The COVID-19 Bazooka for jobs in Europe

Luis Garicano

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Introduction: can we put the economy in the freezer without damaging it?

Faced with a huge increase in the number of COVID-19 cases, by now all European Union governments have undertaken varying strategies to “flatten the curve”, that is, to reduce the rate of growth of the pandemic in order to avoid a collapse of European healthcare systems. However, this strategy has an unfortunate economic consequence: what was already a sharp supply and demand shock is now a brutal, legally enforced, sudden stop to our highly interconnected economies. Over the next few months, we face an unprecedented drop in the European Union’s GDP, one that may dwarf the 2008 financial crisis.

We cannot predict how long the virus will last, which sectors and supply chains it will disrupt, or how much the GDP will drop. The risk is that many loans will simply not be repaid; ever. Credit default swaps on European corporates (iTraxxIndex) reached prices on March 12 implying a 38% default probability (Ainger, 2020).

As ECB President Christine Lagarde pointed out in her testimony that same day, this is a problem of state and fiscal capacity, not one of monetary policy. However, at this point standard demand management is useless. Governments do not want to stimulate economic activity —they are doing all they can to stop it (they ask people to stay at home!). Instead, economic policy is needed to ensure that the economy survives a "freeze" of (hopefully, no more than) 3 to 6 months.

For this to be possible Member States and EU institutions must ensure all workers, families and small and medium enterprises against the bankruptcy risk this stoppage creates. Sadly, what is now on the table fails to accomplish this aim.

In this paper, I propose a €500bn package (the “bazooka” in Minister Scholtz’s parlance) to fight the virus, stabilize the European economy and protect its jobs while the economy is in the “freezer. Then I discuss how to finance this package.

The package has three aims. First, help Member States undertake the healthcare spending they need to defeat this pandemic. Second, provide a financial backstop to companies, particularly small and medium enterprises. Third, support employment protection schemes throughout Member States, to minimize the number of jobs lost.

To finance the package, I conclude a straight Eurobond is probably not a realistic option, either legally or politically. I discuss three possible alternatives. First, the status quo, where Member States finance the spending, as they do now, with the ECB ready to intervene as needed if and when the markets get riled up by the risk of financing the growing debt. This “path of least resistance” is actually quite risky as it may force the ECB to get too close to the limits of its mandate. Second, the quickest legally and technically and the least politically costly, the SBBS proposal: passed by the European Parliament in April 2019, it is only

lacking the Council's approval. It would allow Member States to finance the "bazooka" with less fear of destabilizing the markets. Third, it could be financed through the ESM, which, to facilitate its usage, should step in using the emergency procedure. A clear engagement by the ESM will allow the ECB to play its role by activating its OMT program. I propose the creation of a specific instrument within the ESM, adapted to the current exceptional circumstances, in which the (necessary) conditionality would be linked to investments in the key priority areas discussed in this piece.

The Commission's response: flexibility, not money

The measures announced by the European Commission this week tried to accomplish two objectives: to make full use of the flexibility in EU fiscal and state aid rules and to mobilize the European budget. The Commission has decided Europe will not stand on the way of Member States' responses, but it has not mobilized any new resources to aid those.

More flexibility. To ensure that Member States act boldly, the Commission has granted them greater freedom to stimulate their economies. First, by relaxing state aid rules if the aid is intended to compensate citizens or companies affected by the Coronavirus. Second, by recalling the exceptions in the Stability and Growth Pact (SGP) that allow for increased flexibility in times of need. By broadly interpreting the provision for unusual events beyond government's control and by triggering the escape clause, the Commission has paved the way for Member States to use ample resources to tackle the crisis.

Target existing resources to Coronavirus response. Commission announced it will mobilize the EU budget through the Coronavirus Response Investment Initiative. First, it has mobilized €1bn in guarantees from the EFSI, which would be leveraged by the EIB to provide €8bn in liquidity to the private sector. Second, the Initiative would mobilize €37bn to support Member States' healthcare systems, SMEs and workers. Out of the €37bn, €8bn will consist of funds that were already allocated to countries to carry out projects but were yet to be completed (and spent). If fully used, these could be complemented by €29bn of further structural funding.

Alas, the Commission's proposal will not be nearly enough. Forgoing enforcement of our common fiscal and state aid rules is not a coordinated action at the EU level. It is just letting Member States act as they see fit. As for the money, it will not suffice, and even then, the allocation of spending among Member States will be that of Structural Funds, and will not be based on any factors related to COVID-19's impact. The Commission's most common phrase while answering questions during their presentation was: "if we had time, the tools would have looked very different".

A European Bazooka to protect jobs and wages

What Europe has put on the table will not be enough. Consider the "protective shield for employees and companies" that the German government proposed (Scholz and Altmaier, 2020). It will bring massive tax cuts, the activation of Germany's short-term employment protection program (the *Kurzarbeit*), and €550bn in loans to the private sector. It is a "Bazooka" for the German economy, as Finance Minister Olaf Scholz put it.

A plan with this level of ambition could not be undertaken by many other Member States. With elevated debt levels and, in some cases, fast growth in contagion, some countries may fear that, were they to propose a plan of this size, they might face funding difficulties in their sovereign debt markets. It is clear then, that a European approach is needed to avoid the financial fragmentation that could, like in 2011, put the survival of the Euro and the EU at risk.

A key argument against any common fiscal policy is the risk of moral hazard —a European budget, it is argued, rewards the imprudent. In the current context, however, this argument does not apply. Given the shock is exogenous, it is ludicrous to imagine countries did not act hoping for a collective action.

What would it entail for Europe to achieve its level of ambition? I believe that €500bn distributed throughout the main priorities that the Commission has outlined:

- Help Member States undertake **the healthcare spending** they need. A 5% increase in EU-wide healthcare spending would cost around €50bn. This would secure an EU-wide medical response in areas such as purchasing medical supplies, recruiting medical personnel and retrofitting different venues to serve as temporary hospitals.

- **A financial backstop** for companies, particularly SMEs. Such a program would bring guarantees, credit lines, and working capital loans to ensure SMEs remain liquid and can return back to normal when the economy is "unfrozen". This would mean a program with the level of ambition of the German Bazooka. Relative to GDP, the German level of ambition would entail a €2.2tr program at the EU level. Assuming the level of leverage the EIB can achieve, this would require around €275bn in guarantees.

- **A European *Kurzarbeit* program.** A program to support employment protection facilities throughout Member States. The main objective of these facilities is to maintain firms' liquidity without their having to fire their workers. Instead of letting them go, under these schemes companies would be able to reduce the hours of their workers (by up to 100% if needed), and the state would compensate workers for (a significant part of) the lost wages and social contribution, under the condition that they all maintain their link to the company.

  Even though the package would be financed with public funds, if the program does not run for an extended period of time, it will end up saving money for the taxpayer, as it will maintain the link between workers and firms and avoid the risk of a deep recession.

  Given that explicit *Kurzarbeit* programs are already in place in 17 EU Member States (EC, 2020), in the rest it would have to finance other similar employment support programs. The general condition would be that the link between employee and the job is not cut, so that the contract remains in place.

Such a program could also serve as a stepping stone for establishing the European Unemployment Reinsurance Scheme, whose drafting the Commission has announced it will accelerate. For this mutualized package, and assuming EU governments would fund half of the cost of an 8% reduction in working hours of EU workers for 3 months, we estimate that the cost of this leg would hover around €175bn.

How to pay for the Bazooka

The three-pronged package would constitute a genuine coordinated fiscal response at the EU level, but it is clear Member States would have to raise substantial amounts of debt to finance it. With automatic stabilizers depleting national budgets and Member States making use of the flexibility provided for in the SGP, concerns about the sustainability of sovereign debt loom large.

After the plunge in the stock markets this past week, a market reaction to increased stress on public finances is likely, so innovative and European funding mechanisms are needed. At the same time, the difficulty is that, given the need for a prompt action, we cannot take the time to develop legislative proposals and ideas from scratch. We must work from what is already on the table. Against this backdrop, I see three ways forward: have the ECB step in, create a European Safe Asset, or integrate the ESM into the EU's legal framework.

Expand the role of the ECB to step in

Some have argued that Member States should borrow as much as they need, and that, in the event of any market reaction, bold action from the ECB would calm the markets. For them, the ECB would expand its sovereign bond purchasing program, and target its purchases to those countries most affected by the coronavirus. However, it is no surprise that the recently announced purchases will be targeted to the corporate debt market: the ECB's headroom for an expansion of sovereign bond purchases is unclear, and would face substantial legal and political challenges.

The ECB faces two self-imposed limits: its 33% position limit, whereby it cannot purchase more than a third of any given issuance, and its capital key guidance, whereby it must attempt to purchase sovereign bonds along the shares of its own capital contribution key. The position limit was raised from a previous 25% during the last crisis, but further increases would present serious legal challenges. If the ECB held, for example, 40% of Italy's debt, and Italy were to default, the ECB would be placed in a position where it would have to vote in favor or against the restructuring; this would expose the ECB to legal challenge since the measure could be interpreted as being contrary to Article 123 TFEU and against its obligation to abstain from monetary financing of Member States. Some have pointed to potential legal loopholes around this (Canepa, 2019), but the legal challenges would be unavoidable.

Alternatively, one could argue there is no need to increase the limit: the ECB today only holds about 22% of the total sovereign debt (Becker, 2019), and it could simply reach the limit for all sovereigns. However, given that countries have widely differing Debt to GDP ratios, reaching 33% on all sovereigns would entail a permanent deviation from the capital key —the ratio of sovereign purchases to capital contribution would be twice as high for Italy

than for Germany (Carrión Alvarez, 2020). Given deviations from the capital have been a major point of contention for northern Member States, the political challenges might be insurmountable.

Sovereign Bond Backed Securities

The establishment of Sovereign Bond Back Securities (SBBS), a new category of bonds, would enable Member States to increase their debt levels without causing market instability. SBBS are new kind of safe asset, issued by the private sector, that is backed by a diversified portfolio of Euro area government debt. Because pooling and diversification is only done at the private sector level, SBBS bring no additional fiscal costs and don't involve any kind of subsidies or mutualization of risks. Crucially, due to the tranching involved in the issuance, SSBS would be considered safe assets, and their prevalence in the market would bring the stability needed for additional public debt issuances to be feasible.

Initially proposed by a group of economists that I was a part of (Brunnermeier et al., 2011), it has been thoroughly studied and endorsed by the ECB and the European Systemic Risk Board (Cœuré, 2016; ESRB, 2018). Essentially, the regulation simply eliminates a few existing prudential obstacles that as of now prevent the market-led development of SBBS.

The key for our purposes is that today there is already a proposal on the table, approved by the European Parliament in 2019. It is just waiting in the Council's drawers. SBBS are a low hanging fruit that could be implemented fast and effectively, and that would help calm market concerns immediately.

Creating the European Monetary Fund

The Euro was built on two complementary but unequal pillars: a single monetary policy conducted by the ECB; and decentralized fiscal policies, left in the hands of the Member States, albeit constrained by common rules limiting their action. Such an asymmetric architecture had shortcomings, as proven by the sovereign debt crisis, contributing to build uncertainty about the permanence of the single currency, and giving way to redenomination risk. To tackle this, a fiscal lender of last resort was put in place in 2012: the ESM. Its purpose was stated in Article 3 of its Treaty: to "provide stability support (…) if indispensable to safeguard the financial stability of the euro area".

Yet, with the Coronavirus causing havoc, pressure could once again become unbearable for Member States, leading the ESM to step in. By involving the ESM, Member States would be granted access to €500bn under the best possible financing conditions. This would be done in full compliance with the ECJ's case-law as set in *Pringle*, as they would still be liable to repay the loans. A key drawback, however, is the lengthy approval process that ESM programs need to undergo as they require the involvement of national parliaments. Moreover, if COVID-19 causes more cases of quarantine/confinement for MPs, national parliaments may not be able to take decisions. To speed up the process it would be desirable to trigger the emergency procedure already in place under the ESM Treaty, which allows for decisions to be taken by a qualified majority of 85% of the votes cast.

The ESM's underlying logic derived from a context in which considerations regarding budgetary discipline and moral hazard were the norm (De Gregorio, 2012). This, however,

cannot be extrapolated to the present situation. That is why it is necessary to adapt its design and make it fit for purpose.

The Commission's 2017 proposal to integrate it into the EU legal order, by establishing the European Monetary Fund, could very well be the perfect occasion to make the necessary changes. Based on Article 352 TFEU and without requiring Treaty change, the creation of the European Monetary Fund should be swiftly approved in the European Parliament and Council. However, if integrating the ESM into our Union's legal order proves arduous, Member States should, contrary to what the Eurogroup decided on March 16th, reopen negotiations and amend the ESM Treaty accordingly. Last time around, its reform was reportedly blocked by Italy. Now, given the circumstances, this resistance could surely be overcome.

Such an endeavor would allow for an ambitious European response. To do so, a new instrument, tailored to take into account the present situation, should be added to the ESM's toolbox. Its required conditionality, legally essential to comply with the no-bailout clause in Article 125 TFEU (De Witte and Beukers, 2013), could be linked to investments in the key areas outlined above: our healthcare systems, short-time employment schemes, and liquidity and other support for SMEs. In addition, this would allow the ECB to get involved through its announced (but never implemented) Outright Monetary Transactions (OMT) program, if the situation continued to deteriorate. The ESM program would provide, following the *Gauweiler* ruling, the legal cover the ECB needs to be able to serve as its *de facto* backstop. By activating the OMT program, the ECB would thus purchase unlimited amounts of Member States' government bonds putting an end to the excessive risk premia asked for in the markets, thus preserving "the singleness of monetary policy".

These efforts must be implemented without delay. In the meantime, other more immediate measures are also on the table. By making targeted adjustments to the 2010 Regulation establishing the European Financial Stabilisation Mechanism (EFSM), revised in 2015, the Commission could mobilize this instrument's remaining lending capacity and focus it on fighting the Coronavirus. According to my estimates, this could amount to between €6bn and €14bn in additional funds.

Conclusion

To prevent the European economy from stalling we must strive to preserve the links that make it up. The disruptive impact of the fight against COVID-19 on jobs, debts and loans as well as on supply chains puts the entire economic fabric of European economies at risk. If we do not act as the situation requires, we may find that, when we want to go back to normal after the virus has passed, we will find it impossible to do so.

The situation is particularly risky for Eurozone countries which, faced with a massive growth in debt levels unbacked by a European fiscal capacity, could face a renewed flight to safety amid doubts about the sustainability of the Euro (redenomination risk). We must assuage market doubts about our determination to protect European economies and the Euro. The funding plans proposed here are based on legislative proposals that already exist but have not yet been developed. It is now time to finish implementing them.

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