cep

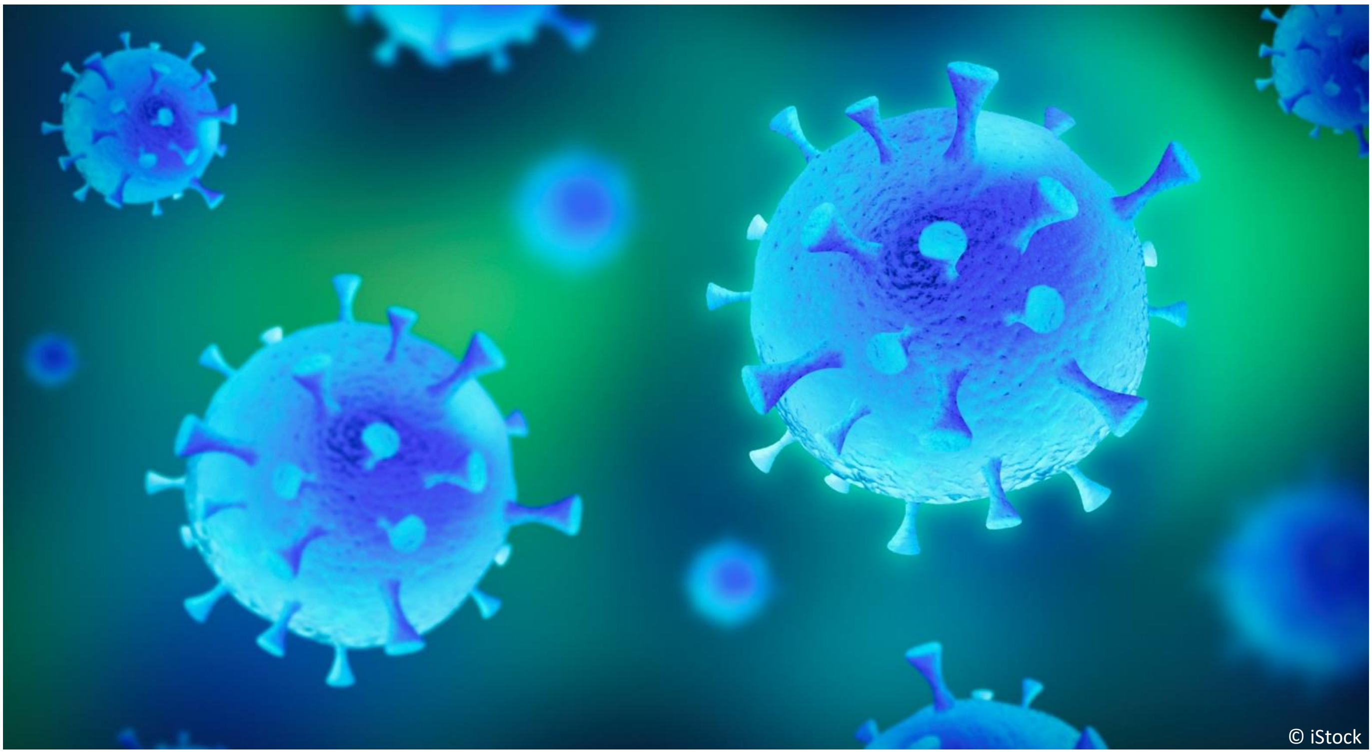
cepInput

No. 8 | 2020 24 March 20

Combating the Corona crisis

Economic and fiscal policy recommendations

Matthias Kullas and Bert Van Roosebeke



© iStock

The economic consequences of the Corona crisis have given rise to doubts about the creditworthiness of some eurozone countries. This cepInput criticises the latest ECB intervention as being the result of a chain of policy errors and calls for ESM credit lines as the sensible choice.

- The effectiveness of economic policy measures in the Corona crisis is limited as long as measures motivated by health policy lead to ruptures on the supply side. The risk of Stagflation looms.
- What is required are EU measures to maintain transnational trade as well as liquidity assistance. These may help to prevent widespread insolvency and an attendant financial crisis.
- ESM credit lines should be activated. Unlike the much demanded "Corona bonds", they match the objective, are compatible with incentives, have democratic legitimacy and are quick to implement.
- If the current ESM funds prove insufficient, they should be increased - rather than further huge government bond purchases being made by the ECB.

Table of Contents

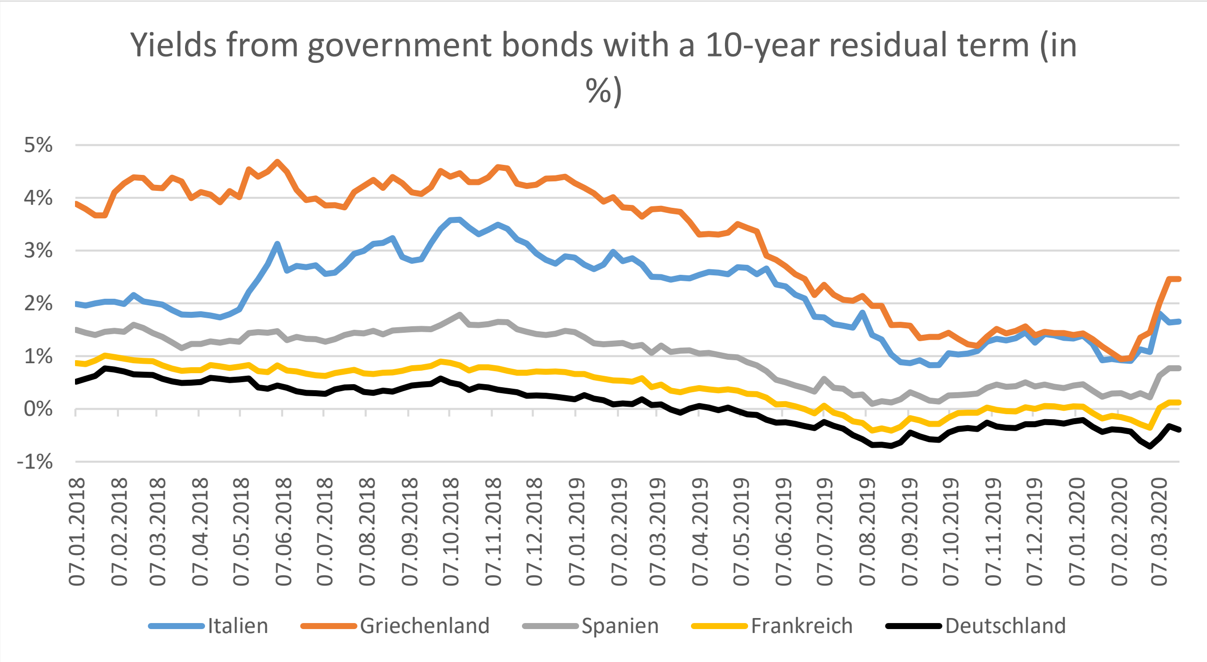
1 The latest measures by the European Central Bank

1.1 ECB decisions of 12 and 18 March 2020

In the past 14 days, the European Central Bank (ECB) has passed two packages of measures to mitigate the economic impact of the Corona crisis. The first package was passed on 12 March.[1] It includes

- the implementation of additional longer-term refinancing operations,
- more favourable terms for the targeted longer-term refinancing operations between June 2020 and June 2021, and
- additional asset purchases of €120 billion until the end of 2020, mainly involving corporate bonds.

When announcing these measures, ECB President Christine Lagarde stated that it was not the task of the ECB to close bond spreads - i.e. risk-based differences in the government bond yields of various eurozone countries. This statement led to a rise in yields, particularly for Italian government bonds, because lenders were worried that it indicated a shift away from current ECB policy.



Graph 1: Government bond yields of selected eurozone countries

Under ECB President Mario Draghi, the ECB consistently ensured that bond spreads did not diverge too far between the individual eurozone countries. The reason given for this was that otherwise the transmission of monetary policy could not be guaranteed.[2] Lagarde corrected her statement in a subsequent TV interview. In addition, the ECB's chief economist Philip Lane wrote in a blog that the ECB would continue to reduce bond spreads if transmission of monetary policy was jeopardised.[3]

[1] ECB (2020): Monetary policy decisions, Press Release of 12 March 2020, online at: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp200312~8d3aec3ff2.en.html.

[2] ECB (2012): Technical features of Outright Monetary Transactions, press release of 6 September 2012, online at: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp200312~8d3aec3ff2.en.html.

[3] Lane (2020): The Monetary Policy Package: An Analytical Framework, online at: www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200313~9e783ea567.en.html.

As the ECB's first package of measures failed to calm the markets, just six days later on 18 March 2020, the ECB passed a second package of measures.[4] Notably, this contained a new purchase programme called the Pandemic Emergency Purchase Programme (PEPP) for the purchase of government and private bonds amounting to € 750 billion. The purchases will take place by the end of 2020.

The ECB announced that the purchasing of securities would be based on the capital key of the eurozone countries. Such a distribution had already been decided under the other major ECB bond purchasing programme, the Public Sector Purchase Programme (PSPP).[5] With the PEPP, however, the ECB has made the existing distribution rule more flexible: it will only apply for the entire duration of the programme rather than for each purchase.

In addition, the ECB is considering lifting the self-imposed 33% issuer limit on its bond purchasing.

The ECB also announced that it would purchase Greek bonds under PEPP. This was not possible under the PSPP due to the poor ratings of Greek bonds. The ECB justified the new bond purchase programme in the same way as the existing one: to reduce risks to the transmission of monetary policy.

As well as establishing the PEPP, the ECB passed two further measures. Firstly, the range of securities eligible for purchase by the ECB under the Corporate Sector Purchase Programme (CSPP) was extended. Secondly, the rules on collateral which banks have to provide to the ECB for refinancing operations will be eased.

1.2 Limits of the ECB's mandates

As in the case of previous measures, the latest decisions of the ECB give rise to questions of whether they comply with its mandate. Of particular relevance is the question of whether the ECB decisions constitute an avoidance of the ban on monetary state financing and whether they remove the incentive for the eurozone countries to maintain a sound budgetary policy.

In its judgement on the PSPP, the European Court of Justice (CJEU) pointed out that the ECB [must] "build sufficient safeguards into its intervention to ensure that the latter does not fall foul of the prohibition of monetary financing in Article 123 TFEU, by satisfying itself that the programme is not such as to reduce the impetus which that provision is intended to give the Member States to follow a sound budgetary policy".[6] The Court already argued in the OMT judgement that an ECB programme would "circumvent Article 123(1) TFEU, recalled in paragraph 100 of this judgement, if that programme were such as to lessen the impetus of the Member States concerned to follow a sound budgetary policy.".[7]

In the PSPP judgement, the CJEU referred explicitly to two features of the PSPP which prevent this. The ECB's new PEPP, however, no longer has those two features:

- In the PSPP judgement, the CJEU referred to the fact that the distribution of the ECB's government bond purchases according to the capital key meant that a Member State which abandons a sound

[4] ECB (2020a): ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP), press release of 18 March online at: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp200312~8d3aec3ff2.en.html.

[5] Thus, 21.4 percent of the bonds purchased by the ECB must be German government bonds as this is the German share according to the ECB capital key.

[6] CJEU Judgement of 11 December 2018, Weis et al., C-493/17, para. 107

[7] CJEU Judgement of 16 June 2015, Gauweiler et al., C-62/14, para. 109

budgetary policy could expect a reduction in the proportion of that country's bonds purchased by the ECB. As a result, according to the CJEU, a Member State could not avoid the consequences of the deterioration in its budgetary position so the ban on monetary financing was not breached.[8] The PEPP now derogates from this: When purchasing government bonds, the ECB will only comply with the capital key in the medium to long term. Thus, at least in the short term, the ECB will be able to purchase a larger proportion of Italian and Greek government bonds than corresponds to the shares of those two countries in the capital of the ECB.

- In the PSPP judgement, the CJEU emphasised that the "purchase limits per issue and per issuer" under the PSPP meant that the ECB can only purchase a minority of the bonds issued by a Member State. The Member State therefore has to rely chiefly on the markets to finance its budget deficit. This also led the CJEU to conclude that the ban on monetary state financing has been observed.[9] In the PEPP, the ECB is considering lifting the self-imposed 33% issuer limit on its bond purchasing.

Even if the CJEU is unlikely to find the PEPP to be in breach of the ban on monetary state financing, the ECB has abandoned CJEU's two main criteria for the legality of government bond purchasing programmes.

2 How things got this far

2.1 General economic situation, particularly in Italy

Once again, Italy is particularly hard hit. Due to the lack of real economic reforms and insufficient austerity measures, the economic situation in Italy was already strained even before the Corona crisis started. Thus, between 2010 and 2019, Italy's GDP growth was the second lowest in the eurozone after Greece[10] It fell four times in the seven years between 2008 and 2014. Only since 2015 has Italy shown a sustained growth in GDP. However, this has been so small that even in 2019 it had not yet got back to the 2008 pre-financial crisis level. In 2019, Italy's GDP was at the same level as in 2004. The reason for the low growth in Italy's GDP is the low growth in labour productivity. In the last two years, it has only grown by 6%. In Germany, it grew by 26% in the same period. The low growth in labour productivity is in turn due to low investment and a slump in total factor productivity.[11]

In addition to low GDP growth, Italy's high level of public debt, currently 137% of GDP, is a particular source of concern.[12] In the EU, only Greece has a higher figure with 178%.

2.2 Failure of the Stability and Growth Pact

The Stability and Growth Pact is intended to ensure that high levels of debt are brought down towards 60%. Specifically, the Pact stipulates that Member States with a debt level of more than 60% of GDP must reduce the amount by which the debt exceeds the 60% mark by an average of one twentieth per year.[13] The same applies under the Fiscal Compact.[14] This did not take place in Italy. In fact, the

8 CJEU in C-493/17, para. 140
9 CJEU in C-493/17, para. 141
10 Cf. Eurostat, own calculations.
11 Cf. Gasparotti A. (2019): Addressing the Italian malaise, online at: https://www.cep.eu/en/eu-topics/details/cep/addressing-the-italian-malaise.html.
12 Eurostat (2020): Press release 15/2020, online at: www.ec.europa.eu/eurostat/documents/2995521/10159227/2-21012020-AP-EN.pdf/85466fed-8e0d-4ad1-9eaa-6b495c4606b8.
13 Cf. Article 2 of Regulation (EC) No. 1467/97.
14 Cf. Article 4 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.

opposite occurred. Since the financial crisis in 2008, the Italian debt level has risen by 31 percent. The EU Commission, as guardian of the Pact, has consistently turned a blind eye to this. As a result, even before the Corona crisis hit, Italy had virtually no fiscal leeway. In fact, in recent years, Italy has only been able to obtain funds on the capital market due to the PSPP and the ECB's promise to minimise bond spreads. However, despite using the ECB's support to reduce public debt, debt levels were increased.

In light of the current crisis, it is appropriate that the EU Commission and the Council of Ministers have now decided to suspend the Stability and Growth Pact, by activating for the first time the Pact's general escape clause, because Member States must do whatever it takes in fiscal terms to mitigate the economic collapse. The mistakes in applying the Pact were made earlier.

2.3 Failure to activate the European Stability Mechanism (ESM)

The eurozone countries created the European Stability Mechanism (ESM) in 2012. It can provide help, subject to conditions, to eurozone countries with "severe financing problems" if this is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.[15]

Under these conditions, the ESM can approve general loans to eurozone countries, loans to eurozone countries for the re-capitalisation of financial institutions, government bond purchases on primary and secondary markets, direct recapitalisations of banks and "precautionary financial assistance" in the form of credit lines.[16]

The ESM Treaty basically provides that any ESM aid must be linked to "reasonable conditions". These conditions will be set out in a Memorandum of Understanding (MoU).[17] They may range "from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions".[18]

In recent weeks, there have been intense discussions about activating ESM credit lines. This reflects the current situation: access to the capital markets for eurozone countries seeking aid is not currently regarded as being at acute risk even though doubts are growing about the medium term (cf. Graph 1).

Credit lines are acquired in the form of ESM loans or ESM primary-market purchases, i.e. ESM government bond purchases directly from the emitting country. They apply for one year and can be extended on two occasions by six months in each case. Until now, the instrument has not been used by any of the Member States. There is a distinction between Precautionary Conditioned Credit Lines (PCCLs) and Enhanced Conditions Credit Lines (ECCLs).

As with all ESM aid, PCCLs and ECCLs are only permitted if there is a risk to the financial stability of the whole eurozone and its Member States, and they are subject to conditions. Although the

[15] Art. 3 ESM Treaty
[16] Art. 14 -18 ESM Treaty The direct recapitalisation of banks was - controversially - introduced not by way of an amendment to the ESM Treaty but by the Board of Governors as an additional instrument on the basis of Art. 19 ESM Treaty.
[17] Art. 13 (3) ESM Treaty
[18] Art. 12 (1) ESM Treaty

ESM guideline on credit lines[19] sets out the requirements for claiming credit lines in more detail, it leaves some questions unanswered. This also applies to the conditions to which they are linked.

2.3.1 PCCLs

PCCLs can only be granted to eurozone countries whose economic and financial situation is "fundamentally sound".[20] In this regard, the EU Commission, in collaboration with the European Central Bank, must carry out a "global assessment" on the basis of six criteria:

(1) Compliance with the Stability and Growth Pact: A eurozone country that is subject to an excessive deficit procedure may only access a credit line if it abides by the Council decisions and recommendations aimed at correction of its excessive deficit.
(2) A sustainable general government debt.
(3) Avoidance of an excessive imbalance: A eurozone country that is undergoing a procedure due to excessive macroeconomic imbalance (excessive imbalance procedure - EIP)[21] may still be eligible for a credit line provided that it "remains committed" to addressing the imbalances identified by the Council.
(4) A track record of access to international capital markets on reasonable terms.
(5) A sustainable external position.
(6) The absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system.

Not only is it unclear, however, whether these are the only criteria that have to be met[22], but the specific meaning of some criteria is unclear due to the vague wording of the ESM Guideline.

In the case of PCCLs, the recipient state must undertake to comply with the six eligibility criteria even after the credit line has been granted - i.e. before it has actually been activated.[23] Whether, over and above this, the MoU can or must contain additional economic policy conditions for this phase, is not clearly stipulated. If the state accepts the approved PCCL, it must adopt measures, that have been agreed with the Commission and the ECB, aimed at addressing the sources of difficulties.[24]

2.3.2 ECCLs

ECCLs are available to eurozone countries whose economic and fiscal situation is "fundamentally sound" but who nevertheless do not meet the conditions for a PCCL.[25]

---

[19] European Stability Mechanism Guideline on Precautionary Financial Assistance of 9 October 2012, https://www.esm.europa.eu/sites/default/files/esm_guideline_on_precautionary_financial_assistance.pdf. There is no official German translation of the Guideline.

[20] "Where the economic and financial situation is still fundamentally sound" (Art. 2 (2), ESM Guideline).

[21] The procedure for monitoring macroeconomic imbalances aims to recognise risks arising from capital market bubbles, property market bubbles or due to a divergence in competitiveness between Member States. The procedure takes a similar form to fiscal monitoring under the Stability and Growth Pact. For details see Kullas (2011): Kann der reformierte Stabilitäts- und Wachstumspakt den Euro retten, online unter: www.cep.eu/fileadmin/user_upload/cep.eu/Studien/Reformierter_SWP/cepStudie_Reform_des_Stabilitaets-_u_Wachstumspakts.pdf.

[22] "A global assessment shall be made (…) using as a basis the following criteria" (Art. 2 (2)).

[23] "The beneficiary ESM Member shall ensure a continuous respect of the eligibility criteria after the PCCL is granted" (Art. 2 (3) ESM Guideline on Precautionary Financial Assistance).

[24] Art. 5 (1) ESM Guideline on Precautionary Financial Assistance

[25] Art. 2 (4) ESM Guideline on Precautionary Financial Assistance

In the case of ECCLs, the recipient state must undertake to ensure continuous respect for the eligibility criteria which were met when the ECCL was granted.[26] In addition, the state must take measures to address its weaknesses and avoid any future problems regarding access to market financing It is unclear whether these measures constitute a condition for being granted the credit line or are part of the economic policy conditions applicable once the credit line has been granted. In any case, once the credit line has been granted, irrespective of whether it has been activated, the state must adopt the measures, that have been agreed with the Commission and the ECB, aimed at addressing the sources of difficulties.[27]

2.3.3 No activation of the ESM credit lines so far

So far in the corona crisis, the ESM has not been activated. It nevertheless offers three important advantages:

(1) ESM aid - more or less - already has conditionality, i.e. it is subject to economic policy conditions which reduce the risk of deadweight loss.
(2) ESM aid has democratic legitimacy by way of the unanimous decision of the eurozone governments; in some states, parliament also has to agree.
(3) ESM aid reduces the likelihood that the ECB will have to pitch in, which safeguards the independence of the central bank.

2.4 Conclusion

The economic impact of the Corona crisis is severe and has given rise to doubts about the solvency of some eurozone countries. Italy is doubly affected: It has suffered a severe outbreak of Corona virus and its economic and fiscal foundations are already shaky.

The latest intervention by the ECB is the result of a chain of policy errors. Firstly: Due to the relaxation and inadequate enforcement of the Stability and Growth Pact, the doubts as to the creditworthiness of some eurozone countries are justified. Earlier enforcement of the Stability and Growth Pact and the reduction in debt levels which this would have engendered, would have reduced the doubts. Secondly: In the current situation, the ESM should have been activated first. Its precautionary credit lines provide instruments that have both conditionality and democratic legitimacy. Instead, the ECB has been forced into an intervention which is even closer to monetary state financing than any of the numerous euro rescue packages since 2010. This damages its ability to implement a monetary policy that is independent of the budgetary situation of the eurozone countries.

3 Necessary measures

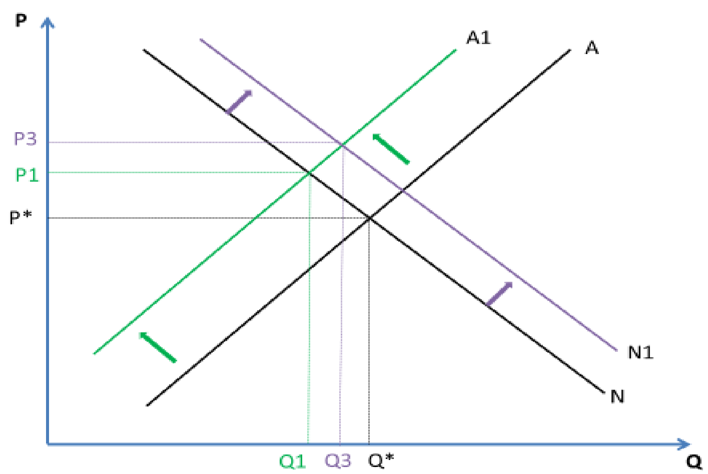
The extent to which the eurozone countries will be affected by the economic impact of the corona crisis is not yet clear. A crucial aspect will be the extent and duration of the national measures resulting from health policy (such as company shut-downs and bans on going out) which differ from one Member State to another. At the same time, due to the close economic relationships and cross-border supply chains, there is a high level of mutual dependence in the EU.

[26] Art. 2 (4) ESM Guideline on Precautionary Financial Assistance
[27] Art. 5 (1) ESM Guideline on Precautionary Financial Assistance

3.1 Necessary measures

The economic impact of measures resulting from health policy first make themselves felt as a negative shock to the supply side. The effectiveness of basically all economic policy counter measures is limited as long as measures motivated by health policy lead to ruptures on the supply side. European measures to maintain transnational trade are therefore necessary. Border closures and checks further restrict production capability because supply chains today are often international. Liquidity assistance for companies is also appropriate. This can prevent companies from sliding into insolvency and help production to ramp up again rapidly once the health-policy-based measures come to an end. Many of the measures currently under discussion - in Germany for example short-time working allowance, tax deferrals and loan guarantees - are therefore absolutely necessary.

Stimulating demand currently makes little sense (cf. Graph 2): As a result of the health-policy measures, any such increase in demand (from N to N1) would not be met with a corresponding increase in supply. On the contrary: Supply is falling (from A to A1). This results in stagflation: The production level falls whilst inflation goes up.



Graph 2: Negative supply-side shock and subsequent demand stimulation

3.2 Europe's task: Provision of liquidity

The ECB's recent measures have triggered a discussion in the eurozone about further economic integration with the principal aim of ensuring that the economies of Europe have the necessary liquidity. The proposals under discussion include:

- activating ESM credit lines,
- setting up a new ESM instrument to provide liquidity,
- setting up government bonds with shared liability (Eurobonds or "Corona bonds") whether through centralised borrowing by the EU or, for the eurozone, through the ESM.

Any measure must satisfy the following criteria:

(1) **Ring-fenced for liquidity** The funds acquired must be used to provide liquidity (see above) in order to avoid a wave of insolvencies in the real economy and a resulting financial crisis. The use of funds should therefore be ring-fenced. Such "conditionality" is best achieved via the ESM rather than Eurobonds.

(2) **Compatibility of incentives and sustainability** Eurobonds or Corona bonds result in shared liability without any centralisation of the underlying economic and fiscal policy. This gives rise to a problem of moral hazard. Although this problem may be mitigated by limitations on time and volume, from a political perspective, it is highly questionable whether the agreed limitations will be complied with. ESM aid is more appropriate. It has conditionality and its duration is clearly limited.

(3) **Democratic legitimacy** Within its own mandate, the ECB is independent of monetary policy. The provision of liquidity to finance a short-time working allowance or tax deferrals is an economic policy measure and should not be undertaken by the ECB. The ECB lacks democratic legitimacy in this respect. The justification that the ECB should take such measures to uphold the transmission channel amounts to a general power and is therefore unacceptable (cf. Section 1.2 in this regard).

(4) **Rapid deployment** The worst hit countries, most of all Italy and Greece, must get help quickly. This supports ESM credit lines which are already provided for under the ESM Treaty. Both the creation of a new liquidity instrument under the ESM umbrella and the creation of "Corona bonds" would have to pass through legislative procedures in the eurozone countries.

	Activation of ESM credit lines	New ESM liquidity instrument	"Corona bonds", Eurobonds
Ring-fenced for liquidity	+	+	–
Compatibility of incentives and sustainability	+	+	–
Democratic legitimacy	+	+	–
Rapid deployment	+	–	–

As a result, the use of ESM credit lines is the method of choice. ESM credit lines provide an instrument that makes it possible to react to short term developments on the capital market and that can be linked to reasonable conditionality.

In view of the requirements for PCCLs, politically it is more likely that agreement will be reached on ECCLs. The conditions attached to them will probably be less strict with reference to the Corona virus as the cause of the crisis.

It is not currently possible to give a reliable forecast of whether ESM funds will be sufficient. Support through further ECB purchases of government bonds under the OMT programme is therefore being discussed. This should be rejected. Such purchases - whether under the PEPP or the OMT programme - limit the ECB's ability to conduct an independent monetary policy, irrespective of the impact on the eurozone countries.

The only appropriate course in this case is to increase ESM funds. This would also have democratic legitimacy as it has to be passed by the ESM Member States in their respective legislative proceedings.

Authors

Dr. Bert Van Roosebeke is Division Head at the Centrum für Europäische Politik, Freiburg.

Dr. Matthias Kullas is Division Head at the Centrum für Europäische Politik, Freiburg.