



DEBT MONETIZATION AND EU RECOVERY BONDS

Fighting the COVID-19 emergency and
re-launching the European economy



Summary

This policy brief highlights some peculiar characteristics, from an economic point of view, of the current Covid-19 crisis. It looks at its exogenous nature with respect to Eurozone countries, as well as at the complex mix of supply and demand shocks it entails. Given these features, the authors suggest two intertwined policy measures in order to tackle the emergency phase of the crisis and the subsequent recovery.

First, a pervasive intervention of Eurozone governments in support of business and households income in the context of the “suspended” economy that measures against the diffusion of Covid-19 have forcefully given rise. The ECB is advised to monetize all public expenditures linked to this emergency plan by purchasing public bonds in the primary market, and to subsequently write them off or exclude these issuances from the computation of public debt-to-GDP ratios. With no signs of inflationary pressures coming, the ECB intervention would avoid Eurozone governments to pile up considerably higher stocks of debts and would help to bypass the current political impasse among Eurozone Member States as to the creation and release of Eurobonds.

In the aftermath of the emergency phase, the authors suggest the implementation of a massive Europe-wide recovery plan centred on public investment addressing the long-lasting technological and environmental challenges of these years, and financed by European institutions through the issuance of European Pandemic Recovery Bonds (EPRBs).

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1. Introduction

The global spread of the Covid-19 crisis is now in the headlines of all media worldwide, and it is at the center of daily discussions among politicians, policy-makers, policy advisors, scientists and common people alike. This is rightly so given the tough toll this crisis is asking to the world in terms of losses of human lives and radical changes to our everyday habits and routines.

When it comes to the scientific response to the current pandemic, epidemiology, virology (say medicine more broadly), and pharma are, by far, the fields of research most affected by the crisis, as they are struggling to find an effective cure or, even better, a vaccine against the coronavirus. Economics, however, is not immune, as it is now clear to everybody that the Covid-19 pandemic will have sharp repercussions on economic activity, employment levels, the income of households and businesses, and ultimately on public budgets.

The spread of Covid-19 has set a time for major changes in governments' and central banks' policies. There is consensus among economists that the governments of developed countries in Europe and in the USA, i.e., the current epicenters of the pandemic, will have to take extraordinary actions, most probably war time-like measures in terms of their magnitude, in order to deal with the disruptive economic consequences of Covid-19 crisis. The overwhelming pressure upon healthcare systems and the forced lockdown of economic activities require massive urgent emergency reactions in order to tame the most direct and immediate consequences of the crisis. In the aftermath of such emergency phase, governments will need to implement further interventions in order to "prevent a recession morphing into a prolonged depression" (Draghi, 2020).

Bold government interventions *might* obviously imply a considerable increase in public debt. However, financial concerns should not limit by any means governments' actions, since that the cost of hesitation may be dramatic both in terms of present and future social wellbeing.

Concerns over the implications for the European public balance sheets may be justified, but they completely vanish in front of the catastrophe that major damages on the European productive system could cause. And this is even more compelling by taking into account that sound public finance ultimately depends on a robust productive system.

In this policy brief, we advance a series of proposals about policy responses to the existing crisis in light of its unique nature, and how such policies should be financed. We focus on the Eurozone. According to the most recent forecasts from Goldman Sachs (Goldman Sachs, 2020), the Eurozone stands out as the region potentially affected the most by the economic consequences of the pandemic. Perhaps more importantly, The European Council meeting held on the 26th March sadly showed that, differently from other countries, no agreement exists about how to tackle the challenges posed by Covid-19 with a joint, cohesive and unique European response. It is of paramount importance to provide policy makers with some advices about which are, in our view, the best responses to the current shock in order to avoid it becoming a long lasting "L-shaped" downturn with no return.

Our proposal hinges upon two lines.

We first advise a strong emergency action by Eurozone governments covering operative costs of companies, small and medium firms in particular, and guaranteeing income flows to households in the context a "suspended" economy. In other words, "[t]he job is maintaining the economy on life support



during a period of an artificially induced coma while we address the public health challenge” (Tooze, 2020). **We then suggest the implementation of a Europe-wide recovery plan based on public investment and addressing the not-to-be-forgotten climate crisis, and the now well understood needs of our healthcare systems.** We propose these interventions to be financed by two sets of bonds:

- i. those issued by the national governments to cover emergency costs, to be fully monetized and subsequently written off by the ECB, thus giving rise to a sort of “mediated” helicopter money, in order to prevent any emergency-related increase in public debt stocks;
- ii. Recovery bonds to be issued by European institutions – let’s call them European Pandemic Recovery Bonds (EPRB)¹ – to relaunch the European economy in the immediate aftermath of the health crisis. The first point is indispensable, urgent and might perhaps help to overcome the existing contrast among Eurozone governments (even though implying other types of institutional changes). The second one is equally relevant, and indeed much needed regardless the current crisis, though there is a little more time for discussion.

¹ See also Kirkegaard (2020), who proposes the issuance of European Covid-19 Investment Recovery Bond (ECIRBs). According to Kirkegaard, these “would be very long (30-to-50 year) maturity bonds issued by a European institution, such as the ESM if only for the eurozone, or the European

1. Three crucial aspects of the Covid-19 economic shock

There is wide consensus among economists that the economic shock associated to the spread of the Covid-19 virus is something unique, probably with costs not seen over the last 70 years. It is important to briefly outline some of the crucial aspects of this shock, and the differences with respect to the previous ones, because this may help us to understand which are the most appropriate policy responses. We would like to stress three points.

1. There is no doubt that the **Covid-19 economic shock is a truly exogenous one**. It does not depend on the will or previous misbehavior of any government or private sector. This is a significant difference with respect to the frequently cited 2007-2008 financial crisis. Indeed, the outbreak of the last financial crisis was due to innovations and new practices in the financial sector, the emerge of the so-called “shadow banking”, which were in turn tightly connected to long-lasting unfolding developments and changes in advanced economies, rising inequality first and foremost (Botta et al., 2019). From the point of view of the Eurozone, even though the financial crisis started in the USA, it cannot be considered as an exogenous shock. European economies were initially affected by the worldwide financial meltdown because European banks were actively engaged in the diffusion of “toxic” new financial products, or in the feeding of

Commission or European Investment Bank for the entire European Union [...], and eligible for purchase by the ECB” (Kirkegaard, 2020). In a similar vein, here, we suggest the EIB issuing long-term bonds aimed at financing European recovery based on a large-scale investment plan.



unsustainable processes such as housing bubbles in Ireland, Spain and Greece. That crisis then morphed into the Eurozone sovereign debt crisis due to (external) imbalances among Eurozone countries, endogenously built-up in the initial phase of monetary integration (1999 – 2007), and the institutional deficiencies in monetary and, especially, fiscal policy (i.e., the pro-cyclicality of austerity measures during recessionary phases) characterizing the European institutional building.

2. The Covid-19 economic shock undoubtedly stands out as **a common shock affecting in a similar way all Eurozone countries**. It might certainly happen that the timing of the shock might slightly differ from one country to the other, perhaps affecting Italy first, and then Spain, France, Germany, and other Eurozone economies. Nevertheless, if we take 2020 as a whole, there are little doubts that all these economies will experience a recession.
3. The economic crisis that Europe has to face consists of **a complex mix of supply and demand shocks**. As to the supply side, the restrictive measures taken by governments in order to implement social distancing and contain the spread of the virus have imposed myriads activities to stop offering their services. For instance, this is the case of the entertainment industry, the construction and renovation industry, hospitality, restaurants and bars, the retail industry and proximity small shops, down to all services involving some kind of people movement to someone else place. An additional supply shock comes from the lock down of some regions, if not entire countries. Indeed, with people being confined at home, workers cannot reach workplace and firms are bound to stop their operations.

This may in turn give rise to shortages in the supply of those goods whose production is the result of complex value chains involving inoperative companies. Last but not least, supply constraints may also emerge in the supply of now vital medical devices whose supply was unprepared to cope with the huge and unexpected increase in their demand.

Restrictions to people mobility and to the functioning of firms have simultaneously induced a tremendous drop in aggregate demand. If there is something that European policy-makers should have learnt from global and the eurozone crisis of the last decade is that with no management of the aggregate demand, the recovery is much slower. In this crisis this becomes particularly relevant as Eurozone economies will have difficulties to rely on the demand of other countries, as the shock is global and exports will also be largely affected. The problem is twofold: On the one hand, the steep rise in unemployment records, the temporary suspension from work, or the inactivity of the self-employed and freelance workers will cause households to cut consumptions. On the other hand, there is no reason for firms to invest in a context of depressed demand, forced closure and radical uncertainty. This is even the more so taking into account that many companies may actually risk going bankrupt once completely “deprived” of their expected cash flows. The contraction in aggregate demand is so acute that may well explain why inflation spikes due to supply constraints do not represents a serious threat at the moment, but rather even more worrisome deflationary trends seem more likely to come (De Grauwe, 2020).



2. Emergency measures for a “suspended” economy and beyond

2.1 A review of existing proposals

What emerges from the above three aspects of the Covid-19 crisis is a suspended economy. The tough but equally necessary and desirable measures implemented by governments to stop the diffusion of the virus have simply made most part of the private sector unable to function, as stuck in a sort of limbo, or have induced a significant reduction in their activity.

There is a mounting debate among economists about which are the most appropriate monetary and fiscal measures for tackling such an extraordinary situation. Some of these actions have been already announced by national governments, the European Commission, and by the ECB.

A first proposal comes from previous ECB governor Mario Draghi (2020), who emphasizes the importance of financial institutions accommodating all credit requests from the private business sector in order to avoid firms' bankruptcies and reductions in the employment level. In this sense, Draghi, as many others (e.g. Bénassy-Quéré et al. 2020) take as welcome news ECB's most recent decisions to extend LTRO operations, to expand quantitative easing (which may help large corporations to issue corporate bonds at cheap rate), to reduce below zero the main refinancing rate for banks (de facto subsidizing their activity), and to temporarily slacken banks' capital requirements. In their view, all these measures may help banks to expand lending as much as possible and at very low rates, possibly close to zero.

Draghi himself recognizes that these actions might not be enough should the lockdown last long. At that point, governments might have to intervene by compensating borrowers and de

facto bailing out private companies by moving private liabilities onto a much expanding public balance sheet. Together with extraordinary measures already taken in order to support healthcare systems, this will obviously imply that “much higher public debt levels will become a permanent feature of our economies and will be accompanied by private debt cancellation” (Draghi, 2020).

Economists all agree that governments should massively intervene via public expenditures. European institutions have somehow conceded their approval by temporarily suspending the Stability and Growth pact (SGP). Their views, however, diverge when it comes to the financing of much larger fiscal deficits of Eurozone countries.

The ECB has already taken a fundamental step in the right direction by creating the Pandemic Emergency Purchase Programme (PEPP). This will add 780 billion euros to existing quantitative easing and make easier and cheaper the issuance of new public bonds on financial markets (overcoming the 33% limit on a single country's bonds share – but not the capital key in the purchase allocation and this may become problematic especially for some countries, like Italy, already at the limits of their allocation). Given such favorable monetary context, some economists think that the best way to go would be the creation of common very long-term (50, 100 years or even perpetual) Eurobonds issued by single member countries but jointly guaranteed by the tax capacity of the Eurozone as a whole (Giavazzi and Tabellini, 2020; Bénassy-Quéré et al., 2020). Alternatively, the expanded asset purchasing programme recently announced by the ECB could represent the proper framework for the introduction of a “European safe asset” possibly issued by a European institution (say the European Commission) rather than by national countries, and backed by a centralized taxation scheme, i.e., revenues from a newly created European tax or compulsory transfers

from Member States to the center (Codogno and van den Noord, 2020). One purpose of such “centralized” eurobonds, among many others ², should be the creation of fiscal space for stabilization policies in times of major crisis, the Covid-19 shock included.

In a similar vein, the European Commission has recently announced the creation of SURE, i.e, a European-level financial scheme supporting EU Member states in the emergency provision of short-term work schemes (STW) such as Cassa Integrazione Guadagni in Italy and Kurzarbeit in Germany. Indeed, the main goal of SURE is to reduce EU Member States single-country reliance over financial markets by partially replacing potentially costlier new issuances of national bonds with cheaper temporary loans provided by the European Commission, and in turn financed by the introduction of a common European AAA rated asset.

The last EU Council held on the 26th of March, however, has clearly revealed that there is no consensus on two possible forms of Eurobonds. Northern Europe countries, Germany first and foremost, do not support the introduction of new financial instruments, either issued by national countries or by a European institution, mutually guaranteed by all Member States.³ As a consequence of such a political constraint, several economists revert to the idea of using the European Stability Mechanism (ESM) to finance Member States’ emergency expenditures. This financing should take place through a newly designed and dedicated financial scheme, the so-called Covid Credit Line (CCL), characterized by a much longer time horizon (with respect to the two year time

frame associated to standard ESM’s credit) and reduced conditionality (Bénassy-Quéré et al., 2020).

Despite obvious differences, the above proposals share a common aspect. They all foresee emergency plans grounded on the functioning of financial markets. Whilst market mechanisms are suspended and cannot work for most part of the real economy, its financial needs should still remain satisfied by the “normal” provision of credit from financial institutions. This aspect is not trivial. In fact, it implies that, at the end of the emergency phase, private companies and/or the public sector might be loaded with a higher stock of debt, albeit at reduced or no (interest) costs. And this fact may in turn weaken the effectiveness of recovery measures implemented in the post-pandemic period but in fragile economies overburdened by newly created emergency-related debt.⁴

Whilst frequently treated independently, the emergency and post-pandemic phases of the current crisis are tightly connected each other. It is by recognizing this fact that Jordi Galí (2020) suggests an alternative way, which relies on the so-called “helicopter money”. This may take the form of either direct money transfers from central banks account to citizens’ bank accounts, which is generally labeled as “direct cash handouts”, or by “monetary financing” governments’ expenditures by providing governments with grants. According to this view, whilst central banks will create all the needed resources to deal with the emergency, no extra debt will be created.

² Codogno and van den Noord (2020) also imagine “centralized” eurobonds replacing national bonds in the balance sheets of financial institutions given their “status” of European safe asset used as collaterals with seniority in refinancing operations with the ECB and in inter-bank transactions.

³ Unfortunately, Eurobonds – or Coronabonds after this emergency – represent a good idea but hardly

viable from a political point of view as recently stressed by Bini Smaghi (2020) among others.

⁴ This also applies to SURE, as this scheme implies Member States being provided with loans (and not grants), albeit a relatively low interest rate, which will eventually raise the debt burden European countries will have to deal with at the end of the emergency.



2.2 An integrated policy package for the emergency and economic recovery

In this policy brief, we advance a proposal for both the emergency and post-pandemic phases of the Covid-19 crisis. It takes inspiration from the main features of the present economic shock as outlined above, and from the other policy options just described. Our proposal could be summarized in four main points.

First point: Short-term actions to sustain the “suspended” economy. Given the present impediments to the functioning of the economy posed by much needed confinement restrictions, Eurozone governments should step in to secure the incomes of large part of the private sector. The idea is to accept that the normal functioning of Eurozone economies is not possible and the E-19 economies are de facto suspended. While continuing to remunerate public servants, a large part of the private sector should be put on freeze.

All businesses requiring support should receive governmental resources covering around 80% of their labor costs (up to a predetermined ceiling) and the full amount of their fixed costs according recent administrative/fiscal data. This should be done in favor of all businesses forced to close and of those, which are still active, but experienced major reduction of their demand. Different type of support can be linked to different types of conditionalities, for instance:

- a. For companies demanding access to temporary unemployment support schemes a no lay-off clause can be included in order to avoid terminations, till the end of 2020.
- b. For companies benefitting from temporary equity by the public sector, the bail-out programme could foresee the establishment of some codetermination

arrangements for workers involvement and the assurance of the re-privatization of the state-owned equity within two years.

In other words, the government should replace lacking demand during the emergency period. Similar transfers should be directed towards self-employed and freelance workers currently unable to work due to restrictions imposed for the sake of public health. Social care measures should also be taken for those citizens who are unemployed but do not have access to standard welfare transfers by the state due to their past employment history, may it be occasional employment or jobs in the black market. Indeed, a non-negligible part of the population is employed in the black market, often not for their choice. Last but not least, extra compensation should be remunerated to still active workers employed in vital sectors, from hospitals to food, energy, communications, etc.

Second point: How to finance the emergency.

In terms of actions, our proposal is in line with the idea of governments as “buyer of last resort”, already advanced by Saez and Zucman (2020), and somehow announced by some governments (see some aspects of the USA emergency plan and the Danish government’s intervention). Differently from Saez and Zucman (2020), however, we stress that the financing of this measures should come from the European Central Bank and not from an increase of taxes, even for the wealthiest. Even though a more progressive taxation would be desirable across Europe, the risk of a recessive effect must be avoided in this present time.

Specifically, we foresee a scheme according to which emergency spending by Eurozone governments should be certified by the European Commission based on shared rules (obviously, it should be taken into account that some governments already spent money to fight the emergency). Provided that the SGP should remain suspended for the all duration of the crisis, thus allowing Eurozone countries to



spend whatever it takes to save their economies, such certification from the EU Commission can effectively replace “weak” conditionality associated to emergency credit line from the ESM.

Given the extraordinary nature of public intervention during this (almost total) suspension of market activities, governments should then finance their emergency plans by issuing public bonds that the ECB directly purchases on the primary market (as suggested also by De Grauwe, 2020) and subsequently writes off from its own balance sheet. By doing so, the ECB will de facto make a transfer to the accounts of eurozone governments’ in order to provide them with all the needed resources to tackle the current economic emergency (see Galì, 2020). Even more importantly, it will avoid national governments to pile up significantly higher debt stocks, which could then restrain their margins of maneuver in the subsequent phase of economic recovery.

The implementation of this financing scheme would certainly represent a violation of the ECB statute. Under the present emergency, however, also the prohibition for the ECB to buy government bonds on the primary markets should be (at least temporarily) lifted. If such an economic taboo cannot be challenged openly, it should be addressed implicitly. ECB’s purchases of government bonds on primary markets could take place indirectly via the creation of a Public Special Purpose Vehicle (PSPV). This is a financial institution aimed at buying bonds from governments on the primary market, and then indirectly passing them to the ECB by issuing liabilities that ECB itself can purchase, perhaps in the context of ECB quantitative easing. Eventually, when public bonds issued during the emergency come to maturity, they should be automatically rolled over (effectively becoming “consols”) and, in any case, they should never be included in the computation of the debt-to-GDP ratios.

It is worth mentioning that such a proposal completely overcomes the political problem of the mutualization of public debt. Indeed, insofar as the ECB monetizes and writes off emergency-related issuances of public bonds by all Eurozone Member States, there won’t be any creation of new (public) debt instruments and, hence, there would be no need for a joint guarantee of public debt. Our proposal will certainly imply no less challenging temporary amendments in the relationship between the ECB and national governments. Nonetheless, the close cooperation between governments and the ECB we envisage in our proposal is vital for activating such emergency plan and rescue Eurozone economies. It is also meant to demonstrate that no financial speculations on government bonds would be acceptable during this emergency period.

Third point: Relaunching the economy in the aftermath of the emergency. When the conditions for a gradual return to social life and for a restart of the private sector hold, European institutions should take a second step supporting the recovery of the Eurozone (though this is what we already needed even before the outbreak of the Covid-19 crisis). We think about a large-scale plan for financing physical and digital infrastructures, healthcare and scientific research, energy-saving and clean technologies along an ecological transition. In simple terms it means that the emergency financing to be mobilized as swiftly as possible should not come at the expenses of the other financial and developmental programmes of the EU, with particular reference to the European Green Deal, the European Social Fund, the EU Invest Fund, Horizon Europe and other cohesion funds. Rather, those programmes should be potentiated to reignite the economy in a timely fashion. In the case of the Eurozone, the Covid-19 crisis is hitting a limping economic system, lagging behind in the evolution of key sectors (just to make an example: automotive) and



characterized by very low level of public investment.⁵ At the global level, the pandemic is taking place in the midst of an ecological crisis. The goal of this recovery plan is thus not limited to jumpstart economic activity, but it rather aims at guiding the economy of the European Union, and of the Eurozone in particular, toward a more sustainable, technologically advanced and inclusive socio-economic system.⁶ On the one hand, public investment may represent an important contribution to euro area aggregate demand. The countercyclical aspect of this plan is fundamental in order to support solid recovery in the profitability of private business and prompt a strong economic rebound. On the other hand, given its exceptional character, and consistently with the view recently expressed by the ECB (see Lagarde, 2019), such a recovery plan should shape the long-run development path of the European economy by supporting public investment (say infrastructure) at European level, but also country specific actions in selected “strategic” areas (say improvements in the healthcare systems or the decarbonization of European economies). Time is a crucial element. A major investment plan needs to be implemented as soon as the health emergency ends. The later EU institutions and national governments intervene to reignite private sector’s confidence, and to counteract self-reinforcing vicious circle of low level of demand and production, the harder will be for the whole European economy to recover.

Fourth point: Financing the relaunch of the economy. In order to emphasize its Europe-wide nature, the recovery plan we described at point three should be implemented and financed by issuing recovery bonds, e.g. EPRBs. EPRBs differ from public bonds issued in the emergency because they aim at financing the medium- to long-term recovery of the European economy by supporting the technological upgrade and ecological reconversion of its productive system. EPRBs could be issued by different European institutions. One first option consists in the European Investment Bank (EIB) being entitled for the issuance of the European recovery bonds. Whilst this option might be the quickest and easiest one to be implemented, since that it might imply relatively minor institutional changes, yet it requires EIB to be recapitalized by European Member States in order to allow it to finance a massive pan-European investment plan. Alternatively, a more structural and deepest reform, but perhaps harder to be agreed upon by Member States in short terms, might see the European Commission being responsible for the financial support of the European recovery plan. In this case, the complexity of the required institutional changes would lie in providing the European Commission with some sort of autonomous fiscal capacity (say a European taxation scheme) that might back and guaranteed the issuance of EPRBs. This will represent a first significant step towards the creation of a proper fiscal union. Following Codogno and van den Noord (2020), EPRBs, either issued by the EIB and/or the European Commission should represent safe assets for financial markets eligible for ECB’s asset

⁵ See Della Posta et al. (2019) for an analysis of investment deficiencies in Europe and the necessity, after the two recessions of 2008-2009 and 2012-2013 (and even more now, we might add), of a Grand European Investment Plan that, among other things, could help in restoring a pro-European

sentiment (after fiscal austerity and the consequent dreadful social conditions).

⁶ There are proposals supporting a European Green New Deal. See for instance the European Commission’s roadmap for a European Green Deal: https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en.

purchase programs, with the ECB deciding which amount of EPRB-financed expenditures to ultimately cover with money (i.e., by purchasing EPRB themselves), and which part to leave to investors' appetite for such an European asset. In this sense, ECB should act by taking into account the fine-tuning of Eurozone inflationary dynamics with respect to its own inflationary target. Nonetheless, the ECB should also bear clearly in mind that both the ability to meet financial commitments by European firms and governments, i.e., the financial stability of the euro area, and the value of the euro currency ultimately depends on the strength of the underlying productive system. All concerns for ECB "monetary financing" of the above plans should thus pale in front of the urgency to preserve and re-launch the European productive system.

Some final considerations are required as to the implications of the different forms of financing of the above emergency and recovery plans, and of government interventions more in general. With respect to bond issuance, major crisis-led increases in public debt are likely unavoidable. There is no magic number in economic theory as to the maximum level public debt could reach whilst remaining sustainable. Numerous elements, of institutional nature mainly, but also historical and cultural, come into play. This said, high levels of public debt may obviously raise some concerns as to the sustainability and composition of future public expenditure (due to the implied burden of interests' payment), as well as to the willingness of financial markets to purchase Eurozone government bonds. The economic theory tells us that when public bonds are not nominated in a foreign currency, the central bank issuing that currency will

always be able to support, in extreme circumstances, the sustainability of public debt and the capability of the government to honor its payment commitments. Despite losses to international investors could still come from the possible depreciation of the currency, the risk of public default will be much lower. This is why the Eurozone badly needs a revision of the ECB's mandate in order to make it more aligned to what other independent central banks can actually do when it comes to the potential support provided to fiscal authorities (national governments in the case of the Eurozone) engaged in substantial counter-cyclical fiscal expansions.

Economic concerns may also arise from the monetization of public expenditures. Inflation is not directly linked to the amount of money issued by the central bank, and no major concerns of inflation seem to plausible today. Nonetheless, it is important to remind that the present crisis, unlike the 2009 Great Recession, involves some aspects of a potentially relevant supply shock so that, if fought only via demand side policies (whatever the financing), it may lead to undesired levels of inflation. It is precisely for this reason that it is of vital importance to intervene to preserve and re-launch the production potential of the European productive system. The much-needed countercyclical fiscal policy should therefore not be limited to relaunching aggregate demand. Still it is also important to keep in mind that, higher level of inflation than what we have been witnessing in the recent years will be desirable to lower the burden of the debt inherited by the crisis.⁷

All in all, public spending during the emergency and along the recovery plan would impede a

⁷ Several more lessons ought to be taken from this dramatic event. One is particularly important in our view. The importance of strong public health systems is self-evident in light of the Covid-19 pandemic. These need reliable and stable source of funding and therefore are incompatible with a

European Union in which fiscal systems compete to attract financial capitals by lowering tax rates. A system of minimum European tax rates both on corporation and wealthy individuals is necessary to counter this major negative externality of free capital movement.



further drop in GDP, thus avoiding an even greater surge in the public debt over GDP ratio. Moreover, a European plan to boost the recovery after the emergency, and based on investments, would have a beneficial role both on the demand side, by increasing aggregate demand – that could give rise to an inflationary pressure as time elapses, and the supply side, by enlarging the productive base – that instead would contribute in keeping inflation under control.

3. A perspective on the future of the Eurozone

The project of building a European Union with common markets and institutions has proceeded by alternate phases, with great difficulties that have sometimes produced relevant progresses in the process of European integration. While fiscal policy has remained anchored to national decisions and inter-governmental coordination, due to the too much timid political climate and the obsession with moral hazard, monetary policy has greatly changed under President Draghi to respond more effectively to the long-lasting consequences of the 2007-2008 financial crisis, and to the specific problems within the Eurozone. A further step urgently needs to be taken. Fiscal and monetary policy must evolve jointly at European level. It is not the time for self-imposed restrictions on the spending capacity of the public sector. It is the time to abandon dogmas and flawed economic theories on the functioning of monetary systems. Interestingly, one of the first conceptualizations of the Economic and Monetary Union, the Werner Report of 1970, outlined very clearly the need of a big community budget, automatic stabilizers and inter-regional transfers to secure the viability of a common currency. With the likely collapse of aggregate demand in the Eurozone as a consequence of the fight against the spread of

the coronavirus, a new expansion of the ECB's balance sheet to create money is needed, this time to be used in the real sectors of the economy. This monetary expansion will hardly have any significant inflationary impact. And if this were not the case, a (modest) increase in price dynamics might actually be welcomed, as it can make more sustainable the likely higher debt burden inherited from this crisis.

The temporary suspension of the SGP in the midst of the current health and economic emergency is certainly a positive fact. Nonetheless, a projection over the longer period of the ongoing discussions among Eurozone Member states seems to suggest that, once the emergency phase will be over, pro-austerity countries will push for reintroducing tough fiscal rules and austerity plans, reiterating the sad story we already saw in the recent past. If we think about a huge contraction in GDP and a strong increase in government spending jointly contribute to give rise to a massive surge in public debt-to-GDP ratio, we can immediately realize that the application of SGP- or Fiscal Compact-inspired fiscal discipline is untenable. Precisely to avoid this dismal scenario that we suggest that:

- i. the emergency-led debt accumulated during this crisis is not accounted for the application of fiscal rules once the emergency is over;
- ii. bonds issued by national governments during the emergency are fully monetized by the ECB – i.e., they cancelled or forgiven at maturity;
- iii. the ECB acts directly as a buyer of last resort, bypassing governments, thus implementing the operations already described above. This is a sort of 'helicopter money' calibrated on the need to replace the working of the private economy during the suspension of market activities under the health crisis.



In the long run, European Institutions, and Eurozone governments in particular, need to take consciousness that changes are unavoidable, as the current crisis makes fiscal rules and existing treaties outdated and inapplicable. Such long-run structural changes should not be the disorganized results of concessions, but the fruits of a vision for the recovery and development of the economy of European Union as a whole, and of the Eurozone in particular. It is time for the Eurozone to act as a union. If this will not be the case even in front of such a dramatic emergency, doubts on the very sense the European project will be legitimized. In a way, the current Covid-19 emergency may be the last call to make significant steps toward a proper political union.

Unfortunately, the state of the debate among Eurozone countries is rather disappointing. Despite the severity of the current crisis requires immediate and bold actions, it seems to be quite unlikely that Eurozone Member States could reach a satisfactory agreement about how to jointly respond, if a common response will ever be found, to the present emergency in a timely manner. In a similar vein, some Eurozone Member States may resist any request for a permanent revision of existing fiscal rules or, even the more so, for the creation of a common European fiscal authority mutualizing national debts. In the absence of a reasonable common view among Eurozone countries about how to move forwards towards a fiscal union, the ECB should be transformed in a way never imagined before. This means for the ECB to go much beyond the very narrow view some Member States share of the ECB itself as “controller” of price stability only. Given the depth of the current health emergency and the challenges it poses to the existence of the euro area, if we aim to save the euro, this time “whatever it takes” requires a more radical move.

These long-term reforms missing, a disintegration of the Eurozone will become more likely, especially if the current emergency phase will last, as expected, more than a few weeks. If even under these exceptional conditions disagreements among Member States will persist as to the need of acting jointly and use all the possible tools against such a huge symmetric shock, then single countries will eventually have to monetize emergency-led debts by themselves. It goes without saying that this will imply leaving the Euro and returning to national central banks, or perhaps move towards a smaller aggregation of countries agreeing on a deeper “sharing” of monetary and fiscal policies in a renewed and more cooperative Europe. This might be the case of a Mediterranean European monetary area, perhaps putting together France, Italy and Spain, arising with its own currency, a common fiscal policy and a fully operational central bank. Needless to say, this is a very different type of Europe, and of European Monetary Union, with respect to what thought by the noble fathers of European integration. This is why, in the midst of a tremendous health and economic crisis, we more than ever need full access to all possible joint fiscal and monetary tools. The suspension of the SGP and now the discussion on a European unemployment dole scheme (though with a very limited endowment), as well as the expanding operationality of the ECB through PEPP and other measures, give us a hope that something is moving in Europe. But, especially for fiscal policy, this is an overly timid step forward. We really need much more.

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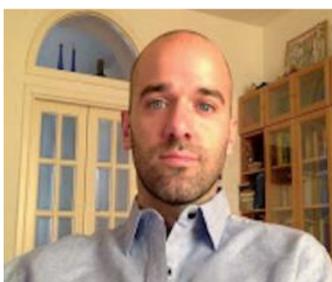
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