

Pandemic shocks and fiscal-monetary policies in the Eurozone: COVID-19 dominance during January–June 2020

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Abstract

We compare the importance of market factors against that of coronavirus disease-19 (COVID-19) dynamics and policy responses in explaining Eurozone sovereign spreads. First, we estimate a multifactor model for changes in credit default swap (CDS) spreads over 2014 to June 2019. Then, we apply a synthetic control-type procedure to extrapolate model-implied changes in CDS. The factor model does very well over the rest of 2019 but breaks down during the pandemic, especially during March 2020. We find that the March 2020 divergence is well accounted for by COVID-specific risks and associated policies, mortality outcomes, and policy announcements, rather than traditional determinants. Daily CDS widening ceased almost immediately after the European Central Bank announced the Pandemic Emergency Purchase Programme, but the divergence between actual and model-implied changes persisted. This points to *COVID-19 Dominance*—widening spreads during the pandemic has led to unconventional monetary policies that primarily aim to mitigate short-run fears, temporarily pushing away concerns over fiscal risk.

JEL classifications: E58, F34, I15, O52.

1. Introduction and overview

The COVID-19 shock hit the Eurozone (EZ) in March 2020, mushrooming into a major pandemic that tested the medical, social, and economic capabilities of EZ countries. Within 2 months, the enormity of the health and economic threats and damages became clear.

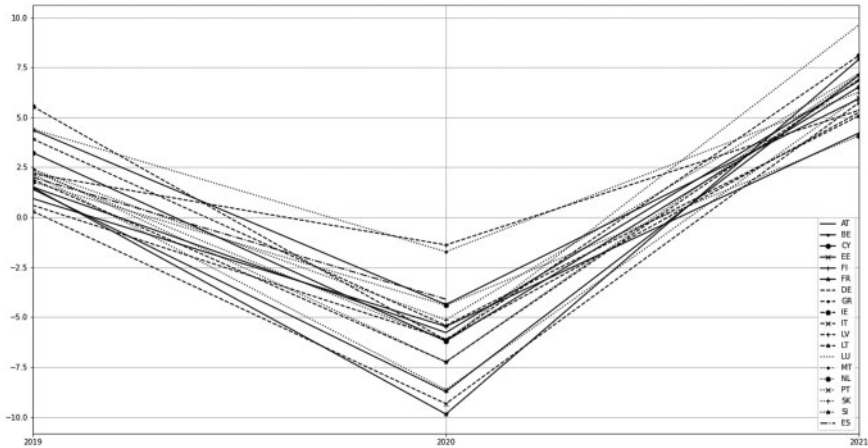


Fig. 1. GDP forecasts

Note: Oxford Economics, INE (Spain); Thomson Reuters Refinitiv (Eikon API).

COVID-19 wreaked havoc on both domestic and external demand in France, Italy, and Spain, while contractions in smaller Eurozone economies were sizeable but less severe. With the exception of Malta, the forecast range is (–5.5% to –9%), based on Focus Economics Forecast (accessed 20 June 2020).

COVID-19 wreaked havoc on both domestic and external demand in France, Italy, and Spain, while contractions in smaller EZ economies were sizeable but less severe. Except for Malta, the forecast range of economic activities in early May for the 18 EZ countries was in the range (–5.5% to –9%), about –7% for the EZ, with Germany and France at about –6% and –7%, respectively (Fig. 1).

In light of another unexpected global crisis, the purpose of our article is to take stock of January to June 2020 data, evaluating the impact of COVID-19 dynamics, the European Central Bank's (ECB) and countries' fiscal policies on the patterns of sovereign spreads in the EZ during the first half of 2020. The COVID-19 pandemic triggered costly containment policies, the collapse of aggregate demand and international trade, and a sharp drop in the gross domestic product (GDP) of Organisation for Economic Co-operation and Development (OECD) countries. Fig. 2a shows the co-movements of the ECB rate and the Federal Reserve Funds rate, both of which were already close to zero. The USA embarked on massive fiscal stimulus, augmented by the expansion of quantitative easing (QE) policies to a wide spectrum of economic activities, and the provision of ample liquidity to foreign countries via swap lines and new repo facilities. The size of these interventions dwarfs the Fed's policies during the global financial crisis.¹

1 These policies include up to \$2.3 trillion in lending to support households, employers, financial markets, and state and local governments. In addition, the Fed activated its international swap lines at low interest rate to Canada, England, the Eurozone, Japan, and Switzerland, and extended the maturity of those swaps. It has also extended the swaps to the central banks of Australia, Brazil, Denmark, Korea, Mexico, New Zealand, Norway, Singapore, and Sweden. The Fed is also offering dollars to central banks that do not have an established swap line through a new repo facility called FIMA (for 'foreign and international monetary authorities'). The Fed will make overnight dollar loans to the central banks, taking USA Treasury debt as collateral. See Cheng *et al.* (2020) for

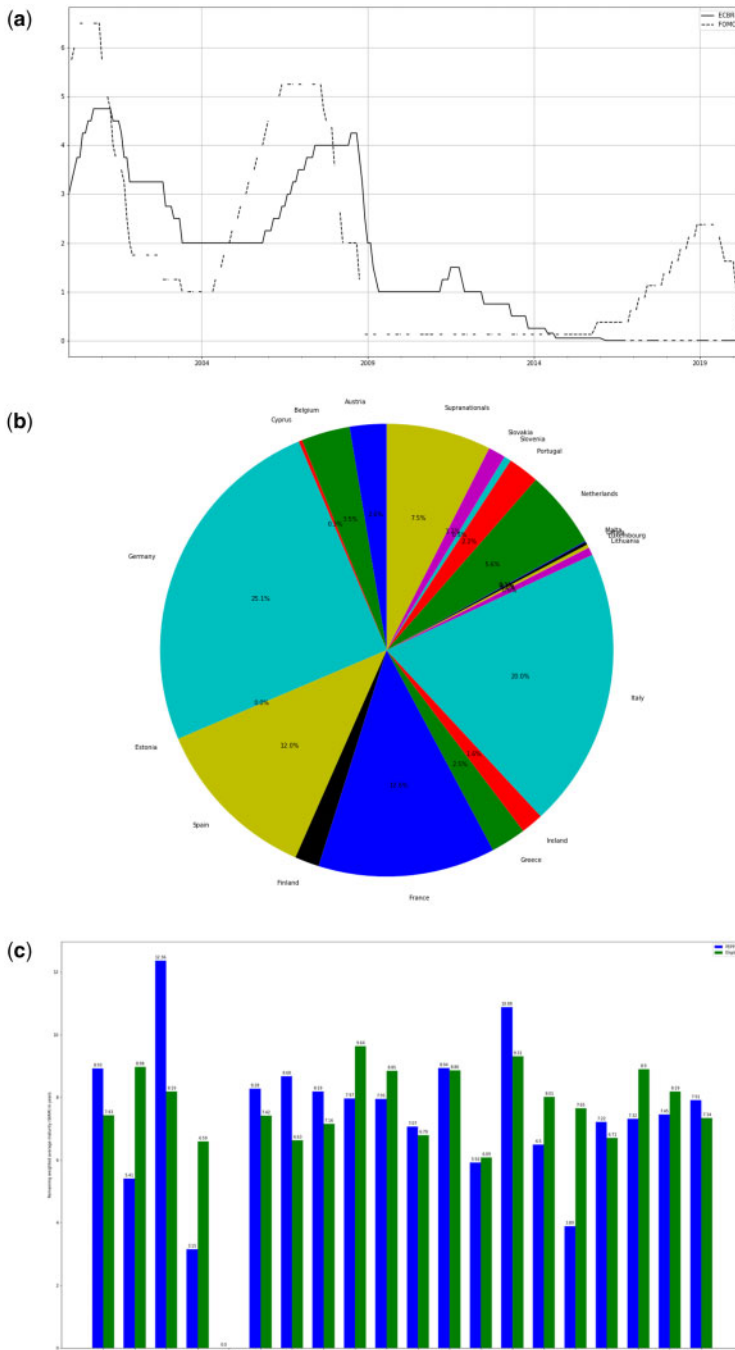


Fig. 2. (a) ECB rate and Federal Open Market Committee decisions. Monthly data from Thomson Reuters Refinitiv (Eikon API). (b) Pandemic emergency purchase programme: net purchases March–May 2020 based on ECB statistics (<https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html>). (c) Remaining WAM in years of public sector securities holdings under ECB-PEPP, based on ECB statistics (<https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html>).

In March 2020, the ECB activated policies tuned to deal with the evolving dire financial and fiscal needs of the EZ. On 18 March 2020 the ECB activated a new QE line of €750 billion through the Euro Pandemic Emergency Purchase Program (PEPP), targeting national and regional government bonds, including Greek sovereign debt, and various private sector bonds. On 4 June 2020, the ECB almost doubled the PEPP, increasing its size up to €1,350 billion. Figure 2b shows the cumulated net purchases of PEPP from March to May 2020, indicating the large weights of Belgium, France, Germany, Italy, Netherlands, and Spain. Figure 2c shows the differences of PEPP in terms of the maturity profile; the remaining weighted average maturity (WAM) in PEPP is shorter than the universe of eligible bonds for Belgium, Germany, and the Netherlands, while WAM is longer for France, Italy, and Spain. These new policies have increased the ECB's balance to about half of EZ's pre-COVID GDP.

Arguably, the sudden stop of economic activities triggered by the COVID shock and accelerating contagion and mortality triggered 'COVID-19 dominance'—whereby nations focused monetary and fiscal policies on mitigating and containing the adverse health and the economic consequences of the pandemic. QE and fiscal policies have been committed to mitigating the fear of the worst outcome: collapsing household and corporate income during times of massive medical and policy effort to deal with the new highly contagious pandemic. To what degree the QE and fiscal policies would help synchronize the asymmetric responses of the EZ countries, by now displaying varying fundamentals (i.e., current account/GDP in Fig. 3a, and business cycles in Fig. 3b) remains an open question.

The main analysis applies a case study methodology, comparing the impact of prevailing systematic market factors against that of COVID-19 dynamics, the ECB's and countries' fiscal policies on the sovereign spreads of EZ countries, and the overall financial and fiscal adjustments to the collapsing demand. In a multi-stage econometric analysis, we focus on daily CDS spreads, leveraging a EZ cross-country panel data-set. In the first stage, we estimate a dynamic heterogeneous multi-factor model for changes in EZ CDS spreads over the period of January 2014 through June 2019, the 'pre-COVID-19' period. Then using the estimated model parameters, we apply a synthetic control-type procedure to extrapolate the model-implied change in the CDS—given realized values of the factors from July 2019 through June 2020. This approach allows us to statistically derive the 'COVID residual,' i.e., the difference between the actual CDS adjustment and the change implied by the model, at both the individual country and aggregate EZ levels over the pandemic period. In the second stage, focusing specifically on the 2020 period, we explore whether daily COVID-19-related mortality rates and the announcements of policy responses help to explain variation in this COVID residual.

In the first stage, we find that (i) the dynamic multi-factor model traces closely the adjustment dynamics of the average EZ CDS spread in the 'validation' period (1 July 2019 to 31 December 2019), but substantially under-predicts EZ CDS adjustment over March 2020, the arrival month of the COVID-19 to EZ; (ii) CDS spread changes of high-mortality and low-mortality country groups were entirely parallel up until around mid-March, at which point we see a persistent gap emerge between high-mortality and low-mortality countries; and (iii) the non-Greece, Ireland, Italy, Portugal, Spain (GIIPS) and core EZ countries saw actual CDS widening comparable to that of the more fiscally fragile GIIPS

more on the Federal Reserve's policies (2020). Also see [Belz et al. \(2020\)](#) for the ECB's policy response to the COVID crisis.

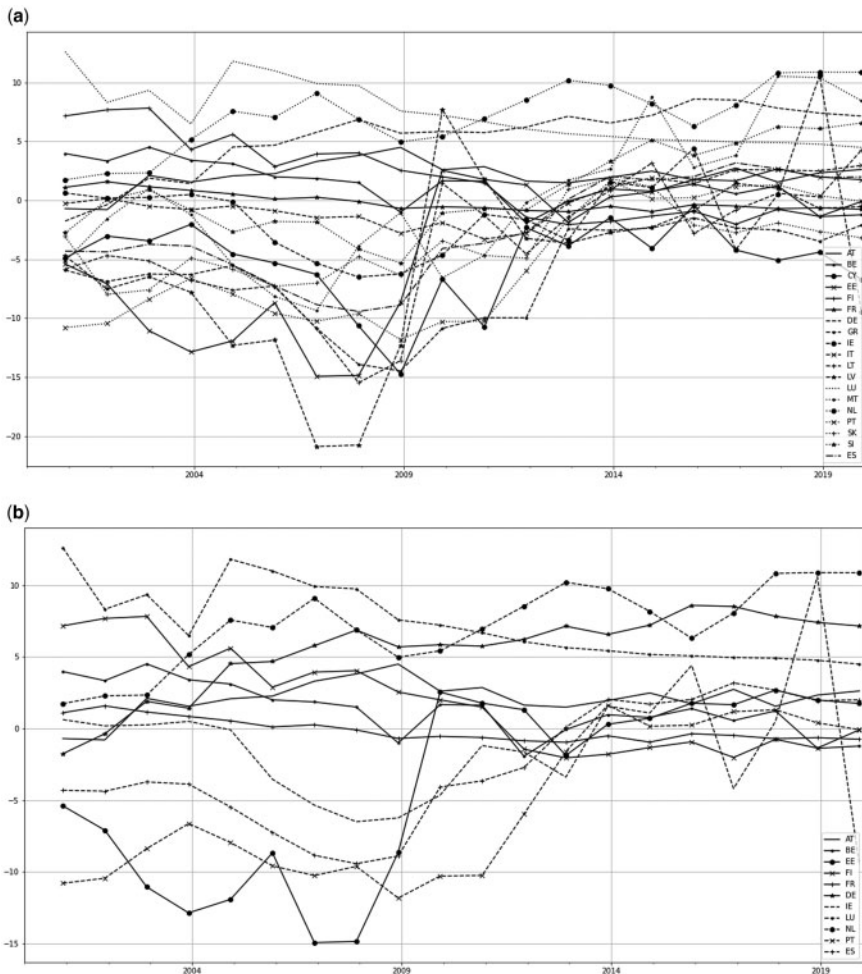


Fig. 3. (a) Current account balance % of GDP. WEO; Thomson Reuters Refinitiv (Eikon API). **(b)** Composite leading indicators in business cycles. OECD main economic indicators CLI, Thomson Reuters Refinitiv (Eikon API).

group. These findings indicate concerns shifted towards short-run economic instability related to the pandemic, temporarily pushing away more traditional sovereign risks such as fiscal space.

In the second stage, we find that the divergence of the CDS COVID residual in March 2020 is well-accounted for by COVID-specific risks and factors, and in particular, mortality outcomes and policy announcements, rather than traditional determinants like fiscal space or systematic risk. COVID-related mortalities explain the greatest share of the variation in COVID residual, and COVID-specific factors (including fiscal-monetary policy announcements) account for a much larger share of the variation in daily CDS spread adjustment than our predictions from the pre-estimated dynamic factor model (five times as large). On the aggregate EZ level, after conditioning on COVID-specific mortalities and

policy announcements, the model-implied CDS spread dynamics almost perfectly trace the realized dynamics.

Daily CDS spread-widening ceased almost immediately around 18 March, when the ECB announced the PEPP, but the divergence between actual and model-implied changes persisted. This divergence goes hand-in-hand with a divergence in the actual CDS spreads of countries hit hard by the virus versus those which were not. Our findings clearly indicate ‘COVID-19 dominance’—The widening spreads during the pandemic induced by COVID-specific risks and fiscal reactions led to unconventional monetary policies that primarily aimed to mitigate the fear of the worst economic outcomes such as collapsing household and corporate incomes, and temporarily pushed away concerns over fiscal risk. Specifically, COVID-19 mortalities and COVID-specific fiscal policies fueled a divergence in CDS pricing from fundamentals. In contrast, the ECB’s policies have been associated with lowering the spreads and their dispersion (with a lag), thereby providing more fiscal space to ‘COVID-19 distressed’ countries, i.e., countries which are systematically riskier and thus issued less fiscal stimulus/GDP in response to the pandemic.

Section 2 describes the patterns of COVID-19 mortalities and the policy responses, accounting for factors explaining variation in the EZ. Section 3 reports the analysis on set of COVID-specific risks and factors including COVID-19 mortalities, ECB policies, and country-specific fiscal stimulus and their association with COVID residuals and CDS spread dynamics. Section 4 provides the concluding remarks.

2. Covid-19 crisis and the EZ

2.1 Mortality patterns

While the entirety of the EZ was hit by the COVID-19 pandemic, mortality dynamics across nations were incredibly heterogeneous. Figure 4a and b illustrates the large discrepancies in mortality per capita and deaths per million residents in the EZ. Belgium, Spain, France, and Italy were amongst the nations with the highest mortality and death rates. Meanwhile, Lithuania, Latvia, Slovenia, and the Slovak Republic held some of the lowest mortality rates per capita. Some of this heterogeneity may be influenced by the different methodologies of local agencies tasked with capturing the contagion and severity of the virus.² At the same time, Jinjara *et al.* (2020) provide evidence that the government pandemic policy interventions (in terms of their strictness, duration, and rapidity), along with initial country characteristics, may have influenced both the mortality growth rates and the empirical shape of the mortality curve (including the duration and peak).³ Their paper

- 2 Belgium, which has a noticeably pronounced mortality curve compared to other Eurozone nations, is radical in the approach they have taken to classifying COVID’s contagion rate. Health agencies in Belgium have classified a far higher share of recent deaths to the virus than other nations, even when the status of the deceased as a COVID-infected individual was not confirmed (Source: <https://www.npr.org/sections/coronavirus-live-updates/2020/04/22/841005901/why-belgiums-death-rate-is-so-high-it-counts-lots-of-suspected-covid-19-cases>).
- 3 Greece has been lauded for its efforts to reduce the contagion of the virus. Amongst the Eurozone nations, Greece had by May 2020 one of the lowest mortality rates. This despite the nation’s recent history of financial troubles and radical cuts to the health system. Many attribute the success of Greece to the precision and promptness of the government in establishing stringent policies to promote social distancing and reinvigorate the reeling medical system (Source: <https://theconversa>

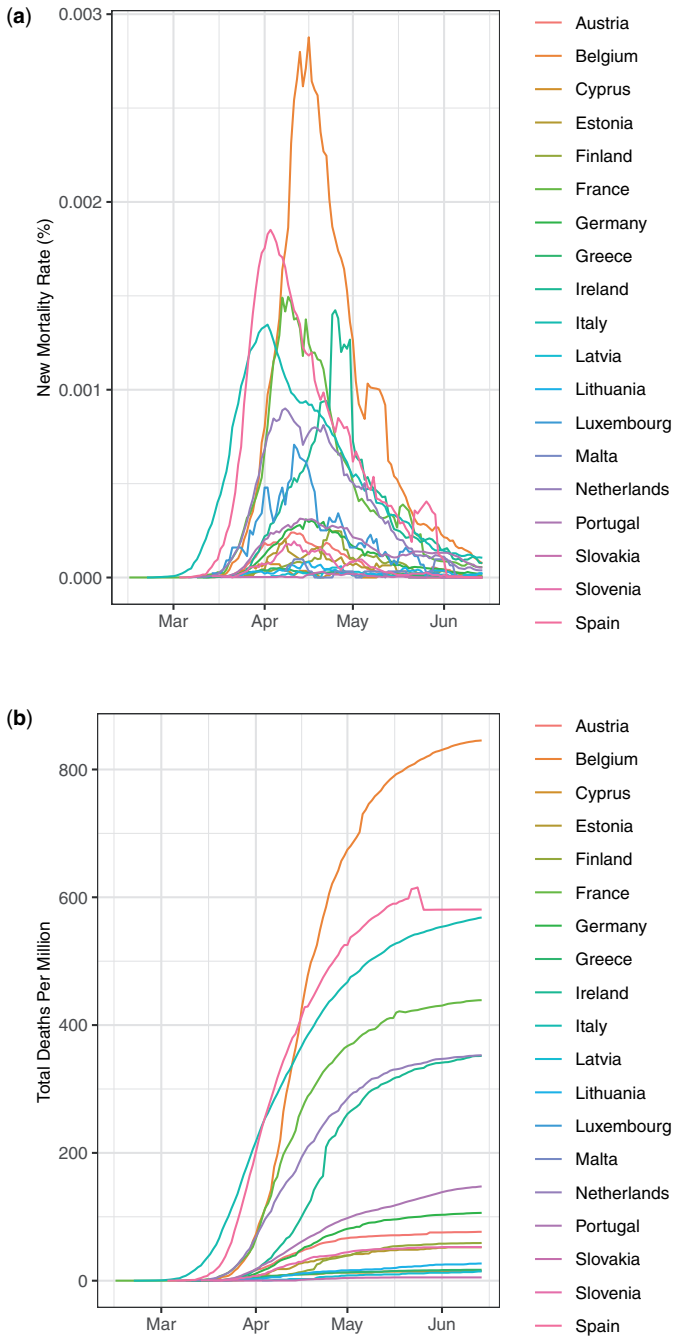


Fig. 4. (a) COVID-19 mortality rate curves, by country. *Note:* New mortality rate, as 7-day rolling averages. *Source:* Johns Hopkins University-Center for Systems Science and Engineering COVID-19 data. **(b)** COVID-19 deaths per million, by country. *Note:* Calculated as COVID-19 deaths per million residents. *Source:* Johns Hopkins University-Center for Systems Science and Engineering COVID-19 Data.

explores several demographic and structural features across a large sample of advanced and emerging economies from 23 January 2020 to 28 April 2020, finding that with a lag, more stringent pandemic policies were associated with lower mortality growth rates.

Furthermore, the association between stricter pandemic policies and lower future mortality growth was more pronounced in countries with a greater proportion of the elderly population, greater democratic freedom, larger international travel flows, and further distance from the equator. In addition, they document that the extent to which the peak mortality rates were explained by government pandemic policies and country-specific structural features is heterogeneous, see [Fig. 5](#).⁴

2.2 Fiscal policies of EZ countries and the ECB monetary policies

While fiscal policies across the EZ varied in their substance and magnitude by nation, they often targeted similar sectors. Much of the funding allocated by key fiscal policies were distributed to the reeling medical sector, as well as public transport, small businesses, and displaced workers. For example, in May alone, Austria allocated €300 million to the public transport sector, €500 million to pubs and gastronomies, and €1 billion in direct support to local municipalities. In the same month, Estonia allocated €70 million to promote local enterprises and alleviate the shock of the virus; France approved a new fund of €50 million to aid the struggling transport industry; Greece approved two entrepreneurship programs with budgets totaling €500 million; and Ireland approved a budget of €250 million to support struggling small businesses and pubs ('COVID-19 Financial Response Tracker,' 2020). The ECB supplemented these country-specific measures with the introduction of the PEPP, which allocated 750 billion Euros to asset purchases, later increased to €1,350 billion by 4 June 2020. Along with these purchase programs, the ECB engaged in healthy doses of forward guidance and assured Member States that the purchases would continue throughout the multiple waves of the crisis. At the same, as part of the European Union Recovery Plan, the European Commission increased expenditure ceilings, granted additional access to emergency loans and assets for member states, and targeted specific funding to hospitals and the agricultural sector ('EU/EA Measures to Mitigate the Economic, Financial, and Social Effects of Coronavirus,' 2020).

The universal fiscal and monetary responses in combination with containment policies across the world, and particularly in the EZ, might give credence to our theory of 'COVID-19 dominance.' While containment policies were targeted specifically at reducing the spread of the virus, despite the associated introduction of painful adjustment costs for the general populace, monetary, and fiscal policies have been committed to mitigating the fear of the worst outcome: collapsing household and corporate income at times of massive medical effort and containment interventions to deal with the new highly contagious pandemic. In this new ultimatum of 'lives vs. livelihoods,' it appears those governments who have prioritized quick and direct interventions to save lives have been the most successful in reducing contagion and mortality. How has this COVID-19 dominance forced the hands of

[tion.com/greece-despite-a-decade-of-health-cuts-coronavirus-death-rates-appear-comparatively-low-136293](https://www.bbc.com/news/health-55761795))

4 Among all countries in the Eurozone, the peak new mortality rates of France, Belgium, Ireland, Italy, and Spain were over-predicted. At the same time, those of Greece, Cyprus, Slovak Republic, Finland, and Portugal were under-predicted ([Figure 5](#)).

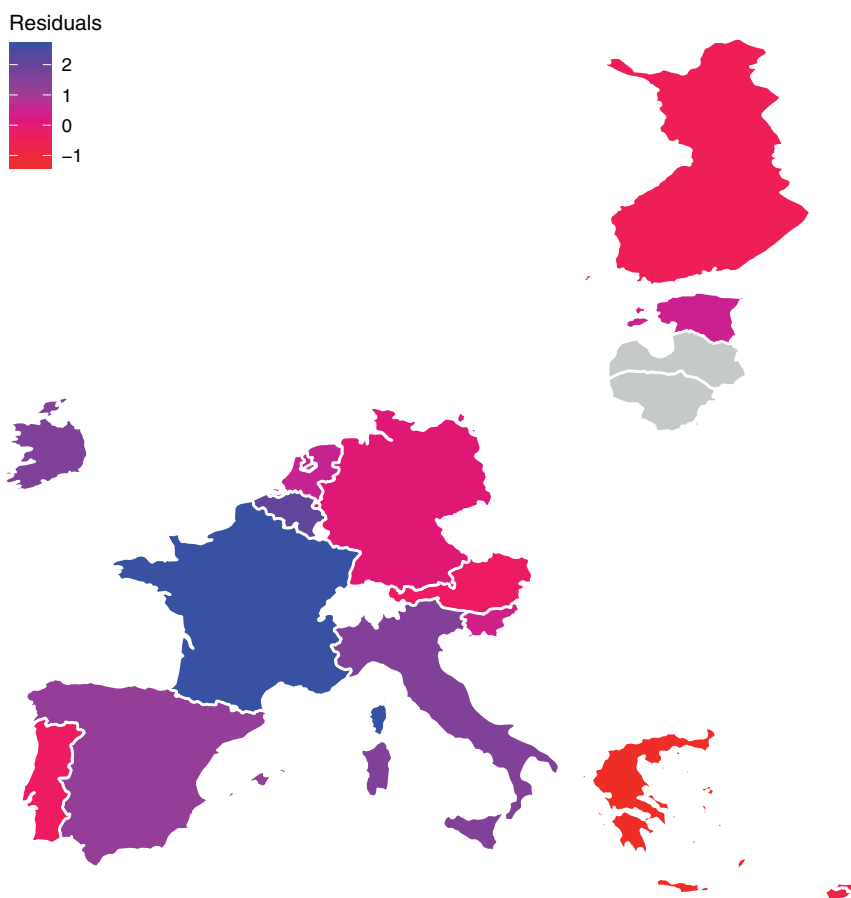


Fig. 5. Patterns of over-/under-predicted mortality rates in the Eurozone

Note: The peak new mortality rates of France, Belgium, Ireland, Italy, and Spain were over-predicted. At the same time, those of Greece, Cyprus, Slovak Republic, Finland, and Portugal were under-predicted (Jinjarak *et al.*, 2020)

financial institutions and regulatory agencies, to ensure short-term stability and restore livelihoods? And how have these policy decisions influenced consumer confidence and economic growth? We turn to explore these questions in Section 3.

3. Analysis of COVID-19 dominance

In this section, our primary goal is to investigate whether and to what degree COVID-related developments and associated policy responses significantly influenced the pricing of sovereign debt across the EZ. We consider data on daily sovereign credit default swap (CDS) spreads to capture fluctuations in debt pricing and sovereign risk across countries and over time.

The literature points to several well-known determinants of sovereign pricing with measures of fiscal space exhibiting robust explanatory power. During a conventional financial crisis, sovereign risk adjustments are relatively sharper for fiscally fragile countries—those with burgeoning

debt/GDP or weaker interest coverage ratios. In a sense, fiscal capacity often dominates the pricing (or repricing) of sovereign debt. As such, one may expect fiscal space to play an important role in explaining differences in sovereign spreads amid the COVID-induced financial panic. However, COVID-19 was a unique shock in many ways: it was a public health crisis, rather than originating from the financial sector. It has been global, and of unprecedented speed and severity. Moreover, not all EZ countries were impacted equally. While Italy and Spain suffered from some of the highest mortality rates during the first wave, countries like Greece and Slovakia managed remarkably well.

In this context, we ask whether and to what degree (i) prevailing factors explain CDS variation through 2020 and (ii) COVID-related dynamics influenced sovereign debt pricing throughout the pandemic. We propose a multi-stage econometric analysis that takes advantage of a daily cross-country panel data-set. Our outcome variables of interest are daily CDS spreads for 17 EZ countries (excluding Malta and Luxembourg, for which data was unavailable). The data are from Thompson Reuters and Markit.

To summarize our methodological approach, in the first stage we estimate a dynamic heterogeneous multi-factor model for changes in EZ CDS spreads over the period 1 January 2014, through 30 June 2019, denoted the ‘pre-COVID’ period. Then using the estimated model parameters, we apply a synthetic control-type procedure to extrapolate the model-implied change in the CDS—given realized values of the factors—from 1 July 2019, through 15 June 2020. This approach allows us to calculate the ‘COVID residual,’ i.e., the difference between the realized CDS adjustment against the change implied by the model at both the individual country and aggregate EZ levels, over the COVID pandemic period. In the second stage, focusing specifically on the 2020 pandemic period, we explore whether daily COVID-related mortalities and announced policy responses help to explain variation in the COVID residual.

3.1 First-stage estimation, January 2014 to June 2019

In the first stage, we estimate a dynamic factor model on the pre-COVID period data of the following form:

$$\Delta \text{cds}_{it} = \alpha_i + \phi_i \Delta \text{cds}_{i,t-1} + \beta_{i1} \Delta \text{GCDS}_t + \beta_{i2} \Delta \text{RCDS}_{i't} + e_{it}, \quad \begin{array}{l} 1 \text{ January } 2014 \leq t \\ < 1 \text{ July } 2019, \end{array} \quad (1)$$

where

$$\Delta \text{cds}_{it} = \ln \frac{\text{CDS}_{it}}{\text{CDS}_{i,t-1}}.$$

Our outcome variable is the daily change in the log CDS spread of country i . On the right-hand side, we include the lagged-dependent variable, along with two factors: A global factor, ΔGCDS_t and a regional EZ factor $\Delta \text{RCDS}_{i't}$. The global factor is measured as the cross-sectional average of daily log CDS changes over a sample of 51 non-EZ countries, therefore capturing the common component of sovereign risk fluctuations at the global level. The regional factor is measured similarly, but over the 16 EZ countries *excluding* country i , hence the notation i' . The regional factor, therefore, captures common fluctuations within the EZ.

It is important to note that the model is heterogeneous, allowing for regression estimates across countries to vary. Therefore, each country has its own unique global and regional ‘betas,’ β_{i1} and β_{i2} , which captures country-specific systematic exposure to aggregate global and regional risk, respectively. The main assumption we make is that the estimated factor ‘betas’ capture the most important determinants which influenced sovereign spreads over

the 2014–9 period. Another assumption of the model is that the regional factor $\Delta RCDS_{i,t}$ is taken as weakly exogenous by country i , which may be less reasonable than the assumption of the global factor being taken as weakly exogenous given the relatively small number of countries in the EZ average (17 vs. 51). Because the regional factor is a weighted average of other EZ countries, there may be an endogeneity concern as changes in country i may affect CDS in countries i' , especially for economically dominant i such as Germany. That is, it may be the case where the estimated regional EZ factor just reflects a dominant unit within the EZ rather than recovering a true factor governing CDS spreads. While it is well-documented that sovereign credit risk obeys a strong global factor structure (Longstaff *et al.*, 2011). Fabozzi *et al.* (2016) provides evidence supporting the existence of an additional EZ factor driving EZ CDS spreads which further corroborates our factor model specification. More formally, in order for the assumption of weak exogeneity of the regional factor, $\Delta RCDS_{i,t}$, to be satisfied are presented in Pesaran *et al.* (2004). The main assumption is that individual weights assigned to the countries composing $\Delta RCDS_{i,t}$ must be sufficiently small, asymptotically approaching zero as the number of countries N goes to infinity. Another assumption, that the de-factored, idiosyncratic errors must exhibit weak

Table 1. First-stage regression results estimated over January 2014 to June 2019.

Dependent variable:	$\Delta cds_{i,t-1}$	$\Delta GCDS_t$	$\Delta RCDS_{i,t}$	R-Squared	Out-of-sample R-squared: 1 July 2019 to 15 June 2020
Δcds_{it}					
(1)	(2)	(3)	(4)	(5)	(6)
Germany	-0.395***	0.322***	0.820***	0.22	0.17
France	-0.223***	0.117	1.156***	0.17	0.19
Greece	-0.019	0.083	0.395***	0.04	0.32
Ireland	-0.050**	0.179***	0.905***	0.28	0.26
Belgium	-0.368***	0.300**	0.578***	0.16	0.17
Spain	-0.337***	0.430***	1.833***	0.33	0.17
Netherlands	-0.212***	0.235***	0.566***	0.15	0.22
Austria	-0.269***	-0.097	0.955***	0.17	0.12
Cyprus	-0.125***	0.161*	0.149**	0.03	0.20
Estonia	-0.222***	0.156***	0.167***	0.09	0.07
Italy	0.021	0.305***	1.470***	0.37	0.16
Latvia	-0.034	0.407***	0.158***	0.09	0.01
Lithuania	-0.093***	0.275***	0.189***	0.10	0.01
Portugal	-0.052**	0.407***	1.229***	0.30	0.55
Slovenia	-0.127***	0.170***	0.200***	0.09	0.01
Slovak Republic	-0.168***	0.305***	0.173***	0.16	0.01
Finland	-0.175***	0.209***	0.459***	0.18	0.19

Source: Authors' calculations.

Note: Country-specific time-series regression estimates from Equation (1). Dependent variable is the change in logged daily CDS spread. ***, **, * correspond to 1, 5, and 10% significance, respectively. Out-of-sample (pseudo) R^2 reports the % variation in actual Δcds_{it} explained by model-implied values $\Delta \hat{cds}_{it}$ over the period outside the estimation sample, from July to December 2019. Number of daily observations per country, T , equal to 1,432.

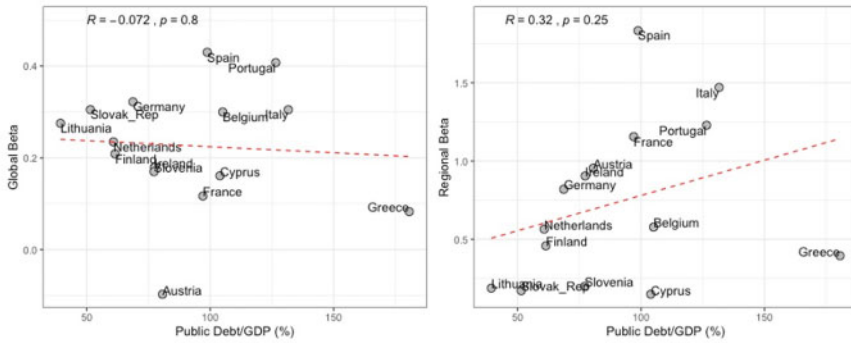


Fig. 6. Public debt/GDP versus global and regional betas

Note: Public debt measures are the 2014–2018 average. Betas are estimated during January 2014 to June 2019, pre-COVID-19.

Source: Authors' calculations.

cross-section dependence, is typically satisfied for sovereign spread data given that the factor structure across countries is well-documented in the literature.

Table 1 reports individual country results from estimating Equation (1). Note that across all EZ countries, the regional factor is significant (column 4), with the global factor significant for all but three EZ countries (column 3). For most countries in the EZ, the regional factor loads more heavily than the global factor with the exception of a few small countries (Cyprus, Latvia, Lithuania, and Slovak Republic). These results corroborate the view that sovereign credit risk covaries strongly across countries, driven by a few common factors. For all but three countries, changes in logged CDS spreads are persistent—the estimated coefficient on lagged-dependent variables is statistically significant (column 2).

Because we rely on daily data for this analysis, low-frequency observables often included in the literature—such as measures of fiscal space—cannot be effectively incorporated into our model without introducing considerable challenges for estimation and inference. However, we believe (and show) that our heterogeneous factor betas can adequately capture these low-frequency observables. We estimate the model over the pre-COVID period of 1 January 2014, through 30 June 2019. Instead of estimating the model through 2019, we choose this particular window because it leaves us the remaining 6 months of 2019 to validate the out-of-sample efficacy of our model, prior to the COVID shock in 2020. Finally, the COVID residual is defined as

$$\Delta cr_{it} = \Delta cds_{it} - \left[\hat{\alpha}_i - \hat{\phi}_i \Delta cds_{i,t-1} - \hat{\beta}_{1i} \Delta GCDS_t - \hat{\beta}_{i2} \Delta RCDS_{i,t} \right], \quad t \geq \text{July 1, 2019}, \quad (2)$$

simply comparing the realized change in log CDS each day after the estimation period to the model-expected value, given the true realizations of the factors and lagged log CDS change.

3.1.1 The global and regional risk exposures and EZ fiscal fundamentals Figure 6 plots public debt/GDP of EZ countries against their estimated global betas and regional betas estimated from the factor regressions with daily data. The public debt/GDP measure is an average over annual data spanning from 2014 to 2018. The association between public debt levels and global betas are weak, while public debt levels are positively associated with regional betas across EZ countries. If Greece is excluded due to its remarkably large debt/GDP, the positive correlation between regional betas and fiscal space strengthens sharply,

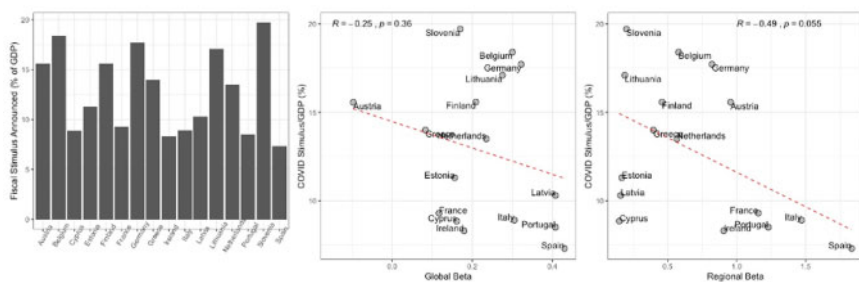


Fig. 7. Announced 2020 COVID-related fiscal stimulus versus global and regional betas

Note: COVID-19 fiscal stimulus data taken from the International Monetary Fund COVID policy tracker.

Betas are estimated during January 2014 to June 2019.

Source: Authors' calculations and [International Monetary Fund \(2020\)](#) COVID policy tracker.

turning significant at the 10% level,⁵ confirming the notion that riskier CDS spreads are associated with fiscal fragility.

Figure 7 shows the correlation between COVID-related fiscal stimulus announced in 2020 and country-specific global and regional betas (estimated over 2014–9). Regional betas are significantly and negatively associated with COVID-related fiscal stimulus size across the EZ. That is, systematically riskier countries (higher regional betas) issued less stimulus/GDP.

Interestingly, these findings support the view that (i) the risks associated with limited fiscal space were priced into EZ sovereign spreads during ‘normal times’ and (ii) country risk possibly constrained, at least to some degree, the size of COVID stimulus which was able to be deployed. However, because of the small sample size of these associations, the interpretation of such relationships should be made cautiously.

3.1.2 Model-implied spreads and COVID residuals, July 2019 to June 2020 After estimating the two-factor model from 1 January 2014 through 30 June 2019, we extrapolate CDS spreads from the model based on realized values from 1 July 2019 through 15 June 2020, which spans the COVID period. Specifically, we take realized values of $\Delta cds_{i,t-1}$, $\Delta GCDS_t$, and $\Delta RCDS_{i,t}$ over July 2019 to June 2020 and recover model-implied values of $\Delta cds_{i,t}$ for the same period using the parameters estimated in Equation (1) on data over the January 2014 to June 2019 period. To emphasize, this extrapolation is completely outside the estimation window and is out-of-sample, and therefore is not subject to any look-ahead bias which typically concerns in-sample extrapolations.

Table 1 column 6 provides country-specific out-of-sample R^2 statistics comparing the model-implied log CDS changes to the actual log CDS changes over the period from 1 July 2019 to 15 June 2020. On average, the model-implied changes in log CDS spreads explain 21% of the variation in realized spreads across the EZ, with individual country explanatory power ranging from close to zero (Latvia, Lithuania, Slovenia, and Slovak Republic) up to 55% (Portugal).

5 We also test the association between the factor betas and the flow cost of debt, given as the product of $r - g$ and public debt/GDP, but the correlations were close to zero. We do not report these results for brevity.

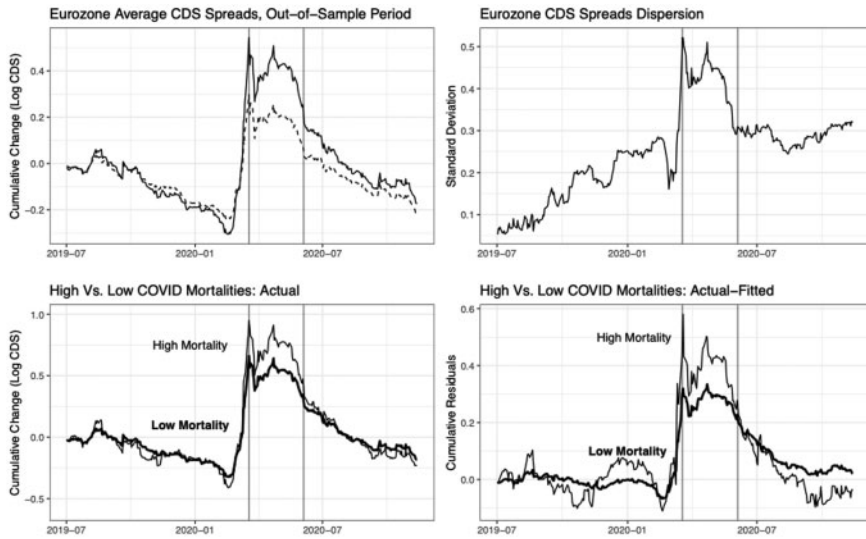


Fig. 8. Eurozone spreads, July 2019 to November 2020.

Note: Dashed line in upper-left figure reflects model-implied values. Vertical lines reflect 18 March and 4 June 2020. Lower-right figure, actual-fitted reflects the cumulative COVID residual, where the model was fitted to January 2014 to June 2019 data (Equation (1)).

Source: Authors' calculations.

Figure 8, upper-left panel traces the EZ average cumulative log CDS change over this period (solid line) against that implied by the model which averages together individual country implied values (dashed). For aggregate EZ CDS fluctuations, the model tightly traces the average realized cumulative log CDS values from July 1 2019 to 31 December 2019, the out-of-sample period prior to COVID-19 (i.e., 'validation period'). A satisfactory fit over the validation period is important because our objective is to use this factor model to construct a synthetic control, or counterfactual of CDS spreads to compare against realizations over the COVID shock period in 2020.

In March 2020, the realized values diverged from the model-implied, triggered by panic over the COVID pandemic. Hence at the aggregate EZ level, the factor model on its own could not explain all of the variation in CDS adjustment due to the COVID shock. CDS spread widening ceased almost immediately around March 18 (the first vertical line), when the ECB announced the PEPP, but the divergence between actual and model-implied changes persisted. The subsequent vertical line represents 4 June, when the ECB announced the doubling of the program.

Figure 8, upper-right charts the cross-sectional dispersion of CDS spreads over the same period, highlighting the sharp rise in volatility amid the COVID panic of March 2020. The lower charts compare high mortality (by end of April) versus low mortality EZ countries. Figure 9 compares GIIPS versus non-GIIPS, and GIIPS versus core (here defined as Germany, France, Belgium, Netherlands).

3.1.3 High- versus low-COVID mortalities Tracing the realized evolution of CDS spreads of high versus low COVID mortality countries in the EZ yields what looks to be a

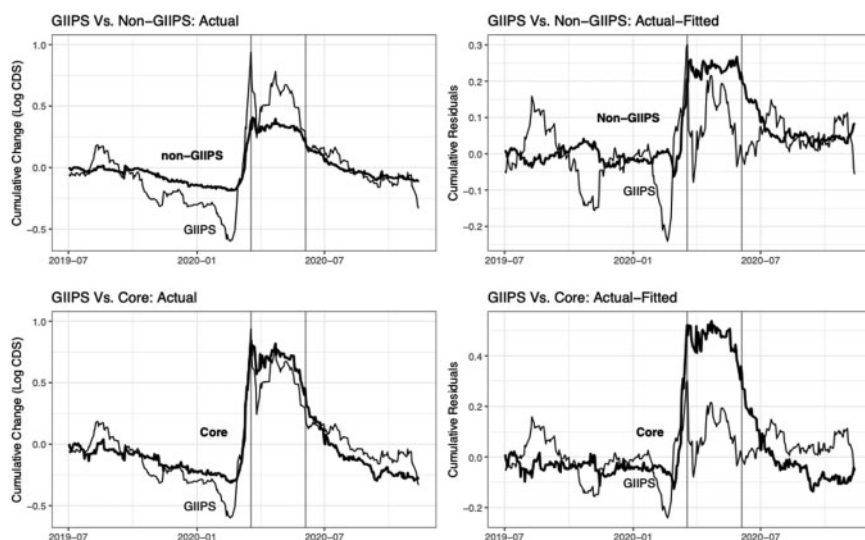


Fig. 9. GIIPS versus other Eurozone countries.

Note: Vertical lines reflect 18 March and 4 June 2020. Right-hand side figures, Actual-fitted reflects the cumulative COVID residual, where the model was fit to January 2014 to June 2019 data (Equation (1)).
Source: Authors' calculations.

very clean illustration of an event study⁶: trends between the two groups were entirely parallel up until around 18 March, at which point we see a persistent gap emerge between high-mortality and low-mortality countries (Fig. 8, lower-left panel). The gap persists when comparing the cumulative COVID residual between these two groups (Fig. 8, lower-right panel), suggesting that this divergence cannot be explained by the factor model, possibly being driven by COVID-specific risks rather than traditional determinants like fiscal space or systematic risk.

3.1.4 GIIPS versus non-GIIPS The GIIPS group cumulative COVID residuals (Fig. 9, upper-right panel) are far more volatile than non-GIIPS. Both groups saw similar spikes following the initial COVID panic in March, but the GIIPS group reverted sharply upon the 18 March announcement of the ECB PEPP. In contrast, non-GIIPS CDS on average rose sharply and remained high. Interestingly, this goes against the conventional view where fiscally fragile countries would realize wider and more persistent credit spreads.

3.1.5 GIIPS versus core Examining the evolution of the GIIPS versus core⁷ show that core country's log CDS moved just as sharply as GIIPS countries. This is peculiar, because if we believe fiscal space matters for debt pricing, we would expect sharper GIIPS adjustment given an adverse macroeconomic shock compared to core, because the latter is relatively less fragile. When we adjust for model-implied movements and look at the

6 High mortality-per-capita countries: Belgium, Spain, Italy, France, and Netherlands. Low mortality-per-capita countries: Slovakia, Latvia, Cyprus, Greece, and Lithuania. We consider mortality-per-capita as off the end of April 2020.

7 We define EZ core countries as: Germany, France, Netherlands, and Belgium.

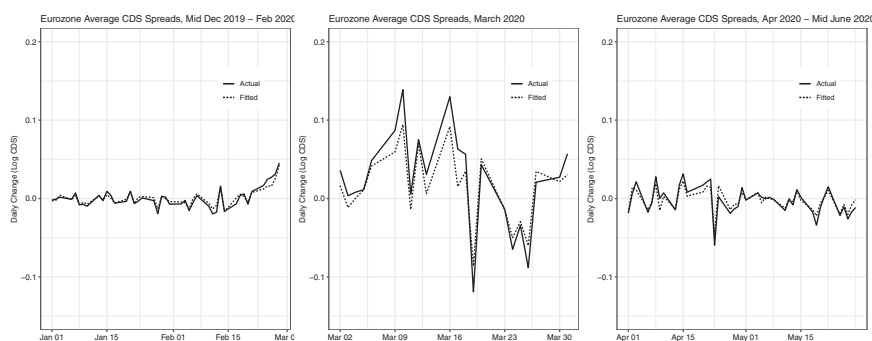


Fig. 10. Eurozone Average COVID residual.

Note: COVID residual: the difference between the actual CDS adjustment and the change implied by the model, at both the individual country and aggregate EZ levels over the pandemic period. Realized (solid) and fitted (dashed, factor model estimated on 2014–2019 data from Equation (1)) daily EZ average CDS changes, separated by 2020 time periods.

Source: Authors' calculations.

cumulative COVID residuals (Fig. 9, upper-right), this peculiarity becomes even more pronounced. On a model-adjusted basis, the core spreads widened *much more* than the GIIPS spreads, despite the GIIPS relatively limited fiscal space. The adjustment in sovereign spreads is the opposite of what one would expect in a typical crisis.

A potential explanation for the ‘GIIPS-core’ puzzle may be that the Netherlands, Belgium, and France are contained in the core, three countries severely impacted by COVID-19, while Greece is contained in GIIPS and was one of the least-impacted countries. Taking this together with the divergence in high-low COVID mortality CDS adjustment, suggests quite clearly that CDS pricing over this period may have been dominated by COVID risk, while the market temporarily pushed away concerns over fiscal risk. To take a closer look at the potential drivers of EZ debt pricing during the COVID pandemic first wave, we move to the second stage of the analysis, where we investigate the 2020 COVID period exclusively.

3.2 Second-stage estimation, 2020

By separating the out-of-sample COVID-19 pandemic period in 2020 (from January to May 2020) into three subsamples: January–February, March, and April–May, we document that March is the period during which the realized values of daily CDS spread change diverged the most from the model-implied values, while the dynamic model does an excellent job of tracing the realized values before and after that (Fig. 10). Moreover, we observe that daily CDS spread changes were the most volatile in March. Therefore, we focus on the sample in March 2020 and examine whether COVID-specific indicators may account for the variation in CDS adjustment that is not explained by the dynamic factor model.

We first estimate a panel model examining the relationship between the COVID residual, defined as the difference between the realized values of daily CDS spread change and the model-implied values of the dynamic factor model (Equation [1]), and a set of COVID-specific variables. Our specification is

$$\Delta cr_{it} = \vartheta_i + \lambda_t + \theta X_{it}^{\text{mortality}} + \gamma X_{it}^{\text{economy}} + \eta X_{it}^{\text{policy}} + \varepsilon_{it}, \text{ March 1, 2020} \leq t \leq \text{March 31, 2020} \quad (3)$$

COVID-specific variables are grouped into three categories: (i) mortality outcomes, in which we include daily new mortality rate (per 1,000,000 population), daily new mortality growth rate, total mortality rate (per 1,000,000 population), and total mortality growth rate and (ii) economic activity, in which we include daily mobility measure in terms of driving (Apple (2020)) and daily growth rates of policy Stringency Indices (constructed by the Oxford COVID-19 Government Response Tracker). While daily mobility is unlikely to cleanly proxy the debt burden, we might expect that lower mobility levels or stricter government non-pharmaceutical interventions signal greater economic contraction, which may increase the debt financing burden and thus impact debt pricing during the COVID-19 pandemic. We choose to include mobility metrics to examine these potential associations. Lastly, we include (iii) policy interventions, in which we encode dummy variables indicating the date of country-specific key fiscal policy announcements, the date of European Commission's fiscal policy announcements, the date of ECB's PEPP announcement, and the date of the Federal Reserve's monetary policy announcements.^{8,9} ϑ_i and λ_t represent country and time fixed effects, respectively.

Results are reported in Table 2. Daily new mortality rates and new mortality growth rates are positively and significantly associated with COVID residuals across all three specifications and explain the greatest share of variation in COVID residuals among all three categories of COVID-specific variables. This implies that debt pricing during the COVID-19 pandemic may have been significantly impacted by country-specific mortality outcomes. Specifically, countries that saw higher new mortality rates or new mortality growth rates were likely to see a wider divergence in realized CDS spread dynamics from model-implied values. In contrast, mobility measures and the Stringency Index do not seem to correlate with COVID residuals. Furthermore, country-specific fiscal policy announcements have a significantly positive association with COVID residuals, indicating that countries that increased their debt burdens were likely to see larger discrepancies in CDS spread dynamics. In sum, country-specific mortality outcomes, especially daily new mortality dynamics, and country-specific fiscal responses help account for the variation in CDS spread dynamics that is left unexplained by the dynamic factor model.

- 8 In order to capture key policy announcements, we aggregated a set of variables from numerous datasets for a set of key fiscal, monetary, and miscellaneous policies, across individual countries, the European Union as a whole, the European Central Bank, and the Federal Reserve. These variables capture *whether or not an action or proposal was made by a given nation/institution on a specific date in the sample*. Thus, we do not control for the size or number of policies on any given day, and only if the date corresponded with the announcement of at least one key policy. With the exception of the Federal Reserve (whose major announcements related to reductions in the interest rate along with fiscal spending), we restricted our analysis of key fiscal policies to those which provided 'millions' or 'billions' of local currency units in spending.
- 9 The primary data sources used to construct these policy announcement variables are listed here and in our references: Yale COVID-19 Financial Response Tracker, [Yale University \(2020\)](#); Harvard Global Policy Tracker, [Cavallo \(2020\)](#); Bruegel COVID-19 National Dataset, [Anderson et al. \(2020\)](#); IMF Policy Responses to COVID-19; [OECD \(2020\)](#) COVID-19 Action Map; [St. Louis Federal Reserve \(2020\)](#); and the [European Parliament \(2020\)](#).

Table 2. Sovereign spread COVID residual, pandemic sample

	Dependent variable		
	Sovereign spread COVID residual		
	(1)	(2)	(3)
New mortality rate	0.0096** (0.0043)	0.0102* (0.0055)	0.0108* (0.0056)
New mortality rate growth	0.0033*** (0.0008)	0.0035*** (0.0010)	0.0033*** (0.0010)
Total mortality rate	-0.0004 (0.0006)	-0.0004 (0.0008)	-0.0004 (0.0008)
Total mortality rate growth	-0.0456 (0.0433)	-0.0510 (0.0482)	-0.0510 (0.0492)
Mobility		0.0004 (0.0006)	0.0003 (0.0006)
SI growth		0.0093 (0.0553)	0.0141 (0.0567)
Country fiscal policy announcement			0.0394* (0.0219)
EU fiscal policy announcement			-0.0065 (0.0647)
ECB policy announcement			0.0323 (0.0696)
Fed policy announcement			0.0414 (0.0747)
Fixed effects?	Y	Y	Y
Observations	156	149	149
R ²	0.0416	0.0423	0.0600
F-statistic	1.2362	0.7883	0.6569

Source: Authors' calculations.

Note: pandemic sample: data in March 2020; COVID residual: the difference between the actual CDS adjustment and the change implied by the model, at both the individual country and aggregate EZ levels over the pandemic period. ***, **, * correspond to 10, 5, and 1% significance, respectively. Heteroskedasticity- and autocorrelation-consistent robust standard errors, clustered by country. Time and country fixed effects.

Next, using a slightly modified specification, we compare the explanatory power of the dynamic factor model predictions and COVID-specific variables. We do this by treating realized log changes in CDS spreads as the outcome variable, while augmenting the panel regression with the model-implied values from Equation (1) on the right-hand side along with COVID-specific variables,

$$\Delta \text{cds}_{it} = \vartheta_i + \lambda_t + \Gamma \Delta \hat{\text{cds}}_{it} + \theta X_{it}^{\text{mortality}} + \gamma X_{it}^{\text{economy}} + \eta X_{it}^{\text{policy}} + e_{it}, \quad 1 \text{ March } 2020 \leq t \leq 31 \text{ March } 2020, \quad (4)$$

where $\Delta \hat{\text{cds}}_{it} = \hat{\alpha}_i + \hat{\phi}_i \Delta \text{cds}_{i,t-1} + \hat{\beta}_{i1} \Delta \text{GCDS}_t + \hat{\beta}_{i2} \Delta \text{RCDS}_{i,t}$ is the model-implied values of daily CDS spread change generated from the dynamic factor model (Equation (1)). ϑ_i and λ_t represent country and time-fixed effects, respectively. Essentially, we take apart the two components that make up the COVID residual. In this way, it becomes obvious that

Table 3. Panel analysis on daily CDS spread change, pandemic sample

	Dependent variable			
	Daily CDS spread change			
	(1)	(2)	(3)	(4)
Fitted daily CDS spread change	0.3689** (0.1797)	-0.4345** (0.1912)	-0.4707** (0.1954)	-0.5135*** (0.1856)
New mortality rate		0.0086** (0.0034)	0.0087* (0.0047)	0.0094* (0.0050)
New mortality rate growth		0.0038*** (0.0008)	0.0038*** (0.0011)	0.0029*** (0.0010)
Total mortality rate		-0.0005 (0.0004)	-0.0005 (0.0006)	-0.0004 (0.0006)
Total mortality rate growth		-0.0169 (0.0407)	-0.0151 (0.0478)	-0.0135 (0.0473)
Mobility			0.00002 (0.0008)	-0.0001 (0.0007)
SI growth			0.0044 (0.0464)	0.0069 (0.0407)
Country fiscal policy announcement				0.0475** (0.0218)
EU fiscal policy announcement				-0.0138 (0.0584)
ECB policy announcement				-0.0261 (0.0678)
Fed policy announcement				-0.0509 (0.0558)
Fixed effects?	Y	Y	Y	Y
Observations	374	156	149	149
R ²	0.0206	0.0812	0.0866	0.1184
F-statistic	7.0406***	1.9975*	1.4351	1.2448

Source: Authors' calculations.

Note: Pandemic sample: data after March 2020; COVID residual: the difference between the actual CDS adjustment and the change implied by the model, at both the individual country and aggregate EZ levels over the pandemic period. *, **, *** correspond to 10, 5, and 1% significance, respectively. Heteroskedasticity- and autocorrelation-consistent robust standard errors, clustered by country. Time and country fixed effects.

the regression in Equation (3) with the COVID residual as an outcome variable is equivalent to the restricted regression shown in Equation (4), when $\Gamma = 1$. Equation (4) relaxes this implicit assumption of Equation (3) while lending to a richer analysis.

Results are reported in Table 3. First, after including COVID-specific variables, the coefficient of model-implied values changes from significantly positive to significantly negative, implying that model-implied values no longer trace realized CDS spread changes during the COVID-19 pandemic. In fact, the changing coefficient on $\Delta \hat{c}_{i,t}$ upon the inclusion of COVID-specific covariates suggests that after conditioning on mortalities, countries expecting wider CDS adjustment realized lower-than-expected spread changes. These results are fully consistent with fragile EZ

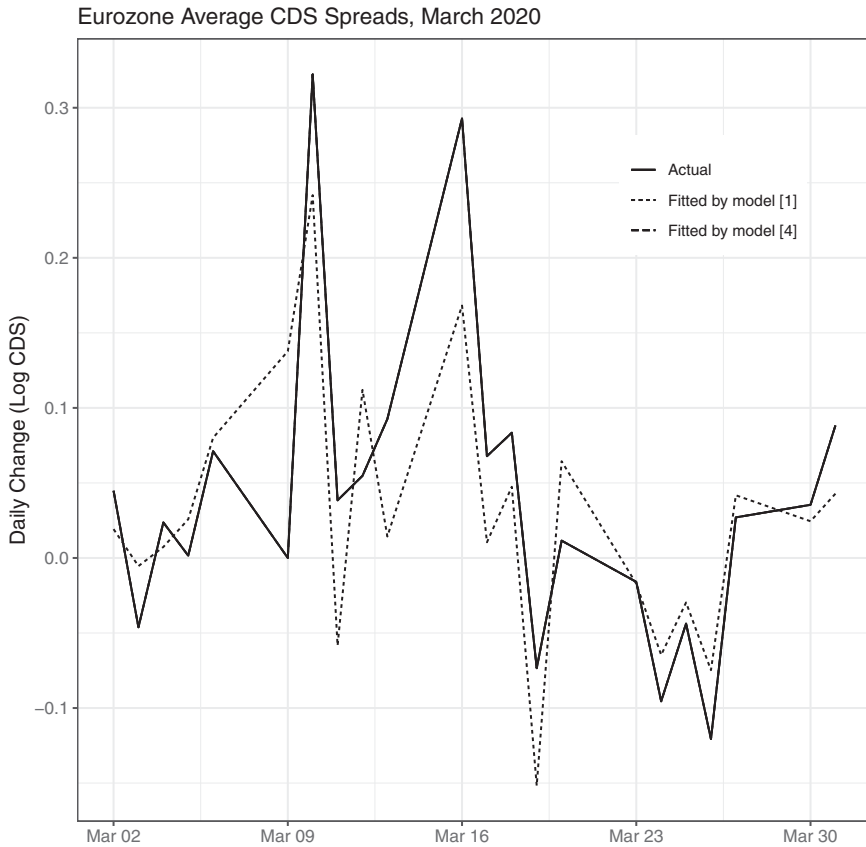


Fig. 11. COVID-related risks and factors accounted for Eurozone average CDS.

Note: Solid lines reflect the realized daily average EZ CDS spreads changes. Dashed lines reflect predicted average EZ CDS spreads changes implied by the specifications [1] and [4] of Table 3, respectively.

Source: Authors' calculations.

countries, like the GIIPS, exhibiting relatively low CDS adjustment given their fiscal space compared to other EZ countries, as we showed in the previous section.

Secondly, new daily mortalities and the growth rate of new mortalities are both positively and significantly correlated with daily CDS spread changes across all specifications. Consistent with time-series evolution of the COVID residuals shown in the previous section (Fig. 8), countries that had higher levels of daily new mortality rates or higher new mortality growth rates were likely to realize more severe daily CDS spread changes. Thirdly, country-specific announcements of fiscal responses to the pandemic appear significantly associated with daily CDS spread changes. Those countries which announced fiscal responses and thus increased their debt burden were more likely to experience greater daily CDS spread changes.

Importantly, our results show that COVID-specific factors explain the greatest share of variation in CDS spread dynamics during the COVID-19 pandemic period. In particular, mortality outcomes, especially daily new mortality dynamics, explain about 6% of the variation, and COVID-specific policy announcements add another 3%. In contrast, the

dynamic factor model predictions only explain around 2% of the variation over this period, which implies an explanatory power of COVID-specific factors almost five times as large as that of the regional and global factors which have done a good job during normal times. The high-frequency cross-country panel regression setting may lead to the overall low explanatory power even after accounting for COVID-specific factors on top of the regional and global factors, but the comparison between the explanatory power before and after including the COVID-specific factors suggest that, within the model specification, COVID-specific factors play a dominant role in explaining the variation in CDS adjustments during the period following the outbreak of the pandemic.

In Fig. 11, we chart the aggregate (average) CDS spread dynamics over all EZ countries during the COVID-19 pandemic by plotting the aggregate realized values, model-implied values from Table 3 column (1), and model-implied values from Table 3 column 4. Surprisingly, the aggregate model-implied values from Equation (4)—which controls for COVID-specific factors, traces the realized values almost perfectly, such that their lines coincide with each other. Hence, we conclude that COVID-specific factors play an important role in explaining the divergence of CDS spread dynamics during the pandemic and should not be ignored in debt pricing in EZ over this period.

A potential limitation of the second-stage analysis, which may contribute to the overall low model R^2 values, is the omission of important variables due to data limitations. For example, credit seniority might play a key role in which assets are eligible to be purchased by the ECB, but we do not control for this.¹⁰ Another important issue is the interpretation of the global and regional factors as reflecting fundamental proxies. If COVID-19 is a global shock, then our interpretation of the global factor may not be precise, as variation in the global factor may embed both fundamental information and that related to the pandemic. This is a special case of the more general problem of identifying global from idiosyncratic or country-specific variations in macroeconomic and finance research, a common dilemma when exploring the extent of financial contagion (Bekaert *et al.*, 2014). As such, our analysis must take a stance based on the assumption that the global and regional factors exclusively capture systematic, non-COVID risks in the 2020 period. However, if COVID risks were priced in the global and regional CDS factors, then our estimates on the impact of mortalities and policy responses in March 2020 (from Equation (4)) are likely to be *underestimating* the true effects on EZ spreads, because the global and regional factors would absorb some of the variation between mortality and policy variables with EZ spreads.

10 The perceived seniority of the ECB and other institutional support versus the private sector may be subject to on-going revisions. In this context, Bulow *et al.* (2020) noted, 'Although theoretically the official sector is a senior creditor to the private sector, much of the historical experience suggests otherwise.' A recent analysis comparing losses (haircuts) taken by official and private creditors raises further doubt about the supposed seniority of official sector loans (Schlegl *et al.*, 2019). These outcomes should not be surprising. After all, governments have a history of protecting domestic creditors who lent abroad, and at the same time also care about stability and welfare in the borrowing country. Such altruism, in turn, weakens the official sector's bargaining position—especially vis-à-vis private creditors. Thus, official creditors may be left holding the bag for the bulk of the losses, even when they start with little of the outstanding debt, as in Greece.

4. Concluding remarks

We conclude the article by placing the ECB's COVID-19 policies in the context of the short history of the EZ and its future challenges. The Euro crisis of 2010–5 exposed the growing asymmetries induced by unsustainable GIIPS borrowing sprees during 2000–8, funded mostly by Germany, France, and other core countries (Gibson *et al.*, 2014). The crisis induced painful internal adjustments and a sharp growth contraction of the GIIPS; at times when Germany and other core countries mostly sustained positive and robust growth (De Grauwe and Ji, 2013). In contrast, the COVID-19 crisis is a global pandemic, adversely affecting EZ countries irrespectively of their borrowing and lending histories. The pandemic induced most EZ countries to follow similar containment policies during the first wave of contagion and mortality, resulting in sharp contractions of demand and production, shared more equally among the EZ countries than the collapses in growth experienced during 2010–5. The GIIPS debt crisis of 2010–2 provided a clear lesson about the risk of delaying policy action at times of peril, triggering self-fulfilling dynamics, and inducing bad equilibria associated with fire sales, defaults, and financial meltdown. The looming threats of accelerated COVID-19 infection and mortality put fighting the medical and economic risks as the top EZ priority. The outcome is ‘COVID-19 dominance’—a rapid mobilization of resources to fund the medical system and local government challenged by emergency expenses, forced to provide emergency credit to the corporate sector to minimize costly bankruptcies and liquidation. COVID-19 dominance suggests the need to keep these unconventional operations at rates dictated by the pandemic dynamics, probably until the arrival of effective vaccination or ‘herd immunity.’

The result was the provision of ample liquidity and credit, the refinancing of existing debts at low-interest rates, and a broadening of the scope of QE policies. The evidence presented in this paper shows that the implementation of the PEPP and other programmes (including the Federal Reserve Swap Arrangements; (Federal Reserve Bank of New York, 2020) substantially reduced the dispersion of EZ sovereign spreads. During the first waves of the pandemic (January–June 2020), these policies prevented self-fulfilling runs on sovereign and corporate debt, thereby freeing and funding resources needed to fight the medical and economic consequences of the pandemic. These policies thereby increased the fiscal space of the GIIPS and other indebted countries, supporting expansionary fiscal policy needed to fund the medical and economic struggles associated with COVID-19.

Supplementary material

The data and replication files used in this article are available from https://github.com/snairdesai/COVID_Dominance.

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