission (EC) augured a decline in the euro area public debt/GDP ratio of 1.3 pp to 85.1%. This was the result of a stable growth scenario, an area-wide primary public surplus and a low interest rate environment, which provided relatively broad leeway for an absence of tensions on the primary sovereign debt markets. Thus, the implied interest rate (i.e. the ratio of interest actually paid to total debt) of the main European countries stood below 2.5%, whereas, in respect of the marginal interest rate, a large portion of new, euro-denominated sovereign issues were at negative rates.

However, this trajectory has been altered by the pandemic. On the one hand, the lockdown measures have had a very marked impact on economic activity, the reflection of which has been a significant decline in GDP in the short term and, in tandem, an increase in countries' cyclical deficit, owing to the fall in tax revenues and the increase in unemployment spending. On the other, countries have approved a series of discretionary measures to soften the economic effects of the pandemic. They are aimed at increasing resources for health systems, supporting household income, reducing firms' recurrent outlays (through deferrals and reductions in taxes and other obligations) and providing liquidity for firms, at a high cost to public finances. Finally, countries must address recovery in their economies, specifically in those segments of the productive sector that have been most damaged, and tackle long-term challenges, such as digitalisation and climate change, which will require new investments.

Accordingly, in the coming years European countries' budget deficits will increase significantly as will their market funding needs. The amount of the increase in the deficit, however, is very uncertain. Chart 1 offers projections for the budget deficit of the four biggest Eurozone economies and for the area as a whole in 2020 and 2021, based on the latest spring forecasts of the EC and of Consensus Forecast. The chart shows that the euro area-wide deficit will stand at over 8.5% of GDP according to the EC, more than 7.8 pp up on the 2019 figure. On the more recent (July) Consensus Forecast figures, the deficit would be somewhat higher. The increase on 2019 will be greater for those countries most affected, as is the case of Spain and Italy. Overall, according to these estimates, the sum of the deficits of the four countries would total €748 billion in 2020 and €330 billion in 2021, around 6.7% and 2.8% of euro area GDP, respectively (see Charts 1 and 2). Adding in the estimated deficit in the remaining euro area countries, financing needs would amount to €941 billion in 2020,[1] meaning that the overall euro area deficit would be close to 8.5 pp of GDP for this year, and around 3.5 pp of GDP for the coming year.

1 According to the EC's latest May 2020 forecasts.

Chart 1

GENERAL GOVERNMENT BUDGET DEFICIT FORECASTS

The EC and *Consensus Forecast* deficit forecasts indicate an across-the-board worsening in the deficit in 2020, which will tend to be partly reversed in 2021.

SOURCES: European Commission (AMECO, May 2020) and *Consensus Forecast* (July 2020).

Along with needs arising directly from the pandemic, national Treasuries must contend with the maturity of debt incurred in the past. As earlier discussed, some countries were running a budget deficit before the health crisis broke, and this will be compounded by the pandemic. In addition, the coverage of public debt maturities must be taken into account, whose structure may differ from country to country, as a result of different Treasury issuance strategies (see Chart 3).

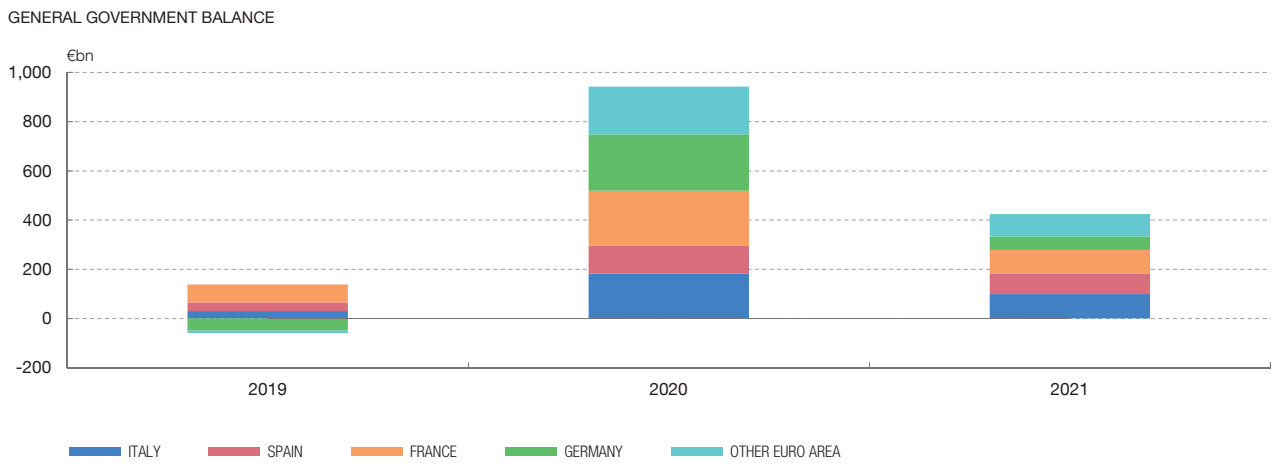
In the main, European Governments finance themselves on the markets through debt securities issues (see Chart 3). In 2019, the weight of debt securities in total public debt was 80% for the euro area as a whole, and up to 86% in the case of Spain and France[2].

2 García-Moral *et al.* (2020) offer a detailed description of Spanish public debt and a comparison with the euro area.

Chart 2

NEW FINANCING NEEDS RELATED TO CORONAVIRUS

The marked increase in financing needs in 2020 is due to the combination of measures to alleviate the effects of the pandemic and to the impact of the automatic stabilisers in the face of diminished economic activity.

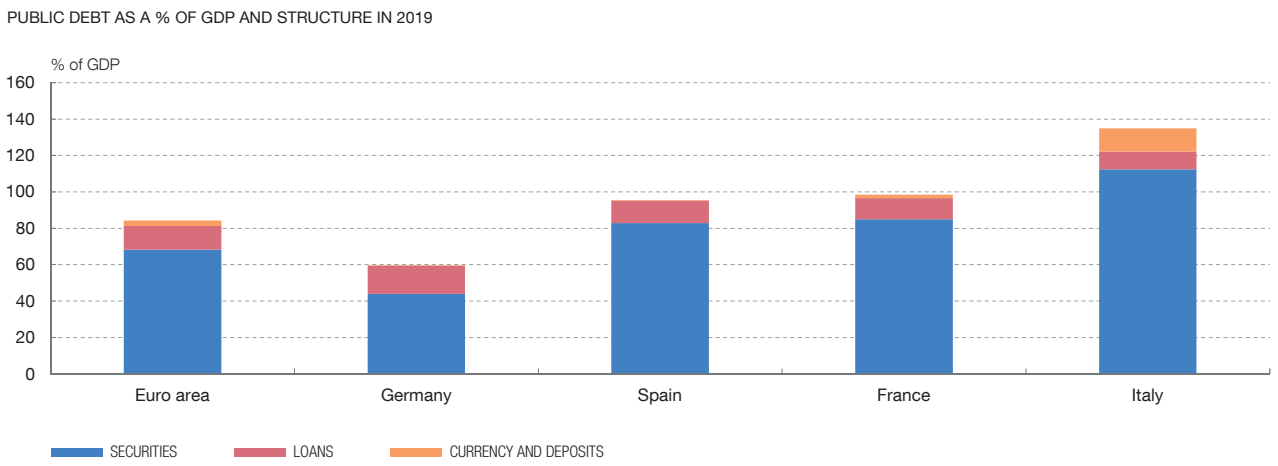


SOURCE: European Commission (May 2020 forecasts).

Chart 3

STRUCTURE OF PUBLIC DEBT

At end-2019, French, Italian and Spanish debt stood at over 60% of GDP. European countries' debt is mainly concentrated in securities, and Governments' credibility on the markets is essential to refinance debt maturities and new financing needs.



SOURCE: Eurostat.

The maturities of debt securities in Spain, Italy, France and Germany that will expire in 2020, arising from debt issued in the past, are significant. As Chart 4 shows, the amounts to be refinanced might account for up to 1.4% of euro area GDP in some months.

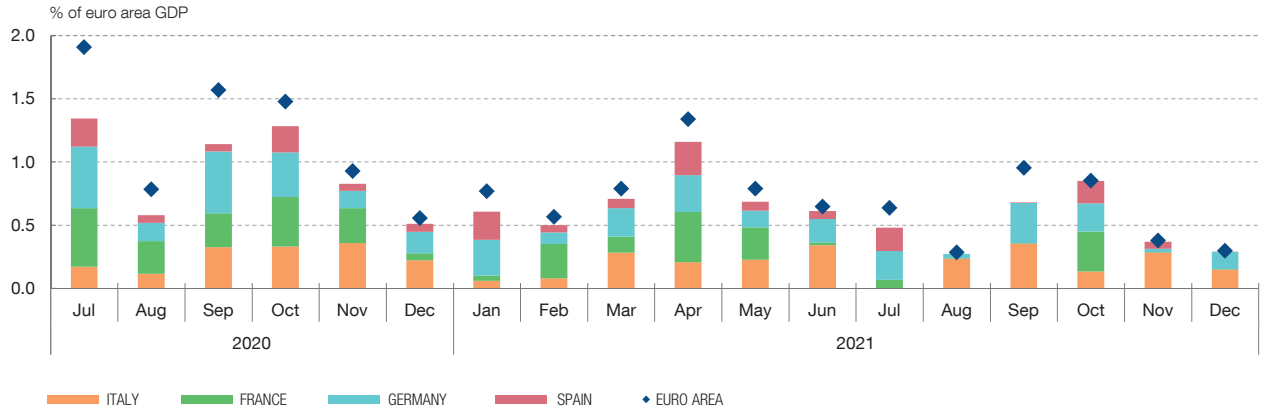
In 2020 as a whole, the maturities of debt already issued by these four countries are expected to be around €670 billion in the second half of the year, 5.7% of euro area

Chart 4

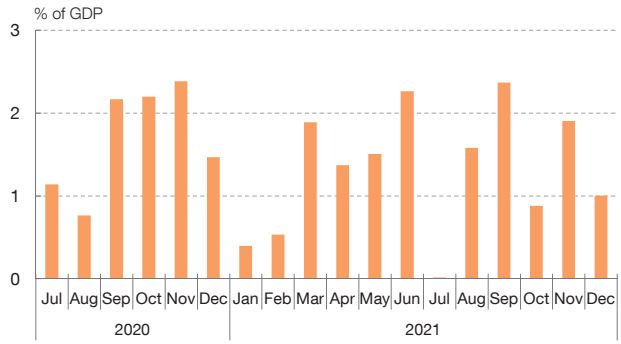
MATURITIES OF PUBLIC DEBT SECURITIES

The coming months will see the concentration of a high amount of maturities of the main European countries. The total amount for the second half of 2020 for the euro area will stand at over 7 pp of GDP.

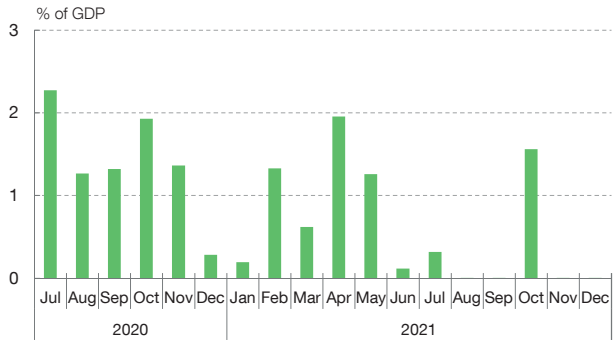
1 MATURITIES OF EUROPEAN COUNTRIES' PUBLIC DEBT SECURITIES



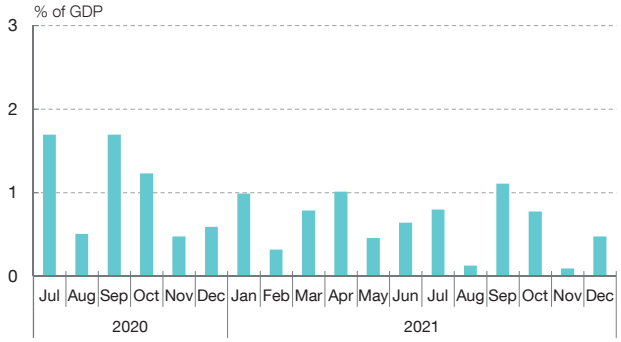
2 ITALY



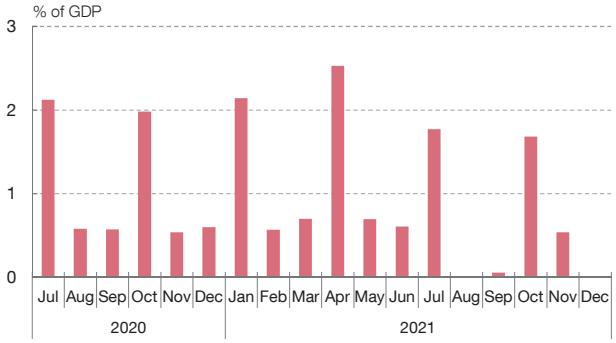
3 FRANCE



4 GERMANY



5 SPAIN



SOURCES: Banco de España and CSDB database (cut-off date: June 2020) (a).

a The CSDB data may be subject to revision.

GDP. And for the overall euro area, the related figure is expected to be about €860 billion (7.2 pp of GDP).

The situation has been accompanied by a global rise in public debt, owing to the effects of the pandemic on other regions, and an increase in private financing needs. The

private sector's needs are being partly covered by the roll-out of extensive public guarantee programmes to provide firms with liquidity against the backdrop of the health crisis, adding a contingent liability that might raise the public sector's financing needs in the future. The confluence internationally of various agents resorting to the markets in search of financing might raise tensions on the debt issuance markets. Faced with this situation, it should be stressed that the ECB has acted forcefully to help ensure the proper transmission of monetary policy and maintain accommodative financial conditions in the euro area.[3]

3 The ECB Governing Council has increased its asset purchase capacity in the secondary market, firstly through its regular programme, with an increase of €120 billion over the course of 2020, and subsequently through a specific programme, the PEPP (Pandemic Emergency Purchase Programme). The volume of the PEPP is €1.35 trillion. For the distribution of public debt purchases across the different jurisdictions, the reference will continue to be the share of the various national central banks in the ECB's capital; that said, a flexible approach will be adopted, allowing temporary deviations from this guideline. Further, for the purposes of this specific programme, the lifting of the ineligibility conditions on Greek sovereign debt is being considered so that these assets may be acquired by the Eurosystem under the PEPP.

2 Governments' supranational financing mechanisms

The European response to this situation has been to create a series of mechanisms and programmes to smooth the financing of national Treasuries. First, in the case of the European Stability Mechanism (ESM)[4], a pre-emptive credit line (Pandemic Crisis Support) that may be drawn down by the euro area countries until December 2022 has been approved, based on the previously existing ECCL (Enhanced Conditions Credit Line). Unlike previous financing programmes, associated with the presence of imbalances in economies and which, therefore, involved macroeconomic and financial conditionality, the only conditionality associated with this credit line is that it should be earmarked for financing direct and indirect pandemic-related expenses. At most, its amount may rise to 2% of each country's GDP, with a maximum repayment term of 10 years, and total funds amounting to €240 billion. This source of financing will be available, at an interest rate that will reflect the ESM's cost of financing, with an additional margin of 10 bp, and an annual commission fee of 0.5 bp plus a single arrangement fee of 25 bp.[5] The cost of financing of the ESM is, in many cases, lower than that prevailing for the euro area countries for the same terms of issue (see Chart 5).

Within the EU, moreover, a reinsurance mechanism for expenses linked to short-time and temporary employment arrangements (SURE) has been approved, providing for the possibility of loans totalling €100 billion for the EU as a whole being made to the Member States (MSs). The exposure to the three countries with most access to SURE may not exceed 60% of the total. As with the ESM, applications for access to these loans by countries will depend on the conditions tied thereto, insofar as they are more favourable than conditions of access to the markets. Overall, therefore, under these supranational arrangements (SURE and ESM), financial resources of around €340 billion may be provided to the MSs. Moreover, in any event, discounting the new precautionary line, the ESM would still have an additional lending capacity of around €170 billion.[6]

As part of the negotiations and agreement on the Multiannual Financial Framework (MFF) 2021-2027, the European Council has approved a supplementary and temporary European budget, dubbed Next Generation EU, conceived as a recovery fund in the wake of the pandemic (resolution dated 21 July 2020). This fund, worth €750 billion, will be financed by the issuance of supranational debt by the EC and is intended for granting transfers, loans and guarantees to the MSs through the various European programmes forming part of the MFF, and directly to the MSs. These amounts will help fund new investments focusing on the recovery of the European economy, which will partly alleviate countries' financing needs

4 The ESM is a European institution created in 2012 by the euro area MSs as a successor to the European Financial Stability Facility (EFSF), to support countries in situations of financial stress. The ESM issues debt on the markets to finance the credit lines granted to applicant countries. It has subscribed capital of close to €700 billion, €80 billion of which relate to paid-in capital, which acts as a security buffer for its debt issues, and lending capacity of €500 billion in loanable funds.

5 By comparison, the ECCL has a marginal cost of 35 bp over the cost of financing of the ESM, plus an annual commission fee of 0.5 bp and an arrangement fee of 50 bp.

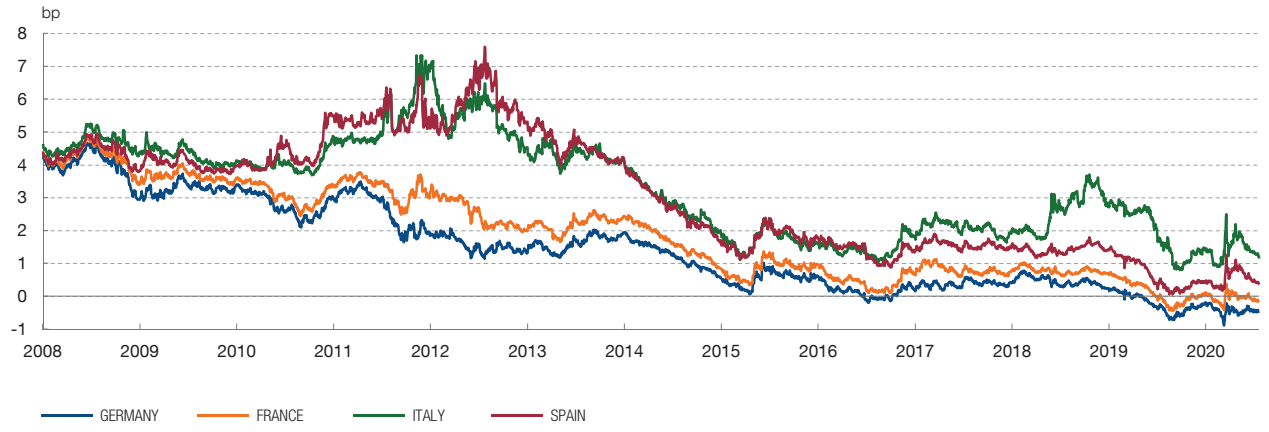
6 Another essential feature of the EU's supranational response to the health crisis has been the approval of an EIB guarantees programme that seeks to mobilise €200 billion to finance private firms' liquidity and investments. The programme will be backed by the EU countries, which will provide guarantees totalling €25 billion.

Chart 5

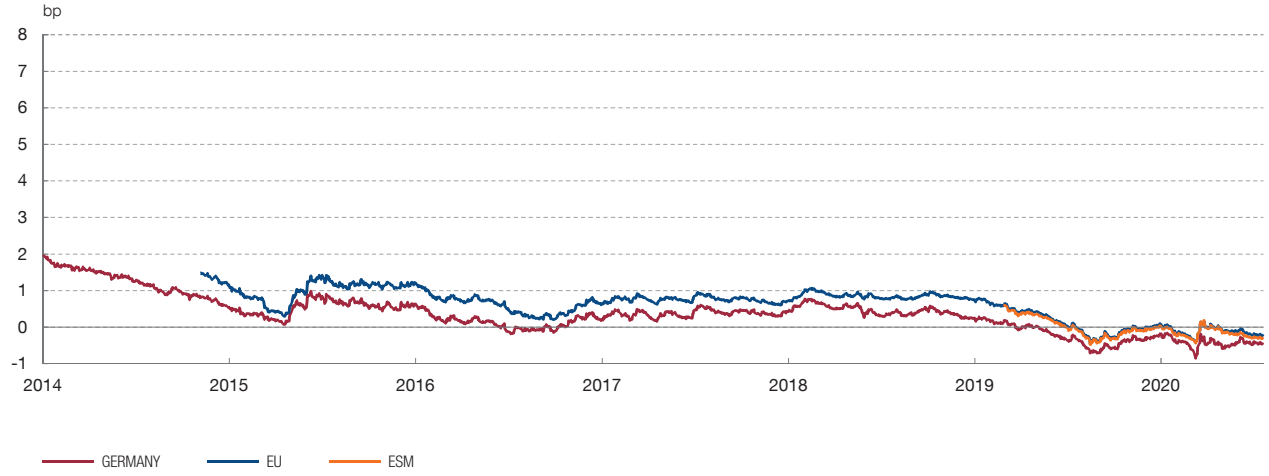
TEN-YEAR BOND YIELDS

Historically, German bond yields have been below those of other major European countries. In recent years, the market presence of supranational bodies has increased, with their yields higher than that of the German bond but below that of other countries, such as Italy and Spain.

1 EUROPEAN COUNTRIES



2 GERMANY AND SUPRANATIONAL ISSUERS



SOURCE: Bloomberg.

in the future and will be linked to the governance framework established in the European Semester. The debt issued will be long-term (maturing between 2028 and 2058) and will be backed by an increase in the EU's own resources.

3 Safe assets and supranational debt

All the aforementioned measures at the European level must be financed by the issuance of supranational debt securities (by the EC, the ESM and the EIB) on financial markets. The securities are backed by voluntary commitments on the part of the MSs to the Community budget (SURE), by regulatory provisions linked to the generation of own resources in the MFF (Next Generation EU), or by legal obligations and capital disbursement commitments to the issuing institutions of these securities (ESM and EIB). What is involved, therefore, is pooled debt, insofar as it is backed by a group of States in proportion to their participation (either via capital, guarantees or the European budget), which would constitute a supply of common safe assets in the EU.

Currently, at the European level, the group of supranational issuers is confined to a limited number of institutions. Under the EU's institutional arrangements, the main issuers of pooled debt are limited to the European Commission (acting on behalf of the EU)[7], the ESM (along with its predecessor, the EFSF) and the EIB (see Table 1). In the first two cases, issues have mainly been earmarked to finance programmes of support to European countries following the 2008 crisis. In the case of the EIB, these issues are intended in many cases to finance programmes and strategies linked to the EU's political priorities, such as climate change, technological challenges and infrastructure investments.

The EC operates several lending programmes on behalf of the EU. To date, the EC would only take on debt under country loan programmes (back-to-back operations), via pooled debt issues, i.e. backed by the MSs. Among these programmes are the European

Table 1
CHARACTERISTICS OF PAN-EUROPEAN OUTSTANDING DEBT (SAFE ASSET) (a)

Issuer	Total amount (€m)	Total amount (% of EU-27 GDP)	Current average term (years)	Rating (b)	Credit status	Capital structure (guarantees)
EIB	469,200	3.4	5.7	AAA/Aaa/AAA	Preferential creditor	Capital of €243 bn
ESM	90,900	0.7	7.9	AAA/Aa1/-	Preferential creditor, after IMF	Subscribed capital of €705 bn
EFSF	217,400	1.6	8.4	AA/Aa1/AA	*Pari passu*	Backed by Member States' guarantees
EU (EFSM, BOP, MFA)	51,300	0.4	8.0	AAA/Aaa/AA	De facto preferential creditor	Backed by Member States' guarantees

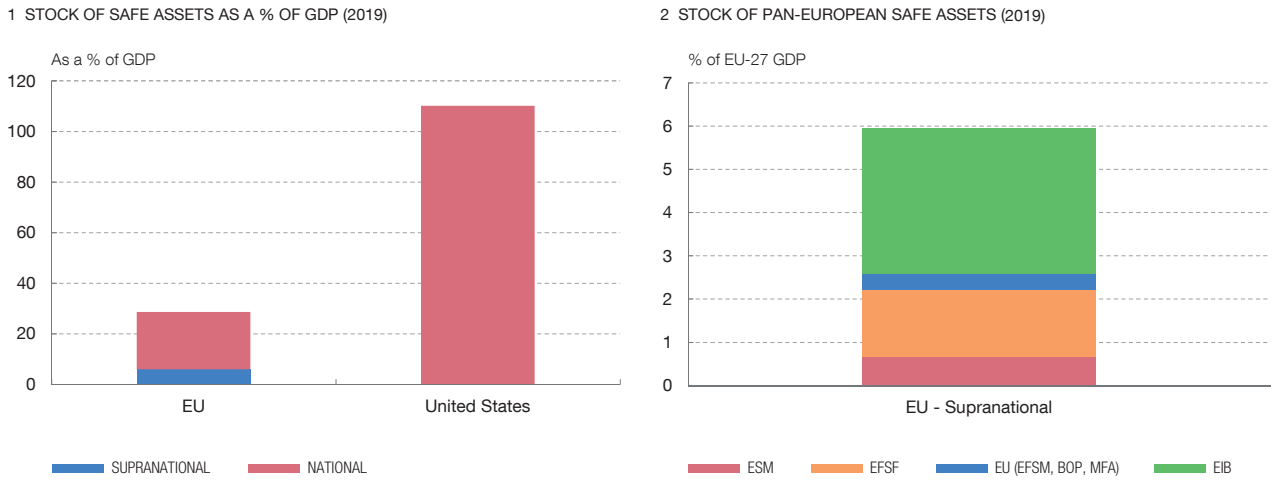
SOURCES: European Commission, Eurostat and European Central Bank.

a Only long-term debt issues are considered to be safe assets.
b Fitch/Moody´s/S&P.

7 The EC also undertakes issues on behalf of the members of EURATOM, the European Atomic Energy Community.

Chart 6
ASSETS WITH A TOP CREDIT RATING (a)

Stocks of US securities with a top credit rating as a percentage of GDP are 3.5 times more than those of European countries. In recent years, the amount of European supranational bodies' securities has increased to close to 6% of EU GDP.



SOURCES: European Commission, Eurostat and national statistics.

a Long-term public debt. AAA/AA+ credit rating according to S&P. National debt in EU includes that of Germany, Austria, Denmark, Finland, Luxembourg, Netherlands and Sweden.

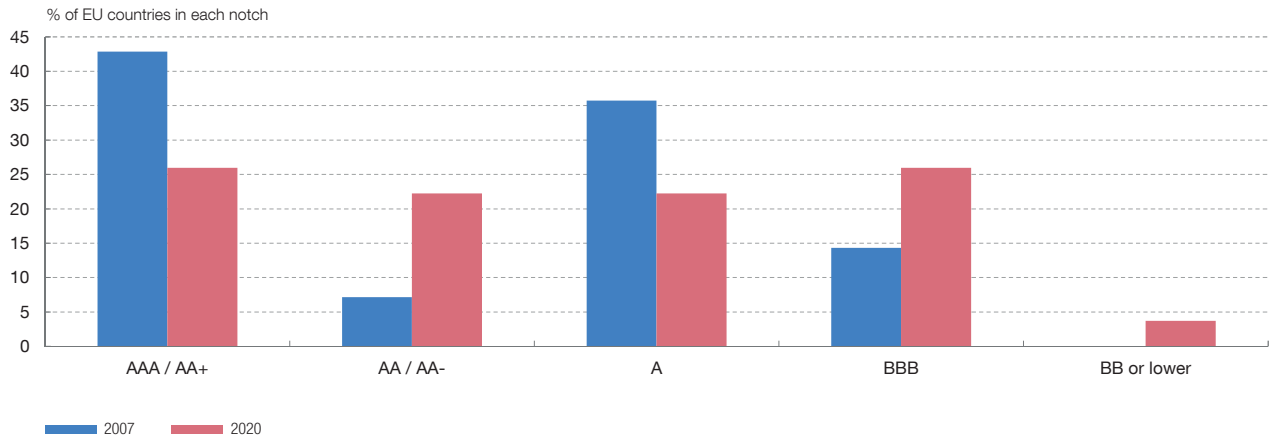
Financial Stability Mechanism (EFSM), the Balance of Payments (BOP) Programme for EU countries not belonging to the euro area, and the Macro-Financial Assistance (MFA) Programme for non-Community countries benefiting from an IMF programme.[8] In the current setting, and faced with the exceptional situation arising from the pandemic, European institutions have approved the issuance of long-term supranational debt which is for the first time not linked to back-to-back loan programmes. This debt is backed, in the case of the SURE, by guarantees issued by the MSs, while in the case of Next Generation EU, it is guaranteed by means of an increase in the own resources of the EU budget, as earlier mentioned.

In total, outstanding EU supranational debt (pan-European safe assets) currently amounts to close to €830 billion, more than 6% of EU GDP (see Chart 6). The EIB is currently the biggest EU supranational issuer, with a volume of outstanding debt close to €460 billion. The outstanding debt issued by the EU amounts to around €51 billion, mainly within the framework of the EFSM (€46 billion) and, to a lesser extent, the BOP (€200 million) and the MFA (€4.7 billion). The ESM maintains a volume of outstanding debt totalling €91 billion.

8 The EFSM was created in 2010 and currently remains active to manage outstanding issues linked to the programmes for Ireland and Portugal; moreover, issues maturing in the period to 2026 may be extended up to an average weighted maturity period of 19.5 years. The BOP programme is for up to €50 billion and is to support the balance of payments problems of non-euro area countries. Finally, the MFA is a programme of aid to non-Community countries that have availed themselves of an IMF programme.

Chart 7
SOVEREIGN RATINGS IN THE EU

The EU countries' credit quality has worsened from 2007 to 2020. Before the financial crisis, over 40% of the countries were in the top credit quality notch; today only 25% of them are.



SOURCE: Devised by authors based on S&P.

The EFSF, which can no longer make new loans following the creation of the ESM, has outstanding debt arising from its intervention during the past financial crisis of close to €217 billion.

All these institutions have the backing of the Community countries, either in the form of legal obligations and irrevocable guarantees, or of commitments to disburse subscribed capital. They also have preferential creditor status in most cases (except in that of the EFSF). This enables them to enjoy the highest credit ratings awarded by rating agencies, something they share with most multilateral organisations.[9]

Consequently, European institutions are financing themselves on the market at close-to-zero and even negative rates, at least on their financial instruments with maturities of 15 years or less, with a minimum spread over the German benchmark (see Chart 5).

On aggregate, however, the supply of safe assets is restricted by the proportion of European national states with a rating similar to that of the supranational issuers. At present, this proportion stands at 25%, whereas in 2007 the number of European countries with a top credit rating accounted for 43% of the EU's total debt (see Chart 7). Accordingly, the volume of sovereign safe assets relative to the total volume of euro area debt has fallen, accounting now for a lower fraction of that total. As a result, action by EU supranational institutions in combating the pandemic should enable the necessary measures to be financed with joint

9 Moody's, for example, confers its highest credit rating (Aaa) to the EU and the EIB, and its second best rating (Aa1) to the ESM and the EFSF.

Table 2
HOLDERS OF EUROPEAN SOVEREIGN AND SUPRANATIONAL DEBT

	Issuer					
Holder (a)	EFSF	EIB	ESM	EU securities (b)	Sovereign debt	Weighted average (c)
Euro area investors	39.8	25.2	33.0	44.7	51.7	49.5
Banks	17.0	8.3	16.5	14.9	14.4	14.1
Pension funds and insurance corporations	12.5	8.8	8.2	17.9	20.7	19.6
Investment funds	8.9	4.2	6.3	8.1	9.6	9.2
Other	1.4	3.9	2.0	3.8	7.0	6.6
Investors from the rest of the world	60.2	74.8	67.0	55.3	48.3	50.5

SOURCE: ECB.

a Excluding Eurosystem holdings.
b European Union issues. Includes Euratom and EFSM issues.
c Weighted arithmetical mean calculated on the basis of the different categories: EFSF, EIB, ESM, EU and Sovereign Debt.

issues under more favourable conditions than national issues, in terms of financial costs, likewise increasing the proportion of euro-denominated safe assets.

Overall, if the purpose-made European programmes were fully used, supranational debt might increase over the next five years by around €1.3 trillion, thereby doubling the outstanding debt of the European institutions (€100 billion, SURE; €240 billion, ESM; €200 billion, EIB; €750 billion, Next Generation EU).[10]

That would have beneficial effects beyond the coverage of financing needs. For one thing, this debt could be acquired under ECB purchase programmes, and under more advantageous conditions than those of national debt, for which stricter limits are applied as regards the volume of debt that may be held on the ECB balance sheet. Along with this, and beyond the specific need in the current crisis to have European safe assets that involve a pooling of common risks, this debate has deeper and more lasting implications.[11] The more structural reasons for a pan-European safe asset include most notably the following.[12] First, it would provide a strong boost to confidence in the construction of the Monetary Union project. The large-scale issue of European debt aimed at financing the Community budget marks an unprecedented step forward in terms of fiscal integration. The existence of European debt of a sufficient size and liquidity contributes to deepening financial integration and to paving the way for the Capital Markets Union. That is to say, the safe asset reinforces risk-sharing mechanisms, helping reduce the impact of idiosyncratic shocks and promoting euro area-wide economic stability. Moreover, this would boost the role of the euro as an international reserve currency. Indeed, more than half the current supranational debt is held by investors outside the euro area, 7 pp more than in the case of national sovereign debt (see Table 2).

10 In the case of the EIB, it is assumed that the total funds mobilised by the €25 billion guarantee are obtained through the issuance of EIB debt. Generally, this assumption is in line with the resulting issues under other EIB financing programmes, and those of the European Investment Fund, and with the proportion of the EIB's gross debt to its own funds.

11 See Banco de España (2020).

12 See, inter alia, Brunnermeier *et al.* (2017), Farhi and Werning (2017), Hernández de Cos (2019) and Iltzezki *et al.* (2020).

In addition, a sufficient supply of safe assets contributes to financial stability and lessens pressures on interest rates, especially at times of crisis, when the demand for this type of asset grows exponentially. Further, a European safe asset would alleviate the problem of the bank-sovereign link, whereby bank or sovereign debt crises ultimately lead to a doom loop. It does so by allowing an appropriate diversification of portfolios without the need to add distortionary regulatory elements.[13] In this respect, Table 2 shows that euro area banks hold a percentage of supranational bonds that is similar to or higher than that recorded in the case of the MSs' sovereign debt. Finally, the introduction of a safe asset would have benefits for the conduct of the common monetary policy, allowing for better handling of expectations and greater effectiveness in monetary policy transmission.

13 See, for example, Codogno and Van de Noord (2019) or Brunnermeier *et al.*(2016).

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