

### 3. Can debt mutualisation make the euro area more resilient? An overview of proposals for common safe asset creation

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**Abstract:** Could common safe assets make the euro area less fragile? This chapter reviews proposals developed after the global financial and sovereign-debt crises, including Eurobonds, blue-red bonds, sovereign bond-backed securities, E-bonds and debt issued by a euro-area budget. The comparison considers guarantee structures, moral hazard, institutional demands, Treaty constraints and political feasibility. Common euro-area safe assets are shown to offer external and internal benefits: a stronger international role for the euro, relief for global safe-asset scarcity, weaker sovereign-bank feedback loops, smoother monetary transmission and deeper financial integration. No design, however, eliminates trade-offs between credibility, risk sharing, incentives and legal complexity. The chapter suggests that debt mutualisation remains difficult, yet renewed geopolitical uncertainty and questions about the dollar dominance may again make the issue central.

**Keywords:** safe assets, Economic and Monetary Union, public debt, debt mutualisation.

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## Introduction

A safe asset is a simple debt instrument that provides investors with the promise of retaining its value during adverse economic events (Caballero et al., 2017). Generally, safe assets are low-risk investments that guarantee a fixed value of money without the default risk of the issuer. Safe assets are characterised by their high liquidity and limited inflationary and idiosyncratic risk (Bogołębska et al., 2024, pp. 4–7). The ability of a country to serve as a source of safe assets depends primarily on the fiscal capacity of its sovereign, which determines its ability to service its obligations. The limitations of the fiscal capacity are best described by the ‘Laffer curve’, according to which, after reaching a special threshold, a further increase in public debt translates into a loss of a safe issuer status (Schuknecht, 2018). Moreover, the commitment of the central bank to maintain the price and exchange rate stability is a crucial determinant for a public debt instrument to be named a safe asset.

Economists continue to debate whether the private sector can also produce safe assets (Gorton, 2016; Kacperczyk et al., 2021, pp. 495–535). The general consensus is of only partial substitutability of public and private assets, with its scope depending mostly on market conditions, the quality of the issuer, the time horizon of issuance, or the scope of government support to prevent the run on debt. Ultimately, private-label securities lack the simplicity and value-preserving qualities of public debt.

Apart from the division into private and public producers of safe assets, an alternative classification into global and regional providers is used. Although a general consensus is lacking, it is widely acknowledged that the issuers of the ‘big four’ currencies (the United States, the euro area, Japan, and Great Britain) are global safe asset providers (Aizenman et al., 2019). Thus, a global provider of safe assets is compatible with an international currency issuer (Bogołębska et al., 2019, pp. 65–81). However, the fragmented markets of sovereign debt within the EMU mean that it does not fully seize the opportunities the common monetary area creates. In addition, market participants’ perceptions concerning the relative risks of sovereign bonds change over time (Bletzinger et al., 2022). It is often pointed out that the EMU lacks euro-denominated safe assets when compared to US (Brunnermeier et al., 2011, pp. 1–4; Brunnermeier et al., 2018; Gorton et al., 2012, pp. 101–106).

The project of transforming the euro area into real global safe asset provider is unprecedented, since it will be the first example of producing such assets within the monetary union, with its own currency already highly internationalised. There is a broad consensus that a common safe asset would benefit the

euro area in a number of ways. The potential benefits overlap and are mutually reinforcing. Furthermore, they can be analysed from two complementary perspectives – external (global) and internal (intra-union) views (Bogołębska et al., 2022).

### **3.1. Benefits from the common safe assets – global perspective**

A common safe asset within the EMU should yield benefits in the international field, mainly by influencing the international monetary system. First of all, the greater attractiveness of the euro as a reserve currency would strengthen its international role. Due to the concept of network externalities, using the currency in its reserve function should be followed by other functions of international currency. The ability of the EMU to produce safe public debt instruments can stimulate demand for them because of the many functions' safe assets perform: as collateral in financial market transactions, a store of value, a benchmark for price formations, hedging and valuing riskier assets, for solvency and liquidity regulations, to name the most important ones (see more: Bogołębska et al., 2024, p. 6). Ongoing processes of foreign reserves diversification in the global economy will surely enhance demand for euro-denominated debt stemming from central banks. These processes may be triggered by financial sanctions, geopolitical tensions, fear about the sustainability of US debt, and phenomena stimulating the de-dollarisation trends. Furthermore, by hampering international cooperation, ongoing geoeconomic fragmentation (GEF) can weaken the capacity of the Global Financial Safety Net (GFSN) to support crisis countries and complicate the resolution of future sovereign debt crises (Aiyar et al., 2023).

The development of a common safe asset within EMU can, in effect, translate into the determination of the euro's exchange rate. Jiang et al. (2021) analysed the effects of the supply of dollar safe assets on the nominal dollar exchange rate. With safe asset suppliers, who experience capital inflows in periods of heightened market stress, the currency is subject to appreciation pressures, which may prove troublesome for domestic monetary policy. Thus, the emergence of a similar channel can be anticipated in the case of the euro.

It is commonly highlighted that adding a new global safe asset to the current stock can contribute to curtailing the global shortage of safe assets. This phenomenon, although not unanimously perceived in the literature, is found to result from both a decrease in their supply and an increase in demand (Bo-

gołębska et al., 2024). Among the factors that contributed to decreased supply, the limited capacity of reserve currency issuing countries to provide public debt should be noted. However, as GEF may translate into more severe crises (given lower international risk sharing, higher financing costs, reduced scope for coordination across countries), in effect, a risk of increased, self-defeating competition for scarce safe assets arises (Aiyar et al., 2023). Adding a new category of global safe assets to the international monetary system could make it more symmetrical. Re-channelling the destabilising flight-to-safety capital flows to a larger number of safe asset providers can help create a stable global financial architecture.

Within the discussion on the global scarcity of safe assets and its effects on the real economy, the literature points out that an increase in the supply of safe assets affects safe real interest rates. Ferreira and Shousha (2021), using a cross-country model with many economic drivers for the neutral rates (real rates consistent with both economic activity and inflation at their trends) of 11 advanced countries, find that changes in the net supply of safe assets account for a third of the variance of these rates since the 1960s. They estimate that a larger net safe asset supply between the 2008 financial crisis and the first half of 2020 raised neutral real rates by nearly 1.5 percentage points. The role of safe asset supply in global interest rates determination verifies the prediction that in financially open economies interest rates are determined by global market forces, and global co-movements of neutral rates can be explained by global spillovers. Thus, the power to influence global neutral rates reveals another dimension of the consequences of safe assets in the euro area.

However, as Arslanalp and Eichengreen (2023) reiterate, the relationship between issuance and downgrades for present purposes, between additional issuance and loss of safe-asset status, is nonlinear: high-quality issuers can continue to issue safe assets until their safe-asset status is abruptly lost. In fact, additional public debt issuance does not necessarily translate into alleviating the global safe asset shortage, especially in an environment of higher interest rates. This poses challenges for prompt and reliable debt-service payments, and also means that the current episode of public debt does not guarantee that the EMU's public debt assets are perceived as safe on a permanent basis.

Creating the mechanisms of debt mutualisation can also enhance the credibility of the euro area in the eyes of international investors, all of which should bolster efforts to enhance Europe's self-sufficiency and independence. Creating a common safe asset could be a further step to a higher level of integration, namely a political union, and render the euro area more stable.

### **3.2. Benefits from the common safe assets – monetary union's perspective**

The benefits of common EU safe assets can be grouped with respect to categories of beneficiaries, economic sectors, or some aggregates. Firstly, there should be benefits for the banking system. As a euro area safe asset should reduce the interdependence between sovereigns and domestic banking sectors, by diversifying away from national sovereign bonds, the banking sector automatically reduces its home bias and becomes less dependent on the position of the sovereign. The interconnectedness of debt and banking sector problems is best illustrated by the sovereign-bank nexus, also referred to as the 'diabolical loop', and was particularly detrimental during the euro-area sovereign debt crisis, transmitting sovereign distress to the real economy. If sovereign debt loses value due to the deterioration of the creditworthiness of the public sector, the financial sector balance sheet worsens as a consequence of its high exposure to domestic public debt. Weak bank balance sheets, in turn, lead governments to execute bailouts, increasing government spending and further worsening their fiscal position (Bogołębska et al., 2024, p. 123). Additionally, when adapting a common debt instrument, the bank receives the high-quality collateral needed to secure wholesale funding and central bank liquidity (Bini Smaghi & Marcussen, 2019). It might also prove useful to the sovereign in solving banking crises. Crises in the EMU would be far less damaging if banks held liquid euro-denominated assets not sensitive to sovereign risk (Zettelmeyer & Leandro, 2018, pp. 1–13).

Secondly, there are benefits for central banking and monetary policy within the EMU. The project should support the effective transmission of monetary policy across all euro area countries by facilitating its 'singleness'. The ECB's conduct of monetary policy during the Global Financial Crisis (henceforth GFC) was largely impaired by financial fragmentation in the EMU along the national lines of creditworthiness and the resulting divergent sovereign bond yields. A common debt instrument should ensure the smooth transmission of ECB monetary policy through the sovereign bond markets to the borrowing costs of households and businesses, and ultimately to aggregate demand (Spurga & Šreiberytė, 2021).

Thirdly, a liquid market for a euro safe asset should foster financial development and integration in the EMU, accelerating progress toward banking and capital market unions. (Alogoskoufis et al., 2020). This may happen by:

- facilitating both the diversification and de-risking of banks' sovereign portfolios,

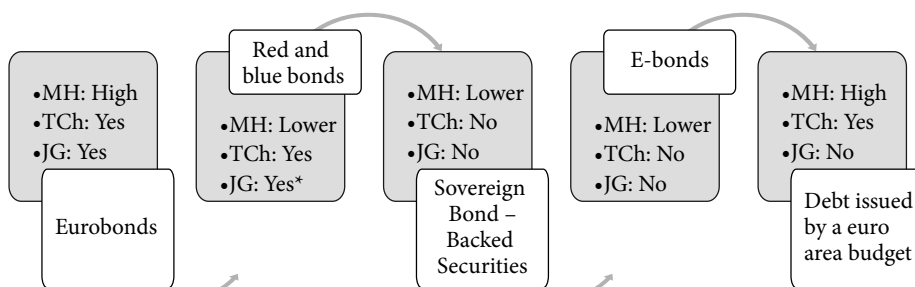
- introducing an additional financial instrument with a different risk-return profile, allowing markets to develop a proper euro area term structure,<sup>1</sup>
- supporting the development of a single securities market in the EU.

The financial stability benefits of gradually neutering the sovereign-bank loop would resolve the political impasse delaying the banking union (Braun, 2018).

A common safe asset should also foster financial stability in the euro area by eliminating or reducing the problem of destabilising capital flight from vulnerable countries to safe havens (e.g., German bunds) in times of distress. Despite the fact no exchange rate risk existing inside the EMU, the bloc suffered flight-to-safety capital flows from its peripheral countries to a few core countries. On the microlevel benefits, a euro-area safe asset should benefit European citizens by funding common projects aimed at addressing the challenges of green and digital transitions.

### 3.3. An insight into various proposals

Since the GFC, numerous proposals for creating a euro-area safe asset have flourished. These vary in terms of the guarantee structure for a joint debt instrument, the risk of moral hazard entailed and the options to address it, and the need to introduce changes to the Treaty on the Functioning of the European Union (henceforth Treaty). The proposals of creating a common euro safe asset backed by full or partial guarantees by Member States (MS) have one main drawback – they may imply that more creditworthy issuers would pay for risks created by less creditworthy ones. For this reason, the search evolved into solutions without requiring any state guarantees, towards a ‘synthetic asset’ (Figure 3.1).



Notes: MH – Moral Hazard, TCh – Treaty Changes, JG – Joint Guarantee, \*partial.

**Figure 3.1. Euro-area safe asset proposals**

Source: based on the cited literature.

<sup>1</sup> More about decreasing the flight to safety occurrence and its magnitude in sovereign bond markets in the article by Janus (2023).

### 3.3.1. Eurobonds (Eurobond 1, Eurobond 2)

The conceptual baseline for “Eurobonds” emerged at the height of the sovereign debt crisis, focusing on a framework where all Eurozone member states would become collectively liable for the total pool of issued debt (Bonnevay, 2010; De Grauwe & Moesen, 2009, pp. 1–4).

The Eurobond 1 proposal was the most radical in terms of creating a ‘genuine’ euro-area safe asset, while at the same time, entailing the greatest risk of moral hazard. The concept envisaged several and joint guarantee structure of common debt, implying a pooling of credit risk. In other words, it made each guaranteeing MS liable for the share of any other MS, should the latter fail to honour its obligations (Spurga & Šreiberytė, 2021). The issuance of Eurobonds 1 based on a joint and several guarantee structure would violate Article 125 of the Treaty (the no bailout clause). Hence, this proposal of debt mutualisation would require Treaty changes.

As a more pragmatic alternative, the Eurobond 2 proposal envisioned the creation of a common debt instrument under several but not joint guarantees, meaning that each MS would be liable for its share of the bond (the interest payments and principal redemption). Such a share would be fixed, reflecting, e.g., the ECB capital key. The amount of funding secured would match the same weights as those applied in the guarantee structure. As such, from an investor’s perspective, Eurobond 2 would resemble a diversified portfolio composed of national EMU sovereign bonds. In effect, the credit rating of the new debt instrument would be close to a weighted average granted to the individual MS. This stands in contrast to the Eurobond 1 proposal, for which expected benefits include a decrease in borrowing costs for participating MS. Eurobond 2 would still present some moral hazard challenges, though significantly lower than those associated with Eurobond 1. At the same time, because the proposal did not envisage joint liability, no changes to the Treaty would be required, rendering this proposal more easily deployable.

### 3.3.2. Red and blue bonds

The Eurobond 1 proposal involves a complete substitution of national issuance. A modification of this proposal (known as the blue-red approach) was brought forward by Delpla and Weizsäcker (2011). It assumed only a partial replacement of the national issuance. More specifically, the authors proposed the issuance of two types of bonds: blue and red ones. The former would be low-risk, high-credit-rating bonds. They would finance each country’s debt up

to 60% of GDP (according to the concept of debt sustainability as reflected by the Maastricht convergence criteria). These blue bonds would be jointly and severally guaranteed. As such, they would constitute 'true' EMU safe assets. On the other hand, their launch would inevitably require Treaty changes. In contrast, the red bonds (any debt issued beyond the 60% threshold) would be riskier for potential investors and would be guaranteed only by the national issuer.

### 3.3.3. Sovereign Bond-Backed Securities

The concept of Sovereign Bond-Backed Securities (SBBS) was advanced by Brunnermeier et al. (2016), evolved from the idea of tranching, originally proposed by Beck et al. (2011) and Brunnermeier et al. (2011). Beck et al. (2011) proposed a European security backed by a basket of sovereign bonds based on the ECB capital key weights (which reflect the relative size of nominal GDP and population) – in effect, a single tranche SBBS. Similarly, Brunnermeier et al. (2011) proposed the creation of European Safe Bond ('ESBies') based on a combination of diversification and tranching. The idea of "single-tranche SBBS" has the distinct advantage of not requiring any new institutions for financial intermediaries. However, Zettelmeyer and Leandro (2018) argue that 'pure diversification' proposals (or single-tranche SBBS) only modestly enhance the protection of the median euro area bank against sovereign risk.

The concept of SBBS was found to be feasible and developed by the European Systemic Risk Board (ESRB, 2018). Consequently, the European Union Commission proposed the necessary regulatory changes to facilitate the development of the SBBS market as a means of fostering financial integration (European Commission, 2018). The general idea was to use financial engineering overcome joint guarantees, the main political obstacle to Eurobonds (Gabor & Vestergaard, 2018). In essence, an issuer of these assets, being a private or a public intermediary (financial institution such as the European Investment Bank), would purchase a diversified portfolio of euro-denominated sovereign bonds (according to fixed shares, like those in the ECB's capital) and would subsequently use them as collateral to issue its own securities, a process comparable to a securitisation operation.

The project envisages two tranches – a senior one (the senior SBBS tranche) and a junior one (the junior SBBS tranche). As Brunnermeier and Huang (2018) put it metaphorically, 'tranching is like building a second, stronger line of defence within a fort'.

The senior SBBS tranche would be protected against losses of up to 30% on the underlying bond portfolio, rendering it a euro area safe asset. The junior SBBS

tranche would bear greater risk. The creation of SBBS should help delink banks from their sovereigns (thus eliminating the ‘diabolical loop’) and curtail destabilising capital flows among the euro area. This is because, in times of heightened market stress, capital would flow from more to less risky asset classes (i.e. from junior SBBS to senior SBBS) rather than from countries with worse macroeconomic foundations to EMU safe havens (core versus periphery division).

The SBB proposal entails no joint liability nor fiscal transfers, hence no amendments to the Treaty would be required. Instead, sovereign bonds with different risk profiles (e.g., German and Greek) would be bundled together to generate a safe asset via market process. Furthermore, the risk of moral hazard is relatively low (as compared to Eurobond 1), since each MS remains fully responsible for managing its debt and providing for its own credit spreads. Beyond protecting against a variety of risks (including correlated defaults), this proposal has other merits:

- SBBS could deliver a relatively large volume of safe assets while maintaining liquid national bond markets,
- would not lead to redistribution across countries.

### 3.3.4. E-bonds

The concept of E-bonds (Monti, 2010; Leandro and Zettelmeyer, 2018a,b) combines some features of ESBies and SBBS proposals. E-bonds involve neither tranching nor public capital. Instead, the framework provides for an intermediary who would hold a portfolio of government debt and issue securities – E-bonds, backed by this portfolio. Because E-bonds would be issued in a single tranche, the riskiness would depend on the share of each sovereign’s debt that the intermediary holds (Zettelmeyer & Leandro, 2018, pp. 1–13).

### 3.3.5. Debt issued by a euro area budget

The main drawback of this proposal would be the necessity to establish new institutions or euro area Sovereign Wealth Funds, and a suitable accountability structure (Zettelmeyer & Leandro, 2018, pp. 1–13). Alternatively, Ubide (2015) argues that the optimal solution would be to create supranational bonds issued by a euro area budget. Debt service could be financed by allocating tax revenue (value-added tax or corporate tax) to the budget or through contributions from Member States. The required safety would be achieved through the commitment

that the common budget has priority access to revenues over national budgets. In practice, this would mean that a Member State would first be obliged to pay its designated contribution to the euro area budget before it could use the tax revenue to service national debts. The main advantage of this proposal lies in its diversification of revenue streams.

## Conclusions

The mutualisation of eurozone debt is a politically complex and economically demanding issue. After the GFC, sovereign debt crisis, and COVID-19 pandemic, the EMU was forced to move from national borrowing to new hybrid models of debt creation, such as common safe assets and Eurobonds. These common safe assets offer numerous benefits: reducing debt levels, boosting public finance sustainability, and strengthening the attractiveness of the euro. While many alternative proposals have evolved to mitigate the main shortcomings, these proposals differ in significant areas: the safety of safe assets produced, particularly in times of market turmoil, the mechanisms of production (guarantees, tranching, and pooling, new institutions involved), their impact on sovereign borrowing costs, and their different risk-mitigating capabilities. Because no single proposal is free of drawbacks, there is still no consensus on the proper design of the safe asset. However, SBBS have recently been proposed by the European institutions for potentially addressing safe asset shortages and excessive bank-sovereign linkages in the euro area.

For the time being, the debate on concept of public debt mutualisation within the EMU has cooled. This seems to be attributable to other issues dominating the EU integration agenda: global challenges such as military spending, green and digital transformation, and post-COVID-19 recovery, which involved fiscal expansions at the national level. However, the risk of rising geo-economic tensions stemming from the Trump presidency and uncertainty surrounding the future of the dollar in the international monetary system will reignite interest in this issue.

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