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THE CURRENT EUROPEAN DEBATE ON FISCAL POLICY: Too much and too little[1]

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1. In the last two weeks the European Central Bank (ECB) decided to launch new LTRO and T-LTRO programs to ensure liquidity to the banking sector as well as to small- and medium-sized firms (March 12, 2020) and to temporarily strengthen its 'quantitative easing' policy (March 18, 2020), which is centered on the purchases of government bonds and of 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 of the European banking sector. Finally, the European Commission (EC) decided to suspend the European coordination mechanism of the national fiscal policies, that is, the Stability and Growth Pact (SGP).

This last step was considered 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 euro into the banking transmission mechanism by the end of June 2021; and the 'quantitative easing' will pump more than 1,000 billion euro into the economic system through the monetary transmission mechanism by the end of the current year. Moreover, members of the ECB's Governing Council acknowledged that it would be possible to indefinitely increase the purchases of government bonds and other financial assets, if Europe's economic situation deteriorated further. Hence, the ECB's current intervention looks like a quasi-monetization of the national government debts in the euro area, allowing each country of the European Economic and Monetary Union (EMU) to increase the public expenditures financed in the market. However, there are three substantial differences with respect to a full monetization of government bonds in the primary market. First, by limiting its intervention to the secondary market, the ECB respects the European Treaties (see also section 3, below). Second, in the current case of high deficit spending, the EMU countries are increasing their government debts for the corresponding amount of this spending. Third, a significant portion of these debts will be held in the ECB's balance sheet; therefore, even in the future, economic sustainability of the EMU countries with high public debt will be vulnerable to monetary policy decisions.

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Given 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 to households, and they cannot address the economic problems that will characterize 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 European Union (EU) member states to implement expansionary fiscal policies, thus fully exploiting the combination between money and public expenditures expansion. Unfortunately, this consideration 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 in its fiscal policy will risk 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. On the other hand, any constraint on the single countries' ability to fight the healthcare and economic impact of this pandemic is a threat to people in all countries, hindering the opportunity to utilize the current dramatic crisis to make progress in the European construction.

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

At the cost of oversimplifying the different solutions proposed in the debate until now, let me summarize 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 handle 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 first steps in the national economic recoveries once the pandemic peaks are overcome. The European issuers could be: the European Commission (EC), the European Stability Mechanism (ESM), and the European Investment Bank (EIB). Depending on the European institution ready to issue and to purchase the CVBs, the latter could apply to the member states either of the EU or of the EMU.[2]

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

[2] For the sake of simplicity, in the following I will just refer to the euro-area countries even if the various points analyzed also involve the EU countries that (still) do not belong to the euro area.

possible low interest rates,[3] for an amount equal to that of the CVBs issued. In principle, to utilize 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 stipulate a debt contract with each of these countries for a duration determined by that of the corresponding CVBs. In this way, the original issuer would not create a disequilibrium in 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 last statement, the EMU member states most vulnerable to the risk of unsustainability of their expansionary fiscal policies would get at least two benefits. The first is that a 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.[4] On the other hand, 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 the public investments 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: either to fall into a long stagnation or to face an unsustainable government debt.

3. The second position in the debate aims at overcoming this last crucial problem by keeping alive the CVB's scheme. There are several ways to do that.

The first possibility 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 of 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 3 and 4).

The proposed solution raises an obvious problem: it implies a monetization 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;

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

[4] 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 3 above).

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 it is well known, the monetization of government debts is incompatible with the European Treaties. 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 organization 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 raises 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 monetize 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 rude solution has a very low probability 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 pandemic peak, in the EMU the total demand would be around 500 billion euro under the optimistic assumption that the healthcare situation will dramatically improve by mid-May 2020. It is very unlikely that the European financial market 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.

4. 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 centralized financing of national expansionary fiscal policies due to the coronavirus impact, and how to avoid that this financing leads to increases in the public debt of the beneficiaries. This objective specifically matters for the EMU member states with a high stock of public debt on GDP. However, it is also in the interest of all the other EMU member states for at least two reasons: to weaken the spillover effects of insufficient measures to face the crisis, and to decrease the probability of a breakdown in the euro area. 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: the issuers of the CVBs, which in this case are plain bonds with a medium-term duration, decide to take the consequent debt upon themselves and to transfer portions of the related revenue to the EMU member states on a permanent basis. These transfers, which could be proportional to the specific intensity of the pandemic in the national territories of the various EMU countries, can 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. 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 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.

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 characterized by a deficit. In principle, the European Council and the Council of the European Union can authorize 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 compensating increases in the revenues of the following budgets. Hence, it is debatable that the European Commission can follow this initiative, unless we introduce additional own resources in the European budgets. This could be a promising tool to improve the progress in the EMU construction; 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 utilization of 410 billion euro to purchase CVBs.

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 pre-determined conditionality. The latter would be replaced by a "contractual arrangement" 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-capitalization by each of the EMU member states necessary. However, in the short run, this re-capitalization could be limited to the guarantees required by the possible issuances of CVBs beyond the threshold of 410 billion euro. The main re-capitalization required to fund the ESM's functioning in 'normal' times can be postponed to the end of the coronavirus pandemic.[5]

The specific contractual arrangement between the European Commission (and the ESM as the financial donor) and each of the EMU countries involved in a grant implies that the parties would have to agree on each fiscal policy initiative utilizing a portion of this grant. 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 impact. It is 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 an ESM financing. However, this financing would activate a debt contract and would require a full reimbursement at 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.

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