



Covid Perpetual Eurobonds: Jointly guaranteed and supported by the ECB

Francesco Giavazzi, Guido Tabellini 24 March 2020

This war-like shock will require very large fiscal support. Its financing cost should be distributed over several generations. This can be achieved by issuing irredeemable or very long maturity Eurobonds. They should be backed by the ECB to keep the financing burden low. This column argues that no institutional or legal constraints prevent this policy response. Prompt action is critical since allowing one crisis to morph into many could disrupt the European project, with far-reaching and unpredictable political implications.

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We do not know yet how large the economic damage of this pandemic will be. But under plausible scenarios, government support to the economy will be in the double digits as a percentage of national incomes. How can such amounts be financed, without sparking a second sovereign debt crisis in the weaker euro area countries?

The ECB's new Pandemic Emergency Purchase Programme (PEPP), launched last week, has bought precious time. But PEPP is mainly designed to reduce liquidity strains and avoid an immediate run on the debt of highly indebted euro area countries. Some of the financing needs will be absorbed by the monetary expansion implied by PEPP. But allowing for only temporary deviations from the capital keys in the ECB asset purchases could limit the extent of the monetary support to the highly indebted countries. More needs to be done. We must find alternative financial arrangements that shield the euro area against a return to 2011-like crises.

COVID consols

We propose that countries issue 50-year or 100-year bonds, or even perpetuities (also known as perpetual bonds or 'consols', i.e. a fixed-income security with no maturity date). The ECB should stand ready to buy them to keep the interest burden low enough to avoid adding to debt sustainability concerns. There are clear economic rationales for this:

- A shock the size of the COVID crisis is like a war, and thus its financing is optimally distributed over several generations.
- The new securities could be issued quickly with conditions that could be crafted to the problem at hand.
- The bold action would provide a signal of the 'what ever it takes' type and thus rule out the nightmare scenario of a new euro area crisis arising in the midst of the COVID crisis.

Member states should jointly issue a large amount of very long maturity COVID Eurobonds backed by their joint tax capacity. Each country would issue its own bonds, but the bonds would otherwise be identical. Their common rating would be the result of all bonds being guaranteed by the joint tax capacity of the countries participating in the joint issues.

There are several advantages to COVID Perpetual Eurobonds:

- With the support of the ECB, interest rates could be kept very low, and the solvency risk would be limited to the unlikely event that countries renege on their initial agreement.



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For instance, with an interest rate of, say, 0.5%, servicing a debt of 10% of GDP with COVID Perpetual Eurobonds would only cost 0.05% of GDP every year – a negligible amount.

- The very long maturity of this additional debt implies that the risk of a funding crisis on the existing debt of the highly indebted countries would not arise.

The same cannot be said about a short-term credit line issued by the ESM.

- Inflation is clearly not a current threat; on the contrary, the danger today is deflation.

Monetary financing of the needed fiscal effort is part of the optimal policy response.

- This financial arrangement would not hinder ECB independence in case inflation risks were to emerge in the future.

The ECB would remain free to reduce the size of its balance sheet if needed.

These new securities would be complementary to other proposals made recently.

Improving on the Benassy-Quéré et al. proposal for a COVID-related credit line

The proposal to create a new COVID-related credit line at the ESM – as proposed by Benassy-Quéré et al. (2020) – could immediately add funding of up to 3.4% of the euro area's GDP. This proposal is a step in the right direction, but it has a few limitations.

- First, the amounts available remain small relative to the likely needs, though they could be increased by raising ESM capital.
- Second, the maturity of the loans granted to individual countries is as important as their magnitude.

These 'multi-generation' maturities are not possible with an ESM credit line. As a result, there is the risk that a sovereign debt crisis is only postponed and not avoided, or alternatively that the fiscal policy action is limited to a size that will not provide adequate support.

- Third, by its statute, the ESM can only lend to a country if public debt is sustainable.

This implies that a prerequisite to any ESM lending is some kind of debt-sustainability analysis. The outcome of such analysis cannot be taken for granted in the current situation.

- Fourth, the ESM was designed to support individual countries during a financial crisis, not to finance a large common shock.

By the same light, it is important that ESM funds remain available for its original purpose, particularly once the peak of the crisis is past.

- Fifth, the ex-post conditionality – which is legally required for ESM lending – could be a barrier to the effective usage of the funding.

During the COVID crisis, which may last a year or more, euro area countries will need to borrow not only to invest in medical infrastructures, but also to provide income support and inject capital to prevent bankruptcies. It is important that any ESM credit lines explicitly allow for this.

- Finally, the ESM is an inter-governmental institution, over which national parliaments of individual countries retain veto rights.

There is thus a risk that the design and implementation of the credit line could be distorted by a zero-sum logic rather than reflecting the common interest.

Each of these limitations could be overcome by re-writing ESM rules and that of its Treaty. We view this as a step towards a first-best institutional setup for COVID crisis financing. The ESM could eventually become the 'euro area Treasury Department' thus allowing fiscal and monetary policy to be coordinated as in 'normal' countries. But the road to the first best would take time, and the negotiating process among members would create ex ante uncertainty about the outcome.

Time, however, is not something we have a lot of at this point in the COVID crisis, and uncertainty about the outcome of rule-changing could, by itself, be destabilising.

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The financing arrangement for Perpetual Eurobonds should be enacted immediately. Postponing it would be counterproductive, for two reasons. First, because an immediate response would be much more effective in preventing economic collapse. Second, because it is now clear that all countries have been hit by a common exogenous shock; in one or two years, there will be more recriminations about moral hazard and policy mistakes, and a coordinated response would be politically even more difficult.

We are living through a critical historical juncture. If mismanaged, the looming economic crisis would disrupt the European project, with far-reaching political implications. The alternative to a bold coordinated response is to continue to bend the existing institutional framework with ad hoc adjustments that undermine its long run credibility, until it will eventually break.

References

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