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The merger of fiscal policy and monetary policy in the euro area

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Abstract

As an answer to the looming economic crisis amid the coronavirus pandemic, several governments in the euro area announced very substantial rescue packages. Moreover, on March 16 the European Commission announced to apply full flexibility provided for in the EU fiscal framework. All this will lead to strongly increasing public debt within the euro area. For a number of countries the debt will not be sustainable without ECB support.

Zusammenfassung

Als Antwort auf die durch die Coronavirus-Pandemie drohende Wirtschaftskrise haben mehrere Regierungen in der Eurozone sehr umfangreiche Rettungspakete angekündigt. Darüber hinaus kündigte die Europäische Kommission am 16. März an, die im EU-Finanzrahmen vorgesehene volle Flexibilität anzuwenden. All dies wird zu einer stark steigenden Staatsverschuldung innerhalb der Eurozone führen. Für eine Reihe von Ländern wird die Verschuldung ohne Unterstützung der EZB nicht tragbar sein.

Corona-driven fiscal expansion

So far, all major euro area member states have reacted with very decisive fiscal responses to the Coronavirus. **Table 1** shows a summary of the announced packages. Further measures can follow.

Table 1: National level fiscal responses to the coronavirus crisis

Euro area member state	Measures announced
Germany	Unlimited liquidity assistance for firms of any size; Expansion of loans of the German development bank (KfW) with overall guarantees of EUR 550 bn; tax payments deferral for companies
Spain	EUR 100 bn of state loan guarantees
France	EUR 45 bn rescue package; EUR 300 bn of guarantees of bank loans to businesses
Italy	EUR 25 bn rescue package for the health system, companies and workers

Source: Own elaborations Flossbach von Storch Research Institute

Among the main measures taken upon the "European coordinated response to counter the economic impact of the Coronavirus", the Commission decided that the member states are allowed to exploit the maximum flexibility and leeway in EU debt, deficit and state aid EU rules for companies. **Table 2** summarizes the main points.

However, due the strong rise of public debt across the euro area over the last decade, the fiscal space to widen government finances is very limited for several of the euro area member states. The most acute situation regards Italy: due to the corona crisis, the debt to GDP ratio in Italy could reach almost 150% in 2021.[1] The use of flexibility of the EU rules postpones but it does not cancel the need of the fiscal adjustment. Consequently, doubts over the survival of the euro might soon rise, calling the ECB to assume its role as a lender of last resort.

ECB options

To this end, the ECB could use two options:

1) Activation of Outright Monetary Transactions (OMT)
2) Adjustment of the rules of the asset purchase program.

[1] For details regarding this scenario, see: https://www.flossbachvonstorch-researchinstitute.com/en/studies/corona-crisis-italys-government-finances-under-pressure/.

Table 2: Summary of the Commission's response to the coronavirus crisis

EU rules	Main points
State aid	Member states can design ample support measures in line with existing EU rules, in particular: - Member states can decide to take measures, such as wage subsidies, suspension of payments of corporate and value added taxes or social contributions - Member states can grant financial support directly to consumers, for example for cancelled services or tickets that are not reimbursed by the operators concerned - Member States can help companies cope with liquidity shortages and needing urgent rescue aid - The Commission can approve additional national support measures to remedy a serious disturbance to the economy of a member state
EU fiscal framework	- The Commission qualifies the COVID-19 pandemic as an "unusual events outside the control of government", allowing exceptional spending on, for instance, health care and targeted relief measures for firms and workers. - The Commission considers proposing to the Council to activate the general escape clause to 1) accommodate a more general fiscal policy support and 2) suspend the fiscal adjustment recommended by the Council upon a severe economic downturn in the euro area or the EU as a whole.

Source: Own elaborations Flossbach von Storch Research Institute based on the press release of the European Commission from March 13, 2020 "COVID-19: Commission sets out European coordinated response to counter the economic impact of the Coronavirus".

Option 1: OMT

The ECB can eventually activate the so-called Outright Monetary Transactions (OMT) program.

The program is subject to conditionality in terms of strict and effective fiscal conditions. In particular, a pre-condition for OMT is the attachment to an appropriate ESM program, being either a macroeconomic adjustment program or a precautionary program.[2] This would require the governments to sign up to a reform program likely to include austerity measures. The aim here is to reduce the moral hazard problem.

[2] Loans under macroeconomic adjustment aims to assist ESM members in significant need of financing, facing liquidity problems. Loans are conditional upon the implementation of macroeconomic reform programs, as set by the European Commission. Precautionary credit line is aimed at supporting sound policies and prevent crisis situations in ESM members with sound economic conditions. Further information on the ESM programs are available at: https://www.esm.europa.eu/assistance/lending-toolkit.

Although the conditionality has been defined as strict, there are no a priori strict numerical rules for conditionality. It could be set to a vague minimum, requiring the country to wind down crisis-related debt once it is over.

However, the activation of OMT could take time. In order to speed up the process, the ECB could use the second option.

Option 2: Adjustment of the APP

The ECB could interpret the existing rules under the asset purchase program very flexibly. The current asset purchases by the ECB are subject to two main criteria[3] 1) the capital key, which reflects the respective country's share in the total population and GDP of the EU 2) and the issuer limit of 33 percent on ECB holdings of debt of a particular country.[4] The ECB could defer adherence to these rules to a future date and buy assets with a view to reducing market pressures.

[3] There are also other eligibility criteria, like the 1 to 30-year maturity restriction, meaning that securities have to have a minimum remaining maturity of 1 year and a maximum remaining maturity of less than 31 years at the time of purchase.

[4] For the currently applied capital keys, see https://www.ecb.europa.eu/ecb/orga/capital/html/index.en.html. Regarding the 33 percent issuer limit, this is applied to safeguard the operating of market forces and to prevent that the ECB would become a dominant creditor of euro area governments. The 33 percent limit is applied to the universe of eligible assets in the 1 to 30-year range of residual maturity.

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