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Europe's C-19 fiscal response to significantly raise euro-denominated safe asset supply

Scope Ratings

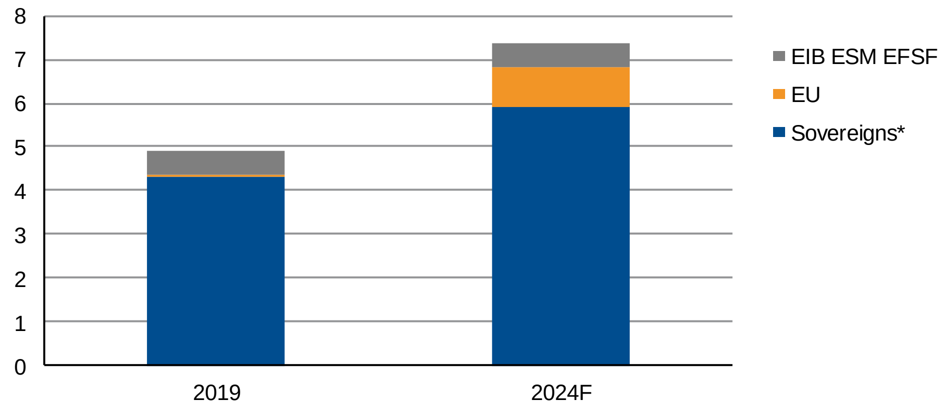
The scarcity of euro-denominated safe assets has been on the academic and political agenda since the global financial and sovereign debt crises. Now, the European fiscal response to the Covid-19 crisis – including national and EU-wide counter-cyclical fiscal stimulus – will increase the availability of euro-denominated safe assets in coming years by almost EUR 2.5trn, an increase of about 50%. The increased supply of highly rated euro-denominated securities could have important implications for financial stability in the euro area, including weakening the sovereign-bank nexus and strengthening the international role of the euro.

We expect the combined national and European fiscal response to the Covid-19 shock to increase the availability of highly rated euro-denominated securities from around EUR 5trn in 2019 to around EUR 7.5trn by 2024. This is about 60% (50%) of euro area (EU-27) GDP.

The two main drivers for the increase in euro-denominated safe assets until 2024 are:

- An estimated increase in debt securities by highly rated sovereigns of around EUR 1.6trn, driven by France (AA/Stable; ~700bn) and Germany (AAA/Stable; ~600bn).
- Issuance at the supranational level, particularly from the European Union (AAA/Stable), will increase significantly to fund the "Next Generation EU" recovery plan (EUR 750bn) and the SURE unemployment scheme (EUR 100bn) over the coming years.

Figure 1: Outstanding euro-denominated safe assets
EUR trn



N.B. *General government debt securities rated AA- or above (excluding Estonia). Estimates assume 1% inflation and that new issuance will be in euro.

Source: IMF, European Commission, EU/EIB/ESM/EFSF financial reports, Scope Ratings GmbH

We highlight three potentially credit-relevant points from the increased issuance:

- Much higher levels of public debt, albeit financed at lower cost mostly driven by the ECB's crisis response which will result in greater interdependence between the ECB and euro area member states given the increasing share of sovereign bonds on the ECB's balance sheet;
- The higher supply of euro-denominated area safe assets, may

i) address some of the adverse effects resulting from the shortage of safe asset supply in the euro area, including the sovereign-bank nexus, as banks holding large portions of domestic sovereign bonds on their balance sheets may now diversify their sovereign bond holdings, possibly reducing the vicious so called doom loop in sovereign debt crises, and

ii) support the euro's international role and likely strengthen its reserve currency status, in turn supporting euro area sovereign creditworthiness.

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Euro-denominated safe assets to increase following national and joint fiscal response to the Covid-19 crisis

Safe assets and sovereign risk in the euro area

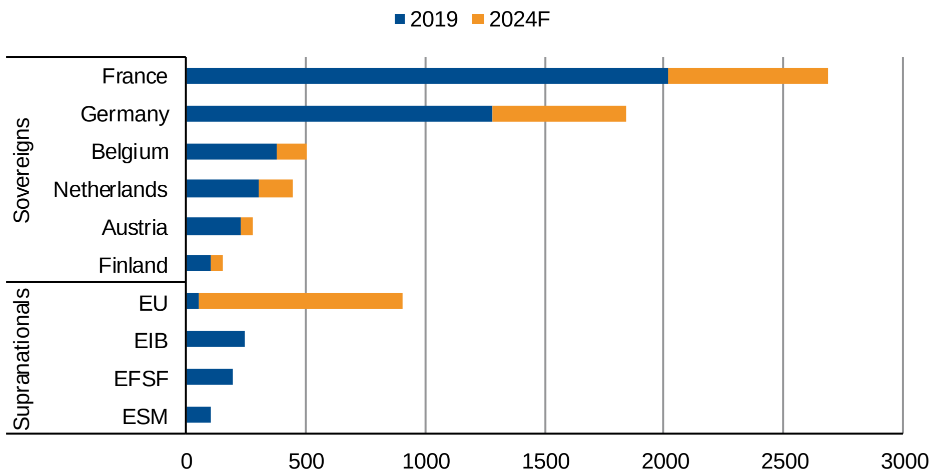
The benefits of having a deeper pool of euro area safe assets affect sovereign credit risk in various ways. A sufficiently high supply of highly rated euro-denominated bonds would facilitate integration between the still-fragmented financial systems, ensure liquid markets for refinancing, especially for less highly rated sovereigns and reduce the sovereign-bank nexus[1]. Benefits for sovereign risk and a greater safe asset supply could also boost the euro’s international role. Under our sovereign rating methodology, rating implications of reserve currency status include limited exchange rate risks and reduced government borrowing costs, and thus the ability to increase spending without materially raising debt sustainability concerns.

Issuance of Euro-denominated safe assets to increase following the Covid-19 outbreak

The fiscal response to the Covid-19 crisis will drive up the availability of euro area safe assets in coming years, via two main channels: the increase in fiscal spending at the national level from highly-rated euro area members and fiscal spending at the European level, especially after the agreement on the EUR 750bn “Next Generation EU” recovery plan in July 2020.

We estimate the share of outstanding securities among highly rated (AA- or above) euro area sovereigns based on our projections of the debt-to-GDP levels[2] by 2024, adjusted for the current shares of euro denominated securities in total debt stocks. We conservatively assume stable levels of outstanding securities for the EIB, ESM and EFSF, while for the EU we include the “SURE” initiative and the “Next Generation EU” recovery fund.

Figure 2: Outstanding euro-denominated securities rated AA- or above
EUR bn



N.B. For Sovereigns: General government debt securities rated AA- or above (excluding Estonia).

Source: IMF, European Commission, Scope Ratings GmbH

Euro-denominated safe assets to increase by almost 50% by 2024

Overall, we expect euro area safe assets to increase from ca. EUR 5trn in 2019 to almost EUR 7.5trn in 2024. This would be mainly driven by issuance in France (AA/Stable) and Germany (AAA/Stable), with higher outstanding debt securities of approximately EUR 700bn and EUR 600bn respectively until 2024. The second key factor will be unprecedented levels of issuance by the EU (AAA/Stable) following the agreements on a total of EUR 850bn capital market funding to boost the European economy via the recovery fund and SURE programme.

[1] “The search for a euro area safe asset”, Leandro and Zettelmeyer, PIIE, 2019.
[2] See Sovereign Outlook Q3 Update.

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