

Discussion of

Asset Purchases in a Monetary Union with Default and Liquidity Risks

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The views expressed here are solely my own.

Research question and motivation

Can targeted central bank asset purchases attenuate the macroeconomic effects of country-specific default and liquidity risks?

- Motivation
 - ▶ European sovereign debt crisis
 - ▶ ECB asset purchase programmes to support market functioning and monetary transmission (OMT, PEPP flexibility, TPI)
- What the paper does
 - ▶ Builds a monetary-union model with sovereign default and liquidity risks
 - ▶ Calibrate model to Italy in 2012
 - ▶ Counterfactual analysis of targeted asset purchases (and their anticipation)

The model in a nutshell

- Two-country (Home and Foreign), sticky-price model of a monetary union
- National fiscal policies are passive, central bank follows active interest-rate rule
- Default risk: Home fiscal authority may default on its bonds; stochastic fiscal limit ("multiple equilibria")
- Segmented financial markets: Intermediaries channel funds from households to goods producers and fiscal authorities; enforcement problem constrains interm.' funding
- Liquidity risk: Severity of enforcement problem is time-varying (η_t^y), and increases with probability of Home default ("liquidity risk channel")
- Crisis scenario: unexpected increase in gov. debt level + downward shift in the fiscal limit

Main findings

- Default and liquidity risks dampen financial and economic conditions (in Home).
- When these risks emerge, (anticipation of) targeted asset purchases improve economic outcomes.
 - ▶ *[I]f the ECB had the OMT in place prior to the 2012 debt crisis, the same shift in Italian fiscal conditions could have led to an increase in the government bond spread that was about a third of what occurred, and the transmission to investment from this channel would have been nearly halved.*

Comments

- ① Monetary union
- ② Fiscal policy
- ③ Central bank balance sheet and bond purchases

I. Monetary union

- To what extent does it matter that Home is part of a monetary union?
 - ▶ More prone to self-fulfilling beliefs (e.g. shifts in fiscal limit)?
 - ▶ Policy rate responds less to macroeconomic conditions in Home
- Further explore potential spillovers to Foreign
 - ▶ Financial linkages: Financial intermediaries hold Home and Foreign government bonds
 - ▶ Yet, spillovers are rather benign: Foreign investment and output increase when Home faces debt and liquidity crisis [▶ Chart](#)
 - ▶ Less benign spillovers if sovereign default risk in Foreign non-zero?

II. Fiscal policy

- Fiscal policy in case of central bank asset purchase programme
 - ▶ ECB's targeted asset purchase programmes are subject to conditionality
 - ▶ OMT tied to macroeconomic adjustment programme
 - ▶ How would fiscal consolidation/reform affect results in the asset purchase scenario?
- Fiscal rule and exogenous debt increase vs fiscal limit shift
 - ▶ Paper finds that *shifts in the fiscal limit, rather than outright increases in debt, have more quantitative significance [...]*
 - ▶ Fiscal rule responds only to debt ratio
 - ▶ If rule also accounted for economy's proximity to the fiscal limit, would negative economic effects of fiscal limit shock be mitigated?

III. Central bank balance sheet and bond purchases

- Exit strategy
 - ▶ *Without a clear exit strategy, it would be difficult to distinguish purchases conducted for market stabilisation purposes from quantitative easing.* (Schnabel, 2024)
- What happens to central bank balance sheet when Home defaults? Are losses shared among member countries? Do these arrangements matter for your results?

Thank you!

Figure 4: Response to a Default Risk Crisis, Home vs. Foreign Country

