

Is this the time for a (euro) Coronabond?

The political will to pool risk across the eurozone with a common Coronabond is not there, yet. As a result, debt mutualisation will continue through the backdoor



Credit, where credit is due

In the current crisis, almost all European governments have reacted much faster and more aggressively than they did during the financial crisis. Whether it has been the measures to limit the outbreak of the virus or the measures to limit the adverse effects on the economy, the policy response has been unprecedented. The fiscal rules of the Stability and Growth Pact will be suspended and almost all governments are providing guarantees and liquidity, labour market support and outright fiscal stimulus.

The eurozone's ability to tackle the crisis is – to some extent – determined by the public finances of each country

Governments were quick to act even as the European Central Bank was prevaricating, with President Christine Lagarde initially arguing that it was not the ECB's responsibility to narrow spreads between government bond yields. But while individual countries

have followed similar patterns, they have not really coordinated their efforts. Looking ahead, the lack of a pan-eurozone fiscal reaction increases the risk that the euro debt crisis will return, once the dust from the current crisis has settled.

The main problem is that the eurozone's ability to tackle the crisis is – to some extent – determined by the public finances of each country. Right now, there is undoubtedly a strong political will to allow for higher deficits and debt. But the risk is that this disappears once the crisis is over. Fiscal rules will be re-established, forcing highly indebted countries to put in place austerity, further feeding populism and anti-European sentiment.

At the same time, doubts about debt sustainability will resurface, leading to a widening of spreads. Eventually, this could lead to a return of the euro crisis.

Coronabonds, Covid-19 perpetuals, ESM credit line?

The economic discussion is often mixed with a political discussion about (the lack of) European solidarity. We don't want to go down that route and rather stick to the economics. When looking at the options for how to avoid a new crisis on the back of the current fiscal measures, a distinction between liquidity and solvency problems needs to be made, that is, if liquidity problems can eventually become solvency problems and vice versa. However, this distinction is essential in the current debate, with several options being discussed:

- **Coronabonds**

The ultimate option would be to introduce a Covid-19 perpetual Eurobond or a Coronabond. This would be a one-off Eurobond, exclusively linked to financing the fiscal policies to tackle the current crisis. It would be a common bond, which brings back the old controversy about the advantages and disadvantages of debt mutualisation. To keep it short here, we will skip a repetition of these arguments. As setting up a structure to issue common bonds would take a lot of time, a potential shortcut could be to introduce this via the European Stability Mechanism. The ESM would actually issue this Coronabond and hand over the proceeds to the member states. Another advantage is that it would probably be easier for the ECB to increase the issuer limit for a supranational entity (like the ESM) than for individual member states, which would imply that the ECB could fund this bond for the large part, if not entirely. However, barring such implicit monetisation by the ECB, a Coronabond would not necessarily improve debt sustainability, it would only make any future debt forgiveness easier as it distinguishes between Covid-19 related debt and legacy debt.

- **Covid-19 perpetuals**

A national solution which eventually could be turned into a European solution. Eurozone countries could agree to issue perpetual bonds up to a certain percentage of GDP. A Covid-19 perpetual bond. Currently, the average fiscal stimulus in eurozone countries is around 2% of GDP. The ECB could then buy these bonds to a certain extent, without risk-sharing; this means that the credit risk lies at the level of the national banks, also implying that the largest chunk of the interest income remains within the national bank of every member state. Hence, financing costs would ultimately be low. Issuing national perpetuals in a coordinated manner could be one pragmatic step away from Eurobonds, actually implying some form of monetary financing.

- **ESM credit line**

A so-called enhanced conditions credit line (ECCL) from the ESM's precautionary credit line

toolkit could be another way to tackle financing problems. Such a credit line does not require a debt sustainability analysis beforehand and would give countries access to a credit line of up to 2% of GDP. It could be crafted to only finance Covid-19 related expenditures. However, the disadvantages of an ECCL are short maturities, stigma and the inter-governmental structure of the ESM, which could complicate decision-making. Also, an ECCL would be a country-by-country solution to a common shock, adding to possible divergence across the eurozone, unless all eurozone countries decide at the same time to collectively apply for an ECCL. It would be the preferred solution of the countries opposing the common bond or some form of debt mutualisation.

No debt sustainability without debt monetisation or writedowns

To be clear, without central bank buying, all three options mainly tackle possible liquidity problems and would keep funding costs low. However, none of the options would reduce the debt burden itself, nor the deficit. Therefore, some kind of debt monetisation, such as permanent refinancing of the bond (which in the case of a perpetual means keeping it on the balance sheet forever) or eventually debt write-downs would have to take place.

Some kind of debt monetisation... would have to take place

The suspension of the fiscal rules, European Investment Bank funding and the ECB's Pandemic Emergency Purchase Programme, as well as the ESM and the ECB's Outright Monetary Transactions, are the best firefighting brigade that the current eurozone set-up has to offer in order to address the speculation about a new euro crisis.

The political willingness to take the next step of debt mutualisation is not there, yet. As a consequence, debt mutualisation through the backdoor will continue and the ECB's 'low for longer' will eventually become a 'low forever', as well as perpetual refinancing of the ECB's sovereign bond holdings.

In fact, it will eventually be a trade-off between debt mutualisation and 'low-interest rates and QE forever'.

Authors

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de**Peter Vanden Houte**

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.