An incomplete union

The US fiscal response to the coronavirus crisis has, for now, been much more substantial than that of European countries. In part, this is because it has had to resort to extraordinary measures in order to fill the gaps of a welfare state that is less generous than those of Europe. The main reason, however, is the fact that the US Treasury enjoys the close collaboration of the Federal Reserve Bank (the Fed), which would even act as a lender of last resort if necessary. This support, in combination with the strength and size of the US economy, is fundamental in order for the Treasury's debt to be considered a totally safe asset, something that greatly facilitates the funding of the public deficit.

Europe lacks this great advantage. Without doubt, the European Central Bank (ECB) is playing a very important role in supporting member states through its public sector asset purchase programme and liquidity injections, but its response is not comparable to that of the Fed. Legal and political issues prevent it, as revealed by Germany's Constitutional Court ruling, which was as surprising as it was debatable. However, the underlying reason is that the euro area has 19 different treasuries, one for each member state, yet lacks a central treasury that represents them all. To mitigate the risk of a country making an inapprorpiate use of the lender of last resort and weakening the euro, Europe banned the ECB from directly financing any national government.

This restriction puts those European countries that have a weaker fiscal position at a disadvantage. They know that if they implement an aggressive fiscal policy, which is necessary to avoid a prolonged recession, the increase in the deficit and in public debt could generate doubts over the sustainability of their finances, driving up their risk premiums and, ultimately, unleashing a new sovereign debt crisis. If they try to avoid these risks then their response could be too timid, which would restrict their recovery and that of the euro area as a whole. It is no coincidence that Germany's fiscal response has been the most aggressive of all the euro area, and Italy's, the least. Moreover, in a context in which the framework for state aid has been relaxed, these discrepancies distort the single market.

A joint fiscal response at the European level is therefore needed. Creating a treasury like that of the US overnight is not politically feasible, but designing a fund that provides sufficient support for a strong recovery is absolutely essential, even if it is temporary.

To fund it, the EU could issue perpetual debt, as proposed by the Spanish government, or at least very long-term debt to make the most of the current low interest rate environment and reduce the risks of refinancing. Austria currently has a 100-year bond which pays a yield of 1% and the ESM pays less than 1% for debt issued for a 40-year term. With interest rates at this level, a one trillion-euro debt issue (representing more than 7% of the EU's GDP) would result in an annual cost of 10 billion euros in interest charges, less than 0.1% of the EU's GDP.

It will be important for the funds to be made available for use as soon as possible. Ideally, they would be deployed between this year and next, not in dribs and drabs over many years. In addition, they should come in the form of non-repayable transfers to member states or projects executed directly at the European level, not as loans that only add to member states' existing debt (debt issued directly by the EU is not assigned to member states individually).

There is a great deal at stake over the coming weeks as the EU decides how to proceed. It is not only a question of emerging from this crisis as soon as possible, but emerging together and with a stronger union.

Enric Fernández
Chief Economist
05 May 2020