Going Fiscal? A stylised model with fiscal capacity and a Eurobond in the Eurozone

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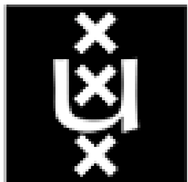
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The motivation of the paper

Economic growth is vulnerable to **external shocks** (the pandemic was indeed a big one, which came after we wrote the paper) and thus requiring a **macroeconomic stabilisation mechanism** in the Eurozone.

Need for avoiding unnecessary strains to macro economic and financial stability, while preserving **market discipline,** avoiding **moral hazard,** and enhancing **welfare** for all.

Need for lightening the **burden of stabilisation** from national sovereigns (**legacy debt constraint**) and the ECB (**zero-lower-bound**), and strengthening the transmission of monetary and fiscal policy.

Literature review – before the 2008-09 crisis

Monetary policy cannot absorb asymmetric shocks (‘one size cannot fit all’) and **fiscal policy** is constrained by fiscal rules. ‘Alternative adjustment mechanisms’ were underdeveloped.

Asymmetric shocks lead to temporary economic divergence, which become **persistent once ‘hysteresis’ kicks in**.

Traditional policy prescriptions:

1. EU **‘Internal Market’** integration for labour and capital for alternative adjustment mechanisms.
2. Reforms of **product and labour markets** to rein in hysteresis.
3. Fiscal consolidation to create **‘fiscal space’** and allow the operation of automatic stabilisers.

Literature review – since the 2008-09 crisis

The **‘doom loop’ between sovereigns and banks**:

1. Higher risk of sovereign default due to insolvencies of the domestic banking system.

2. Liquidity and solvency problems of banks also due to sovereign debt in their balance sheets.

Monetary policy continues to edge at the brink of a de facto **zero-lower-bound (ZLB)**, i.e. ‘one size fits nobody’.

Need for an asset to serve as **collateral for interbank loans and repos and ECB funding** and **break the banks-sovereign doom loop,** while preserving market discipline.

Literature review – safe assets proposals

ESBies (and others): Issued at the centre and used to purchase national sovereign bonds in the secondary market according to the 'capital key'. Reduced risk due to pooling & tranching, and diversification.

E-Bonds: Issued by a triple-A entity and used to issue 'soft loans' to national sovereigns to replace sovereign debt as it matures. No tranching. Long transition period.

ESBies & E-Bonds: Usually capped at 60% of national GDP (risk premium and market discipline above 60%), with 'regulatory encouragement' by exempting ESBies/E-Bonds from risk-weighting.

Literature review – fiscal capacity

Fiscal capacity: It directly affects the fiscal stance, at the national or Eurozone level or both (not with safe bonds)**.**

Loans from the centre: Loans to member states in recession, subject to conditionality (lower borrowing costs).

Public works at the centre and top-down grants: Entity that can raise its own taxes and capital through bonds issued against future proceeds. Redistribution, fiscal stimulus or restrain.

Horizontal transfers: Spending on welfare and other ‘cyclical needs’, i.e. unemployment insurance. Risks: fiscal dominance, lack of democratic legitimacy.

A three-pronged proposal

A '**Eurobond**' is issued at the centre by a new '**fiscal capacity**', with a joint guarantee by Eurozone countries, thus zero risk weight and exclusive eligibility to QE (risk weighting and no QE on national bonds). It is swapped on a voluntary basis, at market prices for national sovereigns on the **balance sheet of banks and the ECB** (30-40% of Eurozone GDP).

'**Doom loop**' between the cost of bank funding and sovereign yields is broken, funding cost at the periphery declines, the interbank market recovers, better ECB handle on the lending channel.

Alongside the issuance of Eurobonds to purchase national sovereigns, fiscal capacity may issue Eurobonds to finance **deficit spending at the centre.**

Several advantages

Limited **moral hazard** due to the domestic component of fiscal policy, which would remain national and could become riskier (as national sovereigns back up the Eurobond and lose eligibility to QE).

Fiscal risk sharing via centralised **automatic stabilisers** (for instance unemployment insurance) or **discretionary spending** on projects that transcend national interests (climate policy, public infrastructure).

A genuinely **risk-free asset**, akin to the US Treasury note. Quantitative easing would become a **genuine monetary policy instrument** (no confusion with fiscal). Better **transmission** of monetary policy through the **banking channel**.

How would the Eurozone have fared in the previous crisis?

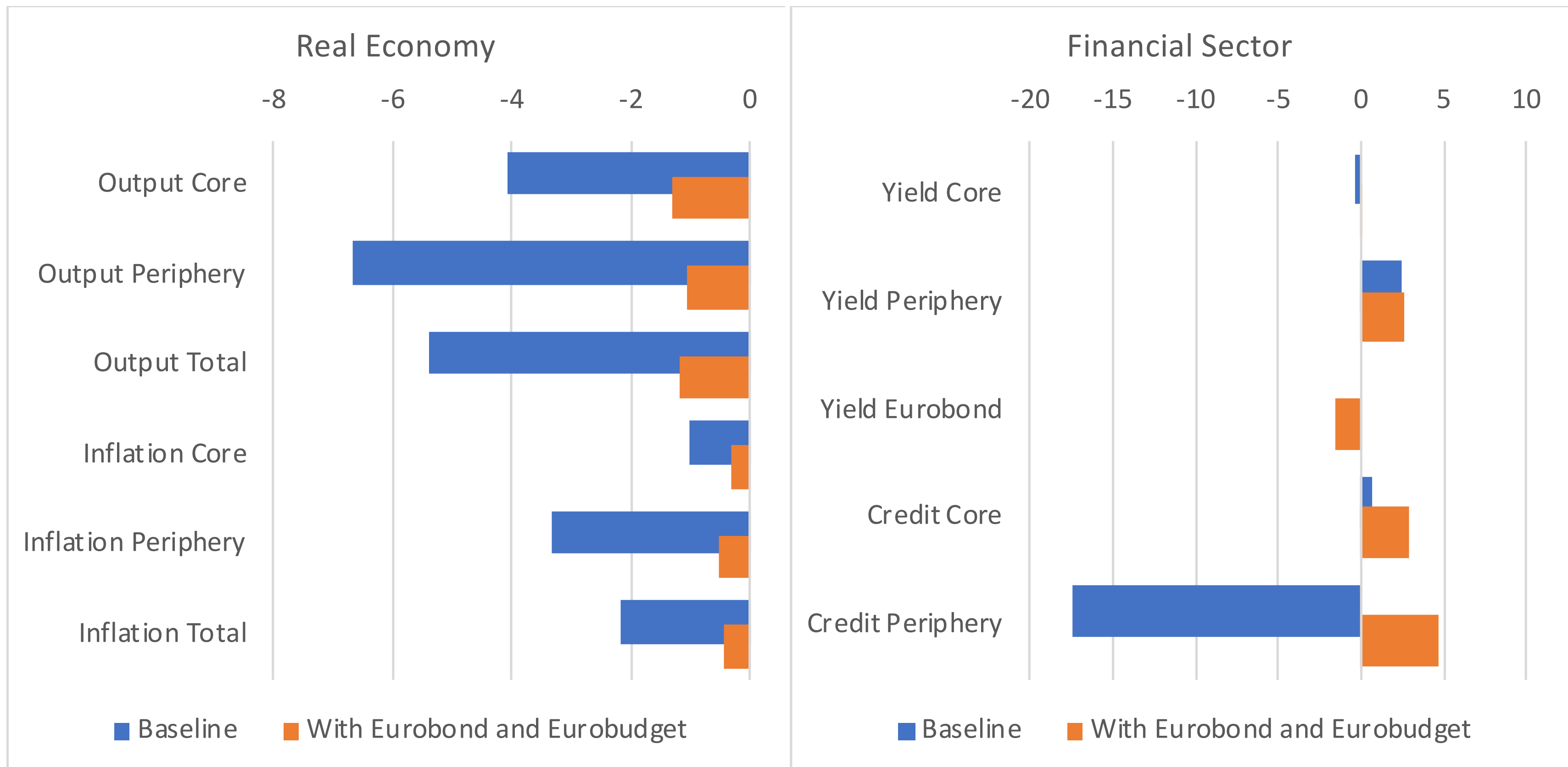
Stylised model with a core and a periphery. Policy is endogenous based on derived optimal policy reaction functions.

Shocks: (i) symmetric demand shock; (ii) adverse supply, risk premium and bank lending shocks in the periphery; (iii) favourable supply and risk premium shocks in the core.

Baseline and **alternative scenario** with:

1. a single Eurobond to replace national bonds on banks' and ECB's balance sheets,
2. Eurozone fiscal capacity, including automatic stabilisers and discretionary (but rules-based) policy,
3. a new QE scheme that mandates the ECB to purchase Eurobonds (national sovereigns lose QE eligibility).

Shock responses – The Great Financial Crisis and its aftermath



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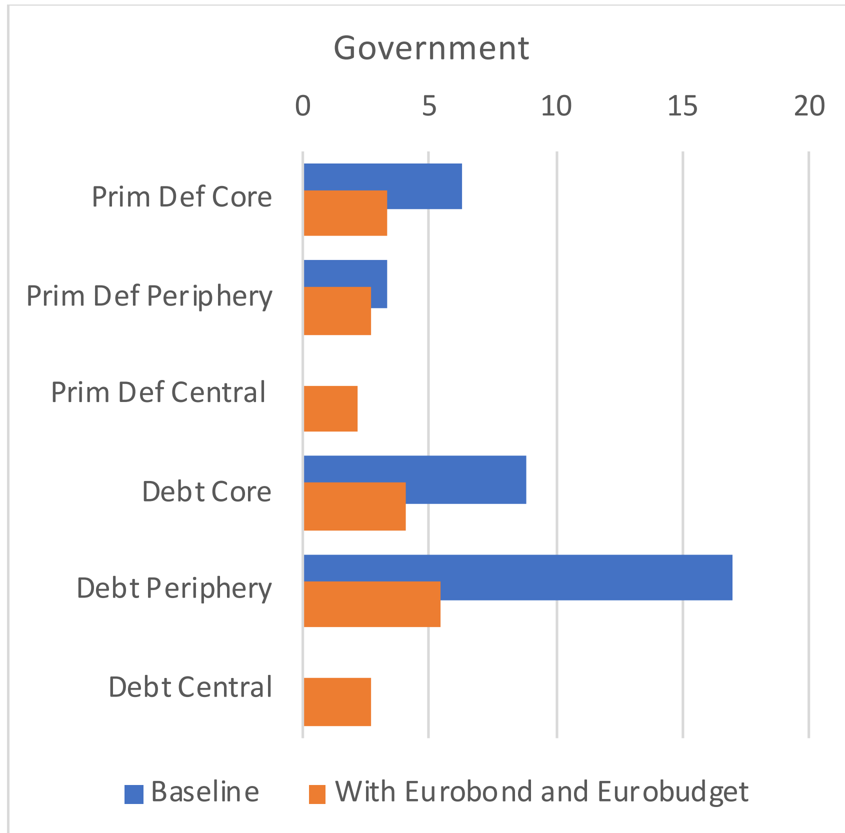

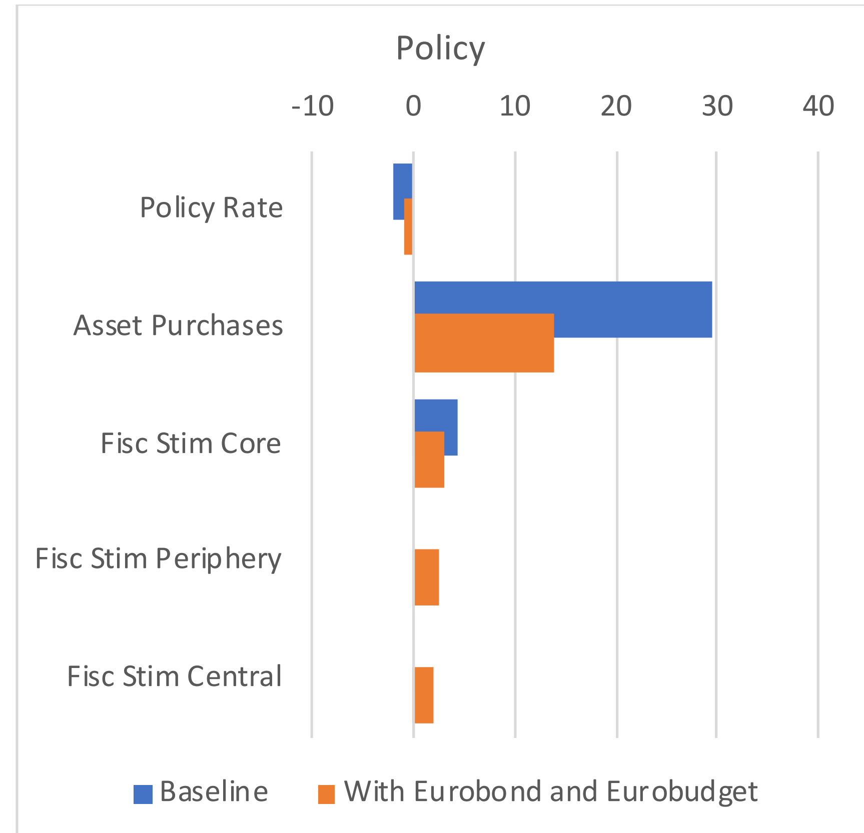

Discussion of the results

With Eurobonds/fiscal capacity, **any recession would be much more muted**.

In the baseline, output is much harder hit in the periphery than in the core, notwithstanding the assumed symmetry of the demand shocks, due to the 'doom loop'. Conventional and non-conventional monetary policy cannot prevent a significant economic slump.

In the alternative scenario**, macroeconomic stabilisation is much more effective**, with a much more muted increase in government debt in the periphery and a more modest monetary policy response required. This owes much to the elimination of the doom loop.

The policy response to COVID-19

It contains elements of our fiscal capacity proposal but only to an extent, and shies away from our safe asset proposal. It is not a **permanent, automatic, rules-based mechanism**. It is a sort of discretionary (ad hoc) ex-post insurance.

Fast ECB action, regulatory changes, national fiscal stimulus and transfers over the EU budget **surrogates a macroeconomic stabilisation function,** limiting the pitfalls of previous policy responses, while 'Next Generation EU' is more about recovery and resilience than macro stabilisation.

Strengthening the EU budget, establishing a EU benchmark bond, and allowing EU borrowing to spend may become a **blueprint for future changes**.