Opinion **Coronavirus**

Europe needs a new scale of stimulus – and cash not credit

Direct payments should be made to citizens and companies

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Christine Lagarde's ECB should act now with other EU institutions to set up a discretionary stimulus © AFP via Getty Images

Wolfgang Münchau MARCH 22 2020

For the eurozone, this is not the 2010-2012 crisis all over again. It is far worse. The coronavirus will prove to be an economic shock, a corporate solvency crisis and a political crisis all folded in to one.

The good news is that it will probably not become a sovereign debt crisis. The European Central Bank last week did the right thing and has reduced that probability. Its pandemic emergency purchase programme will help governments raise money for healthcare and a first set of economic measures. What it will not, and cannot on its own, address is the wider macroeconomic impact of coronavirus. That will require a different set of tools.

The German government will on Monday agree a supplementary budget for just under 5 per cent of gross domestic product, and will set aside additional funds for equity stakes in companies and loans.

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But beware. What is often oversold as a bazooka tends to come with awkward conditions in the small print.

Much of the money is credit, not grants. If a business borrows money while profits fall, solvency deteriorates. This was Italy's problem after the eurozone crisis. Austerity left the economy in a weaker position to pay down debt.

This crisis could easily end up adding 20 to 50 percentage points to Italy's debt-to-GDP ratio over a number of years. If another episode of austerity follows, Italy will be trapped in a vicious cycle. This is why I do not see any merit in a programme of credits by the European Stability Mechanism, the eurozone's rescue umbrella.

What the eurozone needs is cash, not credit. But credit is what it is good at. Bailouts are frowned upon on the grounds that they constitute moral hazard. So is the economic concept of a helicopter drop, or the US idea of stimulus by mailing cheques to households.

European countries do have well functioning fiscal stabilisers such as unemployment insurance. These economic shock absorbers are designed to deal with normal fluctuations. But they are not big or strong enough for emergencies like this one.

The fiscal framework of the eurozone has some built-in flexibility, but it is not set up for discretionary stimulus. A 10 per cent fall in GDP will require it. If governments cannot do this on their own, it will have to be done at EU level.

We could employ some creative financial wizardry involving one or several EU institutions and the ECB together. This could take the form of a one-off fiscal facility partially bankrolled by the ECB. The key characteristics should be: money, not credit; direct cash payments to citizens, households and companies; and, yes, the liability should be mutualised. It should be backed, without limits, by the ECB.

The biggest economic risk right now is not just the steep decline in output, but also the permanent shock it could suffer afterwards. The primary purpose of a discretionary stimulus should be to ensure that the recovery is V-shaped. But there discretionary stimulus should be to ensure that the recovery is V-shaped. But there are a number of reasons to fear that the recovery will peter out. Some of us will be travelling less. Some might seek a different trade-off between work and leisure. European car manufacturers might use Covid-19 as an expedient moment to reduce their structural overcapacity.

As to size, if you expect an economic shock of up to 10 per cent of GDP, a discretionary stimulus to the tune of 5 to 10 per cent of GDP is hardly disproportionate. A payment of €1,000 for each citizen would cost just under 3 per cent of eurozone annual GDP. Alternatively, but with less immediate impact, the funds could be used to generate a huge post-crisis investment programme.

What I have already noticed is that the debate about the future of the eurozone is back. Not everyone will want to be locked in a monetary union with countries like the Netherlands, whose prime minister is ideologically opposed to mutual risk-sharing. This sort of unwilling partnership is not sustainable.

It is not just the scale that is different between today and the crisis of 2012. The politics have also changed. A recent poll registered a rise in the number of Italians who regard belonging to the EU as disadvantageous, from 47 per cent in November 2018 to 67 per cent now. Italy, at the centre of Europe's coronavirus outbreak, has more pressing problems to deal with at the moment.

But be prepared for more in-out debates as a direct result of this crisis. And that is another reason why we should think about stimulus, not credit.

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