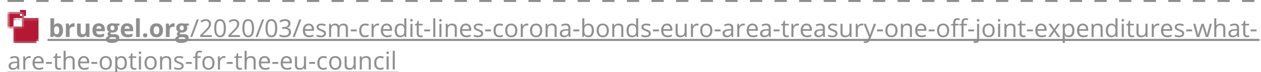
COVID-19 Fiscal response: What are the options for the EU Council?



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It is time for the EU Council to make quick progress on the fiscal front and announce something as soon as possible to show that it taken full measure of the severity of the situation.

As the COVID-19 pandemic intensifies, and now that Europe has become one of its epicentres, voices are raised among EU countries in support of a common and significant European response to deal with the health situation and the related economic crisis currently unfolding.

Many options are currently discussed in policy and academic circles: ESM credit lines, 'corona-bonds', a euro-area Treasury, and even one-off joint expenditures. But, at this stage, those various options are relatively fuzzy, and they sometimes mean different things to different people. This blog post aims to distinguish and explore the pros and cons of each of these possible options at the current juncture.

Option 1: Hoping that the status quo will be sufficient

Euro-area countries finance their necessary expenditures to fight the health crisis and the resulting economic crisis, through a significant increase in national borrowing (now unconstrained by the EU fiscal rules). This is supported by massive ECB QE to ensure that all euro area countries have an easy and cheap access to market funding.

With its announcement of the Pandemic Emergency Purchase Programme (PEPP) on March 18, the ECB has already put in practice this first option. As a result, spreads have substantially decreased on the next day and stabilised at a lower level since then.

Given the significant size and flexibility of the programme, it is possible that it will be sufficient to convince financial markets that the ECB is ready to honour its 2012 promise to do whatever it takes, and ensure that countries can finance themselves cheaply.

The **main potential issue** of this option is that, if markets were to try to test the limits of the ECB's readiness to do whatever it takes, the ECB's Governing Council might be reluctant to make the asset purchases of national sovereign bonds through its QE programme fully unlimited (as the Fed did on 23 March). In fact, the political pressure on the ECB that its current PEPP programme might go too far is already there.

Option 2: Using currently available ESM credit lines combined with OMT

The solution in that case could be for euro-area countries to apply to ESM precautionary credit lines. Given the need for a unanimous approval by the ESM board of governors (ie, the Eurogroup), that would provide the ECB with a political validation to implement unlimited and targeted OMT. An ECB OMT programme should be sufficient to ensure that countries can finance themselves easily and cheaply.

But countries facing higher funding costs than the ESM could also draw on their ESM credit lines in order to benefit from lower rates. At the end of February, the ESM issued a 10-year bond with a 0.01% coupon rate and could pass this low funding cost to all countries with a relatively small fee. In addition, the maturity of ESM loans could probably be longer than what the market could offer. As a result, the combination of those two elements would slightly improve the sustainability of the debt and reduce the roll-over risk.

This is the option currently pursued by the Eurogroup which on 24 March proposed to the EU Council to offer Pandemic Crisis Support (PCS) credit lines from the ESM to individual countries. The current Enhanced Conditions Credit Line (ECCL) would serve as a basis for these credit lines.

Nevertheless, we see **three significant drawbacks** related to this option.

The first problem would be the relatively small firepower of the ESM (€410 billion currently, and the Eurogroup proposal mentions an even smaller 2% of GDP, around €240 billion, dedicated to the PCS for the moment). This would drastically limit its capacity to reduce the debt service of euro-area countries on a significant scale.

The second issue is that resorting to the ESM might not even reduce the funding costs of many countries. At current yields, and taking into account the minimum fees charged by the ESM, an ESM loan could be financially beneficial only for Greece (given its yield stands at 2.4% at the time of writing), Cyprus (1.6%), Italy (1.5%) and, maybe, Portugal (0.9%) and Spain (0.7%).

The third, and probably the most important problem, is that the mere mention of the ESM, of an MoU or of conditionality (which are both requested in an ECCL and thus probably in a PCS credit line) are politically toxic in most of these countries.

Option 3: A common debt-management office for the euro area

A third option would be to put in place a euro-area debt-management office for all borrowing related to the crisis. This could be done through a new agency, but given that the ESM has the advantage of being up and running, it could also be repurposed to this use. It would represent a mutualisation of the borrowing costs.

For that, the three issues described above would need to be solved. First, to avoid any potential stigma, countries should all be the recipients to this ESM credit line, and there should not be any conditionality (as argued before). Second, the size of the ESM would need to be increased significantly so that it can issue bonds on a large scale, say €1

trillion. For the ESM to be able to do this, its callable capital would need to be increased significantly and some changes to its legal base would probably be required. The money raised would then be distributed to its member states based on the ESM capital keys, and the ESM would charge its member states an identical rate, ie its funding cost plus a small fee (preferably smaller than the current ones applied so that it becomes financially advantageous to most countries).

This 'beefed-up ESM' solution would have **two main advantages**.

First, since this would be joint-and-several borrowing (within the debatable limits of Article 8 of the ESM treaty), funding costs could be lower, and if the ECB was a massive buyer of these bonds, rates would probably be even lower.

Second, and more importantly, such a European debt instrument would be politically easier for the ECB to buy than national debt, as possible fiscal risks related to the holding of national debt would be borne by the ESM. In fact, the issuer limit for supranational institutions like the ESM is already larger, ie, 50% compared to 33% for euro-area governments, which suggests that the ECB is more comfortable buying these supranational bonds. Increasing massively the volume of ESM bonds available for purchase would thus also allow the ECB to significantly enlarge its PEPP programme without the usual political controversy surrounding asset purchases of sovereign bonds.

If necessary, this could also make it easier for the ECB to decide at a later stage to keep the debt securities purchased during the crisis on its balance sheet permanently (either because these bonds would be perpetual or because they would be rolled over indefinitely)[1]. This could indeed be the cleanest way to monetise part of the euro-area debt through a European institution with enough democratic legitimacy to ensure that there is a strong political agreement about this plan among European countries.

What would be the **main shortcoming** of that option?

The issuance of joint and several bonds by the ESM to allow countries to finance themselves at a lower and similar rate would provide a first form of mutualisation. However, ensuring low funding costs to countries is necessary but might not be sufficient to deal with the legacy issue that it would entail, ie multiple significant countries of the euro area might come out of this crisis with debt-to-GDP ratios above 150%. In other words, tax payers of the individual countries would still be liable to the burden for their part of the joint borrowing. There would be no cross-border insurance/transfers.

It could be argued (as Blanchard or Krugman did) that in the current low rate environment these levels of debt can be considered sustainable (as the Japanese experience also suggests). However, given the inherent fragility of sovereign debt in the euro area due to the prohibition of monetary financing (and even if massive ESM loans would reduce roll-over risk and ensure lower rates), our main fear is that, even if euro-area authorities do whatever it takes during the crisis, they might end up applying

austerity after the crisis in order to reduce their debt burden. The results would be either a double-dip recession like the one that the euro area suffered in 2011-2012, or a deep and long slump.

Option 4: One-off joint debt issuance to finance common expenditures related to the corona crisis

An alternative solution to avoid this issue is to mutualise fully the costs of the crisis. In practice, this means that the additional debt issued to fight the health and related economic crisis does not remain on national books and that the burden is shared with the whole community. Put differently, while pay-outs would depend on where the shock is strongest, the fiscal burden of the new debt would fall on all euro area tax payers depending on their capacity to pay taxes.

Such insurance makes sense economically if "moral hazard considerations are not warranted here" as Eurogroup President Centeno declared after the Eurogroup. Politically, it would show that the EU is capable of unity and solidarity in these dreadful times.

This approach could be pursued through an amended ESM. But other avenues are possible. Using Article 122.2 of the TFEU, the creation of a new dedicated instrument could be envisaged to "*grant […] financial assistance [to a] Member State […] seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control*". This instrument, which could take the form of a fund, would issue one-off corona-bonds to finance expenditures related to the crisis (which could also be purchased by the ECB, as highlighted by ECB President Lagarde in the Eurogroup) that would in the end be repaid by all European taxpayers.

The exact scope of such an insurance scheme should be well defined. It could be relatively small and circumscribed to the health expenses directly related to pandemic, but its scope could also be broader and for instance cover the cost of a Danish-style temporary lay-off benefit system (or a German-style 'Kurzarbeit') in order to avoid actual lay-offs and protect the solvency of viable companies during the lockdown. Contrarily to the previous option, the geographic distributions of expenditures would be based on the needs of each country to fight the crisis.

The **main challenge**, of course, is that an agreement would need to be found on what its exact scope would be, how much money to devote to this initiative, how to fund it and under what rules decisions would be taken. As an insurance against an exogenous shock, contributions to repay the debt later could be based on the population and GDP of the countries (as in the ECB or the ESM's capital keys). This would involve *ex post* transfers between taxpayers of different countries, but in an insurance mechanism this would be a feature not a bug. If such an ambitious option was chosen by policymakers, it would thus be preferable to put it in place as soon as possible under a relative veil of ignorance rather than wait for later when it is revealed who will need this insurance the most. It

would also be crucial that there are clear decision-making rules that ensure democratic accountability. De facto in the current treaty framework, unanimity might be needed on all major decisions which could also limit the effectiveness of the instrument.

If policymakers really want to avoid creating a new instrument, the ESM could play that role and issue the joint debt. However, contrarily to the previous option, the money raised would be distributed to member states based on the severity of the shock while the fee charged to member states would be related to the ESM capital key. Transforming the ESM in such an insurance in which costs would be shared but benefits would accrue to countries particularly strongly hit by the crisis would nevertheless represent a radical change of the ESM and of its original function and would require a complete overhaul of its legal base (even if the instrument is temporary).

Conclusions

Overall, the experience of the euro crisis showed the need for European policymakers to be pro-active and not reactive. After a mishap, the ECB has delivered on 18 March to ensure that euro-area countries can finance themselves easily and cheaply in the market during the crisis.

Now, it is time for the EU Council to make quick progress on the fiscal front and announce something as soon as possible to show that it has taken full measure of the severity of the situation. Letting every country respond only on its own with only ECB backing could prove an insufficient response, and late fiscal action would likely be more expensive than getting ahead of the markets. Announcing some form of mutualisation would send a strong signal of unity to the world in these difficult times – but it is also fundamental that it is done with strong democratic legitimacy and broad public support. This blog post has aimed to explain the options. It is up to elected officials to see what is democratically feasible and desirable.

[1] This permanent, and possibly significant, increase of the money supply could in the end generate some inflation, but it may not even be the case as the Japanese experience of the last two decades suggests. But, anyway, if it were the case, this consequence might even be welcome if it helps the ECB bring back inflation towards the ECB's target, especially if the crisis ends up being deflationary.