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European Instruments against the Corona crisis in comparison

Jürgen Matthes / Markus Demary, 30 March 2020

Various European instruments for countries particularly affected by the Corona crisis are currently under discussion. In this article several requirements will be established and the existing proposals will be measured against them. The instrument of Corona bonds is considered most effective – provided that German policymakers accept the risk-sharing associated with them.

The Corona crisis forces the affected states to increase government debts. Debt sustainability could be jeopardised not only by higher debt burdens, but also by higher interest rates if risk premiums rose again, as it was the case with some countries recently. As a result of both effects, debt servicing in the coming years could become too heavy a burden on national budgets (Demary/Matthes, 2020).

Against this background, joint European financial support for countries particularly affected by the Corona crisis is being discussed. Various instruments are under consideration:

The **ECB** is already making use of the Pandemic Emergency Purchase Programme (PEPP), which was launched during the Corona crisis. It provides for additional purchases of securities by the Eurosystem of up to 750 billion euros until at least the end of December 2020. However, the ECB allows some flexibility to deviate from the countries' capital shares in the purchases without defining this more precisely. The Governing Council will do everything necessary within its mandate, including to increase the size of its asset purchase programmes and to adjust their composition, by as much as necessary and for as long as needed.

With regard to the **ESM**, there are discussions about granting loans largely without conditionality, apart from conditions to use of funds only for crisis-related objectives and to ensure repayment. The Eurogroup is discussing to provide a pandemic crisis support safeguard for this purpose. To this end, an existing (but as yet unused) precautionary ESM credit line (ECCL – Enhanced Conditions Credit Line) is proposed. The ECCL is available only for one year with the option of an extension for a further year. This credit line would be open to all euro area countries. Apart from the ECCL, it is proposed to create a new credit line (Covid Credit Line) for all euro area countries, but it is meant to be particular and only for the Corona crisis. Conditionality would be similarly low, but maturities of the loans would be very long (Bénassy-Quéré et al., 2020).

Other economists have proposed community bonds (Corona crisis Eurobonds, in short **Corona bonds**) with a volume of 1,000 billion euros, also with the longest possible maturity (Bofinger et al., 2020). The allocation of funds to the euro countries should be based on the severity of the crisis, but debt servicing obligations should be based on the ECB capital shares, so that unlike the other solutions there would be a partial transfer element.

In the following, these instruments will be compared with each other on the basis of several requirements.

The instrument should **not endanger debt sustainability**. Various aspects come into play here:

- Formally, only Corona bonds provide for a partial **limitation of the increase in debts** of the receiving countries. In contrast, the euro area states continue to incur debt under the ECB-PEPP, because it is flanked by the ECB only with interventions in the secondary market. In the case of the ESM solutions, the euro area states' debts also increase to the full extent of the ESM loans. Very long-term Corona bonds also have another implicit transfer element. This is because debts with long maturities and only final redemption have the advantage, that inflation reduces the repayment volume in real terms over time and that the inflation-related losses in value can be passed on to the financial market. The long-term ESM Covid Credit Line also offers this advantage.

- Access to **low interest rates** for the new debts cannot definitely be guaranteed by the ECB because risk premiums could rise despite its inerventions. With the other solutions, however, low interest rates would be secured. The ESM itself issues bonds at very low interest rates, the financial volume of which it passes on as support loans. Corona bonds would work in a similar way. Both are principally backed by a joint and several liability of the euro countries, but with the ESM this has certain limits.

- **Timely repayment requirements** of euro countries (and the associated refinancing risks) **must be avoided** at all costs. This is not the case with the ECB-PEPP, if the countries stick to the usual maturity structure of their debt issuance, as a considerable proportion of the newly issued government bonds would involve short maturities. In the case of the ESM-ECCL, the loan term is only a maximum of two years. This is a disadvantage of this solution. By contrast, the ESM Covid Credit Line and the Corona bonds rightly provide for very long-term loans.

The financial support instrument of choice should be **quickly applicable**. This is the case with the ECB-PEPP and ESM-ECCL, because existing structures can be used. In the case of the ESM Covid Credit Line and Corona bonds, political decisions and implementation processes are necessary, which may delay the introduction.

Intervention to support affected states should be **effective**. This requires a sufficient financial volume. At 750 billion euros, the ECB-PEPP is substantial and can in principle be increased even further. The announced sum of 1,000 billion euros for Corona bonds is even larger. In contrast, the current residual capacity of the ESM is limited to 410 billion euros. The proponents of a covid credit line are therefore calling for an increase in the ESM's financial volume. The Eurogroup, on the other hand, apparently sees the ESM-ECCL only as a flanking element and has not yet expressed its opinion on a possible ESM increase.

It should be possible for the **particularly affected states to benefit asymmetrically**. In the case of the ECB-PEPP, it is not clear to what extent this is possible within the mandate, even though the ECB is seeking to signal great flexibility here. If the ESM was used, the ECB could focus even more on buying sovereign bonds of hard-hit individual countries. With the other solutions, it is envisaged that the distribution should take place as required, even if in principle all euro countries have access. It is still open, however, how exactly the allocation would be effected if the loan demand exceeded the financial volume on offer.

When using the financial support, a **stigma should be avoided** that could lead to higher risk premiums on the financial market for the affected countries. While this risk cannot be excluded, it appears to be low with the ECB and Corona bonds. In the case of the ESM, the stigma could be greater, although both proposals seek to avoid the harsh reform conditionality that has caused the stigma in the past.

Some narrowly defined conditions are nevertheless necessary. **Earmarking only for crisis-related objectives** in the use of aid credits is essential. The **repayment** of the financial support must also be ensured. The ECB-PEPP cannot guarantee either of these, because the ECB has no rights of intervention on the euro countries. The other instruments are likely to seek to ensure both requirements, for example through transparency requirements in the use and repayment conditions.

It is a political question how great the **liability risks for Germany** can be. Each of the instruments entails a certain degree of risk sharing. In the case of the ECB-PEPP, the risk is more limited than the German share of the 750 billion euros due to the mechanisms of the Eurosystem and is also indirectly cushioned via the ECB balance sheet. In the case of the ESM credit lines, Germany's liability is limited to 190 billion euros, even if other ESM members fail to meet their payment obligations. In contrast, the joint liability for the Corona Bonds would not be limited in the event that other payers default, although this has not yet been explained in detail by the proponents.

Legal legitimacy must be ensured, especially with such a substantial liability burden. The ECB undertakes to act only within its mandate. However, there is room for interpretation of the mandate and there are already some critical voices. It is therefore advisable to involve fiscal policy and thus the democratically legitimate political decision-makers and, ideally, national parliaments.

Finally, also due to the high liability risks, it must be ensured that the financial support measures taken are unique and **remain exceptional**. This should in principle be possible for most instruments. However, the ESM-ECCL is most likely to be subject to this risk, as the conditionality that is formally envisaged must be relaxed. Appropriate communication should therefore try to ensure that the current situation does not become a precedent.

In summary, Corona bonds perform best across all requirement criteria. However, they cannot be introduced immediately. With the appropriate political will, yet, larger delays could be avoided. Moreover, Corona bonds entail the highest liability risks for Germany. A difficult political balancing act is required here. In this crisis, effective solidarity in Europe and also German leadership role are needed. It is important to prevent people in the particularly affected countries from feeling left alone by their fellow Europeans as this would endanger European cohesion.

References

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