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Economy

At *Café de l'Europe*, no corona(bond) on the menu

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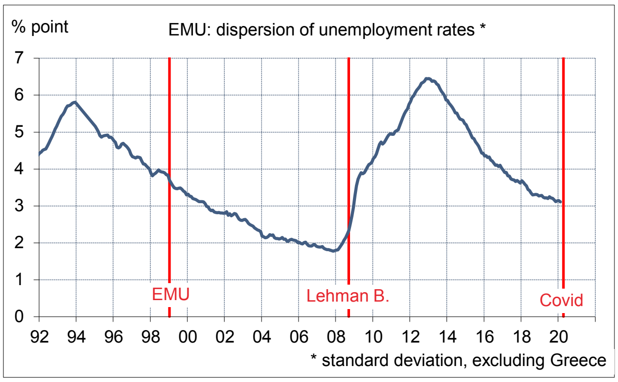
All European countries are affected by the coronavirus pandemic. To curb its spread, all of them have set up a confinement system. As a result, all European countries will suffer the most severe recession in their modern history. No country can durably restore normal living and working conditions if its neighbours are not out of the woods themselves. All in all, there is a strong argument in favour of coordinating health measures and fiscal policies. Europe is failing in both areas. The Eurogroup meeting yesterday ended in failure. There is no joint and several responses to the economic crisis caused by the pandemic.

Rejection of the coronabond…watch out for the political fallout

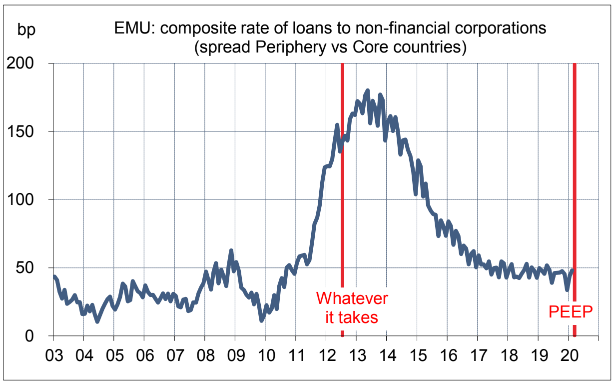
Europe is the continent most affected by the coronavirus: accounting for 54% of cases and 73% of deaths, according to the latest WHO report of 7 April. The human toll varies from one country to another, partly reflecting the quality of health systems (prevention, capacity to treat patients), but all suffer the same fate. **This creates a common experience**. Travellers on the Titanic, too, had the same experience, but the survival rate was not the same for all[1]. No need to develop the comparison further. The current crisis reminds us that European countries, because of their disparities in economic and financial matters, do not have the same means of action. The question facing European leaders is whether they want to avoid this crisis from widening these intra-Eurozone disparities and making them unsustainable. **In short, is there a common destiny?** This note examines the public finance challenges posed by the pandemic and current and future ways to overcome them.

➢ **Convergence/Divergence** – The functioning of a currency area does not imply that all its members are homogeneous but requires a stabilisation tool in case of asymmetric shocks. This was not envisaged at the creation of the euro because it was thought that the "convergence criteria" would be sufficient to reduce asymmetries. The recession of 2008-2009, followed by the double dip of 2011-2012, have put an end to this illusion. Disparities widened sharply from 2008 to 2013 in the real economy (unemployment rate, chart lhs) and in financial conditions (corporate borrowing rate, chart rhs). These differentials then largely disappeared once it became clear that the ECB would not tolerate financial fragmentation in the Eurozone (see Draghi's speech in 2012 and all subsequent ECB actions).

Eurozone: dispersion of unemployment rates



Eurozone: dispersion of corporate borrowing rates



Sources: Thomson Reuters, BCE, ODDO BHF Securities

The current crisis brings to an end an expansionary phase that began in spring 2013. For the past seven years, which were not always plain sailing, all European countries

[1] *According to the British Commission of Inquiry, the survival rate was 62% for 1st class passengers, 41% for 2nd class passengers, 25% for 3rd class passengers, and 24% for crew members. It was 74% for women, 52% for children and 20% for men.*

have made great progress in terms of employment and reducing their imbalances. **Since 2013, economic disparities have narrowed in the Eurozone. They would have been reduced even further if the recovery in certain countries had not been hampered or delayed by overly restrictive fiscal policies. In any event, what we see today is that there are still big differences in terms of public finances. Only a handful of countries have lower government debt ratio than in 2009: Germany (-12 points of GDP), the Netherlands (-9 points) and Austria (-8 points)**[2]. **For the others, debt/GDP ratios are on average 15 points higher than in 2009. Hence the famous north-south divide between "virtuous" and "lax" countries**.

➢ **Solvency** – It is surprising that the public debt issue is often raised in 2020 in the same was as it was thirty years ago when the Maastricht Treaty was written. **Can we still accept that 60% of GDP is a useful reference for judging debt? All is well below that level, but not so above it. In reality, that there is such a thing as a critical threshold, and one which moreover does not change over time, remains to be proven**. After the 2008 crisis, based on the work of Reinhart and Rogoff, it was thought that the level was 90%, but their calculations were wrong. In the last ten years, a large number of countries have had no trouble refinancing public debt in excess of 100% of GDP. **The fall in refinancing rates, encouraged by monetary easing policies, makes higher debt sustainable.** At the end of the day, this financial repression is probably preferable to other means that have historically been used to deal with soaring debt, namely outright repudiation or latent default (inflation).

In Europe, several decisive changes have been made since 2010. First, a new institution, the ESM, has been created, tasked with offering financial assistance to struggling countries subject to conditions. This is an absolute rejection of one key pillar of the Maastricht Treaty (no bailout). Nothing is completely intangible, whatever some people say! Second, the ECB's doctrine and policy have also changed dramatically with no objections from the custodians of the law at the ECJ (no breach of the ban on directly financing public deficits). Via QE, the ECB has the means to ensure that the capital markets remain open to governments on good terms. The recent creation of the PEPP[3] shows that in emergency situations this type of intervention is carried out very flexibly. **These different tools do not solve all the public finance problems in the Eurozone, but they avoid self-fulfilling insolvency crises** (increase in the risk premium ⇨ increase in debt servicing costs ⇨ government solvency fears ⇨ further rise in the risk premium, etc.)

➢ **Nature of the shock** – The current crisis puts public finance issues back in the spotlight, but the nature of the shock and its implications should be taken into account, rather than acting as if it were just a repeat of the previous stress episodes from 2010 to 2015 (Greek, Spanish, Italian, Cypriot crises, etc.).

First, this time the shock is completely external, i.e. independent of countries' past behaviour. It is not the consequence of a credit bubble or public spending splurge that requires a sort of salutary purge. Invoking exceptional circumstances, the European Commission moreover suspended the limits imposed by the Stability Pact. It could hardly have done otherwise without exposing itself to ridicule. In short, no country will be admonished for allowing its deficits to climb, and it is even desirable to have an expansionary fiscal policy to cushion the negative shock to economic agents' revenues.

Second, the shock is symmetrical as regards its immediate impact. From northern Europe to southern Europe, a lockdown has been imposed with the immediate effect of reducing economic activity on an unprecedented scale, by around 25-35% according to the various estimates. In principle, it would seem wise to come up with a common response rather than leave each country to do its own thing. This remark moreover is as valid for public health policy[4] (for example the criteria for ending the lockdown) as for economic policy. According to BIS simulations, the pandemic shock has such large spillover effects than an uncoordinated policy has limited effectiveness[5].

➢**Fault lines** – **Coordinating national policies does not imply the mutualisation of debt, but the mutualisation of the debt caused by this crisis would be the fullest form of coordination. It goes without saying that the obstacle is political.** In June 2012, the German Chancellor said, according to press reports, that there would never be a eurobond in her lifetime. Her position has apparently not changed one iota.

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[2] *Finland, whose debt is admittedly higher than the level in 2009, but below the 60% of GDP threshold, is often included in this group.*
[3] *The* Pandemic Emergency Purchase Programme *was created with an envelope of € 750bn for nine months. In the first week of implementation of the PEPP, on 3 April, the pace of asset purchases exceeded € 30bn, adding to the other asset purchase programmes. Note that the ECB also has the OMT, a tool that it has so far never used, but which can be employed to support an ESM aid programme.*
[4] *The president of the European Research Council announced his resignation yesterday in a sign of the lack of agreement on the European policy for combating the coronavirus.*
[5] *See Kohlscheen & al. (2020), "The macroeconomic spillover effects of the pandemic on the global economy", BIS report, 6 April.*

What has changed, is that we are tackling this crisis with did tools that not exist at the time. Then, a number of countries no longer had access to the markets or only under unsustainable conditions. This is not the case currently. The markets remain open to all countries in the Eurozone, lending rates are low (lower than those on the refinanced debt) and the ECB is checking that spreads remain within reasonable limits. **The problem stems less from *present* financing of spending incurred by the crisis, as from *future* financial conditions, when the emergency situation has passed (restoring the stability pact, the discontinuation of the ECB's PEPP) and that debt ratios almost everywhere will be some 10, 20 or 30 points of GDP above current levels.** In these conditions promoting the use of a tools such as the ESM, even with the reduction to minimum levels of the conditions on credit lines, appears to be of limited interest[6]. Lodging new debt in a shared structure would clearly be a more advantageous option[7].

Mutualising debt with a *coronabond* was the point of contention at the last summit of the heads of state and government on 26 March. The finance ministers of the Eurozone, who met yesterday via video-conference, only confirmed this failure. The Dutch finance minister led this opposition (but the stance adopted by the German government is identical). In one of the drafts of the press release, the possibility of an "innovative financial instrument" was mentioned. It appears that even this was too much to swallow. There are only few points of agreement, with a clear lack of ambition even though in the current circumstances nothing should be dismissed.

- Loans to SMEs – the EIB (European Investment Bank) can underwrite the loans granted by commercial banks. It has been proposed that the existing system is beefed-up to € 200bn (1.8% of eurozone GDP).
- Unemployment insurance – Several countries have put in place specific schemes for temporary lay-offs in order to compensate the revenues of employees who cannot work due to the lockdown. The European Commission has offered to support these initiatives via the creation of a temporary fund to which € 100bn would be allocated[8]. To recap, in France, the latest information indicates that some 5.8 million employees are concerned by these measures, for a cost of close to € 20bn for three months.
- Credit lines - Discussions concern the creation of a special credit line credit, within in the framework of ESM, dedicated to the fight against the pandemic. The amounts alluded to are 2% of a country's GDP with a loan maturity of 5-10 years. That said, apparently not all countries will agree to reducing conditions to a minimum (no signature of the Memorandum of Understanding).

We think that failing to set up a shared financial instrument in the fight against this pandemic is a missed opportunity, since it would be entirely justified in principle. This serves as yet another reminder that the European monetary union is an incomplete structure. **Nineteen countries share a currency, with now proven mutual benefits, but they are incapable of putting in place a shared tool for macroeconomic stabilisation. The response to shocks has been woefully sub-optimal. From the political viewpoint, relations between the countries will not be improved by this crisis, and there will be repercussions on public opinions. Italy is the major risk.** In the surveys that measure the population's attachment to the euro, this country always places at the bottom of the rankings. To the resentment that emerged during the 2011 financial crisis and the migrant crisis of 2015 we can now add that stemming from the health crisis in 2020. We do not need to point out the danger in the forthcoming elections with an opposition party, La Lega, which has often expressed ambiguous positions vis-a-vis the euro. In short, as calamitous as the option of divorce might appear, it could become a reality. We already have Brexit as an example.

[6] *The ESM has a residual loan capacity of € 410bn. This represents around 15% of the total GDP of the countries on the periphery of the Eurozone. Assuming, in the interests of simplicity, a risk premium of 200bp for these countries, financing via the ESM would enable them to gain 0.3 points of debt servicing per annum. EMS loans are conditional on the signature of a memorandum of understanding detailing the structural adjustments that must be made by the bailed-out county.*
[7] *See Beck (2020), "The economic, political and moral case for a European fiscal policy response to COVID-19", Vox EU, 7 April; Grund & al (2020), "Sharing the fiscal burden of the crisis: A Pandemic Solidarity Instrument for the EU", Vox EU, 5 April.*
[8] *The mechanism has been called SURE for Support to mitigate Unemployment Risks in an Emergency. See Vandenbrocke & al. (2020) "The European Commission's SURE initiative and euro area unemployment re-insurance", VoxEU, 6 April.*

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