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Coronavirus: Why The EU Needs to Unleash The ECB

COVID-19 presents the eurozone with an unprecedented economic challenge. So far, the response has been necessary, but not enough.

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The measures taken to limit the spread of the coronavirus - in particular social distancing - come with significant economic costs, as the drop both in demand for goods and services and in supply due to workers being at home sick will create a short-term economic shock not seen in modern times.

Sectors that are usually less affected by regular economic swings such as transport and tourism are being confronted with an almost total collapse in demand. In the airline sector, companies are warning they might only be able to hold out for a few months more.

Building on the calls to provide income support to all citizens and shore up businesses, European leaders should now be giving explicit permission to the European Central Bank (ECB) to provide whatever financial support is needed.

Although political leaders have responded to the economic threat, the measures announced across the continent have mainly been to support businesses. The crisis is broader and deeper than the current response.

Support for weaker governments

The ECB already reacted to COVID-19 by announcing measures to support the banking system, which is important to guarantee the continuity of the European financial system and to ensure financially weaker European governments do not have to confront a failing banking system as well.

Although government-subsidised reduced working hours and sick pay are a solution for many businesses and workers, crucially they are not for those working on temporary contracts or the self-employed. They need direct income support.

This might come down to instituting something that looks like a universal basic income (UBI), and ensuring money keeps flowing through the economy as much as possible to help avoid a cascade of defaults and significant long-term damage.

But while this is likely to be the most effective remedy to limit the medium-term impact on the economy, it is particularly costly. Just as an indication, total compensation of employees was on average around €470bn per month in the eurozone last year.

Attempting to target payments using existing welfare payment channels would reduce costs, but is difficult to implement and runs the risk of many households and businesses in need missing out.

The increase in spending and lost revenue associated with these support measures dwarf the fiscal response to the 2008-09 financial crisis. The eurozone economy could contract by close to 10% this year and budget deficits are likely be in double digits throughout the bloc.

The European Commission has already stated member states are free to spend whatever is necessary to combat the crisis, which is not surprising given the Stability and Growth Pact - which includes the fiscal rules - allows for such eventualities.

Several eurozone countries do probably have the fiscal space to deal with this. Countries such as Germany and the Netherlands have run several years of balanced budgets recently and significantly decreased their debt levels. For countries such as Italy, and even France, it is a different story and the combination of much higher spending and a collapse in tax revenue is more likely to lead to questions in the market over the sustainability of their debt levels. In order to avoid this, the Covid-19 response must be financed collectively.

The Eurogroup could decide to use the European Stability Mechanism (ESM) to provide states with the funds, while suitably ditching the political conditionality that came with previous bailout. But the ESM currently has €410bn in remaining lending capacity, which is unlikely to be enough and difficult to rapidly increase.

So this leaves the ECB to pick up the tab of national governments' increase in spending, as the only institution with effectively unlimited monetary firepower. But a collective EU response is complicated by the common currency, and particularly by the role of the ECB.

The ECB can't just do whatever it likes and is limited more than other major central banks in its room for manoeuvre. It does have a programme to buy government bonds but this relies on countries agreeing to a rescue programme within the context of the ESM, with all the resulting political difficulties.

There are two main ways that the ECB could finance the response to the crisis. First, it could buy up more or all bonds issued by the member states. A first step in this direction would be to scrap the limits on the bonds it can buy. Through self-imposed rules, the ECB can only buy up to a third of every country's outstanding public debt. There are good reasons for this in normal times, but these are not normal times. With the political blessing of the European Council, the Eurosystem of central banks could then start buying bonds issued by governments to finance whatever expenditure they deem necessary to combat the crisis.

Secondly, essentially give governments an overdraft with the ECB or the national central banks. Although a central bank lending directly to governments is outlawed by the European treaties, the COVID-19 crisis means these rules should be temporarily suspended by the European Council.

Back in 2012, the then president of the ECB, Mario Draghi, proclaimed the ECB would do whatever it takes, within its mandate, to save the euro, which was widely seen as a crucial step towards solving the eurozone crisis. The time is now right for eurozone political leaders to explicitly tell the ECB that together they can do whatever it takes to save the eurozone economy through direct support for businesses and households.