

# Outside the box: Why Europe borrows in US dollars

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Earlier this month, the European Stability Mechanism (ESM) issued its fourth US dollar bond to qualified institutional buyers. [This \\$3 billion 5-year maturity bond](#) was our most successful issue since our October 2017 inaugural dollar issue. The new bond attracted new clients, from new central banks to new corporate treasury investors, and generated our largest-ever order book for a US dollar transaction with over \$6 billion of demand.

As an institution based at the heart of Europe and tasked with helping protect the euro, you might well ask why the ESM, and other European institutions, issue dollar bonds? After all, the US Treasury does not issue in euros so far. Well, there are plenty of reasons why.

## How it all began

The ESM and its temporary predecessor the EFSF were created to enable the countries of the euro area to avoid and overcome financial crises. To fulfil this mission we must be able to raise funds at short notice, possibly in difficult markets, creating what we call funding liquidity risk. To manage this risk we use a diversified funding strategy, which gives us the flexibility to raise the needed funds by using a variety of securities with different maturities to approach a wide range of different investors. With this funding strategy, we established ourselves as reliable benchmark issuers in the euro market. That means that our bonds are liquid, tradeable, and set a standard as top-notch-rated fixed income securities.

The ESM and EFSF have issued 91 euro-denominated bonds across 151 transactions since their inception. Some years the ESM ranked as the biggest euro-denominated bond issuer that was not a country, and dwarfed only by each of the euro area's four-biggest economies: Germany, France, Italy and Spain.

But funding is more than issuing large amounts of bonds, however successfully. It is also about managing liquidity risk. For this, we turned in 2017 to a second currency, one with the deepest capital market in the world, the US dollar.

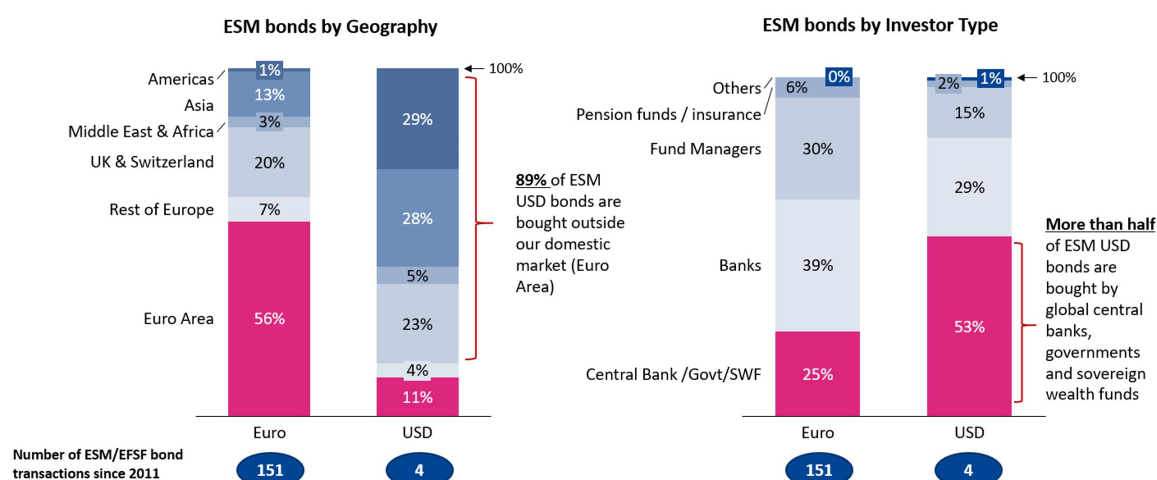
## Diversification not dollarisation

The US dollar market allowed us to access the largest financial market in the world thus diversifying our investor base, reaching investors holding mainly dollar-denominated assets, and opening up new lines with existing investors whose only option at that time was to buy our euro issues.

The diversification has resulted in participation from new investors. When we issue in US dollars 89% is bought outside the euro area, compared to 44% bought by non-euro area when we issue in euro-denominated bonds.

Impressively, more than half of our US dollar investors are from the public sector: central banks, governments, and sovereign wealth funds from around the world. When we issue in euros, that number is cut nearly in half. The dollar allows us to access long-term so-called buy-to-hold investors from outside the euro area – an important benefit in times of crisis that allows for alternative issuance when supply in the euro market soars.

## Figure 1: USD allows 89% of bonds to be sold outside ESM domestic market (euro area) and 53% reaching global public sector institutions



Source: ESM

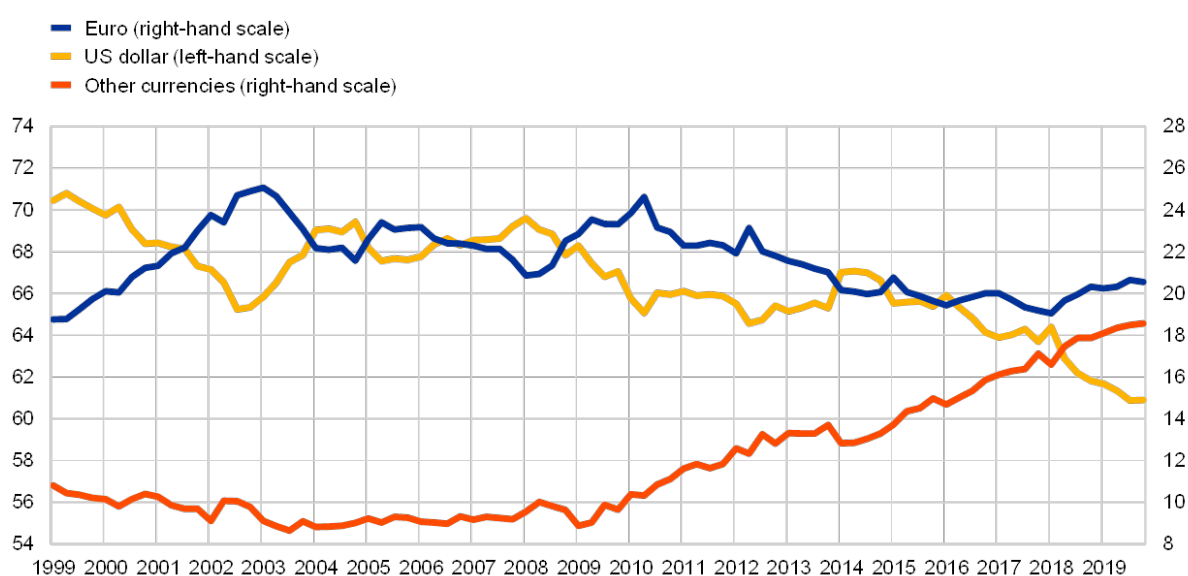
## Why is the US dollar market attractive to investors?

At present, the dollar is the global foreign exchange reserve currency of choice. So accessing the dollar market has advantages to reach these investors. US dollars comprise around 60% of central banks' and other public entities' foreign reserves and around 20% of FX reserves are in euros. Additionally, large US corporate treasuries from car manufacturers to technology companies hold US dollars and are interested in investing them in the safest credits they can find, such as the AAA-rated paper of the ESM.

For investors, US dollar bonds can sometimes offer positive yield. For example, the ESM did two issues in 2019 just a few weeks apart: a 1.375% coupon for five years in US dollar last September and zero coupon for five years in euros last October. Figure 3 further below illustrates the yield gap.

Figure 2: USD is the leading reserve currency globally, followed by the euro. Other currencies (e.g. renminbi) are gaining traction over the last 10 years

Currencies in global official holdings of foreign exchange reserves; (percentages; at constant Q4 2019 exchange rates)



Source: ECB, The international role of the euro, June 2020<sup>[1]</sup>

## Benefits of US dollars for issuers like the ESM

In the US dollar space, the ESM can use its regular and broad strategic market presence to appeal to investors who want to both buy our euro paper and invest in dollar-denominated bonds.

New investors have expressed interest in us as an issuer, and for some investors this is an introduction to the European market. In our four US dollar deals so far, the ESM has added 24 major institutional investors to its list.

A wider investor base means the ESM will have more flexibility to raise the necessary funds rapidly and cost efficiently by issuing bonds in two major currencies.

This summer, the market faced a large supply of euro issues and new issuance premiums went up to counter the risk of saturation. By issuing dollars, we could mitigate risk and move into a market with large absorption capacity.

Additionally, when the ESM issues in US dollars the proceeds of the bond are converted back into euros so that the ESM carries no currency risk.

This reduction in risk and, when applicable, cost arbitrage, allows for cost savings and is ultimately better for our shareholders, the euro area member states.

To have the means to raise considerable amounts in US dollars means building our presence and investor relations in the dollar-denominated market when there is no financial crisis. During roadshows with investors, we also can share the story of Europe and policy decisions with new audiences.

## Table 1: The ESM has issued four US dollar bonds

	<b>Inaugural bond</b>	<b>ESM October 2020 bond</b>	<b>ESM September 2024 bond</b>	<b>ESM September 2025 bond</b>
Amount placed	\$3 billion	\$3 billion	\$2 billion	\$3 billion
Maturity	3 November 2022	23 October 2020	11 September 2024	10 September 2025
Coupon	2.125%	3.00%	1.375%	0.375%
Reoffer yield	2.201%	3.067%	1.455%	0.458%
Reoffer price	99.641%	99.871%	99.616%	99.590%
Settlement date	31 October 2017	23 October 2018	11 September 2019	10 September 2020

	Inaugural bond	ESM October 2020 bond	ESM September 2024 bond	ESM September 2025 bond
Lead managers	Citi, Deutsche Bank and J.P. Morgan	Barclays, BofAML and Citi	HSBC, J.P. Morgan and Nomura	Credit Agricole, Goldman Sachs and TD Securities

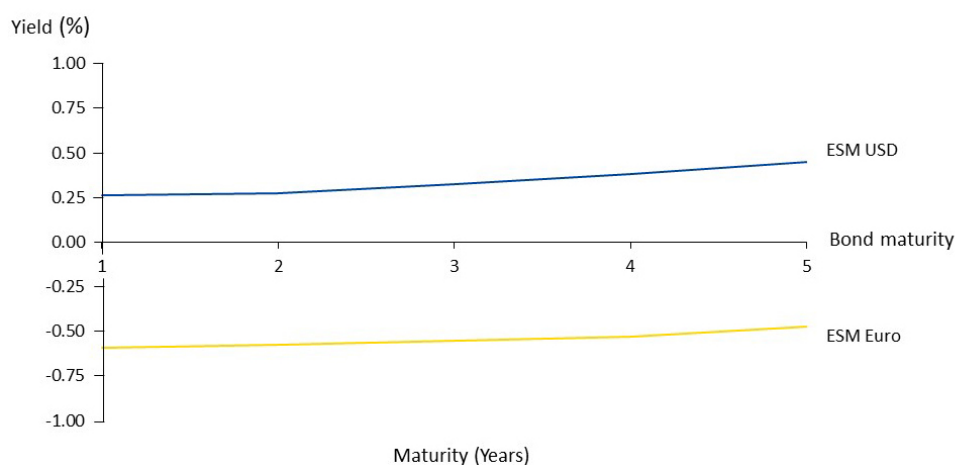
Source: ESM

## The ESM 2020 US dollar note

This month's [\\$3 billion 5-year maturity bond](#) was, like previous issues, a short-dated maturity, in what is sometimes called the “belly of the yield curve”. Our commitment remains to at least one US dollar issue each year. Through our outstanding issues, we now effectively have a short-dated yield curve stretching from one to five years.

## Figure 3: ESM has a USD curve, next to a Euro curve. USD offers positive yields to investors

Yield levels of ESM USD and ESM Euro bonds



Some global investors are not able to buy negative yielding bonds

ESM USD bonds offer them a good alternative to buy with positive return

Source: ESM; Bloomberg

## The ESM also invests in US dollars

If our US dollar issuance is not widely known among the public, perhaps even less familiar are our US dollar investments.

As of 2019, around €2.5 billion, or 3% of ESM's €80.5 billion paid-in capital, is invested in US dollar-denominated bonds. How does this happen?

To help ensure its creditworthiness, the ESM invests by diversifying its exposure across asset classes, issuers, regions, and currencies with an aim to have at least 30% of its exposure in supranational names and non-euro area issuers. To reach this objective, the ESM can invest in nine currencies of developed countries, while ensuring hedged foreign exchange risk. These investments also help enhance ESM's returns, thanks to the yield pick-up offered by the use of the cross-currency swaps, to hedge the foreign exchange positions. By 2019, the ESM's exposure to foreign currency assets increased to reach a little more than 9% of the paid-in capital.

## Euro, dollar, and a multi-currency world

According to a [recent report from the European Central Bank](#), the euro is the global leading currency for sustainable and green finance in capital markets at 45% versus 26% in US dollars. The euro will continue to represent the majority of our issuance in the future, but we can also expect greater depth in our local market. Indeed, a greater internationalisation of the euro could be determined by factors such as growth of sustainable finance.

Still, the dollar will remain the second most important currency for the ESM and we are committed to our strategic market presence in the dollar market with our plan to keep issuing at least one US dollar deal per year to qualified institutional investors.

In the long term, we believe in the importance of a multi-polar currency system.<sup>[2]</sup> It could not only bring benefits to investors, issuers, and the entire international monetary system, but also create a [stronger and more stable financial system](#).

This is why at the ESM, next to the euro, we also love the dollar.

## Acknowledgements

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## Footnotes

[1] European Central Bank (2020) [The international role of the euro](#)

[2] Financial Times (2019) Kalin Anev Janse: [Importance of a multi-polar currency system](#)