UNIVERSITY OF AMSTERDAM

UvA-DARE (Digital Academic Repository)

COVID-19: A euro area safe asset and fiscal capacity are needed now

Codogno, L.; van den Noord, P.

Publication date
2020
Document Version
Final published version

Link to publication

Citation for published version (APA):
Codogno, L., & van den Noord, P. (2020). COVID-19: A euro area safe asset and fiscal capacity are needed now. Web publication or website, VoxEU. https://voxeu.org/article/covid-19-euro-area-safe-asset-and-fiscal-capacity-are-needed-now

General rights
It is not permitted to download or to forward/distribute the text or part of it without the consent of the author(s) and/or copyright holder(s), other than for strictly personal, individual use, unless the work is under an open content license (like Creative Commons).

Disclaimer/Complaints regulations
If you believe that digital publication of certain material infringes any of your rights or (privacy) interests, please let the Library know, stating your reasons. In case of a legitimate complaint, the Library will make the material inaccessible and/or remove it from the website. Please Ask the Library: https://uba.uva.nl/en/contact, or a letter to: Library of the University of Amsterdam, Secretariat, P.O. Box 19185, 1000 GD Amsterdam, The Netherlands. You will be contacted as soon as possible.

UvA-DARE is a service provided by the library of the University of Amsterdam (https://dare.uva.nl)

Download date:06 Sep 2026

COVID-19: A euro area safe asset and fiscal capacity are needed now

Lorenzo Codogno, Paul van den Noord 25 March 2020

The COVID-19 outbreak that is hitting the euro area economy needs to be met by a powerful policy response beyond the emergency measures already in place. This column uses an empirically calibrated model to show that the creation of a safe asset and fiscal capacity at the centre – on which the debate has been ongoing for a long while – would be a powerful means to mitigate the economic impact of the crisis.

Face Twitt Print Ema Add 58Share

A A

The COVID-19 shock initially looked to be mostly a supply-side story, for which both monetary and fiscal stimulus can do little. However, the almost immediate sharp tightening in financial conditions related to liquidity, financial market tensions, and the collapse in confidence and aggregate demand call for an energetic macroeconomic policy response. Monetary policy and national fiscal actions are unprecedented but may still not be enough. A powerful fiscal response at the centre looks necessary.

Both the symmetric nature of the shock and limited fiscal space in several member states argue for a response at the supranational level. However, the political hurdles that the creation of new fiscal instruments at the European level – especially if they entail risk sharing across member states – would have to cross are daunting. The problem would remain even if European leaders decided to go for a quick fix through the European Stability Mechanism, and a more permanent solution would have to be developed over time. This can only be achieved if it is seen as benefitting all, which is what our modelling exercise, discussed below, suggests.

Related

The ESM must help against the pandemic: The case of Spain
Aitor Erce, Antonio Garcia Pascual, Toni Roldán Monés

Covid Perpetual Eurobonds
Francesco Giavazzi, Guido Tabellini

A proposal for a Covid Credit Line
Agnès Bénassy-Quéré, Arnoud Boot, Antonio Fatás, Marcel Fratzscher, Clemens Fuest, Francesco Giavazzi, Ramon Marimon, Philippe Martin, Jean Pisani-Ferry, Lucrezia Reichlin, Dirk Schoenmaker, Pedro Teles, Beatrice Weder di Mauro

Economics in the time of COVID-19: A new eBook
Richard Baldwin, Beatrice Weder di Mauro

Impossible grand bargain

There is a strong case for creating a European safe asset to replace national sovereign bonds in their role as collateral for banks in repos and inter-bank loans (Alogoskoufis and Langfield 2019, Bénassy-Quéré et al 2018, Leandro and Zettelmeyer 2018). Proposals have also been put forward to create a fiscal capacity at the centre of the euro area to finance deficit spending (Arnold et al. 2018). We have combined these proposals into one comprehensive package and quantified its impact on the resilience of the euro area economy in the face of major adverse shocks like the one we are currently experiencing.

Specifically, the package includes the following:

Lorenzo Codogno
Visiting Professor in Practice, LSE

Paul van den Noord
Affiliate Member, Amsterdam School of Economics, University of Amsterdam and ACES, Amsterdam Centre for European Studies

Don't Miss

Covid-19 and School Closures: Can pupils make up for lost time?
Cook

Publishing and evaluating success in economics: A new eBook
Galiani, Panizza

Race and Covid-19: The long-run impact of discrimination
Bertocchi

Events

Taxing the superrich
3 - 3 November 2020 / Webinar / UBS Center for Economics in Society and CEPR

CALL FOR PAPERS - 2020 ECMI Annual Conference
4 - 5 November 2020 /

- A safe asset is issued at the centre underpinned by a stable revenue source, for instance, a proper central tax base or an obligation of national governments to secure a predictable revenue flow to the centre. It is swapped at market prices for national sovereigns on the balance sheets of banks. It replaces national sovereign bonds in their role as collateral for banks in repos and inter-bank loans. Moreover, the safe asset enjoys exclusive eligibility for ECB asset purchases. It thus replaces national sovereign bonds on the ECB's balance sheet. To allow proper price discovery, a sizeable enough new issuance of the safe asset will precede the swap operation.
- The safe asset would receive seniority over national sovereign bonds to ensure it is seen as an attractive investment for banks. The profit banks generate by the sale of sovereign bonds is allowed to be spread over several years. This is to smooth the transition to a bank business model that no longer relies on carry trades with sovereign bonds and to allow sufficient time for banks to achieve higher profitability from other sources. The swap operation would not imply any fiscal transfer. The ECB would enable banks to close in advance their financing operations to offset the selling of national sovereign bonds on their balance sheet.
- Beyond the issuance of the safe asset to purchase national sovereigns, the role of the central fiscal capacity could be expanded to allow borrowing for the purposes of fiscal stabilisation policy. The ECB would be allowed to purchase the safe asset in the secondary market, as is already the case for debt issued by supranational EU agencies (such as the ESM). This would underpin the safe asset's role as a liquid, risk-free benchmark.

The total amount of safe assets needed to purchase national sovereigns in the hands of the ECB and on the balance sheets of the banks would be roughly 30-40% of GDP. This implies that, on average over the cycle, the issuer of the safe asset would need a revenue flow roughly in the range of 0.5% and 1.0% of GDP, the bulk of it being covered by interest receipts on the national sovereigns owned at the centre.

The additional issuance of the safe asset in bad times to fund deficit spending at the centre depends on the depth of the slump. It could – according to the model simulation discussed below – in the current exceptional circumstances be in the range of 5% and 10% of GDP. If this is repaid over a period of ten years, it would require an additional annual revenue flow to the centre in the range of 0.5% and 1% of GDP, given that the yield would presumably be low.

Aside from the stabilisation effects of this package (see below), the financial and policy landscape of the euro area would permanently improve. The replacement of national sovereigns with a safe asset on banks' balance sheets serves to break the 'doom loop' between the cost of bank funding and sovereign yields in the euro area 'periphery'. With the safe asset enjoying exclusive eligibility for the purposes of quantitative easing, the ECB would obtain a monetary policy instrument that does not interfere with national fiscal policies via national sovereign debt purchases. Moreover, as large amounts of national debt are swapped with safe European-level debt, the default risk at the national level is reduced, with fewer calls on rescue programmes.

Impact on the resilience of the euro area economy against the shock

In several papers (Codogno and Van den Noord 2019, 2020), we examined how this new set of policy tools could improve the resilience of the euro area economy against shocks. How would this pan out in terms of absorbing the current shock? We simulate a scenario which we think broadly reflects the shock that hits the Eurozone economy now. Accordingly, we assume a symmetric supply shock of -5% of GDP combined with a symmetric demand shock of -10% of GDP hitting both the core and periphery.

Figure 1 Absorbing the COVID-19 shock: Two scenarios

Brussels, Belgium / European Capital Markets Institute

CEPR Virtual Industrial Organization Seminar 20 - Ratings Design and Barriers to Entry
4 - 4 November 2020 / Online /

Geneva Trade and Development Workshop
9 November - 14 December 2020 / Online / CEPR, the Graduate Institute Geneva, GSEM, UNCTAD and the World Trade Organization.

CEPR International Virtual Organization Economics Seminars - Seminar 7 - The Dynamics of Norm Formation and Norm Decay
9 - 9 November 2020 / Online /

CEPR Policy Research

Discussion Papers | Insights

Homeownership of immigrants in France: selection effects related to international migration flows
Gobillon, Solignac

Climate Change and Long-Run Discount Rates: Evidence from Real Estate
Giglio, Maggiori, Stroebel, Weber

The Permanent Effects of Fiscal Consolidations
Summers, Fatás

Demographics and the Secular Stagnation Hypothesis in Europe
Favero, Galasso

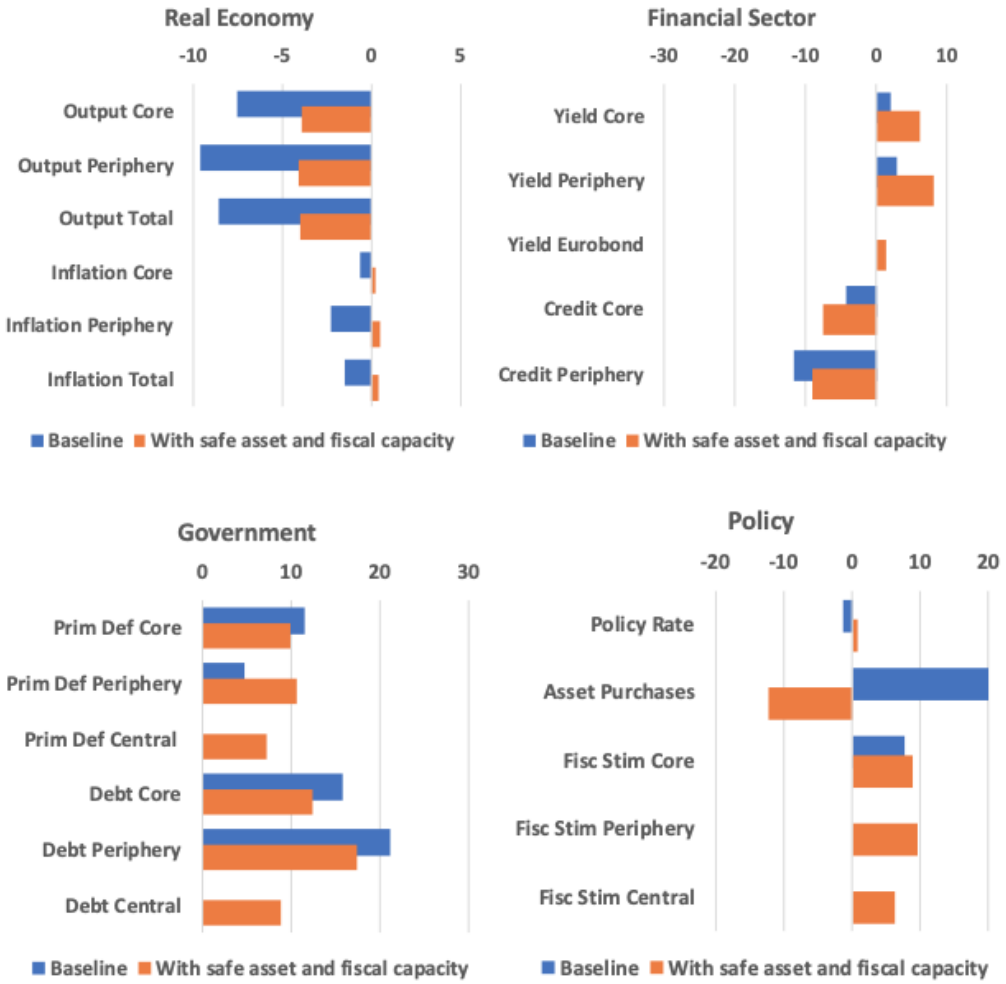
QE and the Bank Lending Channel in the United Kingdom
Butt, Churm, McMahon, Morotz, Schanz

Subscribe

@VoxEU

RSS Feeds

Weekly Digest



Note: Per cent or percent-point changes relative to a steady-state without shocks. The charts show the impact of a -5% of GDP symmetric supply shock and a -10% of GDP symmetric demand shock.

From the simulation results (Figure 1), the following broad picture emerges:

- In the baseline (without Eurobond/fiscal capacity), output is hit twice as hard in the periphery (with a collapse of the order of -8%) than in the core (-4%). This is primarily due to the re-emergence of the 'doom loop' in the periphery, with a collapse of bank lending combined with a substantial increase in public debt and yields. Fiscal policy is eased in both the core and the periphery on the account of automatic stabilisers, but discretionary policy is eased markedly only in the core in a context of greater availability of fiscal space. Monetary policy kicks in forcefully – both conventional and non-conventional – but cannot prevent a deep economic recession.
- By contrast, with a safe asset and fiscal capacity at the centre, bank lending in the periphery would shrink but not collapse, and fiscal stimulus at the centre would provide a substantial demand boost. The increase in public debt in the periphery would be more muted. Yields in both the periphery and the core would increase more strongly as a result of the fiscal stimulus and associated bond issuance. Monetary policy would play a much more modest role, in fact even tighten somewhat in response to higher inflation emanating from the supply shock (which is left to play out even more strongly as the fiscal response absorbs the demand shock).

All in all, with a safe asset and fiscal capacity at the centre, the recession will be much more muted. Fiscal policies could do most of the job of macroeconomic stabilisation without resorting massively to unconventional instruments and without sowing the seeds of sovereign debt increases and bank defaults. Importantly, the package would be Pareto-efficient, i.e. both 'core' and 'peripheral' euro area countries would benefit.

Conclusion

Our simulation suggests that with a safe asset and centralised fiscal capacity, macroeconomic stabilisation becomes much more effective in the face of the outbreak of COVID-19 hitting the euro area economy. Fiscal stimulus at the centre would provide substantial demand offset, with a much more muted increase in government debt in the periphery and a more modest monetary policy response. Both the 'core' and 'periphery' of the euro area would gain.

The policy response to the COVID-19 shock is an opportunity to provide a lifeline to the economy while also permanently fixing some of the vulnerabilities of the euro area policy framework.

References

Alogoskoufis, S and S Langfield (2019), "Regulating the Doom Loop", ECB Working Paper No 2313, September.

Arnold N, B Barkbu, E Ture, H Wang, J Yao (2018), "A Central Fiscal Stabilisation Capacity for the Euro Area", IMF Working Paper No 57, March.

Baldwin, R and B Weder di Mauro (2020), *Mitigating the COVID Economic Crisis: Act Fast and Do Whatever It Takes*, a VoxEU.org eBook, CEPR Press.

Bénassy-Quéré A, M Brunnermeier, H Enderlein, E Farhi, M Fratzscher, C Fuest, P-O Gourinchas, P Martin, J Pisani-Ferry, H Rey, I Schnabel, N Véron, B. Weder di Mauro and J Zettelmeyer (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No 91, May.

Codogno, L and P J van den Noord (2019), "The rationale for a safe asset and fiscal capacity for the Eurozone", LSE 'Europe in Question' Discussion Paper Series; Vol. 2019, No 144.

Codogno, L and P J van den Noord (2020), "Going fiscal? A stylised model with fiscal capacity and a Eurobond in the Eurozone", Amsterdam Centre for European Studies Research Paper, No. 2020/xx (forthcoming).

Leandro, Á and J Zettelmeyer (2018), "Safety Without Tranches: Creating a 'Real' Safe Asset for the Euro Area", CEPR Policy Insight No 93, May.

Face Twitt Print Ema Add
58Share

A A

Topics: Covid-19 EU institutions EU policies

Tags: COVID-19, coronavirus, euro area, safe asset, fiscal capacity

Related

The ESM must help against the pandemic: The case of Spain
Aitor Erce, Antonio Garcia Pascual, Toni Roldán Monés

Covid Perpetual Eurobonds
Francesco Giavazzi, Guido Tabellini

A proposal for a Covid Credit Line
Agnès Bénassy-Quéré, Arnoud Boot, Antonio Fatás, Marcel Fratzscher, Clemens Fuest, Francesco Giavazzi, Ramon Marimon, Philippe Martin, Jean Pisani-Ferry, Lucrezia Reichlin, Dirk Schoenmaker, Pedro Teles, Beatrice Weder di Mauro

Economics in the time of COVID-19: A new eBook
Richard Baldwin, Beatrice Weder di Mauro

Printer-friendly version