

EU sovereign bonds can reshape the bloc's future

Safe assets denominated in euros could help it to displace the dollar

Almost exactly 70 years before the EU agreed its recovery fund package, the bloc was taking its first steps towards monetary union. Chronically short of dollars, the international reserve currency under the Bretton Woods arrangement, and having to resort to barter in order to trade with each other, the war-torn countries of western Europe banded together into the European Payments Union, allowing them to trade on credit and delay dollar payments until the end of the month.

Now the issuance of EU sovereign bonds used to finance the recovery fund agreed this week will enhance the trading bloc's financial autonomy from the US. It has the potential to contribute to the euro's role as a reserve currency by creating a new safe asset that can be used as collateral in money markets and break the "doom loop" between individual countries' solvency and their banks. This institutional shift may, in time, become even more influential on the future of the bloc's economy than the fund itself.

The euro punches below its weight. While the eurozone accounts for around 16 per cent of global income compared to the US's share of 15 per cent, its currency plays second fiddle to the dollar. According to a 2018 report from the ECB, the euro accounts for 20 per cent of international foreign exchange reserves compared to the dollar's 62 per cent — figures for international debt and loans are similar.

The dollar's global reserve currency status not only affords the US leverage in foreign policy — the state department can use sanctions to cut actors off from international finance — but also economic policy. At times of crisis the dollar strengthens at the same time as the federal government's bond yields fall. That may make life harder for US exporters but it means there are few worries about fiscal sustainability or imported inflation at times of crisis.

The dollar inherited this role from the postwar Bretton Woods system of fixed exchange rates but maintained it thanks to the US's deep capital markets. With a shortage of safe bonds thanks to the ECB as well as lingering concerns that the single currency may one day break up, the eurozone has never developed such markets to the same extent. While common euro-denominated bonds will help solve many of these problems it is not a silver bullet: the EU must redouble its efforts to build a capital markets union.

There are plenty of other reasons to be sceptical of the new arrangement. First, the recovery fund is temporary. While the debt issued to pay for it will be around for a while, it is planned to be one-off rather than ongoing spending. Second, the recovery fund is an EU rather than a eurozone

scheme. The distinction between the two has shrunk since the UK left the trading bloc but it adds to the institutional uncertainty.

There are risks for the US too. China is among its main creditors, owning 4 per cent of the US government's debt. Beijing's estimated \$3tn foreign exchange reserves are thought to be mostly in dollar-denominated assets, mainly because there are no viable alternatives to the greenback. The creation of EU bonds may change that calculation, making the US more dependent on the goodwill of its creditors, whether China or the long-dormant private-sector bond vigilantes.

Yet this is a concern for the future. The EU's new "national" debt will not be large: at \$750bn, the borrowing necessary will only be about 5 per cent of the bloc's gross domestic product. That will not be enough to change international finance in the short term. In the longer term, however, it may come to be seen as the beginning of the end of a process that started 70 years ago.