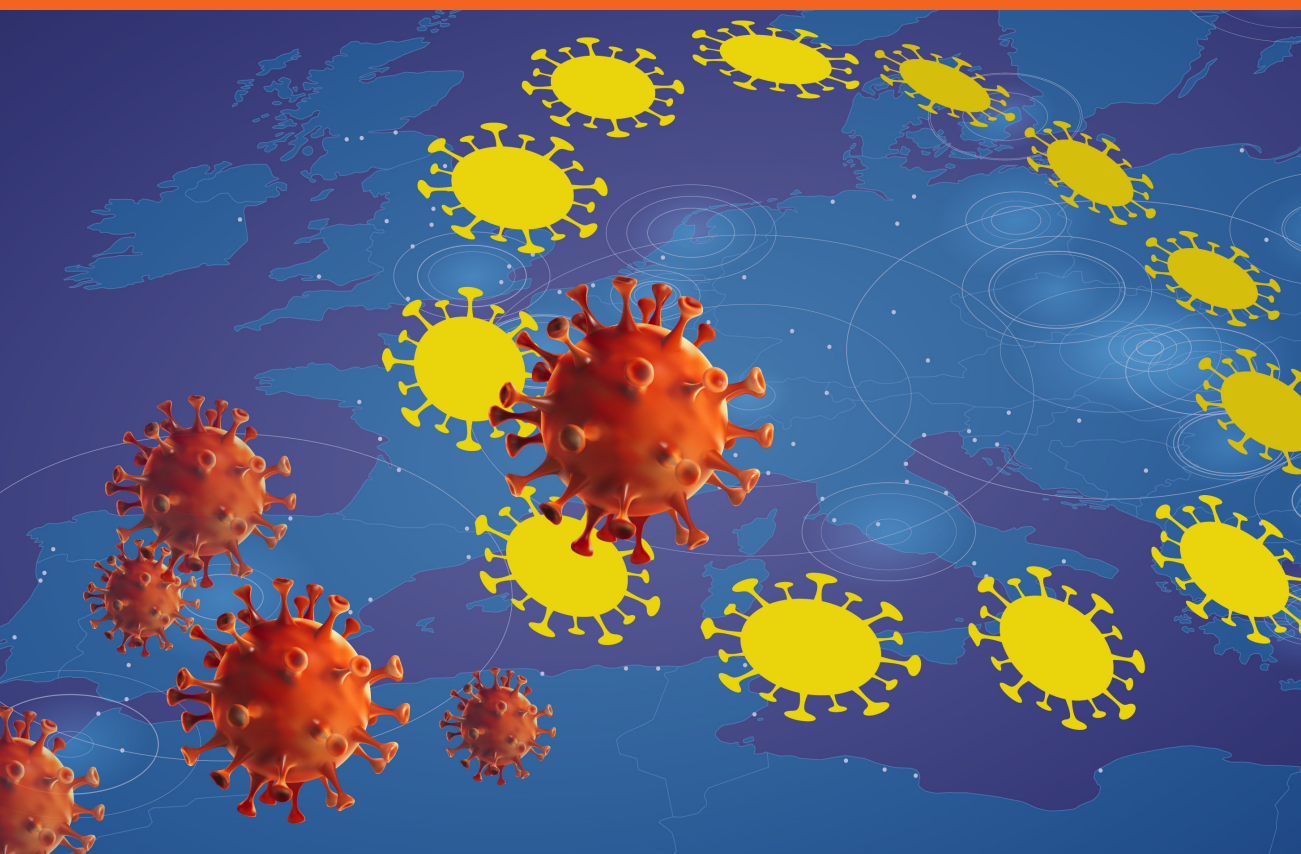


# Europe in the Time of Covid-19

Edited by Agnès Bénassy-Quéré  
and Beatrice Weder di Mauro



**A VoxEU.org Book**

CEPR Press

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**CEPR Press**

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# Preface

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## **Agnès Bénassy-Quéré and Beatrice Weder di Mauro**

Paris School of Economics; Graduate Institute Geneva and CEPR

There is no doubt that the Covid crisis represents a challenge for European unity and another crash test for the euro. A small positive observation in this crisis has been the degree of engagement of economists in an intense debate with policymakers on the appropriate responses to ‘flatten the economic recession curve’ and to safeguard the most impacted groups from the economic fallout of the health crisis.

A new VoxEU eBook offers an illustration of the intense effort of the academic community. It collects a selection of columns, analysis and policy proposals that were published on VoxEU between the end of March and the middle of May 2020. Within each section, the columns are sorted by their date of appearance, which gives the reader a sense of how the debate progressed over a short period of time.

The contributions are organised into two parts.

Part I collects columns that discuss how Europe can help protect lives, firms, workers, the Single Market, banks, national budgets and sovereign debt. Although most of these proposals involve building new institutions and mechanisms, it is remarkable that a high degree of convergence and consensus emerged in this area.

Part II collects contributions that have been, and continue to be, much more controversial. They relate to the form of funding, including Coronabonds, credit lines from the European Stability Mechanism (ESM), EU borrowing backed by contributions to the EU budget, and the role of monetary policy. Some of these debates relate back to the financial crisis and the pre-Covid fault-lines opening up again. However, in the light of this deep crisis, there are also many that call for the breaking of old taboos and to ensure that Europe and the euro area have the firepower to respond adequately to this novel and external threat. With this deep economic crisis unfolding, the fault lines of the euro area are once again laid bare. The optimistic view is that we should not lose the opportunity to complete the economic architecture and make the euro area resilient. After all, it took several decades for the United States to succeed in monetary unification.

In the first chapter of the eBook, we present our view on the ‘State of the Union’, giving an overview of the debate, an analysis of announced policy measures and a discussion of the necessary further steps. Our main conclusion: at this time, there is reason to be hopeful that the immense challenge that this crisis presents for Europe could really become an opportunity to strengthen the Union.

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# 1 Europe in the time of Covid-19: A new crash test and a new opportunity

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**Agnès Bénassy-Quéré and Beatrice Weder di Mauro**

Paris School of Economics; Graduate Institute Geneva and CEPR

19 May 2020

*After a period of hesitation, governments in Europe have reacted forcefully to the Covid-19 pandemic with various strategies combining social distancing, testing/quarantining, and lockdowns. During a pandemic, however, coordination is key, and in responding to the current crisis European coordination has proved as painful as ever. This chapter summarises the three axes of European-level support – monetary policy and banking, state aid and fiscal rules, and funding – and identifies the main difficulties that will appear down the road. It concludes that the EU Recovery plan that is taking shape looks promising and could represent a significant signal of European solidarity and unity.*

## **A new crash test for European unity and the euro**

Europe has been and will likely remain one of the most Covid-infected regions in the world, with a death toll exceeding 150,000. After a period of hesitation, national governments have reacted forcefully to the pandemic through various strategies combining social distancing, testing/quarantining, and lockdowns. Although doing nothing was not an option and would itself have disrupted economic activity, several weeks of strict lockdowns have triggered an economic crisis at least twice the size of the 2009 crisis. Furthermore, the recovery is likely to be slow due to depressed consumption and investment, and it will require fast reallocations in both the labour market and the capital market.

At the time of writing (mid-May) there is still a huge amount of uncertainty, both on the medical front and on the economic front. On the medical front, compared to what we do know, what we don't know still seems overwhelming. As economists, the best we can do is to envisage different scenarios, draw their economic implications and prepare for the worst:

- An optimistic scenario: there are only minor new outbreaks, which can be contained through tracking, tracing and isolating. In this case, life might go back to 'almost normal' very quickly. But even in this optimistic scenario, after governments have relaxed containment measures, a large number of people will still choose to remain cautious, avoiding crowds, public transport, and even offices if they have alternatives. Consumption remains subdued but markets and institutions are resilient. The debt overhang is manageable both in the corporate sector and in the official sector.
- An intermediate scenario: there are further waves and regional outbreaks that escape tracking and tracing and thus require new containment measures. This will be more difficult than the first time they were imposed for several reasons: tolerance for the containment measures will be lower, the economic cost will be more visible and the capacity of government to compensate the loss of income will be lower. Not only is activity more deeply affected, but financial, social and political institutions are under stress, with possible accidents. There is ample room for multiple equilibria, especially if progress is slow in the area of treatments and vaccines. The ECB is active in eliminating the 'bad' equilibrium, but it is increasingly challenged on legal grounds.
- A downside scenario: ongoing outbreaks, failure to coordinate medical measures across countries, continued restrictions of movement of people across borders, increasing divergence of countries' political reactions and economic measures, putting additional pressure on the Single Market and ultimately on the Union. In this last scenario, GDP is expected to remain lower for a prolonged period. Unless national and European institutions are able to adapt quickly, the probability of a major financial, social and political crisis is very high.

The last scenario could be lethal for the euro area and potentially also for the European Union; hence the importance of an appropriate European response in order to both reduce the probability of this catastrophic scenario and to help the market select the 'good' equilibrium in the intermediate scenario.

It should be kept in mind that although the euro area reacted quickly and adequately to the 2008 financial crisis and to the 2009 economic crisis, the treatment of the subsequent sovereign debt and banking crisis was more bumpy. The policy mix revealed itself inadequate in 2012-13 when a new, 'home-made' economic crisis hit the euro area,

and in 2015 Greece came close to being kicked out of the euro area. The euro area is still young and unfinished. At the national level, extensive social safety nets make it easier to shield an optimistic or ‘good’ intermediate scenario. But at the euro area level, the lack of fiscal backing of the euro creates a vulnerability that urgently needs to be addressed.

The failure for Europe to manage a bold, common response would further increase divergence and strengthen anti-European forces and populism. The debate over the financing of the euro safety net (e.g. ESM versus Coronabonds) has already been very bruising and has created the impression of lack of care and European solidarity. The German Constitutional Court’s ruling on the ECB’s past policy may also contribute to further polarisation. This is not the time to play with matches.

The shock being both exogenous and dramatic, one could have expected European politicians to temporarily forget their disagreements. Before the crisis, they were discussing whether the next Multiannual Financial Framework (MFF) – the seven-year budget of the European Union – would be set at 1.02%, 1.07% or 1.11% of gross national income. Just a few months later, we are talking about thousands of lives lost, millions of unemployed, and governments deficits in the order of 10% of GDP or more. To restate the obvious, during a pandemic coordination is key, as the virus disregards national borders and is powerful enough to disrupt cross-border supply chains. However, even under such obvious circumstances, European coordination has proved as painful as ever. Accordingly, pre-Covid weaknesses in the governance of the euro area have quickly come back to the fore.

After briefly recalling where the debate on euro area economic governance was before the Covid crisis, we assess the decisions made so far at the euro area level. Finally, we touch on the fundamental weakness of the euro architecture – namely, that it is a currency backed not by one but by 19, or even 27, sovereigns – and delineate a few priorities for the future.

## **The pre-Covid debate**

The fault lines of the Maastricht architecture are now widely recognised (e.g. Bénassy-Quéré and Giavazzi 2017). During and after the sovereign debt crises of the 2010s, several major reforms were carried out: the introduction of an emergency assistance scheme (the European Monetary Mechanism, or ESM), an extension of the ECB’s toolkit with Outright Monetary Transactions (OMT), negative interest rates and quantitative easing, reinforcement of fiscal and macroeconomic surveillance, and banking union.

Although these reforms were far-reaching, unfortunately the work was unfinished. As argued notably in the ‘7+7 report’ (Bénassy-Quéré et al. 2018), financial markets were still fragmented within the euro area, the ‘doom loop’ (i.e. the close relationship between banking risk and sovereign risk) was alive and well, macroeconomic convergence was a work in progress, inflation was too low despite monetary policy not having yet been normalised, fiscal policy had little room for manoeuvre in various countries and was inexistent at the federal level, and so on. In brief, despite its stronger banking system, the euro area was not ready for the next crisis.

Even more worrisome, the fundamental flaw of the euro area architecture was not addressed before the Covid crisis. Given that both monetary financing of government deficits and fiscal bailouts are prohibited by the Treaty, a country with plunging nominal GDP and rocketing government debt will likely need some form of debt relief. But debt restructuring is extremely difficult given the concentration of government debts in the balance sheets of the resident banks. Some banks may see their capital wiped out. They may also fall short of liquidity, since government bonds are routinely used to get liquidity on the repo market and from the central bank.

Before the Covid crisis, the euro area debate was evolving along three main lines:

- How to stabilise the financial sector through a smooth transition towards more diversified balance sheets, together with the introduction of deposit re-insurance and a ‘safe asset’ (Schnabel and Véron 2018).
- How to restore the fire power of macroeconomic policies, notably through a reshuffling of fiscal rules and the introduction of a European ‘fiscal capacity’ (Bénassy-Quéré et al. 2018, European Fiscal Board 2018, 2019).
- How to avoid a deflationary bias related to the asymmetric adjustment burden between surplus and deficit countries (Bénassy-Quéré 2017).

As the Covid crisis unfolds, the consequences of this unfinished work will progressively appear.

## **Overview of the main European measures**

Since the outbreak of the pandemic, national governments have been at the frontline. However, they have been backed by European action on mainly three economic axes: (1) monetary and banking, (2) state aid and fiscal rules, and more recently, (3) funding. We present a brief overview of these three axes as of mid-May 2020 and underline the main difficulties that will appear down the road.

## Monetary policy and banking

Since the beginning of the Covid-related economic crash, the ECB has reacted swiftly both in terms of monetary policy and as a bank supervisor, while banking regulations were also relaxed (see Box 1).

### **Box 1** The main actions of monetary policy

#### **Refinancing operations**

- Targeted: TLTRO III: funding cost = deposit facility rate - 25 basis points.
- Non-targeted: PELRO (Pandemic Emergency Longer-term Refinancing Operations), seven operations starting in May 2020, fixed rates (25 bp below main refinancing operation rate), maturities up to the summer of 2021.

#### **Collateral policy**

- Expansion of accepted collateral (guaranteed loans to SMEs and self-employed) + freeze of eligibility as of 7 April 2020 even in case of subsequent downgrade (provided >BB); waiver for Greek bonds
- Reduced haircuts (e.g. from 35% to 22% for credit claims)

#### **Asset purchases**

- Renewed asset purchases programme (including public sector asset purchases): €20 billion per month + reinvestment of maturing bonds
- Additional €120 billion up to December 2020
- PEPP: € 750 billion; flexibility with respect to capital key and share in issuance

This timely action by the ECB contrasts sharply with the slow and painful progress in fiscal action at the EU level (see below). The decision-making process of the ECB – an independent institution with a clear mandate – is of course faster than the complex interaction between European and national institutions, especially since unanimity is required for a number of decisions. However, the rapidity of the ECB in taking bold action is also related to the fact that it was better prepared with the wide toolbox developed over the last decade. Part of the action essentially consisted in amplifying and reiterating the use of tools such as the targeted long-term refinancing operation, a relaxation of collateral rules and, last but not least, its asset purchases programmes. There have been, however, two major innovations overcoming two previous taboos. The first was the readiness of the ECB to lose money on its targeted refinancing operations by lending at a rate below the deposit rate (Claeys 2020). The second innovation was the announced flexibility of the newly introduced Pandemic Emergency Purchases



Programme (PEPP) with respect to both the ECB capital key and the self-imposed limits to issue share limits.<sup>1</sup> Potentially, the ECB could be exposed to a portfolio allocation that would not correspond to the share of each government in the capital (hence on the seigniorage) of the ECB. Furthermore, its share in a given debt issue could be such as to give it a decision power in the event of debt restructuring.

The swift action on the monetary front was complemented with measures to incentivise banks to lend. Not only would the latter benefit from a negative refinancing cost, but they would also benefit from a more friendly provisioning framework for non-performing loans, and various capital buffers would also be relaxed to make room for these additional loans (see Box 2). Adding the generous guarantees extended by national governments and by the European Investment Bank (see *infra*), all policy tools converged to prioritise liquidity provision to the corporate sector.

**Box 2** Measures for the banking sector

**Accounting**

- Flexibility in the application of the new accounting standards (IFRS9) concerning expected credit losses (provisioning) when increased probability of default is expected to be temporary; discarding moratoria on loan repayments if they do not change the economic value of the loan; use of transitional arrangements in the calculation of CET1.
- Subtract moratoria in the calculation of non-performing loans (90 days past due) while still assessing credit quality

**Prudential regulations**

- Relaxation of capital requirements: capital conservation buffer, counter-cyclical capital buffer; possible use of Tier-2 capital to meet Tier-1 requirements.
- Relaxation of liquidity requirements (liquidity coverage ratio)
- Postponement of the implementation of the leverage ratio by one year
- Relaxation of concentration limits for bond holdings
- Relaxation of supervisory burden

<sup>1</sup> The issue share limits of the public sector asset purchase programme (PSPP), hence before flexibility was introduced, are detailed in the ECB's decision No. 2020/188, Article 5, 3 February 2020. For a given national signature in the euro area, the limit is set at 33%. See [www.ecb.europa.eu/ecb/legal/pdf/cclex\\_32020d0188\\_en\\_txt.pdf](http://www.ecb.europa.eu/ecb/legal/pdf/cclex_32020d0188_en_txt.pdf)

## Monetary or fiscal policies?

The swift reactions of the ECB and the banking regulators have enabled national governments to deploy their own bold responses. Their immediate priority was to subsidise short-term unemployment and firms' fixed costs in order to keep them alive, with the hope that after the lockdowns, activity could resume almost as before. With a looming financial crisis and no upward pressure on inflation, it was key to secure low borrowing costs for these hugely increased financial needs. However, these were mostly national fiscal responses, and they varied across member states in a way that did not match the severity of the crisis in the different countries.

Since the post-GFC sovereign debt crisis, the ECB has been urging governments to better coordinate their fiscal policies and come up with a common fiscal tool. However, there has been a tendency of governments to procrastinate for legal and political reasons, and the existential risk for the euro area being insured by the ECB's "whatever it takes" stance.

In a sense, the ECB has been a victim of its reactivity: the lack of bold fiscal response at the euro area level has forced it to conduct even more unconventional policies. In a period of excess supply of goods and services, fiscal and monetary policies are part substitutes, both aiming at raising the level of aggregate demand (as a way to increase inflation for the former, and to reduce unemployment for the latter). This situation looks like being the opposite to the traditional fiscal dominance argument, which states that, ultimately, money supply is determined by fiscal deficits (hence they are strategic complements). Here, there was no federal deficit and – for the period between 2011 and 2019 – national government deficits were also reduced. The rise in central bank holdings of government debts was not a result of fiscal profligacy but rather the result of fiscal austerity.

With the Covid crisis, the situation has shifted brutally, with rocketing national deficits but still no euro area federal budget. The lack of the latter makes it impossible to build a coordinated response of fiscal and monetary policies, like in the United States. From the ECB's viewpoint, large purchases are necessary in order to reach the 2% inflation objective. Conditional on inflation being anchored below 2%, the ECB's mandate is also to support the economy.<sup>2</sup> However, the fact that these purchases consist mainly of national debts rather than EU-level ones raises specific difficulties, especially if they do not follow the ECB's capital key. This is because, like any monetary policy, the ECB's

2 It may be useful to recall the formulation in Art. 127 of the Treaty: "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union."

policy has side effects, notably on financial stability. In theory, financial stability is taken care of by micro- and macroprudential policies. In practice, though, the ECB relies on commercial banks for monetary transmission, so it cannot ignore the impact of monetary policy on financial stability. The tiering system applied to the reserves of the banks since 2019, where the marginal deposit facility rate only applies to part of excess reserves, can be understood in this way. However, the side effects of monetary policy may become more difficult to handle when they are the result of sovereign bond purchases that are twisted in favour of specific member states. Even if the purchases follow the ECB's capital key, this is not equivalent to fully-fledged coordination between fiscal and monetary policy, since the head of the executive – the president of the Eurogroup – has little decision-making power on the aggregate fiscal stance.

This problem is made more acute when considering the structure of risk sharing. Although only part of sovereign bond holdings are kept on the ECB's balance sheet (80% of the risk being held by the national central banks), there are two sources of loss mutualization: (1) in the event of an increase in interest rate or of a debt restructuring, and (2) in the event a country leaves the euro (and is unable to repay its Target liabilities). Although a central bank can continue to operate with negative equity, in such an event the ECB would stop paying seigniorage to the governments. It is the task of governments rather than that of the central bank to proceed to one-off transfers to a region that is hit by a specific shock. Should they fail to do so, though, accepting risk makes it less unlikely that risk which is several orders of magnitude larger will materialise. Hence, the first best is clearly a fiscal response at the level of the euro area; but the second best is also clearly the PEPP programme rather than the euro area going bust.

As already stated, the response to the crisis so far has been much quicker and bolder from the ECB than from the Eurogroup and the Council. As of mid-May, though, things were starting to change. Paradoxically, the move towards EU borrowing could be accelerated by the ruling of the German Constitutional Court on 5 May 2020, which has accused the ECB of overreaching its mandate and of neglecting the 'proportionality' requirement with the PSPP programme (the PEPP programme has not yet been scrutinised by the German court).

#### Towards a European fiscal response

On the fiscal front, the European response started by easing the way for national policies rather than designing an EU-level response. Indeed, the Commission was fast to enact two important decisions:

- A temporary framework for state aid rules was introduced on 19 March 2020,<sup>3</sup> and amended on 3 April 2020 and 8 May 2020,<sup>4</sup> in order to help member states to support the business sector during the lockdowns and in their aftermath.
- The general escape clause, which was introduced in the Stability and Growth Pact (SGP) in 2011 as part of the ‘six pack’ reform, was activated by the Eurogroup on 24 March 24 2020.<sup>5</sup>

These two measures have created leeway for immediate support at the level of member states. At the level of the EU and of the euro area, though, progress has been much slower. The debate has developed along five main dimensions:

1. **Conditionality** is in the DNA of (young) European emergency assistance. There is a legal reason for this: due to the no bail-out rule, the Member states in principle cannot lend to a country whose debt sustainability is doubtful. The role of conditionality is to ensure that the loans will be repaid, hence that the emergency assistance is distinct from a bailout. However, the reluctance to lend without conditionality is also related to a perceived governance mismatch: whether the funds are granted by the EU (through its budget) or by an intergovernmental arrangement (through the ESM or an ad hoc special purpose vehicle), the creditors want to have a say on the spending. This concern may seem legitimate in view of the political pressures governments face internally. But it is also informed by moral hazard concerns and by the history of a protracted and polarised debate in the wake of the last crisis. In other words, the internal political discourse in a number of countries is still replaying the last financial crisis rather than confronting the present one.

Nevertheless, at the time of writing it seems that it has finally been decided to concentrate the conditionality on the type of spending: ESM and SURE credit lines should be used to finance Covid-related expenditures, whereas no further conditionality will be requested on top of the ‘regular’ European semester (see Box 3).

3 “Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak”, Communication COM(2020)1863, 19 March 2020.

4 “Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak”, Communication COM(2020) 3156, 8 May 2020.

5 See <https://www.consilium.europa.eu/fr/press/press-releases/2020/03/24/remarks-by-mario-centeno-following-the-eurogroup-meeting-of-24-march-2020/>

**Box 3** Fiscal measures at the European level

**Fiscal and state aid rules**

- Suspension of the Stability and Growth Pact rules by recognising that the conditions for the general escape clause in the EU fiscal framework, namely a severe economic downturn in the euro area or the Union as a whole, were fulfilled (23 March, Eurogroup)
- Relaxation of state aid rules. A temporary framework allows for direct grants or tax advantages, subsidised state guarantees on bank loans, loans at subsidised interest rates, state-sponsored export credit insurance, subordinated debt and equity injections. These various instruments are capped and firms need to be viable as of end-2019.

**Protecting firms: Pan-European guarantee (EIB)**

- €25 billion of national guarantees; increasing by €200 billion the EIB's capacity to extend credit guarantees to commercial banks, national promotional institutions and national guarantee schemes; counter-guarantees; purchases of asset-backed securities from banks and some venture debt.

**Protecting jobs (SURE)**

- Loans to national governments in order to finance surges in expenditures related to short time work (*kurtsarbeit*) and support to independent workers
- Commission borrows up to €100 billion backed by EU budget headwinds + €25 billion of national guarantees, maximum repayments of €10 billion per year, to be discontinued after Covid crisis, Art. 122(2) of the Treaty (Eurogroup, 15 May 2020).

**Protecting sovereigns: Pandemic crisis support (ESM, euro area countries only)**

- Loans to national governments in order to pay for Covid's direct and indirect healthcare and prevention costs, no conditionality, up to 2% of GDP, maximum average maturity of ten years, discontinued after December 2022 (Eurogroup, 9 May 2020).

**Restarting the EU economy (Recovery Fund)**

- Loans to national governments, direct spending on programmes and capitalisation of an equity fund, possibly totalling €500 billion and backed by future surcharges on member states' contributions to the EU budget and/or own resources. To be discontinued after the funds are repaid, possibly over a long period.

2. **Loans versus grants.** Here, again, there is a legal constraint. According to the Treaty (Art. 310), the EU budget needs to be balanced on a yearly basis. Art. 122(2) nevertheless allows the EU to borrow in order to extend back-to-back loans to a member state in case of “natural disasters or exceptional occurrences beyond [its] control”. As for the ESM, it only extends loans. Beyond the legal discussion, there is a strong economic case for a mixture of loans and grants. In particular, when a sovereign or a corporate is already highly indebted, adding on further indebtedness can lead to long run problems of debt overhang.

While the SURE initiative relies on loans (see Box 3), the European Commission and the Franco-German agreement of 18 May 2020<sup>6</sup> envisage a large proportion of spending in the Recovery Fund. The Commission would borrow on markets but instead of lending the money to national governments, it would spend it on specific recovery programmes, as part an EU comprehensive recovery strategy within a temporarily inflated EU budget. Such proposal amounts to some form of ‘targeted grants’. One key element is that the most severely hit countries may contribute less to the repayment of the common debts, hence there would be one-off transfers across member states.

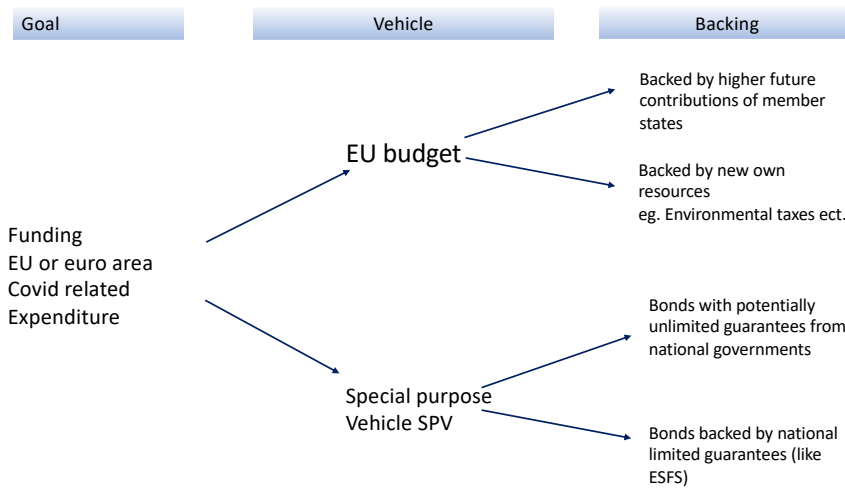
3. **European (EU Budget) versus joint and/or several borrowing (or ‘Coronabonds’).** This is the area where the debate has been most difficult and divisive. In principle, it is in the self-interest of each member state that (1) the other member states have enough resources to fight the pandemic (including with costly lockdowns), and (2) the pandemic does not trigger a sovereign debt crisis. Hence, each government should be able to borrow at low interest rates over long maturities in order to minimise the cost of the debt and the rollover risk. Also, European-level commons should be funded at the supranational level and in common. A key advantage of supranational-level borrowing is that it alleviates the pressure on national debts. Also, it would allow to create potentially large volumes of ‘safe assets’ that would stabilise the banking sector and also make the asset purchasing programmes of ECB easier. However, the different proposals have different implications in terms of liability, as described in Figure 1.

One way is to enable to European Commission to borrow on behalf of the EU, and to back the issued bonds with future higher contributions to the EU budget by the member states. An alternative (or complement) would be to back the debt at least partially with new own resources, like ETS proceeds, carbon taxes or other levies. Given that the annual gross national income (GNI) of the EU without the

6A French-German initiative for the European recovery from the coronavirus crisis, 18 May 2020 (see <https://www.diplomatique.gouv.fr/en/coming-to-france/coronavirus-advice-for-foreign-nationals-in-france/coronavirus-statements/article/european-union-french-german-initiative-for-the-european-recovery-from-the>)

UK is approximately €14,000 billion, the Commission could, for instance, borrow around €500 billion backed by a temporary surcharge of national contributions to the budget and/or own resources amounting to 0.5% of GDP over seven years (which corresponds to the 2021-28 MFF), 0.7% if the repayments only start in 2023 and continue through 2028, or a lower amount if the debt is more long term or rolled over.

**Figure 1** Possible options for funding



Another route is through some kind of ad hoc special purpose vehicle (SPV). This in turn could have two variants. The first is one in which the SPV borrows with a joint and several guarantee from member states (Eurobonds or Coronabonds). However, such solution is less secure legally (see Garicano, 2020) and difficult politically. Alternatively, the SPV could issue debt-backed limited (capped) guarantees of the member states (i.e. several, but not joint guarantees). This was the case of the European Financial Stability Facility (EFSF), a crisis resolution SPV created in 2010 to provide financial assistance to Ireland, Portugal and Greece. The EFSF was eventually superseded by the ESM, which also borrows with euro area member state guarantees, but has its own capital base and can call additional capital from the member states.

The structure decided for SURE funding is modelled after the EFSF, based on national guarantees. In contrast, the Recovery Fund could be backed by additional contributions to the EU budget. Finally, the ESM will rely on its own lending capacity.

4. **Loans versus equity.** Whether European or national, private or public, a debt needs to be repaid or rolled over. The debt overhang that will follow the crisis will create financial fragility and possibly slower growth due to reduced investment. This is especially the case in the non-financial corporate sector. Hence, some authors (Boot et al. 2020a,b) have proposed to set up a European equity or ‘equity-like’ fund whose mission would be to invest in corporate equity, in return for future capital gains or, in the case of very small firms, in return for future taxes. On the sovereign side, GDP-indexed bonds would provide an equivalent of equity, but this possibility has not re-emerged so far in the European debate.
5. **Own resources.** One key element of the equation in the post-crisis period will be the ability of the member states to raise taxes without blocking the recovery of the private sector. There are two ways to do this. The first is to look for a new, ‘own’ resource (Garicano, 2020). A carbon resource (revenues from the ETS market, carbon taxes) would be especially suitable as it would align the incentives of the governments on the Green Deal master project. A second avenue, which should be thought of as a complement to the first, would be to accelerate the tax coordination projects at the EU level – corporate income tax, notably for digital activities; a new VAT regime; digitalisation of tax administrations, etc. (e.g. Bénassy-Quéré 2019) – in order to plug the various cross-border leaks that together amount to more than 1% of GDP, and possibly to enforce more progressive tax systems.

## **The next phase: Repair, reboot, recover**

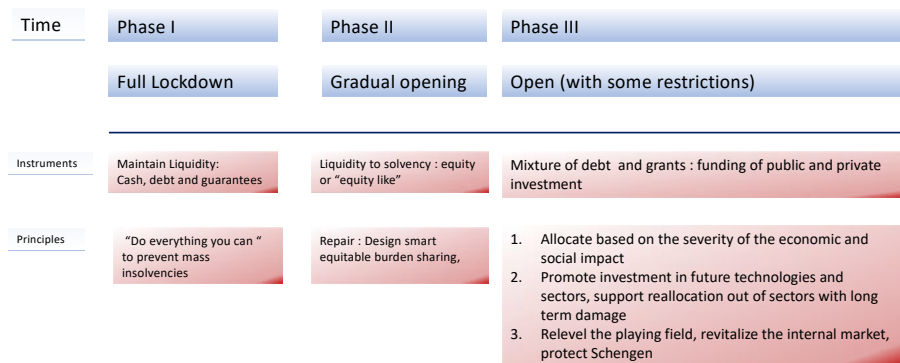
Figure 2, adapted from Anderson et al. (2020), illustrates the progression of the crisis over three phases.

The first was the acute phase of the medical emergency, with the economy in lockdown. In this phase, the first priority of governments was to avoid unnecessary suffering, the closure of firms and the loss of jobs. Governments’ and central banks’ actions were all about providing enough liquidity to households, firms and banks, and the guiding principle was “act fast and do whatever it takes” (Baldwin and Weder di Mauro 2020). In the acute emergency, governments have provided cash, loans and guarantees to compensate as much as possible for the losses incurred because of the lockdown. Considerations about firms’ future repayment ability (due to possible long-term changes



in demand patterns or because they may already have been unviable before this crisis) had to take a back seat. Similarly, the questions of long-run debt sustainability of firms and sovereigns were pushed into the future.

**Figure 2** Phases of the crisis



Source: Authors elaboration based on Anderson et al. (2020).

In the second phase, the gradual reopening of the economy starts. In this phase, demand is still sluggish since people are cautious and choose to restrict their mobility. Social distancing and other regulations mean that some businesses and sectors do not recover quickly. They also have to pass on to the consumer the cost of the new distancing regulations, which contributes to depressing demand in some sectors. Uncertainty about longer-run prospects remains high and the wait-and-see attitude for private investment continues. This is also the time when some of the more long-term damage of this crisis starts to become more visible. Some firms are unable to repay the loans they received and insolvencies increase. Industrial restructuring plans start to be announced. The defining principle during this phase should be to repair corporate balance sheets and avoid the problems of a debt overhang, disincentives to invest and mass insolvencies. This suggests a different package of measures:

- **Cleaning corporate balance sheets.** This would involve moving from debt to equity or equity-like instruments. For the small and medium-sized firms, equity-like instruments would serve this purpose (Boot et al. 2020a,b). A European equity fund should serve to level the playing field across countries (compensating for unequal capacities at the national level to provide generous funding). It could also top-up national schemes, with the national government taking the ‘first loss piece’. However, a number of principles should be observed:

- Simple, transparent rules applying to SMEs. Given the number of firms in the European Union, and given that they mainly finance themselves through the banking sector (rather than directly on the market), it is advisable to channel government and EU interventions through banks and via national development agencies (such as the Cassa di Risparmio di Padova e Rovigo in Italy). However, it will be necessary to ensure that banks incorporate the social cost of bankruptcies in their decision-making. As suggested by Blanchard et al. (2020), public creditors could accept higher haircuts than private ones in case the debts of a viable firm are restructured. A standard scheme needs to be proposed in order to avoid lengthy negotiations and, above all, bottlenecks in commercial courts. In case of equity-like investment, it will be necessary to impose constraints on executive pay in order to circumvent the porosity between profit and labour income in small firms.
- For large firms, simple rules will not work. Given the large externalities for the Single Market (competition, value chains), the Commission should take the lead to organize the restructuring in the most affected sectors (e.g. airlines). In case of temporary nationalisation, contingency plans should be made for subsequent privatisation. Given the level of uncertainty and the necessity to recoup at least part of public investments, it will be difficult to set a precise timeline.<sup>7</sup> The Commission should make sure that conflicts of interests are avoided. For instance, governments should not be, at the same time, active shareholders and active regulators.
- Finally, the (temporary) rise in households' savings rates should be relied on. Although risk aversion will likely be on the rise, share prices will be low, offering good opportunities for capital gains. Since sovereign rates will likely remain very low for a long time, it would be advisable to review existing financial regulations with the perspective of encouraging the development of diversified private equity products. This could be part of an effort to 'humanise' finance through regionalised and/or 'green' savings products. However, the bulk of equity will have to fall on the balance sheets of institutions with long horizons. It would be advisable to adapt the regulation of insurance companies and to accelerate the capital market union project (Demertzis 2020).

7 ABN AMRO, which was nationalised and restructured in 2009, was still 80% owned by the Dutch government ten years later.

- **Encouraging labour reallocations.** Jordà et al. (2020) find that, historically, pandemics have been followed by increases in real wages and falls in real interest rates. This result can be interpreted as the outcome of a lower labour force (due to the death toll and/or reduced participation rate) while capital is basically unaffected. During the recovery phase, demand will stay depressed in some sectors (e.g. restaurants), whereas it may recover relatively quickly in some others (e.g. construction). Within each sector, the demand will also recover unevenly (e.g. more e-commerce and fewer physical shops). Hence, we cannot exclude labour shortages in some sectors or sub-sectors while unemployment would stay high in others. Today, it is impossible to assert whether these effects would be transitory or permanent. Hence, we should perhaps think in terms of short-term flexibility and in terms of option value:
  - Short-term flexibility. Local arrangements where some workers are ‘lent’ by one firm to another firm for a limited period of time could be encouraged - for instance, from restaurants to groceries stores, or from airport security to shopping centre security.
  - Re-training. There is an option value of training the unemployed for new jobs, even if at the end they can recover a job in their initial occupation. Learning a second job could also be welfare-enhancing for the workers, for instance if this allows them to move to another, preferred location.
  - Training. A new generation of youth will arrive on the labour market in September 2020, some of them with limited skills. It is essential to incentivise companies in the relatively booming sectors to hire low-skilled young workers. Existing programmes such as the European youth guarantee or apprenticeship programmes need to be scaled up and adapted to the new context.

Overall, the SURE initiative will shortly have to reinvent itself by moving from compensating short-time work to encouraging flexible labour arrangements and on-the-job training programmes. This will be all the more necessary as the Recovery plan will likely increase the demand in some sectors such as housing renovation or IT services. Not quickly building up sufficient skilled capacity to serve the demand would lead to a mere increase in prices, with little gain in terms of production and employment.

The second and third phases of the crisis will likely overlap. The third phase will however be characterised by return to a ‘new normal’, in which social distancing and other restrictions remain in place for as long as immunisation has not been achieved. This may be a long phase of recovery, in which the EU will kick start its Green Deal

and digitalisation strategies, while at the same time having to still support some injured sectors of the economy. During this phase, a few guiding principles on EU level spending should apply:

1. It should be directed towards the most severely impacted regions and individuals.
2. It should promote the growth of future technologies and sectors (e.g. green, health and digital) while at the same time supporting the reallocation of people out of sectors where the recovery chances are slim.
3. It should serve to relevel the playing field, revitalise the internal market and protect the Schengen area.

The pandemic may well have a long-lasting impact on the distribution of demand between consumption and investment. To the extent that collective preferences have shifted in favour of preserving the environment and investing in health protection, the new growth regime will rely on more public and private investment, and less consumption. The Recovery plan should accompany this structural shift through facilitating factor reallocations, supporting public investment, incentivising private investment and mobilising households' savings.

## **Conclusion**

At the time of writing, the EU Recovery plan is taking shape and the contours that are becoming visible look promising. If enacted as foreseen by the Franco-German agreement (€500 billion of spending along a few strategic priorities, backed by the EU budget with possible own resources), it would indeed constitute a quantum leap for EU-level fiscal policy action. Indeed, fiscal policy starts when the budget can be in deficit in bad times and in surplus in good times. In this sense, the Recovery plan would signal the birth of nothing less than a European fiscal policy, although at this stage the budget would remain modest. The de-correlation between national contributions (based on each country's GDP and/or on own resources) and the allocation of spending (based on the needs) is not entirely new since it is at the core of structural funds. However, it will de facto entail one-off transfers from the least affected countries to the most affected ones. This will be a significant sign of European solidarity and unity.

Of course, a Franco-German agreement is clearly not enough to obtain a consensus among the now 27 members of the EU, and the topic remains highly controversial. However, things are moving that could unlock a number of other topics, notably the financing of the green strategy and the re-balancing between monetary and fiscal policy. Putting together the ESM pandemic credit lines (up to €240 billion), the EIB credit guarantees (€200 billion), the SURE initiative (€100 billion) and the tentative

Recovery fund (€500 billion), we could possibly arrive at a total exceeding €1 trillion, or 7% of EU's GDP. This is still low compared to the budget of existing federations, but sizeable compared to the expected deepening of national fiscal deficits. Furthermore, these borrowings will constitute 'safe assets' that could oil the wheels of the banking sector and the ECB.

Going forward, a number of issues will have to be addressed, notably:

- **The Stability and Growth Pact.** Before the Covid crisis, the fault lines of fiscal rules were widely discussed and understood. In order to avoid the same pro-cyclical fiscal tightening as that carried out after the global financial crisis, the SGP will have to be adapted. The jump in debt-to-GDP ratios will make the debt rule even less workable than before the crisis. Conversely, off-balance sheet liabilities will have to be monitored. For a while, it may be advisable to think more in terms of gross financial needs than in terms of financial or structural deficit, and to develop contingent fiscal planning in case some risks materialise. At a later stage, expenditure rules could replace the pre-Covid SGP as a way to monitor sovereign deleveraging over a long period while allowing for counter-cyclical fiscal policies.
- **Taxation.** National governments should not shift brutally from heavy subsidisation to heavy taxation. The only way to avoid such a self-defeating strategy while raising resources to service the new debts would be to broaden existing tax bases. Hence, anti-avoidance rules, efficient cooperation across national tax administration (for instance, on VAT), fair taxation of digital activities, and the elimination of the various tax holes and exemptions will be crucial elements of the recovery. Stronger cooperation would also be desirable so as to allow for more progressive tax schedules, since low-paid workers will have suffered relatively more from the crisis.
- **Convergence.** The crisis will likely have long-lasting effects on some sectors like car making, aeronautics or tourism, less on others like business services, agriculture or utilities. To the extent that these various sectors are unevenly distributed across the EU, the shock will have asymmetric effects, calling for relative price adjustments, labour mobility or temporary transfers. Some of the instruments put in place during the Covid crisis may need to be prolonged and adapted in order to address this legacy. Failing to do so would raise the discontent with sector specialisation that is at the core of the Single Market.

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## 2 EU solidarity in fighting COVID-19: State of play, obstacles, citizens' attitudes, and ways forward<sup>1</sup>

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26 March 2020

*An initiative to create centralised control of medical countermeasures at the EU level would solve many coordination issues in times of crisis. However, a unified European response faces a number of legal and political obstacles. This column uses a survey conducted before the COVID-19 outbreak to understand EU citizens' attitudes towards a joint solidarity programme. It suggests considerable support already exists for an effective policy framework centralising the procurement, stockpiling, and allocation of medicines.*

Solidarity in health is multifaceted. It refers to the public enforcement of necessary collective action (e.g. quarantines, mandatory medical examinations, and vaccinations) and to systems of insurance and redistribution, ensuring universal access to medical care and public health.<sup>2</sup> This is a shared EU principle (Council of the European Union 2006), but the organisation of the solidarity is a national responsibility.<sup>3</sup> In areas where redistribution and entitlements are at play, the EU is legally prohibited from legislating.<sup>4</sup>

1 The views expressed in this column are those of the authors, and do not necessarily represent those of the institutions with which they are affiliated.

2 Universal access to (public) health care and medicines entails equal access to a predetermined basket of care.

3 For sure, the EU has developed a capacity in the surveillance and early warning of public health threats. The EU also legislates on health and safety; but the latter 'regulatory role' does not interfere with the forms of (redistributive) solidarity mentioned in the text (cf. Majone, 1993, 1999).

4 See these prohibitions in Article 168 (5) TFEU on public health, and for access to health care Article 168 (7) TFEU.



Furthermore, member states have been adamant in drawing strict boundaries between national health law and EU internal market law.<sup>5</sup> Hence, the capacity to organise a true European solidarity response to infectious diseases is limited.

## Export bans of urgent medical supplies

With the increasing shortages of countermeasures to COVID-19, some member states have instituted bans on the exports of crucial medical supplies. In response, the European Commission (2020a) has published a communication that such goods need to be “channelled to those who need them most”. Generally, an export ban is prohibited under Article 35 of the Treaty on the Functioning of the EU (TFEU), unless this national ban can be legitimised by reason of public health. If member states want to restrict exports for solid public health reasons, they have the authority to do so as long as it is proportionate and non-discriminatory (Art. 36 TFEU). Interestingly, the Commission offers a new reading of this proportionality principle:

[The measures need to be] appropriate, necessary and proportionate to achieve such [health] objective, by ensuring an adequate supply to the persons who need the most while preventing any occurrence or aggravation of shortages of goods, considered as essential – such as individual protective equipment, medical devices or medicinal products – **throughout the EU.**

This interpretation of proportionality implies a novel rebalancing of health concerns and market objectives. Where previously this balancing would presume that health is a responsibility of member states and might need protection from internal market principles, now the reading is that health solidarity is an EU objective that can trump member state prerogatives.<sup>6</sup>

Nevertheless, it is questionable that an infringement procedure for enforcement of internal market law along the line proposed by the Commission will be enough to ensure the distribution of urgently needed medicines for the whole EU. Therefore, the EU needs to have actual control of the supply chain of medicinal countermeasures, which is where solidarity is now most at stake.

<sup>5</sup> Case C-376/98 Germany v Parliament and Council (Tobacco Advertising) [2000] ECR I-8419.

<sup>6</sup> To manage such tension, the Commission created a taskforce, including a role for the Member States, to assess export limitations.

## EU control of the medical countermeasure supply chain

Despite the central role for member state solidarity, some legal bases justify a broader solidarity role for the EU in health emergencies. The first is in Article 222 TFEU (solidarity). The second is in Article 168 TFEU (public health), which outlines:

Union action, which shall **complement** national policies, shall be directed towards improving public health, [...]. Such action shall cover the fight against major health scourges, by [...], and **monitoring, early warning of and combating serious cross-border threats to health.** [...]

Article 168 TFEU was amended in this sense after consecutive health crises (e.g. Bird flu, SARS). At the time, an attempt was made to create EU stockpiles of medical countermeasures, such as pre-purchase agreements for vaccines, antivirals, and medical supplies. However, no agreement could be reached between the member states. During the Swine flu epidemic, the distribution problems and costs of medical countermeasures were significant (European Medicines Agency 2011, Turner 2016). Therefore, the EU established an ad hoc, voluntary public procurement system whereby member states lacking access to the vaccine could still obtain it, and a stockpile was created using excess capacity of vaccines in member states. Following this, and despite early opposition from member states, the ad hoc voluntary system became generalised by Decision 1082/2013 (Art. 5) for health emergencies.<sup>7</sup> The Joint Procurement Agreement (JPA) implementing Article 5 entered into force in June 2014.<sup>8</sup>

Although significant steps have been made on this basis – 15 member states joined in a pre-purchase agreement for pandemic vaccines and new initiatives are unfolding – the system does not make it possible to centrally allocate medicines using central EU executive (emergency) powers.<sup>9</sup> Decisions regarding urgency and need are organised in a fully contractual manner, which means that they must be taken inter-governmentally.

7 For a case study on the regulatory changes as a result of Influenza A H1N1, see De Ruijter (2019).

8 This agreement applies to joint procurement of medicines (antivirals, treatments or vaccines), medical devices (infusion pumps, needles) and 'other services and goods' needed to mitigate or treat cross-border threats to health, such as laboratory tests, diagnostic tools, decontamination products, masks or personal protective equipment.

9 Belgium, Croatia, Cyprus, Estonia, France, Germany, Greece, Ireland, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain have signed framework contracts for the joint procurement of pandemic influenza vaccines with pharmaceutical company Seqirus (March 2019). Member States are also preparing joint procurement procedures for Personal Protective Equipment, see European Commission (2019, 2020b).

The role for the EU on the basis of Article 222 TFEU is not very different. This Article mandates that in disasters, member states provide mutual assistance and act in cooperation. However, such cooperation is voluntary.<sup>10</sup> The EU Civil Protection Mechanism established on the basis of this Article also depends on the willingness of member states to join forces. In 2019 the Civil Protection Mechanism was strengthened by ‘rescEU’, in an attempt to centralise EU capacities.<sup>11</sup> Article 12 of this Decision provides for the EU to use its internal funds or pre-committed national funds, and EU co-financed member states’ capacities at the disposal of EU efforts, to respond to a major emergency. Importantly, this mechanism also creates the possibility for joint procurement, operating in parallel to the JPA under the health infrastructure.<sup>12</sup> Here, the Commission can assume a more central role because the Decision allows for central EU implementing decisions towards distribution and allocation. Nevertheless, the actual capacity of rescEU still largely depends on the willingness of member states to contribute, and it is doubtful that for medical countermeasures EU internal funding will be comparable to what can be organised at the national level or through the JPA in the EU health context.

The tension between these two voluntary approaches is clear: one favours forward-looking governments to decide to pool forces while being relatively inflexible amidst distributional challenges; the other is able to cope with distributional challenges, but its activation follows rather than anticipates an outbreak. Merging the two systems is politically controversial, since EU citizens may differ in how they think about joint solidarity.

## **EU citizens preferences**

Public support for improving existing arrangements is therefore essential. To shed light on public support for the EU’s role in the purchase of medical countermeasures, we conducted an original survey as a pilot for a larger project on attitudes towards EU fiscal and medical policies. This pilot used a representative sample of 400 Dutch respondents in November 2019, just prior to the COVID-19 outbreak. This yielded a sample of 2,400 judged packages. The design was a ‘conjoint experiment’ exploring support for different variants of EU risk-pooling in the purchases and accessibility of pharmaceutical medicines relevant to major outbreaks.

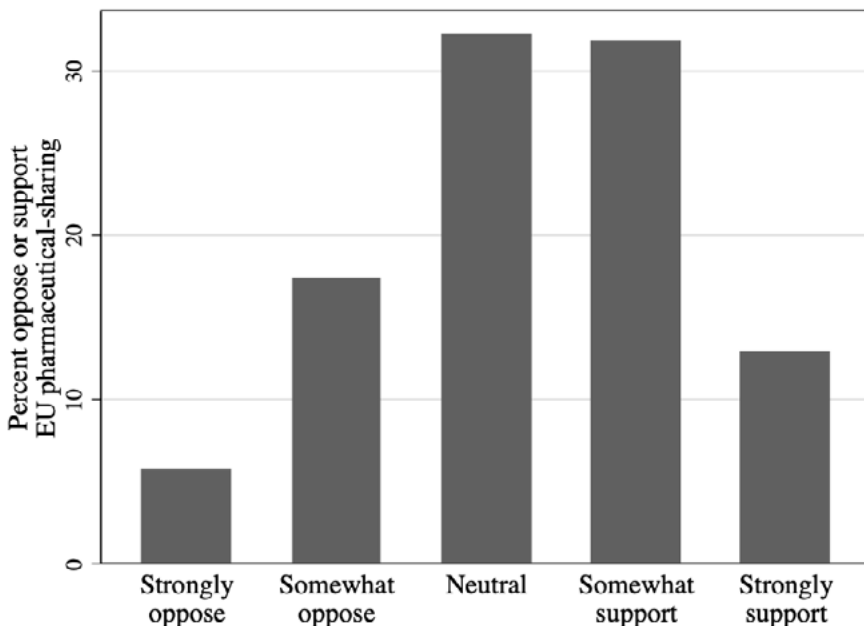
10 Council Decision of 24 June 2014 on the Arrangements for the Implementation by the Union of the Solidarity Clause (2014/415/EU) OJ L 192/53.

11 Decision (EU) 2019/420 of the European Parliament and of the Council of 13 March 2019 amending Decision No 1313/2013/EU on a Union Civil Protection Mechanism (OJ L 77I, 20.3.2019, p. 1–15).

12 Par 20. *ibid.*

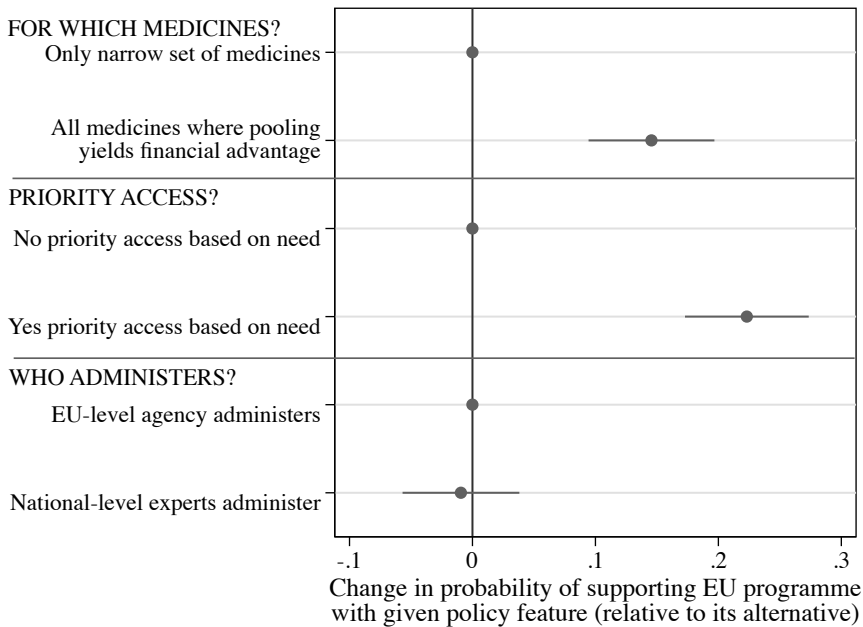
The results, while based on a limited sample in one country and a particular pre-crisis moment, reveal important information about public support for EU competences. First, as Figure 1 summarises, overall support for EU-level pharmaceutical facilities is substantial: 44% of the sample were somewhat or strongly supportive, while 'only' 23% were opposed (32% were indifferent). These patterns are stable across basic demographic sub-groups (younger versus older, more versus less educated, men versus women).

**Figure 1** Support for EU sharing of medicine procurement



Second, Figure 2 summarises preferences about variants of the policy. Respondents were essentially indifferent as to whether EU-level or national experts and agencies administer such programmes. On the other hand, they were 15% more likely to support EU procurement policies covering all products for which public procurement is beneficial rather than a more limited range. Finally, they were also 23% more likely to choose those EU procurement policies that give priority access of medicines to countries where a contagion can be traced, rather than to countries based on actual contributions (the baseline).

**Figure 2** Predicted support for policy features of EU medicine procurement sharing



## Ways forward

The organisation of health solidarity traditionally set limits on market integration. However, the current crisis is demonstrating the limitations of the internal market. Ensuring medical countermeasures go to the places where they are needed most is in everybody's interest. The EU's role in the procurement of a pandemic medicine and other medical products can be scuttled if member states, amidst COVID-19, undermine supply chains. The process within the medical procurement and rescEU remains voluntary and intergovernmental, and may be encumbered by actual export bans. EU solidarity is undermined by hoarding and limitations on supply.

The EU must develop a truly centralised capacity for the procurement of medical countermeasures, to avoid the inefficiencies of the current intergovernmental and voluntary process. Central procurement is now needed for protective devices and will be needed for the COVID-19 vaccine once it becomes available. It will also be needed for future infectious diseases. Funding can come from the EU budget or a separate contribution by member states.

With a common stockpile managed at the EU level, inefficient excess demand and excess supply across countries would no longer exist. Because the stockpile would be common and larger than any potential national stockpile, there would be much greater firepower to target outbreaks of infectious diseases as soon as they emerge. Decisions where to target the firepower should be taken at the central level. This would avoid scenarios where some countries engage in self-defeating deviations from the cooperative solution by securing as much of the medicine supply as possible at the expense of other countries.

Our research strongly suggests that citizens are ready for a more central role for the EU. Even among Dutch survey respondents, who are among the most sceptical about expansion of the EU budget, a majority were prepared to pool medicine procurement and share risks at the EU level. EU citizens seem more willing than their leaders to accept solidarity arrangements to cope with emergencies.

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# 3 The EU needs an independent public health authority to fight pandemics such as the COVID-19 crises

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2 April 2020

*The response to the COVID-19 pandemic has varied widely across the EU, member states following their own self-interests and limited coordination. This column argues that an independent public health agency could help overcome problems of collective action.*

The COVID-19 crisis is, without a doubt, the most important health challenge that European countries have suffered in the last century, although its effects are only now beginning to be quantified. The crisis is illustrating, sadly in the form of fatalities, that while globalisation entails benefits via free trade and mobility, it also carries health risks.

Although the consequences of the crisis are yet to be determined, it is already suspected that, even at best, it will lead to a paradigm shift in almost every area, and perhaps be the turning point desperately needed to address the challenges of globalisation once and for all.

In this column, I argue that a key political lesson of this crisis is that further collaboration is required in Europe to face such health challenges. Collaboration does not occur spontaneously, but rather requires stable institutions that allow problems of collective action to be solved. I suggest that a possible solution is the transfer of public health responsibilities to the EU when a health risk goes beyond the borders of a member state.



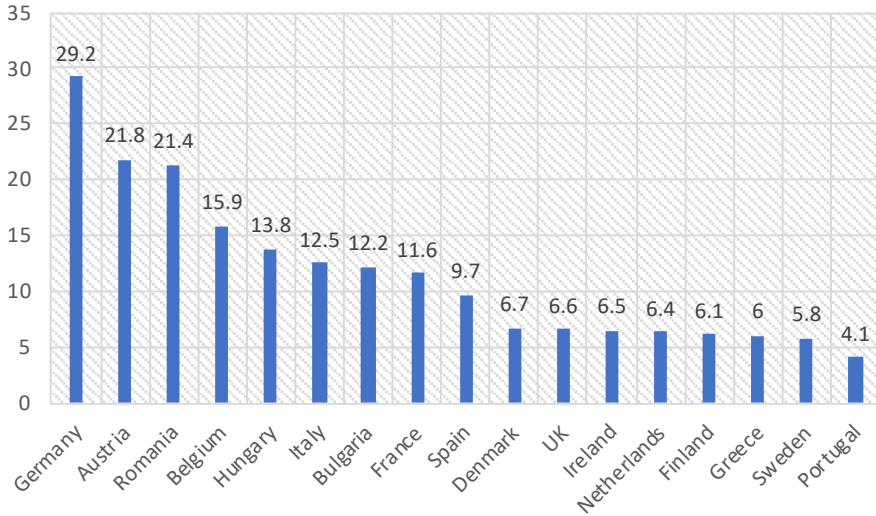
Most federal states have an authority or an agency with such a remit, such as the Centres for Disease Control and Prevention (CDC) in the US, a federal agency under the Department of Health and Human Services with responsibilities on global health and epidemic intelligence. In contrast, while there is a DG Health in the European Commission, the equivalent of the CDC does not exist for the EU. Responsibilities are decentralised to member states, which only began sharing information after the European Centre for Disease Prevention and Control (ECDC) was created in response to the SARS outbreak in order to coordinate a European response to future outbreaks. However, it has a limited data-sharing function and barely any authority. Other European agencies, such as the European Medicines Agency (EMA), are focused on medicines but do not engage in public health decision making.

### **Higher exposure to COVID-19 given Europe's ageing population**

EU member states share common concerns about the readiness and capacity of their health systems to respond to pandemics. The ECDC (2020) reported on 25 March that 30% of diagnosed COVID-19 cases in the EU were being hospitalised and 4% had severe illness, which is slightly higher than the world average given to the large share of elderly in the population. Both the probability of death and the absolute number of deaths increase rapidly with age for those aged 60 years and over in every country. Among hospitalised cases, 12% have resulted in death, with higher case fatality rates among the elderly. In Italy, however, approximately 40% of patients have been hospitalised, with close to 7% admitted to intensive care units.

Another reason for a European authority lies in the similarities in the cross-country health system organisation in the continent. By influencing the spread of the virus, public health interventions (lockdowns, social distancing etc) can have significant spillovers on the way a health system works. If the transmission is slowed and the curve is flattened, stress on the health system in terms of hospital beds and the risk of intensive care units collapsing are reduced. As Figure 1 shows, there are large differences in critical care bed capacities across EU countries (from 29.2 beds per 1000,00 inhabitants in Germany to 4.1 beds in Portugal). Importantly, these differences are not correlated with the share of GDP invested in health care (Rhodes et al. 2012).

**Figure 1** Critical care beds per 100,000 inhabitants



Source: <https://www.covid-19.no/critical-care-bed-numbers-in-europe>

## Heterogeneous responses to the same pandemic

The way in which each country has responded to the pandemic does not reflect the objective needs of that country (number of fatalities, share of older people or people infected, etc.), but rather the differences in the character of its national elites and, almost without exception, the country's self-interest.

While Germany has managed to keep death rates low with intense testing – and testing seems key (Baldwin 2020) – other European countries have reacted much more slowly. Austria and Poland revealed some nationalistic instincts in their responses by closing their borders. And while Finland locked out the region of Helsinki (where most cases emerged at the beginning of the spread), in Spain no region was locked and instead the regional health systems were centralised under the declaration of a state of alert, despite the knowhow being at the regional level. France followed Spain's steps. Hungary offers another example of the politicisation of the crises – the pandemic has been used as an excuse to control the country to a degree which has been denounced by the European Parliament.<sup>1</sup> In contrast, in Italy, the regions were the first to establish quarantines and

<sup>1</sup> <https://www.europarl.europa.eu/news/en/press-room/20200324IPR75702/ep-stands-up-for-democracy-in-hungary-during-covid-19>

to urge locals to stay home, and the results in Veneto region have been exceptional (unlike other regions with the same or more resources). In the UK, Wales and Scotland acted first by announcing policy measures such as the closure of schools, which were then followed by similar measures in England.

## **The modest role of the European Union**

Article 3 of the Treaty of the European Community establishes that the European Community will contribute to a “high level of health protection”, and public health is explicitly mentioned as an EU responsibility in the Maastricht Treaty. More recently, a 2013 European Council decision opened the possibility for the EU to act in the face of “serious cross-border threats”. The COVID-19 crisis undoubtedly represents a threat that exceeds the territorial limits of the states. However, the EU has reacted with considerable delay – it was only in the second week of March that travel to the EU was suspended for 30 days, and earlier in March the EU threatened France and Germany with infringement proceedings for limiting the export of masks.

There is no doubt that the COVID-19 crisis is an example of a situation where the EU should be more proactive. It is at times of crisis that member states are tempted to follow their self-interest and face problems of collective action. They prioritise their own interests, even when it undermines solidarity with other EU countries. The most obvious example is the exports limits on medical protection equipment (such as face masks) imposed by France and Germany, despite severe shortages in some countries.

That said, we have seen some examples of cross-border collaboration, such as the help offered by the German state of Baden-Wuerttemberg to patients in the French region of Alsace. And on 28 March, a handful of patients in Lombardy were transferred to Cologne and the European Commission interceded to send masks to Italy from Austria, France and Germany. However, these examples of collaboration have been the exception rather than the norm, and an argument can be made that such help was aimed at minimise the potential externalities from an increase in cases in a neighbouring state.

## **A European authority to respond to ‘cross-border health risks’**

One way to overcome problems of collective action would be to create a public health authority at the European level, with powers beyond the limited coordination activities carried out by the European Centre for Disease Prevention and Control. Pandemics such as COVID-19 affect EU countries in a different way from the rest of the world

(given the unique institutional design of health systems defined by universal coverage and healthcare mobility), and a public health authority could ensure cooperation when each member state is tempted to follow its own self-interest. If all European countries had implemented the same response to the current crisis as Germany, Europe would probably have prevented some deaths.

Given that the management of pandemics does not respect borders, and pandemics are a ‘global public bad’, they require form of collective action to face the challenges. Such action would not occur spontaneously unless some institutional design is put in place to enforce cross-country collaboration across EU countries. This collaboration could potentially involve EEA countries, the UK and other neighbouring countries to the EU. If such institution building were to take place soon, it could arrive in time to face the needs of a potential second phase of the pandemic later in 2020 and into 2021, and it could support, with other agencies, the rapid diffusion of a vaccine and related treatments as they become available.

The European public health authority should be as independent as the ECB is with regards to price stability, with a clear mission and remit for global health. The authority would confer additional value on EU membership in a time of rising populism, and would add to the technical guidance offered by WHO to ensure that European countries build their capacity to respond to pandemics and other public health challenges.

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## 4 Corporate debt burdens threaten economic recovery after COVID-19: Planning for debt restructuring should start now

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21 March 2020

*The coronavirus pandemic is likely to lead to a steep, and potentially protracted, economic downturn. In response, many countries have implemented ambitious packages to support households and businesses. This column argues that in light of already elevated debt burdens, provisions for future debt restructuring should be made as soon as possible. These include carefully designed bailout packages, speedier in-court insolvency proceedings, and a stronger role of the state in dealing with renegotiations. Failure to plan and prepare for these cases could lead to a much slower economic recovery.*

Apart from the important threat to human health posed by COVID-19, there are significant economic risks. China's economy plunged in January and February of 2020 for the first time in many decades, with a 13.5% contraction of manufacturing output.<sup>1</sup> As other countries move into lockdown, they may experience a similar fall in economic activity, and macroeconomic forecasts of the impact of the COVID-19 pandemic, at the time of writing, include a global recession (OECD 2020). It seems increasingly plausible that the coronavirus crisis will not only trigger a steep contraction but also a protracted one, as public health policies will backload the time when the peak of the epidemiological curve will be reached. Financial markets around the world point to

<sup>1</sup> <https://www.scmp.com/economy/china-economy/article/3075314/coronavirus-caused-dramatic-collapse-chinas-economy-warning>

a severe economic impact. Travel, hospitality, leisure, and some manufacturing firms have already experienced considerable revenue deteriorations; other sectors are likely to follow.<sup>2</sup>

To mitigate the economic impact of the coronavirus pandemic, governments are putting ambitious support programmes in place for both households and firms. Many countries, including Germany, France, Sweden, and Denmark are extending unemployment and short-time work benefits. Meanwhile, the US is considering direct transfers to households. Emmanuel Macron has announced that “no company, whatever its size, will have to face the risk of bankruptcy”. Other countries act similarly. Policy responses outlined so far largely aim to be broad and fast (‘keeping the lights on’, as per Baldwin 2020). Germany has announced “unlimited loan support via KfW, its public development bank. France and Spain are offering loan guarantees of up to €300 billion and €100 billion for companies, respectively. Italy and others are also putting in place massive business support programmes. Several countries plan to offer tax deferral programmes (Brown et al. 2015). Central banks use various policies to encourage banks to lend to affected firms, by releasing countercyclical capital buffers or extended facilities to purchase government and corporate debt. These include the ECB’s targeted longer-term refinancing operations (TLTROs) and Pandemic Emergency Purchase Programme (PEPP),<sup>3</sup> the Fed’s revival of the Primary Dealer Credit Facility,<sup>4</sup> and the Bank of England’s unlimited commercial paper facility.<sup>5</sup>

Much of the hundreds of billions of emergency aid packages for companies will come in the form of credit or credit guarantees. This makes sense for two reasons.

First, many sovereigns go into this crisis with high levels of government debt, largely due to policies adopted in response to the Global Crisis. Sovereign spreads in the euro area, for Italy in particular, are already widening, indicating that there could be more trouble ahead for the credibility and solvency of sovereign borrowers. Sovereigns now need to preserve their fiscal resources, and gifts are more demanding than loans and guarantees. Second, the economic effects of the pandemic are likely to be very different across sectors, and there is little time to fully understand this heterogeneity. In short, the heterogeneous impact of the health crisis and lockdowns, large uncertainty about the course of the health crisis, the need to use sovereign resources wisely, and a great urgency to respond, all favour using credit to support the private sector.

2 <https://www.bloomberg.com/news/articles/2020-03-05/airlines-see-up-to-113-billion-in-lost-2020-revenue-on-virus>

3 [https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318\\_1~3949d6f266.en.html](https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html)

4 <https://www.federalreserve.gov/monetarypolicy/pdcf.htm>

5 <https://www.ft.com/content/bfb22e3e-6921-11ea-800d-da70cfff6e4d3>

However, the coronavirus crisis arrives against a backdrop of private sector indebtedness. Corporate and household balance sheets in Europe are extended - neither firms nor households deleveraged substantially since the Global Crisis and the European sovereign debt crisis. On the contrary, low monetary policy rates and low credit spreads lured them into complacency about debt levels. Corporate leverage is at an all-time high (IIF 2020, Graham et al. 2015). A large fraction of corporate debt is now rated BBB, the lowest investment grade rating, while corporate debt rated below investment grade is at an all-time high. For example, almost half of all US corporate bonds maturing in the next five years are below investment grade.

Current policies will inevitably leave parts of the corporate sector with even larger debt burdens. These will delay a recovery - distressed firms tend to implement labour reductions, sell assets, reduce investments and employment, and shrink their business, and they become reluctant to raise new capital. Additionally, banks and other lenders stuck with underperforming loans may restrain lending (Becker and Ivashina 2014) and misdirect it to 'zombie firms' (Caballero et al. 2008). If one firm is affected, its customers, suppliers and employees are affected in turn. All of this can turn a temporary economic shock into a long-term balance-sheet driven dislocation. One policy lesson of the big financial crises in the developed world, starting with Japan in the early 1990s, is that the effects of simmering corporate debt overhang are multiple and nefarious (Koo 2003).

To manage the looming corporate debt strains and keeping the likely precarious situation of sovereign finances in mind, we see three broad policy areas that require addressing.

First, public credit packages such as loan guarantee programmes should be designed with the looming debt overhang problem and the future need for debt restructuring in mind. Conflicts of interest become important when companies have multiple creditors (Gertner and Scharfstein 1991, Hege and Mella-Barral 2019), and bailouts create new creditors, making restructuring more complicated, as the bank bailouts after the Global Crisis demonstrated. Programmes must also ensure that bailout funds are used as intended to ensure business continuity, and not to benefit existing debt holders or shareholders. Policy should also have an eye to future crises. One important difference between the coronavirus crisis response and bank bailouts after the Global Crisis is the extent of moral hazard. This time, bank risk-taking did not trigger the crisis and this means moral hazard concerns are weaker. They are not absent, however, since banks may infer from current policy choices what taxpayer support will be available in other types of crises. Therefore, bailouts should be designed to avoid benefitting existing creditors and shareholders, when possible. Given all these concerns, bailouts should contain provisions that limit the scope to which investors benefit from support. We



recommend banning dividend payments and most debt reductions for all recipients of support. We also recommend that any taxpayer-funded credits be senior in the event of future restructurings. It may also make sense to attach options to the bailout funds in the form of stock warrants or convertibles that can ensure that the public benefits from future gains in corporate valuations made possible by public money, especially for publicly listed companies.

Second, European systems for handling insolvency in court are not good at protecting viable businesses with unsustainable capital structures. Businesses are too often liquidated, generating poor returns for bankruptcy claims, and processes can be slow. These inefficient in-court proceedings hold back credit market development even in good times (Becker and Josephson 2016). In a recession or crisis, it slows down returning productive assets to the economy and may destroy valuable businesses (Gilson 2012). Any reforms that can simplify and speed up in-court processes should be considered. Such reforms would need to be exceptionally quick to impact short-run developments, but they can help support a vigorous recovery. Current EU initiatives for better resolution of corporate insolvency should be accelerated.<sup>6</sup>

Third, given the inefficiencies of court-supervised bankruptcy procedures, government agencies must be prepared to be a leader in debt restructuring for the companies that receive bailouts. They should prioritize out-of-court renegotiations whenever possible. They have proven to be a successful tool after the Global Crisis (Bernstein et al. 2019, Hotchkiss et al. 2014). This can include temporary nationalisations where needed, with tough conditions for existing shareholders to avoid distortions. Public agencies such as public development banks in charge of loan guarantees may not be the best placed to oversee debt restructuring – with their own balance sheets exposed, they may be inclined to ‘extend-and-pretend’ distortions in their actions (Sapienza 2004, Bertay et al. 2015). So, it is worth thinking about an independent organisation of government leadership in debt restructuring.

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6 [https://ec.europa.eu/info/policies/justice-and-fundamental-rights/civil-justice/civil-and-commercial-law/insolvency-proceedings\\_en](https://ec.europa.eu/info/policies/justice-and-fundamental-rights/civil-justice/civil-and-commercial-law/insolvency-proceedings_en)

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# 5 Coronavirus and financial stability 3.0: Try equity – risk sharing for companies, large and small<sup>1</sup>

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3 April 2020

*COVID-19 is a disaster for many firms – especially small and medium-sized ones. This column proposes a scheme that could bring funding to firms quickly without increasing their leverage or default risk. The plan combines outright cash transfers with a temporary, elevated corporate profit tax at the firm level as a form of conditional payback. The implied equity-like payment structure has positive risk-sharing features for firms, without impinging on ownership structures. The proposal should be implemented at the European level to strengthen euro area resilience.*

This column builds on our earlier work on the coronavirus and financial stability and adds to the current debate about effective policy responses to mitigate the COVID-19 economic crisis (e.g. Bénassy-Quéré et al. 2020, Brunnermeier et al. 2020, Giavazzi and Tabellini 2020). In our earlier note (Boot et al. 2020), we discussed the potential consequences of the current broad-based interruption of economic activity in a number of countries around the world. Imminent liquidity problems and the ensuing solvency concerns need to be addressed swiftly and through vigorous government programmes, as is already happening in most countries. While warranted as an immediate response,

<sup>1</sup> This column was first published as SAFE Policy Letter No. 81. SAFE Policy Letters represent the authors' personal opinion and do not necessarily reflect the views of the Leibniz Institute for Financial Research SAFE or its staff. We want to thank Johannes Kasinger and the SAFE Policy Center Team for their excellent guidance through the discussion and writing process.

we emphasised the problematic longer-term consequences of some of these measures, in particular due to their uncoordinated, national scope, particularly in the European context. Upcoming problems may relate to 1) rising corporate leverage, 2) increasing bank risk exposure, 3) growing sovereign exposures, and 4) emerging cross-country distortions to competition in product and capital markets.

The current substantial policy measures in the EU are characterised by a broad similarity in goals and structures. However, they are divergent in size and fall short on one important dimension – effective risk sharing across firms and countries in Europe. Our proposal is not a cure-all solution but suggests a pan-European risk- and reward-sharing mechanism for firms, while providing crucial funding at the firm level. Most European firms are small or medium-sized and privately owned with no access to capital markets, generally relying on bank loans for their funding needs. Therefore, it is imperative that the choice of policy instruments properly reflects these initial conditions.

Most government assistance programmes in Europe during the coronavirus crisis, thus far, rely on some form of debt financing, which increases firm leverage even if there is some sort of a guarantee attached. Rising corporate debt levels have a negative impact on firms' default risk. Moreover, they may, sooner or later, overwhelm the fiscal capacity of at least some guarantors. The incremental rise in corporate leverage due to the coronavirus crisis can, however, be limited by relying more on equity-like instruments, i.e. financial contracts that imply loss absorption in case of poor future firm performance and reward participation otherwise. If implemented on a European level with a European Pandemic Equity Fund (EPEF), all citizens would participate in the common risks and potential rewards of a broad-based participation in Europe's industry post-crisis. This would be akin to a pan-European sovereign wealth fund of -hopefully- substantial proportions.

The major characteristics of equity-like financing provided by a government-backed pan-European fund are as follows:

1. Initial payments (from the fund to firms) carry no direct repayment obligation, although they are not outright transfers either (see 4).
2. Firm leverage (and thus, firm default risk) does not rise as a result of the financing operation.
3. The risk of a future loss of the initial payment is assumed by the investor, the EPEF.
4. In the same way, future profits are also shared by the EPEF, with repayments to the fund being conditional on positive firm performance.

The mechanism and structure of the EPEF we propose would strengthen euro area stability in conjunction with financial stability in the European Union. The equity fund would strengthen the resilience of businesses (reduces debt build-up and creates risk absorbing capacity), strengthening local conditions, and together with the strong, pan-European backing, would provide for direct sharing of firm risks (losses and rewards) across member states. This would augment the resilience of the euro area and ultimately ensures the stability of the European Union. Moreover, the reduced leverage at the firm level would reduce the risk to the banking system (lower loan losses) and, thus, strengthen financial stability. This in turn, would mitigate the doom loop between local banks and governments, further strengthening the resilience of the euro area, in a virtuous cycle.

## **Our approach**

In this section, we focus on the design of the EPEF's equity-like participation scheme. Its elements are novel, given that most firms do not have direct access to capital markets. Of course, the scheme would also work for larger firms, which have easier access to capital markets.

The difficulty of reaching firms through equity-like financing differs between large firms and small and medium-sized firms, along several dimensions. For the first group, a set of financing instruments, typically with conditions attached, are well known, and can be used for the purpose at hand. One way is to use non-voting stocks, which differ from common equity in terms of dividend payouts, voting rights, and potentially further restrictions or conditions. Thus, the EPEF could offer to take an equity-like claim, offering cash to the firm, in exchange for a fair share of future profits.

The second group consists of small and medium-sized enterprises (SMEs), typically without direct access to capital markets. Reaching these firms with an investment in their equity is notoriously difficult, because entrepreneurs from family businesses tend to dislike external ownership of the firm, particularly when accompanied with voting rights. This is often why such firms stay away from the capital market in the first place and rely on bank financing instead. Since these SMEs are the backbone of continental Europe's economies, it is important to find an equity-like access route to such smaller, unlisted firms.

Our proposal meets this requirement: it is applicable even to sole proprietors of ‘mom and pop businesses’. The basic idea is simple: the EPEF offers cash to firms in exchange for a temporary increase in the future corporate profit tax rate post-crisis. In the case of sole proprietors, a temporary rise in their personal income tax rate is the equivalent formula. The additional tax income raised in that way is channelled back to the fund in the future, representing the return to the cash investment made by the fund.

Note that our cash-for-tax scheme is intended to be an offer to firms of all sizes, in all industries and across all countries in Europe. Its conditions, like the basic initial investment amount, tax surcharge, duration, as well as specific conditionalities (covenants) on corporate actions, are set up in a non-discriminatory way.

To reach out to firms, small and large, throughout the economy, we propose to rely on existing networks of national entities, such as development banks, tax authorities or other such institutions. These agencies should be able to channel cash directly to firms through their existing networks. The firms in each country would, in exchange for accepting a cash transfer of a defined size, accept henceforth a surcharge on their corporate profit tax rate for a defined number of years. By relying on existing networks and direct cash transfers, the programme would facilitate quick assistance to firms in need. Specific criteria and terms of the investments would be decided at the European level but implemented at the national level through designated entities.

What does an outright transfer of cash tied to a temporary increase in profit tax have to do with equity financing? Actually, a lot. The cash flows emanating from firms under our scheme are identical to those associated with an equity stake in that firm. In both cases, an investor hands over cash to the firm in the initial year. Every year thereafter, conditional on the firm making profits, a defined share of profits flows back to the investor; else, the investor shares in the losses. The properties of our scheme are similar to those described above: the investor participates proportionally in gains and losses. An additional advantage of our scheme, in the eyes of the investee (the SME), is the limited number of years that the fund participates in the firms’ profits. This aspect may be of great relevance if family enterprises are to be included in the programme, which is doubtless intended essential throughout Europe.

The fine-tuning of our scheme involves additional considerations, as there may be opportunistic behaviour by some firms to lower or even avoid payments in good states (i.e. if the firm does well after the crisis years). In that case, the firm may try to delay tax payments, for example by overinvesting in long-term assets, or by relocating parts of their activities in countries without tax surcharges. Firms may also be in a position to partially affect their tax base, by splitting the firm or by paying out excessive wages to themselves. These are, however, technical details that need to be worked out,

particularly since the scheme is of a pan-European nature. Those issues have been dealt with successfully in the past in cases of state involvement in corporate restructurings, and we believe firmly that it can be done again.

As already alluded to, there are several implementation options, the national execution may occur via the national tax authorities or other entities expressly set up for this purpose. Similarly, whether the repayment in good times is via a tax surcharge or via a separately arranged profit sharing agreement is not central for our idea either. Key, however, is the equity-like payment pattern that we envisage with its beneficial impact on firm leverage and its benign effect for banking stability.

## **Discussion**

The suggested scheme of an equity-like funding mechanism fits well into several programs announced recently, in the midst of the Coronavirus crisis. For example, the German government in its latest fiscal ‘bazooka’ programme, presented on 25 March, has introduced a €600 billion Economic Stabilization Fund (Wirtschaftsstabilisierungsfonds, or WSFs) with €400 billion for guarantees, €100 billion for credit lines and another €100 billion for facilities to recapitalize, i.e. to take direct stakes in companies (although it has not yet specified what channel or instrument it will use). Similarly, as was announced on 28 March, the US government is considering taking equity stakes in large firms, including airlines, in exchange for rescue money. The distinguishing feature of our proposal is that it generalizes the equity approach to rescue measures by opening a path to reach smaller and medium-sized firms.

An issue we have left intentionally untouched in this column is the question of funding. What European fiscal scheme will provide the funds needed for a sizable equity-like funding spree in Europe? Since there is a large literature on how such funding instruments could be set up – ranging from public private partnerships, to ‘Coronabonds’, to less ambitious, national solutions – we wanted to avoid losing focus in this column and instead concentrated on the important and original idea of how to use it.

We focus on the concept of the financing arrangement here and also defer to our next policy note the important question of how to design the governance of the proposed fund – in particular, the connections of the EPEF with the national fiscal authorities and the supranational financial institutions (EIB, ESM) to ensure that the various demands of fiscally stronger and fiscally weaker countries, north and south, are met simultaneously. We also leave to the next note the question of whether our proposed scheme is complimentary to existing national programmes, or rather a substitution for some of them.



However, we reiterate our belief that any effective solution to the current economic problems must eventually entail a coordinated European approach, and it is more efficient to do this right now in a consciously designed, structured manner, rather than kicking the can down the road until some broken pieces of the European financial system, especially in the euro area, have to be realigned and reassembled.

We conclude on a bright and positive note: by designing a broad-based European equity-like participation scheme, funded with resources from all countries in the EU, we will not only help to create a common perception of shared responsibility and solidarity across Europe, but also – equally important – a strong perception of shared success. In that latter sense, a European Pandemic Equity Fund fits perfectly into the narrative of an emerging European capital markets union and may indeed be one of its defining moments. In the words of Jean Monnet, one of the founding fathers of the European Union: “Make men [and women] work together, show them that beyond their differences and geographical boundaries there lies a common interest.”

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# 6 Corona and Financial Stability

## 4.0: Implementing a European Pandemic Equity Fund<sup>1</sup>

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*The involvement of the EU in fighting the detrimental consequences of the Covid crisis has to be increased. This column expands on an earlier proposal for a European Pandemic Equity Fund – a programme of government assistance for firms hurt by the crisis in the EU – and discusses the principles and conditions relevant for the operationalisation of such a fund.*

The involvement of the EU in fighting the detrimental consequences of the Covid crisis has to be expanded (e.g. Bénassy-Quéré et al. 2020). This column builds on our earlier work on the coronavirus crisis and its implications for financial stability (Boot et al. 2020a, 2020b, 2020c). We have argued that massive financial support during the Covid crisis is warranted in order to bridge the almost universal cash flow shortfalls at the firm level, and across euro area member states, caused by the series of shutdowns.

The provision of bridge financing is also necessary from a systemic risk perspective. Significant cash flow shortfalls – highly correlated across firms and countries in a deeply integrated economic zone – could quickly translate into solvency problems for firms and subsequently for banks, ultimately undermining the financial positions of euro area member states. Current rescue programmes have important side effects as they are largely debt based, suggesting a rapid rise in debt levels at the firm level, not coordinated at a European level, and differ greatly in volume across EU member states.

<sup>1</sup> This column represents the authors' personal opinions and does not necessarily reflect the views of the Leibniz Institute for Financial Research SAFE or its staff. We want to thank Johannes Kasinger and the SAFE Policy Center Team for their excellent guidance through the discussion and writing process.

Based on the above analysis, we propose a European Pandemic Equity Fund (EPEF). The EPEF would undertake equity-like investments, particularly in small and medium sized enterprises (SMEs), which generally tend to oppose the outright dilution of existing control rights that occurs if common equity is issued. Since such firms are the backbone of Europe's economy, their concerns are of paramount importance.

Our proposed scheme is simple: it basically trades an initial cash flow injection by the EPEF into the firm against a proportionate participation in future gross earnings ('value added') or net earnings ('profits'). The former can be implemented by conditioning on the firm's value added tax (VAT) remittances, while the latter relies on a tax surcharge, conditional on corporate tax payments. Moreover, the firm can terminate its annual payment of surcharges to the fund by paying, after a number of years, a fixed amount to the EPEF, as the exercise price of an option to terminate the assistance programme.

The open questions posed by this proposed scheme and tackled in this column, are the following:

- What are the general conditions ('criteria') that the EPEF needs to fulfill in order to be financially viable, effective and, at the same time, politically acceptable?
- What are specific requirements relating to the implementation and structuring of the cash (equity-like) investments in the firms (e.g. general eligibility criteria and contract features)?
- What are suitable funding/sourcing options for the EPEF?

### **Criteria for the operation of the EPEF**

What are the general conditions that the EPEF needs to fulfill in order to be financially viable, effective and politically acceptable? We define eight criteria that need to be met:

1. **Commonality:** The EPEF's capital is jointly raised by member countries, allowing for some form of risk sharing across firms and countries.
2. **Need-based investments:** The disbursement key of the EPEF is defined by firm eligibility criteria, which may lead to a divergence between the sourcing and funding keys.
3. **Financial stability:** The risk-absorbing capacity of the EPEF should be substantial, thus requiring the fund to have low leverage.
4. **Independence:** The EPEF organisation would be kept at arm's-length from the political process, run by professionals and bound by a mandate that is democratically legitimated, using existing institutional infrastructure where possible.

5. Conditions and credible controls: Eligibility criteria for investment by the EPEF should be carefully set, such that adverse selection concerns (e.g. firms that were most probably not viable even before the crisis hit) and moral hazard fears (e.g. avoidance of surcharges) are addressed.
6. Informed decision making: In deciding about its investments into firms, the EPEF should use local knowledge as available at ‘housebanks’, development banks, or other local expertise to assess expected firm performance;
7. Temporary nature of the scheme: The scheme needs to provide incentives for firms to buy-out the EPEF when the funds are no longer needed.
8. Transparency: Regular reporting and clarity on how/when/where the EPEF money is at stake.

These eight criteria are reflected in the details of how the EPEF resources are allocated to firms, and also shape the financing structure of the EPEF, as explained in the subsequent section.

## **Investment structure and contract features**

The general characteristics of the cash-against-surcharge scheme are as follows. Initial payments (from the EPEF to firms) are transfers – i.e. they carry no unconditional repayment obligation as a traditional debt claim would. Conditional on the firm being successful again in future years, the recipient firm would pay a surcharge to the fund, in addition to its present corporate tax payment and/or the firm’s actual VAT remittances. These payments flow directly into the EPEF, representing a conditional quasi-return to the EPEF and repayment of the initial cash transfer. The link to VAT remittances (rather than declared profits) may be needed, for example, if it captures future success of the firms better.<sup>2</sup>

To ensure that the instrument we propose remains attractive to the candidate firms, and reinforce the temporary nature of the scheme, firms would have the right to buy out the EPEF in the future (a ‘termination option’). The investor – i.e. the EPEF – assumes both the risk of a loss of the initial transfer amount, and the potential for earning future gains, through receiving surcharges.

2 Note that our proposal does not require any harmonization of tax systems across countries, but rather a uniform mechanism of implementing the surcharge.

The cash-against-surcharge contract makes its performance dependent and renders the scheme equity-like, without being equity in a strictly legal sense of the term. As a consequence of the initial transfer, firm leverage (and thus firm default risk) would decrease, in contrast to a loan of the same amount. Furthermore, the scheme allows the firm, at some later point, to end the tax surcharge obligation of its own volition, by buying out the EPEF at a pre-set price that appropriately compensates the EPEF. In that manner, the firm is not indefinitely tied to the EPEF, while the EPEF can expect to be appropriately compensated.

With respect to the contract terms, four variables have to be agreed upon initially: the size of the initial transfer payment to the firm (in euros); the rate and base of the surcharge (in percentage points); the minimum number of years that the firm is obliged to pay the surcharge, if performance allows (before the termination option kicks in); and the exercise price to be paid when triggering the termination option. The surcharge will stay in place as long as the firm does not call the termination option written by the fund.

The calibration of the tradeoff between the annual surcharge and the exit cost would create incentives for highly successful firms to choose an early exit. The overall return of the EPEF will be the weighted average of the returns on all investments, those that turn out well and those that are less fortunate. Several implementation issues and conditions are necessary to make the scheme workable. We discuss some of the main issues below:

#### Defining eligibility

The EPEF should identify those SME firms that have good prospects to return to profitability once the pandemic will have eased. We suggest, as a starting point, to base that assessment on firm's performance right before the outbreak of the pandemic, say at year-end 2019. For that purpose, one may use accounting numbers, tax filings, and concurrent assessments by firm creditors (the internal ratings of banks), credit bureaus, trade creditors (e.g. using Hermes and Dun & Bradstreet), or central bank ratings, to further refine and update these assessments. One may also consider information available with the tax authorities on reported profits and VAT remittances. The preferred assessment method may depend on established financial practice and, thus, may vary from country to country.

### Choosing the size of the investment

To define the size of the cash injection, one could look at 2019 earnings or value added assessments. Balance sheet measures could also be considered for this assessment. A pragmatic way to calculate the net value added at the firm level are VAT remittances, i.e. the difference between VAT charged and VAT paid.

### Size of the surcharge

This specification would need a calibration involving the annual surcharge, the minimum duration of the investment, and the buy-out clause conditions. The calculations would be based on the characteristics of a cross section of SME firms throughout Europe. As an illustrative example, one could envision a surcharge of, say, five percentage points and a minimum duration of five years before the buy-out clause kicks in. To terminate the relationship, a suitable buy-out price should be specified at the outset. To stimulate early exit, such a buyout price should not drop over time.

### Calibration

A detailed exercise can be used to better understand how the cash payment, the surcharge and the terminal conditions interact; and how these conditions and probabilistic assumptions on firm survival and profitability, based on firm- and industry-level data in Europe, would translate into an expected return for the EPEF that is deemed acceptable.

### Operational issues

To make the scheme effective, a precise channel for the cash flows between the EPEF and the local businesses is required. Efficiency might call for delegated management at the national level. Existing channels include the banking system, with its close ties to and deep knowledge of SMEs, as well as public agencies with similar levels of information about firms, such as national or regional development banks, tax authorities and their administrative networks. These institutions and/or networks could be involved in the disbursement and collection of funds, as well as in the design of individual contracts.

There are also serious moral hazard issues that need to be addressed. One important concern is that companies could seek to avoid the annual surcharges by behaving strategically with respect to their obligations, for example by siphoning out income to owners. To address this concern, the contract has to be designed in a manner that properly incentivizes the firm to act in the right spirit of the scheme, e.g. through covenants that limit management compensation during the life of the scheme.

## **Funding/sourcing structure**

A proper funding/sourcing structure should address five main characteristics: its legal status, the agency concept, its equity structure, its debt structure, and its relationship to capital markets. We discuss potential options below.

### Legal status

The EPEF should be a legal entity with its own standing. Any risk that the fund may invest in is eventually borne by the investors holding the claims on the fund, i.e. the fund equity holders, as well as its debt holders, in the case of a leveraged fund.

### Agency concept

From the perspective of speed and accountability, it may be helpful to entrust a well-established European agency with setting up, and eventually managing, the EPEF. The agency may then act as a trustee, and the EPEF may not be part of the agency's balance sheet. The most likely candidate for filling this role is the European Investment Bank (EIB). The EIB has a long history of carrying out public and industry related programmes. It has access to a European network of commercial and public sector banks. It has financed firms, particularly SMEs, over many years. It is owned by the EU member states, according to a particular key, and it is ultimately backed by the EU budget. Irrespective of how the funding concept is designed, it eventually has to find approval by the European Council.

### Equity structure

The backing by the EU budget might also be applied to the EPEF itself. The possibility for the European Commission to pledge current and future allocations from the EU budget towards its capital is one way the EPEF might obtain direct funding. Another way would be contributions via (or by) the EIB itself. We see both sources as potential providers of the equity to the EPEF. These sources of equity funds for the EPEF could be augmented by voluntary (additional) contributions from some member states. This may open up the possibility that relatively richer countries could take over a larger share of the EPEF's equity than the minimum required by the agreed EIB key. Importantly, these would not be transfers between countries, because to the extent that the parameters of the scheme would allow for positive value generation by the EPEF, over the years, those returns would also be shared in proportion to the EPEF shareholdings.



## Debt structure

In addition to its paid-in equity capital, the EPEF could also issue its own bonds. Again, it is important to emphasise that running the EPEF in a professional manner with appropriate returns would avoid creating a transfer mechanism between member states. Since there is no co-liability assumed by EIB or other institutions, it would depend on the parameters of the scheme, whether or not the issuance of the EPEF bonds on the capital market would be feasible.

## Capital markets

The EPEF could, at a later stage, be opened for risk-bearing equity contributions by private investors (e.g. institutional investors in Europe, such as pension funds and others). Today, these institutional investors have no direct, equity-based access to Europe's SME market and its returns – and the EPEF could deliver just that.

## **Conclusion**

As we highlighted in Boot et al (2020c), the wide participation in an equity-like scheme via the European Pandemic Equity Fund (EPEF) would allow all EU citizens to participate not only in the common risks, but also in the potential post-crisis rewards of a broad-based participation in Europe's industry, particularly its SME sector.

The overall payoff profile of the proposed scheme is largely similar to an equity contract: a claim, contingent on the success of the project. The 'cash-against-surcharge contract' makes it performance dependent and renders the scheme equity-like, without being equity in a strictly legal sense of the term. Furthermore, the scheme allows the firm to end the tax surcharge obligation of its own volition, by buying out the EPEF at a pre-set price that appropriately compensates the EPEF. In that manner, the firm is not indefinitely tied to the EPEF, while the EPEF can be appropriately compensated.

Here, we have focused on the principles and conditions relevant for the operationalization of the EPEF. We also specified the investment structure, the contract features for the support for businesses, and the sourcing of the EPEF. As we also alluded to in our earlier SAFE Policy Letter, by designing a broad-based European equity-like participation scheme, funded by public investors from all over the EU, potentially augmented by private investors, we would create a strong perception of shared success.

Equity participations in the backbone of the European economies – Europe's smaller and medium sized businesses – would enhance entrepreneurial spirits and may contribute to a reemergence of prosperity in Europe.

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## 7 The European Commission's SURE initiative and euro area unemployment re-insurance

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*The European Commission proposes a pan-European support for short-time work arrangements (SURE). This column discusses the relationship between this proposal and the idea of a European unemployment re-insurance scheme, to which the Commission also refers in its Communication on SURE. It sketches the merits of SURE and signals some caveats.*

Nearly all existing monetary unions are true ‘insurance unions’. They not only centralise risk management with regard to banks; they also centralise, at least to some degree, unemployment insurance. Historically, the European Economic and Monetary Union (EMU) was the one exception. In the aftermath of the euro area crisis, the European Commission started arguing that EMU needs both a fully-fledged Banking Union and automatic fiscal stabilisers. One of the options for establishing automatic fiscal stabilisers, suggested by the Commission, would be the re-insurance of national unemployment benefit schemes at the euro area level. Another option, which the European Commission formulated in 2017, would be a scheme that supports member states’ public investment capacity when they are hit by a crisis and have to cope with reduced revenue and increased spending on unemployment benefits (European Commission 2017a, 2017b). In fact, both options share a common insight, to wit, that it is that member states’ automatic stabilisers should play their role in times of crisis whilst simultaneously protecting their public investment capacity. Alas, no progress has been made with regard to the implementation of such proposals. Today, triggered by the economic fall-out of the COVID-19 pandemic, the European Commission launches

what seems a third variant of the same generic idea, that a monetary union must act as an insurance union when confronted with severe economic or financial shocks: a new instrument, labelled SURE (temporary Support to mitigate Unemployment Risks in an Emergency), will provide financial assistance, in the form of loans granted on favourable terms from the EU to member states, of up to €100 billion in total. These loans will assist member states to address sudden increases in public expenditure to preserve employment. Specifically, these loans will help member states to cover the costs directly related to the creation or extension of national short-time work schemes, and other similar measures they have put in place for the self-employed, as a response to the current crisis (European Commission, 2020). The Commission communication adds that “this temporary instrument should be seen as an emergency operationalisation of a European Unemployment Re-insurance Scheme in the specific context of the COVID-19 crisis, without prejudice to the possible subsequent establishment of a permanent instrument under a different legal basis in the TFEU.” (European Commission, 2020, p. 3).

We will first return to the debate on a euro area re-insurance of national unemployment benefit schemes (indicating, in passing, that this might be more popular than many hesitant European leaders have thought), and then position SURE within that broader debate. In order to avoid any misunderstanding, our argument is not that SURE or re-insurance of unemployment benefit schemes can be the main component – let alone, the only component – of the EU’s response to the corona-crisis: a much broader and massive intervention is needed. But risk-sharing in the domain of unemployment should be part and parcel of a more encompassing European relief initiative. Hence, the question is to what extent SURE fits the bill and how it relates to further work on a European unemployment re-insurance scheme, as also envisaged by the current Commission.

### **European unemployment re-insurance: Rational arguments and public opinion**

The reference to unemployment insurance in debates about automatic fiscal stabilisers for the euro area is not happenstance. Unemployment insurance supports purchasing power of citizens in an economic downturn, and is therefore an automatic stabiliser par excellence. Existing monetary unions either opt for a downright centralisation of unemployment insurance (as was historically the case in Canada or in Germany), or they demand some convergence in the organisation of unemployment insurance and provide a degree of re-insurance and centralisation when the need is really high (as in the US, which combine centralisation and decentralisation in unemployment insurance,

notably when a deep recession hits). Both economic arguments and arguments related to political legitimacy are relevant in this debate (Andor, 2016). From an economic point of view, re-insurance is a rational policy option for more than one reason.

First, without automatic fiscal stabilisers a monetary union is inherently fragile. We need not rehearse this 'fragility argument' (De Grauwe, 2018, notably pp. 140-141), but one aspect of the underlying analysis is important in the current situation. While the advantage of risk pooling in the face of asymmetric shocks has often been the main argument in support of automatic fiscal stabilisers (with a view to the interregional smoothing of such shocks), there is quite broad consensus that an effective European scheme that organizes interregional smoothing must be able to also organize intertemporal smoothing – that is, the scheme must be able to issue debt at the euro area level. Interregional smoothing and intertemporal smoothing must be combined. Next, it is crucial that the system is set up *ex ante* (rather than negotiated *ex post*, when a crisis has hit) and functions in an automatic way: its mere existence should change the expectations of all economic agents with regard to the fall-out of an economic shock, when a shock occurs. In a nutshell and leaving aside all the technicalities, the *ex ante* commitment of re-insurance means that member states are assured that they will receive budgetary support from a European fund when they are confronted with a sudden and severe increase in unemployment.

This fragility argument is key. However, there is in addition a second reason why a degree of centralisation of unemployment insurance is useful for countries that are economically highly integrated. This second argument can be compared to well-known arguments about vaccination. National insurance systems create a positive externality: a country that properly insures itself, also helps its neighbours (as individuals do with regard to their neighbours when they vaccinate themselves against infectious diseases). Because of that positive externality, it is a matter of common concern that all members of the monetary union dispose of an effective stabilisation capacity.

Simultaneously, as with any good with a positive externality, there is a risk of insufficient, sub-optimal provision of that good, if it is not promoted or supported in one or other way (think again about vaccination, which is promoted by public authorities and/or made compulsory). The effectiveness of the stabilisation capacity of member states depends on a whole cluster of policy principles: sufficiently generous unemployment benefits; sufficient coverage rates of unemployment benefit schemes; no labour market segmentation that leaves part of the labour force poorly insured against unemployment; no proliferation of employment relations that are not integrated into systems of social insurance; effective activation of unemployed individuals; and the constitution of budgetary buffers in good times, so that the automatic stabilisers can do their work

in bad times. The implementation of such a cluster of principles in each member state of the monetary union is a matter of common concern. Whether or not unemployment risks are shared at the euro area level, the implementation of such common ‘stability-supporting’ domestic principles would benefit the euro area as a whole.

The argument in favour of EU support for national unemployment benefit schemes is that a European support scheme would contribute to the national implementation of these domestic principles (think about the subsidisation of vaccination by public authorities). Conversely, it is plausible that these stability-supporting domestic principles become a fortiori imperative should the euro area be equipped with re-insurance of national unemployment insurance systems: surely European countries would not agree to support each other’s unemployment benefit system, if national governments – in exchange for this support – cannot guarantee that their national system function adequately.

Wrapping up the whole argument, the quality of domestic policies and cross-border risk sharing are intrinsically related, whereby the latter should support the former and the former conditions the latter. At least, that is a plausible approach to the development of risk-sharing in the domain of unemployment in the EU (for further discussion of the normative argument at play here, see Vandembroucke 2020).

It is also a plausible approach, if one wants to gather sufficient public support. Indeed, such public support is crucial to any broadly democratic reckoning of EU initiatives. To be sure, the mutual relationship between the quality of domestic policies and cross-border risk sharing is not present in all policy scenarios published over the last years. But it has inspired a survey experiment organized on public support for European unemployment re-insurance, in which 19500 respondents in 13 EU member states had to judge different specific designs of such re-insurance. These specific designs varied in terms of the minimum generosity of unemployment benefits that member states had to guarantee, in terms of conditions with regard to the education and training programmes provided to the unemployed, conditions with regard to activation policies. The results of this survey show that fundamental opposition to cross-border risk-sharing when unemployment hits is confined to a small segment of the European population, contrary to what one might think when listening to the political debate about this over the last 10 years. In all countries in our sample, there are potential majorities for specific policy packages that organise unemployment re-insurance. The conditions associated with these packages – conditions referring to the quality of the national programmes – are key to gather sufficient support (Vandembroucke et al. 2018, Burgoon et al. 2020).

## **The role of short-time work schemes**

Short-time work schemes provide a subsidy for temporary reductions in the number of hours worked in firms affected by temporary shocks; this allows employers who experience temporary drops in demand or production to reduce their employees' hours instead of laying them off. Employees receive from the government a subsidy proportional to the reduction in hours. Thus, deteriorating of work skills is mitigated, firing and future hiring costs are reduced, networks are kept alive, and so on. Giupponi and Landais (2020) explain convincingly why the sharp contraction caused by the public-health response to COVID-19 is a textbook case for the use of short-time work: in this context, short-time work can be much more effective than other forms of insurance such as unemployment insurance or universal transfers, and more efficient than other forms of wage subsidies. Moreover, the case for collective action at the EU level to support short-time work is very strong. Both reasons for collective action mentioned in the previous section apply (the fragility of a monetary union without fiscal stabilisers; and the positive externalities of adequate national unemployment benefit schemes, cf. the vaccination metaphor). The second argument even gains in force. Admittedly, in the context of normal business cycle movements, the actual empirical weight of the 'vaccination argument' might be questioned, since the cross-border externalities of adequate unemployment benefit schemes might be relatively limited. But when economic disruption destroys existing matches of human capital and supply chains on a large-scale in some national economies, the external impact on other national economies can be huge. Hence, 'vaccinating' national economies against such disruption is a matter of common concern for all economies in the Single Market.

For all these reasons, the Commission's current focus on short-time work and schemes that avoid lay-offs is well-taken. In fact, rather than an 'unemployment (re)insurance scheme', the proposal envisages, in its first-order effect, a 'job insurance scheme'. The distinction between an unemployment benefit scheme and such a job insurance scheme is meaningful, and the Commission might as well have labelled it as such. Nevertheless, it is likely to be true that if SURE helps lowering the number of actual unemployed, the national unemployment benefit schemes will cope better.

It is crucial that the Commission initiative promises a significant volume of support (€100 billion) – volume is key for stabilisation. It is equally important and positive that SURE will be based on Art 122 and funded as a European instrument. By not using the ESM, the Commission avoids interference with the (divisive) debate on whether or not the ESM should be the vehicle for European solidarity in the corona crisis. To ensure that sufficient finances are available even when all countries are hit at the same time, SURE will be able to borrow from financial markets; the underlying logic of SURE



is therefore close to the functioning of the original European Financial Stabilisation Mechanism (EFSM), but almost double the firepower (€100 billion versus €60 billion). Another interesting feature of SURE, is that it introduces intertemporal smoothing (cf. *supra*, the need to combine interregional and intertemporal smoothing).

Having identified a range of reasons to support the core features of SURE, one must also keep in mind some important caveats, next to the caveat on the actual volume that will be disbursed (cf. *supra*). First, the Commission proposes support in the form of loans to the member states that are in need. Support in the form of soft loans is better than no support, but without a broader EU initiative that avoids sharply increasing levels of public debt in countries like Italy and Spain, soft loans will do little to reduce the looming risk of debt unsustainability in those countries.

Second, Giupponi and Langlais also list a number of concrete guidelines for the best implementation of short-time work schemes in the current context. These guidelines are well-taken, but this list also signals a difficult policy trade-off for the European Commission. On the one hand, the current situation and the policy legacies in the member states are very heterogeneous, and there is no time to lose; hence, the Commission should not try to impose detailed conditions on how short-time is implemented. The Commission rightly allows a broad range of measures: SURE will cover “the costs directly related to the creation or extension of national short-time work schemes, and other similar measures they have put in place for the self-employed, as a response to the current crisis.” On the other hand, some guidance is indicated. As already said in the previous section: the quality of domestic policies and cross-border risk sharing should support each other. But, discussing and imposing relatively detailed conditions will imply delays, which one cannot afford in this emergency context.

Third, schemes that avoid lay-offs for a certain period of time cannot be the only solution in the domain of unemployment, as Giupponi and Langlais also underscore. Inevitably, workers are already and will be laid off: hence, in all member states, there should be sufficiently generous unemployment insurance for the laid-off and for those ineligible for short-time work. The number of unemployed is also bound to rise given the significant number of people with temporary contracts in many of the affected sectors: if these contracts are not renewed, people end up in unemployment without being dismissed either *de facto* or *de jure*. On a more general note, the lacunae in the coverage of self-employed workers and precarious workers in many member states underscore the urgent need to establish universal access to adequate social insurance, including unemployment insurance, to all workers in the EU, in whatever type of employment relationship, sector or activity they earn their living. This is one of the key principles of the European Pillar of Social Rights, which was proclaimed in 2017.

A (soft) Council Recommendation on access to social protection for all was agreed in 2019; its effective implementation is badly needed. Implementing this principle in all member states should feature prominently in a roadmap towards an effective euro area unemployment re-insurance scheme. Establishing SURE is an important step forward in the organisation of European solidarity, but it does not dispense us of making progress towards a fully-fledged European unemployment insurance scheme.

Fourth, whilst SURE will be operated on the basis of requests by member states and the disbursement of support will depend on bilateral agreements and discretionary decision-making in the Council, a European unemployment insurance scheme, for it to function effectively and to have impact on expectations, must be based on ex ante solidarity and entail as much automaticity as possible. In a sense, SURE can be seen as a complement to 'normal' unemployment insurance: it adds 'job insurance' in the context of a specific temporary emergency, created by a large-scale and exogenous disaster. So conceived, it might one day be a specific 'plug-in' to an encompassing European unemployment insurance scheme, ready to be installed immediately in the context of such exceptional emergencies.

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## 8 Immigrant key workers in Europe: The COVID-19 response that comes from abroad

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5 May 2020

*‘Key workers’ are performing these crucial tasks on the front line of Europe’s COVID-19 response. This column describes how migrant workers are playing a critical role in performing basic functions in EU societies hit by the COVID-19 epidemic. In addition, low-educated migrants, not just high-skilled ones, are employed in occupations that are key for their host societies, which suggests the need to reconsider, once the crisis has passed, a migration policy debate which is currently almost entirely focused on the importance of attracting high-skilled migrants to the EU.*

After announcing via Twitter his intention to temporarily halt immigration to the US in “light of the attack from the Invisible Enemy”, Donald Trump signed an executive order to pause the issuance of green cards for 60 days. At the same time, however, it was announced that the ban will not apply to farm workers, implicitly recognising that a crucial component of the COVID-19 response is coming from abroad. The value of migrant workers for the US emergency economy has been quantified in a recent note by the Migration Policy Institute (Gelatt 2020), which estimates that foreign born workers account for 19% of the US workers in frontline essential industries, while making up approximately 17% of the employed workforce.

In Europe, public policies affecting migration and the surrounding political discourse in the middle of the pandemic, have taken a different path. Italy, for instance, is currently discussing the possibility of granting an amnesty for undocumented immigrants, mixing the concern about labour shortages in the agricultural and personal care sectors with the willingness to provide these workers with some form of social and health protection. Portugal has announced that it will grant temporary residence permits to all asylum seekers who had their application still pending. And Sweden has announced a 12-month extension to several labour market integration programmes allowing migrants whose subsidies would expire in the near future to remain employed.

## **The COVID-19 response in Europe: Lockdowns and key workers**

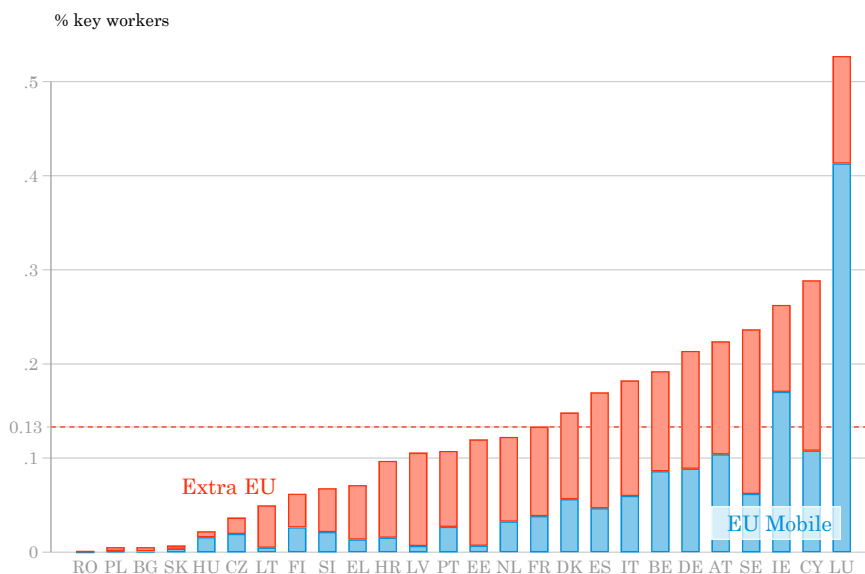
The rapid spread of the COVID-19 contagion has induced many EU member states to temporarily shut down large sections of their economies with the aim of slowing down the virus propagation rate and allowing national health systems to offer adequate care to all citizens seriously affected. While the forced shut down has confined large fractions of the workforce at home, some essential functions still need to be performed in order to keep European citizens healthy, safe and fed during the pandemic. ‘Key workers’ are performing these crucial tasks on the front line of Europe’s COVID-19 response. Understanding who these workers are and under which conditions they can effectively continue the provision of their essential services is a crucial element of any informed strategy to cope with the pandemic. A major concern here is whether ‘key workers’ belong to categories of individuals that may be particularly vulnerable during the crisis. The government-imposed heterogeneity in the lockdown across occupations and industries will obviously lead to differential impact of the recession on different groups of workers based on their pre-COVID-19 employment. In addition, we can expect economic impacts of the pandemic to further vary by age, gender, household structure, type of employment contract, firm size, etc. (Bell et al. 2020, Adams-Prassl et al. 2020, Hupkau and Petrongolo 2020). The nationality of workers is another important variable to take into account. Since immigrants are typically more exposed to economic downturns than natives (Dustmann et al. 2010), assessing their involvement in key occupations is the first step to conceive interventions that may reduce their vulnerability.

### **Immigrant key workers in Europe: How many and where?**

How many immigrants are employed in the occupations that have been identified as essential in the response to the COVID-19 pandemic in the EU? We address this question in joint work with Jacopo Mazza (J.R.C. European Commission) (Fasani and Mazza 2020). We base our analysis on the most recent wave (2018) of the EU Labour Force Survey (EU-LFS). We restrict our sample to employed workers in the 15 to 64 age bracket and distinguish two main groups of migrants (EU mobile and extra-EU citizens) based on their country of birth. Finally, we identify the list of key occupations by combining information from the European Commission and the Dutch government.

According to our definitions and estimates, approximately 31% of employed working-age individuals are key workers in the EU, although this share varies widely across Europe, from over 40% in Denmark and France to just above 10% in Bulgaria and Slovenia. On average, 13% of key workers are immigrants in the EU. Figure 1 shows wide variation across member states: The share of immigrant key workers is close to zero in Eastern European countries such as Romania, Bulgaria, Poland and Slovakia, while it fluctuates around 20% in countries such as Italy, Belgium, Germany, Sweden and Austria. The largest figures are observed in Ireland (26%), Cyprus (29%) and Luxembourg (53%). In most countries, the share of Extra-EU key workers is larger than the EU-mobile share.

**Figure 1** Share of Immigrants among key workers, by EU member state



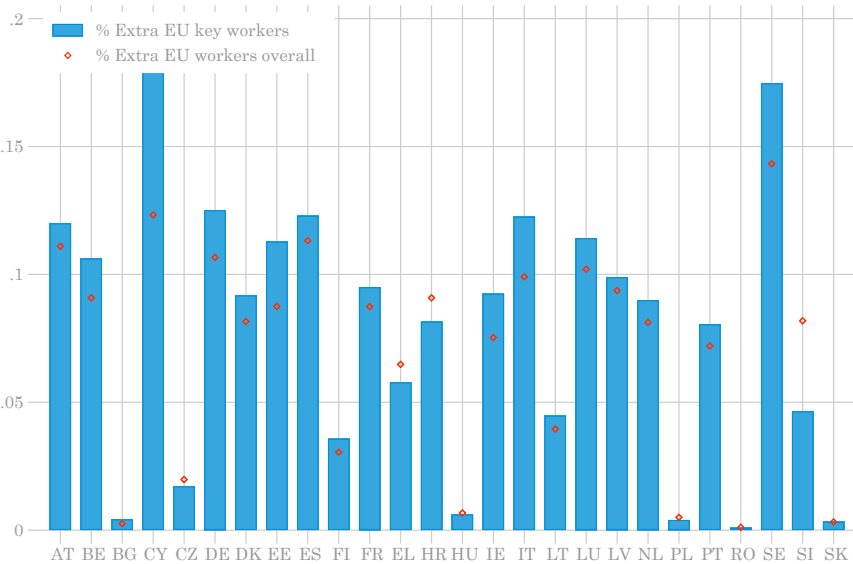
*Notes:* The bars report the percentage of immigrants over total key workers for each Member state. The red dotted line represents the average share of immigrant key workers across the EU (13%).

*Source:* EULFS (2018) data.

A substantial fraction of the variation we observe in Figure 1 is driven by differences in the overall share of migrants residing in each country. To take into account this aspect, in Figure 2 we compare the share of migrants among key workers (blue bars) to the share of migrants in the employed population (red dots). The figure refers exclusively to extra-EU citizens. The dots tend to lie below the bars, implying that extra-EU

workers are actually overrepresented among key workers relative to their prevalence in the general population of workers. The largest difference is observed in Cyprus (where extra-EU migrants account for 13% of total workers, but for almost 20% of key workers), but relatively large gaps are observed also in major immigration countries such as Germany, Italy and Sweden. Notably, Extra-EU workers are slightly underrepresented among key workers in just four member states (Czech Republic, Greece, Croatia and Slovenia), all of which are in Eastern Europe and have a relatively low share of migrants.

**Figure 2** Extra-EU citizens: Share of migrant key workers versus share of migrant workers, by EU member state



*Notes:* For each EU member state, the bars report the share of migrants among key workers and the dots the share of migrant among the overall employed population.

*Source:* EULFS (2018) data.

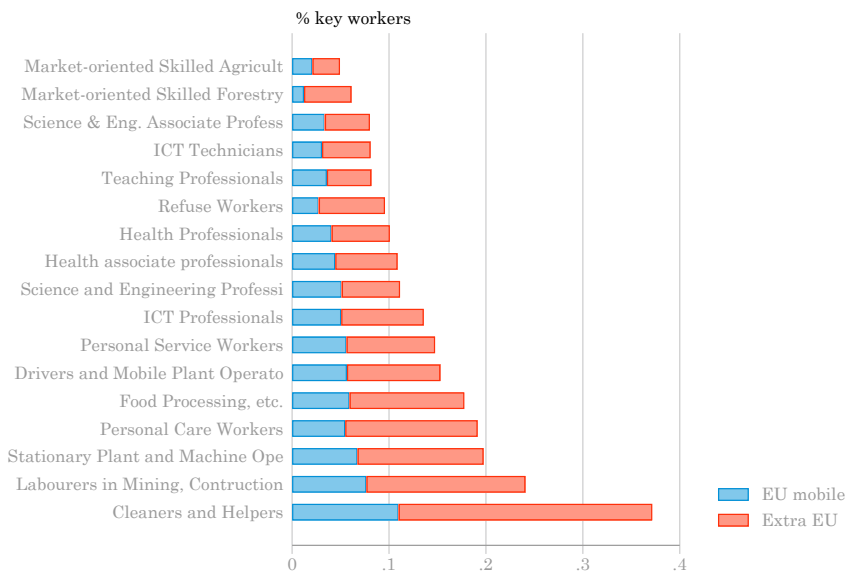
## Essential occupations and migrants

According to our definitions, the largest five categories of key workers in the EU are teaching professionals (14.5%), skilled agricultural workers (11.9%), science and engineering associate professionals (11.1%), personal care workers (10.3%) and cleaners and helpers (9.9%). Since natives are by far the most numerous group, their distribution



across key occupations closely resembles the overall distribution. Important differences are visible instead for the two migrant groups, who appear to be far more concentrated in low-skill occupations. Indeed, the first three key occupational categories for EU mobile workers are cleaners and helpers (20.9%), personal care workers (12.5%) and teaching professionals (11.1%). The top two occupations are the same for extra-EU workers – cleaners and helpers (27.8%) and personal care workers (16.6%) – while the third most frequent occupation is drivers and mobile plant operators (9%).

**Figure 3** Share of immigrants among key workers, by occupation



Notes: For each occupation, the bars report the percentage of immigrants over total key workers for each occupation.

Source: EULFS (2018) data.

Migrants’ skills and educational attainments – combined with existing hurdles to the recognition of foreign qualifications and to the access to certain professions in the EU – will determine how represented foreign-born workers are in each occupation. In most member states, EU-mobile key workers are predominantly middle or highly educated, while extra-EU key workers tend to have lower education (especially in countries such as Italy, Spain, Portugal and Greece). This is partly due to the original skill distribution of migrants in each country, as well as to the process of selection of individuals into migration. If we consider the concentration of migrants in key occupations by educational level (low, middle, high), we see that, irrespective of their level of education,

EU-mobile workers' concentration in key occupations closely follows that of the native population. The overrepresentation of extra-EU workers in key occupations is driven by a strong overrepresentation of low educated migrants.

Finally, in Figure 3 we consider the entire EU area and report the share of foreign-born key workers by occupation. The figure clearly shows how heavily some key occupations rely on migrant workers. While foreign-born workers account for 13% of key workers in the EU (see Figure 1), in many key occupations we observe shares that are substantially higher. For example, more than a third of cleaners and helpers, more than a quarter of labourers in mining and construction sectors, stationary plant and machine operators and one in five workers in food processing are migrants. Extra-EU citizens alone account for more than 25% of cleaners and helpers, 17% of mining and construction workers and 14% of personal care workers.

## Conclusions

There are two major lessons for policymaking arising from this evidence. First, migrant workers are playing a critical role in performing basic functions in EU societies hit by the COVID-19 epidemic. This calls for interventions in the short run that may allow foreign-born workers to better cope with the crisis and keep contributing to its solution. Second, low-educated migrants – and not just high-skilled ones – are employed in occupations that are key for hosting societies. This latter fact suggests the need for reconsidering – in the aftermath of the pandemic crisis – a migration policy debate which is currently almost entirely focused on the importance of attracting high skilled migrants to the EU.

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# 9 EU state aid policies in the time of COVID-19

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18 April 2020

*State aid is essential to reduce long-run harm to the EU economy as a result of the Covid-19 crisis. However, non-harmonised programmes across EU member states generate serious risks to the functioning of markets, particularly if they go beyond short-term liquidity provision or employment support. This column suggests imposing strict conditions on state aid for recapitalisation of firms and argues in favour of an EU-wide programme for critical sectors. Such a programme would prevent harmful market distortions and maintain a level playing field for EU companies.*

In recent days, a lot of media attention has been devoted to the different instruments that may allow EU member states – and in particular those most affected by the coronavirus outbreak – to raise funds for the economic policy response to the crisis (e.g. Galí 2020).

The crucial issue is how to use such funds – however they are raised – to provide support to European businesses. We focus here on the severe distortionary risks created by state aid policies which are heterogeneous across EU member states.

State aid to firms should be used only when there are market failures. That is, when there are good reasons to believe that the market would not result in efficient and/or equitable outcomes. It should also be effective, and proportional to the aims it intends to achieve. In the EU context, there is also the risk that public support for national companies creates trade and competition distortions within the internal market, and for this reason the European Commission has been given powers to control state aid.

In the current situation, markets have disappeared on a daily basis, and in most sectors firms' assets are rapidly depleting, thereby further undermining their ability to obtain funding. Thus, there are no doubts that state aid is necessary to avoid long-run consequences for European firms, workers, and their human capital.

In line with this, the European Commission adopted a ‘Temporary Framework’ to state aid schemes aimed at ensuring firms’ access to liquidity and finance, and at preserving employment (European Commission 2020a,2020b). This framework already provides some limiting principles, establishing the temporary nature of such public interventions, and to favour their effectiveness and their incentivising nature. For instance, firms which were already in difficulty by 31 December 2019, and hence before the crisis, cannot have access to most measures. Credit guarantees for loans beyond €800,000 cannot apply to more than 90% of the loan; the loan principal should normally not go beyond certain amounts (25% of yearly turnover, or twice the yearly wage bill). Lastly, wage subsidies given to workers which would have otherwise been laid off because of the crisis should not exceed 80% of the monthly gross salary.

While such state aid in support of liquidity is certainly justified, we note that not all member states will be able to provide the same level of support to their firms, creating the risk of market distortions. Although we understand this option is not feasible at the moment, it would have been much better if such liquidity interventions had been offered by an EU-wide fund, so as to maintain the level playing field among EU companies.

The European Commission is now considering the extension of the state aid temporary framework well beyond liquidity support and employment preservation, so as to include the recapitalisation of businesses (European Commission 2020c). In some circumstances, short-run liquidity support may not be enough, and lack of finance may have long-run consequences. For example, a firm which just about keeps up with its payment obligations may have to abandon or postpone investment and innovation plans. To the extent that such plans meet important EU policy objectives – for instance in energy transition and digital agenda – aid which allows to roll them out may exceptionally be allowed.

There are several risks if public money is used well beyond providing firms with liquidity and helping them to maintain their human capital intact. In particular, there are the risks of tilting the level playing field and of a ‘domino effect’. If only some firms in a given industry are eligible for aid, while others are not – something inevitable when aid is provided by some countries and not by others (for instance because only some member states can afford such aid, or because different states support different industries) – competition will be necessarily distorted. A firm that is generously funded by its home country becomes artificially more competitive, to the detriment of other equally or more efficient rival companies. As a result, the latter may be relegated to niche markets, or even forced out of business. Or, to the extent that some of these rivals come from a home country which can afford offering state aid as well, a subsidy race among member states may be triggered, with significant waste of public money.

A truly EU public support programme would not suffer from these risks, since funding decisions would be made at a European level, based on commonly agreed goals. In addition, all companies operating in a sector covered by such a programme could be beneficiaries, independently of the country they originate from. It goes without saying that an EU programme should also be well targeted and take into account that market conditions after the crisis may be different than before it.

Absent a programme at the EU level, distortions are hard to avoid. The European Commission should then limit state aid schemes which go beyond liquidity and employment support as much as possible and impose stringent conditions onto them. In our view, firms which receive state aid must have constraints on their managerial remuneration, must not distribute dividends, and should not engage in mergers and acquisitions.

If recapitalisation takes the form of partial state ownership, this should be temporary, and fully repaid after a period of at most, say, two years. Shares should be assessed at the market valuation after the crisis has hit but before the rumour of state aid support has spread. The longer the participation of the state, the bigger should be the dilution for current shareholders. If a hybrid instrument allowing converting debt into equity was the chosen form of state support, similar principles should apply.

Further, and importantly, a credible restructuring plan should be approved before any such recapitalisation, also to avoid that public money goes into firms and industries which are unlikely to be viable in the long run. After the crisis, market conditions will not return to the ex-ante status quo in many industries, including transportation and tourism.

On 27 March, the German Parliament enacted a law that allows partial state ownership as part of its state aid programme. The press has reported that the German government expects hundreds of companies to seek such support. In other countries, governments are also envisaging public recapitalisation of firms (e.g. in support of airlines). And we should not forget that even before the coronavirus outbreak, several member states had called for a relaxation of EU antitrust and state aid rules so as to foster national champions.

If these developments are not discouraged, we shall see an unprecedented volume of state aid which is likely to disrupt the internal market with dramatic long-run consequences.

The founders of the EU understood very clearly that the internal market should be protected from member states favouring their own companies. The Treaty introduced provisions to this effect, and awarded the European Commission the task of state aid control. Now it is the time for the Commission to raise its guard, and make sure that those principles are fully respected.

As believers in the European project, we argue in favour of a well-funded EU aid programme backed by EU money. Such a programme should pay particular attention to sectors such as energy and mobility that are of European importance and faced important structural changes even before the current crisis. Notwithstanding the legal constraints to raise European debt, this is the right time to push for such a proposal (Benassy-Quere et al. 2020). A key advantage of an EU programme over national ones backed by so-called Eurobonds is that the former would avoid the moral hazard problems some fear in the latter case, and may therefore receive wider support among member states.

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# 10 The EU recovery fund: An opportunity for change

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30 April 2020

*The European Commission has been asked to develop a proposal for a new recovery fund of more than €1 trillion. Given the substantial support needed by most sectors in the present circumstances, it is crucial to identify the ones which are most important to proper functioning of the EU economies. Based on the principle of subsidiarity, this column formulates two general criteria to identify these sectors: those for which (i) the volume of cross-border trade within the EU is large, or (ii) externalities across member states are important. Support schemes should be oriented towards the future and not try to preserve the status quo ante.*

The EU has been criticized for not reacting quickly enough to the COVID-19 crisis and for providing neither a vision nor instruments to deal with its economic impact. Short term emergency funding has so far been mostly provided through aid programmes by the individual member states.

However, on 23 April 2020, the European Council agreed in principle on a “Roadmap to Recovery” and on establishing a new fund with the volume of more than €1 trillion to help overcome the severe economic crisis that the EU – as well as most of the world – has entered. The European Commission has been asked to develop a proposal for how to use this recovery fund. We see a unique opportunity to develop a truly European programme that helps restructure the EU economy. The recovery fund may be instrumental for the economy to recover, but this requires new directions and bold restructuring instead of preserving the old economic landscape.

We see this funding proposal as complementary to other proposals aimed at reducing short-term pain and massive immediate firm closures, especially in those countries hit hard by the crisis and in a poor fiscal position (see, in particular, Bénassy-Quéré et al. 2020a, Grund et al. 2020, Lamadrid and Buendía 2020). The general argument why governments should intervene and avoid massive firm closures is laid out in Didier et

al. (2020). Boot et al. (2020) make a proposal for how the EU can channel funding to firms in distress because of the COVID-19 crisis. Here, we focus on the purpose of the recovery fund that goes beyond the short term (see also Bénassy-Quéré et al. 2020b).

## **Why an EU programme for certain sectors instead of aid by individual member states?**

Allocation of competences between the EU and the member states is defined by the principle of subsidiarity. When aid to particular sectors is at issue, there are two circumstances under which responsibility should be at the EU level. First, when there are affected sectors whose volume of EU trade is such that the scope of the market is truly European. This includes products such as cars as well as services such as flights. Second, when there are externalities across member states, so that a national programme would not fully internalize the benefits that would arise at the EU level. This includes security of supply, infrastructure relevant for cross-border trade, and environmental issues which spill over national borders.

An EU programme is likely to reduce competition distortions and domino effects by which member states escalate the support for their home industries when the respective sector features cross-border trade within the EU. We elaborated on this reason in our VoxEU column published on 18 April (Motta and Peitz 2020). If member states support individual companies, there exists the risk of distorting competition, even though such aid requires the approval by the European Commission. Since some member states have already approved national support schemes for specific companies (e.g. for airlines), a European programme for the respective sector can mitigate this risk.

The airline industry is a case in point. France and the Netherlands have already announced measures of recapitalisation in support of AirFrance/KLM (which already benefit of liquidity and employment support measures available to all companies). Lufthansa and its subsidiaries are in talks about state support with the governments of Germany, Austria, Belgium, and Switzerland. Such measures will distort competition to the detriment of other EU airlines, and may push other member states to support national airlines. We find it difficult to understand what is the rationale for state intervention into this industry that goes beyond short-term liquidity support. For example, why do Italian governments continue to support Alitalia, which was losing up to €2 million a day well before the COVID-19 crisis, to provide a service that private airlines could offer more efficiently? If any support should be given to this industry, then it would be desirable for the European Commission to put forward a restructuring and support plan for the airline industry that is compatible with the EU's climate policy objectives, avoids competition concerns, and thus aligns the support programme with other policy

goals. This plan would need to account for the fact that the industry outlook will likely be different after the crisis, as tourism may take time to pick up, but above all because physical meetings are likely to be replaced by virtual meetings and thus reduce the volume of business travels. A restructuring of the airline industry should go hand-in-hand with a commitment to introduce a kerosene tax at the EU level.

The automotive industry is another case in point. Germany, Spain, France, and Italy have a significant automotive industry (but also smaller countries such as the Czech Republic and Slovakia). A rule-based European solution here would hopefully prevent national go-it-alones and an escalation of aid. It should also make support contingent on fulfilling EU-wide objectives such as climate policy, as we argue below.

Whatever sectors are selected for aid, an advantage of an EU-wide system compared to national programmes is that all firms in that particular sector would be eligible for aid, which would eliminate a source of distortion, namely, that only firms from some member states may receive aid within the sector.

One of the advantages of the Commission playing a central role in designing a European aid programme is that it would reduce horse-trading between member states. To some extent, our trust in the Commission also comes from the fact that over the years the Commission has (in general) been able to resist the recurrent pressure to relax state aid control and to include exceptions to competition (e.g. in merger control) for many sectors.

Apart from competition policy reasons we can also think of other policy objectives that are linked to EU-wide goals of society and may justify a leadership role by the European Commission. Individual member states may not have the resources or, because of cross-country externalities, may not be willing to provide sufficient resources to pursue objectives such as climate and digital ones, or resilience in times of crisis, which generate benefits in other member states (see also Bénassy-Quéré et al. 2020b).

### **What should be guiding principles and what pitfalls are to be avoided? And how can this funding be used to make Europe a better place in the future?**

While the recovery fund's €1 trillion is a large sum, neither would it be sufficient to cover all the claimed needs by so many firms in so many industries, nor would it be desirable to develop specific support schemes for all the sectors of the economy.

Under the EU umbrella, several sector programmes can be launched after consultations to ensure different preferences of individual member states are voiced. It is also important for the countries without a significant domestic industry in the respective sector to take part in the consultations since they might also suffer from distortions of competition, and would, therefore, be interested in avoiding them.

Criteria for support should be well thought: assigning it to firms and industries on a first-come-first-serve basis, or according to the strongest lobbying power, or proportionally to the pre-crisis turnover would certainly not be a good idea. When setting up support schemes, the Commission should identify core competences and infrastructures that should be improved and identify sectors that are of EU-wide importance in this respect. Focusing programmes on specific societal goals and identifying relevant sectors, will ensure that the possibilities for horse-trading in such transfer programmes is limited.

The Commission should use aid programmes to help make the EU fit for the future. The fund should be forward-looking, and not aimed at restoring the pre-crisis status quo. It is an opportunity to improve our economy and achieve long-run EU objectives. We should not miss it.

Concretely, if, for instance, support programmes for the car industry are envisioned, they should be based on climate objectives. For example, transfers for R&D in emission-free vehicles could be part of the funding programme.

Funding programmes should go beyond funding only those industries in which selective funding by some countries would distort competition. Physical and digital infrastructure build-up could also be part of a funding proposal because of cross-border externalities.

Another dimension for funding programmes would be resilience regarding certain supply chain disruptions in the global supply chain outside the EU and demand shocks within the EU. Since private companies have little incentives to build up capacities that will only be used in unlikely events, there may be a need for government-sponsored markets for reserve capacities (as is already done in energy markets). This may take the form of a government paying for the option to procure certain products at specified terms, whereby the party signing such a procurement contract has to regularly prove that it is able to deliver as agreed in case an emergency arises. This applies in particular, to parts of the pharmaceutical and medical equipment sectors. Such a EU-wide programme is essential to be able to respond when the EU at large faces a shock to security or health.

Infrastructure needs may be interpreted broadly. Thus, it is conceivable to have an EU programme that supports firms in the arts and culture. Such cultural offers can be considered essential for the social fabric of Europe.

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# 11 Green bridges: Reconnecting Europe to avoid economic disaster

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**Bary Pradelski and Miquel Oliu-Barton**

CNRS, Oxford-Man Institute; Paris-Dauphine University - PSL Research University

30 April 2020

*The tourism industry has already been heavily impacted by the Covid-19 pandemic, and a ‘cancellation’ of the summer season would further push many European countries towards an unprecedented economic crisis. This column proposes to elevate the authors’ recently proposed zoning approach to the pan-European level. Allowing ‘green bridges’ to exist between regions where the virus is under control – regardless of whether the latter are in the same country – could help save the tourism sector, the economic viability of several European countries, and probably also the balance within the European Union.*

The tourism industry has already been heavily impacted by the Covid-19 pandemic, and a literal cancellation of the summer season would further push many European countries towards an unprecedented economic crisis. As most countries are still struggling to contain the virus, as well as with their respective exit strategies, we are heading towards a summer during which international travel might be, if not forbidden, highly discouraged. Such travel restrictions will additionally damage the already weakened economies of Europe’s southern countries, such as Croatia, Spain, or Italy, because they rely on tourism more heavily than the northern countries. Beyond the direct effects on their GDP, this could also serve to weaken the balance within the EU and endanger its future.

How to exit from the Covid-19 lockdown measures is the most pressing question on the policy agendas of all major European countries. France, Italy, and Spain have already announced a regional approach whereby policies may vary from one territory to another, depending on their current situation with respect to Covid-19. Their exit strategy relies on disconnecting regions by forbidding unnecessary travel between them. This approach – which, in France and Spain was partly based on our proposal (Oliu-Barton et al. 2020) – labels each region as either red (virus not under control) or

green (virus under control) in order to (1) avoid the spread of the virus throughout the territory, and (2) allow economic activity to restart on a more local level as soon as it is safe to do so (Philippe 2020, Government of Spain 2020). In addition, some European countries have started to discuss bilateral corridors to allow for limited tourist travel between two countries during the holiday season (Harper 2020).

We propose that the zoning approach is elevated to the pan-European level. Suppose, for example, that Bavaria, a German state, and Crete, a Greek island, are deemed safe (i.e. that they receive the green label from a common EU authority). We argue that it is safe to travel between two such green zones, just as it is safe to travel between two green zones in the same country. Allowing ‘bridges’ to exist between green zones (or regions), regardless of whether the zones are in the same country, may help save the tourism sector and, most likely, the wider economic viability of several European countries.

## **Pan-European green-bridging**

Building on our work in Oliu-Barton et al. (2020b), we propose the following strategy which should be orchestrated on the European level:

1. Divide each country into geographic areas (e.g. regions, provinces, or departments).
2. Label each of these areas as either red or green depending on whether the virus is under control or not.
3. Gradually add ‘green bridges’ between pairs of green areas so that travelling between them would be allowed.

Our proposed strategy has the following sanitary, economic, and political advantages:

### Controlling the virus

By differentiating between red and green zones, the spread of the virus across the entire territory is minimised. This is the case because travel to and from red zones would be limited to necessary travel only – such as that by key workers – and rigid testing routines would be implemented at borders between red and green zones.

### Reducing the economic burden

We focus on the tourism sector as it likely would benefit the most from green bridging. It is the largest sector in several European countries, accounting for 26% of employment and 25-30% of GDP in Greece, 13% of employment and more than 20% of GDP in Croatia, and 11% of employment and 14% of GDP in Spain. Furthermore, tourism

activity is highest over summer months, which are upcoming – the intra-EU inbound tourism trips from June to October account for 79% of the annual flow in Croatia, 78% in Greece, and 60% in Italy (Eurostat 2019). Consequently, enabling pan-European tourism over the summer months is probably the single most important determinant for the economic survival of several European countries. In addition, Baldwin and Evenett (2020) argue that insular policies will fail to foster economic recovery across sectors. Finally, returning to a more regional scale, we note that tourism accounts for 47% of Crete’s economy and 45% of the Spanish island of Mallorca’s economy.<sup>1</sup> This highlights the importance of green-bridging between regions.

### Fostering community and the European identity

Giving the opportunity for regions to ‘determine their own fortunes’ would create a stronger incentive for communities to follow regulations and actively contribute to the control of the Covid-19 outbreak. Nationalistic considerations thus become less important and people’s identification with the European project has the potential to increase, as green bridges are built between regions irrespective of which country they belong to.

## **The role of the European Union**

The role of the EU during the Covid-19 pandemic has repeatedly been questioned as a result of slow reactions and little coordination in the early stage of the outbreak (Georgiou 2020). By showing definitive leadership, the European Commission should rise to this opportunity. Its action could define the future of several European countries and prevent the entire European project from failing. Our ‘green-zoning’ approach can only be orchestrated on a pan-European level. This is not a slogan but an important legal predicament because it entitles the Commission to take action under the Treaty of the European Union, Article 5 §3:

Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

1 Employment data from Eurostat (2019). GDP data for direct and indirect contribution to tourism from Ikkos and Koutsos (2019) for Greece, (Orsini and Ostojic (2018) for Croatia, and WTTC (2019) for Spain.



With this competence, the Commission should lead the implementation of steps 1–3 outlined above. In particular, we foresee the importance of:

- **Zoning.** The delimitation of the zones should not pose a major political obstacle because our approach builds on divisions that have already been implemented in several European countries, including France, Italy, and Spain.
- **Testing.** To ensure a consistent implementation of the red and green labelling, a workforce attached to the European Commission should execute independent testing. In particular, this independent testing should focus on areas that have recently applied for a green label and special effort should be put into areas that heavily rely on summer tourism.
- **Green labels.** Green labels must be administered by a common EU authority in order to ensure that the meaning of this label does not vary from country to country. Otherwise, an imbalance in health risks and economic benefits may arise.
- **Green bridges.** To maximise the economic impact while also distributing benefits between different countries and regions, the allocation of bridges needs to be led by the Commission.

## **A prosperous future in a unified Europe**

In summary, we believe that the green-zoning approach – which has already been implemented at the sovereign level by many European countries – could reap even greater benefits when used on a pan-European scale. By focusing on the tourism industry, we outline the importance of elevating the exit strategy from the Covid-19 pandemic to the European level. We firmly believe that pan-European green-zoning is a unique opportunity for the EU to show its strength by creating a win-win situation for all countries and not allowing the summer season to fall victim to the Covid-19 pandemic.

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# 12 European bank regulators aren't yet doing what it takes

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**Ignazio Angeloni**

Harvard Kennedy School

24 March 2020

*Banks are the key to providing financial oxygen to the economy, but the coronavirus pandemic is raising the risk that banks in the euro area will cease to function. This column argues that the return to normality we all crave requires, among other things, that banks be saved, and that this will not happen unless regulation is adapted and more public support is provided.*

One after another, all the long-held tenets and taboos of Europe's postwar rule-based liberal order seem to be falling away. National borders close. Personal liberties are curtailed. Governments rule by decree, while deserted parliaments hastily rubber stamp. Fiscal limits are overstepped; barely noticed, days ago, were the suspension of the EU stability pact and the approval of a jumbo budget deficit plan by Germany.<sup>1</sup> The ECB has launched a massive monetary attack<sup>2</sup> using all its instruments, and made no secret of its readiness to trespass its hitherto 'red lines' in terms of which and how many assets it can buy.

This is exactly what should happen. Against a fearsome and unknown enemy, the sensible strategy is to overwhelm by speed and size. This applies to the health and the economic areas alike. "Whatever it takes" in present circumstances means "More than you consider sufficient". Acting quickly and big<sup>3</sup> is of the essence.

The only exception to the prevailing war-like approach at the moment is banking regulation. This is surprising: it should be well understood that banks are the key to providing financial oxygen to the economy. Even the ECB's big bazooka cannot work fully if banks cease to function or, heaven forbid, go bankrupt on a massive scale. Yet this is precisely the risk the euro area faces, if a real economy in freefall – at it will

1 <https://www.ft.com/content/dacd2ac6-6b5f-11ea-89df-41bea055720b>

2 <https://www.ft.com/content/711c5df2-695e-11ea-800d-da70cff6e4d3>

3 <https://www.ft.com/content/bc1cd972-6a8e-11ea-a3c9-1fe6fedeca75>

surely be at least for several months – results in a surge of credit defaults and massive losses on market exposures. The latter have already occurred; the former is a virtual certainty.

Regulators – the EU, national governments, law-makers and supervisors – must act decisively and urgently to block this doom scenario. Following a logic applied in other areas – from labour markets<sup>4</sup> to corporate subsidies<sup>5</sup> – the goal should be to ensure that banks overcome the critical phase as unharmed as possible. For that purpose, normal prudential rules should not apply to the effects of the virus on their balance sheets. Such effects should instead be neutralised by public support – capital injections, guarantees, and for what is left, supervisory forbearance. The attack needs conducting on three fronts: bank assets, bank liabilities, and bank governance.

On the asset side, ECB supervisors<sup>6</sup> have promised “to allow banks to fully benefit from guarantees and moratoriums put in place by public authorities”. This commendable intention, however, leaves the ball in the hand of national authorities, not all of which are willing or able to play their part. The Italian budget package approved last week, dubbed “cura Italia” (“cure Italy”), contains no mention of such guarantees; it concentrates – understandably given local conditions – on supporting families and the health and other priority sector. On the contrary, the German plan earmarks €400 billion for corporate loan guarantees. As currently set, the combination of conditional forbearance by the ECB and wide differences across borders risks increasing bank fragmentation and penalise ‘southern front’ countries which are hit hardest by the virus.

Protecting the liability side requires propping up both funding and capital. The actions undertaken by the ECB through its long-term (LTRO) and conditional (TLTRO) open market operations aim at keeping funding sources open. Their effect, however, depend on banks having enough ‘adequate’ collateral – a requirement set in the Treaty. The availability of such collateral is likely to be highly asymmetric, exacerbating the aforementioned fragmentation. Capital is also likely to become a constraint. ECB supervisors have pledged<sup>7</sup> leniency in administering their Pillar 2 Guidance, but P2G is only a small fraction<sup>8</sup> of the overall capital requirement. European law contains no escape clauses to reduce capital obligations in emergencies or downturn. The only flexibility lies in the so-called macroprudential buffers, which unfortunately were raised little during the preceding cyclical upturn. At the present juncture, the much-needed capital flexibility can only come either from a suspension or deferment of existing legal capital

4 <https://www.ft.com/content/927794b2-6b70-11ea-89df-41bea055720b>

5 <https://www.bloomberg.com/news/articles/2020-03-23/germany-approves-800-billion-package-to-counter-virus-impact>

6 <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html>

7 <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html>

8 <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200128~20e2703d8e.en.html>

requirements, or from injections of capital by the public sector, banned under EU state aid rules. Commissioner Vestager published on 17 March a “temporary framework”<sup>9</sup> containing a number of virus-related relief measures, but not this possibility.

Suspension of prudential norms, asset guarantees, public ownership – all needed under present circumstances – would bring the euro area’s banking framework close to wartime conditions for a limited but indefinite period. Restrictions in certain bank managerial decisions would be inevitable, first and foremost in the distribution of bonuses and dividends,<sup>10</sup> as recommended by the Systemic Risk Council.<sup>11</sup> Interference in other areas on a temporary basis may also ensue. While free market diehards may turn up their nose, this is probably a lesser evil. The return to normality we all crave requires, among other things, that banks be saved. They will not unless regulation is adapted and more public support is provided.

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<sup>9</sup> [https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT\\_20\\_479](https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_20_479)

<sup>10</sup> <https://www.ft.com/content/ed87b5d6-6a8e-11ea-af6ac-9122541af204>

<sup>11</sup> <https://www.systemicriskcouncil.org/>

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# 13 The coronavirus shock to financial stability

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**Enrico Perotti**

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27 March 2020

*Years of quantitative easing by the ECB have suppressed sovereign yields to historic lows. This has contributed to a shadow banking boom, as market participants invested heavily in various private asset constructions. This column argues that the coronavirus shock poses a serious liquidity risk for the shadow banking sector, where significant funding has been extended on the basis of cash flow rather than real collateral. Avoiding financial panic is key, and will require liquidity support as well as targeted fiscal measures.*

The coronavirus pandemic will cost many lives. It will not wipe out the population, but it will make us wiser and poorer. In the medium term, economic activity will resume, albeit with some major impact on our wealth, work, and social habits.

In the short term, widespread lockdowns have hit the world economy during a phase of economic and financial stagnation. Unlike a financial crisis, this is a real shock that reduces production and income, affects both demand and supply, and disrupts value chains. Avoiding a rapid contraction thus requires broadly targeted fiscal measures (Baldwin and Weder di Mauro 2020), such as tax postponement or direct income support, perhaps via ‘helicopter money’ (Galí 2020, Turner 2020).<sup>1</sup>

A key question is whether and where a financial panic may strike. If this were to happen, the coronavirus shock would imply a quick and sharp recession.

The immediate effect would be a sudden repricing of financial and real assets, together with a heavy withdrawal of liquid reserves by household and firms. A short-lived reduction in savings is not alarming per se. Withdrawals made to fund spending are largely redeposited in other banks, and central banks can redistribute liquidity across the regulated banking sector. Due to the Basel III framework, at a time when everyone

<sup>1</sup> A distribution targeting immediate needs may be coupled with restatements or suspension of fixed rent and mortgage obligations, as in the statutory elimination of the Gold Clause in debt contracts during the Great Depression.

seeks safety there should be no immediate risk for banks and sovereign bonds, provided the more vulnerable cracks in the euro area are protected with a collective backup mechanism.<sup>2</sup> Banks will suffer credit losses, but there is no indication of panic at the moment. However, their fate will depend on the timely resolution of the crisis, since a default wave is likely to occur.

Our claim is that the immediate risk for financial stability is illiquidity, rather than insolvency.

### **What stability risks may lie ahead?**

So, what stability risks may lie ahead, given the state of the financial system before the shock?

The major risk is a systemic illiquidity shock on shadow bank constructions that proliferated during quantitative easing, as Figure 1 shows. How serious is this risk?

Figure 1 shows massive outflows of bond funds in response to the coronavirus shock.

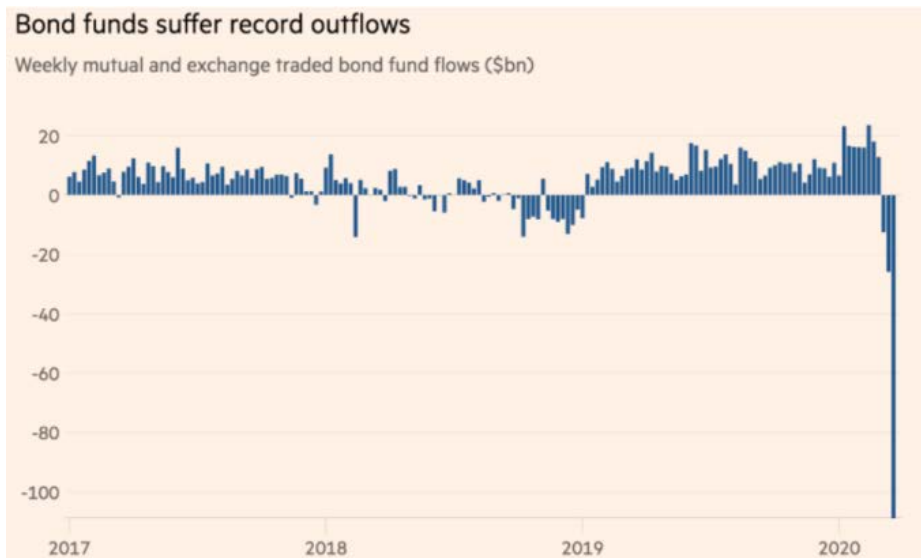
Is the panic justified? What type of debt has been funded by these shadow banks? A broader perspective can help answer these questions.

First, it is useful to consider the effects of ECB policies. For mainly political reasons, ECB bond buying has targeted many 'super safe' assets, compressing sovereign yields at the EU core. This 'risk channel' of monetary policy boosted demand for private 'safe asset' constructions such as bonds and ETF mutual funds. Such shadow banks can no longer promise the safety of principal, but they do promise immediacy. As they have no central bank or fiscal backing, they rely heavily on market liquidity to support their promises.

This is a classic profile of any shadow banking boom. A pattern of increasing liquidity mismatch is common in phases of abundant savings in excess of investment opportunities, often defined by falling interest rates.

2 Funding a joint EU response to the coronavirus crisis directed at firms and households may require a major ESM bond issuance, which would also ensure an adequate supply of euro safe assets at a critical juncture.

**Figure 1** Bond mutual fund outflows



Source: Financial Times

There is a risk that many investors in bond funds were mainly seeking a bit of yield with moderate risk, reassured by the right of immediate redemption and the assumption of limited downside risk for bonds. Once individuals and professional investors consider withdrawing from these funds, market liquidity will be tested. A key question is how risk-intolerant these shadow bank investors may be once mutual share prices drop fast. Already at present, even after large price corrections, many fund shares trade at a large discount to net asset value.

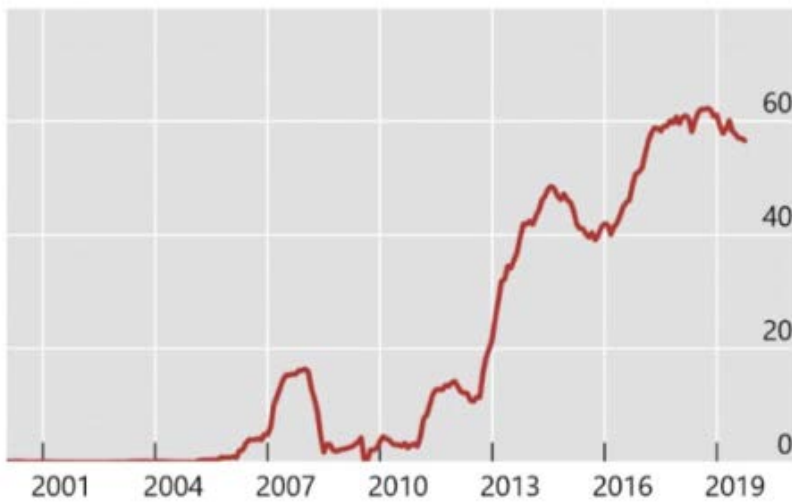
Regulatory reform for mutual funds has lagged the Basel process, under the view that investors were aware they were acquiring risky assets with no principal guarantee. Last year, Bank of England Governor Mark Carney advocated for measures to realign fund redemption terms with their actual asset liquidity. The preparedness of these investors for a liquidity shock is soon to be tested.



## How large is the illiquidity risk for these assets?

Because of a steady decline in demand for credit by healthy firms, and a massive shift to intangible assets, banks responded to demand for highly leveraged transactions in the syndicated loan market. Most syndicated loans have been repackaged as collateralised loan obligations (CLOs). While the senior tranche of this securitisation is smaller than the asset-backed securitisation 15 years ago, these loans are extended on the basis of cash flow rather than real collateral.

**Figure 2** Global covenant-light share of debt issuance

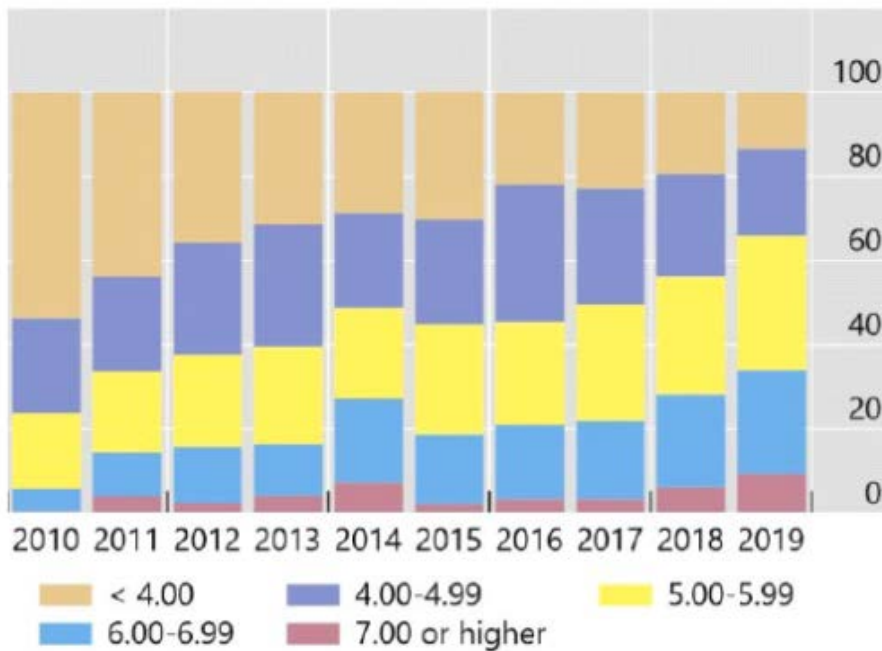


12-month rolling average 2000-2019  
Source: FSB

The Financial Stability Board has become alert to the rising risk associated with the rapid expansion of CLOs (see Figure 2), issuing a report assessing the associated financial stability risks (Financial Stability Board 2019).

Disturbingly, studies from legal and financial scholars have reported an alarming decline in the quality of debt coverage covenants, now relying on weaker notions of earnings in violation of proper accounting standards (Badawi and de Fontenay 2019). In a sharp recession, such unsecured loans are potentially exposed to much larger losses than the historical average.

**Figure 3** Falling lending standards: Debt-to-EBITDA ratios



Are these concerns excessive? What about market discipline in pricing debt? Dispersed market participants have historically relied on banks as gatekeepers of bond issuance, establishing covenants to control leverage and risk. Unfortunately, a long period of few good lending opportunities and low rates has tempted banks to satisfy demand for highly leveraged loans by private equity, often by funding buyouts and equity payouts in sunset industries rather than new investments (see Figure 3). These bonds are protected only by current cash flows, which will be hit very hard by the coronavirus shock.

Recent evidence suggests that the issuance of covenant-lite bonds, their securitization into CLOs, and the emergence of CLO-related structured products appears to be a response to high inflows into mutual funds, who are also the main investors (Becker and Ivashina 2016). In a sharp recession, these bondholders will be left as sitting ducks.

Academic research has shown how bond investors are often oblivious to rising risks at times of abundant funding (López-Salido et al. 2017). This was also highlighted by Jeremy Stein, a leading Harvard professor and ex-Fed board member, at the recent ECB Macprudential Policy Conference.

## Concluding remarks

In conclusion, if redemptions accelerate, bond illiquidity may soon prove to be extreme. The downside risks have been increasing markedly in recent years, and investors have little insight on potential losses on covenant-lite unsecured loans which private equity funds used to extract equity while often retaining secured rights on real assets.

The rapid recession caused by the coronavirus shock will be a major test of these choices. A final question concerns the amount of retained CLO tranches on bank balance sheets.

Mutual funds cannot default by design, but once redemptions pass a certain level, they may be forced into liquidation or seek close fund status, producing massive shocks to confidence for both liquidity and safety. While central banks will be under pressure by demands for liquidity support, the top policy priority should be given to real and diffused needs.

A final word is that caution is needed in the ongoing EU bankruptcy reform plans, originally aimed at harmonisation while potentially allowing weaker protection of unsecured debt. History teaches us that poorly designed bankruptcy reform always creates new financial stability risks.

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# 14 IFRS 9 and COVID-19: Delay and freeze the transitional arrangements clock

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**Jorge Abad and Javier Suarez**

CEMFI; CEMFI and CEPR

2 April 2020

*Incurring loss provisioning is due to be replaced by expected loss provisioning in many countries around the world, because it was perceived to increase procyclicality. This column quantifies, under alternative provisioning standards, the impact of the arrival of an average recession on a bank portfolio of European corporate loans. It argues that expected loss provisioning may in fact worsen procyclicality, and policymakers should, therefore, delay and freeze the transitional arrangements currently in place for the duration of the COVID-19 crisis.*

Provisioning standards prevailing before and during the Global Crisis were based on the concept of incurred losses. They were criticised for excessively delaying banks' recognition of credit losses, and thus being a source of procyclicality (Financial Stability Forum 2009). In response, the International Accounting Standards Board and the US Financial Accounting Standards Board introduced new rules based on the concept of expected loss. In the EU and a good part of the rest of the world, IFRS 9 entered into force in 2018, while in the US, the current expected credit loss (CECL) approach is scheduled for 2021. With some differences, both standards call for the recognition of credit losses that, on the basis of available information (including macroeconomic information), can be expected to occur over horizons varying from one year to a credit instrument's lifetime. The goals behind this more forward-looking approach to provisioning included inducing more cautious lending behaviour in good times and prompting earlier corrective action in bad times.

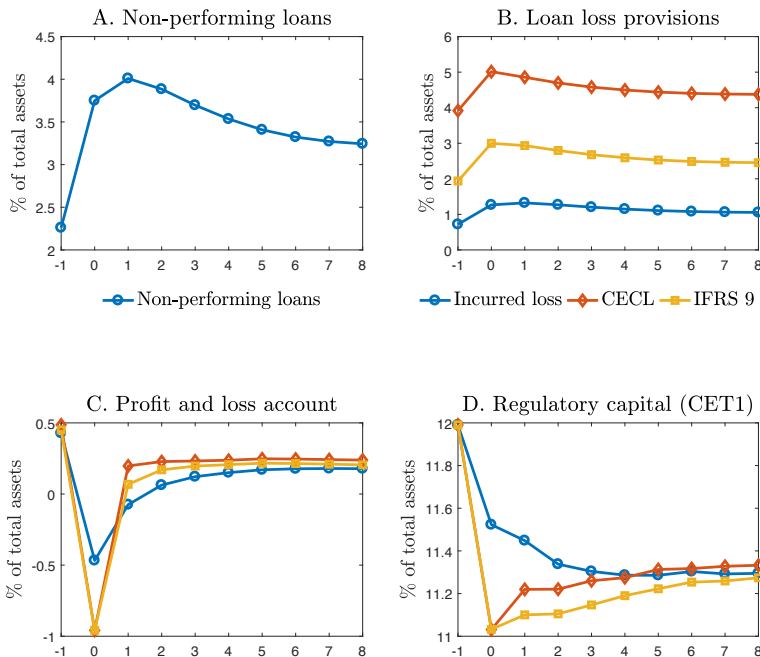
Many observers and the proponents of the new standards got intellectually captured by the idea that provisions based on 'expected' rather than 'incurred' losses ought to be less procyclical. However, the complicated internal modelling required to estimate future credit losses under IFRS 9 and CECL would be truly countercyclical only if the bank modellers were able to predict turning points in the cycle, or the arrival of disasters such

as the COVID-19 pandemic two or three years in advance. In such circumstances, they would be called to nurture their provisions (loss absorbing buffers) at the right time: against the profits made in the two or three years before the cycle turns or the disaster arrives. This would make the banks enter the contraction with additional buffers.

## Expected loss provisioning can add procyclicality

However, as we show in Abad and Suarez (2018), absent the capacity of banks to anticipate adverse shifts in aggregate conditions sufficiently in advance, the upfront recognition of future expected losses may paradoxically imply that, right at the beginning of economic contractions, banks suffer a more abrupt fall in profits and subsequently capital than under the old incurred loss paradigm. Intuitively, the expected loss approach implies having to provision, when the contraction starts, some anticipated credit losses that would only be provisioned as they gradually occur under the incurred loss approach (see Figure 1).

**Figure 1** Effects of the arrival of a contraction under different provisioning rules



*Note:* This figure is based on the results in Abad and Suarez (2018) that quantify, under alternative provisioning standards, the impact of the arrival of an average recession on a bank portfolio of European corporate loans and its implications for the profit and loss and regulatory capital (CET1) of the corresponding bank. The horizontal axis represents years after the arrival of a recession.

For banks' subject to capital requirements and with limited capacity to raise fresh new capital, losing capital may imply contracting their supply of lending, as previously emphasized in the literature on the procyclicality of Basel capital requirements (Kashyap and Stein 2004, Repullo and Suarez 2013). This mechanism is particularly relevant in the context of the COVID-19 pandemic where an unanticipated shock has caused an abrupt contraction in economic activity. The least traumatic absorption will require channelling enough credit and liquidity to the most affected sectors, thus bringing into question the implications of expected loss provisioning in such times.

The quantitative results of our analysis indicate that, for a hypothetical bank fully specialized in European corporate loans, the arrival of an average recession would imply on-impact increases in IFRS 9 and CECL provisions equivalent to about 100 basis points of CET1 (as a fraction of total assets), that is, more than a third of the bank's fully loaded capital conservation buffer (CCB). This impact is about twice as large as that implied by the previous incurred loss approach.

## **The COVID-19 crisis calls for preventing the procyclical effects**

If the COVID-19 contraction were to cause an impact on foreseeable defaults several times the size of an average recession, the initial impact on bank capital might easily deplete the voluntary and regulatory capital buffers (on top of the minimum requirements) with which banks enter this crisis. Additionally, beyond its initial impact, the uncertainty regarding the depth and duration of the COVID-19 crisis can make banks face higher variability in their provisioning needs (and higher volatility in their available capital) under the new provisioning standards as compared to the old ones.

The sudden and unexpected nature of the pandemic, and the certainty that its implications will be less damaging for the economy if there is plenty of credit flowing towards the affected businesses and households, suggest the desirability of preventing the procyclical damage that the new provisioning standards can cause in this crisis.

In a recent column advising against any change in current provisioning standards, Nicolas Véron argues "there is no perfect accounting thermometer for credit risk in banks' loan books, but breaking the current thermometer in the midst of a crisis would do far more harm than good." Fortunately, however, there are ways to neutralize the capital (and likely credit supply) impact of IFRS 9 (or its US companion CECL) without "breaking the thermometer," that is, without forsaking estimation of the expected credit losses arising out of this crisis or any other in the immediate future, and their reflection in banks' profit and loss accounts.

## **No need to break the thermometer: use the transitional arrangements**

Such a solution relies on allowing for capital adjustments of the same nature as those that have been applied in the EU in the form of ‘transitional arrangements’ since IFRS 9 was first introduced in 2018. Such arrangements were put in place to smooth away over time the impact on capital and credit of the additional provisioning needs implied by the new standards. Banks were given the option to use them or not.

In essence, the existing transitional arrangements allow banks to write back as available capital as much as 95% of the additional loss absorption implied by the new provisions in 2018, 85% in 2019, 70% in 2020, 50% in 2021, and 25% in 2022. The transition was planned to end in 2023. Under these arrangements, the provisions are made according to the new expected loss paradigm, so there is transparency about banks’ estimates of the expected incoming losses, but part of their impact on a bank’s available capital (CET1) is neutralized.

In our view, guaranteeing that the new standards are not a source of additional procyclicality during the fight against the economic consequences of the COVID-19 pandemic calls for, at the very least, stopping the clock of the transitional arrangements (which in 2020 would still allow banks to write back 70% of the extra provisions). In fact, we think it would make sense to delay the clock all the way back to its 2018 position: allowing banks for a 95% addback until further notice.

To avoid banks’ temptation to enter into games where they signal their strength by opting out of the transitional arrangements, we argue for making the adoption of the modified transitional arrangements mandatory. And to avoid ‘wasting’ the freed capital in distributions, we would expect banks and/or their supervisors to guarantee the freeze of dividends and share repurchases during the standby period, as part of a ‘quid pro quo’ deal. Finally, our proposed measure would come with the announcement that, once this exceptional period is over, the path of the transitional arrangements would be retaken, after proper rescheduling.

In the EU context, with the IFRS 9 transitional arrangements already in place, dictating the freezing or delaying-and-freezing of the transitional clock would involve minor legislative adaptations. This would pose no challenge to the verification of compliance with the rules relative to the status quo (in which such transitional arrangements already exist). From the point of view of preserving the informative value of the accounting statements and the continuity of the costly procedures that are needed to adopt, internally validate, and enforce the new standards, we think our proposal is superior



to the alternatives arguing for simply waiving the new standards (Stein et al. 2020) or applying them with additional (and ambiguously defined) flexibility, as was recently recommended by the Bank of England and the ECB.

## **Afterword**

To conclude, while we sympathize with the principle that one should avoid changing the rules of the game in the middle of a match, the nature and severity of the COVID-19 crisis and the foreseen importance of bank credit in coping with it would call for and fully justify the adoption of our easily implementable proposal by the authorities.

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# 15 Unintended effects of loan guarantees during the Covid-19 crisis

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**Giorgio Gobbi, Francesco Palazzo and Anatoli Segura<sup>1</sup>**

Bank of Italy; Bank of Italy; Bank of Italy and CEPR

15 April 2020

*Most governments have introduced temporary credit guarantees to ensure banks can provide the liquidity needed by firms during the Covid-19 crisis. This column argues that these policies create incentives for banks to foreclose guaranteed loans maturing close to the expiration date of the guarantee scheme. This hidden effect is worse for firms whose debt is set to substantially increase during the pandemic. To avoid foreclosure ‘waves’ on the eve of the public guarantee termination, complementary measures that reduce firms’ debt burden should also be adopted.*

The Covid-19 shock and the subsequent lockdown measures have led to a collapse in corporate cash flows, especially in economic sectors where physical proximity among workers and customers is unavoidable. In contrast to a traditional liquidity shock, firms are not subject to a sudden change in the cash flow distribution over time, but are instead experiencing a short-term output loss due to a temporary halt of economic activities. In this respect, the shock should not compromise their long-term viability. As a result, it also differs from a solvency shock, at least at this stage.

The speed at which the economic activity will recover (once health restrictions are eased) depends crucially on how the measures adopted by governments and other authorities affect the allocation of losses among different agents (firms, banks, households, governments and central banks), as well the timing of the measures themselves.

<sup>1</sup> Authors’ note: The opinions expressed are those of the authors and do not necessarily reflect the views of the Bank of Italy.

## **Main government measures adopted so far**

Governments have already taken several policy actions aimed at supporting firms, households, and banks. Some measures involve a direct transfer of current losses from the private sector to the government balance sheet, including direct cash transfers to households and firms, temporary lay-off assistance (including the recently announced SURE programme by the European Commission), and higher unemployment subsidies. Some measures, on the other hand, do not change the allocation of losses among agents, but instead provide liquidity at subsidised conditions to postpone and smooth their impact over a longer time horizon. These measures include targeted temporary loan guarantees, temporary tax waivers, the temporary suspension of loan instalments, and the extension of loan maturities.

Measures such as temporary loan guarantees play a prominent role in the Governments' policy responses because they represent a fast way to incentivise banks to accommodate the liquidity needs faced by firms during the Covid-19 crisis. In some of the key jurisdictions (the US, Germany, France, Italy, Spain), the guarantee covers at least 80% of the loan value to small and medium-sized enterprises (SMEs). The strong reduction in the expected losses faced by the bank provides substantial incentives to grant new loans (or roll over existing ones) in a situation of heightened credit risk. Loan guarantees can be seen as an effective tool for the 'evergreening' of loans to help keep businesses running, as advocated by Brunnermeier and Krishnamurthy (2020).

## **The medium-term loan foreclosure incentive created by guarantees**

However, temporary loan guarantees may have an unintended effect which has been overlooked in the analysis so far. Once within close proximity to the guarantee scheme expiration date, banks will have incentives to foreclose maturing loans that benefit from such a guarantee that will be removed in the near future. Indeed, when the guaranteed loan expires, and guarantees are about to stop being available, the bank would prefer not to roll over the debt if the expected return from continuing the client relationship without guarantees is lower than the expected recovery value of the loan (an amount at least equal to the public loan guarantee that still protects the loan).

Put differently, the introduction of public guarantees increases the collateral value of the loan above its stand-alone value, encouraging bank lending. By the same token, the removal of guarantees will reduce collateral values, encouraging loan foreclosure. Foreclosure incentives (in proximity to the guarantee removal) will, all else being equal, be stronger (i) the higher the guaranteed amount per unit of loan face value, and (ii) the higher the probability of default and loss, given default of the loan.

### **Debt reduction policies to avoid foreclosure waves in the medium-term**

Temporary public guarantees might introduce a trade-off between current and future availability of credit to firms. In order to avoid a loan foreclosure ‘wave’ ahead of the removal of guarantees, it is crucial to ensure that firms return to their long-term economic viability and achieve a sustainable risk profile before that date.

A fraction of the output losses suffered by firms during the Covid-19 crisis will not be recovered, and the additional guaranteed debt piled up by firms to cope with the shock will inevitably lead to an increase in their financial leverage. It is therefore crucial to complement public loan guarantees with other policy actions that allow firms to maintain their debt at (or at least close to) pre-crisis levels. Debt reduction policies will not only avoid foreclosure waves down the road, but also avoid debt overhang problems that might hamper investment when it will be needed most in order to speed up economic recovery.

Three possible complementary policy options, different in terms of timing of implementation and level of disbursements by governments, are conceived as follows:

- **Short-term implementation:** Additional direct government transfers to firms to compensate for the short-term loss of revenue and to cover operating costs (Drechesel and Kalemlı-Ozcan 2020). During a lockdown that reduces many firms’ sales down to zero, the already-adopted temporary lay-off assistance measures (and the short-term adjustment of other operating costs) reduce, but do not eliminate, firms’ cash outflows. Additional transfers to firms to substitute for the missing demand (Saez and Zucman 2020) would further reduce the need for firms to take on extra loans to overcome the Covid-19 shock, preserving their net worth. These transfers would also insulate banks from short-term losses. However, they would entail a large immediate expense for the government, the circumvention of substantial legal issues, the rapid definition of eligibility criteria for firms, and bring with them the related controversies among different economic sectors.

- **Medium-term implementation:** Establishment of a vehicle with public equity for the restructuring of debt of medium and large sized companies. Governments could set up a special purpose vehicle that would purchase from banks the loans granted to meet firms' liquidity needs during the lockdown phase. The vehicle would be funded with equity provided by each Government (or, in the case of an EU-wide initiative, by supranational agencies) and with long-term debt placed in capital markets. The amount of equity provided by public authorities should be sufficient for the long-term debt issued by the vehicle to meet the eligibility criteria of some of the ECB asset purchase programmes.
- **Medium-term implementation:** Introduce strong incentives to inject equity into firms. Governments could introduce strong tax incentives to inject private capital into firms in the form of equity. For example, this could be implemented through a 'reinforced' allowance for corporate equity (ACE). In comparison to policy option 1, there is no need to compute the 'right' amount of direct transfers to each firm, and no engagement in controversies over eligible industries and firms. This mechanism also avoids an immediate (and very large) disbursement for the government, linking its implicit tax liability to the effective survival of the firm. However, budget constrained SME owners may not participate in this programme, unless willing to allow new equity partners to join the company. In this respect, corporate governance seems to be a key factor for the success of this type of policy programme.

## Conclusion

Governments have responded promptly to the urgent liquidity needs faced by firms during the initial phase of the Covid-19 emergency. In order to ensure access to liquidity, a prominent role has been given to the introduction of temporary public guarantees for corporate loans. While effective in the short-term, this column alerts that, in proximity of the guarantee expiration date, there could be a wave of loan foreclosures, unless further measures aiming at private debt reduction are also adopted.

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# 16 COVID-19: Europe needs a catastrophe relief plan

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**Agnès Bénassy-Quéré, Ramon Marimon, Jean Pisani-Ferry, Lucrezia Reichlin, Dirk Schoenmaker and Beatrice Weder di Mauro**

Paris School of Economics - University of Paris 1 Panthéon-Sorbonne; European University Institute; European University Institute, Bruegel and PIIE; London Business School and CEPR; Erasmus University Rotterdam and CEPR; Graduate Institute of Geneva and CEPR

11 March 2020

*The unfolding coronavirus epidemic represents a severe economic stress test for Europe as well as a test of European unity. This column discusses how the crisis might unfold and the appropriate policy response. It advocates a comprehensive emergency package through which the EU would take responsibility for a meaningful share of the overall emergency effort.*

Beyond its public health dimension, the unfolding coronavirus epidemic also represents a severe economic stress test for Europe that comes from a totally unexpected side. This time, it is primarily a shock to the real economy hitting all European countries more or less equally (time lags will soon become a footnote). The buffers and firewalls put in place after the global financial crisis and the euro crisis have been designed to fight a different sort of crisis, originating in the financial sector or in a particular sovereign. This time is different.

For this reason, and because its fallout for integration may be persistent, this crisis calls for a common Europe-wide response. **This is not only an economic crash test, but also a test of European unity.** How European leaders will deal with the fear and the suffering of their fellow citizens will be remembered. By the same token, the crisis is an opportunity for leaders to build trust and to show unity, strength, consequence and solidarity. They will need to demonstrate that Europe can help put in place an effective catastrophe relief plan. Just a few weeks after Brexit, it is time for the EU to demonstrate that it can deliver in the face of dramatic events.



## **There is no European roof**

Twelve years ago, the global financial crisis triggered a major recession and marked for many countries the beginning of a ‘lost decade’. **Europe is entering this new crisis with different strengths and weaknesses.** Among the strengths are that the banking sector is better capitalised and more liquid; the derivative markets are more transparent; the European Stability Mechanism can act as a backstop in case of bank resolution and, more importantly, it can deliver emergency assistance to a member state, conditional on an adjustment programme; and last but not least, the ECB can help counter an attack on a member state by purchasing potentially unlimited amounts of sovereign bonds, again conditional on an adjustment programme. Hence, banks are stronger than they used to be; and although sovereigns are weaker (due to accumulated debts), the potential for multiple equilibria on the bond market is reduced.

As for weaknesses, the ECB is running out of fire power, with a still negative deposit rate and little room for further quantitative easing. A long period of extremely low interest rates has encouraged borrowing and buoyant asset prices in the euro area, although through different channels and to different extents across member states; it has also weakened the banking, pension funds and life insurance sectors. Although macroprudential policies have been activated in most countries, various actors are entering the crisis with debts, overvalued assets and small interest margins.

**On the fiscal side, the European roof is not only leaking, it is missing altogether for the kind of shock that is unfolding.** Europe is equipped with a fair-weather budget that has not been designed to cope with emergencies. The pre-COVID negotiations on whether the EU budget should amount to 1.11% of national income (the European Commission’s proposal), 1.02% (the 2014-20 level) or 1.07% (a compromise) will probably appear pathetic to future historians, who will compare the Chinese and European reactions to COVID-19. More importantly, the adequacy of a pre-allocated budget over a seven-year period is problematic: it leaves no room for frontloading (with common borrowing) and even little room for the rearrangement of spending priorities. Moreover, the long-lasting discussions on the need for a fiscal stabilisation capacity at euro area level have gone nowhere, except for the meaningless micro-BICC (Budgetary Instrument for Convergence and Competitiveness) agreed upon in October 2019.

## **A very serious economic crisis for Europe**

The COVID-19 shock combines features of a demand and a supply shock. Assuming, as a working hypothesis, that the epidemic is over in the summer of 2020, the crisis in Europe could unfold through four partially overlapping phases:

- **Phase 1 – the China Shock** (January-March): mostly adverse supply-side effects of the Chinese health crisis through global manufacturing value chains. Supply-side shortages are specific to some producers and products; sectoral effects are significant but macro effects are small since the most affected sectors (transport equipment, electronics, pharmaceuticals, textiles) represent some 4% of GDP (though more for Germany), according to OECD data.
- **Phase 2 - sectoral disruptions** (starting in February): a sectoral and regional demand shock hitting mostly tourism, air transport, hospitality and entertainment. This is a more violent shock but again, the impacted sector is small overall – at most, 5% of GDP if restaurants are included, with some variation across countries (more in Spain, less in Germany).
- **Phase 3 – acute overall disruption** (starting early March in Italy, 1-3 weeks later in other European countries): aggregate supply shock resulting from contagion containment measures with restrained demand and mobility. The nature of these may not be the same in all countries, but all will need to tackle the acceleration of contagion with measures such as travel bans, shutdowns of public transportation systems and school closures. **Such broad-based measures are bound to be very damaging** economically because of labour supply reductions (around 15% for school closures, based on simulations for the UK; Sadique et al. 2008), obstacles to business activities, financial disturbances (stock markets, credit standards) and a drop in social consumption. **Aggregate quarterly output is likely to fall severely during this phase, but hopefully still by single-digit numbers.** Reduced oil prices will act as a very partial stabiliser, with other international spillovers being clearly negative.
- **Phase 4 – recovery** (starting in May or June): **a sharp rebound is likely but may be muted by hysteresis** due to confidence effects, lost corporate income in the service sectors, bankruptcies among SMEs and credit constraints resulting from the accumulation of non-performing loans on banks' balance sheets and the rebuilding of dented savings at the household level. The danger is that such hysteresis effects prevent a return to the pre-crisis path once the health emergency is over. Again, major international spillovers will be at work, compounding national and regional difficulties. If the lesson from the global financial crisis is of any relevance, it is because it underlines the extent to which major shocks can have strong spillovers and persistent consequences.

## The adequate policy response depends on the phase

**The right policy response depends on which phase the economy is in.** During the first phase, there was limited scope for policy intervention at the aggregate level. Some targeted sectoral measures, such as subsidised short working hours ('Kurzarbeit'), were already being discussed in Germany for firms hit by disruptions to their trade with China.

In the second phase, liquidity lifelines – starting with automatic delays to tax and social contribution payments and partial unemployment schemes – have been or are being deployed at the national level. **This is on the whole an adequate response**, on top of additional funding for healthcare.

**Phase 3 requires more generalised emergency support measures** for various reasons. First, spending on healthcare (temporary facilities, equipment, hires, overtime for medical personal) and on related items (security, control of lockdown measures, etc.) must be stepped up significantly. The corresponding one-off cost is hard to assess, but may amount to several tenths of a percent of annual GDP. Second, some service sectors will suffer permanent income losses instead of just liquidity shortages. SMEs in particular need substantial financial support in this phase, in the form of tax relief and concessional credit lines and grants on top of the previous measures in order to forestall bankruptcies. Temporary partial unemployment support (Kurtzarbeit in Germany, Cassa Integrazione Guadagni in Italy and chômage partiel in France) needs to be activated as it helps cushion the shock and avoid lay-offs, which is exactly what is needed when facing an exogenous drop in activity. Direct support to households, through relief of cash payments (such as tax holidays or relief from paying electricity bills, as announced in Italy) or cash handouts (as already announced in Hong Kong and Singapore) may also be necessary, as well as direct transfers to independent workers.

In the event of a one-month lockdown leading to a temporary 50% drop in private-sector activity, we estimate that the cost of exceptional support measures would amount to 0.5% to 1% of annual GDP.<sup>1</sup> The direct cost of discretionary measures (emergency health and lockdown measures plus economic relief) would therefore be of the order of magnitude of 1% to 1.5% of annual GDP. This may seem a large number, but Italy has already announced an emergency support programme amounting to €10 billion, or 0.6% of GDP. Together with the fiscal stabilisers, such an action plan would imply accepting a short-term deterioration of the fiscal balance by about 2% of GDP.

<sup>1</sup> Assuming that the government would cover one-third of income fallout of the reduced economic activity and that the other two-third would be borne by companies and, to a lesser extent, households.

These are large enough numbers to test the fiscal capacity of the most vulnerable member states. As there are now large externalities of containment measures, the economic response should also involve the European level.

**Phase 4 will call for significant fiscal demand support to help avoid hysteresis effects.** The magnitude of the effort will depend on the length and severity of the Phase 3 recession, but it is best to plan for action that is meaningful, comprehensive and long-lasting enough to ensure the elimination of the scars inherited from the crisis. The priority in this phase will be on aggregate demand rather than supply-side or sectoral measures. The most appropriate vehicle is likely to be direct transfers to households. There is a need to plan the boost beforehand so that it can be activated at the right moment. Again, the European dimension will be key to internalising externalities.

During phases 2 and 3, the ECB should stand ready to provide liquidity to banks that are likely to be affected by the deterioration of credit quality, while facing urgent demands for short-term credit. The ECB also has a long experience with (targeted) long-term refinancing operations and should consider launching such a programme (conditional on bank lending to SMEs). As for monetary policy, the best course of action would be a monetary easing in coordination with a fiscal stimulus. The decline in oil prices will affect headline inflation and, as happened in the past, could affect household and corporate inflation expectations. It is therefore key that the ECB provides firm communication on its inflation target to avoid a deflationary scenario.

Since non-performing loans (NPLs) will be on the rise, the ECB and national supervisors **could provide temporary relief (for example, for the remainder of the year) of the agreed framework to reduce NPLs in the EU.** A temporary waiver on the implementation of the Basel standards for loans categorisation might also be useful. Finally, some specific buffers could be relaxed. However, supervisors should not allow a massive deterioration of banks' balance sheets, since the banks will be needed to finance the restart of the economy in phase 4. Guarantees extended by the European Investment Bank would help protect banks' balance sheets, while at the same time allowing for an extension of credit lines to SMEs.

**The bottom line, though, is that phase 3 will create not just a liquidity problem but also a solvency problem** in the various economies, although to a varying extent depending on specific sectors and firm sizes. These solvency problems cannot be addressed by monetary policy and even less so by micro- and macroprudential policies; fiscal intervention will be key.

## **A European fiscal response**

Under current circumstances, **the Economic and Financial Affairs Council should formally rule that all temporary additional public expenditure caused by the outbreak of the health crisis will be deducted from 2020 public expenditures** and the corresponding public deficit for the assessment of the member states' compliance with the Stability and Growth Pact (SGP). The Commission has already given indications of this, but a formal EU decision covering the period of the health emergency is needed. This would require triggering the general escape clause introduced in the SGP 2011 to cope with “an unusual event outside the control of the Member State concerned and with a major impact on the financial position of general government, or when resulting from a severe economic downturn” (Council Regulation No 1177/2011, Art. 2).

However, as after the global financial crisis, **the hard constraint may not be the SGP but rather the ability of national governments to borrow several additional percentage points of GDP**. Here, member states are not equal. Between 22 February and 10 March 2020, interest rates on 10-year sovereign bonds fell by 0.3 percentage points in Germany and stayed stable at a negative level in France; but they rose by 0.4 and 0.15 percentage points in Italy and Spain, respectively. It could be argued that such divergence is the logical outcome of different situations in terms of debt sustainability. However, it is not in the interest of Germany or France to see Italy or Spain restricting spending related to the epidemic, since this might impact on them in the form of further contagion and economic weakness. Conversely, costly containment measures will produce positive spillovers on other countries, and thus should be co-financed.

**A European catastrophe relief plan aiming at supporting the combined efforts of the member states in combating the pandemics should be urgently conceived and decided upon.**

The most pressing priority is to help finance the additional cost of improving hospital infrastructure (especially the number of intensive care beds) and paying for the extra workload of medical staff. The second priority is to open a window to finance indirect expenditures related to public health measures, such as containment and school closures. This mutualisation of healthcare costs should be subject to screening by an expert committee. Eligible expenditures could include security, partial unemployment schemes and support targeted at specific sectors such as hospitality, airlines and entertainment (after alleviating existing constraints on state aid, which should be easier to do if all countries are concerned simultaneously than if only one asks for it). The Commission could extend the funds on a weekly basis and carry out the audits once the crisis is over, hopefully in the second half of the year. Transparency (not

bureaucracy) over how support is being spent will be a key element in the success of the fiscal intervention. Within each country, it is well understood that the shock is truly exogenous, hence moral hazard should not be a core concern and temporary support – for example, through Kurzarbeit – is legitimate. The same line of reasoning should apply at the EU level.

We are advocating a **comprehensive emergency package through which the EU would take responsibility for a meaningful share of the overall emergency effort**. This would require finding the means to release tens of billions of euros from EU resources, despite existing limitations on the use of the EU budget.

European Council President Charles Michel and European Commission President Ursula von der Leyen declared on 10 March that the EU should both take part in the fight against the disease and act on the macroeconomic front, and they announced initiatives that remain to be specified. We welcome such initiatives but underline that a mere renaming of existing budgetary credits and the announcement of large headline figures based on virtual multipliers would not do any good. The situation calls for the allocation at EU level of new funds dedicated to addressing the consequences of the disease wherever they occur within the Union. This is not a moment when the EU members should be afraid of ‘mutualisation’. Rather, they should be afraid of the consequences of ring-fencing.

Possible sources of funding include the following:

- **Existing EU funds**, including the European Solidarity Fund and the European Globalisation Adjustment Fund, which would need to be leverage as they currently totalize less than €1 billion.
- **Reallocations within the EU budget**. Budgetary credits earmarked for the structural funds in the 2020 budget should be mobilised for the emergency health initiative. Article 317 of the TFEU Treaty makes it possible to reallocate funds within the budget. It will be important to provide relief to all member states, irrespective of their share in the structural funds or the distribution by country of as yet unspent money. A straightforward solution would be to reallocate within the EU budget specific budgetary items to the European catastrophe relief plan, and to negotiate a political agreement that would compensate the would-be beneficiaries of the reallocated funds through an exceptional allocation in the 2021 budget.
- **Cooperation among member states** outside the framework of the EU budget. Article 122(2) could provide a basis for organising such voluntary cooperation in the same way as was done for the creation of the European Financial Stability Facility (EFSF).

## What could be plan B?

We know that our proposal is unlikely to receive warm backing from policymakers in several part of the EU and the euro area. Before discarding it, however, it is useful to understand the risks involved in an attitude of denial.

The starting point is that although the crisis today is believed to be mostly temporary, financial markets are short-sighted: they do not weigh future profits or tax receipts as they should based on the low level of interest rates. Hence there is room for multiple equilibria, and we should not rely on the assumption of well-behaved financial markets.

**What would happen in the case of a sudden rise in interest rates in some member states, which would in turn make their debts unsustainable?** This is not a theoretical threat, given that some governments are already on the razor edge. In such circumstance, there would be no solution other than an ESM financial assistance programme or, rather, the activation of the ECB's Outright Market Transactions (OMT) scheme. The fiscal adjustment programme would need to be postponed to the post-crisis period, with all the governance problems involved.

In the end, we think plan B would be more costly than plan A. Policymakers in all countries will likely be better-off if they can be granted for solidarity in the face of a common health drama than if they muddle through and ultimately have to cope with new emergency assistance, new conditionalities, and the involvement of the ECB in solving another sovereign debt crisis. It is time for the Europeans to think more deeply about opportunity costs, which are at the same time economic, social and political.

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# 17 A progressive European wealth tax to fund the European COVID response

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3 April 2020

*European governments have reacted swiftly to the COVID crisis and are now discussing ways to mutualise the cost of the epidemic. This column proposes the creation of a progressive, time-limited, European-wide progressive wealth tax assessed on the net worth of the top 1% richest individuals. If fighting COVID-19 requires issuing 10 points of EU GDP in Eurobonds (or a rescue fund worth 10 points of EU GDP), a progressive wealth tax would be enough to repay all this extra debt after ten years.*

European governments have reacted swiftly to the COVID crisis and are now discussing ways to mutualise the cost of the epidemic. This mutualisation is not only politically sound to save the European project, it is also the optimal response from an economic perspective. The COVID shock, sudden and massive, puts European countries with limited fiscal room, such as Italy, under financial stress. Mutualisation is the most efficient way to allow these countries to quickly implement the policies necessary to deal with the public health crisis and shield the population from economic hardship. Solidarity is the best strategy given the large positive externalities that swift public health and stimulus policies in one country have for other EU member states.

Various options on how to mutualise the cost of the pandemic are on the table.<sup>1</sup> One option involves a new dedicated European Stability Mechanism (ESM) credit line with limited conditionality. Other options involve the issuance of Eurobonds, or the creation of a EU coronavirus rescue fund.<sup>2</sup> Whatever the exact implementation details, all these options will benefit from the backstop of the ECB, so that in the short and medium run,

1 See chapters in Baldwin and Weder di Maruo (2020), Giavazzi and Tabellini (2020) and <https://www.bruegel.org/2020/03/esm-credit-lines-corona-bonds-euro-area-treasury-one-off-joint-expenditures-what-are-the-options-for-the-eu-council/>; <https://www.theguardian.com/commentisfree/2020/mar/25/shock-coronavirus-split-europe-nations-share-burden>

2 <https://www.ft.com/content/3f6c31fb-c59c-4aa0-88fd-275a880dad1a>

all countries will have the necessary liquidities to fight the virus. But the question of how to deal with the mutual legacy debt, after the crisis is over, will arise. The danger is that, when the worst of the crisis passes, the sense of solidarity quickly evaporates and Europe repeats the tragic mistakes of the European debt crisis, which hampered a swift recovery from the Great Recession.

This is why it is essential to define a clear and common strategy for the repayment of any extra debt now. A clear strategy will not only favour a rapid economic rebound after the crisis, it will also facilitate the political acceptability of putting in place Eurobonds (or a common rescue fund) today, by clarifying the allocation of the costs.

What does economic history teach us about fair and effective ways to deal with public debt overhang? We can look back at how governments dealt with the massive public debt accumulated over the course of the first half of the 20th century. In hindsight, Germany followed the best path. Instead of inflating its debt away, like France did immediately (with 50% annual inflation rates between 1945 and 1948) or like the UK did more gradually (only erasing its massive debt in the 1970s with double digit inflation rates for an entire decade), Germany put in place progressive wealth taxes. These taxes, which applied to net wealth (all assets net of debts), were time-limited, and highly progressive, paved the way for the German post-war economic miracle (Hicks et al. 1941, Eichengreen 1990, Hughes 1999). We would be wise to follow the example Germany set after WWII. This is why we propose the creation of a progressive, time-limited, European-wide progressive wealth tax assessed on the net worth of the top 1% richest individuals. The revenues would be dedicated to the repayment of Eurobond issued during the COVID crisis or to the funding of a common rescue fund.

Why is a progressive European wealth tax the best solution? Issuing public debt is effectively transferring wealth from the public sector to the private sector. Individuals who keep their incomes during the crisis cannot consume as much, and therefore save more. These savings finance the new public debt that helps those who lose their incomes during the crisis. As a large increase in public debt means a large creation of private wealth, it seems natural to ask private wealth to contribute to repaying the public debt after the crisis. As private wealth is fungible, it is not reasonable to ask only those who own the Eurobonds to contribute to repay the debt. That is why a wealth tax based on comprehensive wealth makes the most sense. A wealth tax is preferable to inflation because it would provide clarity on the allocation of costs while inflation redistributes wealth in an opaque and chaotic manner.

The most vulnerable have been hit disproportionately by the lockdown, as most high-income earners can still work from home and the wealthy can use their wealth to weather the shock better. Therefore, making the wealth tax progressive makes sense as well. Given that wealth is very concentrated — more than income and consumption — it is the most progressive fiscal tool. The top 1% wealthiest individuals own around 20%–25% of total wealth in France, Germany, Spain, and in Scandinavia.<sup>3</sup> This means that a wealth tax levied only on the top 1% wealthiest Europeans would generate a large amount of tax revenue while preserving wealth for the bottom 99%.

Why levy this tax at the European level? First, because this is probably the best level to implement and enforce an effective wealth tax. With a European wealth tax, migration of wealthy taxpayers within the European Union becomes irrelevant (Kleven et al. 2020). Enforcement is facilitated by cross-border bank and tax administration cooperation (Saez and Zucman 2019). Most importantly, a tax at the European level would be a concrete embodiment of European solidarity in the fight against the COVID epidemic. It would shift the discussion about how to pay for the costs of the crisis away from a question of international transfers (across European countries) and instead focus the discussion on transfers across individuals according to their means (irrespective of their nationality). This would overcome oppositions based on selfish national self-interest, and contribute to creating a sense that Europe can indeed work for everyone.

Some may argue that there is currently no legal basis for a European tax. But treaties can and will be changed to allow for debt mutualization. There is no reason to believe that the arguments that justify the need to coordinate our response to the virus cannot similarly apply to justify coordination in the payment of its costs. Should an EU-wide agreement fail to materialise, a smaller group of countries could choose to create a common wealth tax, eventually paving the way for a EU-wide tax.

Such a tax would levy 1.05% of EU GDP each year, accounting for evasion and avoidance responses. If fighting covid-19 requires issuing 10 points of EU GDP in Eurobonds (or a rescue fund worth 10 points of EU GDP), a progressive wealth tax would be enough to repay this extra debt after 10 years.

By our estimates, an EU wealth tax on the top 1% could generate a sizable amount of tax revenues. To see this, start from the fact that aggregate EU household wealth is worth about five times GDP (Piketty and Zucman 2014). The top 1% wealthiest European adults own approximately 22.5% of total wealth, and the top 0.1% approximately 10%. The European wealth tax we propose would exempt individuals below the top 1%

3 See Alvaredo et al. (2018) for estimates for France and Spain; Albers et al. (2020) for estimates for Germany; Alstadsæter et al. (2019) for Scandinavia (sum of Norway, Sweden, and Denmark).

threshold (which is around €2 million); it would only tax wealth above this threshold. The taxable wealth would represent about 60% of the total wealth of the top 1%, that is, the equivalent of 67.5% of the GDP of the EU.<sup>4</sup> The taxable wealth above the top 0.1% threshold (which is around €8 million per adult) would represent 30% of EU GDP. Based on Forbes billionaire data for 2019, there were 330 EU billionaires with a collective taxable wealth almost exactly equal to €1 trillion, about 7% of EU GDP. A progressive wealth tax at a rate of 1% above the top 1% threshold and an additional 1% above the top 0.1% threshold, and an additional 1% above €1 billion, would thus raise 1.05% of EU GDP in revenues each year.<sup>5</sup> If fighting COVID-19 requires issuing 10 points of EU GDP in Eurobonds (or a rescue fund worth 10 points of EU GDP), a progressive wealth tax would be enough to repay all this extra debt after ten years.

**Box 1** Proposed parameters for a European COVID wealth tax

Wealth group	Threshold	Marginal tax rate	Tax base above threshold (% GDP)
Top 1%	2m Euros	1%	67.5%
Top .1%	8m Euros	2%	30%
Billionaires	1b Euros	3%	7%

What about the risks that taxing wealth may hinder growth coming out of the recession? It is likely that, compared to other forms of fiscal consolidation or public expenditure contraction to repay for the COVID Eurobond debt, a wealth tax is the less likely to harm growth. In large part because a time limited wealth tax operates like a capital levy: you tax past accumulation but the returns to current investment and innovation are unaffected. It is worth bearing in mind that such tax rates (1% above €2 million, 2% above €8 million, 3% above €1 billion) are neither large nor unprecedented. They are in line with the rates applied by the many European countries that had wealth taxes until recently, such as France, Germany, Denmark and Sweden and as in recent proposals for a federal wealth tax made in the US (Saez and Zucman 2019).

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4 This amounts to assuming that the Pareto parameter of the top tail of the wealth distribution is  $a=(2.5)/(2.5-1)=1.67$  in line with the estimates of Garbinti et al. (2017) for France.

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# 18 EU solidarity in exceptional times: Corona transfers instead of Coronabonds

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**Daniel Gros**

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5 April 2020

*The countries hit hardest by the COVID-19 crisis already have too much debt. Lending from the European Stability Mechanism or via Coronabonds would add to that debt, potentially making it unsustainable. This column suggests that European solidarity should take the form of transfers, not credit. A substantial transfer could be organised via the EU budget simply by exempting the weakest countries from their contributions to the EU budget for the duration of the programming period 2012-2027.*

There can be little question that the economic fallout from the COVID-19 epidemic is hitting different EU member states with very different intensity levels. In this exceptional situation, solidarity is warranted. The weakest members, which are unfortunately often hit hardest, deserve help. Those member states which are able to help, mostly in the North, are likely to themselves experience a sharp recession. However, they have the financial means to overcome the crisis by providing generous assistance to their enterprises and provide a safety net to their unemployed citizens. They would also be able to provide some assistance to the member states most in need.

The first question to ask is whether the coronavirus crisis calls for solidarity within the EU or the euro area. During the financial crisis, one could argue that membership of the euro area was, itself, a source of some of the difficulties for Italy and Spain (because in the face of pressures on their financial markets, they could not turn to their national central banks for liquidity).

The origin of this crisis is very different. Being hit by an unforeseen epidemic has nothing to do with euro area membership. There is therefore a strong argument to consider the present situation as a case which requires solidarity at the EU level.



Nonetheless, what kind of assistance should be provided – loans or grants? This is the second key question.

It is possible to argue that the additional state expenditure required to mitigate the impacts of the coronavirus shock should be financed by issuing common bonds. The shock is symmetric in nature and all governments will now have large deficits. One could therefore consider allowing all member states to issue ‘Coronabonds’, to the value of, say, 5-10% of GDP (€500-1000 billion). These bonds would have a low interest rate if they were supported by a ‘joint and several’ guarantee from all member states. That being said, this would not solve the key problem for the fiscally and structurally weaker countries, whose situation is further complicated by the fact that are already heavily in debt (Martin 2020, Gros 2011). The Italian government would pay a lower interest rate on the part of its debt financed by Coronabonds, but the overall public debt in Italy would still increase. Moreover, the relatively small gain in terms of interest savings through Coronabonds would probably be offset by a higher cost of the remaining debt (still 135% of GDP), since that ‘old’ debt would effectively be subordinated to the Coronabonds (Gros 2011).

Increasing the total public debt of Italy would be dangerous because a higher debt level usually requires a higher risk premium, which can lead to a doom loop. In this case, the higher debt leads to a higher risk premium, which in turn leads to higher deficits, and even higher debt (Alcidi and Gros 2019).

This is why the countries in the South (which are, for now, hit hardest by COVID-19) need grants, not credit. The simplest way would be for the EU to issue ‘eurobonds’ and then make a large transfer to Italy and any other countries in need. However, under present conditions this may not be possible because the Treaty stipulates that the EU budget has to be in balance (Article 310.1). This is why a number of proposals have been made to find a way around this prohibition of a deficit via guarantee schemes, sometimes involving the European Stability Mechanism (ESM).

Fortunately, there is no need for financial ‘acrobatics’, as there may be a simple way through. Italy, and some other countries, could be exempted from contributing to the next EU budget for a number of years. Normally, all countries contribute about 1% of their GDP to the common budget. Exempting the ‘Corona South’ from its obligations to contribute would be worth 1% of GDP per year. This could be framed as a sliding scale over the seven-year cycle of the Multiannual Financial Framework (MFF), under which the contribution for the ‘Corona South’ would increase, starting from zero in 2021, to 100% in 2027. The new MFF (which has to be agreed later this year anyway) could incorporate such a provision. The lower contributions to the budget would of course have to be made-up by the other countries. The burden would therefore fall on

those hit less hard by this crisis, or those simply better able to withstand the impact of the pandemic. These stronger countries in the North and East would have to abandon the principle of 'juste retour', at least for this MFF. For domestic political purposes they could label the 'extra-contribution' as 'Corona solidarity' in their national budgets.

In principle, the amount transferred implicitly could be quite high. For example, if Italy were exempted from contributions to the EU budget for seven years (and the expenditure structure of the Budget were to remain essentially the same), the transfer would amount to 7% of GDP (over €100 billion). If the exemption from contributions were to be scaled down linearly to zero over the life of the next MFF, it would still be worth approximately 3.5% of Italian GDP (or close to €60 billion over the entire MFF). For Greece, the figures would be smaller, at around a tenth of this (pro-rata).

The burden on the 'strong' North appears to be manageable: if about a third of the EU needs financial help worth about 1% of GDP, the remainder would have to shoulder about 0.5% of GDP (for a number of years). This approach would of course transform the nature of the negotiations for the new MFF which will take place later this year. Presumably, the budget would be refocussed along the priorities of the North, but even the proposals from the 'frugal five' foresee a budget of around 1% of GDP.

It would of course be possible to use also the expenditure side of the EU budget, which could foresee substantial sums for public health infrastructures and other investments (which might be needed more in the South). However, the sums involved here would probably remain much below the 1% of GDP contribution rate.

Of course, the transfers envisaged here would not come all at once. This means that in the short run the debt of the Southern countries would increase. Nonetheless, given that this is transitory (and that, on average, even Italy only pays less than 1% on its public debt), this should not be a problem. Moreover, financial markets are very likely to react to the announcement of such a scheme with more confidence within the country.

Therefore, there exists a plausible and simple way to organise a real expression of EU solidarity, without engaging in any large-scale financial transactions.

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# 19 Coronataxes as a solution

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30 April 2020

*The Covid-19 crisis is raising the financial burden for governments in Europe and worldwide. The current focus is on short-term immediate actions and targeted financial benefits to minimise the negative economic impacts. Soon the discussion will focus on how to manage the sovereign debt burden. In Europe, the public debate has centred around Coronabonds, while inflationary solutions have also been receiving academic attention. This column argues that a more practical solution is to introduce simple, temporary ‘coronataxes’ over the next five to ten years. These taxes could be implemented nationally and supported by European-level coordination.*

The coronavirus pandemic poses an immense challenge to society and citizens in terms of health and the economy. Currently, decision makers are focusing on public health and the performance of healthcare systems. At the same time, it is important to minimise the damage to businesses and wage-earners, as summarised in Baldwin and Weder di Mauro (2020). Next, we will have to think about how to pay the bill.

In Europe, the measures taken by the public sector enjoy broad-based support. Central banks have been quick in their responses and offered financing for those who need it. Governments have done their part by extending loans and offering financial support. Part of the assistance provided by the public sector is in the form of loans that are expected to be repaid, while part consists of financial support which will not be repaid. Financial support refers to measures whose cost impact will be spread over the coming years, with the public sector becoming increasingly indebted. While estimates vary from one country to the next, sovereign debt is expected to grow by 10–30 percentage points relative to GDP as a result of the rescue operations triggered by the Covid-19 crisis.

## **Public debt has been growing for a long time**

So far, the increase in public debt has been manageable because the ECB has been purchasing government bonds, thereby keeping the interest rate at a moderate level. The central bank may be expected to continue doing so, but the public debt will have to be repaid over time and further growth of debt brought under control. This can only be achieved through taxation.

Taxation is a tricky issue in a democracy. Irrespective of the country involved or the political party in power, tax rates and debt ratios have increased in most European countries, as well as in the US, over the past decades. Indebtedness has grown as a result of tax cuts or increased benefits. It is only fair to ask how we expect things to get better in the future when we have failed to fix the problem in the past?

Understandably, concerns over a disproportionate public deficit and national debt are increasing, and efforts are being made to find a way out, preferably other than taxation. Before taking a closer look at taxation, we need to consider two other potential solutions to servicing the debts incurred as a result of the corona crisis.

## **Coronabonds increase debt levels**

One proposed solution is Coronabonds, or Eurobonds as they could be called for simplicity. These are bonds issued indirectly by euro area countries, which would make it possible to target support to countries most impacted by the corona crisis. For many of the impacted countries, this joint liability would mean cheaper financing costs. However, in the current situation the cost of financing the debt is not a problem, thanks to the ECB. It has kept, and will keep, interest rates low. Shared liability would mean that the costs would be spread widely. But the problem with Coronabonds is that liability for one's own debt would be shouldered by others. In the absence of stringent conditions, this solution would, with time, lead to new problems and would, most likely, increase total debt. The scheme would not reduce the amount of debt, which should be one of cornerstones of sound financial management policy in a situation in which the level of debt is already excessively high. Efforts must be made to reduce debt levels because buffers should be created to cushion the impact of new crises that will inevitably emerge in the future. According to estimates by Reinhart and Rogoff (2010), a national debt of 90% relative to the GDP can be regarded as a sort of critical limit. If this is exceeded, the necessary preconditions for economic growth will suffer, paving the way for a range of financial crises. This level has been exceeded by some countries and may potentially be exceeded by number of more countries if the crisis continues.

## **Central bank-generated stable inflation is hard to engineer**

Another proposal calls for various schemes by which the central bank could induce inflation or otherwise create room for additional government borrowing. Gali (2020) calls for the use helicopter money as this emergency situation calls for emergency action whereby money-financed fiscal intervention would be the solution. Vihriälä (2020) suggests a big enough debt relief by the ECB for euro area government debt. This could take the form of conversion of ECB-held sovereign debt into perpetuity with zero coupon. Blanchard and Pisani-Ferry (2020) have stated that the current central bank policies have not provided evidence that the central banks would be giving up their price stability mandates. Even the current public bond purchases should not be regarded as indicative of future excess monetisation.

With time, a higher inflation rate would reduce the amount of debt in real terms. While the goal is extremely simple, a simple solution may be difficult to find. Market interest rates could easily jump and cause problems for indebted countries in the short term. To be successful, inflation should be generated over the medium term and remain steady and controlled. One potential way of making it work would be to raise the inflation target to 4% for a period of 10–15 years. The practical implementation of this would call for helicopter money in various forms. This approach might be termed ‘generated stable inflation’. Considering that the current rate of inflation in the euro area is hardly one percent, the mechanism described above would reduce the amount of debt by 35–55% over the years. Whether it could be achieved without close regulation remains to be seen. At least for the transition period, low-interest government bonds should be issued, which would only be purchased by the central bank. On the drawing board the solution looks simple enough, but market forces would make it bumpy and painful.

The solutions outlined above would provide no easy way out and would expose the economic system and the euro to elevated risks. Hence, they should only be resorted to if nothing else works and no other option remains.

## **Coronataxes as a solution to the debt problem**

Before anything else, we should take a closer look at taxation as a solution to the growing amount of debt. Taxation is mostly national. It would be advisable to think how the cost of countering the coronavirus could be financed through coronataxes. Corona taxation could be accomplished at the national level, and possibly even supported at the EU level, through joint coordination, declaration or even payments.

For example, coronataxes could be collected by raising overall taxes temporarily for 5–10 years, the objective being to repay the extra 10–30% of public debt incurred as a result of the corona crisis. The increase would apply to all forms of taxation. Income taxes should be increased by 1–5 percentage points for all wage-earners. Corporate taxes should be increased by 1–5 percentage points for all tax-paying businesses. Value added taxes should be increased by 1–5 percentage points across the board. The simplest and easiest solution would be to increase all forms of taxes by an annual 3-percentage point coronatax for the next 5–10 years.

Unfortunately, it is impossible to make the culprit of the corona crisis pay for the cost. In the financial crisis, the blame could be placed squarely on the banking sector, as its high indebtedness was one of the reasons for the problems. In addition, the financial support, in its various forms, had to be channelled to the banks. After the financial crisis, the EU saw the establishment of the Single Resolution Board that raised, in just four years, €33 billion euros from over 3,000 euro area banks and is set to collect a total of €60 billion by 2023. The funds were collected according to a formula worked out by member states under which large banks and those perceived most at risk contributed more than others.

With the corona crisis, it is hard to name the culprit. The number of those who benefit from the support measures, directly or indirectly, is high and difficult to tell apart. The fact is that everyone will benefit. The schemes help sustain society and the existing economic system. Consequently, it is probably necessary to spread the cost among the maximum number of payers.

### **Support for EU-wide coronataxes**

The tax schemes discussed above are still fairly straightforward. If we wish to set our sights a little bit higher, we could contemplate a European-wide decision or guidance on said temporary national taxes and tax rates. After all, it would be easier to sell the idea at home if all EU countries were involved. Maybe even a recommendation could be enough if decision-making within the EU proves too complicated.

Recently, the EU presidents published a joint roadmap for easing the restrictions imposed to combat the coronavirus. A similar roadmap for taxation could help with tax solutions at the national level. It could make national decision-making easier. Moreover, a uniform, coordinated temporary tax increase would tone down cross-border tax competition.

If we want to set the sights even higher and invoke nobler ideals of sustainability, we could consider an EU-wide carbon tax, emission trading pricing as well as carbon duties. That way, we could shift to taxing natural resources and environmental impacts, such as harmful externalities that accelerate climate change. While much progress has been made in these areas in recent years, we are just taking the first steps.

Perhaps EU-wide decisions are now conceivable, as we are compelled to collect taxes anyway. If it proves to be necessary to issue Eurobonds and there is sufficient innovativeness, the bonds could be tied to revenues from carbon taxes, emissions trading and carbon duties at the EU level. Emissions and air quality are supranational phenomena without national borders.

### **No viable alternatives to coronataxes**

Even though taxation undermines economic growth, there are, unfortunately, no sound alternatives. Taxes generate protests because few people love to pay them. Those who demand substantial subsidies and quick action on the part of the governments and central bank are presumably willing to accept coronataxes in exchange. The coronatax would be a natural solution, in preference to complicated schemes that would anyway fail to address the core problem. Coronabonds and central bank-generated stable inflation would only be conceivable when all other options are exhausted. Strong economic growth will hardly rescue us because the challenges of an ageing population will only grow and erode the basis for growth across Europe.

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# 20 A proposal for a Covid Credit Line

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*It is in the interest of every EU member state that countries in the Union hit by the coronavirus are able to take the necessary measures to control the pandemic and deal with the economic consequences without being constrained, and to do so very quickly. This column proposes a Covid credit line in the European Stability Mechanism, with allocation across member states proportionate to the severity of the public health and economic challenges encountered. While it would involve some coordination and solidarity among member states, the dedicated credit line would reduce risks to economic and financial stability for all while allowing members to sustain their efforts by making their borrowing costs less dependent on individual fiscal situations.*

The fight against the Covid pandemic in the EU requires that all national governments can finance the required spending, hence that they are not constrained on the markets. To this aim, the ECB's announcement on 18 March of a Pandemic Emergency Purchase Programme (PEPP) goes a long way. In a war, a government is usually backstopped by its central bank. Despite announced flexibility, though, the ECB may find it difficult to carry out potentially largely asymmetric interventions without an explicit joint fiscal backing.

It is still too early to know whether this pandemic will develop into a fully symmetric or somewhat asymmetric shock, where some member states are more hardly hit than others. What is sure, though, is that the Member states are unequal when it comes to borrowing large amounts on the markets. Hence the ability of financial support to adapt to the need of each country will be key. It is definitely in the interest of each Member state that a hardly hit country takes the necessary measures to control the pandemic. And from the perspective of those deeply hit countries, European solidarity will be key during this dark period and afterwards. Failure to cooperate in this crisis would send a very negative signal, potentially fatal to the European endeavour.

Tackling these issues requires a combination of fiscal and monetary actions. Given the time constraint, the solution to this coordination problem has to be found within a framework initially designed to protect monetary policy from fiscal policy: While a Eurobond would be appropriate, it is unlikely that an urgent introduction could be made. We therefore conclude with a proposal for a Covid Credit Line (CCL) of the European Stability Mechanism (ESM).

### **State of play: An enhanced, powerful response whose scope is however limited**

Over the last decade, we have been concerned by the lack of a significant fiscal capacity to react to shocks at the level of the euro area. The reaction to the Covid crisis reflects this persistent flaw. So far, national governments and the ECB have been at the forefront while the other European institutions have remained well behind. The risk is that the euro area will lag behind the US and the UK in its fiscal response to the pandemic-induced economic crisis, with adverse social and economic implications.

On 13 March the Commission proposed to allocate to the relief effort €8 billion of unspent past Structural Funds credits and €28 billion from yet unallocated funds (total 0.25% of EU GDP). This action amounts to a sectoral reallocation of structural funds but not to a mutualisation or a reallocation across member states. On 16 March the Eurogroup announced agreement on (a) the overall economic response to the outbreak of the Coronavirus; (b) the exclusion of temporary fiscal measures taken in response to the Covid crisis when assessing compliance with the fiscal rules; and (c) the full use of the general SGP flexibility clause for all member states.<sup>1</sup>

<sup>1</sup> This clause refers to “unusual events outside de control of government”.

On 18 March the ECB announced the launch of the PEPP, which complemented its previous week announcements of a new targeted longer-term refinancing operations (TLTRO), a new 120 billion tranche of asset purchases and temporary capital and operational relief for banks. The overall envelope for PEPP, €750 billion or more than 6% of GDP, is already substantial can be increased and its composition can be adjusted “by as much as necessary and for as long as needed”.

We regard the ECB initiatives as very significant and positive, which offer the possibility of responding flexibly to tensions on the sovereign bond market, while providing a backstop to the member states’ immediate relief effort.

The main problem with these initiatives is that the burden is once again on the monetary policy side. While this is perhaps inevitable in emergency and it has been the case also in other jurisdictions, we believe that, in a monetary union in particular, a large stimulus package needs to be more balanced on the fiscal side to be legitimate.

## **A joint Euro Relief Bond**

Proposals have been made for embarking on a coordinated relief effort financed by joint debt issuance, effectively mutualising the response to the crisis. Member states would pledge tax revenues to the fund, allowing it to borrow on the market (with joint and several liability) and to finance relief actions throughout the EU/euro area. Expenditures would be allocated according to the severity of the health crisis and the need for relief.

**There is much to say in favour of such an approach from the economic and political standpoints.** However, a scheme of this sort faces two difficulties:

- **There is no ready-to-use vehicle for joint debt issuance by the euro-area members.** The EU budget cannot go into debt beyond Treaty-allowed financial assistance programmes. There is no euro-area budget; and the ESM is not a budgetary institution, so it can only lend to individual member states. Joint borrowing would require allocating tax revenues to repaying the debt, but no European institution has taxing power;
- **Member states still have different strategies to cope with the crisis.** This reduces the already fairly limited inclination towards joint solutions.

These obstacles can be overcome. A solution of this sort may eventually emerge as the first-best response to the emergency. But we fear its time has not yet come.

## **A dedicated ESM credit line: The Covid Credit Line**

A possible scheme would be that a series of member states – ideally all of them in order to avoid any sort of stigma – apply to the Enhanced Conditions Credit Line of the ESM. This would give them access to ESM loans and open the way to an activation of the ECB’s Outright Monetary Transactions scheme, thereby further strengthening the ECB’s ability to control bond yield spreads and avoid self-fulfilling debt crises.

The ECCL is however a specific instrument intended to address country-specific market access risks. It can lend only for one year, with possible extensions up to another year.<sup>2</sup> A better alternative would be for the ESM to **create a new, dedicated Covid Credit Line with a long duration, access conditions and ex post conditionality.**<sup>3</sup> It should grant to all member states long-term credit lines dedicated to the financing of the Covid relief effort. Allocation across member states should be proportionate to the severity of the public health and economic challenges encountered. Conditionality should be minimal and consist in member states committing to be transparent in the use of the Covid Credit Line and not to introduce new discretionary spending or tax reduction measures that are not Covid-related as well as to wind down the Covid relief effort once the crisis is over. The duration of these credit lines should be very long because member states will emerge from the Covid crisis severely weakened and will not be in a position to repay soon. And the alternative of replacing ESM credit lines with newly issued domestic debt would frustrate the exercise. Consistently, the new bonds issued by the ESM should be of very long maturity, though at maturities that have a market.

This option would represent a concrete improvement in comparison to the current situation. The ESM has currently a €410 billion lending capacity (3.4% of euro area GDP), which can be increased by the Board of Governors. It would still involve little coordination and solidarity among member states, as each of them would remain sole responsible for its debt vis-à-vis the ESM. But a Covid Credit Line would help sustain the members’ effort, it would help make the corresponding borrowing cost independent of individual fiscal situations. Raising the volume of European (ESM) bonds would also be stabilising for the financial sector and would broaden the scope for ECB action.

- 2 “A PCCL and an ECCL credit line can be drawn via a loan or a primary market purchase. Both types of credit line shall have an initial availability period of one year and shall be renewable twice, each time for six months”. (ESM Guidelines, Art. 2.1)
- 3 Art. 19 of the ESM Treaty makes it possible for the Board of Directors to create new financial assistance instruments. Alternatively, the guidelines of the ECCL could be adjusted to fit for the purpose.

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# 21 The ESM can finance the COVID fight now

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LUISS; Johns Hopkins University; European University Institute

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*Member states are currently debating how to finance the fight against COVID-19. As time is pressing, practical and readily implementable solutions are needed now. Using the ESM to provide the funds needed is a reasonable and workable way forward. Italy, Spain and other states would benefit from using the ESM access to AAA funding to reinforce their debt dynamics: a combination of loan size, maturity and interest rates would strengthen debt sustainability. This column shows the stabilisation power of an ESM-ECB intervention, using existing instruments and the just announced ESM Rapid Financing Instrument, showing the case of Italy as an example. Combining ECB support with ESM funds would deliver a more resilient euro area, better placed to engage in a post-virus economic recovery. The announced EIB guarantees and the SURE unemployment re-insurance will also help countries. However, these measures are not a supplement, but a complement, to the already feasible ESM financing discussed.*

The COVID-19 pandemic outbreak is creating severe health and economic emergencies for Italy and other EU member states. Gathering all the necessary financial resources to fight it without the support from Europe not only would be inefficient, but a social risky bet.

Why will some European countries be able to confront the crisis on their own while others will not? Focusing on the case of Italy, the fundamental reason is pre-existing vulnerabilities, which limit fiscal space and magnify the impact of the economic sudden stop.

**1. High public debt.** As COVID-19 hit Italy, public debt,  $d$ , stood at 136% of GDP, the second highest in the euro area after Greece. Italy's debt dynamics were already on a knife-edge, stabilising at levels such that even small changes in growth or interest rates could make Italian debt unsustainable.



2. **Low growth.** In 2019, Italy's growth rate,  $g$ , was 1.2% and prior to the outbreak, the IMF projected Italian growth to be the lowest in the EU over the next five years, with estimated potential growth at just 0.5% (IMF 2020: Art IV consultation).
3. **High financing costs and needs.** In 2019, Italy's 'effective' interest rate,  $r$ , was 2.7%, the highest among the medium and large euro area countries, reflecting the fact that Italy is BBB-rated largely as a result of its high debt,  $d$ , and low growth,  $g$ . A direct implication is that Italy's financing costs and needs are very high. Italy's annual financing costs amount to 3.6% of GDP and its annual gross financing needs (GFNs) are over 25% of GDP.<sup>1</sup>

These three elements – high  $d$  and  $r$ , and low  $g$  – are the key to Italy's economic weaknesses. Before the COVID crisis, Italy was the only country of the euro area with  $(r-g) > 0$ . Hence, its debt will not decrease with time, as it would with  $(r-g) < 0$ , but must be reduced to arrive to a stable debt/GDP ratio,  $d^*$ , and a primary balance  $pb^*$  (the fiscal balance before interest payments) satisfying the public-debt equation:  $pb^* \approx (r-g) d^*$

Other factors should also be accounted for, as either weaknesses or strengths of the Italian economy, such as the following:

- **A high primary balance is a strength.** Italy has historically had high primary balances (1.7% of GDP in 2019). However, political fragmentation may be an obstacle to maintain a primary balance above 1% of GDP in the future (it should be noted that EU support may be key to maintain the historical Italian consensus). Cautiously, the IMF projects over the medium term a primary balance of 0.9% of GDP.
- **More committed investors now compared to the sovereign debt crisis.** The ownership of debt remains to a large extent domestic. The good side of this is that domestic investors are less footloose than international investors. Nonresident investors now account for (just under) 30%. In addition, the ECB holds about 28% of Italian debt, it will increase over time, and it will be reinvested for the foreseeable future. This means that the so-called capitulation risk, while present, may be lower than in 2010-13.
- **Vulnerable banks.** While banks have built sizeable capital and liquidity buffers, many still suffer from low profitability, excess capacity, and high NPLs. The ability of banks to support the economic recovery may be more limited than in other regions.

1 In recent years, the Italian Treasury increased the average duration of public debt to nearly 7.5 years. Although this reduces rollover needs, this positive effect was mitigated by higher interest payments.

## 1. Baseline scenario: Debt sustainable with risks

In our baseline scenario there is no COVID-19 crisis. We adopt the same medium-term macroeconomic scenario as the IMF (March 2020, IMF Art.IV). As described in Table 1, we only depart from the IMF's assumptions on the interest rate path, we project medium-term interest rates based on the benign market conditions prevailing pre-COVID shock. Under these assumptions, Italy's public debt was sustainable but vulnerable to macroeconomic and market shocks. In addition to the large public debt, debt rollover risk was high, since debt maturities alone over the next four years amounted to €1.83 trillion, roughly the size of Italy's GDP (Table 2 shows key summary statistics from a debt sustainability under the baseline, COVID-19 stress, and alternative ESM funding scenarios).

**Table 1** Macroeconomic and financial scenarios

<b>Interest rates</b>						
<b>Baseline</b>	<b>2025</b>	<b>2026</b>	<b>2027</b>	<b>2028</b>	<b>2029</b>	<b>2030</b>
Italy 1y	0.0	0.0	0.0	0.6	1.1	1.4
Italy 3y	0.2	0.2	0.2	0.7	1.3	1.8
Italy 5y	0.6	0.6	0.6	1.1	1.8	2.3
Italy 10y	1.0	1.0	1.0	1.9	2.7	3.2
<b>COVID19</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Italy 1y	1.0	1.0	1.0	1.3	1.6	1.9
Italy 3y	1.5	1.5	1.5	1.7	1.9	2.3
Italy 5y	2.0	2.0	2.0	2.2	2.3	2.8
Italy 10y	3.0	3.0	3.0	3.1	3.2	3.7
<b>COVID19+ESM +OMT</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Italy 1y	0.0	0.0	0.0	0.6	1.1	1.4
Italy 3y	0.2	0.2	0.2	0.7	1.3	1.8
Italy 5y	0.6	0.6	0.6	1.1	1.8	2.3
Italy 10y	1.0	1.0	1.0	1.9	2.7	3.2
<b>COVID19+ESM +OMT aggressive</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
Italy 1y	-0.7	-0.7	-0.7	0.6	1.1	1.4
Italy 3y	-0.6	-0.6	-0.6	0.7	1.3	1.8
Italy 5y	0.4	0.4	0.4	1.1	1.8	2.3
Italy 10y	1.0	1.0	1.0	1.9	2.7	3.2
<b>ESM rates</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>
ESM 1y	-0.7	-0.7	-0.7	0.0	0.7	1.1
ESM 3y	-0.6	-0.6	-0.6	0.2	0.9	1.3
ESM 5y	-0.5	-0.5	-0.5	0.4	1.1	1.6
ESM 10y	-0.3	-0.3	-0.3	0.7	1.5	2.1

## 2. COVID-19 scenario: A very risky path

The Italian government announced in March a series of support measures amounting to €24.7 billion and guarantees amounting to €65 billion, and a second aid package of €25 billion to be approved in April (see Appendix for the details of the measures).

Table 1 shows our macroeconomic scenario under the COVID-19 shock. Real GDP contracts to almost -8% in 2020, bounces back in 2021 to +5%, and converges towards a medium-term growth of 0.6%. The primary deficit rises to 7% of GDP and, once recovered from the COVID shock, gradually improves towards a primary surplus of nearly 1% of GDP.

Table 2 shows that after the COVID-19 shock, public debt jumps to 162% and increases gradually towards 165% over the next ten years. We estimate the debt-stabilising primary balance at 1.3% of GDP over the coming years, up from 0.1% of GDP in the baseline — a very large increase in the required fiscal effort to ensure the sustainability of debt.

The annual gross financing needs (debt maturities, interest payments and primary balance) increase by over 10 percentage points of GDP per year to 36% of GDP. After the shock, the Italian Treasury would need to rollover an additional €670 billion of debt over the next four years.

On its own, Italy could stabilise its debt with a relatively high primary balance, as it has had in its recent history — Italy had sustained primary balances above 1.5% of GDP. However, such extra fiscal effort can be socially very costly in the aftermath of the COVID crisis and possibly endanger the recovery. Instead, using euro area support Italy could put its debt in a clearly manageable path in the medium run, as we show in Table 2. Which form should the financial support of the euro area take?

## 3. ESM and ECB support: Reinforces debt sustainability

It is critical that the euro area shows its determination, beyond the already expressed support by the ECB, as, fortunately, seems to be the case. A European Recovery Programme will require different instruments to address different needs (firms and workers in distress, health security, etc.) However, there is a crucial need that must be confronted: to make sure that the effort that member states are making to fight, and recover from, the COVID-19 does not become an excessive debt burden or, even worst, another euro debt crisis. To address this, here we evaluate alternatives that combine COVID-related ESM loans and ECB support. We see this as the fastest way to provide low interest funding while the pandemic freezes economic activity.

We evaluate various scenarios (Table 2) which combine different intensities of support by the ESM and the ECB.

On the ESM funds, we consider the following alternatives:

- **Loan size.** We consider two alternatives: a smaller and larger ESM loan of €35 billion (2% of GDP) and €120 billion (6.5% of GDP), respectively. The smaller loan is in line with the maximum size proposed by the Eurogroup. Both are well within the existing ESM funds of €410 billion.
- **Loan interest rate and maturity.** We assume a 12-year maturity with a 5-year grace period. We also assume that the ESM maintains a funding strategy with an average maturity between 2 and 3 years. We assume a 10 basis point spread charged on its standard loans (Table 1 shows the assumptions on the ESM funding rates).

In addition, we also assume that the ECB's asset purchase programmes continue as planned and that the ECB's OMT is activated. On the back of ESM support and ECB's asset purchases, we assume that Italian yields are brought back to levels similar to the baseline (pre-COVID-19). In a separate scenario, we also consider a more aggressive OMT programme, where 1- to 3-year bond yields are compressed towards those of France.

A note of caution. Our assumption regarding the prevailing market rates does not change in a scenario with a big or a small ESM loan; in both cases we use the no-stress, pre-COVID-19 rates. We could have assumed lower medium-term market rates in the scenario with bigger ESM loan. Needless to say, this would make the outcome of the debt sustainability analysis even more favourable toward the bigger size programme.

The upshot of these scenarios is that Italy's debt dynamics improve markedly and become sustainable and, in particular, that the reduction of gross financial needs and interest payments plays a crucial role.

- **Public debt on decreasing path.** Debt/GDP falls by 10 percentage points of GDP from its peak of 162% in 2020 to 152% in 2030. Extending our medium-term macroeconomic assumptions into the longer term would show a further reduction in Italy's debt/GDP.
- **Fiscal effort back to normal.** The annual fiscal effort needed to stabilise public debt is brought back to a level similar to the pre-COVID19 shock: the debt-stabilising primary balance (PB\*) drops by 1.4 percentage points of GDP relative to the stress scenario without support.
- **GFNs considerably lower.** Annual gross financing needs drop by over 7 percentage points of GDP per year, relative to a scenario without European support.

- **Debt issuance at manageable levels for the Italian Treasury.** The cumulative market financing needs over the near term (2020-25) would drop by €730 billion (about 40% of GDP) relative to a scenario without ESM support. This massive improvement substantially reduces the costs of the Treasury monthly issuance.
- **Stronger ESM and ECB support is preferable.** There are differences among the level of ESM and ECB support. Comparing the most supportive scenario (€120 billion loan and aggressive ECB's OMT) to the least supportive (€35 billion loan and less aggressive ECB's OMT), the former delivers €182 billion (10% of GDP) less market funding needs than the latter.
- **Interest payments drop.** Under the most favourable scenario, with strong ESM and ECB support, the cumulative interest payments 2020-30 fall by about €260 billion, over 14 percentage points of (2019) GDP relative to a scenario without European support.

**Table 2** DSA scenarios: Main results

Scenarios	ESM Loan size (bn)	Debt 2020 (% GDP)	Debt 2030 (% GDP)	Cum. market funding 2020-24 (bn)	Avg. GFNs (% GDP)	Avg. PB* (% GDP)	Cum. Interest Payments 2020-30 (bn)
Baseline, pre-COVID	-	137	129	2.466	25	0.1	565
COVID	-	162	164	3.476	36	1.3	898
COVID+ESM_35 + OMT	35	162	153	2.927	29	0.1	669
COVID+ESM_35 + OMT aggressive	35	162	152	2.903	29	0.0	640
COVID+ESM_120 + OMT	120	162	153	2.767	29	0.1	666
COVID+ESM_120 + OMT aggressive	120	162	152	2.745	29	0.0	639
Euro group 3rd April	45	162	153	2.970	30	0.1	670

Source: Authors' calculations

In addition to these results, we also analysed an ESM scenario based on the information leaked by the press on 3 April regarding the latest Eurogroup proposal (negotiations are ongoing). The proposal reported by the media would entail a €45 billion loan at 5-year maturity. The upshot of that scenario is that the results would be very broadly similar to the €35 billion scenario analysed here. However, the cumulative market financing needs by the Treasury over the next years (2020-24) would increase by over €200 billion (12% of GDP) as the loan maturity considered in the Eurogroup proposal is only 5-year versus 12-year maturity and 5-year grace-period assumed in our scenarios.

#### **4. What are the differences between Coronabonds, ESM loans and ECB purchases of sovereign bonds?**

What shape could euro area coordinated fiscal support take? While following the last Eurogroup meeting, the use of ESM resources appears to be the preferred alternative for northern European countries, a variety of alternatives are currently on the table. In this section we explain what differentiates (and what does not differentiate) Coronabonds and similar forms of common issuance (i.e. the European Recovery Fund) from an ESM loan and from maintaining the status quo, in which support is obtained using sovereign bond issuance and ECB purchases in secondary markets.

To facilitate the comparison, Table 3 summarises the main aspects of each funding alternative. First, ESM funding could be available rapidly. The ESM is already fully operational and has €410 of available funds, which (with political will) could be tapped without delays. In contrast, Coronabonds, even if there would be political will, would require a process of design – including legal aspects – and ratification that could last for months. It should be noted that the ESM alternative involves only euro area countries, while SURE or measures involving the EIB would be at the EU level.

In addition, funding through the ESM presents some financial advantages. The ESM can pass on its low (AAA-rating) funding rates at an almost zero spread and it is more legally secure (Pröbstl 2020). Currently, even under the ECB's PEPP program, there is a 150 basis point spread between a 7-year BTP and a German Bund (7-year is roughly Italy's average debt maturity). An alternative common issuance instrument is likely to have a strong rating. Whether it would reach the level of the ESM, where the capital structure includes committed capital from high rating stockholders covering the maximum lending capacity, would depend on the agreed guarantee structure.

Under a joint guarantee structure, the rating of the new instrument would be similar to AAA. Instead, guarantees according to the ECB capital key could imply a lower credit quality of the guarantee, and thus more expensive borrowing. A new common instrument, even if designed to be AAA, would lack the liquidity of a well-established market of ESM bonds. This comparatively lower liquidity is likely to translate into more expensive and less effective financing terms.

Second, ESM loans perform a powerful maturity transformation for member states. The ESM funds itself on average between two and three years (at negative yields for an AAA-rated issuer) and provides long-term loans to member states (up to 35 years). The proposal currently under discussion by the Euro group foregoes this important benefit by proposing a maturity of the ESM loans not higher than five years.

Last, but not least, by replacing issuance by domestic DMOs, ESM loans reduce the risk of tensions on primary markets by making lighter the (already very heavy) debt issuance of Italian Treasury.

**Table 3** Principal features of different funding strategies

	<b>Sovereign Bonds</b>	<b>ESM Bonds a/</b>	<b>Corona/Euro Bonds b/</b>
<b>Availability</b>	Yes	Yes	No
<b>Time to deploy</b>	Readily available	Yes c/	Several months
<b>Issuer</b>	National DMO	ESM	Euro area institution
<b>Beneficiary</b>	Issuing country	Borrowing country	All (in Bofinger et al. 2020 proportional to crisis costs)
<b>Payor</b>	Issuing country	Borrowing country	All (in Bofinger et al. 2020 proportional to ECB capital key)
<b>Volume</b>	Fiscal space	410 billion	Crisis costs
<b>Cost</b>	Dependent on country rating	AAA	Depends on guarantee structure (almost AAA for joint and several)
<b>Maturities</b>	Varies by member states. OMT only up to three years	Borrowing 1-10 yrs Lending up to 35 yrs	Undetermined
<b>Liquidity</b>	Established market, depending on rating	Established market	Low (new instrument)
<b>Seniority</b>	Pari-passu, but ECB purchases can block CAC recourse	Senior, but 1) it can be waived and 2) long maturity defers seniority	Senior
<b>Fiscal transfers</b>	No	No	No (Giavazzi and Tabellini 2020), Yes (Bofinger et al. 2020)
<b>Guarantee structure</b>	None	Joint and several (capital of AAA issuers)	Multiple alternatives d/

a/ See Benassy-Quere et al. (2020) or Erce et al. (2020)

b/ See Bini Smaghi (2020), Giavazzi and Tabellini (2020) or Bofinger et al. (2020)

c/ Requires the parliamentary approval of three member countries.

d/ Alternatives that rely on joint and several guarantees (as in Giavazzi and Tabellini 2020 or Bofinger et al. 2020) will be less affected by the credit quality of weaker guarantors.

On the negative side, the conditionality accompanying an ESM loan can be a deterrent for governments, particularly if, as in the case of Italy, they are under political pressure. Against this argument, it seems that the Eurogroup is ready to agree on access to ESM without strings attached if the funding is for the COVID emergency.<sup>2</sup>

The seniority of ESM loans is also seen by some as a potential problem. We believe this risk to be manageable for the three following reasons. First, the size of the ESM loan would be small relative to the stock of debt. Second, seniority could be waived, as with the ESM programme to Spain in 2012. Third, the long maturity of ESM loans dilutes/defers any market concern about seniority (Ghezzi 2012a).

Closely related to the seniority issue are the limits set by the ECB for its asset purchase programmes. In particular, the purchase of more ESM bonds and less national government bonds could be beneficial for member states and the euro area as a whole. Financing euro area countries through ESM bonds reduces the likelihood that the ECB will hit the capital key limit for the borrowing country.<sup>3</sup>

## 5. Conclusions

COVID-19 has changed the lives of European citizens, at least temporarily, and there is widespread consensus that how this crisis is resolved will mark the evolution of the EU and the euro area. Member countries have taken individual initiatives first, but the virus has no nationality and European action is needed. After the ECB took the lead, the European Commission and the other European institutions – in particular, the ESM and the EIB – are now reacting to the call, which hopefully will become “our Marshall Plan” as Mário Centeno, President of the Eurogroup, said (El País, 4 April 2020). Support will take different forms and use different instruments, with a common goal: to avoid that coronavirus overburdening any European country or region.

Preventing that the COVID-generated sovereign debt becomes an unnecessary – crisis-ridden – burden must be a central part of this programme. The announced EIB guarantees and the SURE unemployment re-insurance will also help countries. However, these measures are not a supplement, but a complement, to the already feasible ESM financing discussed here. In this column we have exemplified how combinations of COVID-conditional ESM loans and ECB interventions can be used to support Italy, one of the most COVID-stressed euro area countries.

<sup>2</sup> Benassy-Quere et al. (2020) and Erce et al (2020) discuss how to design COVID-related light conditionality.

<sup>3</sup> Euro area sovereign bonds contain two-limb aggregation clauses. ECB purchases can reduce their effectiveness by diluting the bonds for which purchases are relatively smaller. This could disrupt liquidity on primary markets at times of distress



There is the view that the ESM intervention should be saved for a later day, in case that a debt crisis really emerges. However, the fact that the ESM was originally designed as crisis resolution mechanism, cannot mean that it should not be used as an effective crisis prevention mechanism, when it can. In the same way that countries that have not been heavily hit with by the coronavirus should not procrastinate over their preventive testing, preventive economic measures should be resolute. ESM and ECB support would reinforce Italy's public debt sustainability, support confidence, and fundamentally alleviate the market funding needs over the next years of the Italian Treasury.

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## **Appendix. Italian fiscal package**

Here are the details of the Italian government fiscal support plan:

(i) Law Decree n. 9/2020 of 2nd March, containing measures for families, workers and business.

(ii) Law Decree n. 14/2020 of 9th March (strengthening the healthcare system and civil protection).

(iii) Law Decree n. 18/2020 of 17th of March (“Cura Italia” decree).

(iv) Additionally, various Decrees of the President of the Council of Ministers and Civil Protection ordinances were used to enact measures for the containment and management of the emergency.

From the summary presented by the Ministry of Finance on their webpage, the measures taken, presented along with the amounts of funding or guaranteeing involved, are the following:

- Strengthening the National Health Care System and the Civil Protection Department (3.2 billion)
- Preserving employment levels and incomes (10.3 billion)
- Pumping liquidity to help businesses and households (5.1 billion + 60.5 billion in guarantees).
- Suspending tax payments and providing tax incentives for workers and businesses (1.6 billion)
- Additional measures to support central and local public administrations, including municipalities, are worth €45.5 billion.

This adds to around €24.7 billion direct measures and above €60 billion in guarantees. In addition, new measures have been announced by PM Conte for April 2020, amounting to €25 billion.

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## 22 Maturity, seniority and size: Make sure the ESM's pandemic crisis support is fit for purpose!

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**Giancarlo Corsetti and Aitor Erce**

London School of Economics; Center for Equitable Growth, University of California Berkeley; UC Berkeley

29 April 2020

*The Eurogroup recently agreed to provide support during the Covid crisis through a dedicated European Stability Mechanism credit line. A discussion is playing out in European capitals, most intensely in Rome and Madrid, regarding the usefulness of tapping these credit lines. While the final details are still pending, this column evaluates the conditions that seem to be currently on the table. As these programmes provide very little interest savings, designing them in such a way that would not trigger disruptions in the bond markets of borrowing countries is key. To this end, the ESM should consider waiving its seniority and engaging with countries using longer maturity structures.*

Most of the discussion regarding access to European Stability Mechanism (ESM) financing to fight the Covid-19 crisis has focused on the importance of removing conditionality from ESM loans. Memories of harsh austerity and fears of an electoral backlash made it imperative that a detailed memorandum of understanding (MoU) was not part of ESM loans. Removing conditionality would not only eliminate the stigma that asking for help could create (already an important concern), it would also prevent the potential damage from ill-timed fiscal measures during a reconstruction process that is quite uncertain in all but one feature – it will be long and difficult. On 9 April, EU finance ministers agreed that the ESM can provide loans with the sole requirement to commit to use the money to pay for direct and indirect healthcare, cures, and crisis-related costs. This new dedicated facility will be called the Pandemic Crisis Support Credit Line (PCSCCL).

However, while we know the PCSCL will not include thorough conditionality in the form of a MoU, there is much less clarity regarding what type of financing terms it will offer. According to officially disclosed information, the PCSCL will be based on the existing Enhanced Conditions Credit Line (ECCL). This implies that there are additional characteristics of the loans that are known:

**Maximum size:** The finance ministers have agreed that the ESM can grant PCSCLs amounting to 2% of each member's GDP.

**Interest rate on the loan:** The standard pricing of an ECCL, once it is activated, is 35 basis points (plus fees) over funding costs. To this, commitment fees for making the credit line available should be added.<sup>1</sup>

**Type of access:** ECCL credit lines have an availability of one year (renewable) and can be drawn via a standard loan or a primary market purchase.<sup>2</sup>

## What is missing?

The following are financial aspects that would shape the impact of the PCSCL, but for which we still have no detail:

**Funding strategy:** In order to understand what the cost of the PCSCL will be, we need to know not only what margins and fees the ESM will charge, but also how the ESM is going to finance the loans.

What issuance strategy by the ESM should back PCSCL support? While ongoing debates have brought proposals for the issuance of perpetual bonds, as we argue in Erce et al. (2020), the most effective way to provide official support is to obtain financing using instruments that are as short as possible. In this way, the ESM can leverage the currently ultra-low short-term interest rates and perform a strong maturity transformation.

**Loan maturities:** According to the existing guidelines, there is no written limit to the maturity of the ECCL support. We know, however, that the amended ESM treaty, the discussion of which was frozen by the Covid crisis, wanted to impose a maximum average maturity of five years. In a recent interview, Klaus Regling argued that average maturities for the PCSCL could be as long as 10 years. In Erce et al. (2020), we show quantitatively the extent to which maturities longer than 10 years would help smooth refinancing needs in the medium term.

1 The ESM pricing guideline is available [here](#).

2 The detailed guideline for the ECCL is available [here](#).

**Seniority:** The typical loan from the ESM is senior (its repayment has priority in default) to every creditor but the IMF, although ESM seniority can be waived (as in the 2012 Spanish programme). Will the ESM remain senior under the PCSC? Or will it, as the ECB, lend in a pari-passu fashion (i.e. be treated equally as the rest of creditors)?<sup>3</sup>

### **The risk to avoid: “Too senior not to disrupt”**

During the euro area crisis, the seniority status of official lenders became an especially contentious issue. The senior role of the ESM replaced the de jure pari-passu approach initially pursued. The rationale for claiming seniority is that official support (both through liquidity and conditionality) increases a country's ability to repay, to the benefit of all existing creditors. In exchange for ‘enlarging the size of the cake’, the ESM claims seniority (Corsetti et al. 2020).

The seniority of ESM loans can have undesired effects on sovereign (junior) bond markets. According to Ghezzi (2012), the euro area experience proved that private sector subordination can have perverse effects when markets are not certain about the success of the programme. If the sovereign borrower does not recover following official lending, the loss given default increases as the official loan dilutes private creditors. This can undermine market access.

On the ‘positive’ side, the small loan size proposed makes dilution less important. How important dilution is would depend on the repayment structure of the loan. A bullet repayment approach would imply an increase of refinancing needs of 2% of GDP the year the ESM loan would mature.

### **What are the interest savings from the PCSC?**

As long as the ECB prevents belief-driven speculative behaviour in the euro area bond market (i.e. Europe remains in a good equilibrium), the interest savings are not great.

Italy's three-year yield currently hovers at around 1%. This is in contrast to the ESM loan, which would add 40 basis points (fees included) to the borrowing costs. If the average maturity of the ESM bonds is three years, the ESM loan would cost 30 basis points. In this scenario of stress, actual savings would then amount to  $(0.01-0.003)*27$  billion= €150 million of direct interest savings a year.<sup>4</sup>

3 See Gelper (2016). A complication is that the preferred creditor status of the ESM is anchored in the ESM Treaty. Spain benefited from a waiver that was explicitly foreseen as a possibility only during the transition from the EFSF.

4 Direct savings may be larger if uncertainty causes yields to rise. Indirect savings may be substantial if PCSC triggers OMT.

This benefit seems too small to add senior creditors and dilution risk into the sovereign bond market.

## **Seniority can have consequences: Evidence from 2011**

Despite the relevance of seniority in sovereign debt markets, there is very little systematic evidence on seniority in practice (Schlegl et al. 2015). Here, we provide evidence using the recent experience of the euro area, where the official sector seniority was effectively diluted by its longer maturities (Hatchondo et al. 2016).

In December 2010, Ireland received support for almost €65 billion, of which €40.2 billion came from the EFSF/EFSM, the prequels to the ESM.<sup>5</sup> Originally, the loan carried a margin of 250 basis points over funding costs and an average maturity of 7.5 years. In turn, Portugal entered its programme in May 2011. The size of its package was €78 billion, of which €52 billion came from the EFS. Initially, Portugal's loan featured a 210 basis-point margin and an average maturity of 7.5 years. In July 2011, the Eurogroup granted both countries a reduction of the loan margins (to 0 basis points) and an extension of the average maturities to 15 years.

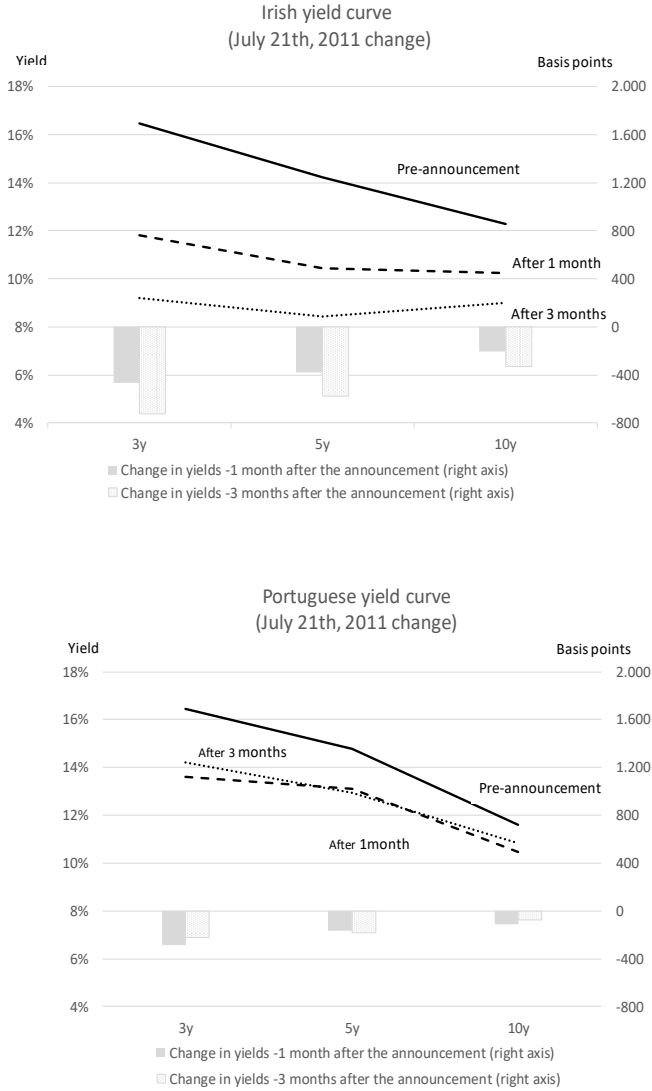
This experience provides an opportunity to analyse whether and how longer maturities can mitigate the negative effect of seniority (Chatterjee and Eyigungor 2015). We study how the bond market responded to the change in the repayment profiles of official lending, such that senior debt repayments became more backloaded. This change substantially reduced the concern of bondholders that, at maturity, they would have to stand in line with senior creditors able to dilute them.

To obtain a first insight, we compare the change in both the sovereign yield curve and bond market liquidity (as measured by bid-ask spreads) around the time in which official lending, originally with a repayment structure falling in a window five to ten years ahead (prior to the loan amendment), was “extended” to be repaid beyond ten years. We do this in Figures 1 and 2.

Figure 1 describes the dramatic yield compression and flattening of the yield curve that followed the extension of maturities and suppression of margins. In Figure 2, we present the change in the value of the average bid-ask spread of the corresponding sovereign bonds, in the month before and after the amendments to the lending terms. While in Ireland the liquidity improvement was sizeable, this positive effect did not play out in Portugal.

<sup>5</sup> The overall programme financing was above €80 billion but, as Daragh Clancy likes to remind us, almost €20 billion of that amount were Irish savings.

**Figure 1** Irish and Portuguese sovereign yield curves around the 2011 extension of maturities and reduction of margins

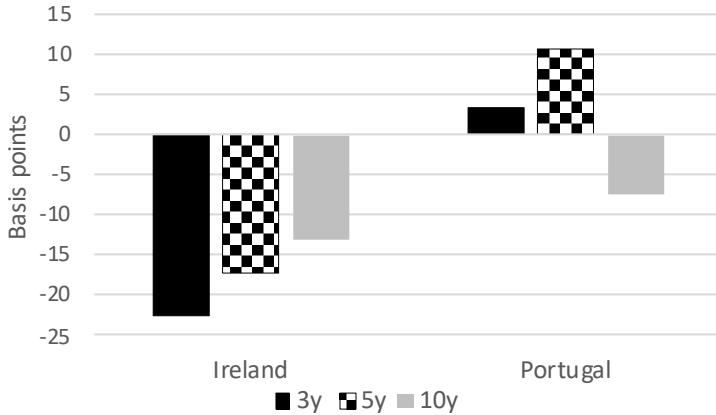


Source: Corsetti et al. (forthcoming), from Bloomberg and author's calculations.

Notes: The right-hand axis contains the difference (in basis points) between average yields (at each maturity) one month after the amendment. The left-hand axis measures yields in percentage points.



**Figure 2** Bond market liquidity



Source: Corsetti et al. (forthcoming).

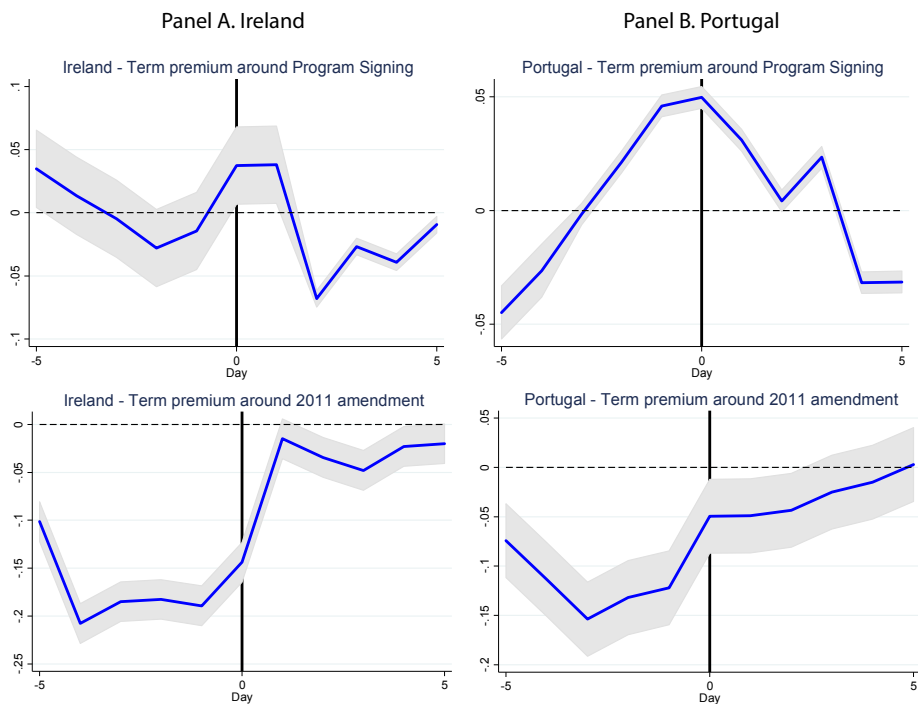
There is an important caveat to keep in mind when looking at this evidence. Many concurrent factors, first and foremost ECB actions, could contribute to explaining the dynamics in Figures 1 and 2.

However, we also use a regression-based event-analysis framework (Gourinchas and Obstfeld 2012), which allows us to understand how the difference between the 10-year and 3-year bond yields (term spread) deviated from a fair-value model (defined by a rich set of variables, including ECB policy measures) during the weeks around (i) the signing of the ESM loan and (ii) the 2011 modification of the loan. We build the term spread using daily data from 2009 to 2016 for the corresponding benchmark 3-year and 10-year maturity sovereign bonds. Figure 3 presents the results.

Panel A in Figure 3 shows the results for the Irish case. In the week ahead of signing its EFSF loan, the excess term premium hovered around 0. In the week following the announcement, as yields went up, the term spread went 5 basis points negative. An inversion of the curve, at such high-yield levels, is an indicator that markets are increasingly concerned about default. In contrast, while ahead of the July 2011 change in lending terms the excess term premium remained deeply negative (-20 basis points), following the amendments yields fell dramatically (Figure 1) and the negative term spread disappeared. This bullish flattening of the curve indicated that default concerns receded as official loan repayments were postponed.

The results for Portugal, presented in Panel B of Figure 3, are consistent with those for Ireland. In the run-up to the signing of the ESM loan in March 2011 there was a very short-lived improvement in the term spread, but this soon turned back to negative, indicating markets were not convinced the programme solved the problem. Instead, when maturities were extended, the drop in yields and fattening of the yield curve (Figure 1) coincided with the disappearance of a negative excess term spread.

**Figure 3** Econometric evidence



### **Policy implications: Dilute official loan seniority, de jure or by maturity**

A small PCSCL, together with standard margins, would deliver only a modest amount of savings. Moreover, if the maturity of the loans is not long, the loans would not deliver significant smoothing of financing needs and would embed senior creditors and dilution risk in sovereign bond markets.

Experience shows seniority can be destabilising. De-jure seniority does not eliminate credit risk for the official sector, but it can tilt the balance of risk against private creditors and disturb bond markets (Schlegl et al. 2015). If waiving seniority is not possible, the use of longer maturities can smooth such effects by placing repayment senior creditors later in time.

Why should the ESM restrict the maturity of its lending through the PCSCL to a window below ten years? In fact, the longer the loans the ESM provides, the easier it will be for borrowers to recover swiftly, and the more room for manoeuvre it will have to design an adequate financing strategy.

These considerations imply that to enhance the effectiveness of the PCSCL, access should be provided both without seniority and by back-loading loan repayment. These features would avoid dilution risk, making the PCSCL more attractive for potential borrowers.

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## 23 COVID-19: A euro area safe asset and fiscal capacity are needed now

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*The COVID-19 outbreak that is hitting the euro area economy needs to be met by a powerful policy response beyond the emergency measures already in place. This column uses an empirically calibrated model to show that the creation of a safe asset and fiscal capacity at the centre – on which the debate has been ongoing for a long while – would be a powerful means to mitigate the economic impact of the crisis.*

The COVID-19 shock initially looked to be mostly a supply-side story, for which both monetary and fiscal stimulus can do little. However, the almost immediate sharp tightening in financial conditions related to liquidity, financial market tensions, and the collapse in confidence and aggregate demand call for an energetic macroeconomic policy response. Monetary policy and national fiscal actions are unprecedented but may still not be enough. A powerful fiscal response at the centre looks necessary.

Both the symmetric nature of the shock and limited fiscal space in several member states argue for a response at the supranational level. However, the political hurdles that the creation of new fiscal instruments at the European level – especially if they entail risk sharing across member states – would have to cross are daunting. The problem would remain even if European leaders decided to go for a quick fix through the European Stability Mechanism, and a more permanent solution would have to be developed over time. This can only be achieved if it is seen as benefitting all, which is what our modelling exercise, discussed below, suggests.

## **A possible grand bargain**

There is a strong case for creating a European safe asset to replace national sovereign bonds in their role as collateral for banks in repos and inter-bank loans (Alogoskoufis and Langfield 2019, Bénassy-Quéré et al 2018, Leandro and Zettelmeyer 2018). Proposals have also been put forward to create a fiscal capacity at the centre of the euro area to finance deficit spending (Arnold et al. 2018). We have combined these proposals into one comprehensive package and quantified its impact on the resilience of the euro area economy in the face of major adverse shocks like the one we are currently experiencing.

Specifically, the package includes the following:

- A safe asset is issued at the centre underpinned by a stable revenue source, for instance, a proper central tax base or an obligation of national governments to secure a predictable revenue flow to the centre. It is swapped at market prices for national sovereigns on the balance sheets of banks. It replaces national sovereign bonds in their role as collateral for banks in repos and inter-bank loans. Moreover, the safe asset enjoys exclusive eligibility for ECB asset purchases. It thus replaces national sovereign bonds on the ECB's balance sheet. To allow proper price discovery, a sizeable enough new issuance of the safe asset will precede the swap operation.
- The safe asset would receive seniority over national sovereign bonds to ensure it is seen as an attractive investment for banks. The profit banks generate by the sale of sovereign bonds is allowed to be spread over several years. This is to smooth the transition to a bank business model that no longer relies on carry trades with sovereign bonds and to allow sufficient time for banks to achieve higher profitability from other sources. The swap operation would not imply any fiscal transfer. The ECB would enable banks to close in advance their financing operations to offset the selling of national sovereign bonds on their balance sheet.
- Beyond the issuance of the safe asset to purchase national sovereigns, the role of the central fiscal capacity could be expanded to allow borrowing for the purposes of fiscal stabilisation policy. The ECB would be allowed to purchase the safe asset in the secondary market, as is already the case for debt issued by supranational EU agencies (such as the ESM). This would underpin the safe asset's role as a liquid, risk-free benchmark.

The total amount of safe assets needed to purchase national sovereigns in the hands of the ECB and on the balance sheets of the banks would be roughly 30-40% of GDP. This implies that, on average over the cycle, the issuer of the safe asset would need a revenue flow roughly in the range of 0.5% and 1.0% of GDP, the bulk of it being covered by interest receipts on the national sovereigns owned at the centre.

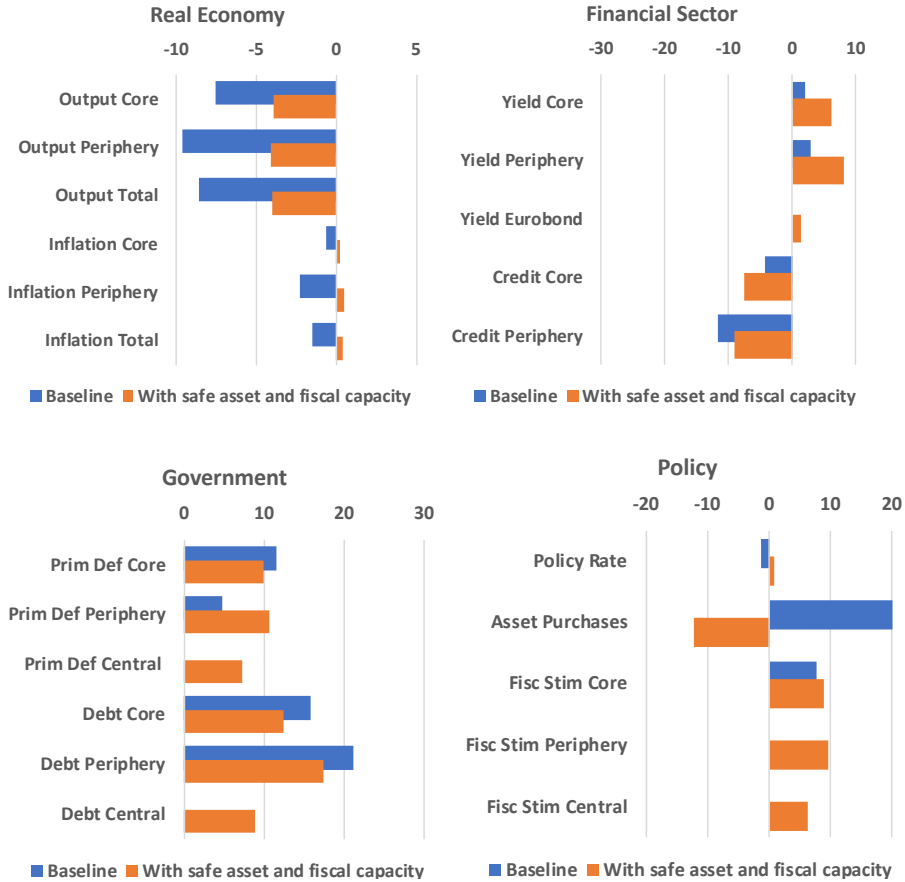
The additional issuance of the safe asset in bad times to fund deficit spending at the centre depends on the depth of the slump. It could – according to the model simulation discussed below – in the current exceptional circumstances be in the range of 5% and 10% of GDP. If this is repaid over a period of ten years, it would require an additional annual revenue flow to the centre in the range of 0.5% and 1% of GDP, given that the yield would presumably be low.

Aside from the stabilisation effects of this package (see below), the financial and policy landscape of the euro area would permanently improve. The replacement of national sovereigns with a safe asset on banks' balance sheets serves to break the 'doom loop' between the cost of bank funding and sovereign yields in the euro area 'periphery'. With the safe asset enjoying exclusive eligibility for the purposes of quantitative easing, the ECB would obtain a monetary policy instrument that does not interfere with national fiscal policies via national sovereign debt purchases. Moreover, as large amounts of national debt are swapped with safe European-level debt, the default risk at the national level is reduced, with fewer calls on rescue programmes.

## **Impact on the resilience of the euro area economy against the shock**

In several papers (Codogno and Van den Noord 2019, 2020), we examined how this new set of policy tools could improve the resilience of the euro area economy against shocks. How would this pan out in terms of absorbing the current shock? We simulate a scenario which we think broadly reflects the shock that hits the Eurozone economy now. Accordingly, we assume a symmetric supply shock of -5% of GDP combined with a symmetric demand shock of -10% of GDP hitting both the core and periphery.

**Figure 1** Absorbing the COVID-19 shock: Two scenarios



Note: Per cent or percent-point changes relative to a steady-state without shocks. The charts show the impact of a -5% of GDP symmetric supply shock and a -10% of GDP symmetric demand shock.

From the simulation results (Figure 1), the following broad picture emerges:

- In the baseline (without Eurobond/fiscal capacity), output is hit twice as hard in the periphery (with a collapse of the order of -8%) than in the core (-4%). This is primarily due to the re-emergence of the ‘doom loop’ in the periphery, with a collapse of bank lending combined with a substantial increase in public debt and yields. Fiscal policy is eased in both the core and the periphery on the account of automatic stabilisers, but discretionary policy is eased markedly only in the core in



a context of greater availability of fiscal space. Monetary policy kicks in forcefully – both conventional and non-conventional – but cannot prevent a deep economic recession.

- By contrast, with a safe asset and fiscal capacity at the centre, bank lending in the periphery would shrink but not collapse, and fiscal stimulus at the centre would provide a substantial demand boost. The increase in public debt in the periphery would be more muted. Yields in both the periphery and the core would increase more strongly as a result of the fiscal stimulus and associated bond issuance. Monetary policy would play a much more modest role, in fact even tighten somewhat in response to higher inflation emanating from the supply shock (which is left to play out even more strongly as the fiscal response absorbs the demand shock).

All in all, with a safe asset and fiscal capacity at the centre, the recession will be much more muted. Fiscal policies could do most of the job of macroeconomic stabilisation without resorting massively to unconventional instruments and without sowing the seeds of sovereign debt increases and bank defaults. Importantly, the package would be Pareto-efficient, i.e. both ‘core’ and ‘peripheral’ euro area countries would benefit.

## **Conclusion**

Our simulation suggests that with a safe asset and centralised fiscal capacity, macroeconomic stabilisation becomes much more effective in the face of the outbreak of COVID-19 hitting the euro area economy. Fiscal stimulus at the centre would provide substantial demand offset, with a much more muted increase in government debt in the periphery and a more modest monetary policy response. Both the ‘core’ and ‘periphery’ of the euro area would gain.

The policy response to the COVID-19 shock is an opportunity to provide a lifeline to the economy while also permanently fixing some of the vulnerabilities of the euro area policy framework.

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## 24 Corona bonds – great idea but complicated in reality

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**Lorenzo Bini Smaghi**

Société Générale and Italgas

28 March 2020

*Since the outbreak of COVID-19 in Europe, calls have been made by academics, politicians and observers to adopt Eurobonds to finance the actions needed to support economic activity. This column argues that the proposal poses two important political challenges. The first is to promote a broad transfer of economic and social competences from the national to the European level. The second is to reform the European Stability Mechanism and ensure that a sufficient number of countries apply so as to avoid stigma.*

Since the outburst of the COVID-19 crisis, Eurobonds have become fashionable again. Calls have been made by academics, politicians and observers to adopt such an instrument in order to finance the actions needed to support economic activity. The term ‘Corona bonds’ has even been coined.

Eurobonds look like a great idea, at least in theory. They would enable European countries to get funds to support increased spending and lower taxes without increasing their national debt.

In practice, however, it’s a bit more complicated. The reason is that the adoption of Eurobonds is not so much a technical decision, which pertains to finance ministers or bureaucrats. It entails a major political choice to transfer sovereignty, on a whole range of issues, from the national to the European level. While this may be desirable, it is certainly not easy to achieve in a short time period.

Eurobonds look like are a great idea, at least in theory ... In practice, however, it’s a bit more complicated. ... entails a major political choice to transfer sovereignty, on a whole range of issues, from the national to the European level.

What needs to be made clear is that the attractiveness of any bond issued in the markets depends on its guarantees, which should reassure investors that interest will be regularly paid and that the outstanding debt is sustainable. Public bonds are generally guaranteed by the state's assets and the ability to generate a sustainable flow of taxation over time. The greater the doubts on these guarantees, the higher will be the risk premium demanded by investors, and thus the yield.

The risk – and thus the interest rate – on the debt of some European countries is higher than others in particular because of the higher level of the debt, the lower rate of growth and possibly also political uncertainties. This may suggest that the risk of a Eurobond would be lower than some of the national debt instruments. There would thus be an advantage in issuing European debt rather than national debt.

Unfortunately, this is not the case, at least in the current institutional environment. Indeed, a Eurobond issued at the EU level, whose proceeds would be distributed to the member states to support their respective budgetary policies, would have a higher risk unless supported by specific dedicated guarantees. There are today no European assets nor European capacity to generate autonomous tax revenues that can be used to guarantee European public debt.

## **What is needed to issue Eurobonds**

In order to issue Eurobonds, the EU needs to be able to generate new fiscal proceeds. The Eurobonds would have the highest credit rating, such as a triple A, only if the EU had direct fiscal authority over the European economy and European citizens.

The easiest way would be to transfer whole parts of the national budgets to the European budget, under the authority of European institutions. For instance, it could be decided that health systems would no longer be under the authority of member states but would become a European competence. Decisions on health issues – hospitals to close or open, salaries, procurement, insurance, etc. – would be decided in Brussels, including overall spending and how to finance it (either through revenues or debt).

Other examples could be offered of which parts of national budgets could be transferred to the European level, providing the latter with sufficient guarantees for raising new debt. These may range from unemployment insurance to general welfare. It means, however, that key decisions such as the retirement age would become a European decision rather than a national one.

This is not an impossible scenario, and it may be a desired one in the view of many. It cannot be ignored, however, that this requires a major transfer of sovereignty that needs to be agreed by all member states. It would be an illusion to think that this would be easy and quick to achieve.

Some have suggested that in order to avoid the problem of the guarantees, Eurobonds should be purchased by the ECB, directly at issuance. This is currently not legally possible. The statutes of the ECB – as is actually the case for most other central banks – do not permit the purchase of government bonds on the primary market. This prohibition aims at avoiding money being used as an undemocratic fiscal instrument to distort market prices. If the central bank purchased a Eurobond at its face value when the market value would be much lower – for instance, because it lacked adequate guarantees – it would incur a loss that would later translate into lower seignorage distributed to its shareholder (i.e. the treasury).

Incidentally, a change in Article 21 of the ECB statutes, which prohibits monetary financing, requires not only the unanimous agreement of the Council but also national ratification by the member states.

■ To sum up, Eurobonds cannot be issued to finance current expenditure, unless such expenditure and the resources to cover it are brought under the responsibility of the EU.

The guarantees would be less of an issue if Eurobonds were issued to finance investments, such as European infrastructure, rather than current expenditure. The investments, and their proceeds, would represent the guarantees.

To sum up, Eurobonds cannot be issued to finance current expenditure, unless such expenditure and the resources to cover it are brought under the responsibility of the EU.

## **What can be done, instead?**

An alternative is to resort to the European Stability Mechanism, which has a triple A rating thanks to its capital basis. The ESM has already issued bonds to finance the adjustment programmes of countries including Spain, Portugal, Greece and Ireland. The ESM could issue an additional €400 billion, and even more if its capital is further increased. The proceeds could then be lent to the member states that apply to the foreseen facilities. This mechanism would not avoid an increase in national debt, but the latter is incurred with the ESM rather than with market investors. The advantages are a lower cost of borrowing and lower risk of illiquidity.

The problem of using the ESM is mainly political. The ESM can grant loans only on the basis of an adjustment programme agreed with the European institutions, which contains a series of conditions. Conditionality can be relatively lighter for the precautionary credit line. However, resorting to the ESM would create a stigma if the number of countries applying is limited. It may signal a fragility to the markets and a relative loss of sovereignty with respect to conditionality, while the crisis is due mainly to exogenous health factors rather than fiscal indiscipline.

The solution would be two-handed. First, conditionality could be limited to an ex-post monitoring of the resources used to address the systemic crisis, as proposed for instance by Olivier Blanchard (Blanchard 2020). This can be done by the ESM governing bodies. Second, several countries could apply simultaneously, to reduce stigma. This would require a sign of solidarity, especially by countries that have a relatively good rating and would not directly benefit from accessing the ESM. The ideal solution would be that all 19 countries apply for the facility, even if they do not draw on it.

This solution would require the pending ESM reform to be adopted by member states, which is currently blocked by Italy over the fear that access to ESM facilities would trigger debt restructuring.

A final issue relates to the interaction between the ESM and the ECB.

## **Connections between the ESM and the ECB**

To be sure, access to ESM is a pre-condition for the ECB to adopt OMT. This means that a country that would use the ESM would also benefit from the umbrella of ‘whatever it takes’, which would probably lead to a reduction of the interest rate spread even without any action being taken by the ECB.

Some suggested that the ECB could also purchase the bonds issued by the ESM in the context of the asset purchase programme, which has been enhanced recently to over €1 trillion.

This would be a mistake, because the bonds issued by the ESM are considered among the safest and are in high demand by investors from all over the world. Their issuance in the market would enhance the international role of the euro. It would thus make no sense for the ECB to create liquidity by purchasing an asset which is itself very liquid. This would not be the best way to counter market instability and to accommodate the appetite for liquidity.

The ECB should rather continue to purchase assets issued by the member states or by private institutions. The ECB has on average bought slightly more than 20% of the countries' existing debt and is committed to maintain the exposure when maturities expire. It has committed to purchase about another 10%. This significantly reduces the risk of liquidity and sustainability of countries' debts going forward. It creates room for further fiscal policy action by member states to address the crisis.

## Concluding remarks

In conclusion, the debate on the Eurobonds poses two important political choices. The first is to promote a broad transfer of economic and social competences from the national to the European level, which is necessary to give the Union the ability to finance European bonds. The second is to adopt the ESM reform, perhaps by further strengthening its potential with conditionality better calibrated to systemic crises, and to ensure that a sufficient number of countries apply so as to avoid stigma.

The two choices are not necessarily alternative. On the contrary, they can be complementary and carried out with a different time frame. However, they must be made explicitly. Otherwise it is useless, and illusory, to talk about Eurobonds.

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# 25 ESM loans or Coronabonds: A legal analysis from the German perspective<sup>1</sup>

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*The massive fiscal packages being deployed in Europe raise issues of financing. Economists have proposed three main models. This column offers a pragmatic legal perspective on the options, focusing on their compatibility with EU Law, the ESM Treaty, and German Constitutional Law. It argues that, from a practical legal standpoint, the use of the ESM is preferable to issuing Coronabonds, because it offers more legal certainty and could be implemented more quickly. However, jointly issuing Coronabonds would send the stronger political signal.*

As COVID-19 threatens an unprecedented economic crisis, the Council asked the Eurogroup on 26 March<sup>2</sup> to present proposals for common fiscal measures to tackle the crisis within the next two weeks. So far, three models have been put forward by economists that could serve as a template:

- First, the creation of a Covid Credit Line under the ESM (Bénassy-Quéré et al. 2020).
- Second, the one-time only joint issuance of Coronabonds by the euro area member states (Südekum et al. 2020).
- Third, the creation of a new fiscal capacity at the EMU level that issues common safe assets (Codogno and van den Noor 2020).

In this column, I add to the ongoing debate by offering a pragmatic legal perspective. It focusses on the first two proposals, because a permanent fiscal capacity at EMU level requires amending the TFEU, which seems unlikely to happen in the current political environment. It takes a closer look at their compatibility with EU law, the ESM Treaty

<sup>1</sup> This column reflects exclusively the opinion of the author.

<sup>2</sup> <https://www.consilium.europa.eu/media/43076/26-vc-euco-statement-en.pdf>



and German constitutional law. I argue that, from a practical legal standpoint, the use of the ESM is preferable to issuing Coronabonds, because it could be implemented more quickly and offers a higher degree of legal certainty. However, jointly issuing Coronabonds would send the stronger political signal and they could be designed in accordance with Art. 125 (1) TFEU.

## **From health crisis to economic crisis to sovereign debt crisis?**

A symmetrical external economic shock is currently hitting all euro area member states simultaneously. The short-term effects are already extreme (Roubini 2020). Forecasts suggest that the worst is yet to come. In order to counter the effects, almost all euro area member states have adopted fiscal aid programmes of unprecedented proportions, made possible by the first-time suspension of the EU Stability Pact. In the medium term, this threatens to cause a sharp increase in public debt. This could endanger their (re-)financing capacity. It also creates risks for the banking sector, as banks in the most vulnerable countries of the euro area still hold large amounts of their home countries government bonds. The vicious circle between states and banks may resurface and threaten the integrity of the euro area.

## **Use of the ESM for preventive purposes?**

At first glance, the simplest way seems to be direct lending by the ESM. So far, the ESM has primarily fulfilled the function of a lender of last resort for euro area member states. Accordingly, until now, it has only used reactive instruments. These include, in particular, the loans to Ireland, Portugal, Greece and Cyprus, which were linked to far-reaching macroeconomic adjustment programmes.

No euro area country is yet in a sovereign debt crisis due to COVID-19. But the ESM Treaty also provides for preventive measures. In general, according to Art. 12 (1) ESM Treaty, the objective of the ESM is “to safeguard the financial stability of the euro area as a whole and of its Member States”. To this end, the ESM Treaty provides in Art. 14 two instruments which have not yet been applied: the Precautionary Conditional Credit Line (PCCL) and the Enhanced Conditions Credit (ECCL). The respective ESM guideline regulates these in more detail. The aim is to maintain market access for countries with still healthy public finances. The ESM grants the funds via loan or primary market purchase of sovereign bonds at the request of the state seeking

assistance and after examination by the Commission and the ECB. The terms of the loan are set out in a Memorandum of Understanding. Both programmes initially run for one year, but can be extended twice for six months each.

The PCCL is aimed at countries whose financial position is fundamentally sound. The ESM examines this on the basis of six criteria, among which are compliance with the requirements of the Stability and Growth Pact, sustainability of public debt, and the absence of problems in the banking sector that could lead to systemic risks for the euro area banking system. However, PCCL is not eligible, particularly for Italy. This can already be concluded from the EU Commission's country report on Italy for the European Semester 2019, in which it was described as having "excessive macroeconomic imbalances" (European Commission 2019). The same goes for other states with weaker fiscal positions. If a country is not eligible for a PCCL, but still has a healthy ("sound") financial position overall, the ECCL remains, which is subject to much stricter conditionality (albeit not as strict as those of a loan with full macroeconomic adjustment programme). Within the existing instruments of the ESM, an ECCL is the right instrument for most of the weaker member states.

## **A COVID-19 Credit Line under the ESM**

However, the problem with the PCCL and ECCL is their short maturity and their relatively strict conditionality. Thus, some call for a new special COVID-19 Credit Line (CCL) with much longer maturity and less strict conditionality. Would this also be covered by the ESM Treaty? According to Art. 14 (4) of the Treaty, the ESM Board of Directors adopts guidelines on the implementation modalities of the precautionary financial assistance. It has already issued such guideline. The ESM Treaty itself says nothing on the duration of the loans. These are only laid down in the guideline and could therefore probably be modified by amending it. However, an appropriately modified guideline would have to include instruments for continuously monitoring compliance and the possibility to terminate the loan in case of non-compliance, as Art. 3 ESM-Treaty calls for strict and appropriate conditions. This serves to ensure that the ESM, and ultimately the member states behind it, incur no losses. Art. 7 (2) and (3) of the guideline on precautionary financial assistance already provide for the possibility of closing existing credit lines in the event of non-compliance. The state concerned would then have to submit an application to switch from CCL to a loan linked to a macroeconomic adjustment programme.

The ESM Treaty allows issuance of precautionary financial assistance with a longer duration via a CCL due to the amendment of the relevant guideline, provided that the outlined requirements (appropriate and strict conditionality) are respected. However, depending on the specific conditions of the loan, national parliaments would most likely have to approve a corresponding use of the ESM. This is true particularly in the case of Germany. The German Constitutional Court plays an important role in assessing the legal boundaries of European integration in general, and specifically euro area crisis measures from the perspective of the German constitution. This became especially evident following the euro area crisis (see the cases of the ESM, OMT and PSPP). Under German law, the national parliament has to approve ESM measures in case they concern the overall fiscal responsibility of the German parliament (see Art. 4 (1) ESM-Finanzierungsgesetz – Act on the Financing of the ESM). This is especially so if the ESM seeks to grant new stability support to a member state, and this would clearly be the case with a CCL, irrespective of its specific conditions laid down in the Memorandum of Understanding or later in a respective facility agreement.

### **A one-off joint issue of Coronabonds by euro area member states**

The idea goes as follows. For one time only, due to the COVID-19 crisis, the euro area member states jointly issue bonds with an aggregate value of up to €1,000 billion (equivalent to approximately 8% of the euro area's GDP) at a long-term maturity backed by their joint financial strength. The funds thus created would be used to support member states that risk losing access to capital markets on acceptable terms. All member states would be jointly and severally liable for the repayment of the bonds; the amount of interest and redemption payments could be based on the ECB capital key. It should therefore be possible to place the bond on relatively favourable terms. Due to the low probability of default, Coronabonds would also represent safe assets that could be acquired in particular by banks in weaker countries.

However, many key practical questions remain open. How exactly would the modalities of distribution from the pool to the individual countries look like? What would be the terms of repayment? Which vehicle would be used to issue the bond? Who would manage the pool and process the loans from it? Could the ESM be used for this purpose? Would the ESM Treaty have to be changed? Could banks use the bonds for refinancing with the ECB and would the ECB be allowed to purchase them as part of its secondary market purchasing programmes?

The question arises whether a Coronabond would be compatible with Art. 125 (1) TFEU and whether EU law provides a sufficient legal basis. These questions can only be touched upon in the context of this column and cannot be assessed conclusively. In contrast to Eurobonds, whose admissibility under EU law is largely doubted, Coronabonds would only be issued once. No permanent mechanism for automatic joint liability for the national debt of all euro area member states, which would be incompatible with Art. 125 (1) TFEU, would be created. In light of the CJEU's Pringle ruling, according to which Art. 125 (1) TFEU does not prohibit all types of financial assistance per se, such assistance would only be compatible with Art. 125 (1) TFEU if it did not provide an incentive for unsound fiscal policies. This in turn depends on the specific conditions under which the financial assistance would be paid. If necessary, such arrangements would have to be accompanied by clarifications under secondary law pursuant to Art. 125 (2) TFEU.

Thus, the admissibility of Coronabonds under EU law does not appear to be excluded from the outset. In addition, however, the question of compatibility with national constitutional law also arises, especially with regard to national budgets. According to the German Federal Constitutional Court, the German parliament has to approve such measures if the concern its overall fiscal responsibility. Coronabonds would be issued at EMU level, they would require joint and several liability by its member states. Nation states would therefore have to convey fiscal powers to the EMU level. Given the enormous volume envisaged, this would clearly concern the overall fiscal responsibility of the German parliament, and therefore require its consent.

Not least for the practical reasons laid out above, Coronabonds raise more complex questions than the use of the ESM. It is difficult for political decision-makers to resolve these issues conclusively and with legal certainty in the short time available. Thus, from a legal point of view, the implementation of a novel Covid Credit Line within the existing structures of the ESM would be the preferable to the issuance of Coronabonds.

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# 26 Sharing the fiscal burden of the crisis: A Pandemic Solidarity Instrument for the EU

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*To ensure that all EU countries can do what is necessary to fight the economic fallout of the pandemic, the fiscal costs of this crisis must be shared. This column proposes that the EU give member states €440 billion in grants to support health care, liquidity to the private sector, short-time work schemes and stimulus packages. The EU should raise the funds in bond markets backed by guarantees. It also shows how this is could work under EU law.*

In a public health crisis, the EU has limited authority and few tools at its disposal to help fight it. The EU Commission can help by coordinating member states' policies, via joint procurement of medical equipment or the safe return of Europeans overseas, for example. It can use its limited funds for virological and epidemiological research and help redirect EU budget items to support health systems. At times, the Commission has had to keep member states from harming the common interest, such as excessive use of border controls or export bans.

Economic policies are also largely in the hands of national governments. It is they who decide how to support a struggling economy under lockdown, whether to defer taxes, subsidise lending to companies, increase sick pay, institute schemes to keep workers on the payroll and the like. And national governments will have to foot the bill for these measures.

The COVID-19 crisis, however, is bound to be so expensive that some national governments may be overwhelmed by the subsequent increase in public debt (see chapters in Baldwin and Weder di Mauro 2020). In that case, two equally dangerous scenarios are possible. Either some member states, fearful of a high future debt burden, may not spend as much as is needed to preserve their economies and will end up much worse off than countries that are able to spend more. Or these member states do spend

as much as needed, but may face increasingly high interest rates as markets doubt that public debt is sustainable, at which point the euro area may face yet another existential crisis.

To avoid these two scenarios, we propose a Pandemic Solidarity Instrument (PSI) that would lead to a partial sharing of the fiscal costs of this crisis through the issuance of a one-off EU – not euro area – asset in the market. The funds raised through this asset would then be used to:

- help countries to cover the costs that are directly related to fighting the virus
- ensure firms have enough liquidity to survive the lockdown, via the European Investment Bank (EIB)
- subsidise firms to keep workers on the payroll, via new European co-financing of national short-work schemes
- kickstart the economy, once it is safe to do so, where the hit was hardest, via new European co-financing of national stimulus plans.

Our proposal would not add another layer of market-access insurance for euro area countries.<sup>1</sup> There are already two powerful institutions providing those. The first is the ECB, which not only sets monetary policy for most European countries, but is also de facto the lender of last resort to euro area governments – much like national central banks everywhere. With its recent Pandemic Emergency Purchase Programme (PEPP), the ECB has made sure that all countries will have low funding costs during this crisis. The second institution is the European Stability Mechanism (ESM), the euro area's bailout fund, which can provide loans and precautionary credit lines to countries that struggle to fund themselves on markets. Non-euro countries have access to the EU's balance-of-payment facility, which provides similar help. Our proposal rather fills a gap left by the EU budget: it is currently unequipped in terms of both size and structure to provide the kind of burden sharing across the entire Union that is needed in this unprecedented crisis.

<sup>1</sup> For a comprehensive proposal on a safety net for market access see Guttenberg and Hemker (2020).

## **The economic hit, and possible fiscal response needed, and the impact on debt**

It is near impossible to predict the economic fallout from this crisis. Governments have not shut down societies in living memory, and at the time of writing, it was still unclear when countries in Europe will be ready to lift the restrictions on workers and the economy, and how strongly the economy will rebound.

But we can draw on first estimates. The OECD and the IMF (as well as various national bodies) have recently published their assessments of the economic impact of the current shutdown in Europe. The conclusions are roughly similar. We follow the OECD's assessment, which calculates that economic output under lockdown is 25% lower than would otherwise be the case. If we assume a lockdown of three months and a linear recovery over the next three months, output would be 8.3% lower than it would otherwise have been. For the EU, this would mean about €1.2 trillion in lost output for 2020.<sup>2</sup>

There are two effects on government balances.

The first is a hit to GDP reduces tax revenues. A revenue shortfall of 8.3% amounts to €560 billion in lower revenues for EU-27 governments in 2020 (roughly 4% of 2019 EU-27 GDP).<sup>3</sup>

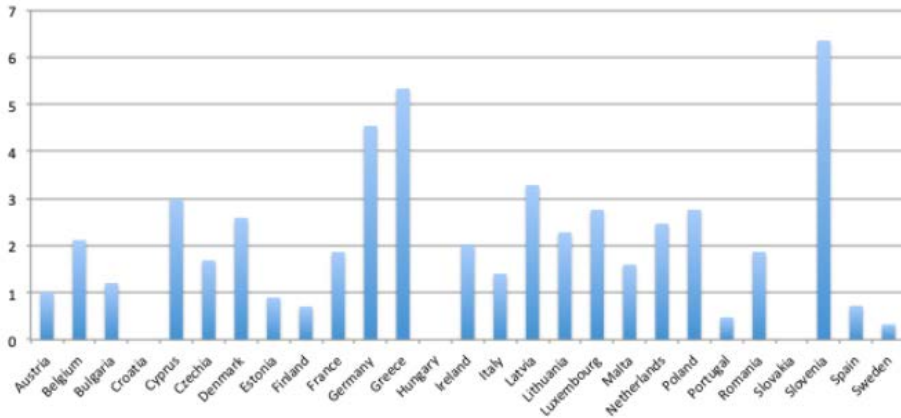
Second, governments are scrambling to enact support packages for firms and workers, in the form of liquidity loans, grants to the self-employed and subsidised short-work schemes to encourage firms to keep workers on the payroll, and one-time cash grants to the hardest hit in society. Later on, when confinement measures are gradually lifted, they will have to put in place sizable stimulus packages. Some of these policies will limit the revenue shortfall, as they stabilise incomes and consumption which are then taxed. Others are liquidity provisions which will be repaid. But by and large, these measures add to public deficits, which governments will have to fund on markets.

2 This assumes the same growth rate of EU27 GDP, absent the corona crisis, for 2020 as 2018 and 2019 (roughly 3.2% nominally).

3 We use the long-run elasticity of 1 based on Köster and Priesmeier (2017). Total government revenues of the EU27 stood at €6.3 trillion in 2018, after growing roughly 4% in nominal terms in the previous two years. Assuming a similar growth rate for 2019 and 2020, total general government revenues in the EU27, absent the corona crisis, should have been around €6.7 trillion in 2020.



**Figure 1** Direct fiscal expenditures in response to COVID-19 (% of GDP)



Source: Redeker and Hainbach (forthcoming).

All member states of the EU are having to impose shutdowns. But the impact of COVID-19 will be asymmetric, for three reasons.

First, the health impact may be different across countries, for various reasons. Italy was unfortunate that it was hit first, without being able to draw on lessons other than those from China. Differences in social interaction across the EU may also have contributed, as well as different healthcare structures and funding.

Second, the economic structure of EU countries differs. Some countries, such as Germany, are heavily reliant on manufacturing; others on services, especially tourism. Manufacturing not only stands a good chance of making a full and relatively swift recovery; there is also a good chance for some pent-up demand, as some purchases will be postponed. Services, on the other hand, stand to suffer for a longer period: customers may continue to fear infection, and are less likely to make up for foregone purchases (people are unlikely to go to the restaurant twice because they missed out on a visit during the lockdown). More services- and tourism-oriented economies will therefore be hit harder.

Third, countries start from different positions. Italy was already struggling economically and labouring under a debt burden of over 130% of GDP. In Spain, unemployment still stood at 14% as a result of its long-lasting economic crisis. Not all countries are therefore in a position to shake off a public health crisis without considerable long-term economic damage.

### **Three scenarios for Europe's economic response**

For these reasons, Italy and Spain are likely to suffer most, both economically and in terms of health outcomes. This leads to the following three scenarios for the economic response to the crisis in Europe.

#### Scenario 1: Timidity and divergence

Countries in the EU enact support and stimulus packages according to their respective economic and fiscal strength. Countries with high debt burdens and struggling economies, such as Italy or Spain, implement the most urgent support measures only; while economically and fiscally strong countries support their firms and workers generously, and stimulate a swift recovery after the lockdown ends.

As a result, economic fortunes in Europe diverge drastically, as some member states limit the economic fallout and generate a proper recovery, while others see a sizable part of their private sector go into bankruptcy, leading to mass unemployment and long-term economic scars. The effect on public debt in the most vulnerable countries is uncertain: a timid response to the unfolding economic crisis could well make public debt (relative to GDP) increase faster than a bolder policy response and stimulus. In any case, this is a nightmarish scenario for Europe. Divergences of economic fortunes within the Single Market were already substantial before the crisis. In this scenario, they would become politically untenable and would give rise to economic nationalism in countries like Italy, probably leading to calls for an exit from both the Single Market and the euro. Worsening economic prospects in some countries would also have negative spill-over effects on others, as bankruptcies would raise the cost of imports, and there would be lower demand for exports.

#### Scenario 2: Overburdening vulnerable member states

The ECB's PEPP and access to the ESM convince all countries that their response to the on-going crisis should be as bold as is necessary to minimise the economic fallout. For the reasons noted above, that bolder response may lower public debt relative to scenario 1. But countries will end up with a much higher debt burden. As the ECB withdraws PEPP support, markets may reassess whether Italian or Spanish debt is sustainable.

The ECB's PEPP programme can be defended on legal grounds (Grund 2020), but the ECB is still barred from financing governments directly. Monetising public debt is therefore the absolute last resort, and may be impossible politically. Rapid reductions in debt ratios through post-crisis growth is unrealistic for countries with low growth

potential. In this scenario, some member states may be constantly in danger of losing access to financial markets, which would inevitably undermine their growth prospects further. Resolution may come through a restructuring of one or several member states' public debt, or countries might need constant support by the ECB. This scenario is also unviable for Europe.

### Scenario 3: Burden sharing

Scenarios 1 and 2 are likely to break the political fabric of the EU. The only viable scenario involves burden sharing among all EU member states. Countries need to be able to spend what is needed without ending up on the cusp of an unsustainable debt burden. Europe needs political agreement on the principle that a large part of the costs of the pandemic have to be shared in a way that all countries can take the necessary measures without being financially overwhelmed. Then member states can agree on an economically and legally sound instrument that is capable of delivering this kind of burden-sharing.

In what follows, we outline what such an instrument could look like.

## **The Pandemic Solidarity Instrument**

We propose a one-off common EU crisis response that is tailored to this specific crisis. Burden-sharing in this crisis should not permanently alter the financial architecture of the EU or of the euro area. Nor do we need to create new institutions. The aim is to ensure that the old institutional setup has a reasonable chance of surviving this crisis. It also aims to give all countries the certainty they need to spend as the crisis requires. Otherwise, we may end up in scenario 2, with highly indebted countries doing too little, causing long-term economic damage. To provide this certainty, burden-sharing has to be agreed now, not in a few months.

Through our Pandemic Solidarity Instrument, the EU would raise the necessary funds in markets on its own account. It would spend those funds in four ways: to cover costs directly related to fighting the virus; to strengthen the EIB; to subsidise short-time work schemes; and to co-finance national stimulus packages once economies are opening up again. The Instrument would be set up under Article 122 of the Treaty on the Functioning of the European Union. The appendix below explains in detail the legal implications.

This is how the Instrument would work in practice.

### *Expenditure*

- All countries should have the necessary means to finance the health-related costs of this crisis. €20 billion of the funds raised by the Instrument should be made available to member states to cover COVID-related healthcare costs, such as the purchase of additional ventilators, protective gear and the set-up of new intensive-care units. The Instrument would cover 80% of eligible expenditures while member states cover the remaining 20%.
- Companies should receive the necessary liquidity throughout the Union to survive the lockdown. The EIB has proposed an EU-wide scheme to this end and has asked for €25 billion in guarantees to fund liquidity support of about €200 billion. This is a good start, but too small to have a sizable effect throughout Europe. Initially, Germany's liquidity programme, via its public investment bank KfW, had a volume of about €465 billion, but it is now unlimited. Since Germany makes up 25% of EU27 GDP, an EU-wide scheme should aim for liquidity support of at least €1.8 trillion. The EIB should provide half of this support, with the other half provided by national governments and public investment banks. To this end, the EIB should receive about €120 billion of the Instrument's funds in the form of direct guarantees from the EU.
- The EU should support efforts that help Europeans keep their jobs during the containment phase, such as the French 'chômage partiel' or Germany's 'Kurzarbeit' (short-work) scheme. Such schemes already exist in many member states and could be introduced in more.<sup>4</sup> For every worker that is furloughed under such a scheme, the EU should contribute up to 40% of the net salary as long as member states match this one-to-one. In addition, all member states should receive a subsidy of short-term unemployment benefits of up to 25% of the net salary as long as the subsidy is matched by the member state for the first six months of unemployment. Payouts here would depend on labour market developments in member states. It is impossible to estimate ex ante the cost of this scheme, given the uncertainty about the size and duration of the impact of COVID-19. The German 'Kurzarbeit' scheme cost about €4.6 billion in 2009, with 1.1 million beneficiaries.<sup>5</sup> A ballpark estimate is that uptake in the German Kurzarbeit scheme could well end up three times higher than in 2009. In 2009, Germany also paid out €17 billion euros in unemployment benefits in a situation where job losses were comparatively limited. Taken together, these figures lead us to estimate a minimum EU-wide need of about €30 billion for short-term work schemes and about €70 billion for short-term unemployment benefits, thus bringing funding needs to €100 billion.

<sup>4</sup> For an overview see Schulten and Müller (2020).

<sup>5</sup> This covers both replacement of 60% of the salary and the payment of social security contributions by the state.

- All countries will need to deploy substantial fiscal stimulus once containment measures can be gradually lifted (Odendahl and Springford 2020). Some countries will need more than others. The more an economy relies on sectors in which pent-up demand is unlikely (in particular services such as tourism), the more the state will have to stimulate spending. The EU should support such measures: our Instrument should fund 50-75% of eligible fiscal stimulus measures. Measures should be eligible if they have a clear stimulating effect; are not undermining EU goals such as the fight against climate change; and have tangible spill-overs to the rest of the Union. The overall envelope per country should be calculated based on the GDP shortfall in the first half of this year. The more dependent the economy is on sectors that are unlikely to see catch-up effects, the larger co-financing should be. If we assume that the necessary stimulus will be 2% of EU GDP and an average co-financing of 65%, this brings us to an envelope of about €200 billion.

Altogether, this means that the EU would need additional funds of about €440 billion to be spent over the coming 12 months.

### *Funding*

The EU should borrow the funds in the market. It would issue a one-off Pandemic Solidarity Bond backed by the EU budget with long maturities of 20-50 years. To raise €440 billion, the EU would need to receive irrevocable and unconditional guarantees from member states.<sup>6</sup>

These guarantees could, in principle, follow the model of the European Financial Stability Facility (EFSF), which was set up as a temporary lending facility during the euro crisis. The guarantee structure of the EFSF proved financially solid and has the advantage that it has already been tested during adverse market conditions.<sup>7</sup> However, the EU would remain the bond issuer and would be liable to repay it. It could draw on the guarantees if need be, but it could potentially make good on its liability by other means. This is important. The EU is an institution with its own capacity to act, and therefore, the guarantees would not count as member states' individual debt by Eurostat.<sup>8</sup> This is

6 The EU can issue debt without guarantees but is limited to the margin between the expenditure ceilings in the Multiannual Financial Framework and the revenue ceiling in the Own-Resources Decision. This margin is about 0.2% of GDP per year and thus too small. Increasing that margin is possible, but politically more challenging in our view, which is why we prefer one-time guarantees.

7 See ESM, "Top credit rating for EFSF's debut debt issuance", Press Release, 19 January 2011, <https://www.esm.europa.eu/press-releases/top-credit-rating-efsf%C2%80%C2%99s-debut-debt-issuance>.

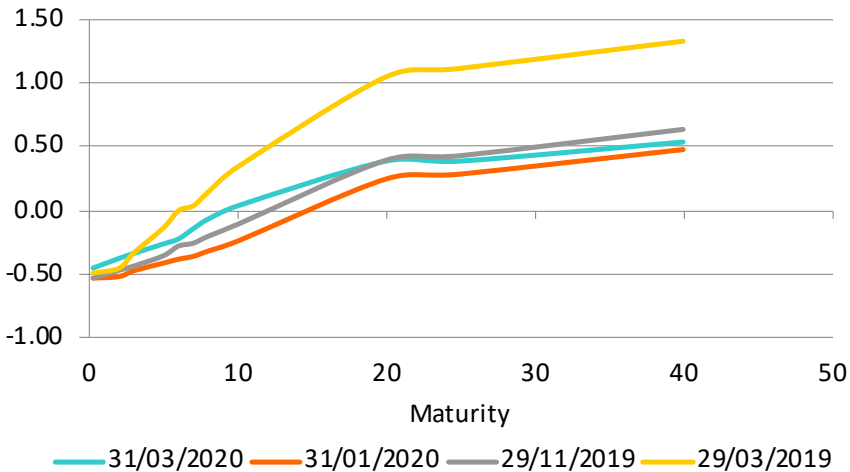
8 Eurostat counts EFSF debt to the Maastricht debt of member states based on the guarantees given to the facility, because it is not an "institutional unit" but an "an accounting and treasury tool". It does not do so for the ESM as it is considered an "institutional unit" even though the callable capital of the ESM has very similar characteristics to the EFSF guarantees. As the EU is definitely an "institutional unit" in the Eurostat sense, debt incurred under our proposal would not be counted as public debt of member states by Eurostat.

a major advantage compared to all variants that rely on extra-institutional setups such as special purpose vehicles (SPVs), as guarantees to SPVs are counted as national debt. The legal act setting up the asset and establishing the guarantees would need to be ratified by some parliaments, such as the German Bundestag.

The bonds could be perpetually refinanced in the market when they come due, leaving the guarantees in place. But the legal act should contain a provision that regulates how the bonds are repaid, should member states decide to do so when the bonds come due. We propose a simple solution here: member states should be liable for repayment not according to their share of the guarantees, but according to their share in EU GDP at the time of repayment. A 30-year bond would thus be repaid by member states according to their economic strength in 2050. So the Instrument would have a guarantee structure to give the EU the solid legal basis for cases of default – and a repayment structure that ensures that the strong end up supporting the weak, whichever countries those will be in the distant future.

The Pandemic Solidarity Bonds would not only finance the measures above. They would also substantially enlarge the volume of supranational safe assets that the ECB could buy in its purchase programmes and that banks could pledge as collateral. At the same time, markets would be able to absorb such a large sum of new, safe assets and fund the Instrument at similar rates to those of the ESM.

**Figure 2** ESM yield curve (%)



Source: ESM

*Necessary measures beyond the Pandemic Solidarity Instrument*

Our proposal would not fully mutualise the costs of this crisis. Doing so may seem justified, but would not be politically feasible. All member states will thus have to finance a portion of their additional fiscal expenditure on markets. They will face different funding costs when doing so.

With the PEPP, the ECB has intervened forcefully in government bond markets and will continue to do so until the European economy has recovered. But the ECB should not be the only backstop for member states' access to markets. There are political and legal limits to ECB bond purchases. On 5 May, the German constitutional court will deliver its judgment on the ECB's QE programme and this could lead to doubts about the legality of PEPP if the Court puts severe limits on the Bundesbank's participation in QE. What is more, the ECB will face questions about whether mass purchases of government bonds are still legitimate when they mostly serve the purpose of keeping member states afloat. The ECB has no legal or political mandate to fully mutualise or even monetise European public debt.

This is why additional lines of defence for member states' financing are necessary. Given the severity of the crisis, such transfers are justified, above and beyond the risk sharing in the Instrument outlined above. The Commission's SURE proposal is a good start – a credit line of up to €100 billion to support countries' fight against unemployment. A special COVID credit line in the ESM (Bénassy-Quéré et al. 2020) would further help countries finance their increased debt burdens. A credit line of €100 billion credit would reduce Spain's interest costs by €100 billion over a 10-year period, for example (Erce et al 2020). Both the SURE proposal and a special ESM line would entail some transfers, as lending rates and funding conditions in both are subsidised by the fiscally strong countries in the EU. But given the severity of the crisis, such transfers are justified, above and beyond the risk sharing in the Instrument outlined above.

## **Conclusion**

The Pandemic Solidarity Instrument would provide more vulnerable member states with enough fiscal relief to act as forcefully as the strong. Action cannot be left to a “second phase” of crisis-fighting – member states need that certainty today that they will have the necessary fiscal space in a few months' time. The proposal does not create a ‘transfer union’ feared by some in Germany, the Netherlands and elsewhere, nor opened debt mutualisation. It is sizeable but proportionate, since COVID-19 could result in an existential crisis for the European project.

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## Appendix: The opportunities and limits of Article 122 TFEU

Article 122 TFEU provides the EU with a legal basis to enact extraordinary measures under “exceptional occurrences”. Article 122 TFEU has two prongs: while Article 122(1) allows the EU to take measures appropriate to the economic situation “in the spirit of solidarity”, Article 122(2) provides a legal basis for ad-hoc financial assistance to one or more Member States. There is no doubt that the current COVID-19 pandemic and the ensuing economic crisis constitutes the type of exceptional occurrence that Article 122 TFEU sought to address. One may even go as far as arguing that there has never been a more urgent need to make real the overarching principle of solidarity enshrined in the EU Treaties.



Since Article 122 TFEU provides an exception from other primary law provisions, such as the no-bailout clause, it is not limitless: it must be narrowly framed and follow the subsidiarity principle.<sup>9</sup> Given that the COVID-19 pandemic affects the Union as a whole and causes severe economic disturbances in all Member States, there should be little doubt that collective action is necessary. With respect to the type of measures that may be taken on the basis of Article 122 TFEU, the Council has a wide margin of discretion. The main requirement is that the measures need to be “appropriate to the economic situation.”<sup>10</sup> Given the unprecedented disruptions that the pandemic has already caused, even highly extraordinary common economic measures are likely to be deemed appropriate.

With respect to the law-making process, the Council decides with qualified majority on Article 122 TFEU measures following a proposal by the Commission, which can take the form of either a directive or a regulation.<sup>11</sup> The European Parliament has no formal role in the legislative process stipulated by Article 122 TFEU. However, national parliaments will have to play a strong role according to national constitutional requirements if the legal act under Article 122 involves guarantees provided by member states, as we propose here. This means that although theoretically legal acts under this article can be adopted by a qualified majority in the Council, some parliaments, such as the German Bundestag, will have to ratify the act to comply with domestic constitutional law.

In the case of our proposal, Article 122 TFEU provides an exception with regard to two relevant primary law provisions: The no-bailout clause (Article 125 TFEU) and the prohibition for the EU budget to go into deficit (Articles 310 and 311 TFEU).

#### *Article 125 TFEU - no bailout clause*

Article 122 TFEU can be understood as an exception to the no-bailout clause.<sup>12</sup> More specifically, Article 122 TFEU epitomizes the principle of solidarity among Member States in cases where the economic situation in one or more member states warrant exceptional measures by the EU. The solidarity clause would thus counterbalance the strict no-bailout clause with a view at allowing collective action in certain exceptional circumstances.<sup>13</sup> In this re, we must also differentiate between Article 122(1) and

9 In other words, the objectives of the measures taken must be of such nature that they could not be achieved at the national level. Bernardus Smulders/Jean-Paul Keppenne in von der Groeben/Schwarze/Hatje, *Europäisches Unionsrecht*, AEUV Art. 122 (ex-Artikel 100 EGV), para 7.

10 *ibid.*

11 Kempen in Streinz, *EUV/AEUV*, AEUV Art. 122, para 5.

12 See for this reading of the provision in Bernardus Smulders/Jean-Paul Keppenne in von der Groeben/Schwarze/Hatje, *Europäisches Unionsrecht*, AEUV Art. 122 (ex-Artikel 100 EGV), para 11.

13 *Ibid.*

Article 122(2). While Article 122(1) focuses on measures taken in the spirit of solidarity, Article 122(2) talks specifically about “financial assistance.”<sup>14</sup> For the purpose of a Pandemic Solidarity Instrument, the former provision seems more suitable, since the measures we propose go beyond “financial assistance” in the strict sense of the word, i.e. beyond the mere granting of loans. Relying on Article 122(1) TFEU also seems more appropriate in light of the new instrument’s objective, not least since (only) Article 122(1) explicitly refers to measures taken “in the spirit of solidarity.” Finally, Article 122(1) TFEU also provides more flexibility against the backdrop of the European Court of Justice’s Pringle judgement.<sup>15</sup> Pringle raises some questions as to the precise meaning of “financial assistance” under EU law and leaves some uncertainty whether Article 122(2) requires conditionality.<sup>16</sup> This is not to say that Article 122(2) TFEU is unsuitable, but rather that Article 122(1) TFEU provides a superior legal basis for the instrument we propose.

#### *Article 310 and 311 TFEU*

The other relevant provision is Article 310 TFEU which stipulates that all revenue and expenditure of the Union have to be shown in the EU budget and that the EU budget has to be balanced. As our proposal entails grants, i.e. direct expenditure, one could argue that these have to be financed by actual contributions and cannot be financed by bonds issued by the EU. However, this argument is not convincing. As explained above, Article 122 TFEU gives the Union wide discretion to act “in the spirit of solidarity” and Article 311 TFEU stipulates that “the Union shall provide itself with the means necessary to attain its objectives and carry through its policies.” In the current situation, it would be very hard to argue that any meaningful act of solidarity can be taken by the Union without fresh money and it would be equally hard to say that this fresh money can come from member states’ direct contributions at a time when all member states have to turn to markets to finance their own expenditures. In this context, raising funds from bond sales by the Union that are backed by member states’ guarantees to finance emergency expenditure should qualify as “means necessary” for the Union to be able to reach the solidarity objectives pursuant to Article 122 TFEU. All revenues from the bond sales would then count as normal revenues of the EU budget and potential interest payments on bonds issued to finance the new instrument would count as normal expenditures. To be sure, just like measures based on Article 122(1) TFEU, any financing by EU member

14 To recall, Article 122(2) provided the legal basis for the European Financial Stability Mechanism (EFSM).

15 C-370/12, *Thomas Pringle v. Government of Ireland and Others*, 27 November 2012.

16 See for a recent discussion of the meaning of “financial assistance assistance” in M. van der Sluis, “A Euro area budget: another seedling?”, Maastricht Faculty of Law Working Paper Series, 2019/04.

states outside the ordinary budgetary process must be limited in time and in scope to fighting the extraordinary threat that the COVID-19 outbreak poses to the Union and its members.

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## 27 COVID-19 economic crisis: Europe needs more than one instrument

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5 April 2020

*There are now several proposals for complementing the vigorous decision of the ECB to launch a mega ‘pandemic emergency purchase programme’ with fiscal and financial initiatives at the European level. These proposals sometimes overlap, which is a good sign of convergence. This column argues that they are also largely complementary to one another. Hence, it calls for a multi-instrument approach that would jointly achieve three objectives: sharing the cost of the COVID crisis, helping member states to borrow at very long maturities and low interest rates, and relaunching the EU after the crisis. In addition to existing tools, the authors believe that a tryptych built around a COVID fund (with borrowing capacity), specific credit guarantees with the European Investment Bank and dedicated credit lines such as an ESM COVID line or the recently proposed temporary Support to mitigate Unemployment Risks in an Emergency (SURE) would be appropriate, provided it is sized up and allows for very long-run borrowing.*

**There are now several proposals** for initiatives to complement the vigorous decision of the ECB to launch a mega ‘pandemic emergency purchase programme’ (PEPP) with fiscal and financial initiatives at European level. These proposals all start from a number of agreed points.

- The COVID crisis is an exceptionally large exogenous shock affecting all EU member states. It is still too early to say whether all will be affected with the same intensity. In any case, the pandemic by definition is borderless: its successful control in any country is a **public good** for an integrated economy such as the EU where value chains cannot be restarted properly if important suppliers in partner countries remain idle or if major intra-EU borders remain closed.
- Responsibility to safeguard the Single Market lies with national governments, but **the backing of the central bank is key** because this crisis involves a huge fiscal cost whose magnitude cannot be determined in advance, and because it is not certain that the corresponding debt issuance can be absorbed by financial markets. For euro area member states, this means backing by the ECB. The role of the central bank is to avoid both inflation and deflation, but also prevent self-fulfilling sovereign debt panics and to buy time for the member states that will then be able to spread the cost of the crisis over a long period.
- Although ECB large asset purchases can be justified as necessary to protect the integrity of the euro area, its action as a backstop to single states could be challenged on the basis of its political legitimacy. For this reason, there is a need for **fiscal and financial instruments at the euro area level**.
- Idiosyncratic or single country risks could in principle be addressed by the European Stability Mechanism (ESM) adjustment programmes and the Outright Market Transactions (OMTs) scheme. However, **it would be wise not to come to the point where these emergency rescue instruments need to be activated, as it would be costlier for all involved than earlier action**.

Against this common background, the proposals on the table **differ along five dimensions:**

- **Objective:** some schemes explicitly aim at sharing the burden of the COVID crisis among member states and therefore involve explicit temporary transfers. Some rather aim at providing a common shield to the member states, while minimizing distributional implications.
- **Mutualisation:** all proposals involve a modicum of mutualisation. But channels and amounts differ. Some scholars have proposed to let the European Commission, the ESM or a special purpose vehicle lend to all national governments at the same rate, while keeping each member state solely responsible for its debt (borrowing

cost mutualisation). In contrast, a proper Eurobond or its temporary variant (the Coronabond) would involve one-off borrowing to finance common actions (expenditure-side mutualisation).

- **Institutional features:** some proposals rely on existing instruments (ESM credit lines, EU budget); others rely on adjusting existing instruments (an ESM COVID credit line); others envisage dedicated instruments such as a special-purpose vehicle.
- **Conditionality:** some instruments intend to address the COVID crisis itself, and they are hence free from usual conditionalities; others address the risk of a sovereign debt crisis and envisage some conditionality; others are intended to buttress the economic recovery.
- **Scope:** it can be the EU or the euro area, as there is both a need to preserve the single market and to avoid a euro-specific sovereign debt crisis.

Three distinct aims can, and should, be pursued:

- **To share the cost of the crisis** if it turns out to be significantly asymmetric (the extent of which is not yet known). This would imply designing mechanisms that involve temporary transfers (ex post), but only if the shock turns out to be actually asymmetric.
- **To help all member states** – including those whose initial fiscal position is weak – COVID-19: Europe needs a catastrophe relief plan and finance their crisis-fighting needs. This requires, when the instrument involves debt, that the maturity be very long, for example 30 years. The goal here is to make sure that all member states have the possibility to tackle the public health and economic emergencies while retaining market access. If asymmetry arises from the initial position, not from the shock, the aim should not be to share the burden but to ensure that each member state can pull itself out of the crisis.
- **To relaunch the EU after the crisis**, since not only member states have come to a halt but also the EU as a whole, with the closure of frontiers, the disruption of most of its programmes (Erasmus, et al.) and the new challenges that the COVID crisis poses, starting with the need to treat health safety as a public good for the EU.

Drawing on the various proposals advanced by European institutions, member states and academics, we believe that **multiple initiatives are necessary at the European level**. We specifically propose that **support should be given to three instruments**: a COVID Fund, EIB credit guarantees and dedicated credit lines.

## 1. A COVID Fund

**Proposals for a COVID Fund aim at expenditure-side mutualisation** to help the EU assist the worse-hit member states. The logic of these proposals is to provide a conduit for temporary and limited crisis-related transfers. Funds should be allocated depending on the severity of the crisis and the magnitude of the corresponding needs. They could finance common expenditures (on research, procurement, etc..) or provide grants to affected member states, depending on how severely they are hit. They would in turn be financed through time-bound dedicated resource commitments by all member states based on an objective basis for proportionality (such as gross national income). For example, each member state would annually contribute a fraction of its GNI over a period of ten years. The fund would be balanced inter-temporarily but expenditures could be front-loaded and temporarily financed by borrowing on the market through some form of joint issuance, as some of us have proposed. It would be terminated once contributions have extinguished the debt.

A fund of this type would express solidarity in a direct and concrete way. Its size would depend on the scope of its actions, which could range from health-related expenditures to a broader sharing of asymmetric damages. It could also complement the EU budget to address the special needs that the rebooting of the economy will require.

## 2. EIB credit guarantees

The lives of many smaller companies are being threatened by the collapse of their market. Even if they remain solvent, their liquidity needs have increased dramatically and often fail to be met by banking institutions under stress. This is why credit guarantees are necessary. Several member states have already launched major programmes to ensure that banks will extend credit to struggling companies, but there is a need to buttress these initiatives by a similar move at EU level. The European Investment Bank (EIB) has experience in extending such guarantees through the banking system. Beefing up the EIB may prove instrumental in avoiding a major weakening of our production potential.

## 3. Dedicated credit lines

A family of proposals aims at providing a channel for long-term financing, such as the COVID credit line from the ESM proposed by some of us (Bénassy-Quéré et al. 2020) and the SURE proposal (temporary Support to mitigate Unemployment Risks in an Emergency) released by the European Commission on 2 April. **They aim at borrowing**

**cost mutualisation and lengthening maturities.** In order to spread the cost of this crisis over several generations, the ESM benchmark of **30 years** would be appropriate, and it would match the maximum maturity of the bonds purchased by the ECB. Because health security is a public good and because strong economic interdependence makes each economy's recovery dependent on that of its neighbours, it is in the interest of all that each government implements with full force the most efficient and coordinated strategy, even if this involves additional costs in terms of partial unemployment.

The SURE scheme would offer up to €100 billion in long-term lending to the national governments to finance one specific, very costly aspect of the fight against the pandemic, namely, partial unemployment schemes and the related expenditures – without further conditionality. In doing so, it would transform some national borrowing into EU borrowing, backed by the EU budget and by national guarantees. Although the total amount of €100 billion is clearly too small compared to the costs it intends to cover if the crisis persists for longer than a few months, it would nevertheless be a good start, especially if the lending could be extended for very long maturities (the current proposal states that the EU will not repay more than 10% of its debt per year, which would translate into a minimum of 10-year maturity).

Both the ESM COVID line and the SURE proposal would be relatively simple and quick to establish from an institutional viewpoint. However, the restarting of the economy will be gradual and partial, with trials and errors. Hence, there is a case for these initiatives to be used to address some of these reboot needs. The corresponding total would likely reach several hundreds of billions. This would involve either more guarantees or the risk of a lower rating. Maintaining the AAA rating on EU borrowing may no longer be worth the effort if most advanced sovereigns no longer enjoy this top rating. It should be remembered here that there is no difference between the euro area as a whole and 'stand alone' advanced economies such as the United Kingdom, Japan or the United States: to the extent that the ECB stands ready to buy EU bonds, there is no reason to fear an abrupt increase of interest rates.

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**The need for a strong, quick and significant European initiative is beyond doubt.** Crises of this sort test the relevance and legitimacy of institutions. If the EU does not raise to the challenge, it is doomed.

**Since there are multiple objectives, the EU should not hesitate to use different instruments rather than try to find a single silver bullet.** In particular, there is a need for helping countries to borrow at very long maturities and low interest rates, but also for sharing the asymmetric part of the costs. The EU contribution to the crisis response



should rely both on its existing instruments and on new, dedicated mechanisms. Among the former, the ongoing negotiations on the new Multiannual Financial Framework offers an opportunity to reassess priorities and allocate resources to the building of a strong, resilient, inclusive and climate-neutral European economy. Among the latter, a proper COVID Fund would provide a conduit for solidarity in fighting the pandemic and ESM or SURE credit lines would help secure the long-term financing member states need to tackle its economic fallout. Moreover, it is time to design a new financial instrument to help transform the European economy as it recovers from the deepest peacetime crisis seen in centuries.

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# 28 The economic, political and moral case for a European fiscal policy response to COVID-19

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**Thorsten Beck**

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7 April 2020

*There has been a lot of discussion in recent weeks on whether an EU-wide fiscal policy response to COVID-19 should include common liability for the additional debt that such a response would imply. This column lays out the arguments in favour of such an approach – arguments that go beyond economic ones.*

There has been a lot of discussion in recent weeks on whether or not an EU-wide fiscal policy response should include common liability for the additional debt that such a response would imply. Some observers see a replay of similar discussions from a few years ago on Eurobonds, even though the circumstances are very different. Others observe that it would not be the first time such community bonds were issued after a major economic disruption (Horn et al. 2020). In the following, I will lay out the arguments in favour of such an approach – arguments that go beyond economic ones.

## **Principle of subsidiarity**

The principle of subsidiarity, as defined in Article 5 of the Treaty on European Union, is a basic tenet of European decision-making. It aims to ensure that decisions are taken as closely as possible to the citizen and actions on EU level have to be justified in light of the possibilities available at national, regional or local level. Responsibilities for specific policy areas should only be transferred to the EU level if objectives can be better reached at Union level.

One can easily apply this principle to policy actions in the context of coronavirus. Neighbourhood-based WhatsApp groups have mushroomed across London (and I am sure they have so in other cities around the world) to offer help to vulnerable residents. Given differences in the organisational structure of health systems across EU countries, the primary public health response has happened on regional or national levels. Other

actions, however, clearly benefit from being undertaken at the EU level. This is the case, for example, for procurement of ventilators and other medical equipment, which is cheaper for the EU than for individual countries given a larger market share on the demand-side if countries act together. Incentives to find reliable tests and a vaccine can benefit from more generous funding on the supra-national level. These public health actions benefit from being taken on the European rather than national level, given scale benefits, strong externalities and the character of a vaccine as public good.

This argument for policy action on the European (or even global) level also applies to the economic policy reaction to the COVID recession. The socioeconomic lockdown made necessary by the COVID-19 virus will damage economies. A quick recovery and limitation of further damage will require fiscal policy actions. While many such actions have been taken already to help firms and households during the lockdown phase, more might be needed in the recovery phase. Given the close interconnectedness of European economies (in the form of supply chains, good and service market integration and labour mobility) it is in every country's interest that such recovery happens quickly and across all countries in Europe. There are thus strong externalities of national fiscal policy actions, which – without coordination - can result in too little fiscal policy. As important, however, is that some countries have less fiscal space available than others. This is clearly reflected in the fiscal policy measures to-date, which have been much more expansive in Germany than, for example, in Italy or Spain. So, what role can European institutions play in these circumstances?

### **Why not the ECB?**

As has become tradition over the past 12 years, the ECB was the first European institution to step up to its responsibility. The pandemic emergency purchase programme (PEPP) and its flexibility is an aggressive monetary policy step, more effective than pushing interest rates further into negative territory. The PEPP as well as the “no limits” policy announcement (the equivalent to Draghi's “whatever it takes”) has helped reduce panic on financial markets, including on the sovereign bond markets. There is the suggestion that the use of the OMT programme (announced after Draghi's “whatever it takes” speech in summer 2012 but never actually used so far) can help reduce pressure on euro area governments that have reached the limit of its fiscal space.

While the ECB is clearly the first line of policy defence in this recession when it comes to financial markets, there are several reasons why it should not bear the main burden of the necessary public support programmes for the recovery. First, the COVID and the consequent government expenditures are clearly fiscal policy tasks; the losses incurred during this crisis will have to be funded and distributed. There are different (non-

exclusive) ways of doing so – one is through higher taxes on, for example, income or wealth; another is through higher government debt over the next decades, thus spreading the costs to future generations. In either case, the most transparent way is to do so openly and sanctioned by democratically elected parliaments and governments.

The alternative of using ECB monetary policy tools to keep interest rates and spreads (and thus the cost of such debt) low would also imply that a normalisation of interest rates and reduction of quantitative easing would be even further away. I would not expect any tightening of monetary policy any time soon during the next few years but having the additional task of avoiding runs in the sovereign bond markets would push such a return even more into the future.

A further consideration when burdening the ECB with what is effectively a role for fiscal policies is that it would undermine the standing of the ECB as independent monetary policy institution even further. The ECB has been criticised for keeping interest rates at zero or in negative territory for too long, as often as this argument has been proven wrong; it has also been accused of overstepping its mandate and entering effectively fiscal policy. Forcing the recovery of COVID losses through long-term financial repression is certainly counter to its mandate. While this is what was partly done in many European countries post-WWII (Reinhart and Kirkegaard 2012), central banks were not independent during these times but rather seen as part of democratically elected governments.

### **Why not the ESM?**

The ESM has been established for situations where individual governments are hit by shocks and cannot finance themselves any longer on the market. Similar to the IMF on global level, such a programme comes with conditionality.

There have been suggestions that the easiest way (partly because of existing structures) is for countries at risk of not having sufficient access to market funding to tap ESM funding (e.g Erce et al. 2020). There are several problems with this. First, ESM loans would still be part of national debt and would thus not solve the problem of sovereign debt sustainability. While the idea of using the ESM together with OMT might get around this constraint, this would effectively mix fiscal and monetary policy, as discussed above.

Second, the ESM was not founded for a crisis like this one but rather to provide liquidity support for individual countries that got into temporary problems. But COVID-19 is not an asymmetric shock hitting one or some countries, but a shock that has hit all economies, though at different points in time. Finally, the tapping of the ESM comes with a stigma, not only in terms of market signals, but also politically, unless all countries commit to tapping the ESM at the same time.

### **The economic case for COVID debt mutualisation**

This leaves the idea of Coronabonds, as suggested for example by Bofinger et al. (2020) or Giavazzi and Tabellini (2020). But why should countries with higher fiscal policy space take on liability for the benefit of countries with lower fiscal policy space? There are several answers to this question. One answer is that of economic self-interest. The countries currently most affected by the virus in human and economic terms are among the countries with the lowest fiscal space even though they are most in need of a fiscal stimulus. On the one hand, a lower fiscal stimulus from these countries dampens the recovery throughout the euro area and the Single Market. On the other hand, a strong fiscal stimulus that turns sovereign debt of these countries unsustainable can result in a vicious cycle of lower growth perspectives endangering access to sovereign debt markets, which in turn lowers growth perspectives further. Such a vicious circle will not only result in more divergence within the currency union, but negatively affect all euro area countries, not even to mention the risk of a possible exit of countries with unsustainable government debt from the euro area.

The experience of the past decade should be a clear warning signal. The Global Financial Crisis and the Great Recession increased sovereign debt burdens throughout the euro area and ultimately resulted in the Eurodebt crisis, deepening social and economic misery and contributing to the rise of populism. There is a clear economic case to avoid that the COVID-recession is followed by a second Eurodebt crisis! Arguing that even a hint of debt mutualisation would result in a further rise of populist parties in Germany, Netherlands and Finland ignores that such a rise would follow from another Eurodebt crisis anyway and underestimates the pan-European spirit of solidarity that can be awoken through right political leadership.

## **The political case – looking at history**

The last global pandemic – the Spanish influenza in 1918-20 – came at the end of WWI. European countries already devastated by the war faced an additional human and economic burden. The next two decades brought nationalistic resentment, authoritarianism and fascism – culminating in WWII and the Holocaust. While I would not for a moment argue that the Spanish influenza had a decisive role in this turn of history, I cannot avoid seeing some parallels in the current circumstances.

The European Union, founded after WWII, has contributed to 75 years of peace in our continent. The current pandemic brings the chance to a common European approach, building on decade-long cooperation and institutional infrastructure, thus ‘updating’ the role of the European Union as peace project. The failure to do so, on the other hand, will undermine the case for Europe even further and will give further impetus to populist if not authoritarian parties. We should have learned over the past ten years (Brexit and a close shave with Grexit) that progress in European integration is not irreversible and not having a common approach to this crisis can have serious political repercussions. The recent open letter by Italian politicians of the centre-left, reminding Germany of the debt rescheduling in 1953 and accusing the Dutch of robbing other European countries of tax revenues (Calenda et al., 2020) gives us a small flavour of what could be the beginning of a slow reversal of decades of European integration.

## **Finally, the moral case**

Finally, there is a moral case: Germany is receiving COVID patients from other countries at the time of writing; a clear sign of European solidarity. But the crisis will not be over once the first COVID wave has receded – rather the public health challenge will be replaced by an economic challenge – why should European solidarity be less important or justifiable for economic recovery than for public health challenges? As many developing countries will struggle with public health and debt challenges in the years to come, global solidarity is the only feasible way forward – starting in Europe is important.

## **Why now?**

There are arguments that now is not the time to build the necessary institutional framework for Coronabonds or comparable funding structure and that the use of existing structures, including the ESM and the ECB, is preferable. I have argued that this would be the wrong path. While it might help hold off pressure, financial markets anticipate

future problems. As important, however, is it to send a political signal of European solidarity now. This is especially important for the younger generation, whose early adult experience will be dominated by the COVID fallout. We do not need another Lost Generation or Depression Babies (Malmendier and Nagel, 2011)!

What is needed now therefore is a signal on the highest political level – a signal of fiscal policy solidarity, driven as much by economic self-interest as by historic lessons and the moral case for pan-European solidarity.

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# 29 Coronabonds: The forgotten history of European Community debt

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*The introduction of European Coronabonds is sometimes described as an unprecedented step that would create a dangerous precedent of debt mutualisation. This column shows that this view is wrong and ignores the history of European financial cooperation. Since the 1970s, the European Commission has placed more than a dozen community bonds on private markets, which were guaranteed by the member states and distributed to countries in crisis. These bonds have been fully repaid in the past. Coronabonds with joint and several liability go a step further, but they would stand in a long tradition of European financial solidarity and cooperation.*

The proper European response to the coronavirus crisis is intensely debated at the moment, with European Stability Mechanism (ESM) loans and Coronabonds being the most prominent alternatives (e.g. Bénassy-Quéré 2020a, Bénassy-Quéré 2020b, Bofinger et al. 2020, Erce et al. 2020, Grund et al. 2020). One of the arguments against Coronabonds – a one-off mutual European bond issuance – is that this would be an unprecedented step and break a dangerous taboo.

This column adds to the debate by showing that that bonds issued and guaranteed jointly by European states are not a novel instrument but have repeatedly been issued since the 1970s. We summarise the forgotten history of European Community bonds and the reliance on European joint debt issuances in fighting deep economic crises in Horn et al. (2020a). It is not widely known that prior to the instruments created during

the euro crisis, such as the ESM, Europe relied on a range of earlier crisis-response instruments and cooperation mechanisms, as we document in an ongoing research project on international official lending (Horn et al. 2020b).<sup>1</sup>

## **The oil crisis and the Community Loan Mechanism of 1975**

One of these little-known instruments is the European Community bond, which was triggered by the 1973 oil crisis (James 2012). The oil crisis was a deep shock to the European states, both economically and politically, and was perceived as an existential threat to the economic union (Dickmann 1990). Italy was particularly hard-hit and entered a deep recession, with a GDP growth rate of -2% in 1975.

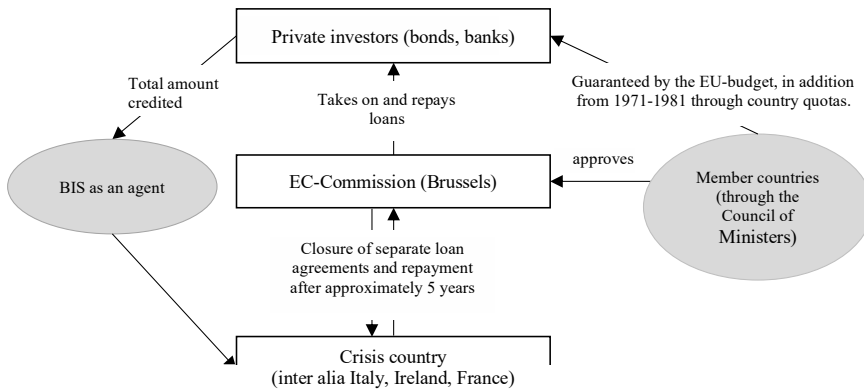
In response to the crisis, the so-called Community Loan Mechanism (CLM) was implemented in February 1975 with the goal of issuing European Community bonds on private capital markets to support countries in crisis. The German government was a pivotal player in creating this mechanism and also added a bilateral \$2 billion loan granted to Italy in 1974.

The program complemented the European Medium-Term Financial Assistance Facility (MTFA), which had been created in 1971 and enabled the provision of direct financial aid through intergovernmental loans, without placing community loans on the private market. The main goal of these programs was to cushion balance of payments difficulties caused by external shocks via intra-European financial cooperation and to provide aid to crisis-hit countries in Europe in order to limit their dependency on loans from the IMF and the US Federal Reserve (Kruse 1980).

The basic design of the Community Loan Mechanism was as follows: The European Commission would raise community loans on behalf of the European Community. The Council of Ministers, which represents the governments of the member states, made all relevant decisions, while the Commission acted as the executive body. To raise funds, the Commission negotiated with private investors and presented the results to the Council of Ministers. The loans were then transferred to the crisis-hit countries' central banks via the Bank for International Settlements (BIS), which acted as an agent. Figure 1 summarises the design graphically.

<sup>1</sup> A VoxEU column summarising this research can be found at <https://voxeu.org/article/coping-disasters-lessons-two-centuries-international-response>

**Figure 1** Design of the Community Loan Mechanism of 1975



Source: EEC Council (1975a), EEC Council (1975b), own illustration.

As for the liability structure, the Commission guaranteed the repayment to the private creditors by means of its budget. In addition, the mechanism included a guarantee commitment from the member states, according to fixed quotas. The maximum credit volume was set at \$3 billion in 1974 and the guarantee increased to a maximum of 200% of this credit limit. The twofold guarantee of 200% was intended as a buffer against payment problems by one of the guaranteeing member states. For example, under the program, Germany had an initial guarantee share of 22% and thus assumed a maximum guarantee of 44%, or \$1.32 billion in total (Stieber 2015). The volume of the program was considered to be extensive at the time and, in the case of Italy, exceeded the financial resources provided by the IMF.

## A survey of European Community loans and their recipients

In 1976, the first European Community bond was placed on private capital markets, with funds lent to Italy and Ireland. Further community bonds were distributed to Italy (1977), France (1983), Greece (1985) and Portugal (1987). In the 1990s, community bonds were issued in favour of Greece (1991) and Italy (1993). The mechanism was merged into the EU Balance-of-Payments Facility in 1988 and, in 2002, was restricted to countries outside of the euro area. It was again activated in 2008/2009 to support Hungary, Latvia, and Romania. In addition, the European Financial Stability Facility (EFSF) and ESM were created after 2010 to support euro area members.

Table 2 provides an overview of the European Community loans by year and recipient country. The EFSF and ESM loans granted to Cyprus, Greece, Ireland, Portugal, and Spain during the 2010-2013 crisis are not listed, since they are much better known and well-documented (for details see Corsetti et al. 2017).

**Table 2** Overview of European Community loans since 1974

Year	Recipient Country	Amount authorised (nominal, in billion EUR)	Amount authorised (in % of GDP)	Amount authorised (in % of currency reserves)	Program
1974	Italy	1.72	1.0	14.1	MTFA
1976	Ireland	0.37	3.9	23.5	CLM
1976	Italy	1.22	0.5	9.5	CLM
1977	Italy	0.54	0.2	3.8	CLM
1983	France	4.00	0.7	7.4	CLM
1985	Greece	1.75	3.6	78.8	CLM
1987	Portugal	1.00	2.6	10.7	CLM
1991	Greece	2.20	2.2	46.6	BoPF
1993	Italy	8.00	0.6	16.0	BoPF
2008	Hungary	6.50	4.6	27.0	BoPF
2009	Latvia	3.10	8.7	59.1	BoPF
2009	Romania	8.40	2.3	12.6	BoPF

*Notes:* The table presents a summary of the European Community's borrowing programs financed by community bonds. In columns 4 and 5, the authorised loan amount is scaled by the GDP and foreign reserves of the year prior to the crisis. CLM: Community Loan Mechanism, MTFA: Medium-Term Financial Assistance Facility, BoPF: Balance-of-Payments Facility.

*Source:* Horn et al. (2020b)

## Lessons for today

How strong are the parallels to today? Most current Coronabond or Eurobond proposals imply joint and several liability by all member states. This would go a step further compared to the Community Loan Mechanism of the 1970s, which involved country guarantees with maximum quotas. Nevertheless, there are important lessons to be learnt from our review of European lending practices since the 1970s.

One important insight is that, now and then, the EU budget played a central role in the European bond guarantee schemes. Direct guarantees by member states only served as a second guarantee tier, which would be activated if EU funds would not suffice (CLM rules until 1981). It is therefore no surprise that current proposals also suggest using an (enlarged) future EU budget to guarantee the repayment of potential Coronabonds.

Second, history leaves some ground for optimism: The European Community bonds we surveyed were all repaid in full and on time and the guarantees were never activated.

The third and most important lesson is the bigger picture: During deep crises the European governments have repeatedly shown willingness to extend rescue funds along with substantial guarantees to other members in need. The necessary institutional arrangements were often set up flexibly and quickly. Coronabonds would thus stand in a long tradition of European financial cooperation and solidarity.

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# 30 Towards a European Reconstruction Fund

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**Luis Garicano**

European Parliament

5 May 2020

*The idea that Europe's response to the economic crisis should be based on the issuance of common perpetual bonds has been slowly gaining ground, but proposals that entail substantial increases to member states' debt risk hampering growth for decades to come. This column argues that the time has come for genuine European spending financed through European borrowing. It examines the legal and financial issues around the possible implementation of a proposal for the Commission to issue consolidated annuities ('EU Consols') to finance a €1 trillion economic reconstruction package.*

After being first proposed by Francesco Giavazzi and Guido Tabellini (2020), the idea that Europe's response to the economic crisis should be based on the issuance of common perpetual bonds has been slowly gaining ground. They first highlighted that issuing at ultra-long or perpetual maturities would take advantage of the low-yield environment, eliminate refinancing risk, and send a strong signal of European unity to the market.

Nevertheless, their proposal would entail a substantial increase to member states' debt. Both authors suggest member states should issue perpetual bonds backed by their joint tax capacity. Given how high debt levels are in many countries, this would threaten to hamper growth for decades to come. It operates under the same logic as the three instruments (the ESM, the EIB, SURE) in the Eurogroup's deal – namely, that European issuances should only be used to generate more debt in member states.

The time has come for genuine European spending financed through European borrowing. To this end, Guy Verhofstadt and I recently proposed that the Commission issue consolidated annuities (or 'EU Consols') to finance a €1 trillion economic reconstruction package (Verhofstadt and Garicano 2020a, 2020b). Our proposal, in line with the European Parliament's 17 April resolution,<sup>1</sup> would see the money spent (and

<sup>1</sup> [https://www.europarl.europa.eu/doceo/document/RC-9-2020-0143\\_EN.html](https://www.europarl.europa.eu/doceo/document/RC-9-2020-0143_EN.html)



not lent) along the EU budget's future-oriented priorities. We propose that to prevent any increases in the financial contributions of member states, the additional EU-level (interest) expenses must be paid for with new revenue sources at the EU level.

Since then, this proposal has been taken up by the Spanish government and is one of the contending landing zones for the Reconstruction Fund debate. Building on our previous articles, in this column I expand on the proposal's legal and financial implementational aspects.

## The economics

The grand bargain that we put forth to member states is that they can keep their contributions to the EU's next seven-year budget – a matter of constant bickering – at current levels. In exchange, we ask them to drop their reluctance to allow the creation of new, modern EU-wide streams of revenues that could bring between €26 billion and €38 billion a year. These new revenues would be used to pay the interests on the EU Consols. Of the potential sources of revenue that have been discussed (including the Financial Transactions Tax and the Carbon Border Adjustment Mechanism), we put to use four that have already been designed and proposed by the Commission:

- 1. The Emissions Trading System (ETS):** Today, all of the revenues from the ETS are kept by member states. To ensure that they do not lose any existing revenues, we follow President Michel's February proposal: only ETS revenues in excess of the average amount member states received in the 2016-18 period (about €8 billion) would flow into the EU Budget. ETS revenues are the most volatile of our proposal, but we can work with existing estimates of €20 billion in total annual revenues in Phase IV of the program (WWF 2020). For reference, in 2018, it generated €15 billion, growing more than 150% with respect to 2017. Net, the ETS would entail €12 billion in annual EU revenues.
- 2. Plastic-based contribution:** The European Court of Auditors estimates this would amount to €7 billion a year from a €0.8 per kilo call rate. Applying the maximum call rate allowed for in the proposed Regulation (€1.0 per kilo), we can increase revenues by 25% to yield around €9 billion a year.
- 3. Digital tax:** The Commission's 2018 proposal for a 3% tax on revenue on large tech companies is the only new revenue we propose that has not been formally proposed as a new 'Own Resource'. Assuming a 100% call rate on the revenue estimates of the 2018 proposal, the digital tax could bring in around €5 billion. According to the Commission's impact assessment, however, potential revenues could be as much as €10 billion (European Commission 2018).

**4. Common Consolidated Corporate Tax Base (CCCTB):** Approving the CCCTB as proposed by the Commission in 2018, and applying a 3% call rate on member states' revenues, would generate €12 billion a year, according to the European Court of Auditors. This would be the only new revenue to the EU budget that would reduce existing revenues that member states already have. However, we would expect this reduction to be offset by a general increase of revenues due to the harmonised tax rates.

Taking into account the perpetual nature of the Consol's principal, how much leverage could these new sources of funding allow for? We see three main precedents of publicly syndicated long-term bonds that could help us ballpark the coupon of the EU Consols:

- 1. Israel in 2020:** Israel secured \$1 billion in dollar funding through 100-year bonds to combat the COVID-19 crisis. Five times oversubscribed due to the unprecedented context and nature of the issuance, they priced at a 4.5% coupon.
- 2. Austria in 2017:** Austria raised €3.5 billion by issuing a 100-year bond at a 2.1% coupon, which now trades at a 1% yield. It is the sovereign bond with the longest maturity in the EU.
- 3. European Stability Mechanism (ESM) in 2018:** The ESM issued almost €1 billion in 40-year bonds at a 1.85% coupon, which now trades at a 0.7% yield. It is the longest-dated debt issued at the European level.

The first conclusion to draw from these precedents is that our trillion euros would have to be issued progressively and not all at once. Putting this aside, and taking into account the above, the Commission's AAA rating, and the ECB's support, we find it fair to conservatively estimate a 2.5% coupon on the annuities (Alogoskoufis and Langfield 2020).

With all the key financing figures in mind, Table 1 shows the issuance potential of different combinations of new resources and coupon rates.

**Table 1**

New EU revenues	(bn)	Interest rate					
		0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
Digital + CCCTB	17	3,340	1,670	1,113	835	668	557
ETS + Plastic	21	4,238	2,119	1,413	1,060	848	706
ETS + Plastic + Digital	26	5,178	2,589	1,726	1,295	1,036	863
ETS + Plastic + Digital + CCCTB	38	7,578	3,789	2,526	1,895	1,516	1,263

### Inside or outside the budget?

Under our proposal, the Commission would use its existing powers to borrow in the markets and would start issuing annuities when the next long-term EU Budget begins in 2021. The proceeds would finance a new European Reconstruction Fund. The spending of the fund would be aligned with the EU budget's priorities, also potentially co-financing EU programmes in lieu of national authorities.

When designing the Reconstruction Fund, it is essential that we stay away from intergovernmental solutions such as the establishment of a Special Purpose Vehicle (SPV), as some countries are currently proposing. Acting in such a way is not only plagued with issues regarding the lack of democratic accountability, judicial protection and burdensome decision making – as is well understood by now – but also has four crucial implementational difficulties:

- **Externally assigned revenue:** In the EU Budget, earmarking is not permitted. There are some exceptions (deemed 'assigned revenue'), but it is difficult to see how a Reconstruction Fund could fall into any of the categories for which the exception is permitted (see the Financial Regulation). Furthermore, the size of the instrument would pose problems as regards the autonomy of the Union's law, as it would legitimately raise the question: is this not a parallel budget to which no EU rules apply? The possibility of establishing the Reconstruction Fund on the basis of certain Own Resources permanently earmarked to feed it therefore seems legally unwise if left outside the EU Budget.
- **Time:** We have eight months before the next seven-year EU Budget starts. It is imperative to act fast. Past experience proves intergovernmental agreements are not a speedy option, as shown by the ESM, which took years to finalise.

- **Accounting:** Even if we followed the example of the European Financial Stability Facility (EFSF) – an SPV set up while the ESM Treaty was being finalised – and established a provisional fund while the intergovernmental treaty is negotiated, a central accounting issue would arise. For accounting purposes, the debt issued by the provisional fund, and the guarantees provided to it by member states, would have to be consolidated into the national accounts (Eurostat 2019). Correspondingly, the gross debt of member states would increase substantially, defeating the very purpose of the fund.
- **Legal certainty:** The national law of the member state in which the SPV is located would apply, leaving the door open for said country to unilaterally change its applicable law. This could have an impact on the fund's governance, the execution of the guarantees and even the possibility for shareholders (the member states) to withdraw under ordinary private-law conditions. This uncertainty would surely translate into higher interest payments for the annuities, as is the case of systemically higher yields paid for by the EFSF with respect to the ESM (ESM 2019).

At the same time, to make the Fund work within the EU Budget, the current budgetary treatment of outstanding European debt – a legacy of the sovereign debt crisis – must be changed. In 2010, when the European Financial Stabilisation Mechanism (EFSM) was established, the Commission decided that the entire balance of its loans should fit within its yearly budgetary 'headroom'. This means that the total loans outstanding in any given year must be below the difference between the budget's spending ceiling and its 'Own Resources ceiling', which determines the maximum amount of money the EU can mandatorily request from member states in any year (today fixed at 1.20% of GNI).

The idea was that this would provide creditors the maximum degree of certainty that the Union would repay its obligations. However, the decision severely hampers the EU budget's ability to issue debt and counter the economic effects of the crisis. Because of it, the EFSM alone, with its €47 billion in loans, consumes the entirety of the EU budget's headroom, forcing the Commission's SURE programme to be backed beyond the headroom (and the Own Resources ceiling) by member state joint pro rata guarantees.

It is hard to argue in favour of this decision in economic terms. After all, the only money that the budget of a particular year should guarantee is that which has to be paid in that year. Neither do legal considerations apply, as no specific impediments can be found in the EU Treaties. Because of this, we propose that this budgetary treatment of EU loans be put to rest, and that only the interest be guaranteed in the budget of any given year, with only these counting towards the Own Resources ceiling. The rest of the payments would be simply assumed by the Union, in the same way member states assume their respective debts.

The consequences of such a change would be felt immediately. Under our proposal, for instance, the required increase of the budgetary headroom would be relatively small: €26 billion only amounts to 0.19% of EU27 GNI (assuming a 7% GDP drop from the economic crisis; IMF 2020).

## **How to set it up within the EU legal framework**

The establishment of a European Reconstruction Fund that would secure the financing needed for a swift recovery of the Union's economy would be carried out by means of Article 122 (1) TFEU. By utilising this legal basis, the Council would be allowed to take, "in a spirit of solidarity", the "measures appropriate to the economic situation". This temporality safeguard is not only politically tenable but further reinforces the validity of Article 122 (1) TFEU as the appropriate way to finance the reconstruction from Covid-19, an exceptional occurrence for which no member state is to blame. Acting in this way would attain the Union's goals as established in Article 3 (3) TEU, most notably "to promote economic, social and territorial cohesion, and solidarity among Member States".

Unlike the EFSM and SURE, Article 122 (2) TFEU would not serve as the European Reconstruction Fund's legal basis. Its narrower conception of solidarity exclusively entails loans. The gravity of the current situation, however, calls for a different kind of action, setting aside the logic of European borrowing for loans.

Providing a long-term legal basis for the European Reconstruction Fund would require the use of Article 352 TFEU, better known as the 'flexibility clause', which served as the basis for the Commission's proposed integration of the ESM into the EU legal order. Although legally sound from the outset, it certainly is not as politically attractive as Article 122 (1) TFEU. First, it is too broad as it does not require an exceptional 'economic situation' to justify its deployment. Second, it does not provide for such a temporality safeguard. And, third, the flexibility clause hinges on unanimity and cumbersome national procedures (see, for example, the Bundesverfassungsgericht's Lisbon decision).<sup>2</sup>

<sup>2</sup> [https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2009/06/es20090630\\_2bve000208en.html](https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2009/06/es20090630_2bve000208en.html)

### Compatibility with Article 310 TFEU

Under Article 310 TFEU, the EU Budget must be balanced and expenditure must equal revenues. This is an obligation that is, however, nuanced by the following provision, Article 311 TFEU, which stipulates that “the Union shall provide itself with the means necessary to attain its objectives”. As argued by Grund et al. (2020), this is a moment in which all over the globe national governments are looking for extra funding. Therefore, setting up a Fund that maximises the efficiency and efficacy with which financing operations are carried out is justified. This would allow the Union to guarantee the financial stability of the single currency by preventing further strain on member states’ finances. It is important to highlight that actions taken through Article 122 (1) TFEU are strictly temporary, and exceptional, in nature.

### Compatibility with Article 125 TFEU – the ‘no bailout clause’

By acting “in a spirit of solidarity”, the member states would not need to impose conditionality for the funds provided. This is justified given the lack of blame and moral hazard, unlike in the sovereign debt crisis, for a pandemic that affects the Union as a whole.

Article 122 (1) TFEU is, however, an exception to the famous ‘no bailout clause’. It must therefore be justified to take these extraordinary measures. It is worth noting that in *Pringle*, the Court of Justice ruled that the obligation enshrined in the ‘no bailout clause’ meant member states must remain subject to the logic of the markets when incurring in debt. As long as they are not incentivised to set aside or reduce budgetary discipline, Union action is allowed. Several safeguards are in place to guarantee this is the case. First, the fund and its spending would not be managed by member states. Instead, it would be managed by the Commission, the guardian of the Treaties, in accordance with the Union’s priorities. Second, the Fund’s establishment does not entail the mutualisation of existing nor future debt beyond what is necessary for the achievement of the instrument’s goal: to provide, in a spirit of solidarity, assistance to member states in light of the outbreak.

### Compatibility with 123 TFEU

Some have expressed concerns over the supposed impossibility for the ECB to purchase EU Consols given their perpetual maturity and the self-imposed limits currently in place for its various quantitative easing programmes. The risk, this reasoning goes, is that by doing so, the ECB would breach Article 123 (1) TFEU’s prohibition on monetary financing.

The European Court of Justice's case law on the matter paints a different picture. In both *Gauweiler* and *Weiss*, the Court stated that the ECB, when conducting monetary policy, is granted broad discretion to accomplish its objective of maintaining price stability. Only two limits, in relation to Article 123 (1) TFEU, would apply: that the ECB shall not directly purchase the government's debt; and that its actions, similarly to the logic discussed above as regards the 'no bailout clause', should not de-incentivise member states from conducting sound budgetary policies. At any rate, the Court would recall, the ECB has the possibility to sell, at any time, the bonds it purchases.

Crucially, no exact safeguards to be put in place by the ECB were defined by the Court. It deliberately left the matter wide open, stating that in a potential review of a programme's legality, it would take into account the context and economic situation on which decisions had to be taken (including the actions put forth by other central banks). The ECB could, therefore, make full use of its powers in a flexible way so long as this did not exceed what is necessary to achieve its goals.

At a time in which a pandemic has ravaged our Union's economy, it is difficult to argue that the Court's interpretation would change. This is even more so the case in light of the ECB's secondary objective as per Article 282 (2) TFEU: to support the general economic policies of the Union.

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# 31 The EU response to the coronavirus crisis: How to get more bang for the buck

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**Massimo Bordignon and Guido Tabellini**

Catholic University of Milan; Bocconi University and CEPR

13 May 2020

*The subsidiarity principle implies that the EU should do what member countries cannot do by themselves. In the context of the current crisis, this implies issuing very long-term debt. This column argues that this could be achieved by endowing the new EU Recovery Fund with genuinely own EU sources of revenue. Providing the EU with revenue from EU own tax bases would also improve the quality of EU expenditures, and could pave the way to the creation of a euro area fiscal capacity.*

In designing the EU responses to the coronavirus crisis, the European Commission and European policymakers should be guided by the subsidiarity principle. Action should be taken at the EU level “if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States ... but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level”.

## **So far, very little bang for the buck**

This criterion implies that a significant fraction of the €540 billion already committed by the EU is only of limited use.

- The €240 billion of the new ESM credit line is restricted to a maturity of at most 10 years, and ESM loans are senior. But even the weaker member states can already issue debt at this maturity, and this is unlikely to change while the ECB’s Pandemic Emergency Purchase Programme (PEPP) continues. A senior loan with a below-market interest rate would raise the cost of issuing subordinated national debt expiring around the same dates. By the Modigliani-Miller theorem, the average cost of total national liabilities would not be much affected (see also Corsetti and

Erce 2020). If another potential benefit of ESM lending is to open the door to Outright Monetary Transactions (OMT) by the ECB, this could be achieved without committing all these resources.

- Another €100 billion are made available through the SURE mechanism (out of an additional guarantee of €25 billion by member states) as loans to support unemployment benefits. The maturity of these loans is still unknown, but it is also unlikely to exceed 10 years. Here, disbursement will be based on needs, and hence there will be some risk sharing. But it will be very limited, since the shock is symmetric and all EU countries will be hit by a severe recession in 2020, ranging from minus 6.5% to minus 9.7% according to the Spring 2020 Economic Forecast of the EU Commission (see also Boone et al. 2020)

## **What about the Recovery Fund?**

In light of this, it is important that the new Recovery Fund be designed so as to achieve something that member states cannot already do on their own. Besides its size and the criteria for disbursements, which will be the outcome of political negotiations, two other aspects will be key:

- The maturity of the resulting obligations for member states. Enabling member states to borrow at very long maturity (longer than they can currently do on their own) could be useful, despite the seniority, because it reduces the risk of a funding crisis when debt is rolled over. As argued by Giavazzi and Tabellini (2020), from an economic point of view the ideal debt instrument in the current circumstances would be a perpetuity. Additional lending to member states at the same maturity at which they can already borrow would be of very limited value.
- Whether the Recovery Fund will be a first (albeit small) step towards remedying the fragilities of the euro area. The single currency is not backed by a fiscal capacity, and its legal foundations prevent explicit monetary and fiscal policy coordination in times of crisis. Moreover, the lack of a common safe asset makes the banking and capital market unions incomplete. The Recovery Fund provides the opportunity to start remedying these fragilities.

Since the EU does not have an independent fiscal capacity, the Commission is working on the idea that the Recovery Fund issues debt backed by resources committed by Member States for the 2021-27 EU budget, in excess of planned expenditures for the same period. This raises the problem of the mismatch between the timing of the committed resources, the next seven years, and the need to issue long-term debt. If the Recovery Fund will not be able to directly borrow at very long maturities, the EU

would have to choose between two unpleasant alternatives: either (i) engage in maturity transformation, lending to member states at a longer maturity than it borrows in the markets, thus subjecting itself to a potential interest rate risk; or else (ii) lend at the same maturity of its own liabilities, with little or no benefit to member states.

## **A step towards completing EMU**

The problem of how to enable the Recovery Fund to borrow at long maturities could be reduced if the funding of the EU budget was based on genuinely own EU tax revenue, as proposed by the Spinelli Group (2020). A similar proposal has been made by Garicano (2020). Currently, the EU's own resources largely consist of transfers from member states. Replacing these transfers with revenue from own EU tax bases would reduce the uncertainty surrounding the seven-year cycle of bargaining on the EU budget. If the revenue from the EU own tax bases were committed by member states for more than seven years, and earmarked for servicing the EU debt, the Recovery Fund could easily borrow at very long maturities. Reasonable proposals on which tax bases to devolve at the EU level abound (e.g. High Level Group on Own Resources, 2016). In normal circumstances, these EU taxes would be used to finance the EU budget; but in exceptional cases, such as the present crisis, they could be used to back the issue of long-term EU debt. Over time, the EU could be allowed to set the tax rates on the devolved tax bases. Of course, this last step would require further and much bigger steps towards political integration, including giving the European Parliament a stronger voice over the EU budget.

Financing the EU budget with genuinely own tax revenue would have other advantages. For example, it would weaken the current incentives for national governments to claim 'their money' back. The reason is that EU taxes would redistribute within member states, possibly much more than between states, allowing cross-border political coalitions to form. This could facilitate the funding of truly European public goods, which are currently underprovided, and possibly reduce EU expenditures that primarily redistribute between members states.

A step in this direction would also be a step towards remedying the incompleteness of the euro area. It is well understood that a key fragility of the common monetary policy is that it lacks a solid common fiscal capacity. The recent decision by the German Constitutional Court, although questionable under many respects (e.g. Poirares Maduro 2020), makes it clear that member states cannot keep delegating all macroeconomic policy management to the ECB. The euro area is not equipped to face large crises. Experience also shows that one cannot rely on coordination of national fiscal policies to provide the necessary stimulus. Free-riding, lack of fiscal space by some member states,

and other national political distortions typically lead to late and sub-optimal national responses (Blanchard et al. 2020). Building a fiscal capacity at the EU level could be done relatively quickly, and it would provide a way to address these difficulties for the future. Issuing a truly European debt, backed by genuine own EU tax resources, would also create a common safe asset, and it would allow a more effective and transparent coordination between monetary and fiscal policy in times of crisis.

A possible problem with using the EU budget to provide a fiscal basis for the euro area is that not all member states have adopted the common currency. Brexit has reduced the economic relevance of this issue, and all member states (except Denmark) have taken legal obligations to eventually adopt the euro. But solutions could be found to limit this source of funding (and possibly related expenditures) to only euro area countries.

A possible obstacle to exploiting the creation of the Recovery Fund to endow the EU with genuinely own resources is that this could take too much time, and the Fund should be available immediately. This is not a good reason to postpone indefinitely the search for better methods of financing the EU budget, however. Initially, the additional own resources needed to issue EU debt could take the form of government transfers, but member states could commit to immediately starting the preparatory work to replace such transfers with an adequate EU own tax.

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## 32 Perpetual bonds are not the best way to finance the European Recovery Fund

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14 May 2020

*Prominent voices propose financing the European Recovery Fund using joint perpetual debt. This column argues that there are gains from using European borrowing and lending as two separate policy levers. In a world of ultra-accommodative monetary policy, financing the Fund issuing debt at shorter maturities and passing those low interest rates onto member states through loans with low margin and with very long maturities is financially cheaper. Supporting the recovery through this maturity transformation would reinforce debt sustainability across the EU.*

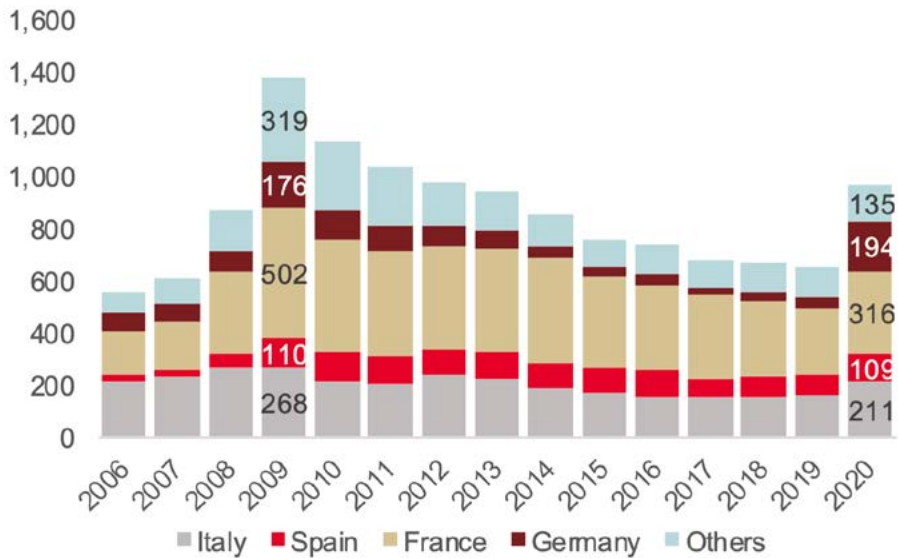
A number of prominent voices have put forward the idea of funding a large investment package (€1.5-2 trillion) to support the EU recovery from Covid-19 by issuing EU perpetual bonds (consols). Such a joint recovery plan is seen as vital for the stability of the EU. One argument in favour of using consols is that committing to joint perpetual debt delivers a high degree of mutualisation.

The idea has recently been floated by Garicano (2020), Giavazzi and Tabellini (2020), Verhofstadt and Garicano (2020) and the Spanish Government (EU Council 23 April 2020) to name a few recent ones (see the discussion in Baldwin and Weder di Mauro 2020). Soros (2020) also backed the idea, stressing that consols were used in the past by both the UK and US. Prior to COVID-19, in a somewhat different context, Paris and Wyplosz (2014) proposed a “plan PADRE” to deal with high public debts in the euro area, essentially by swapping existing debt instruments into zero-coupon consols held by the ECB.

We share the objectives motivating these proposals: lending long-maturity to states will be crucial to create space for effective recovery policies. However, we want to call attention to one fact. By borrowing through consols, the EU would stand in sharp contrast with the recent practice of countries like the US or Germany that, when facing

unexpectedly large financing needs, have relied heavily on the shorter part of the curve. Figure 1 shows that, both in 2009 and today, Germany reacted to tensions by significantly increasing short term issuances. How come the Debt Management Offices (DMOs) in Germany and other European countries prefer not to issue consols or very long-term debt? What are they (we) missing?

**Figure 1** Yearly bill supply for main euro area issuers\* (billion euros)



Source: Individual insurers and SG Cross Asset Research/Rates

Note: \*2020 assumption based on 2019 plus projected increase in net bill supply. Others includes Finland, Ireland, Portugal, Belgium and the Netherlands.

## What is a consol? A historical perspective

Consols are the longest-term debt possible. In fact, the holder of a consol does not get its principal back, but is indefinitely entitled to an annual fixed coupon.

Perpetual debt can be dated back to the 8th century (Mihm 2019). In order to encourage the bequest of land to monasteries, the Catholic Church promised donors an annual sum reflecting the land's value. This annuity would often run in perpetuity. In the middle-age, the church's fight against usury created an unexpected new risk for lenders. When confronted with large liability payments, debtors could charge creditors with usury and walk away from their debts. By ruling out large principal repayments, perpetuities provided a way to contain this risk.

National governments also experimented with perpetuities. By the 16th century, sovereign consols were traded in secondary markets. In 1752, the UK converted its debt into perpetual bonds. Alexander Hamilton did the same when he consolidated the debts of the US.

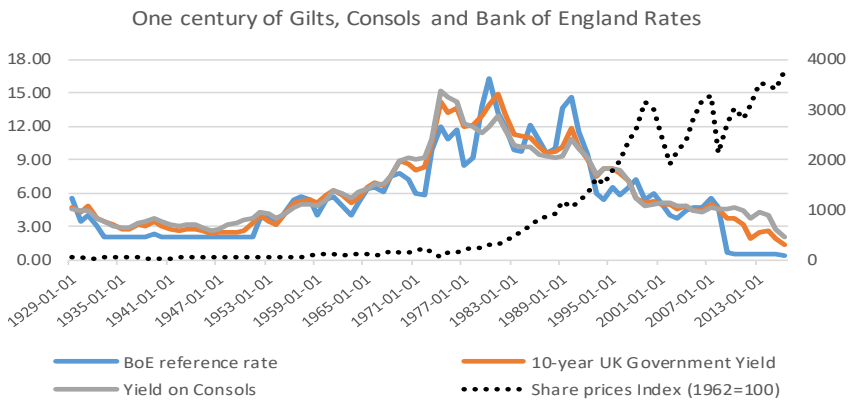
Consols fell from favour during the 19th century. The US replaced them with fixed-maturity obligations during the 1830s. The UK redeemed most of its perpetuities in 1888. The last UK perpetual bonds were redeemed in 2015.

### Is issuing consols a cost-effective option?

There is one essential problem with financing the current crisis issuing consols. In a world of ultra-accommodative monetary policy, not taking full advantage of ultra-low rates de facto amounts to working against the efforts of the monetary authorities which try to keep down the interest burden weighing on private and public debtors.

Why would AAA-rated treasuries that can issue debt at negative interest all the way up to 10 years want to pay comparatively higher coupons by issuing consols?

**Figure 2** One century of Gilts, Consols and Bank of England Rates



Source: Bank of England

Source: Bank of England



When the UK announced the redemption of the last consols in 2014, the head of multi-asset allocation at Threadneedle Asset Management argued “I hope that this move is the first of many to cut the interest bill and save taxpayers money” (Financial Times 2014). This divergence in funding costs is exemplified in Figure 2, which uses data provided by the Bank of England.

In fact, the ECB has deployed quantitative policies and negative rates precisely to ease financing conditions. Issuers with strong market access and low roll-over risk have no reason to go into consols, missing the opportunity to take advantage of the low, front-end interest rates. In a low-growth environment, lower funding cost are paramount for debt sustainability (Blanchard 2019).

Certainly aware of this, Soros proposal envisages a consol with a 0.5% coupon, which is close to current short rates for various euro area sovereigns. With such a coupon, however, it is unclear that there will be significant private demand. The 1927 UK consols retired in 2015 had driven private sector interest because their coupon was 4%. Which coupon would make sense for the markets today: 1%, 2%, higher?

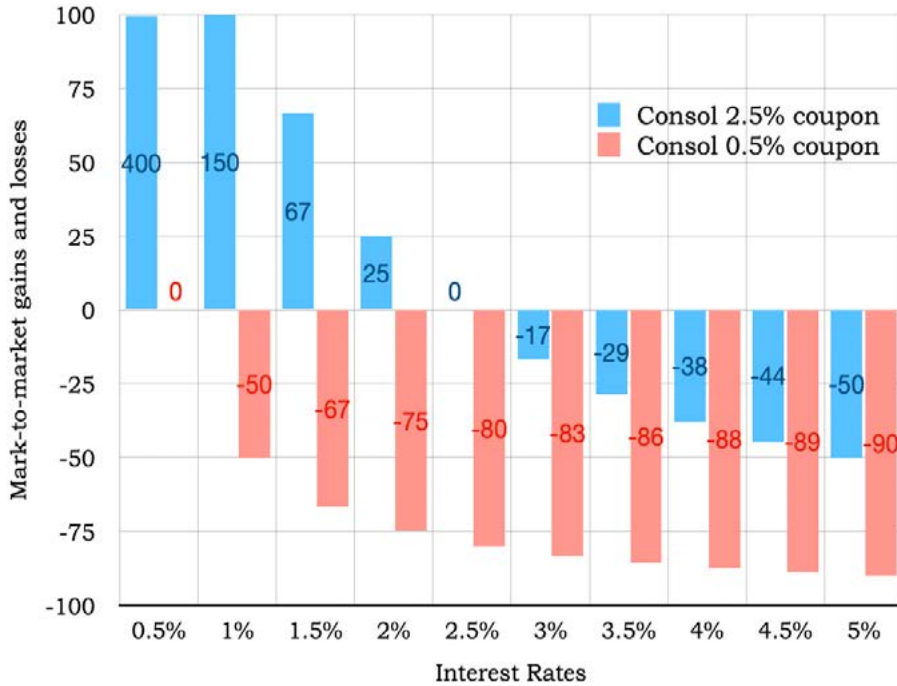
## **Duration risk and the price of consols**

Consols have a defining feature that makes them a risky fixed-income investment. The price of consols is extraordinarily sensitive to changes in the interest rates. This is referred to as having high duration, and it translates into potentially dramatic jumps in the consol’s mark-to-market price.

The price of a consol rests on two elements: its coupon  $c$ , and the discount rate  $r$ . The price is simply  $c/r$ , and its duration is the inverse of the interest rate,  $1/r$ . Intuitively, discounting the future at a low interest rate assigns high values to distant payments.

We illustrate the price sensitivity of consols to market rates in Figure 3, contrasting consols issued with a 0.5% coupon (as in Soros’ example) and consols paying a higher coupon of 2.5% (closer to the yield that can be expected on an EU consol, as we will explain below). As shown in this figure, suppose consols could be issued at par with a 0.5% coupon as proposed by Mr. Soros (if the coupon  $c$  equals  $r$ , the price of the consol is 1). If the reference market rate were to increase to, say, 2%, the price of the bond would go down to 25 cents! Conversely, if long-term interest rates were to drop further in the future, closer to zero, the price of a consol would increase sharply. In our example with a 0.5% coupon, if long-term yields were to drop to 0.1%, the value of the consol would multiply by 5. This would make it very expensive to buy them back in the future.

**Figure 3** Duration risk of consols



Source: authors' own calculations. Gains and losses on €100 consol, issued at par, as interest rates change

The sensitivity of consols to interest rates makes them particularly risky for investors in a scenario where uncertainty about future interest rates is elevated. While interest rates are likely to remain at current historical lows for long, the unprecedented monetary stimulus can be expected to bring back some inflation over the medium-term, and, with it, higher interest rates. In view of the risk of an increase in future interest rates, investors would naturally demand an adequately high coupon.

In the case of a perpetual bond issued by the EU (a supranational entity), the coupon will naturally be based on the interest rate of risk-free instruments with the longest maturity available, plus some risk premium to account for the elevated duration risk of a consol. Under current monetary policy, as a reference, the 46-year French bond trades at a yield-to-maturity (YTM) of nearly 1%. In contrast, Italy's 47-year bond trades at YTM of nearly 3%. The average spread between 50- and 10-year maturity bonds for A-rated (or higher) sovereigns stands at nearly 100 basis points (Bloomberg 5 May 2020) — a combination of term premium and rates expectations. Based on current market conditions, the coupon on a euro area consol could be reasonably set in

the range of 2.0% and 3.0%.<sup>1</sup> Therefore, the interest cost of a consol would be much higher than the market rates on shorter-maturity sovereign debt: 10-year French bonds are currently trading at just under 0% interest rate, and 10-year German bonds at -0.5%.

Moreover, a significant share of consols in the market could raise financial stability issues. Long-duration assets are likely to end up with insurance companies or pension funds that need to match long-term assets and liabilities. While these institutions should be better able to manage duration risk than other investors, the duration risk of consols is extremely high. The risk is that large prospective losses in the balance sheet of the institutions holding these instruments may weigh on the ECB's willingness to normalize rates. Taking the proposal of Soros to illustrate the issue, if financial intermediaries were to buy €2 trillion in 0.5% coupon consols at par and if long-term rates move to 2%, the mark-to-market losses would amount to €1.5 trillion (Figure 3).

## **Two policy instruments: Joint European borrowing and lending**

Strong issuers can afford to borrow short term at very low rates and engage in debt roll-over as debt matures, reducing the term premium they pay. The picture is different for weaker issuers. Weaker issuers face both higher borrowing costs and more uncertain future access to capital markets. For these issuers, using long maturity debt to finance long-term projects makes more sense. Matching the duration of assets and liabilities is a sound practice when refinancing risks are non-negligible.

The question is hence whether there is a way for Europe to allow all countries to benefit from matching long-term investment spending with shorter term liabilities? We argue that there is. The EU is a strong issuer which can use the asset and liability side of its balance sheet as two separate policy levers. European loans given to member states for support should be long maturity in order to improve debt sustainability and reduce near-term gross financing needs. Instead, the financing of the loans, through the issuance of EU bonds, should rely more on the front-end of the yield curve to take full advantage of ECB's accommodative monetary policy. In other words, by using the two sides of its balance sheet wisely, the EU can deliver powerful 'maturity transformation' on behalf of its member states. Crucially, this exercise of maturity transformation is financed by borrowing countries, hence it does not rely on transfers or use of tax payers' money from other countries.

<sup>1</sup> See Alogoskoufis and Langfield (2020) for further analysis on the pricing of consols.

To put it simply, the EU is best placed to take advantage of its status as a borrower with strong market access. The cheapest way to finance the European Recovery Fund would be to issue joint EU debt at shorter maturities, then pass those low interest rates onto member states through loans at low margins over funding costs and with very long maturities. Supporting member states through low rates and maturity transformation would further reinforce debt sustainability across all member states (Erce et al. 2020).

It is important to think of EU debt issuance and the provision of EU financing to member states as two separate policy instruments. As we are facing large and complex shocks challenging our capacity to stabilize the economy, we cannot afford the luxury of overlooking stabilization tools that can help us designing efficient and equitable solutions to the current European problems.

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# 33 Helicopter money: The time is now

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**Jordi Galí**

Universitat Pompeu Fabra and CEPR

17 March 2020

*The measures many countries are taking to contain the spread of coronavirus, while necessary, are bound to have a direct impact on the economy. This column argues that rather than raising taxes and/or increasing government debt to finance the necessary fiscal programmes, the time has come for ‘helicopter money’ – direct, unrepayable funding by the central bank of the additional fiscal transfers deemed necessary.*

The rapid spread of the coronavirus in many countries constitutes a major challenge to their health systems. Under all realistic scenarios, an overwhelming number of human lives will be lost, partly as a result of the inability to provide proper intensive care to all patients that need it. This has led many governments to attempt to slow down the rate of infection through a number of measures, including home confinement, travel restrictions, closing of restaurants and theatres, suspension of sports events, and so on.

Those measures, while necessary, are bound to have a direct impact on the economy, operating through different channels.<sup>1</sup>

- First, they will have a direct effect on production and sales in many sectors, where activity will collapse partly or completely during the emergency, either as a result of supply disruption (due to the unavailability of inputs, labour or otherwise) or a fall in demand (due to the forced change in consumption patterns resulting from health-related measures).

A direct loss of GDP is thus unavoidable, given the path of action required to contain the spread of the virus. And if prolonged by more than one or two months, it is bound to result in a cumulative loss of output similar to or larger than that experienced during the last financial crisis.

<sup>1</sup> See Baldwin (2020), Benassy-Quere et al. (2020) and Gourinchas (2020) for a related discussion of the macroeconomic consequences of the health crisis, with somewhat different policy recommendations

That direct loss of GDP, which will be largely reflected in a decline in the consumption of goods and services during the health crisis, will be painful but relatively bearable. Unfortunately, that direct cost may be amplified by the presence of indirect effects if the fall in output leads to a significant reduction in employment (with the consequent loss of income and consumption). Alternatively, firms may try to keep their payroll unchanged and keep meeting other fixed expenses (e.g. rent, interest) during the inactivity period, by taking loans from banks. But banks may be reluctant to extend those loans, given the probability of default and the likely deterioration underway in their balance sheets. In the case banks went ahead and provided that additional funding, the resulting increase in firms' indebtedness would weaken their balance sheets permanently and may cause – sooner or later – a wave of bankruptcies or, in the best case, a highly deteriorated balance sheet.

A swift and well targeted policy response that is commensurate to the size of the challenge is needed to minimise the indirect (and likely more persistent) economic effects of the coronavirus crisis. One approach would be for governments to step in and provide affected firms (and self-employed workers) with the funds to keep meeting their payroll and unavoidable expenses, without raising their financial liabilities. That assistance would ideally take the form of a (non-repayable) transfer during the period of forced inactivity. A component of that net transfer should consist of immediate (and permanent) tax relief.

Unfortunately, such a strategy would only transfer the problem to governments, which would need to raise taxes (thus increasing the burden of households or firms, counterproductively) or to borrow in capital markets and increase their debt burdens (and be forced to raise taxes in the future).<sup>2</sup> Even if the EU were to relax the restrictions on that further borrowing, it would be a risky strategy given the high debt ratios (above 100% of GDP in some cases) in many of the most affected countries, with the consequent risks of a debt crisis and an immediate rise in spreads.

An eventual massive purchase of the newly issued debt by the central bank through an expanded quantitative easing programme would certainly facilitate its absorption but would not prevent the increase in governments' debt ratios, with the risks of putting some countries' public finances on an unsustainable path.

“There is an alternative ... direct, unrepayable funding by the central bank of the additional fiscal transfers deemed necessary, an intervention commonly known as ‘helicopter money’”

2 A massive debt-financed fiscal stimulus at the European level is the solution proposed in e.g. Benassy-Quere et al. (2020) and Gourinchas (2020).



Fortunately, there is an alternative to a strategy based on higher taxes and/or more government debt in order to finance such an emergency fiscal programme, albeit one that has remained a taboo among most economists and policymakers – namely, direct, unrepayable funding by the central bank of the additional fiscal transfers deemed necessary, an intervention commonly known as ‘helicopter money’.<sup>3</sup>

Central banks have the ability to create money in the form of currency or, more relevantly, a credit to an account held at the central bank. In the typical arrangement, only banks and governments hold an account at the central bank. In the current context, the central bank could credit the government’s account (or governments, in the case of the ECB) for the amount of the additional transfers and for the duration of the programme. That credit would not be repayable, i.e. it would amount to a transfer from the central bank to the government. From an accounting viewpoint, it would be captured by a reduction in the central bank’s capital or by a permanent annotation on the asset side of its balance sheet. Thus, it should not have an impact by itself on the central bank’s profits which are periodically transferred to the government, especially if the interest rate on reserves were to remain at zero. Note that such a transfer from the central bank to the government would be equivalent to a commensurate purchase of government debt by the central bank, followed by its immediate writing-off, thus no longer having an impact on the government’s effective debt liabilities.<sup>4</sup>

“Money-financed fiscal interventions are a powerful tool ... policymakers should resort to them only in emergency situations ... Unfortunately, that emergency is currently upon us ... If ever, the time for helicopter money is now.”

The money-financed fiscal intervention described above raises a number of issues.

- First, it is clear that there are numerous practical implementation challenges in adopting such a policy, including the need to determine (quickly) the size of transfer to which each firm would be entitled.

But those problems seem of second order relative to the macroeconomic challenge facing many countries, and they can be surmounted with sufficient political determination.

- Second, such an intervention is likely to be considered illegal in many jurisdictions.

3 See Gali (2020) for a formal analysis of money-financed fiscal stimuli.

4 An alternative approach, proposed by Paris and Wyplosz (2014) in the aftermath of the European debt crisis (and referred to as PADRE), would involve the conversion of ECB government debt holdings into zero interest perpetuities to be held permanently on the balance sheet, in exchange for a permanent reduction in the transfer of ECB profits to governments in proportion to the effective debt cancellation. Such a debt restructuring would generate sufficient fiscal space to allow governments to run large fiscal deficits if needed without the risk of triggering a debt crisis.

In particular, the fact that monetary policy is (at least temporarily) driven by the requirements of the fiscal authority may be perceived as an outright violation of the principle of central bank independence. But we have seen many occasions in which rules that were considered sacred have been relaxed in the face of extraordinary circumstances (such as the ECB's decision to buy government debt during the European debt crisis). Furthermore, the central bank could agree to participate voluntarily in such a scheme, thus preserving its formal independence.

- Finally, and legal issues aside, it is clear that a recurrent use of such policies by governments could be a source of an inflation bias and bring about changes in individual behaviour likely to undermine their effectiveness.

But this should not be a concern in the current context, since the reliance on money financing would be strictly restricted to the duration of the emergency measures linked to the health crisis. This is a commitment for which fulfilment can always be guaranteed by the central bank, which would put its reputation at stake.

## Concluding remarks

Money-financed fiscal interventions are a powerful tool. The caveats mentioned above suggest that policymakers should resort to them only in emergency situations, when other options are bound to be ineffective or trigger undesirable consequences, current or future (e.g. a debt crisis down the road). Unfortunately, that emergency is currently upon us, provoked by the coronavirus. If ever, the time for helicopter money is now.

*Author's note: I am grateful to Mark Gertler and Francesco Giavazzi for comments.*

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# 34 Covid Perpetual Eurobonds: Jointly guaranteed and supported by the ECB

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**Francesco Giavazzi and Guido Tabellini**

Bocconi University and CEPR; Bocconi University and CEPR

24 March 2020

*This war-like shock will require very large fiscal support. Its financing cost should be distributed over several generations. This can be achieved by issuing irredeemable or very long maturity Eurobonds. They should be backed by the ECB to keep the financing burden low. This column argues that no institutional or legal constraints prevent this policy response. Prompt action is critical since allowing one crisis to morph into many could disrupt the European project, with far-reaching and unpredictable political implications.*

We do not know yet how large the economic damage of this pandemic will be. But under plausible scenarios, government support to the economy will be in the double digits as a percentage of national incomes. How can such amounts be financed, without sparking a second sovereign debt crisis in the weaker euro area countries?

The ECB's new Pandemic Emergency Purchase Programme (PEPP), launched last week, has bought precious time. But PEPP is mainly designed to reduce liquidity strains and avoid an immediate run on the debt of highly indebted euro area countries. Some of the financing needs will be absorbed by the monetary expansion implied by PEPP. But allowing for only temporary deviations from the capital keys in the ECB asset purchases could limit the extent of the monetary support to the highly indebted countries. More needs to be done. We must find alternative financial arrangements that shield the euro area against a return to 2011-like crises.

## **COVID consols**

We propose that countries issue 50-year or 100-year bonds, or even perpetuities (also known as perpetual bonds or ‘consols’, i.e. a fixed-income security with no maturity date). The ECB should stand ready to buy them to keep the interest burden low enough to avoid adding to debt sustainability concerns. There are clear economic rationales for this:

- A shock the size of the COVID crisis is like a war, and thus its financing is optimally distributed over several generations.
- The new securities could be issued quickly with conditions that could be crafted to the problem at hand.
- The bold action would provide a signal of the ‘what ever it takes’ type and thus rule out the nightmare scenario of a new euro area crisis arising in the midst of the COVID crisis.

Member states should jointly issue a large amount of very long maturity COVID Eurobonds backed by their joint tax capacity. Each country would issue its own bonds, but the bonds would otherwise be identical. Their common rating would be the result of all bonds being guaranteed by the joint tax capacity of the countries participating in the joint issues.

There are several advantages to COVID Perpetual Eurobonds:

- With the support of the ECB, interest rates could be kept very low, and the solvency risk would be limited to the unlikely event that countries renege on their initial agreement.

For instance, with an interest rate of, say, 0.5%, servicing a debt of 10% of GDP with COVID Perpetual Eurobonds would only cost 0.05% of GDP every year – a negligible amount.

- The very long maturity of this additional debt implies that the risk of a funding crisis on the existing debt of the highly indebted countries would not arise.

The same cannot be said about a short-term credit line issued by the ESM.

- Inflation is clearly not a current threat; on the contrary, the danger today is deflation.

Monetary financing of the needed fiscal effort is part of the optimal policy response.

- This financial arrangement would not hinder ECB independence in case inflation risks were to emerge in the future.

The ECB would remain free to reduce the size of its balance sheet if needed.

These new securities would be complementary to other proposals made recently.

### **Improving on the Benassy-Quéré et al. proposal for a COVID-related credit line**

The proposal to create a new COVID-related credit line at the ESM – as proposed by Benassy-Quéré et al. (2020) – could immediately add funding of up to 3.4% of the euro area's GDP. This proposal is a step in the right direction, but it has a few limitations.

- First, the amounts available remain small relative to the likely needs, though they could be increased by raising ESM capital.
- Second, the maturity of the loans granted to individual countries is as important as their magnitude.

These 'multi-generation' maturities are not possible with an ESM credit line. As a result, there is the risk that a sovereign debt crisis is only postponed and not avoided, or alternatively that the fiscal policy action is limited to a size that will not provide adequate support.

- Third, by its statute, the ESM can only lend to a country if public debt is sustainable.

This implies that a prerequisite to any ESM lending is some kind of debt-sustainability analysis. The outcome of such analysis cannot be taken for granted in the current situation.

- Fourth, the ESM was designed to support individual countries during a financial crisis, not to finance a large common shock.

By the same light, it is important that ESM funds remain available for its original purpose, particularly once the peak of the crisis is past.

- Fifth, the ex-post conditionality – which is legally required for ESM lending – could be a barrier to the effective usage of the funding.

During the COVID crisis, which may last a year or more, euro area countries will need to borrow not only to invest in medical infrastructures, but also to provide income support and inject capital to prevent bankruptcies. It is important that any ESM credit lines explicitly allow for this.

- Finally, the ESM is an inter-governmental institution, over which national parliaments of individual countries retain veto rights.

There is thus a risk that the design and implementation of the credit line could be distorted by a zero-sum logic rather than reflecting the common interest.

Each of these limitations could be overcome by re-writing ESM rules and that of its Treaty. We view this as a step towards a first-best institutional setup for COVID crisis financing. The ESM could eventually become the ‘euro area Treasury Department’ thus allowing fiscal and monetary policy to be coordinated as in ‘normal’ countries. But the road to the first best would take time, and the negotiating process among members would create ex ante uncertainty about the outcome.

Time, however, is not something we have a lot of at this point in the COVID crisis, and uncertainty about the outcome of rule-changing could, by itself, be destabilising.

## **Seizing the historical moment**

The financing arrangement for Perpetual Eurobonds should be enacted immediately. Postponing it would be counterproductive, for two reasons. First, because an immediate response would be much more effective in preventing economic collapse. Second, because it is now clear that all countries have been hit by a common exogenous shock; in one or two years, there will be more recriminations about moral hazard and policy mistakes, and a coordinated response would be politically even more difficult.

We are living through a critical historical juncture. If mismanaged, the looming economic crisis would disrupt the European project, with far-reaching political implications. The alternative to a bold coordinated response is to continue to bend the existing institutional framework with ad hoc adjustments that undermine its long run credibility, until it will eventually break.

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# 35 Breaking the taboo: The political economy of COVID-motivated helicopter drops

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26 March 2020

*The use of helicopter money has been proposed to help combat the economic repercussions of the COVID-19 pandemic. The policy has been seen as blasphemy until now, and this column presents a political economy plan to break the taboo. The creation of emergency authority for central banks and the formation of a COVID policy committee could help establish the policy as a one-off, emergency money-financed plan, giving the central bank the authority to act quickly and then revert to the ‘no money-printing’ norm as the crisis subsides.*

In a world that suddenly finds itself in the midst of an unprecedented health crisis, policymakers appear unprepared. Only after much deliberation do they realise the extent of the crisis and its severe economic repercussions. Economists have been mobilised to offer economic policy solutions (Baldwin and Weder di Mauro 2020), but it remains to be seen as to which solutions are feasible and politically up to the task.

I would like to argue that the fastest and most feasible way to respond is by breaking a taboo. In this column, I want to suggest ways in which to implement Jordi Galí’s [proposal on Vox](#) (Galí 2020a), arguing that it is the best way forward. In order to establish this route, it is necessary to outline a political scenario for implementation, with a practical institutional and legislative way forward.

The main idea proposed by Galí is one of ‘money-financed fiscal stimulus’. Rather than raising taxes and/or increasing government debt to finance the fiscal policy plans, the use of ‘helicopter money’ (direct, unrepayable funding by the central bank of fiscal transfers) is instead proposed. Galí (2020b) presents an analysis comparing this policy

<sup>1</sup> I am grateful to Jordi Galí for comments.

to conventional debt-financed stimulus. He proposes that when the ZLB is not binding, a money-financed fiscal stimulus has much larger multipliers than a debt-financed fiscal stimulus.

However, it is clear that such a policy (often used in the past with inflationary or even hyper-inflationary consequences) is seen as ‘blasphemy’ now. Galí quotes a passage from Turner (2013), who states that “the prohibition of money financed deficits has gained within our political economy the status of a taboo, as a policy characterised not merely as –in many circumstances and on balance– undesirable, but as something we should not even think about let alone propose...”

In response, I would like to present a framework to ‘break’ this taboo in the current circumstances.

First and foremost, it is important to emphasise to policymakers and the public that the current situation has the following combination of crisis elements. This unique combination provides the rationale and justification for the subsequent discussion. The current crisis is:

- global crisis, on a humanitarian scale, and
- the worst pandemic since the 1918 Spanish flu.

At the same time:

- the economic crisis is one of significant declines in both supply and demand, and
- the economic toll is bound to be very high.

Consequently, it is necessary to put aside some of the conventional discussions in which we have been engaged over the past few decades. For example, the discussion on structural-cyclical distinctions is now irrelevant.

More importantly the use of debt finance (which was the subject of much debate since 2008) should be understood in the current context. Conventional debt-financed plans have serious drawbacks in the current situation. One aspect has been mentioned above, namely, it is a less effective policy. Another aspect is that it is essentially a taxation deferral plan. In political economy terms, it would lead us back to the ‘austerity saga’. Politicians and voters, following this massive COVID-19 shock, will have no appetite for another round of austerity measures.

The proposed political economy plan to break the money-financing taboo consists of two principle ingredients:

First, legislatures would enact specific emergency ‘COVID-19 legislation’, authorising the central bank to conduct ‘helicopter money policy’ for 90 days (within the current calendar year). This could then be extended for another 90 days if requested by the central bank. The bank can terminate the programme earlier, if it deems fit. The government, including the treasury, would have no legal authority in this policy process. This legislation would supersede any laws forbidding money finance of fiscal plans.

Second, a COVID policy committee would be set up with equal representation for the central bank (including its governor), the treasury (including the minister), and outside economic experts. Aided by professional staff, this committee will set the amounts of transfers, the breakdown into policy items, and the speed of implementation over the 90-day period(s).

The idea is to ensure that this is an emergency-only procedure and not a way to go back to money-financed deficits. The pivotal role of the central bank is meant to preserve central bank independence.

In the case of the euro area, the situation is, regrettably, different. While this is potentially an opportunity to undertake euro area measures (and have the ECB play a major role), it is difficult to see how these steps can be implemented. This is both because of legal restrictions on monetisation and the lack of political and fiscal union. The second element of the above plan may be feasible, but it is hard to see the first element ever being realised. This shows once more the limitation of the current EMU set-up, which has long been recognised as problematic.

I would like to be more specific about two elements of the above set-up.

In terms of the policy items, it would be reasonable to consider fiscal transfers which are directly related to the crisis situation, namely:

- Budgets for the health-care system, in particular labour costs (e.g. wages and other income for overworked medical staff), capital costs (e.g. testing apparatus, respiratory equipment, and protective gear), sick pay, and insurance subsidies.
- Assistance to households, in the form of direct monetary assistance and enhanced and lengthened unemployment benefits and income support.
- Assistance to firms, in the form of subsidies, transfers, and tax cuts.
- Assistance to maintain the functioning of markets, such as insurance and financial market access.

It should be noted that there may well be other items to add. It is important to be attentive not stray too far from the emergency situation mandate.

In terms of outside experts on the COVID policy committee, the idea is to engage leading public finance, macro, and monetary economists from academia, from the domestic private sector institutions, and from overseas groups as well. This would endow the committee with objectivity and respectability and facilitate overcoming the taboo, enhancing trust in this endeavor.

The idea, then, is essentially for a one-off emergency money-financed policy plan that would give the central bank the authority to act and the authority to (subsequently) get the economy back to the ‘no money-printing’ norm that we have been enjoying over the past few decades. This would avoid the pitfalls of having governments and their treasuries embarking on a path of recurrent deficit finance by money printing. All the while, it would enable a swift policy response to counter both the pandemic spread and its devastating economic effects.

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In the years 2012 and 2013, Prof. Yashiv was Chair of the Public Policy Department at Tel Aviv University. In 2013 he founded the Center for Regulation Policy at Tel Aviv University and was its first Director. In the years 2014-2018 he was the head of the Economics and National Security program at the INSS.

Professor Yashiv has been a visiting faculty member at MIT (1991), NYU (1992, 1994, 2003), HEC (1994-2001), LSE (2003-2006, 2017) and UCL (2019/20).

He is a research fellow at the Center for Economic Policy Research (CEPR), at the Centre for Research and Analysis of Migration (CREAM) in University College, London and at IZA, Bonn.

In recent years, Prof. Yashiv has been a consultant to the Bank of England and to the Bank of Israel on issues regarding labor markets. These were projects involving both academic, empirical work and policy prescriptions.

Prof. Yashiv was involved in other policy related activity: as Academic Director of the Sapir Forum for Economic Policy (2012-2014) and as head of the Economics Program at the Taub Center (2010-2013); he was the head of the Macroeconomics team at the 17th annual Caesarea conference (2009), and has been a consultant to the Ministry of the Economy. In the context of Israeli economic policy issues he has published numerous OpEd pieces in Haaretz, The Marker, and Globes.

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# 36 COVID-19: OMT is second-best, but still welcome

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**Lorenzo Codogno and Paul van den Noord**

LSE ; University of Amsterdam and ACES

5 April 2020

*The emergency measures in place to absorb the COVID-19 shock need to be supplemented by OMT unless leaders agree to create a euro area safe asset and fiscal capacity. This column employs an empirically calibrated model to show that OMT is second-best to the creation of a safe asset and fiscal capacity at the centre, but would still be a powerful means to mitigate the economic impact of the crisis.*

We argued in our previous column (Codogno and Van den Noord 2020a) that a euro area safe asset – swapped against national sovereigns on banks’ and the ECB’s balance sheets – and a centralised fiscal capacity render macroeconomic stabilisation policies much more effective in the face of the outbreak of COVID-19 hitting the economy. This would be the first-best solution in our view, not only for the periphery but also the core.

However, we acknowledge that it may not be politically and technically feasible to adopt it with the urgency required by the current situation. It looks more likely that the member states of the euro area would agree on a package revolving around conditional support of the European Stability Mechanism (ESM) to hard-hit countries. This opens the way for the ECB to launch unlimited purchases of the national debt of countries in distress under the Outright Monetary Transactions (OMT) programme. This is welcome, even if second-best in our view. Please note that, although massive, the current ECB programmes are mostly limited to year-end and a total ticket of €1.1 trillion.

## **Three scenarios**

In this column, we compare three scenarios which we have tried to quantify with our empirically calibrated model for the euro area (Codogno and Van den Noord 2020b). In the first scenario, we assume that all measures that have been announced by the member states and the ECB are implemented. Instead. In the second scenario, we assume that

on top of these measures, the ECB resorts to OMT. By way of reference, we compare these scenarios with a third scenario in which a safe asset and fiscal capacity at the centre are created.

The numerical results reported in Table 1 are surrounded with wide margins of uncertainty, for at least three reasons: (i) we have entered uncharted territory which our model (or any model) may be able to capture only to an extent, (ii) the quantification of the policy measures is necessarily crude due to scant information on the fine detail, and (iii) the size and persistence of the corona shock is still ambiguous. We believe, however, that the results give an impression of the direction and orders of magnitude of the effects.

**Table 1** Absorbing the COVID-19 shock: three scenarios

	<b>Actual policy</b>	<b>Actual policy + OMT</b>	<b>Safe asset/ fiscal capacity</b>		<b>Actual policy</b>	<b>Actual policy + OMT</b>	<b>Safe asset/ fiscal capacity</b>		
<b>Real economy</b>	<b>Output</b>			<b>Public finances</b>	<b>Primary deficit</b>				
	Core	-10.7	-3.7		-1.9	Core	15.3	11.9	10.5
	Periphery	-18.0	-4.6		-2.2	Periphery	19.0	12.3	10.5
	Aggregate	-14.4	-4.2		-2.1	Fiscal capacity	0.0	0.0	5.5
	<b>Inflation</b>				<b>Debt</b>				
	Core	-1.4	0.3		0.8	Core	21.5	13.5	11.2
	Periphery	-6.5	0.2		1.4	Periphery	54.3	18.1	12.8
	Aggregate	-4.0	0.3		1.1	Fiscal capacity	0.0	0.0	5.9
	<b>Yields</b>				<b>Fiscal stimulus</b>				
Core	1.3	-0.5	0.8	Core	10.0	10.0	10.0		
Periphery	13.0	0.6	4.7	Periphery	10.0	10.0	10.0		
Fiscal capacity	0.0	0.0	-0.1	Fiscal capacity	0.0	0.0	5.0		
<b>Financial sector</b>	<b>Bank credit</b>			<b>Policy</b>	<b>Monetary policy</b>				
	Core	-6.3	2.3		-0.4	Policy rate	-0.3	-0.3	-0.3
	Periphery	-71.3	-3.5		0.0	Asset purchases	10.0	25.0	0.0

Note: Per cent or percentage point changes relative to a steady-state without shocks.

In all three scenarios, the assumed corona shock is identical. It comprises a symmetric supply shock of -5% of GDP, a symmetric demand shock of -10% of GDP, and a flight-to-safety shock to core sovereign bonds yields of -300 basis points (bps). We assume the demand shock to outweigh the supply shock because the latter is expected to be more short-lived (as eventually lockdowns will be lifted, although disruptions may continue for a while). In contrast, the demand shock will be more persistent due to the need to restore the unsettled balance sheets in the private sector.

### 1. Actual policy

In the first scenario (labelled ‘actual policy’ in the table) we assume: (i) fiscal stimulus of 10% of GDP in both the core and the periphery, (ii) guarantees on bank loans entailing a +5% symmetric shock to bank lending broadly in line with the size of the aggregate supply shock, (iii) an effective rate cut of -25 bps by the ECB (the rate on refinancing operations was cut from -0.5% to -0.75%), (iv) asset purchases by the ECB of 10% of GDP.

In this scenario, output collapses -10% in the core and -20% in the periphery. Core yields rise 100 bps as the primary deficit is up 15 percentage points (ppts) of GDP and periphery yields go through the roof by 1,300 bps with the primary deficit soaring 20 ppts. Periphery bank credit is slashed by three-quarters (the number should not be taken literally and should be interpreted to imply default) and drops slightly in the core. Core debt increases 20 ppts, and periphery debt soars 50 ppts. Prices fall on aggregate.

### 2. Actual policy + OMT

In the second scenario, we have run the same set of shocks and policies as in the first scenario, but now including OMT purchases by the ECB worth 30% of periphery GDP. That boils down to a shock onto periphery yields of -300 bps, equivalent to the flight-to-safety shock on core yields of -300 bps so that the increase in the spread is eliminated on impact.

As shown in the table, output now shrinks by ‘only’ about -3½% in the core and -4½% in the periphery. Bond yields remain broadly in check, though the spread still rises 100 bps. The primary deficits and debt ratios in both economies rise by the order 10-15 ppts. Bank credit remains broadly in check in both economies. Deflation disappears. This scenario clearly shows how crucial OMT is to keep the spreads in check and prevent financial turmoil that would otherwise reignite the banks-sovereign doom loop in the periphery.

### 3. Safe asset/fiscal capacity

In this scenario, we introduce (i) a safe asset which is swapped for national bonds on banks’ and the ECB’s balance sheets (for more details, see Codogno and Van den Noord 2020a); and (ii) a fiscal expansion at the centre of 5% of GDP financed by the issuance of the single safe asset, over and above the national fiscal expansions of 10% of GDP; while (iii) the -25 bps rate cut by the ECB is left in place. The asset purchases (including under OMT) are abandoned, as are the guarantees on bank credit (since the safe asset would take over that role).



As the table shows, the recession would comparatively be mild, the public debt ratios would rise by ‘only’ 10 ppts, and bank credit would remain at its pre-crisis level. The yield on the safe asset would fall in line with the relevant policy rate change of -25 bps. By contrast, periphery yields would rise substantially, but this no longer hurts the banks, though it would help to discipline fiscal behaviour in the periphery. Everybody would win.

A concern expressed by some (Bini Smaghi 2020) is that the creation of a euro area fiscal capacity would involve a massive transfer of sovereignty from the member states to the centre. We beg to disagree. The fiscal capacity would, in our view, always be accountable to the Council and would, at a maximum, obtain ‘instrument independence’; for instance, with regard to the maturity structure of bonds to be issued.

In any case, the purpose of fiscal policy at the center in our proposal – and what makes it distinct from ‘Coronabonds’ proposals – is primarily to rebalance the policy mix away from monetary policy, without automatically resorting to fiscal transfers across member states. This does not rule out ‘solidarity’ in exceptional circumstances, but it would be left to the discretion of the Council and would not involve a transfer of sovereignty.

## **Conclusion**

Our simulations suggest that launching OMT over and above the policy measures that have already been decided would play a crucial role in the face of the outbreak of COVID-19 hitting the euro area economy. However, with a safe asset and centralised fiscal capacity, macroeconomic stabilisation would become even more effective. In both scenarios, the ‘core’ and ‘periphery’ of the euro area would gain. Still, the gains would be larger in our preferred scenario in which the crisis is met by the creation of a euro area safe asset and fiscal capacity.

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# 37 To fight the COVID pandemic, policymakers must move fast and break taboos

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**Sony Kapoor and Willem Buiter**

RE-DEFINE; Citigroup and CEPR

6 April 2020

*COVID-19's economic impact on crumbling GDPs, collapsing tax revenues and ballooning fiscal deficits will be much larger than what has been reported thus far. Any hesitation in throwing everything but the kitchen sink at the health, employment, state aid and financial rescue interventions that are needed will literally kill citizens and destroy the economy. To combat COVID-19, central banks, including the ECB, must cross the Rubicon of monetary financing and immediately transfer the 20%-30% of GDP this will cost into fiscal coffers.*

The lightning speed and gargantuan scale of the COVID-19 hit to the global economy, where large chunks of economic activity have come to a literal standstill overnight, requires a 'shock and awe' policy response that is overwhelming in both scale and speed.

Countries have launched a dizzying array of measures that range from the ECB's pandemic asset purchase programme (PEPP)<sup>1</sup> to the direct cash transfers<sup>2</sup> the US has promised tens of millions of Americans, and wage subsidies<sup>3</sup> rolled out across much of the EU. But these unprecedented measures are just the start.

Policymakers need to move fast and break taboos. After all, governments are the insurers, lenders, spenders, and suppliers of last resort. The risks for them to do too little, too late far outweigh the risks of them doing too much too quickly.

1 [https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318\\_1~3949d6f266.en.html](https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html)

2 <https://www.ft.com/content/422f727c-6931-11ea-800d-da70cff6e4d3>

3 <https://www.france24.com/en/20200325-the-race-to-save-jobs-european-governments-step-in-to-pay-wages>

## **As GDPs crumble...**

With the pause button pressed on nearly half of economic activity in the US and the EU for what is likely to be at least a period of three months, consumption, investment and trade have all collapsed. A contraction of as much as 10-20% of GDP or worse is possible. Pervasive uncertainty about the timing of the development of a viable treatment and/or vaccine means there is no light at the end of the tunnel yet. Even when we get there, the trauma of the COVID-19 meltdown will keep investors and consumers on the sidelines.

## **...tax revenues will collapse...**

This will blow a massive hole through tax revenues. Corporate taxes that derive from profits will collapse first. Sales and value-added taxes will register a dramatic fall in line with the collapse in economic activity. The gigantic scale of job losses and/or job subsidies to stem such losses will depress income taxes. Tax revenues may fall by 30%-40%, maybe more.

## **...and deficits balloon...**

Even as tax revenues dry up, governments need to spend unprecedented sums of money not just on healthcare and social interventions to fight COVID-19, but also on welfare payments and job guarantees. Mortgage and rental market interventions, rescuing and resuscitating private sector firms, even whole industries, and inevitably bailing out large tracts of the financial sector will require record fiscal interventions. The pincer movement of falling taxes and rising spending will drive eye-popping fiscal deficits of 10%-20% of GDP, and beyond.

## **...leading to counterproductive austerity**

The double whammy of crumbling GDPs and ballooning deficits may drive OECD debt/GDP ratios up by 30% or so by the end of 2020 as countries scramble to borrow, mirroring the effect of the global financial crisis and its aftermath. It may push Italy and Japan past the 160% and 270% of GDP mark, respectively, and no country would be immune. Inevitably, this will fuel future calls for austerity, with the counterproductive logic and toxic politics of the EU's Stability and Growth Pact and Fiscal Compact, driving long-suffering euro area economies further into the ground.

## **A poisoned political economy**

This will strain already fragile relations between member states, possibly to breaking point. But it will also worsen the intergenerational rift. Leaving our children with an unaffordable fiscal burden, on top of a climate catastrophe is not the legacy we wanted, nor one they might be willing to take.

## **There is one way out**

There is, however, one way out that can both deliver the shock and awe necessary to get ahead of the pandemic, and deliver us from counter-productive future austerity, political conflict, and intergenerational schism.

## **Central banks must break new taboos**

And that is for the COVID-19 response to be funded not by borrowing, but through the creation of new money, particularly by OECD country central banks, which include the US Federal reserve, the Bank of Japan and the ECB.

The decade since Lehman's collapse has already seen central banks break many taboos, but they must now cross the Rubicon of monetary financing. The case for them to do so has never been stronger, and in fact it may be irresponsible for them now not to do so.

The ECB and the Bank of Japan, in particular, have been struggling to hit their inflation targets, and the mass layoffs now underway will only worsen this undershoot. As large tracts of the economy have come to a dead halt, the circulation of money in the economy has been gravely interrupted. This breakdown of the normal channels of transmission of monetary policy will be exacerbated as the economic meltdown takes its inevitable toll on banks and the financial sector. With risk aversion high, and the propensity to consume and invest low, normalization is impossible in any foreseeable horizon. Printing new money can help mitigate each of these critical challenges

## **It is time to print, but this time for the fiscal authorities**

The traditional notion of helicopter drops,<sup>4</sup> wherein central banks transfer cash balances to citizens, are being talked about again, but they work best when the problem is primarily insufficient demand. Moreover, the plumbing to make these drops work is not yet in place, and time is of the essence.

This crisis is different. It is governments that need to spend on healthcare, employment, critical supplies, state aid and bank rescues and are best placed for targeted interventions on all of these fronts. A one-off transfer of 20%-30% of GDP worth of cash to governments by their respective central banks may be the single best macro policy to fight the COVID-19 crisis.

It will provide the kind of lightning speed and gargantuan scale needed to outrun the meltdown and will leave no debt overhang or counterproductive future austerity. It will help avoid the kind of hesitation, from governments trying to raise cash or balance books, that can literally kill citizens and destroy economies.

A percentage of the transfer – say, 5% of the overall amount – could be set aside to help fund the COVID-19 fight in developing economies that are not in a position to either borrow cheaply or print their own money. This would be then be sufficient, alongside the issuance of new SDRs<sup>5</sup> by the IMF, and enhanced support from the Multilateral Development Banks and Development Finance Institutions to fund a genuinely global response to the pandemic.

Outside the euro area, the central banks' transfers to their national treasuries could be affected by crediting the treasury's account with the central bank. Article 123 of the EU's Treaty explicitly bans credit and overdraft facilities from the ECB for the EU and member states, but says nothing about helicopter drops or transfers, which are neither. Nor does it ban a one-off ECB extraordinary dividend payment of an equivalent amount to member national central banks (its shareholders), and through them to member states' governments. It will be challenged and litigated no doubt, especially in the German Federal Constitutional court, but at least the euro area will have lived to fight another day.

4 <https://www.ft.com/content/abd6bbd0-6a9f-11ea-800d-da70cff6e4d3>

5 <https://ftalphaville.ft.com/2020/03/20/1584709367000/It-s-time-for-a-major-issuance-of-the-IMF-s-Special-Drawing-Rights/>

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# 38 Make room for fiscal action through debt conversion

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**Vesa Vihriälä**

University of Helsinki

15 April 2020

*The high level of public debt in the euro area and doubts over debt sustainability in some member states mean that the fiscal expansion necessary to counter the Covid crisis will be challenging. This column argues for debt relief by the ECB that would allow all member states to finance the necessary fiscal measures in a normal fashion. While effectively forgiving past debt would create expectations that the same could happen again in the future, this moral hazard should be weighed against what is likely to happen without such relief.*

The corona crisis is a massive supply shock turning rapidly into an equally massive demand shock. A wide consensus exists that a large-scale fiscal expansion stemming not only from automatic stabilisers but also from discretionary measures is necessary.

The starting point for fiscal expansion is unfortunately far from ideal in the euro area because of the high level of public debt – almost 90% of GDP – prior to the crisis. More importantly, some countries have debt levels that clearly make them vulnerable to doubts over debt sustainability. Even more unfortunate is that the corona shock has hit some of these fiscally vulnerable countries hardest, notably Italy.

## **Coronabonds are a non-solution**

The vulnerable countries – rightly – point out that the current shock is not of their making and, if European solidarity has any meaning, it should be forthcoming now. Therefore, these countries and many economists have proposed a completely new financial instrument, Coronabonds, guaranteed by all member states by a joint and several guarantee, as a way to finance the necessary expenditures of the highly indebted countries.



The Coronabond is a temporary version of the old Eurobond idea. That is why countries whose own public finances are in a better shape are resisting the idea. They see it as a way to start a permanent programme, which would lead to increasing mutualisation of the risks associated with the debt issued by countries pursuing imprudent fiscal policies. This has been politically impossible for many countries to accept; it is considered unfair by large parts of their populations. The argument is that while the current shock is not due to bad policies by individual countries, the fiscal vulnerability is.

### **Old and new debt instruments**

This unwillingness to engage in direct debt mutualisation has prompted the search for other solutions. They now involve some reallocation of EU budget towards coronavirus-related expenditures in member states. This implies modest transfers to the countries hit by the greatest healthcare problems.

But the bulk of the measures take the form of credits. This applies to the new vehicle, SURE, the €100 billion mechanism set by the EU Commission to borrow funds against the future EU budget to refinance national unemployment insurance schemes. Additional EIB funding to the private sectors is also loans.

The decision on 9 April to use the European Stability Mechanism (ESM) belongs to the same category. It makes an ESM credit line available to finance coronavirus-related healthcare expenditures up to 2% of GDP. While this is a creative way of using the existing crisis institution for the crisis at hand, it is problematic at the same time. First, particularly when limited to healthcare expenditures, it may not help the worst affected countries sufficiently. Second, the new credit line is effectively without conditions, blurring the original idea of the ESM support, which is supposed to be a bulwark against threats of financial instability by means of strictly conditional loans.

The essential thing is that all of these instruments add to the debt burden of the already highly indebted countries.

### **In the end, it is up to the ECB**

Given the limited size of the aforementioned programmes and the high debt levels of the relevant countries, the avoidance of a new debt crisis continues to depend on the ECB, as the purchaser of last resort of government debt.

So far, the ECB has managed to be very effective in providing liquidity not only in aggregate but also with regard to limiting the spreads between different countries' bonds. The new programmes, especially the Pandemic Emergency Purchase Programme (PEPP), serve the same twin objectives, particularly as the PEPP involves a significant degree of flexibility with regard to country composition. The new programmes also show the ECB's ability to take swift and quantitatively decisive actions.

The question, however, is how far the ECB can go with debt purchases, which deviate from the capital key, to assist fiscal expansion of the member states vulnerable to doubts over debt sustainability. Guaranteeing liquidity can easily drift into guaranteeing solvency, which is a deeply political issue and is certainly not part of the ECB mandate (Beck 2020).

Applying PEPP with a lot of flexibility approaches OMT but without conditionality. For the OMT, the conditionality requirement is at least in principle stringent: "A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme." This, like the conditionality on the ESM loans themselves, is not for nothing. It exists to ensure that credits remain credits, and will not turn into unintended transfers.

Importantly, the bond purchases by the ECB, presumed to be temporary monetary policy actions, do not solve the fiscal conundrum; sovereign debt levels increase strongly, including in the highly indebted countries like Italy. While the additional burden is not overwhelming with low interest rates, things may change in the future.

## **A stock operation as a solution**

The need to be able to run deep deficits in the current situation directs attention to possible ways of reducing debt levels by stock operations. The first option is debt restructuring. However, subjecting particularly a large country to restructuring in the midst of a worldwide economic crisis would almost certainly lead to a massive financial crisis, the very thing one wants to avoid.

The second option is debt relief by the ECB on all countries' debt. Converting a fraction of the sovereign debt held by the ECB (or better the European System of Central Banks, or ESCB) into perpetuity with zero coupon would ease the debt burden instantaneously.<sup>1</sup> Monetary financing strictly speaking, yes. But how different economically from the

<sup>1</sup> This type of stock operation was discussed in a somewhat different context in Vihriälä and Weder di Mauro (2014).

continued holdings and rollover of large amounts of the same sovereigns' debt at (close to) zero rates? Relative to trusting the ECB to continue to pursue extremely accommodative policies for undetermined period of time, such a conversion would make debt relief certain. This would make a significant difference in the eyes of the investors in government bonds.

The conversion would contribute to anchoring inflation expectations at a higher level, given that undoing the associated stimulus would require active tightening measures by the ECB. This would help the ECB to achieve its inflation target at a juncture where the well-below-the-target-inflation economy is hit by an extraordinary shock. In this sense, the conversion would serve the ultimate purpose of price stability against the threat of deep deflation, even if it would bend one of the institutional constraints set to prevent a route to accelerating inflation.

A key point is that if the conversion took place in relation to the capital key, it would not involve any direct transfers between member states, and thus would not reward imprudent behaviour any more than prudent behaviour. The capital key-based relief would also match very well the broadly symmetric nature of the shock.

The size of the conversion should be big enough to bring debt-to-GDP ratios to lower levels even after the increase in current deficits by at least 10 percentage points. On the other hand, the stock of the Eurosystem-held sovereign bonds, currently somewhat over €2,000 billion or some 18 % of euro area GDP, is a technical upper limit, though increasing rapidly. Any share around 20% is also well below the present value of ECB seigniorage income consistent with 2% inflation in most scenarios (Buiter 2019). This means that such a debt relief should not excessively threaten price stability even in the longer run.<sup>2</sup>

## **A clearer division of labour of the instruments**

The proposed debt relief would allow all member states to finance the necessary fiscal measures in a normal fashion. It would not eliminate the moral argument for burden sharing by all member states of part of the shock, which has been exceptionally large for some of them. But it could reduce the size of the needed transfers to a level which would be easier to agree on, be it through the reallocation of the future EU budget contributions (Gros 2020) or otherwise.

<sup>2</sup> This type of stock operation was discussed in a somewhat different context in Vihriälä and Weder di Mauro (2014).

Should member states still have financing difficulties, the ESM and the OMT programmes with the appropriate conditionality would be the right instruments to meet such challenges. A significant reduction of the effective indebtedness of all member states might also help to expand the resources of the ESM. This would be helpful in meeting future financial stability threats and obviously benefit most the member states at greatest risk of market pressures.

The proposed debt conversion is very close to the helicopter money proposals by Gali (2020) and Kapoor and Buiter (2020). A difference is that here the debt relief would be a part of package that would seek to maintain a clear division of labour between programmes that involve, or are likely to involve, politically sensitive transfers between member states and liquidity provision.

### **A Münchhausen scheme?**

Why could a conversion scheme like this help alleviate the constraints of the highly indebted states? After all, the budget constraints of the states including their central banks would not change as a result; the reduction of the nominal debt service burden of the states would be exactly compensated by a reduction of seigniorage income from their respective central banks.

What changes is inflation. As noted, the conversion would make a significant part of the current monetary expansion permanent unless undone by active policy measures. This would ultimately result in more inflation than currently on the cards, which would transfer some of the real burden from debtors to creditors. This applies to sovereign debtors as well as to private ones. And obviously, to the extent the fiscal expansion facilitated by the scheme lifts real economic activity, it would also contribute to better debt service capacity.

Additional inflation would imply some transfers also across national borders. But unlike in a Coronabond/Eurobond scheme, there would not be any explicit commitment by governments to share other sovereigns' credit risk now or in the future. The member states would remain responsible for their debts, supporting incentives of the governments to pursue prudent policies. These incentives could also be strengthened by making debt restructuring a more credible way of solving debt sustainability problems in the future. A reform of ESM statutes with regard to debt sustainability requirement, stronger common action clauses and effective constraints on banks' holdings of single sovereign debts would be ways of achieving this.

## **Exceptional times require exceptional measures**

Effectively forgiving past debt obviously creates expectations that the same could happen again in the future. Nevertheless, this moral hazard should be weighed against what is likely to happen without such relief.

Either fiscal expansion would fall badly short of what is needed in the highly indebted member states, or it would be financed by ever-increasing asymmetric ECB bond purchases, perhaps aided by a depletion of ESM resources before an acute financial crisis. The marginal financing – and, yes, solvency – of the vulnerable member states would become increasingly dependent on the ECB.

Both alternatives risk creating an existential crisis for the euro area and the whole EU. Not facilitating fiscal expansion in Italy and other highly indebted countries would be economically stupid and politically explosive. Increasing the dependence of these countries on the ECB (and the ESM) liquidity increases the likelihood that the liquidity support has to be recognised as solvency support for individual countries in not too distant future. What turn the events would take at that point is anybody's guess, but it is not at all clear that the euro would survive.

Compared with this perspective, the political and legal difficulties of the symmetric debt relief outlined should not be insurmountable.

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### **About the author**

**Vesa Vihriälä** is since July Professor of Practice at the University of Helsinki and the Graduate School of Economics. He received his Doctor of Social Sciences (Econ.) degree from the University of Helsinki. Vihriälä has also studied at the Massachusetts Institute of Technology. Previously he has worked briefly as State Secretary in the Prime Minister’s Office and for 7 years as the Managing Director of the Research Institute of the Finnish Economy, ETLA. Vihriälä has also worked as Adviser to Olli Rehn, EU Commissioner for Economic and Monetary Affairs, as State Under-Secretary at the Finnish Prime Minister’s Office, as Managing Director of Pellervo Economic Research Institute, in various positions at the Bank of Finland and as Economist at the OECD’s Economics Department. Vihriälä has worked on a wide variety of policy issues related to financial crises, globalisation and ageing.

There is no doubt that the Covid-19 crisis represents a challenge for European unity and another crash test for the euro. Europe has been, and will likely remain, one of the most Covid-infected regions in the world and, while doing nothing was not an option and would itself have disrupted economic activity, the forceful reactions of national governments to the pandemic, through various strategies combining social distancing, testing/quarantining and lockdowns, have triggered an economic crisis at least twice the size of the 2009 crisis. Furthermore, the recovery is likely to be slow due to depressed consumption and investment, and it will require fast reallocations in both the labour market and the capital market.

A small positive observation in this crisis has been the degree of engagement of economists in an intense debate with policymakers on the appropriate responses to 'flatten the economic recession curve' and to safeguard the most impacted groups from the economic fallout of the health crisis.

This eBook is an illustration of the intense effort of the academic community during this time. In a selection of columns, analysis and policy proposals that were published on VoxEU between the end of March and the middle of May 2020 it provides a remarkable example of the response of economists to the unfolding crisis and of the value of VoxEU as the platform for such high quality exchange of views. Within each section, the articles are sorted by their date of appearance, which gives the reader a sense of how the debate progressed over a short period of time.

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