A EU and ECB policy responses to the COVID-19 pandemic and the international role of the euro

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The coronavirus (COVID-19) pandemic triggered a strong policy response by European Union (EU) policymakers and the ECB to counter the economic fallout of the crisis. Several elements of the policy reaction, such as the launch of new EU borrowing programmes by the European Commission and the ECB´s policy response, may have implications for the global status of the euro. Moreover, in January 2021 the European Commission launched a new strategy to foster the international role of the euro.[55] *The purpose of this special feature is to review these policy initiatives and analyse their implications for the international role of the euro.*

The EU policy response to the COVID-19 pandemic and its implications for the international role of the euro

The fiscal policy response at the EU level to the economic fallout of the COVID-19 pandemic crisis was forceful and complemented policies at the national level. At the national level, euro area countries activated the fiscal policy lever to counter the economic impact of the pandemic, including fiscal emergency packages and extensive liquidity support measures in the form of tax deferrals and State guarantees. The budgetary impact of discretionary fiscal measures, amounting to around 4% of euro area GDP on average, is unprecedented compared with previous crisis episodes.[56] Crucially, national government measures have been complemented by the launch of a range of new facilities to be financed at the European level through debt issuance by the European Commission. Notably, these facilities include the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) programme, providing financial assistance of up to €100 billion in the form of loans from the EU to affected Member States, and the Next Generation EU (NGEU), a €750 billion temporary instrument to support the post-pandemic economic recovery, which is expected to become operational in summer 2021 at the earliest. NGEU issuance will imply a maximum debt-based fiscal expansion of around 1% of GDP on average in the euro area over the period 2021-24, assuming that the support is used at the national level to finance additional expenditures.[57] To a large extent, the proceedings from these bond issuances will finance investment and structural reforms

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55 Box 5 provides an overview of the Communication entitled "The European economic and financial system: fostering openness, strength and resilience" issued by the European Commission on 19 January 2021.

56 See Haroutunian, S., Osterloh, S. and Sławińska, K., "The initial fiscal policy responses of euro area countries to the COVID-19 crisis", *Economic Bulletin*, Issue 2, ECB, Frankfurt am Main, March 2021.

57 See Giovannini A., Hauptmeier, S., Leiner-Killinger, N. and Valenta, V., "The fiscal implications of the EU's recovery package", *Economic Bulletin*, Issue 6, ECB, Frankfurt am Main, September 2020.

by EU countries that are expected to lift the growth potential of the EU economies and reduce divergences in the euro area.[58] When designing their country plans, Member States need to allocate at least 37% of the funds to support the green transition and at least 20% to support the digital transformation. The NGEU programme therefore has the potential to increase both the resilience of the euro area economy to global shocks and the attractiveness of the euro as a global investment currency.

The new EU bond issuances will constitute the largest ever euro-denominated issuance at supranational level, raising the attractiveness of the euro as an investment currency for international investors, in particular official ones. The bond issuances under the SURE and NGEU programmes contribute to increasing the global supply of safe assets, as the EU currently enjoys the highest creditor status by the majority of rating agencies.[59] Indeed, the first issuances of SURE bonds, amounting to almost €40 billion in the course of 2020, attracted considerable attention from investors, including non-euro area investors, whose share in total take-up of the new bonds at issuance ranged between 31% (20-year tenor) and 60% (5-year tenor). The higher take-up by international investors at the short end of the maturity structure is positively correlated with the higher share of central banks and official investors participating in these issuances, since these institutional investors have a lower tolerance for risk than other market participants (**Box 7**). This confirms the potential for these EU bond issuances to bolster the status of the euro as a major international reserve currency.

The new EU bond issuances will increase the amount of highly-rated euro-denominated assets and could represent a further step towards establishing a common European safe asset. Currently, a significant amount of highly-rated national government debt is already available in the euro area. However, the euro area government bond market is fragmented among different bond issuers with a wide range of credit ratings and different levels of liquidity, potentially discouraging foreign investors (**Chart 21**). Moreover, the insufficient depth of segmented euro-denominated bond markets discourages foreign issuers from issuing international bonds denominated in euro. The establishment of a well-designed common European safe asset could bring substantial benefits in terms of enhancing financial integration and stability, fostering financial development and allowing markets to develop a proper euro area term structure.[60] In turn, this will support the international role of the euro. To deliver these benefits, a common safe asset should have a very high credit standard, be resilient to idiosyncratic shocks and have sufficient size and liquidity. The new EU bond issuances represent a first step in the direction of establishing a European safe asset. They are expected to increase the

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58 The Recovery and Resilience Facility will account for €672.5 billion of the total envelope of €750 billion of the NGEU. This facility will disburse loans and grants to support reforms and investments by EU Member States to mitigate the economic and social impact of the coronavirus pandemic and improve the sustainability and resilience of European economies.

59 All major rating agencies assign the highest creditor status to EU debt, with the exception of Standard & Poor’s, which assigns a lower rating (AA), similar to the rating assigned to US debt (AA+).

60 See Alogoskoufis, S., Giuzio, M., Kostka, T., Levels, A., Vivar, L.M. and Wedow, M., “How could a common safe asset contribute to financial stability and financial integration in the banking union?”, in *Financial Integration and Structure in the Euro Area*, ECB, Frankfurt am Main, March 2020.

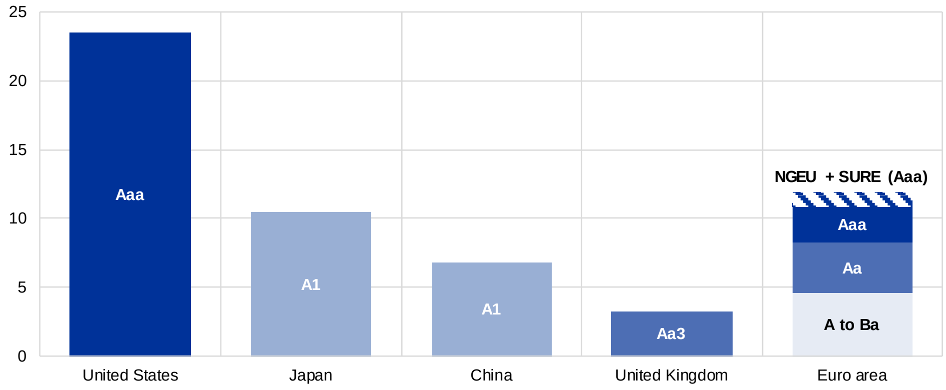
safest tranche of euro area government bonds – currently around €2.2 trillion as of the third quarter of 2020 – by almost 40% over the next few years.[61]

Chart 21

Public debt markets in the euro area remain fragmented compared with those in the United States

Outstanding general government debt securities

(USD trillions)



Sources: BIS, Haver Analytics, Bloomberg, European Commission and ECB calculations.
Notes: The data refer to total debt securities issued by the general government. Planned issuance for NGEU. The latest Moody's local currency long-term sovereign debt rating is reported for each country and NGEU. The observations are for the third quarter of 2020 for the amount outstanding of debt securities and for March 2021 for credit ratings.

Nevertheless, as new EU bond issuances are still relatively small on a global scale and are also temporary, they are unlikely to fundamentally alter the international role of the euro, in particular its position as a global safe asset. Over the past two decades, a relative scarcity of safe assets – liquid assets that maintain or increase their nominal value even in the worst state of the world – has emerged.[62] On the demand side, this has been driven by several factors, such as international reserve accumulation and demographic factors, as well as rising global risk aversion and sizeable asset purchase programmes by the major central banks since the global financial crisis. At the same time, on the supply side, issuance of safe assets did not keep pace with rising demand, remaining relatively stable compared with world GDP over the past twenty years and only recently increasing above its long-run average owing to the large public debt issuance triggered by the COVID-19 crisis (**Chart 22**, **left panel**). To a large extent, safe assets are mainly in the form of US dollar-denominated securities. For instance, US dollar-denominated securities accounted for more than 70% of the securities included in the Bloomberg Barclays Global Aggregate – Aaa index, a global market benchmark for safe bonds, whereas

[61] The figure corresponds to the general government debt securities outstanding for Germany, the Netherlands and Luxembourg, the only three euro area sovereign that enjoy the highest creditor status.

[62] See Caballero, R.J., Farhi, E. and Gourinchas, P.-O., "The Safe Assets Shortage Conundrum", *Journal of Economic Perspectives*, Vol. 31, No 3, Summer 2017, pp. 29-46. Some scholars disagree with the view that there is a global shortage of safe assets (see, for example, Cochrane, J., comments presented at the conference "International Monetary Stability: Past, Present and Future", Hoover Institution, 5 May 2016).

euro-denominated securities accounted for only 16% in 2020.[63] Notably, the share of the euro in global safe assets has halved since the global financial crisis, as the debt of a number of euro area economies was downgraded (**Chart 22**, **right panel**). The size of planned EU bond issuances will not fundamentally alter the relative currency shares in the supply of global safe bonds and, so far, EU bonds have not been included in the sovereign segment of broad bond indices. In addition, the temporary nature of the new EU facilities is a drawback for establishing these bonds as a benchmark in the portfolio of risk-averse global investors. Recent evidence has shown that there are three main factors that make government bonds a safe asset: (i) the quality of institutions of the issuing economy, (ii) the size of the debt market, and, importantly, (iii) the past track record of government bonds in hedging global risk, i.e. whether the asset behaved like a safe asset in the past.[64] At the same time, government debt needs to be sustainable to receive a sufficiently high rating. While EU bond issuances will certainly possess the first characteristic, namely a strong credit quality, they rank below the US dollar as regards the second characteristic – size – and, crucially will not satisfy the third factor as long as they remain a temporary facility and do not have an established track record as a hedge against global risk, even though issuance of new bonds under this programme is likely to continue for decades once refinancing transactions of maturing bonds are taken into account.

63 The Bloomberg Barclays Global Aggregate – Aaa Index is a measure of Aaa index rated debt including treasury, government-related, corporate and securitised fixed-rate bonds. As of the end of 2020 the index capitalised around USD 22 trillion. This is a lower bound for the universe of safe securities. For instance, US Treasuries account for around USD 9 trillion worth of securities included in the index, whereas US public debt amounts to USD 27 trillion as of the third quarter of 2020, according to the US Treasury. Nevertheless, excluding US Federal Reserve and Government accounts, privately held US Treasury debt is significantly lower, at USD 16.5 trillion. By using a different proxy for safe assets, such as the outstanding amount of public debt of countries with at least two major rating agencies assigning the highest creditor status, the share of the euro in the global supply of safe assets would be even lower, at around 10%.

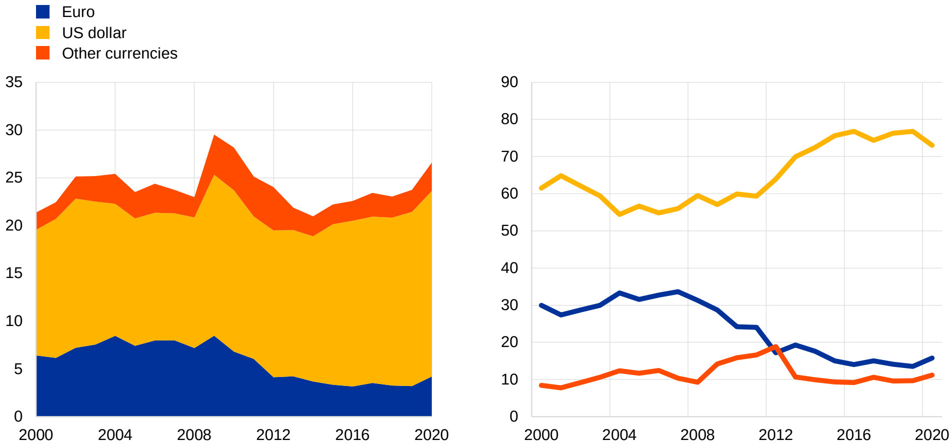
64 See Habib, M.M., Stracca, L. and Venditti, F., “The fundamentals of safe assets”, *Journal of International Money and Finance*, Vol. 102, 2020, pp. 102-119.

Chart 22

Stable supply of safe assets against a declining share of the euro

Market capitalisation of Bloomberg Barclays Global Aggregate – Aaa Index relative to world GDP (left panel) and currency composition (right panel)

(left panel: percentages of global GDP; right panel: percentages of total market capitalisation of the index)



Sources: Bloomberg, IMF and ECB staff calculations.
Notes: The Bloomberg Barclays Global Aggregate - Aaa Index is a measure of Aaa index rated debt including treasury, government-related, corporate and securitised fixed-rate bonds.

The ECB policy response to the COVID-19 pandemic and its implications for the international role of the euro

Since the start of the COVID-19 crisis in early 2020 the ECB has taken monetary policy measures to dispel tail risks in financial markets, ensure credit supply and stabilise the euro area economy. Notably, ECB monetary policy measures include three elements, two of them directly aimed at the euro area economy – asset purchases and lending operations – and a third element – the provision of euro liquidity to non-euro area central banks through swap and repo lines – aimed at preventing indirect negative spillback effects from non-euro economies to the euro area. First, in March 2020 the ECB expanded the asset purchase programme and launched the pandemic emergency purchase programme (PEPP) in order to stabilise financial markets, contribute to easing the overall monetary policy stance and counter severe risks to the outlook for the euro area. The PEPP had an initial envelope of €750 billion, which was increased twice in the course of 2020, reaching an overall envelope of €1,850 billion in December 2020. Second, the ECB revised the structure and pricing of longer-term liquidity refinancing operations to provide banks with access to central bank liquidity and support the supply of credit to the euro area economy during the pandemic. In particular, the ECB lowered interest rates during the pandemic period, increased the borrowing allowance, added new operations and expanded the range of eligible collateral for targeted longer-term refinancing operations (TLTRO III), and introduced new pandemic emergency longer-term refinancing operations (PELTROs).[65]

The provision of euro liquidity to non-euro area central banks through swap and repo lines represents the third element of the ECB strategy to forestall the potential adverse implications of the COVID-19 crisis on the euro area economy. By ensuring that euro funding is available to counterparties outside the euro area, the Eurosystem's swap and repo agreements help the ECB fulfil its monetary policy objectives. In particular, they prevent euro liquidity shortages from morphing into financial stability risks, avoiding forced asset sales and negative spillback effects stemming from the use of the euro by non-euro-area residents as a funding or investment currency.[66] Since the start of the pandemic crisis, the ECB has reactivated existing swap lines and established new swap and repo agreements with the central banks of several EU countries and non-EU countries in southern and eastern Europe. Finally, the ECB set up a new temporary Eurosystem repo facility (EUREP) to provide euro liquidity to a broad range of non-euro area central banks (**Figure 1** for an overview and **Box 6** for details), which did not meet the criteria for a bilateral liquidity line under the ECB´s framework. Even though these liquidity lines have only been drawn sporadically and for relatively small amounts, there is evidence that their sheer availability has been successful in mitigating stress in euro funding markets, preventing a tightening of lending and financing conditions in economies with strong economic and trade ties to the euro area (**Box 6**).

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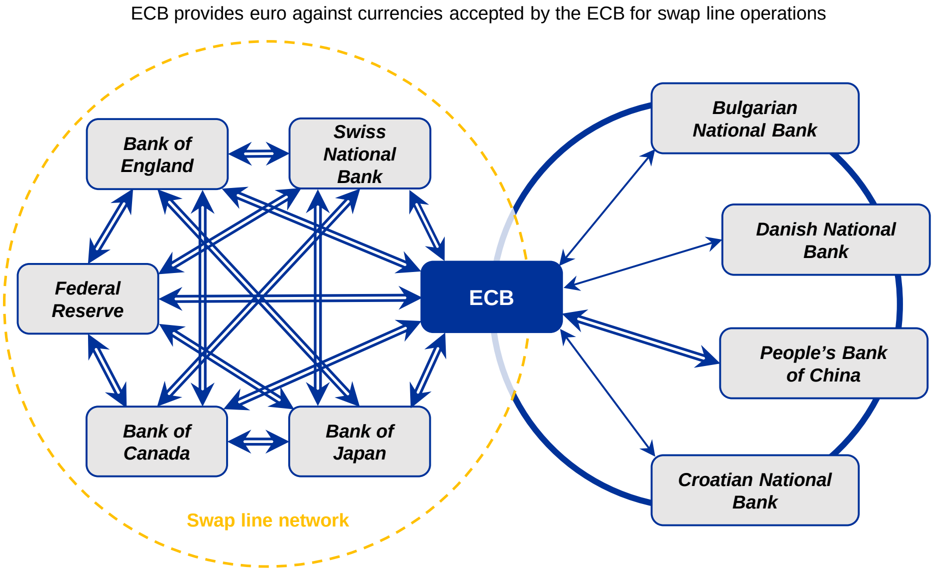
[65] For an assessment of the contribution of these monetary policy measures to countering the COVID-19 shock, see Lane, P., "Monetary policy in a pandemic: ensuring favourable financing conditions", speech at the Economics Department and IM-TCD, Trinity College Dublin, 26 November 2020. See also Schnabel, I., "The ECB's policy response to the COVID-19 pandemic", guest lecture at the University of Chicago Booth School of Business, 18 February 2021.

[66] For a discussion, see Panetta, F. and Schnabel, I., "The provision of euro liquidity through the ECB's swap and repo operations", The ECB Blog, 19 August 2020.

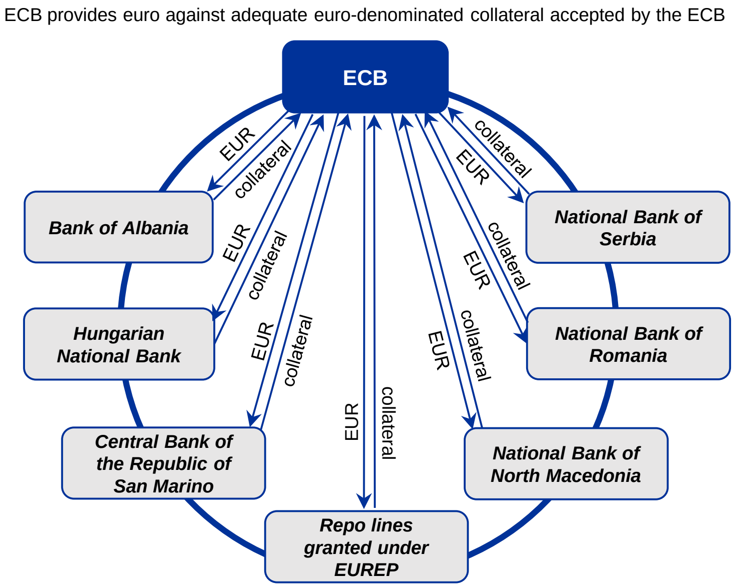
Figure 1

Eurosystem framework for providing euro liquidity to other central banks

a) Swap lines



b) Repo lines



Source: ECB.
Notes: Under the swap line arrangements, the ECB provides euro liquidity against currencies accepted by the ECB for swap line operations. Under the repo line arrangements, the ECB provides euro liquidity against adequate euro-denominated collateral accepted by the ECB. EUREP is the Eurosystem repo facility for central banks. The countries mentioned in the overview of the Eurosystem's repo line arrangements are included by way of example to illustrate the functioning of these types of agreement. A double line in the swap lines overview indicates that the agreement is reciprocal.

The ECB's response to the crisis may have had the side effect of supporting the international role of the euro. First, a global currency benefits from a central bank that acts as a credible backstop to safeguard liquidity conditions in the financial system in times of stress. According to recent research, a link exists between central bank policies in global downturns and firms' debt currency choice in international markets.[67] By providing ample liquidity during the COVID-19 crisis, the ECB countered the negative effects of the pandemic shock to the euro area economy, enhancing the stability of the euro, which, in turn, can support its international status. Second, through its swap and repo lines, the ECB was one of the major central banks that offered access to its currency at the international level. The ECB provided liquidity lines for monetary policy purposes. By providing an effective backstop to private currency markets, the risk of fluctuations in euro funding costs in international markets for non-euro area residents is diminished. In turn, this may increase the attractiveness of financial and commercial contracts based on the euro and enhances confidence in euro asset markets.[68] The attractiveness of a currency in global banking and financial markets and its use as an invoicing currency for trade reinforce each other.[69] There is also evidence that currency swap lines and international currency usage are positively correlated. However, the direction of causality between the two is debated. Some observers see currency swap lines as an "exorbitant duty" and responsibility of a central bank that issues an international currency. Others claim that currency swap lines themselves foster international currency status. In any case, it might be plausible to assume that currency swap lines and international currency status tend to reinforce each other.[70]

Concluding remarks

National fiscal policies, the facilities that have been set up at the EU level and the ECB's monetary policy have all supported a strong and cohesive economic recovery from the COVID-19 crisis, thereby enhancing the resilience of the euro area and the international role of the euro. EU bond issuances planned under the NGEU programme will significantly increase the amount of highly-rated euro-denominated assets and represent a further step towards establishing a common European safe asset. This will help to foster financial deepening and capital market integration in the euro area and, in turn, the international role of the euro. However, insofar as NGEU remains relatively modest in size compared with bond markets in other major currencies and is also a temporary initiative, it is unlikely, at this stage, to fundamentally change the global status of the euro. At the same time, NGEU is linked to investment and structural reforms which are expected to increase the

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67 See Eren, E. and Malamud, S., "Dominant currency debt", *BIS Working Paper*, No 783, Bank for International Settlements, 2019.

68 Some authors argue that central banks' currency swap lines, by putting a ceiling on deviations from covered interest parity, incentivise cross-border gross capital flows and provide a decisive contribution to raise the international status of a currency. See Bahaj, S. and Reis, R., "Central bank swap lines," *CEPR Discussion Paper*, No 13003, 2018.

69 See Gopinath, G. and Stein, J., "Banking, trade, and the making of a dominant currency", *Quarterly Journal of Economics*, Vol.136, No 2, May 2021, pp. 783-830.

70 See Box 7 entitled "Currency swap lines and international currency status", in *The international role of the euro*, ECB, Frankfurt am Main, 2019.

growth potential of the euro area and its internal cohesion, thereby increasing the resilience of the euro area economy to global shocks and boosting the attractiveness of the euro as a global investment currency. Furthermore, the monetary policy measures taken by the ECB in response to the pandemic have been swift and forceful. They have helped to stabilise the euro area economy in the face of an exceptionally large shock. In addition, the measures it has taken to provide euro liquidity to non-euro area central banks have helped to forestall potential adverse implications of the crisis on the euro area. All these measures had a knock-on effect of supporting the global appeal of the euro over the review period.

Ultimately, the global attractiveness of the euro is primarily supported by a deeper and more complete EMU, including advancing the capital markets union. Similarly, pursuing sound economic policies in the euro area is important for the euro's global attractiveness. Completing banking union would make the euro area more resilient, while progress towards a capital markets union would contribute to deeper and more liquid financial markets. In turn, this would indirectly support the international use of the euro as an international investment, financing and settlement currency.