Sprængfarlig cocktail for EU-samarbejde

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Document Version
Forlagets udgivne version

Published in:
Børsen

Publication date:
2020

Citation for published version (APA):
Hougaard Jensen, S. E. (2020). Sprængfarlig cocktail for EU-samarbejde. *Børsen*, 4.
https://borsen.dk/nyheder/opinion/spraengfarlig-cocktail-for-eu-samarbejde

Salus publica suprema lex esto

by

Svend E. Hougaard Jensen

Until now, the coronavirus pandemic has attacked the global economy on two fronts; supply and demand. This has led to a dramatic drop in economic activity. The next casualty will be considerable losses in the banking sector. So, very soon, we'll be fighting on three fronts: A health crisis, an economic crisis and a financial crisis.

Despite the virus being global, both the direct health crisis and the secondary economic crisis are being met with initiatives at a national level - in the health area with lockdowns, social distancing and improved hygiene. To counter the subsequent financial knock-on, most countries are therefore allowing cash to flow from public coffers to avoid mass lay-offs.

The initial national handling of the pandemic has been appropriate and necessary, but not sufficient. The effect of the corona virus hasn't been equally distributed across individual countries and individual countries' preconditions for handling its effects are very different. That's why there's also a need for an international component in the battle against corona.

From a European perspective, the situation is further complicated by the fact that those countries who are hit harder – Italy and Spain, in particular – are also those countries with the weakest fiscal capacity to withstand the attack. With the corona crisis, the already well-known imbalance between North and South in the EU has become increasingly apparent.

The coinciding occurrences of a major health crisis and a weak economy in South Europe – and the opposite in North Europe – is a poisonous combination, with the potential to create a time-bomb for European integration. Recent opinion polls indicate waning support of the EU in the otherwise EU-friendly Italy. This political rebound can lead to an existential crisis, not only in the Eurozone, but for the future of the EU itself.

How do you avoid this going so far? As a starting point, we need to distinguish between normal and abnormal times. It's tempting to resort to the famous words of Cicero, *"Salus publica suprema lex esto"*, "The health of the public should be the supreme law". Indeed, this motto could serve as guidance for the conduct of monetary policy by the European Central Bank (ECB) in these abnormal times.

To better understand the role of monetary policy in a time of corona, a distinction should be drawn between *liquidity* and *solvency*. As to liquidity, ECB can intervene via the purchasing of financial assets in the secondary market. An example hereof is the latest ECB programme, *Pandemic Emergency Purchase Programme* (PEPP), which commits ECB to carry out open market operations for 750 billion euros before the end of 2020. While originally being very controversial, ECB operations in the secondary market is nowadays regarded as an activity within the framework of legality.

As to solvency, or concerns about the sustainability of public debt, there are a lot of good things to be said about PEPP, but it is not directly aimed at countries' solvency issues. This can be addressed in two different ways:

The first option is to issue so-called 'corona bonds', i.e. bonds with joint and multiple liability between members of the Eurozone. The main objection to joint liability is the moral hazard risk. The point is that common corona bond issue contains an implicit insurance for the participating countries.

With collective responsibility for the joint debt issue, some of the weaker countries with large budget deficits and high public debt may rely on this implicit insurance, and there is a risk that such countries will have weaker incentives to tighten up, because they can now share the burden with others and even issue debt at a lower interest rate.

In normal times, this objection would be entirely legitimate. The question is whether it also applies in an abnormal situation, such as the current corona crisis. Indeed, a dramatically increasing budget deficit would hardly reflect a greater appetite for incurring debts but would rather be seen as an outcome of a ‘biological phenomenon’, which suspends standard economic and financial principles.

Applying the term ‘corona bonds’ – rather than euro bonds – may be a good choice, as it indicates a time limit, i.e. the option is closed when times return to normal. Put differently, it can be considered a short-term instrument of macroeconomic stabilisation, rather than a medium-to-long term instrument of structural intervention or reform.

The other option is that ECB gets involved in actual monetary financing of the deficits caused by the corona crisis. Monetary financing is the buying up of government bonds in the primary market, which, according to the EUF treaty, is illegal. But as we are in a situation of ‘monetary necessity’ there is a need for thinking out of the box.

LSE professor, Paul De Grauwe, has suggested a model in which the Italian government, for example, issues bonds at zero-rate, which are first bought by national banks, who will then sell them to the ECB a few days later. This operation would make it a formally legal intervention in the secondary market… But perhaps it’s a little bit too creative.

By the way, don’t panic about whether monetary financing causes inflation. Right now, the pressure on prices is only going one way – down – and most likely will do for quite a while. This means that monetary financing contributes to avoiding deflation. But of course, once we are back to normal, monetary policy must also get back on track.

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