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Policy Brief

Corona: A European Safety Net for the Fiscal Response

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#Corona
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In order to avoid permanent scars from the economic impact of the Coronavirus in Europe, a determined fiscal response will be necessary. We argue that there should be a clear division of labor between Europe and national governments: the latter will have to provide stimulus with targeted measures, while Europe needs to build a safety net so that member states will not lose access to bond markets due to speculative attacks. This safety net should have three components: A commitment by member states to use ESM instruments without conditionality; a commitment by the ECB to use all of its tools; and a number of flanking measures to underscore member states' commitments.

Efforts to contain and mitigate Coronavirus rightly focus on public health. But Europe is also at the cusp of an unprecedented economic situation: a standstill of many if not most European economies, potentially for a long period of time. The pandemic will eventually pass. But its initially short-run economic impact could leave permanent scars on the European economy. In order to avoid these permanent scars, fiscal policy will be key.

Because there is still no viable instrument to deliver a coordinated fiscal response for the Eurozone or the whole continent, it will need to come from member states. It will be essential for this response to arrive quickly, and for its size to be sufficient to dispel any doubts about the determination of European policymakers.

However, for national governments to be able to deliver a massive response, they need a safety net to give them the certainty, underpinned by concrete measures, that responding appropriately will not subject them to speculative pressures and attacks on bond markets. In the worst case, such attacks could cut off countries' market access at precisely the time when they need it most.

Such a safety net for EU member states' fiscal response to the pandemic should consist of three layers:

- A clear commitment by governments to use all European Stability Mechanism (ESM) instruments necessary to ensure market access of all member states;
- A clear commitment by the European Central Bank (ECB) to use all its instruments to prevent fragmentation of bond markets marked by rising differences (spreads) in interest rates between countries;
- A clear commitment by member states to a package of flanking measures consisting of a swift implementation of the backstop to the Single Resolution Fund for banks, an insurance for social security schemes, and a co-financing instrument at the European Investment Bank (EIB) to safeguard private sector liquidity.

A clear distribution of labor between Europe and its member states

The economic impact of the virus will be messy and manifold as the virus affects both the supply and the demand side of the economy. Accordingly, appropriate fiscal and monetary policy responses will have to be different from what they would be in a normal cyclical downturn. A number of excellent publications already provide a very helpful and comprehensive overview of possible measures.[1]

These point to an emerging consensus that policy action is necessary along four lines:

- Companies need liquidity to stay afloat in the short run as their revenues tumble due to quarantine measures and the interruption of supply chains.
- Employees and the self-employed need support when they have to stay home and/or if their employers have to reduce working hours.
- Banks need a backstop so that they can continue to provide liquidity to the real economy
- The economy will need a timely demand-side boost in order to reduce the loss of output

Since the last crisis, we have not managed to establish any instruments or vehicles at the European level to deliver on any of the aggregate fiscal measures that are needed, despite the fact that there were numerous proposals for such instruments. But now that ship has sailed: a functioning fiscal policy tool will not be built on short notice.

An appropriate fiscal policy response will therefore require a clear division of labor. member states will need to provide fiscal stimulus without holding back. And the European level, i.e. EU institutions and member states collectively, will need to enable member states to follow through without real or perceived threats of speculative attacks. This requires both a guarantee for member states' bond market access and for the stability of their banking systems.

A "national but coordinated" response

At the European Council on March 26th and 27th, member states should commit to a sizeable discretionary fiscal stimulus. The coordinated fiscal stimulus of 2008 was 1.5% of GDP and a similar order of magnitude would likely be required here.

1 See e.g. C. Odendahl and J. Springford, Bold Policies Needed to Counter the Corona Recession; A. Benassy-Quéré et al., COVID-19: Europe needs a catastrophe relief plan; M. Demertzis et al., An effective economic response to the Coronavirus in Europe.

All governments should be able to deploy these ambitious measures irrespective of their current debt level, for three distinct reasons. First, the measures will be as temporary as the pandemic. Second, the cost of the measures is very likely to be significantly smaller than the losses incurred in a deeper crisis that would permanently wipe out production capacity and human capital. Third, in Europe's integrated economies, measures will spill over between member states. Therefore, governments should have a keen interest in ensuring that their neighbors and trading partners also deliver a forceful response to avoid a deeper recession.

The European level can immediately support them by clarifying that European rules will not constrain national action:

- The Commission should make clear that state aid rules will not constrict policy action. The virus is clearly an "exceptional occurrence" in the sense of Article 107 TFEU which allows for state aid to remedy the impact of such an event.

- The Commission should also clearly state that the virus is an "event outside of the control of the Member State" as provided for in the fiscal rules so that the rules do not constrain temporary measures to fight the impact of the virus. And what is more, the pandemic will lead to a downturn in the whole of the EU. Therefore, the escape clause of the Stability and Growth Pact should be immediately triggered.

This is the bare minimum EU institutions can do to support the member states. But such a blank cheque does not amount to a truly common response.

A safety net for national fiscal responses

As the reactions to ECB President Lagarde's press conference on March 12th showed, government bond markets are very volatile and could easily turn on individual member states. This is a problem for two related yet distinct reasons:

- First, increased market pressures could cause governments to hold back on a forceful and fast fiscal response for fear of losing market access.

- Second, there is a real threat that governments will come under market pressure if left to fend for themselves. Especially for large member states, it might be too late to save them once they do lose market access. This would result in the unraveling of the Eurozone with devastating economic consequences.

For both of these reasons, Europe needs to do more than giving a blank cheque to member states. A safety net that would enable governments to deliver the appropriate fiscal policy response should consist of three steps:

1. Member states should send a clear and unequivocal message that they want all governments to deliver a forceful fiscal policy response regardless of their current fiscal situation, and that they are ready to use all available ESM instruments to ensure the necessary market access. Should member states lose market access, it will not be because of policy mistakes, but because of the Corona pandemic. Therefore, they should get full access to the ESM without losing any of their sovereignty in this crisis and hence should not face any conditionality. Specifically, member states could point to the precautionary credit lines available under the ESM treaty. The biggest advantage we have compared to the great financial crisis is that today we have the instruments in place to guarantee market access. But their effectiveness depends on the political will to actually use them in times of need.

2. The ECB needs to complement this statement by governments with a clear commitment to use all its available instruments, including Outright Monetary Transactions (OMT). This is particularly important now as ECB president Lagarde has called into question whether she would be ready to use OMTs, saying that "we are not here to close spreads".

3. Member states could underscore their commitment with three flanking measures:

   a. The backstop for the Single Resolution Fund should be put in place immediately to assure markets that there are sufficient funds available to tackle a systemic banking crisis. They should do so without ratifying the whole of the agreed ESM reform, as the new rules for precautionary lending that are also part of this ESM reform would make it impossible for a large number of member states to access precautionary credit lines.

   b. As welfare states will come under considerable strain in terms of both health and social security expenditure, the EU should set up a scheme based on Art. 122 of the Treaty. It would extend interest-free loans to national social security schemes so that labour costs do not have to increase at the worst possible time for companies and employees. The scheme would borrow against the remaining margins in the EU budget. This would also introduce an important visible element of solidarity. The European Financial Stabilisation Mechanism (EFSM) set up in the sovereign debt crisis could serve as a useful blueprint.

   c. The EIB should support guarantees by national promotional banks for private sector loans to businesses under strain from the virus. If the EIB needs more capital, member states should provide it jointly. Again, this would underscore member states' commitment to weather the crisis together.

Conclusion

These are dramatic times that require decisive action. It may not yet seem like it yet, but the integrity of the Eurozone and the health of European economies are acutely at risk. The biggest mistake now would be to react half-heartedly or to dismiss the systemic threat that could emerge from underestimating the depth of the economic impact of the Coronavirus. As most of Europe appears likely to go on lockdown, it is time for bold action – with a common European safety net. And while the situation might seem dire, it is worth appreciating that common European institutions and policies allow Europeans to respond much more forcefully than they ever could on their own.

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