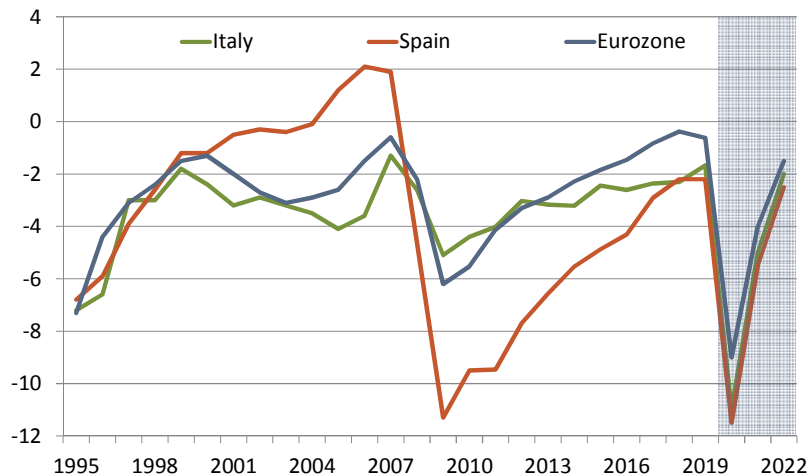


20 March 2020

The case for corona bonds

Coping with the fallout to come: fiscal balance in % of GDP



General government balance in % of GDP, adjusted for one-offs such as bank support
Source: Eurostat, Berenberg projections for 2020-2022

- The worst economic shock in decades:** Europe has turned into the epicentre of the [coronavirus pandemic](#). Case numbers are surging across the continent and some fiscally challenged countries, such as Italy and Spain, are being badly hit. With 3,405 deaths as of yesterday, Italy has already paid a higher toll than China. While lockdowns cripple the economy, expenditures to support the health system, ease a dangerous liquidity crunch and contain the risk of mass unemployment are surging. All European countries will need to finance huge budget deficits in a year when GDP might even fall by 5% or more. In Italy, Spain and a few other countries, the deficits may exceed 10% of GDP.
- The economic logic for corona bonds:** More than ever before, Eurozone members must be able to borrow at tolerable terms in such an emergency. For countries with yields close to zero, this is no issue. For Italy, Spain, Greece and a few others, it is. ECB asset purchases, now scaled up to a total volume of at least €1.1trn for 2020, are too blunt an instrument to limit peripheral yields in the most efficient manner. Despite all the ECB's flexibility, it will roughly adhere to the "capital key" distribution of purchases over time. To buy additional Italian paper, as the ECB should, it must, in the end, acquire even more German paper, as it need not. Issuing joint Eurozone bonds and channelling the funds as credits to members in dire need would serve the purpose even more effectively.
- The political logic should be overwhelming:** If there ever was a time for solidarity in Europe, it is now. Whether or not Europeans help each other in this acute emergency can shape popular perceptions of what Europe stands for – and for a long time to come. Well-handled solidarity in an emergency that affects the entire continent can debunk the narrow "my country first" narrative. A lack of solidarity may risk a dangerous anti-EU backlash instead.
- A corona bond proposal:** To deal with a unique but temporary emergency, the Eurozone/EU should establish a special-purpose fund with a lending capacity of up to €500bn. The fund would issue corona bonds this year, and this year only. The one-off special purpose nature should help to circumvent the stale Eurobond/moral hazard debate. The fund should be structured like and administered by the European Stability Mechanism (ESM) with its well-qualified staff, without formally being part of the ESM. Participating countries could draw credits from the "Pandemic Emergency Facility" of up to three times of what their share in the €500bn would be according to a "capital key" rule. For such lending to members, the fund should charge a premium of, say, 5bp per year of duration. For example, Italy would thus have to pay 35bp or 50bp above ESM funding costs for loans from the fund with a seven- or 10-year maturity, respectively. Only countries with higher borrowing costs than that would access the money.
- Can it be done?** The political hurdles remain high. But in "[whatever it takes](#)" times, taboos can be broken. Expect a decision to generously help member states one way or the other within days. At the moment, an invitation to members to use the ESM's precautionary and/or enhanced credit lines for a total of up to €410bn seems more likely than outright corona bonds, despite the stigma risk attached to ESM credit lines. Of course, ESM credit lines, or a new way to draw on current ESM capacities under a facility with a new name, would be very helpful. They could be backed up with a commitment to increase the ESM capital base and, if need be, by the ECB's Outright Monetary Transactions bazooka. But it would be better, in my view, to keep such ESM facilities in reserve and go for outright corona bonds now to show solidarity within Europe and highlight the exceptional nature of the emergency.

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