Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

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Serious concerns about the idea of confiscating Russian assets

The European Union is exploring ways to confiscate part of Russia's central bank's frozen $280 billion in assets. According to Bloomberg, European officials are considering different options to find funds to finance the Ukraine war, as they perceive a significant risk of lower United States support, as well as the significant challenges that member states will face if they try to increase defence spending.

The European Commission estimates that the EU needs to invest €500 billion in the defence sector over the next decade, according to Euronews. Additionally, NATO is expected to raise its minimum target from the current 2% of GDP to around 3.6% of GDP, according to ING.

Therefore, an increase in the EU's annual defence spending from 2% to 4% of GDP would amount to approximately €340 billion per year, something that appears difficult to finance considering the current fiscal challenges of countries like France, Italy, or Spain.

To accommodate the increase in security spending, European Union officials are considering various policy choices, including issuing mutualised debt and even extracting the defence investment from the European Commission's fiscal rules.

Issuing Eurobonds to finance defence spending is complex because many countries do not feel comfortable with the additional risk coming from fiscally irresponsible member states and the possible spillover effect if a new European debt crisis emerged.

Eurobonds may be easy to issue, but it will be difficult to allocate the funds to each member state and monitor the way in which the money is administered. Furthermore, those bonds could be volatile in a period of economic uncertainty and weak public finances.

Cheating at the EU's own game

The European Commission has proposed activating an escape clause for defence investments, allowing member states to increase defence expenditure without violating fiscal rules, according to Euronews. This would allow higher deficits and debt levels but also potentially weaken EU solvency and credit profiles.

A decision by the European Union to extract the newly issued debt from the fiscal rules is basically cheating at their own game. It does not matter if they do not count the new debt with the rest, as the market will still consider the total figure.

> The EU is simply unable to pay for its own defence

The European Commission already tried something similar with the concept of "debt under the excessive deficit protocol," which deducts bonds in the hands of public administrations and state-owned entities from the official public debt figure.

It does not matter whether the EU decides to exclude it from the official debt figures, as it has been issued and needs to be paid. Hiding debt under the carpet does not make it disappear.

The EU is simply unable to pay for its own defence once we consider the elevated public spending and giant unfinanced committed liabilities, which rise to an average of 350% of GDP in the main European economies, according to Eurostat.

The temptation of confiscating

Once we understand that all these options are complicated, we can see why the European Union is considering the temptation of confiscating the frozen assets of the Russian central bank.

These assets were held at European banks and institutions like Euroclear and were frozen as part of the sanctions after the Ukraine invasion. However, the confiscation of these assets may bring significant legal and economic challenges.

Seizing Russia's sovereign assets could violate international law, as these are considered protected state property. Freezing the assets did not create a relevant outflow of capital from European banks in 2022, as global investors were reassured that it was a temporary measure and there would not be retaliatory actions against countries or individuals trading with Russia. However, this could change if global investors see a leap from freezing assets to direct confiscation.

The EU is examining whether judicial decisions or damage calculations would provide a sufficient legal basis for asset seizure, according to Bloomberg.

> Countries like China or Saudi Arabia could impose direct retaliation measures against large EU member states

However, this could create a legal nightmare, as Russia could sue the EU for perceived violations of international law, and countries like China or Saudi Arabia could impose direct retaliation measures against large EU member states such as France and Germany, or withdraw state assets from European banks, according to EU Observer.

European officials worry about setting a controversial legal precedent that could undermine the EU's role as a defender of the rule of law. However, the most important impact could be on the euro as a world reserve currency.

Weaponising the euro

Confiscation could accelerate the decision to move some sovereign wealth funds and central bank assets out of the euro area and abandon European sovereign bonds as a reserve asset.

We must remember that the increase in central bank holdings of gold at the expense of sovereign bonds is not a future risk but a current policy that is widely implemented.

Retaliation can also come with the confiscation of European assets in Russia, which are estimated to range between $100 and $200 billion, according to SP Global. Furthermore, economic retaliation could arrive from more countries like China, India, Brazil, or Saudi Arabia.

Weaponising the euro and seizing frozen assets could lead investors to look at other alternatives like gold or the Chinese banking system and currency - Daniel Lacalle

A significant outflow of capital out of Europe and abandoning EU sovereign bonds as safe investments and reserve assets could generate a sizeable depreciation of the euro and increase the borrowing costs for European countries just when they are trying to issue more debt to finance social and defence spending.

Even the European Central Bank has expressed concerns about the idea of asset confiscation, according to CNBC, fearing a significant backlash against euro area debt and its currency utilisation.

Weaponising the euro and seizing frozen assets could lead investors to look at other alternatives like gold or the Chinese banking system and currency. It could even accelerate the creation of a global alternative to the European and US financial systems.

Irreparable damage

The European Union is not able to pay for its own defence, and, at the same time, seizing the Russian central bank assets can lead to irreparable damage to the euro and the European financial system.

The challenge is enormous, and the risk to legal and investor security should not be overlooked. The damage may not be limited to Russian assets but to the investments of all the countries that maintain a solid trading and diplomatic relationship with Russia, which account for almost 40% of the world's GDP. Not a small risk.

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The euro and the European financial system are much weaker than EU officials think. The euro is the only reserve currency with redenomination risk, and its use is significantly below the US dollar as a world currency.

The European financial system cannot afford large outflows of foreign capital and putting its legal and investor security perception under question. Seizing the Russian central bank's assets could potentially signal the beginning of the end of the euro as a reserve currency.