Why do we talk about Eurobonds? Or: The Big Division in the Euro Area

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The corona virus health crisis sent many countries of the world in a lock down to protect their elderly and vulnerable from severe illness and death. With the pandemic epicentre reaching Europe in March 2020, also the European Union (EU) Member States (MS) shut down – but while most of them are unified in their crisis response and seem to agree on the correctness of their measures, the lock downs' economic side effects would soon divide policy makers across the EU and, specifically, across the euro area. Only one word, one compound word, was powerful enough to restart a decades old discussion and trigger strong emotions usually unknown to finance – *the Eurobond*. How did we get there? Stay tuned during this short summary of corona macroeconomics with a political twist!

Already in early March 2020, the corona lock-down side effects had turned into an economic shock of such size that it made the EU (and most of the rest of the world) expect the next big economic crash since the global financial crisis (e.g. Foronaro & Wolf, 2020). But now, "this time is different" (Bénassy-Quéré et al., 2020a; Schmidt, 2020) note several scholars, which becomes inevitably clear when listening to war phrases used by leading politicians in public addresses (e.g. Macron, 2020). Thus, in the course of March, economics and politics agreed that this crisis, unlike the previous one, would lie with the real economy, (equally) affecting supply and demand, production and services, capital and labour, rich and poor, etc. And most importantly, both sides understood that this crisis would, unlike the previous one, come along with such severe losses, that monetary policy alone couldn't fix it.

Hence, the EU MS not only accepted the (upcoming) crisis' seriousness and severity, but endorsed that is had to be met with bolder answers than last time: One after the other, they presented national fiscal rescue and support measures going far beyond the stimulus of the last crisis' short Keynesian renaissance (eventually overrun by austerity). Baldwin (2020) even argues of these measures as shields, which shall not simply stimulate the economy in Keynesian fashion, but are put in place to protect economy and citizens against the crisis[1]. On top of this, the European Central Bank (ECB) – after initial reluctance – announced additional measures to ensure banking liquidity and a little later started the Pandemic Emergency Purchase Programme (PEPP). PEPP adds another €750bn to the ECB's existing private and public asset purchasing programmes in order to calm economies and markets (ECB, 2020a). Thus, one may argue that a bold answer of fiscal and monetary instruments is already on its way – based on an emerging consensus that only together, fiscal and monetary policy can help through this crisis. At least, this is how one could understand the actions taken in March.

At second sight, however, things look a little different, making underlying constraints become apparent: First of all, a closer look to the national fiscal rescue measures reveals their tremendous differences in size and longevity,

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[1] [1] These shields were effectively approved by the European Commission which set the EU level fiscal rules on hold (as of Council Regulation No 1177/2011, Art. 2; Council Regulation No 1175/2011, Art.5,9) to allow the MS greater fiscal maneuver (EC, 2020).

for example Germany proposing a €156bn budget extension (ca. 4.45% of gross domestic product (GDP)) and another €500bn emergency fund, versus Italy with measures amounting to €25bn (ca. 1.4% of GDP) in total (FT, 2020a). This indicates the differences in national fiscal room, which are *inter-alia* based on state's revenues – i.e. taxes, which in times of crisis are usually not raised but reduced. Second, it remains a fact, that despite any potential consensus, some euro MS cannot borrow as easily and to the same conditions as others on sovereign bond markets (Bénassy-Quéré et al., 2020b). Their borrowing ability depends on investors' trust in the countries' economies and repayment ability – which again is reflected in their debt to GDP ratios. If these ratios are perceived as unsustainably high, trust and investment switch to safer investments. Hence, a country's fiscal room not only depends on revenues but also on its ability to borrow from financial markets which is smaller for some MS than others. Ultimately, less fiscal room means less speed and volume of fiscal crisis-handling capabilities. Hence, some euro MS face a fiscal constraint, which may hinder them to live up to the bold answer expectations (by other MS and their own citizens). At this point, the introduction of a common bond, the Eurobond, which the euro MS are (at least to some extent) together liable for, could remedy the cross-national inequalities or differences. To this end, such talks, however, had not yet started.

Instead, the constraints revealed to be a greater danger to the whole currency union than described above: This became visible when the ECB's president Christine Lagarde announced the ECB's crisis measures and contributions but did not come along with a corona version of 'whatever it takes'. Instead she mentioned that it was not the central bank's mission to "close spreads" (ECB, 2020b; i.e. the top up for debtors to pay over the risk-free interest rate) between government bonds. This led to an immediate widening of the Italian ten-year sovereign bond spreads, which would only begin to sink again with the announcement of PEPP and an assurance of unlimited extraordinary measures (Arnold, 2020). But despite the ECB's reassurance to stand behind its MS as lender of last resort, this event made the vulnerability of the Italian state and economy visible beyond sovereign bond investors. The scenario of Italy and potentially Spain, the countries *inter-alia* hit hardest by the virus in medical regards, losing access to sovereign bond markets and potentially default, became widely discussed (Chazan, Fleming & Johnson, 2020; FT, 2020b; Münchau, 2020). In this light, academics eventually started prophesizing that the corona crisis could bring more damage to the currency (union) than the almost Greek-default and euro crisis in 2010 had done (Toouze & Schularick, 2020; Schmidt, 2020; Elliot, 2020; Scazzieri, 2020; Bénassy- Quére et al., 2020a). The outlook to a second sovereign bond crisis makes the corona crisis side effects, as Bénassy-Quéré et al. put it, "not only an economic crash, but also a test of European unity" (2020a).

Whether the euro area will pass this test can only be answered in retro-perspective. Whether the euro area has the capabilities to pass this test, however, is currently under discussion. A big part of this discussion includes what is often described as the euro area's birth defect (e.g. Jabko, 2015; de Grauwe, 1992 & 2006) – the lack of a common fiscal capacity. Such can have several forms but as of the Optimum Currency Area theory (Mundell, 1961), ideally involves a system allowing for fiscal transfers across the currency union (for example, based on a union wide collected tax). Accordingly, Codogno and van den Noord frame the corona crisis as opportunity "to fix[..] some of the vulnerabilities of the euro area policy framework" (2020). And here Eurobonds and the big division come into play: Given that the opposition against a fiscal union roots deep in some MS (Blyth & Matthjis, 2017; Jones, 2014), which still have difficulties digesting how the last euro crisis scratched on the 'holy' no-bailout clause (Art. 125 TFEU; see Boger, 2016 on Gauweiler and others versus Deutscher Bundestag), the appetite to address this lack (of a fully-fledged fiscal union) among policy makers seems limited. Instead, politics found a way around this: at the end of March, nine out of the 19 Euro MS publicly asked for a common debt instrument to share the crisis' burden (Wilmés et al., 2020). Or, as some more than 400 academics from in- and outside the EU had called it just a few days before, they asked for commonly issued Eurobonds (Regan et al., 2020**).** Such would, depending on design and operationality, mirror a fiscal transfer union to the extent that the economically stronger MS, which currently enjoy rates around zero or even negative ones on their bonds, would offset weaker MS' rates and thereby themselves pay more than they do now. On top of this remain questions of moral hazard and constitutionality in the EU and MS. Goldmann (2020) therefore distinguishes between Eurobonds to directly finance national budgets and Coronabonds – a form of common bond with common (i.e. joint and several) liability, issued by a (new or existing) European institution but constituted by an intergovernmental treaty and used as a common budget to finance common projects, e.g. health investments. The latter would resolve problems with the no bail out article 125 (TFEU) and prevent moral hazard while providing the necessary fiscal answers (on top of national efforts) without endangering sovereign default.

So why has this not happened yet? Four remaining euro MS have built a coalition of opposition – and with Germany, Austria, Finland and the Netherlands as members, this coalition includes some of the financially and economically strongest euro MS. While all of them agree that these times demand common measures, they favour the European Stability Mechanism (ESM) as solution. The ESM had already in the last crisis proven its functioning by lending money to troubled countries against strict conditionalities. And although the coalition may be right that the ESM is well-suited to bring the euro area through another crisis, it may not be enough to pass the test of European unity – this is, at least, what Italy's public rejection of the ESM corona credit line indicates (Duff, 2020). Despite the compromise the Eurogroup found on ESM loans' conditionalities – i.e. loans do no come with strict austerity measures but a limited use to finance health related costs only (Council, 2020) – Italy's Prime Minister is likely to cancel the deal during the next European Council meeting on 23rd of April (Seisselberg, 2020). This rejection roots in bad memories of the euro crisis, the fear of adding more debt to its existing pile, and an oath the five-star party, which is part of the Italian governing coalition, gave to never use the ESM, or more precisely, its conditionalities, for Italy (ibid). Hence, the Eurogroup's grid lock does not seem to be resolved any time soon. Instead, the concept of European unity and solidarity becomes an ever-stronger synonym for euro- or coronabonds, facilitated by the media presenting Italy as the suffering but proud southern country that the richer countries deny solidarity. Unfortunately, this debacle does not seem to allow neutral discussion anymore – but puts ever more pressures on the contra coalition. It seems that from here, the coalition is only allowed two ways forward: either it agrees to the common bonds or will always be held responsible for failing the test of unity and every of the following consequences. Either way, the contra coalition can only loose – to their own public and right-wing parties (which usually oppose European communitarisation of any kind and will use it to gain power) or to the rest of the euro area and their right-wing parties (which also oppose communitariasation but will use the failure as another reason arguing for Italexit, Spanexit, and the like; also see Münchau, 2020). To this end, the prospects are quite negative. Even the introduction of a coronabond, which the last Eurogroup's compromise promising a common recovery fund and to discuss "innovative financial instruments" (Council, 2020) does not reject at all – may bring only temporary relief. Eventually the introduction of coronabonds could deepen the euro area's divisions ever more if this decision does not come from heart but pressure. Hence, in the end – even if it will not involve a second sovereign bond crisis – the euro area may break on the corona crisis and the question of Eurobonds.

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