POLICY INSIGHTS
Thinking ahead for Europe

No 2020-08 / April 2020

Europe's debate on fiscal policy:
too much yet too little

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Abstract

The initiatives taken by the ECB in mid-March 2020 flatten the structure of interest rates and ensure short-term sustainability for the EMU countries with high government debt/GDP ratios. But the challenges posed by the pandemic require a huge amount of public spending and therefore threaten this sustainability in the long term.

This paper proposes 'contractual arrangements' between high-debt countries and European institutions, namely the Commission and the ESM as financial donor, which transfer grants (a 'gift') to high-debt countries to cover the national public expenditures resulting from the impact of the pandemic. In exchange, the beneficiary countries would share the design and implementation of these public expenditures with the European institutions, thereby giving up a portion of their fiscal sovereignty.

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The author wishes to thank Cinzia Alcidi, Carlo Bastasin, Pierpaolo Benigno, Daniel Gros, and Roberto Tamborini for their very useful comments to a previous draft of this paper. An earlier version of the paper was published as a Policy Brief on the SEP-LUISS site.

978-94-6138-773-8

Introduction

The European Central Bank (ECB) recently decided to launch new LTRO and T-LTRO programmes[1] to ensure liquidity for both the banking sector and small- and medium-sized firms (12 March 2020) and to temporarily strengthen its 'quantitative easing' policy (18 March 2020), which is centred on the purchases of government bonds and on a large set of private financial assets (including commercial papers). Moreover, the Single Supervisory Mechanism improved the positive impact of the ECB's initiatives by temporarily weakening the capital requirements and the assessment of the non-performing exposures in the European banking sector. Finally, the European Commission (EC) decided to suspend Europe's coordination mechanism of national fiscal policies, that is, the Stability and Growth Pact (SGP).

This last step was thought to be crucial, since it is commonly agreed that even a generous unconventional monetary policy cannot face the short- and medium-term economic impact of the current pandemic shock. The new LTRO and the T-LTRO could inject more than €1,500 billion into the banking transmission mechanism by the end of June 2021; and 'quantitative easing' will pump more than €1,000 billion into the economic system through the monetary transmission mechanism by the end of the current year.

Furthermore, members of the ECB's Governing Council acknowledged that it would be possible to indefinitely increase the purchase of government bonds and other financial assets, if Europe's economic situation deteriorated further. Hence, the ECB's current intervention looks like a quasi-monetisation of national government debt in the euro area, allowing each country in the European Economic and Monetary Union (EMU) to increase the public expenditures financed in the market. There are three substantial differences with respect to a full monetisation of government bonds in the primary market, however. First, by limiting its intervention to the secondary market, the ECB respects the European treaties and its own statute (see also section 3, below). Second, in the current situation of high deficit spending, the EMU countries are increasing their government debt for the corresponding amount of this spending. Third, a significant portion of this debt will be held on the ECB's balance sheet; therefore, even in future, the economic sustainability of the EMU countries with high public debt will be vulnerable to monetary policy decisions.

In view of these considerations, the T-LTRO and the quantitative easing may, at most, provide liquidity to different economic activities and flatten the structure of interest rates. They cannot absorb the 'real' shock on the supply side and transfer income to temporarily unemployed workers and households, and they cannot address the economic problems that will

[1] The Long-Term Refinancing Operation (LTRO) was launched by the European Central Bank (ECB) at the end of 2011 (December) and at the beginning of 2012 (February) to overcome the liquidity problems of the European banking sector. The ECB launched, instead, the Targeted Long-Term Refinancing Operations (T-LTRO) in the summer of 2014 to incentivise the European banks to lend to the 'real' sector. The T-LTRO evolved over timeand became an important complementary tool to strengthen the impact of the non-conventional monetary policy implemented by the ECB since the end of 2014 (the so-called 'quantitative easing').

characterise the immediate post-pandemic phase. The latter are duties that pertain to fiscal policy.

At least at first sight, the suspension of the SGP allows each of the EU member states to implement expansionary fiscal policies, thus fully exploiting the combination between money and public expenditure expansion. Unfortunately, this desirable effect may turn out to be unfounded. European countries with a high stock of public debt face binding constraints in their fiscal strategies due to the possible reaction of their private bondholders. As shown by the case of Italy, which is the country most hit by the coronavirus pandemic and the euro-area member state with one of the highest government debt/GDP ratios, any significant expansion of its fiscal policy risks leading to unsustainable equilibria in its balance sheet; and, for the reasons stated above, the ECB's interventions can overcome the problem temporarily without solving it permanently. However, any constraint on an individual country's ability to fight the healthcare and economic impact of this pandemic is a threat to people in all countries, hindering the opportunity to utilise the current crisis to make progress in the European construction.

The above considerations illustrate the 'diabolic dilemma' that binds the reactions of the EMU countries with high government debt to the impact of the pandemic: either to pursue insufficient short-term expansionary monetary policies to preserve their long-term sustainability, or to endanger the latter in order to absorb the short-term economic and social consequences of this impact.

The paper aims to overcome this 'diabolic dilemma' by designing a 'contractual arrangement' between the high-debt countries and European institutions: the latter could transfer grants (a 'gift') to the former to cover the national public expenditures resulting from the pandemic's impact; in exchange, the beneficiary countries could share the design and implementation of these public expenditures with the European institutions, thus giving up a portion of their fiscal sovereignty.

The coronavirus bonds: benefits and limits

In recent days, debate among European economists has focused on the possible centralisation of the financing of national fiscal policies inside the euro area. The two open questions that lead to different suggested solutions, are: how to implement this centralised financing of fiscal policies; and how to make the specific forms of financing compatible with the sustainability of the government balance sheets.

At the risk of oversimplifying the different solutions proposed in the debate so far, allow me to summarise three possible positions.

The first position calls for the issuance of a so-called corona-virus bond (CVB), which is a kind of combination between a euro bond and a project bond aimed at financing the additional government expenditures needed to manage the impact of the coronavirus pandemic in the short term (current purchases and investments in the healthcare sector and other basic welfare interventions) and, eventually, to support the initial national economic recoveries once the pandemic peaks are reached. The European issuers could be the European Commission, the European Stability Mechanism (ESM), and the European Investment Bank (EIB). Depending on the European institution ready to issue or to purchase the CVBs, this centralised financing could apply to the member states either of the EU or of the EMU. For simplicity's sake, in the following I will just refer to the euro-area countries, even when the specific case analysed would also involve the EU countries that do not yet belong to the euro area.

The new issuances of CVBs could be guaranteed by: i) the Multiannual Financial Framework and by new possible own resources, in the case of the EC; ii) the current availability of a funded capital and possible additional funding by the euro-area member states (according to the capital-key rule), in the case of the ESM; iii) a new specific liquid fund, in the case of the EIB. Each of these issuers, however, would have to contract a debt in the market, even if at possible low interest rates,[2] for an amount equal to that of the CVBs issued. In principle, to utilise portions of the CVBs' revenue to finance that part of the EMU countries' expenditures imposed by the impact of the coronavirus pandemic, the original issuer would have to draw up a debt contract with each of these countries for a duration determined by the maturity of the corresponding CVBs. In this way, the original issuer would not create a disequilibrium on its balance sheet. However, the result is that each of the EMU countries involved in a debt contract would have to issue an equivalent amount of its government bonds to be sold to the European institution issuing the CVBs. The government debt of these same countries would thus record a corresponding increase.

Despite the previous statement, the EMU member states most vulnerable to the risk of unsustainability of their expansionary fiscal policies would benefit in at least two ways. The first is that an increased portion of their government debt would not be allocated in the volatile portfolios of private investors, and the second is that the interest rates to be paid on this portion would be lower than the market interest rates.[3] However, these member states would not solve their fundamental problem: in the medium-long term they will have to deal with an increased and excessive public debt/GDP ratio. This problem is particularly important in the current dramatic situation: to exploit the potentials of the economic recovery after the pandemic peak, it will be necessary to increase public investment and to support the private ones for a long period. Growing and binding constraints in the public balance sheets could hinder these policy initiatives, thus undermining the future structural competitiveness of these countries with a high public debt/GDP ratio. For instance, a country such as Italy would be forced to make a difficult decision in the post-pandemic phase (i.e., the evolution of the 'diabolic dilemma' illustrated in section 1): either to fall into a long stagnation or to face an unsustainable government debt.

[2] Let us assume, for the sake of simplicity, that the interest rate is equal to 0.

[3] Let us assume that the paid interest rates are equal to 0, since the European institutions do not aim at any net return on these transactions (see footnote 2 above).

Some inconclusive refinements

The second position in the debate aims to overcome this last crucial problem by keeping alive the CVBs scheme. There are several ways to do that.

The first is to issue unredeemable CVBs to be purchased by the ECB in the primary market. The EIB is a bank and is partly subject to the related regulation, whereas the ESM is a crisis manager that plays the role of lender in relation to specific credit lines and to specific aid programs. It follows that both these institutions cannot issue unredeemable bonds aimed at financing EMU (or EU) member states. Hence, this solution focuses on the EC as issuer of this type of consol. Let us go back to the analysis developed in section 2 above: in their turn, the EMU member states could have access to portions of the EC's revenue by issuing and selling national consols to the EC. In that case, the government debt of these countries would be increased just for the amount of the yearly financial charges to be paid to the EC, and, in the current scheme, the debt of the EC itself towards the ECB would amount to the sum total of the national financial charges. Moreover, since the ECB plays the role of 'purchaser of last resort' towards EMU member states, the unit cost of these financial charges could be as low as desired by the maker of the monetary policy (hence, in the current scheme, even equal to 0: see footnotes 2 and 3).

The proposed solution highlights an obvious problem: it implies a monetisation of the government debts in the euro area. In this solution, the ECB indirectly purchases the government debt of EMU member states at its issuance; moreover, it alters the determination of the financial charges that, in the case of a consol sold in the financial market, would have to include the reimbursement of the principal by a given time. As is well known, the monetisation of government debts is incompatible with the European treaties, as well as with the ECB's statute. Hence, its implementation would require the long procedure of changing these treaties and would thus imply a permanent reversal of the ECB's role. To go back to the current organisation of the central bank, it would be necessary to reach a general agreement for another change in the European treaties aimed at bringing into force again the original formulation once the peak of the pandemic is over. It is difficult to understand why member states with a high propensity to handle disequilibria in their balance sheets would accept this further reversal (time inconsistency problem).

This same solution points to a second problem. Let us assume that all EMU member states agree on a quick and temporary change in the treaties so that the ECB is free to monetise the government debts. In that case, it becomes difficult to understand why it would be necessary to go through the complex creation of the CVBs. It would suffice to ask the ECB to directly purchase the government bonds issued by the EMU countries, thus covering the public expenditures due to their short-term reaction to the economic impact of the pandemic and, eventually, due to the support for the first steps of the national economic recovery in the medium term.

This rough solution is unlikely to be implemented even in the current dramatic phase. Hence, we should consider another possibility: the EC issues unredeemable CVBs to be sold in the financial market. In this second proposed solution, there are at least two difficulties whose importance is hard to assess without empirical evidence: the lack of demand, and the related costs of the allocation. The amount of CVBs needed to cover the total amount of financing demanded by the different EMU member states is huge, since the coronavirus epidemic requires various public expenditures. If the benchmark is represented by Italy, which is the first European country to be close to the peak of the pandemic, in the EMU the total demand would be around €500 billion under the optimistic assumption that the healthcare situation will dramatically improve by mid-May 2020. It is very unlikely that Europe's financial markets would be ready to absorb this amount of unredeemable assets. Moreover, it is very likely that investors would ask for high financial charges in order to absorb even a small portion of this amount; these charges would include the yearly reimbursement of the principal by a given date in the future.

A new proposal: the 'gift'

The provisional conclusion is that none of the two previous solutions can satisfy the twofold objective of the current debate among European economists, that is, how to implement the centralised financing of national expansionary fiscal policies due to the coronavirus impact, and how to prevent this financing from leading to unsustainable increases in the public debt of the EMU member states. The latter objective specifically matters for the EMU countries with a high stock of public debt on GDP. However, it is also in the interests of all EMU member states that the high-debt countries are able to overcome the 'diabolic dilemma' cited in section 1. If this happens, the spillover effects of the insufficient measures implemented to face the crisis will be weakened, and the probability of a breakdown in the euro area will decrease. Hence, the drawbacks of the previous solutions imply that it is necessary to look at a third possibility.

The core of this third solution is quite simple: it requires that the intervention of a European institution avoids the excessive burdening of national balance sheets. Either the EC or the ESM could issue the CVBs in the form of plain bonds with a medium-term duration, could decide to take the consequent debt upon itself, and could transfer portions of the related revenue to the EMU member states on a permanent basis. To minimise the distortions in the pre-existing competitive relationships among EMU member states, the supply of the transfers to the various EMU countries could be proportional to the specific intensity of the pandemic in their national territories. These transfers must be conceived as financial grants (a kind of gift). Hence, they would imply neither financial charges nor increases in the stock of public debt of the beneficiaries.[4] However, as anthropologists explained a long time ago, a 'gift' requires some form of reciprocity due to the crucial role played by the 'exchange' in a large number of societies. From the economic point of view, here reciprocity means that the countries benefiting from the grants cannot maintain full responsibility for the design and

[4] The proposal, elaborated by Daniel Gros (cf. "The Corona crisis: does Italy need the ESM or eurobonds?", *Ceps*, forthcoming) follows a similar approach. Referring to the national contributions to the Multiannual Financial Framework, his solution is simpler to implement. However, it does not utilize the €410 billion that the ESM could easily mobilise (see below).

implementation of their fiscal policies relating to the expenditures deriving from the impact of the coronavirus pandemic. This responsibility would have to be shared with the donor according to a pre-determined agreement.

As noted above, the two European candidates to issue the CVBs with the aim of transferring the revenues to EMU member states are the EC and the ESM. The EC can play this role by creating a new line in the European Multiannual Financial Framework (MFF) devoted to the EMU, and by offering the whole MFF as a guarantee. The consequence is that the MFF would be characterised by a deficit. In principle, the European Council and the Council of the European Union can authorise the European Commission to draw up yearly budgets with a negative temporary imbalance. However, in this case, the imbalance would become permanent, if there were no compensatory increases in the revenues of the following budgets. Hence, it is debatable whether the European Commission can follow this initiative, unless we introduce external resources or additional own resources in the European budgets. The latter could be a promising tool to improve the progress in the construction of the EMU; however, it is hard to implement in the short term. The reference to the ESM has the advantage that its current funded capital would allow for the rapid utilisation of €410 billion to purchase CVBs. Hence, my proposal is to attribute to the ESM the role of financial donor towards EMU member states.

The problem is that the current as well as the new ESM's statutes allow for conditional lending but do not envisage a line of permanent grants. Exploiting the flexibility in the ESM's statute, it would be necessary to design and implement this new financial line of grants without any standardised conditionality. The latter would be replaced by a 'contractual arrangement'. Following the current ESM's statute and the old European project for the implementation of 'contractual agreements', the latter would be signed between the European Commission and the ESM (as the financial donor), on the one side, and each of the countries benefiting from the grants, on the other. The actual stipulation of these contractual arrangements will probably make the ESM's re-capitalisation by each of the EMU member states necessary. However, in the short run, this re-capitalisation could be limited to the guarantees required by the possible issuances of CVBs beyond the threshold of €410 billion. The main re-capitalisation required to fund the ESM's functioning in 'normal' times can be postponed to the end of the coronavirus pandemic.[5]

Conclusions

To complete the proposal outlined in the previous section, it is worthwhile pinpointing the main feature of the 'contractual arrangement' to be signed between the European Commission (and the ESM as the financial donor) and each of the EMU countries involved in a grant. This arrangement is characterised by the fact that the parties would have to agree on each fiscal policy initiative utilising a portion of the grant transferred from the European institution to the

[5] This implies that the grants transferred from the ESM to the EMU member states ready to sign a contractual arrangement would not require a huge mutualisation. The latter would be limited to that part of the ESM's funded capital covering the issuances of CVBs.

given beneficiary country. This is equivalent to stating that each of the countries involved would have to give up a portion of its fiscal sovereignty in designing and implementing the public expenditures due to the pandemic's impact. This partial resignation is the reciprocal of the 'gift', and as such it represents a step towards a strengthened European coordination of national fiscal policies. In this perspective, overcoming the 'diabolic dilemma' would become the main tool for a gradual centralisation of fiscal policies, which is one of the crucial components of a European federalist construction. If this actually happened, the European institutions would be able to transform the pandemic threat into an opportunity.

It is important to stress that the 'exchange' promoted by the 'contractual agreement' cannot be compulsory: it would be signed on a voluntary basis. It is thus conceivable that some of the EMU member states would not be ready to sign a contractual arrangement with the European Commission (and the ESM) to avoid any European interference in their fiscal policy mix. In this case, the EMU member state could still apply for ESM financing. However, this financing would activate a debt contract and would require full reimbursement by the due date. It is worth noting that, as a consequence, this member state would increase its government debt for the same amount as the required financing.

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