

European fiscal responses to the Covid-19 crisis: share the bonds or split the bill?

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The lock-down of most EU countries, in response to the Covid-19 pandemic, has produced disruptions in the production process and has put consumption and investment to a halt. Against the backdrop of these supply and demand shocks, EU member states have implemented [different public policies](#): they have deferred or waived tax payments and social security contributions; they have raised spending towards the health sector; and they have provided more generous welfare payments to short-term working schemes. Quite strikingly, EU fiscal cooperation has stalled and no common European initiative has emerged, with the exception of a temporary lift of the fiscal constraints of the Stability and Growth Pact (SGP) ([the escape clause has been activated](#)) and a softening of State Aid regulations. Yet, various policy proposals coping with the economic and budget consequences of the pandemic at the European level have flourished: Coronabonds, recourse to the European Stability Mechanism (ESM), the SURE initiative by the European Commission, and monetisation of

public debt are all widely debated. This post lists the proposals and highlights their respective potential benefits and shortcomings.

The SURE Unemployment Mechanism

The [European Commission](#) announced on April 2 2020 its proposition of a mechanism to support Member States in their attempt to deal with the surge of labour market related expenditures (unemployment subsidies, temporary unemployment, etc). The initiative of the European Commission to support Member States in designing short-term work arrangements is important politically.

The Support to mitigate Unemployment Risks in an Emergency (SURE), should take the form of a loan program to member states, modelled on the functioning of the predecessor of the ESM, the EFSF created in 2010 to provide assistance to Member States in financial distress. The legal basis of SURE, which the Commission sees as “ad hoc and temporary”, is Article 122 of the Treaty on the Functioning of the European Union (‘TFEU’), which states that a Member state in trouble because of exceptional circumstances may seek financial assistance from the EU. Like the ESFF, the facility would raise funds on financial markets (at preferential rates), guaranteed by capital guarantees provided by governments; these could be passed on

to Member states
that have a lower credit rating and face higher financing costs. Article 122
has been conceived for asymmetric shocks, and SURE would be the first instance
in which it is used to shield Member states from a symmetric shock.

SURE is capped to €100bn (0.8 % of the Eurozone GDP), and the amount obtained by each member is undefined (although caps are defined). Article 6 of the proposed regulation simply says that following the
request by the Member State, the amount, pricing and maturity are decided by
the Commission, after it has assessed the extent of public expenditures
directly related to the creation of “short-time work scheme and similar
measures for the self-employed” (page 7 of the Regulation proposal). Guarantees
(“irrevocable, unconditional and on demand”) to the Fund are given by Member
states based on their share of GNI of the Union, on a voluntary basis, for an
amount of at least 25% of the total amount lent; the instrument will not become
fully operational until all countries contributed.

While it was presented as a solidarity scheme,
with a subliminal reference to a pan-European unemployment scheme, SURE is not
such a thing. It is simply a loan scheme, aimed at ensuring that the recipient
country obtains reasonable interest rates. Its capacity to be a game changer,
therefore, will eventually depend on the size of loans

actually available for a given country. And this is where the problems begin.

The Commission has designed the proposed Regulation to ensure its financial viability, and with the priority of protecting its standing as a good quality borrower. The total amount available for loans will therefore depend on the guarantees. The €100bn will be reached only if countries commit to guarantee 25% of that amount. Furthermore, caps to each Member quota (the three largest loans cannot exceed 60% of the total), strongly limit the amount of funds available for each country.

Let's just make an example, taking the most favourable case. Suppose that Member states pledge enough guarantees to reach the full fund capacity of €100bn, which is far from obvious. If we take the two countries that most likely will need the fund, Italy and Spain, and we assume that they manage to ensure 25% each of that amount (remember that there is a 60% limit on the three largest loans), this will make a loan of €25bn.

Assuming furthermore that this will yield a savings in interest payments equal to the current spread (190 and 115 for Italy and Spain respectively as of April 4), we are talking about €475 and 287 million (0.03% and 0.02% of GNI) respectively. An amount that will hardly make any difference in the current situation, even abstracting from the fact that Italy and Spain will have to

commit in guarantees €2.7 and 1.9bn respectively (corresponding to the respective quotes of EU GNI of 11% and 7.6%).

To summarize, SURE is a tool to provide Member states with extra resources without the conditionality that would be involved in other instruments such as the ESM (see next). The extra resources would come from interest payment savings. SURE is not, as might be understood at first sight, a mutual insurance tool. As such, it has no resemblance to [existing proposal for unemployment \(re\)insurance schemes](#), although it may be argued that it is a first decisive step towards a permanent European unemployment benefit scheme ([Vandenbroucke et al., 2020](#)). The most apparent flaw of SURE is its firepower. The €100bn advertised are an upper bound unlikely to be reached in practice. And the boundaries set to preserve the borrower rating of the Commission will severely limit the amount of fresh resources quickly usable by the Member countries that need them most.

A Special ESM Covid Credit line

A number of European economists have proposed the [creation of a Covid credit line](#) within the ESM. This would have the advantage of requiring no new institution, as the credit line could be created by the ESM Board of Directors ([article 19 of the ESM Treaty](#)) as a new financial assistance instrument. Contrary to existing ESM credit lines, the Covid credit line would consist in very long-term loans (that the ESM should finance

issuing bonds of equally long maturity), so as to avoid that countries are forced to repay when still in financial distress.

The ESM firepower is large but not unlimited. It is currently €410bn (3,4 % of the Eurozone GDP), which is most likely going to be insufficient in view of the challenges created by the pandemic. If that amount had to be scaled up, additional guarantees by Eurozone countries would have to be called in.

According to the authors, the creation of a special line would allow to avoid the most serious and controversial shortcoming of current ESM lending: stigma for countries applying for it and heavy conditionality. The Covid credit line would involve very little conditionality, just a commitment to spend the resources in Covid related expenditures.

Like for SURE, ESM financing involves very little risk sharing, as borrowing from the Mechanism adds to domestic sovereign debt. This is why it is today the most preferred option for core eurozone countries. And like SURE, its main advantage is that it would shield financially fragile Member countries by allowing them access to preferential interest rates.

The main problem with the Covid credit line is that being created within the ESM, it is organized by the same normative

framework that rules the other credit lines. ESM lending reposes on two principles. The first, introduced in the Treaties following the creation of the ESM in 2012, states that financial assistance to Member States “will be made subject to strict conditionality” ([Article 136\(3\) of the TFEU](#)). The second principle, introduced by one of the two regulations that make up the Two pack ([No 472/2013, Art7\(5\)](#)) states that the Council, acting on a proposal by the Commission, can decide on changes to be made on a programme. This means that whatever conditionality is agreed upon right now, in the framework of the new Covid line, may be changed unilaterally by the creditors later along the road. If the Covid line were to be agreed at the Eurogroup, together with the light conditionality proposed by [Benassy-Quéré et al \(2020\)](#), changes would have to be made to the normative framework to make it sure that such conditionality cannot be changed later on, once things “go back to normal”.

Another potential problem of embedding the Covid credit line within the ESM is that the latter is an intergovernmental institution that has been agreed upon by Eurozone governments alone. The Covid credit line would in principle only be available to them. Given the global nature of the current pandemic, cutting out non-Eurozone countries would be unthinkable. Therefore, even if it was possible to credibly commit to light conditionality, the Covid line could not be the foundation of the European

joint effort.

Coronabonds as temporary Eurobonds

A group of [German economists](#) has proposed the implementation of a common debt instrument at the Eurozone level. Such “Coronabonds” would be jointly issued under shared liability. The amount issued would be of or €1,000bn (8 % of Eurozone’s GDP) and a key feature of these Coronabonds for their political feasibility in the short-run would be their limitation to the current crisis period as a one-off measure.

The liabilities for Coronabonds being shared, national sovereign debts would only increase proportionally to the share of each country’s GDP in the euro area (equivalent to the ECB capital key). The maturity of Coronabonds should be as long as possible, and the interest payments being based again on ECB capital key, it would imply a mutualisation of borrowing costs. In a more ambitious scheme, member states that are the most severely affected and for which sovereign financing conditions are the tightest could benefit in priority from these funds, but this would involve more than just a mutualisation of borrowing costs, its timely feasibility being greatly reduced.

The question of the guarantees for these Coronabonds is key since they would most

likely finance other expenditures than infrastructures that could act as collateral. They could be purchased by the ECB under PEPP (not at issuance, which is currently not legally possible, but on the secondary market). The ECB self-imposed issuer limit for supranational securities is 50% normally, but does not apply to PEPP holdings, and there would be no capital key to respect. In an extreme case, even an issuer limit of 99% would be legal: the EU Court of Justice in 2018 made the point that ECB purchases are legal as long as the ECB is “not permitted to buy either all the bonds issued by such an issuer or the entirety of a given issue of those bonds”.

The issuance of Coronabonds could be organised by an existing institution like the ESM or the European Investment Bank (EIB) so it would not entail creating a new legal framework or require a change in the EU Treaty. Under these conditions, this framework would be operational quickly as the crisis requires. Another advantage of such Coronabonds is that they would act as a “safe asset” that could be used by Eurozone banks as collateral and would reduce the probability of a vicious circle between banks and governments as experienced during the 2012-2015 sovereign debt crisis. The main drawback of this proposition relates to its political feasibility and whether countries that opposed Eurobonds would not oppose such mutualisation of

borrowing costs as well.

Perpetual bonds or debt monetisation: the solution of last resort?

The ECB has committed to being the lender of last resort of banks, e.g. through favourably-priced long term refinancing operation (LTROs) at the negative deposit facility rate, and it has extended the Asset Purchase Programme by €120bn, then by an additional €750bn a few days later with the temporary Pandemic Emergency Purchase Programme (PEPP). Yet, the ECB has not become the *de jure* lender of last resort for euro area Member States. The current health, economic and financial crisis requires strong fiscal stimuli but the rise of public debt to GDP ratio in highly indebted euro area countries, like Italy and France, raises doubts on their debt sustainability. To mitigate the risk of debt unsustainability, two additional proposals have been put forth recently.

[Giavazzi and Tabellini \(2020\)](#) advocate the issuance of perpetual Covid Eurobonds to fund the necessary rise in public spending and decline in tax revenues that the pandemic is generating in the euro area. Most characteristics of perpetual bonds resemble those of the Coronabonds, except that the capital of the former would never be redeemed. The Covid Eurobonds would be backed by the joint tax capacity of euro area Member states. Each country would issue

the amount of Covid Eurobonds depending on its funding needs, but all bonds would be the same. If the ECB committed to purchasing these Covid Eurobonds on secondary markets, it would make their yield minimal. In the actual low rate environment, Giavazzi and Tabellini argue that the yield on these bonds could be low as well – they take the example of a yield of 0.5% – and that overall funding could easily outweigh all other European funding instruments. The initiative for [European Renaissance Bonds](#) is very close to Covid Eurobonds in its spirit. In contrast though, the Renaissance bonds would finance a common, centralized fund under the responsibility of the Union's institutions (e.g. the Commission), and would not raise national debts. In contrast with other discussed Coronabonds or Covid Perpetual Bonds, Renaissance bonds would be entirely mutualized within the dedicated fund. Risk-sharing would be heightened, as well as European solidarity.

[De Grauwe](#) (2020) does not propose the creation of a new fund, a new financial instrument or the extension of a credit line out of an existing institution (like the ESM). Instead, he advocates that the ECB and the EU cross the Rubicon and accept that the former purchases the public debts of the latter on the primary markets, hence at debt issuance. While this would require either a Treaty change – the second indent of Article

132(1) of the Treaty on the Functioning of the European Union forbids monetary financing – or much agility (or ingenuity to take De Grauwe's word) of public lawyers, this is not impossible to achieve as the [recent example of the Bank of England shows](#), at least on a temporary basis. First and foremost, the current context is exceptional and requires exceptional measures. Second, what was considered impossible in the past has finally been possible: the development of non-standard policies by the ECB in 2008 with the Fixed Rate Full Allotment for the main refinancing operations is one example. With the acceleration of the so-called European sovereign debt crisis, the ECB has done "whatever it takes to preserve the euro". With the creation in 2012 of the not-yet-used Outright Monetary Transactions programme (OMT), then the Assets Purchase Programme (APP), the ECB has acted *de facto* as the lender of last resort of euro area Member States. De Grauwe's argument would lift a contradiction between the behaviour of the ECB and the absence of a *de jure* lender of last resort in the euro area ([Creel 2018](#)): debt monetization would make it clear that, as in the US, the UK or Japan to name only a few, the central bank is the lender of last resort not only of banks but also of States. To cope with the health, economic and social costs of the pandemic, debt monetization through secondary markets would have to be applied by all EU central

banks, and not
only by the ECB.

The main risk with debt monetization though is
inflation. In the current circumstances, with the demand shock
that seems to
dominate the supply shock and with oil prices collapsing, this
is not likely.

Yet, if it happened, it would be welcome with joy at central
banks which target
inflation and which are unable to fulfil their mandates in
this respect. That

being said, debt monetization may be limited to newly-issued
public bonds funding

the fiscal response to Covid-19 in the Member States. This
would give them

almost unlimited fiscal margins for maneuver to dampen the
crisis, without any

risk of seeing the spreads resurface between the core and the
peripheral

countries of the euro area. Finally, long awaited inflation
after debt

monetization would also alleviate the real debt burden, a
characteristic shared

after most episodes of war-accumulated debts.

The second risk of debt monetization is the ECB
balance sheet risk it embeds, via the ECB backing of domestic
fiscal policies. The

balance sheet risk is shared by all eurozone countries
proportionally to ECB

capital keys. A temporary debt monetization conditional on the
funding of

Covid-19 related expenditures or tax deference would not
neutralize this kind

of risk, but it would limit it to exceptional circumstances.

Another substantial risk of debt monetization,

and of any form of debt mutualisation, is the moral hazard it could generate.

For instance, the ECB could actually back possibly inappropriate fiscal policies. Here again, a temporary debt monetization conditional on the funding of Covid-19 related expenditures or tax deference would not totally neutralize moral hazard, but this one is very limited in the current Covid-19 context, where the nature of fiscal policy as a necessary support to the economy is uncontroversial. As a consequence, any temporary policy mechanism during this crisis period is unlikely to generate wrong incentives.

Finally, it is useful to provide an order of magnitude of the transfer to a European country of the most favourable financial scheme of debt mutualisation. Assume, as an example, that public debt increases by 10 points of 2019 GDP (public debt over GDP will increase at much higher level due to the fall in GDP). With the spread between Germany and Italy currently at 200 basis points, funding Italian public debt at the German interest rate would save 0.2 point of 2019 GDP, hence €36 bn. In addition, it may be possible that the interest rate on other countries' debts increase a little. The ensuing redistributive effect would thus help countries most affected by the Covid-19 crisis, which have substantial borrowing needs.

Some reflections on the ECB's Comprehensive Assessment

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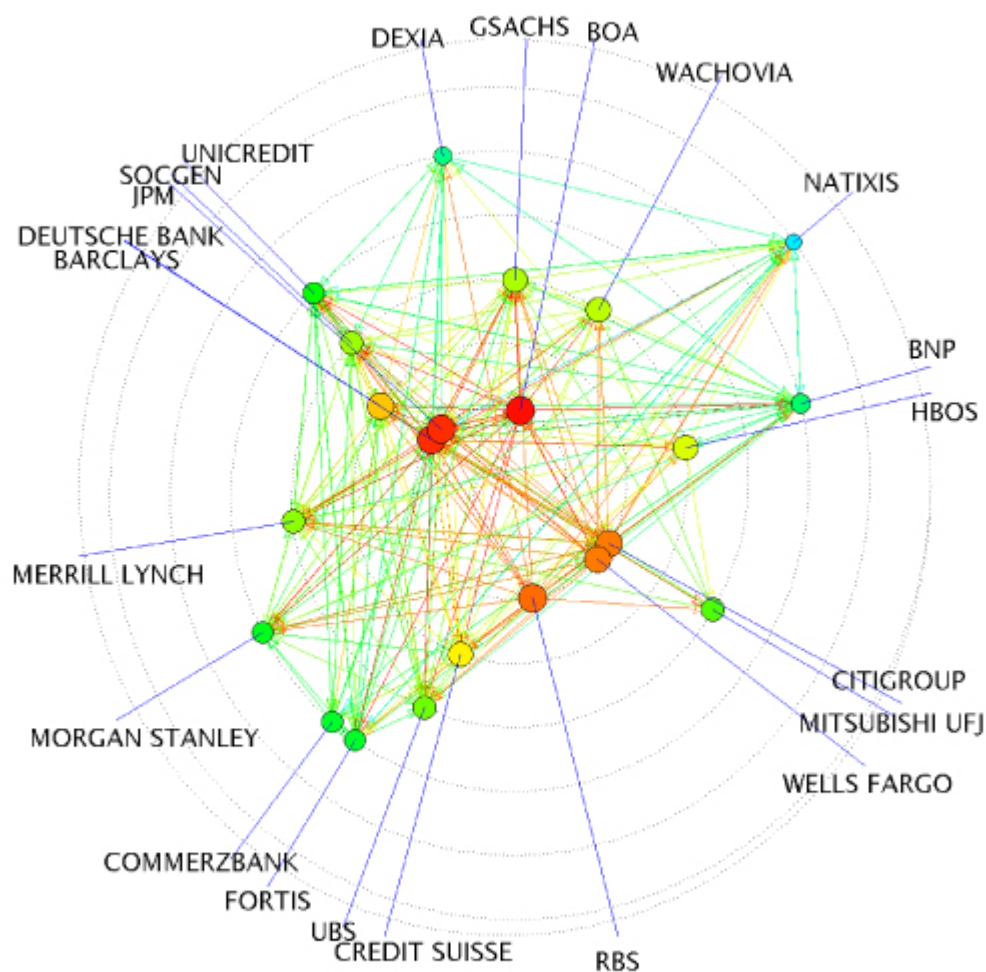
(Ce texte n'est pas publié en français)

The European Central Bank (ECB) officially released the results of its Comprehensive Assessments of euro area banks on October 26th, thus making a very important step towards the creation of the European Banking Union. The ECB exercise unveiled the global robustness of the euro area banking sector despite the bumpy week financial markets had after its release. On the one hand, most banks hit by important financial shocks and affected by privately and publicly funded re-capitalization efforts (as in Spain) passed the stress test hurdle. On the other hand, fragilities were identified only in few countries (notably Italy, Greece and Portugal) and were basically the result of balance-sheet problems in some big institutes therein (e.g. Monte dei Paschi di Siena in Italy). One may nonetheless wonder whether the above picture of global stability, emerging from the results of the ECB assessment, is well-founded, and whether the methods used by the ECB, and the consequent re-capitalization efforts required, will be sufficient to insulate the Euro Area financial systems from financial meltdowns like the one of 2008/2009.

To shed more light on such issues it is important to remark that the Comprehensive Assessment is articulated into two blocks[\[3\]](#). The first one, the stress test on banks, amounts to a check of the robustness of bank's balance sheets in adverse scenarios provoked by financial and real shocks of different nature. The second one is the so-called "Asset Quality Review"

(AQR) and corresponds to a point-in-time evaluation of the assets portfolio of Euro Area banks with the goal of identifying problematic assets. The AQR constitutes a great innovation of 2014 assessment with respect to similar ones carried out in 2010 and 2011, which did not feature a detailed evaluation of banks' asset book. Performing such a comprehensive evaluation has two clear advantages. First, it is a big step towards improving the overall transparency of the financial system. Second, and relatedly, it helps regulating authorities to get important details about the [degree of complexity of the asset side of banks](#), which has played a key role in the unfolding of the financial crisis of 2008/2009. The Euro-Area comprehensive AQR is not the only positive aspect of the current assessment. Other welcomed novelties are represented by the higher coverage of the current assessment (130 banks) with respect to the sample of banks considered in the 2010 and 2011 stress tests [\[4\]](#) (respectively 91 and 90 banks). Moreover, the scope of macro-shocks and country-specific shocks considered in the stress tests [was broader](#). More in detail, the ECB considered [four different types of adverse financial and real shocks](#) that could threaten banks stability: a) an increase in global bond yields; b) a deterioration of credit quality; c) a stalling of policy reforms; d) a lack of necessary balance-sheet repair to maintain affordable market funding. Finally, the 2014 assessment has been based on a unified methodology, which has limited the discretionary interpretation of rules by national authorities and by banks.

Figure 1. The financial network among the top 22 borrowers of the FED at the peak of the 2008/2009 financial crisis



Source: Stefano Battiston, Michelangelo Puliga, Rahul Kaushik, Paolo Tasca & Guido Caldarelli, "DebtRank: Too Central to Fail? Financial Networks, the FED and Systemic Risk", *Scientific Report*, 2012.

The ECB assessment constitutes an important step towards a better monitoring of euro area financial stability. At the same time, the structure and the methods used by the ECB lead one to raise more than one concern the overall stability picture that emerges out of it. [Recent accounts of the ECB's exercise](#) stress that the ECB assessment has partially accounted for some important banking risks, like for instance liquidity risk (the risk of not being able to honor payments). In addition, results of the AQR and the stress tests were conducted in parallel. Accordingly, results from the evaluation of the quality of banks asset books were not used to test the stability of the bank themselves. Last but not least the ECB performed the assessment using a bottom-up

approach, *i.e.* relying on the information provided by banks and national regulators. The latter were in close contact with banks in their country to check the validity of the information. This governance structure of the assessment poses some problems, as national regulators may have the incentive not to disclose relevant information that would reveal the extent of the capital shortfall in their countries.

However, the main weakness of the ECB assessment as a banks' financial robustness exercise probably lies in the failure to consider one fundamental property of current financial systems (Euro-Area one included), namely its interconnectedness. Indeed, the financial system is structured as a complex web of financial relationships of very different nature (*e.g.* unsecured lending, repurchasing agreements, derivatives) and among different types of actors (*e.g.* banks, hedge funds, money market, pension funds).

There is a [growing consensus](#) around the idea that financial interlinkages play an important role in the emergence of financial instabilities. Their role is also acknowledged by the Basel Committee on banking supervision that uses interconnectedness as one of the dimensions to determine the list of Globally Systemic Financial Institutions (G-SIBs). Figure 1 provides a visual idea of an empirically-observed network of financial inter-linkages across some major banks. Links appearing in the figure show the estimated impact of a bank on the balance sheet of another one and were estimated at the peak of the 2008/2009 financial crisis (March 2009, *i.e.* the period of minimum market capitalization of banks) by using the "Debt-Rank" method developed in [Battiston et al. \(2012\)](#). In the figure higher systemic importance is identified by the color of the node by a more central location of the node. In other words, banks colored in red (rather than in yellow or in green) and closer to the center are also the banks that are systemically more important, in the sense that the default of one of them would have larger impact on other institutions in

the financial system.

One main reason why financial linkages matter for financial instability is that they can have ambiguous effects on the risk exposure of banks: on the one hand, they increase individual profitability and reduce individual risk, but on the other hand, they may generate important external effects (e.g. my insolvency can become yours if it causes a significant drop in the value of your assets), thus increasing systemic risk. On this topic several issues remain open but [much work](#) has already been done in recent years and two main “transmission channels” have been emphasized. First, shocks move from a bank to another *via* the direct interlocks between balance sheets. That is, since the liabilities of one bank are the assets of some other banks, the default of the debtor may imply a loss for the creditors. Likewise, in case [creditors decide to hoard liquidity](#) rather than providing it to other market players, this has negative external effects to other institutions as it can reduce the liquidity accruals of the latter and the overall liquidity in financial markets. Second, there are indirect connections among banks due to the fact that they invest in common assets. This implies that, for instance, if as a result of a shock on the price of an asset, a bank sells a quantity of that asset sufficient to move down the price, the other banks holding the same asset will experience both the initial shock and the secondary shock and may start in turn to sell the asset themselves, triggering a devaluation spiral.

Embedding the above described channels of financial contagion and distress is thus fundamental for a proper evaluation of the stability of banks in the euro area financial system, and for the stability of the system as a whole. Indeed, interconnectedness implies that the stability of one bank cannot be assessed independently from the stability of other banks in the system. It also implies that the stability of the financial system as a whole cannot be reduced to the sheer sum

of the stability of the single banks composing it. The AQR uses the Basel Committee's G-SIBs list (which does account for interconnectedness) to classify banks in the euro-area. However, the notion interconnectedness is not used, neither in the evaluation stage of the AQR nor in the stress test.

To sum up, the ECB assessment is a key step towards the creation of a banking union in the Euro Area. At the same time, it is important that financial network aspects are taken into serious consideration, to get better measures of the possible financial fragilities of banks and of the necessary actions to tame them. Some stress tests methodologies accounting for the complex features and consequences of financial inter-linkages are already available (see e.g. the discussion in [Staffen, 2014](#), and the works of [Markose et al., 2012](#) and [Battiston et al., 2012](#)). It is also likely that the new data resulting from the ECB's AQR will foster future research on these new stress test methodologies and bring some of their hints in the future assessments of the euro area banking sector.

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[3] The ECB has conducted a comprehensive assessment of 130 banks in the euro area. The AQR was undertaken by the ECB and national competent authorities (NCAs), and was based on a uniform methodology and harmonized definitions. The stress test was undertaken by the participating banks, the ECB, and NCAs, in cooperation with the European Banking Authority (EBA), which also designed the methodology along with the ECB

and the European Systemic Risk Board (ESRB). See [the ECB comprehensive assessment aggregate report](#) for more details.

[4] The 2010 and 2011 stress tests exercises were EU-wide and conducted by the EBA in collaboration with national supervisory authorities.