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Financial markets risks

The COVID-19 lockdown is a major aggregate shock on the world economy. Because it is aggregate, it will not be easily mitigated through fiscal transfers across citizens and countries. Intertemporal consumption reallocations, i.e., a sizeable fall in the world aggregate savings appears to be the only tool. This will lead to a surge in public debt and, quite likely, to a rise in real interest rates. Given the size of the Euro Area economy and its large current account balance, a large fiscal expansion is feasible, but not all countries have the same fiscal capacity and ability to raise funds at reasonable costs. This heterogeneity may trigger a financial meltdown, like the one we witnessed in 2011. A flight to safety may raise interest rate spreads and limit the ability to contain the effects of the shock in countries where public debt is already large, banks are riskier and growth prospects less promising. The bottom line is that intertemporal risk sharing may be limited and the COVID-19 lockdown, even if short lived, could trigger a long-lasting recession.

Rejecting the ESM's assistance is a mistake, but the ESM will not solve the problem

The European Monetary Union is particularly exposed to these risks because, due to the absence of a legitimate political authority, it lacks a centralized fiscal budget and a federal public liability.

In an effort to sidestep this problem, the European institutions have created the ESM, with a lending capacity close to 400 billion euro, and allowed the ECB to expand its role of lender of last resort and to become an important player in the secondary market for sovereign debt and other secure private bonds. So far, the main component of the ECB's total assets are loans to commercial banks, since the size of the ECB interventions in the sovereign debt markets are still limited by regulations. The basic idea is that sovereign bonds are risky assets and the ECB balance sheet should be sufficiently safe to preserve price stability for shareholders. For these reasons, many commentators and governments would like the ESM to step in, with a specific credit line. The problem with using the ESM is that countries of Core Europe have no incentive to request ESM assistance because they are able to borrow at better conditions from the market, so that this institution is, in fact, an intermediary between markets and risky sovereigns. In order to provide funds at low rates, investors should be insured with joint guarantees from ESM equity holders. This makes the countries of Core Europe the *de facto* lenders to Peripheral Europe. Quite naturally, joint guarantees can only be sustained by some form of control and conditionality on the borrowers' actions

and use of funds. Although this mechanism has worked quite well in the case of the recent sovereign debt crisis, it is not clear that it would work just as well in this case. One problem is that conditionality, even if light and reasonable, may discourage countries from asking for assistance. This does not mean that the ESM should not step in. In particular, the Italian government's opposition to using the ESM as a source of funding is a mistake. Past experience suggests that conditionality may be politically troubling but it is economically irrelevant. Ireland, Portugal and Spain have greatly benefited from ESM assistance and Greece's painful post-assistance recession and policies were largely a consequence of pre-existing conditions and self-inflicted damages. Recent evaluations of the implicit fiscal transfer received by the Greek government through the ESM (and previous programs) hovers around 40% of the country's GDP. The key issue, however, is that, in the present circumstances, the size of the ESM exposure should probably go beyond the 400 billion euro limit, so that a recapitalization of the ESM may be necessary.

A larger role for the ECB

For these reasons, faced with the scale and dimension of the fiscal cost of the Covid-19, I think that the ECB should become the most important player in the Covid-19 crisis by absorbing a much larger share of the Euro Zone sovereign debt. By now, the ECB and the NCBs hold about 2,500 billion euro of EA assets, of which 2,000 are public sector bonds. An estimated 20% of total EA public debt is in the asset side of the ECB balance sheet. On March 19 the ECB announced a plan to launch a 750 billion bond buying program. In principle, the combined effort of the ESM and the ECB to sustain the demand for sovereign debts can have a strong impact on the demand side of the sovereign debt market in the spirit of Mario Draghi's "whatever it takes" principle, but more action may be necessary. The ECB should switch to a model more similar to the Fed or the Bank of Japan, which hold a larger amount of government securities. To approach this model, the 33% limit on sovereign debt issuance and the obligation to purchase sovereign bond shares within the limits of each sovereign's capital contribution key should definitely be eliminated. It is very difficult, at this stage, to assess whether this will be enough to provide sufficient support to the fiscal expansion that will be necessary to fend off the COVID-19 lockdown, but I see no alternative route.

Helicopter drop is not a good idea

Given these premises, how should we assess the (money) "helicopter drop" proposals that have been circulating recently? As far as I understand, a helicopter drop corresponds to a situation in which the ECB buys government securities (either in the secondary market, or at issuance) and "immediately" writes them off. Essentially, this is equivalent to the monetization of public debt. It is a huge step that would face strong opposition from almost all sides. Are there more effective and promising alternatives? To answer this question, we should first understand how the helicopter drop proposal differs from a public debt buying program. The logic suggests that buying 1 billion euro of government securities and writing them off (helicopter drop) is equivalent to buying 1 billion euro of government securities and (1) exempting the issuer (governments) from servicing the debt, i.e., forcing the ECB to give up seigniorage and (2) repurchasing the same 1 billion euro of bonds at maturity (roll over). Under the current rules, the ECB is already returning

the seigniorage from money creation to the EA governments. In particular, the ECB website states that "some [of the ECB income from seigniorage] may be set aside to cover any future losses. But after that, any remaining ECB profits go to the national central banks of the euro area countries, as the shareholders of the ECB. The central banks may save some of this money or use some in their work, but profits usually go to the country's government, thus contributing to its budget. This benefits euro area taxpayers." To be sure, not all of the ECB's seigniorage is rebated to taxpayers, part of it is retained as reserves and part to preserve equity capital. These two items can be compressed at the cost of exposing the ECB to capital losses, but I doubt that this would make a huge difference (capital and reserves amount to about 2% of total liabilities). The main difference between a central bank's asset purchase program and a helicopter drop is, then, that the ECB would give up the right to stop rolling out sovereign debt lending in the future, if this is justified by market conditions. Is this a good idea? I do not think it is, for the following reasons.

A) The benefits of a debt write-off by the ECB could be replicated by a credible commitment to the objective of providing sufficient liquidity in times of distress. By writing off the sovereign bonds, the ECB would (permanently) give up the ability to withdraw money from circulation, and, then, fight inflation if and when it is necessary. In other words, a write-off of a central bank liability may be useful only as a way to generate inflationary expectations, but it is not clear to me why we need this now, since the main reason why the ECB intervention is necessary is to contain sovereign debt spreads. Higher inflation may generate higher nominal rates and a higher cost of servicing the debt.
B) The most obvious problem with a debt write-off is the huge moral hazard that would arise from a "soft budget constraint". One thing is endowing central bankers with discretionary power to be lenient in exceptional circumstances (and, then, repurchase the stock of maturing debt if necessary), another is providing funds to governments upon request. The latter possibility may still be seen as part of the ECB's discretionary powers. According to Jordi Gali, an advocate of the helicopter strategy, "the reliance on money financing would be strictly restricted to the duration of the emergency measures linked to the health crisis" (VoxEu.org, March 17, 2020). But, even in this case, it is quite likely that the inauguration of a new direct funding facility for national governments would seriously undermine the ability of the ECB to resist political pressures in the future.
C) An additional cost of helicopter drops is validating the illusion that money financing bears no costs for taxpayers. A simple accounting identity (based on the assumption that the long run real rate exceeds real GDP growth) states that total real outstanding public liabilities (including money and interest-bearing bonds) equal the present value of future government real primary surpluses plus seigniorage. Few people believe that money is neutral, but, given this identity, a fall in long run primary surpluses must be compensated by a higher government revenue from seigniorage, or by a surge in the price level, no matter how much money financing there is.

Then, these two scenarios, i.e., market interventions in the form of asset purchase programs by the ECB or the ESM, and helicopter drops, are totally different from a political economy point of view but not so different from the perspective of the final objective: allowing national governments to make fiscal expansions in hard times without incurring the risk of a liquidity crisis. I fear that, by pursuing the unrealistic objective of transforming the ECB into a funding facility for fiscal expansions, we may miss the most pressing objective of expanding the ECB's more traditional policy tools and, ultimately, implementing a Euro Area safe asset.