Economic policies in the face of COVID-19: will the boundaries of the impossible be broken?

There are two major differences between the current crisis in the euro area and that of 2009-2012. Firstly, the coronavirus and the containment measures implemented by the countries of the euro area represent a much greater economic shock than the previous crisis. In 2009, the GDP of the euro area fell by 4.5% compared to 2008, whereas this year the fall may well be twice as deep. Secondly, the economic impact of the coronavirus is quite symmetrical and will affect all euro area economies to a similar degree. These two characteristics of the current crisis justify both risk-sharing mechanisms between countries and coordination between fiscal policy and monetary policy.

A differing response at the national level

The scale of this crisis has given rise to unprecedented national responses. National governments have adopted a wide variety of measures aimed at cushioning the impact of the crisis on firms and households. The most prominent measures include programmes of guarantees for bank loans and lines of credit through national development banks, temporary employment reduction measures (such as ERTEs in Spain or the *Kurzarbeitgeld* in Germany), deferrals of tax payments and, in some cases, direct payments to citizens and direct subsidies to companies. These measures will entail a significant increase in European countries' level of public debt. For this reason, the magnitude of the economic response thus far has been very different between countries depending on the strength of the public accounts. In Spain and Italy, for example, both the guarantee programmes and the direct expenditure have been much more timid than in Germany, which has announced unlimited guarantees for loans to SMEs, among other measures.

Without risk-sharing mechanisms between European countries, this discrepancy between the national responses constitutes a distortion of the single market and could lead to an asymmetric recovery and a deepening of the economic disparities in the euro area, which in turn could put the very existence of the monetary union at risk.

The severity of the situation requires a coordinated response on many levels

The recovery will be weaker and slower if there are no mechanisms that help it occur in a synchronised manner.[1] In the absence of synchronisation, the first countries to begin to recover will find themselves with a weak external demand, both within the euro area and worldwide. In addition, firms will continue to be stunted by disruptions in supply chains that are highly highly integrated at the European level. What is more, without a common response there could be financial and economic fragmentation between EU countries, while the differing responses at the national level could compromise the level playing field in the European single market. For instance, a company's survival or its conditions for accessing credit will depend not only on its creditworthiness and competitiveness, but also on the generosity of the support schemes available in the jurisdiction where it is established. The political effects of a prolonged economic divergence between countries after the crisis could also be harmful to the euro area, with the possibility of a rise in populism in the worst affected countries. In short, a synchronised recovery at the European level is not only a question of solidarity between countries but it is also in each country's own interest. In other words, all economies would benefit from coordination at the European level.

The current context also requires the coordination to go beyond synchronisation or a common response between states: it requires coordination between the public and private sectors, and between the various flanks of economic policy. On the one hand, if firms and households fund the decline in their income with excessive debt, then the burden of this new debt will curb the recovery in demand and prolong the difficulties. Hence a significant portion of the aid must be direct and not only in the form of debt. Furthermore, the fact that it is the public sector that is absorbing these costs ought to allow for a greater mobilisation of funds, at a lower cost and using debt with longer term maturities.[2] On the other hand, faced with the prospect of public debt increasing substantially during the course of the COVID-19 crisis, fiscal policy and monetary policy must also be coordinated in order to dispel any doubts about the sustainability of the debt, to lighten its burden and to ensure that it does not compromise the economy's future performance.[3]

1. According to ECB estimates, the close economic links in Europe mean that a 15% exogenous increase in the production of the main euro area economies is amplified, generating a 20% increase in the production of the euro area as a whole, even in the short term. Fabio Panetta, «Joint response to coronavirus crisis will benefit all EU countries», opinion article from Politico.eu.
2. Taking on longer-term debt facilitates the distribution of the costs across different generations - a necessary strategy for dealing with impacts of a great magnitude and with abundant historical precedents, particularly in relation to the financing of wars.
3. As the euro area already learned in the public debt crisis of 2010-2012, doubts over the sustainability of debt lead to a tightening of financial conditions, which exacerbates the weakness of the economy. On the other hand, the requirement for an excessively fast reduction in debt could lead to a sustained restrictive fiscal policy, which would make the recovery more difficult and restrict future economic performance (even compromising it).

A European fiscal response

On 25 March, nine European heads of state (of Belgium, France, Italy, Luxembourg, Spain, Portugal, Greece, Slovenia and Ireland) wrote a letter to the president of the European Council demanding a pooling of the European fiscal response, backed by shared debt. The European response so far has been very different. On 23 April, the Council adopted a series of measures that are not aimed at sharing the costs of combating the coronavirus crisis, but rather at sharing the cost of funding the national measures. In this regard, the Council approved the creation of a new line of credit under the European Stability Mechanism, a fund which would serve to provide loans to national governments in order to finance their various temporary workforce reduction measures (such as furlough schemes, or ERTEs in Spain), and a fund of guarantees so that the European Investment Bank can increase its lending to European companies. These measures are welcome, since they reduce euro area countries' funding costs. However, they are insufficient because they do not respond to the main problem: the fact that some countries cannot take all the necessary measures for fear of the increase in public debt they will entail.

This is why the European Recovery Fund, on which the European Council has still not been able to reach a consensus, is so crucial. In order for it to be effective, this fund will need to have two essential characteristics: it must be big enough (at least 10% of euro area GDP or a figure of a similar magnitude to the public deficit that most countries will reach this year) and it must incorporate an element of redistribution. The idea would be for this fund, supported by national guarantees, to be able to issue debt and then invest in the countries most affected by the crisis, thus ensuring a symmetrical recovery. Although some of these investments can be implemented in the form of loans to member states (long-term and at low rates), it will be important for a large portion to take the form of direct transfers. This will avoid an excessive rise in the debt of the recipient countries and prevent its sustainability from being called into question.

The creation of a fund with these characteristics would be a huge step forward for the euro area, and that is precisely why it is politically so difficult. The idea of direct transfers and shared European debt is met with fervent rejections in the bloc's richest countries. Furthermore, if such measures were adopted without taking their opinion into account, there would be a risk of a rise in anti-European populism in the countries of the north, as happened after the last crisis with the creation of parties like the AfD in Germany. Indeed, it seems somewhat politically infeasible to move towards a true fiscal union, with taxation powers for the euro area and a European ministry of finance with a significant budget, and with the possibility of issuing eurobonds. This would require a level of political union which, for now, is non-existent and for which there is no political consensus. But this crisis is demonstrating the need, at the very least, for an element of central fiscal stabilisation which facilitates the sharing of risks, like the Recovery Fund, and a European safe asset, as the debt issued by this Fund would be. This is not just a matter of solidarity; it is also in the self-interest of all the countries involved, as well as being a matter of stability for the monetary union. Moreover, the Recovery Fund could carry out investments that would help achieve progress towards the EU's objectives: the digitisation of the economy and green and social sustainability. In a world with high national debts, these objectives could be called into question.

If European fiscal policy fails to step up to the plate and establish a mechanism of this nature, monetary policy will have to take the reins. For now, through its asset purchase programmes, the ECB has been the European institution that has reacted the quickest and most decisively to this crisis. As shown in the table, the ECB's purchases of euro area countries' sovereign debt in 2020 are expected to be highly significant; in fact, they will be comparable to the increase in the deficit projected for this year. Nevertheless, assuming that these purchases are temporary, their

Purchases of public debt by the ECB in 2020 and the impact of the COVID-19 crisis

(% of 2019 nominal GDP, except where otherwise indicated)

	Estimated purchases	Purchases in an extreme scenario	Impact on real GDP in 2020 projected by the IMF (%)	Capital key (% relative to the capital of euro area countries)
Germany	5.7 (5.2–6.3)	7.8	–8.2	26.4
Austria	5.4 (5.0–6.0)	7.5	–8.7	2.9
Belgium	5.7 (5.3–6.3)	7.8	–8.2	3.6
Spain	7.1 (6.5–7.9)	9.7	–9.8	11.9
France	6.3 (5.8–6.9)	8.6	–8.4	20.4
Ireland	3.6 (3.3–4.0)	5.0	–10.3	1.7
Italy	7.0 (6.5–7.8)	9.7	–9.7	17.0
Netherlands	5.3 (4.9–5.9)	7.3	–9.1	5.9
Portugal	8.2 (7.5–9.1)	11.2	–9.6	2.3
Others	7.5 (6.9–8.3)	10.3	–9.6	7.8

Note: *The estimated purchases assume that 75% of the total purchases correspond to public debt (in line with the proportion registered in March 2020). In the extreme scenario, it is assumed that the APP and the PEPP allocate 82% (in line with the average registered since June 2016) and 100% of their purchases to public debt, respectively. In both estimates, it is assumed that 10% of the public debt purchases is allocated to debt of supranational agencies. The impact of the crisis on real GDP growth is calculated as the difference between the 2020 growth forecast per the WEO of October 2019 and per the WEO of April 2020.*
Source: *CaixaBank Research, based on internal estimates, data from the ECB and GDP forecasts from the IMF's World Economic Outlook of April 2020.*

function is once again to contain member states' financing costs, not to share the expense of combating this crisis. Of course, these purchases could be extended and the ECB could even hold the sovereign bonds on its balance sheet indefinitely, resulting in a *de facto* pooling and monetisation of the debt purchased.[4] In fact, some political leaders may prefer this option, which offers an «implicit» way of pooling the debt that would go more unnoticed by the electorate, rather than an explicit sharing of the debt through the issuing of eurobonds, which could prove more costly from an electoral point of view. But this would be a risky strategy, as there are legal limits to what the ECB can do and the possibility of the European Court of Justice declaring such action to be unconstitutional cannot be ruled out.

Coordination between fiscal and monetary policies: as necessary as the preservation of independence

Central bank independence is one of the cornerstones of the proper functioning of the economy. Episodes of European hyperinflation of the 20th century, as well as more recent cases like that of Venezuela, leave no room for doubt: when institutions are fragile and fiscal policy forces the central bank to monetise public deficits on a recurring basis, the sustained growth in the supply of money ends up causing runaway inflation and, ultimately, economic collapse.[5] However, we should not confuse independence with an absence of coordination between fiscal policy and monetary policy.

Rarely is it desirable for fiscal and monetary policy to act in opposite directions: when a central bank wants to combat a scenario of high inflation, it requires the tightening of monetary policy to be accompanied with a certain fiscal restraint (otherwise, the two policies would be counteracting each other). And vice versa: if fiscal policy becomes restrictive during a phase of cyclical weakness (for instance, by trying to contain the rise in public debt), in the end it is exerting a contractionary effect on the economy which counteracts the action of monetary policy.

It is therefore important that the coordination between fiscal and monetary policy is the result of decisions that are taken freely and independently and are guided by the respective mandates of the fiscal and monetary authorities. This is why it is key to have a strong institutional system which is capable of allowing monetary policy to provide coverage for fiscal policy when, as is currently the case, the severity of the economic recession requires a fiscal boost (with the consequent increase in public debt) and which, at the same time, protects the central bank from attacks on its independence when a tightening of monetary policy is required in order to avoid an excessive rise in inflation as activity returns to normal.

The central banks with greater independence lead the coordination

Under the protection of these strong institutions, the Bank of England has gone as far as opening a direct line of credit to finance the needs of the United Kingdom Treasury.[6] In principle, this is a temporary measure and the Treasury must repay the full amount of the credit granted by the end of the year. In general, the measures of the Fed, the ECB, the Bank of Japan and the Bank of England have stood out for incorporating a significant increase in purchases of public debt in their jurisdictions.[7] Such actions are aimed at anchoring a low interest rate environment and providing coverage for a fiscal expansion without the fear of this generating doubts about the sustainability of the debt.[8] Like any other investor, the central bank receives interest payments and, if the bonds reach maturity, repayment of the principal. In addition, when the economic environment improves, the central bank can sell these assets and return them to the market. In this regard, more than monetising debt, asset purchases conducted by the central bank serve to reassure investors and prevent a panic in the market which, by tightening financing conditions, would lead to their fears that the debt is unsustainable becoming self-fulfilled. In other words: they prevent the economy from falling into disarray as a result of the mere fear of it doing so.

ECB: beyond the limits?

Are these purchases sufficient to accommodate the fiscal expansion and the increase in public debt? For example, with the measures announced so far, the ECB will make net purchases of assets amounting to around 9% of the euro area's GDP: a quantity unprecedented in the history of the euro area. However, throughout April, when the ECB not only had announced the stimulus

4. Under the PSPP and PEPP asset purchase programmes, there is a pooling of the risk in 20% of the purchases. Specifically, 10% of the purchases of public debt are allocated to debt of supranational European institutions, while another 10% is implemented by the ECB directly. The remaining 80% of purchases are made by each country's central bank (of their own respective sovereign debt), which would also assume any potential losses themselves (as opposed to the Eurosystem as a whole).
5. The IMF estimates that Venezuela suffered an inflation rate of 65,374% and a budget deficit of 30% in 2018, while in 2019 its GDP would have shrunk by 35%. The supply of money, meanwhile, has grown by some 350,000,000% over the past five years, according to data from the Central Bank of Venezuela.
6. Specifically, it has increased the limit up to which the government can draw down on the «Ways and Means Facility» (the Treasury's current account with the central bank) by an undisclosed amount.
7. See the details in the Fed and ECB Observatories of 23 and 24 April at www.caixabankresearch.com.
8. A more explicit way to do this is through so-called yield curve control, which consists of announcing that the central bank will purchase whatever volume of public debt is required to keep sovereign rates anchored at a given target rate. The Bank of Japan has been implementing this strategy since 2016 in order to keep 10-year sovereign interest rates at 0%.

package but had also begun aggressively implementing it, the sovereign risk premiums of the euro area remained relatively high – an indication of the concern over the absence of greater joint action on the part of the European authorities. The reason for this concern is that the bulk of the fiscal stimulus still falls to national governments and the severity of the declines expected in economic activity require a substantial increase in the levels of public debt, which were already high to begin with. In fact, as shown in the table, the severity of the scenario is such that it has even dwarfed the purchases announced by the ECB: when the restrictions of the programmes in their current configuration are taken into account, we see that even in the best case scenario the ECB's capacity to absorb public debt of economies such as Italy or Spain will be limited to around 10% of their GDP. This figure would have seemed like more than enough at the beginning of the COVID-19 crisis, but it could prove insufficient if the declines in GDP end up being greater than currently anticipated and if the recovery is more gradual, such that the deficits are not reduced quickly after this exercise.

«Helicopter» money: a worryingly suitable option

As an alternative to asset purchases, a much more direct and profound form of coordination has been proposed: for the central banks to buy as much public debt as is needed to finance the fiscal stimulus to combat the COVID-19 crisis to perpetuity (i.e. its repayment is not required). This option, popularly known as «helicopter money» due to the fact that it effectively involves the central bank «giving away money» to citizens (money that can be distributed by the government), has some major attractions in the current situation, at least theoretically speaking.[9] Firstly, it would involve an injection of liquidity to firms and households that would be quick to deploy and could offset their drop in income. Secondly, it is a solution in which neither households, nor firms nor governments are left burdened by debt (and, therefore, the debt does not curb the recovery in demand). Finally, insofar as it is a temporary measure and it is only used in a critical emergency, it is possible that it will not result in unwanted spikes in inflation: the injection would occur at a time of a freeze in economic activity and, when the economy is reactivated, the central bank would retain its independence in order to adjust monetary policy as required to control inflation. However, even if this option were feasible, it should be borne in mind that governing a stimulus of this nature would be very difficult. The monetary financing of a fiscal stimulus would set a precedent and strong political pressure could emerge to gradually lower the bar for such interventions – if they are effective in these circumstances, why not for causes as worthy as the fight against extreme poverty? Such a response could also generate perverse incentives: the incentives to adopt a disciplined fiscal policy in order to build a protective buffer against the onslaught of the next recession (even when the cycle allows it) would be lost. Even with less aggressive coordination, such as public debt purchase programmes (in secondary markets) like those currently in force, the fiscal consequences of the monetary action could affect central banks' credibility, reputation and independence: the more public debt the central bank holds on its balance sheet, the greater the fiscal consequences of its decisions and, therefore, the greater the temptation to politically influence the course of monetary policy. Hence, before COVID-19 rocked the scenario, the strategies of central banks such as the Fed involved gradually reducing the size of their balance sheets in parallel with very gradual rate rises.

Coordination or tightrope walking

With all these ingredients, it is clear that the COVID-19 crisis puts economic policies at a true crossroads: the blow to the economy is so profound that they are required to act quickly, aggressively and in a coordinated manner. But is it possible to do so while also preserving the credibility of the central banks' independence? In Europe, greater ambition on the part of fiscal policy at the European level would help to relieve the pressure of having to adopt more extreme solutions. If the film is left with just one actor, the ECB, it will be navigating the biggest drop in GDP since the Great Depression while walking a tightrope.

Álvaro Leandro and Adrià Morron Salmeron

9. J. Galí (2020). *Helicopter money: the time is now*. Column from VoxEU.org.