FINANCING THE CORONA CRISIS IN EUROPE

Hans-Bernd Schäfer[1]

1. THE LOANS PROVIDED BY THE EUROPEAN STABILITY MECHANISM TO COMBAT THE CORONA CRISIS ARE TOO SHORT, ONLY SIMULATE EUROPEAN SOLIDARITY AND CARRY A HIGH MONETARY POLICY RISK

On the 9th of April, after two days of negotiations on a European financing programme to deal with the Corona crisis the finance ministers of the euro area agreed, amongst other things, on a line of credit provided by the European Stability Mechanism (ESM). All further-reaching proposals from France, Italy and Spain, but also from many respected economists in Germany, are thus off the table for the time being. Nevertheless, the German government has succeeded in presenting this as a breakthrough in European solidarity. The headlines of the world press spoke of a line of credit of 240 billion euro. According to Politico on April 10 "The ESM will make €240bn available in spending for indebted countries." The Süddeutsche Zeitung already titled "240 billion from rescue aid" on March 25. On the homepage of the German government it says "The Eurogroup has agreed on a 500 billion euro protection program." This indirectly puts the ESM loans at EUR 200 billion.[2] These are widespread but misleading claims, as we will show here.

2. ONLY 5 STATES WOULD HAVE AN INTEREST RATE ADVANTAGE AND ONLY 3 STATES WOULD HAVE A SIGNIFICANT INTEREST RATE ADVANTAGE FROM ESM LOANS

The finance ministers of the euro zone proposed that each member state can borrow an amount of 2 percent of its gross national product as a loan under the ECCL (Enhanced Conditioned Credit Line), set out by Art. 15 of the ESM Treaty, as a "Pandemic Crisis Support".[3] The strict conditionality laid down in Art. 3 and Art. 12 of the ESM Treaty is waived. The only condition is that the loan has to be used for health care costs arising from the Covid 19 crisis.

[1] Affiliate Professor of Law and Economics, Bucerius Law School (Hamburg) and Professor (em.) of Economics, University of Hamburg.

[2] Federal Finance Minister Olaf Scholz, *A Day of European solidarity and strength*, THE FEDERAL GOVERNMENT (Apr. 11, 2020), https://www.bundesregierung.de/breg-de/aktuelles/statement-scholz-1742786.

[3] *Report on the policy response to the Corona-19 pandemic*, CONSILIUM EUROPA EU (Apr. 9, 2020, 11:05 PM), https://www.consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/.

How attractive are the Corona loans for the member states of the euro zone? The ESM refinances itself with loans, including bonds,[4] which are guaranteed by euro zone member states in proportion to their share of equity. The German quota is 26.9 percent.[5] Depending on the creditworthiness of the individual member states, the ESM's refinancing loans are subject to interest rates that are equal to the average of all interest rates that the member states have to pay on their debts in the national bond markets, weighted by their equity ratios. This interest rate is currently 0.53 percent. In addition, there is an interest margin which allows "full coverage" of all costs of the ESM, Art. 20 (1) ESM Treaty. In April 2020, lending interest rate at 0.76 percent according to ESM figures.

It is quite plausible that the interest margin for corona loans will be reduced somewhat because the mild conditionality of these loans provides for comparatively low administrative costs. At present, however, the lending rate is 0,76 percent.

Using this interest rate as a comparison, it turns out that 14 of the 19 euro zone countries pay a lower interest rate for national government bonds with a duration of 10 years than for ESM loans. In only 5 euro zone countries is an ESM loan cheaper than national government bonds. The finance ministers of the eurozone countries, of course, knew this when they made their decisions on 9th of April. However, they insinuated to the European public that there is a much higher credit volume. They blew up a balloon, that for a few days produced the desired headlines, that the ESM would provide 240 billion euros to fight the Corona crisis.[6]

Table 1: Interest rates on 10-year government bonds in the member states of the euro zone in percent

Member State of the euro zone	Interest rate for 10-year government bonds in percent, as	Member State of the euro zone	Interest rate for 10-year government bonds in percent, as

[4] The eurobonds, often scorned in the public debate, therefore already exist and are explicitly set out in Art. 21(1) ESM Treaty: "The ESM shall be empowered to borrow on the capital markets from banks, financial institutions or other persons or institutions for the performance of its purpose."

[5] *Amended Annexes I and II to the Treaty*, ESM (Jan. 15, 2020), https://www.esm.europa.eu/sites/default/files/2020-01-20_amended_annexes_i_and_ii_effective_from_15012020.pdf

[6] It is also to be noted that it is currently entirely unclear, what duration the loans provided by the ESM shall have. According to an internal guideline of the ESM, the ECCL, which is supposed to be used according to the finance ministers, has a duration of only one year and can be prolonged twice for a further duration of six months. It only serves as a measure for ensuring liquidity and does not meet the criteria of the long term need for corona-loans. While this can be altered by a resolution of the finance ministers, official documents have so far remained silent in this regard and so have the people, who might know more, when asked about this issue.

	of April 13 2020		of April 13 2020
Belgium	0.087	Luxembourg	-0.36
Germany	-0.349	Malta	0.553
Estonia	n.a.	Netherlands	-0.086
Finland	-0.24	Austria	0.087
France	0.1	Portugal	0.856
Greece	1,776	Slovakia	0,43
Ireland	0,206	Slovenia	0,731
Italy	1,587	Spain	0,777
Latvia	-0.04	Cyprus	1.929
Lithuania	0.31	Average of all euro area countries	0.539
Source: Bloomberg, Eurostat and ESM, the values for Luxembourg, Finland, Latvia and Lithuania date from February 2020.			

Let us now take a look at those eurozone countries for which an ESM loan is cheaper than national debt. These are Greece, Italy, Portugal, Spain and Cyprus.

Table 2: Potential loan volumes and savings of the 5 countries for which an ESM loan is beneficial

	Euro zone, gross domestic product 2019 at market prices in billion euros	Maximum ESM loan to combat the corona pandemic of 2 percent of GDP in billion euros	Interest savings when taking out an ESM loan compared with the issue of 10-year national government bonds in percentage points Interest savings per year	

			in million euros	
All euro area countries	11,905	238.1		
Greece	187	3,74	1,016	38,0
Italy	1.788	35,76	0,827	295,7
Portugal	212	4,24	0,096	4,1
Spain	1,245	24.9	0.017	4.9
Cyprus	22	0,44	1,169	5,1
Total of the 5 countries	3,454	69.08		
Sources: Eurostat, ESM, Bloomberg				

The highest possible loan amount of those countries for which an ESM loan results in an interest rate advantage over national government bonds is less than 70 billion and thus amounts to 29 percent of the amount that politicians and newspapers blurt out. If there were a political consumer protection law, every citizen could obtain a temporary injunction to have the misleading information on the homepage of the Ministry of Finance deleted. For two countries the financial advantage is so small that it almost vanishes into thin air. In order to estimate this advantage, column 3 of table 2 contains the current difference between the interest rate for 10-year national government bonds and the interest rate for ESM loans. Multiplying this difference by the highest possible ESMC loan for each country results in the highest possible interest saving per year and country. Only Italy, Greece and Cyprus can count on significant advantages, taking into consideration the size of the country. For Portugal and Spain the savings are not worth mentioning and are so low that the question arises whether the additional transaction costs of an ESM loan, such as negotiation and reporting costs, do not render borrowing from the ESM unattractive from the outset.

For the remaining 3 countries, the benefits are modest but significant. These advantages, however, cannot belie one important fact. The ESM credit line is - even in combination with further lines of credit from the European Commission amounting to 100 billion euros and the European Investment Bank amounting to 200 billion euros - so small that these countries would have to increase their national debt considerably if another solution were not found.

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According to this calculation, the interest savings for those countries that have any advantage at all from taking out an ESM loan amount to 311,8 million euro per year. This amount does not constitute an ongoing burden in the budgets of ESM-member countries, but is a consequence of the state guarantee. The German share in this guarantee is 26.9 percent. If all 5 countries with relatively high interest rates take out an ESM loan, the total loan amount will be 69.1 billion euros and the German share of liability will be 18.1 billion Euros in the worst case scenario, if all loans were to be completely defaulted on.

3. ESM LOANS, CONDITIONALITY AND "OUTRIGHT MONETARY TRANSACTIONS" (OMT) OF THE EUROPEAN CENTRAL BANK

The German government claims that the ESM is a well-established crisis mechanism that can be deployed quickly. This, rather light-footedly, disregards the fact that the ESM's corona loans do not comply with its statutes. Neither do they correspond to the ESM's general objectives of providing stability aid to members with serious financing problems under strict conditionality, nor was the ECCL set up for the purpose of disease control. What the ESM is doing now is comparable to an automobile company deciding to breed sheep for a transitional period instead of producing cars. Now, the ESM is not a listed company for which such a thing would be completely unthinkable, but a legal entity with its registered office and head office in Luxembourg. It came into existence by means of an international treaty outside the institutional framework of European law. Ultimately, the ECJ, as court of last instance according to Art. 37 III ESM Treaty, would have to decide by means of an interpretation under international law whether this construction is permissible without amendments to the articles of association. There are also exceptions in German law which, for example, allow a GmbH to deviate from the articles of association if the decision is urgent and does not entail any permanent change.[7] The legal problems pertaining to these decisions, born of necessity and time constraints, are only hinted at here.

However, it seems crucial that taking out an ESM loan to combat the Corona crisis could have far-reaching consequences for the overall structure of the European Monetary System. This applies above all to the abrogation of strict conditionality and the question of how this affects the permissibility of the OMT (Outright Monetary Transactions) of the European Central Bank. The conditions for a corona loan for the improvement of the health care system must be different and much milder than for an ESM loan, which serves to restore financial stability. As a consequence, this raises the question what impact taking out an ESM loan as part of "Pandemic Crisis Support" will have on the central bank's ability to buy government bonds of individual countries if they fall into a financial crisis.

When, at the height of the financial crisis in 2012, Italy came under pressure from the financial markets and the interest rates for government bonds rose to unsustainable levels, the President of the European Central Bank Draghi gave his famous speech "Whatever it takes". He announced a programme to buy government bonds of distressed member states, provided that the state had previously borrowed from the ESM, subject to strict conditionality. This announcement alone caused interest rates on Italian government bonds to fall rapidly. This so-called Draghi Plan was the subject of decisions of the German Federal Constitutional Court and the European Court of Justice. It was accepted as admissible under European law and under the German constitution. The arguments behind these decisions, however, rely heavily on the fact that the OMT transactions of the central bank to support individual member states are accompanied by the strict conditions attached to taking out an ESM loan. The European Central Bank had in a press release in September 2012expressed in a clear manner the conditions , attached to OMT purchases.[8] According to this statement, the "strict and effective conditionality" of an ESM loan is a necessary precondition for any OMT purchases, which, moreover, according to this statement, will be terminated as soon as the borrowing state fails to meet the conditions. The ECJ found that this programme is covered by the mandate of the central bank and in its reasoning made particular reference to strict conditionality.[9]

How are OMT purchases by the central bank of government bonds of a country taking out an ESM loan to cover corona-related health care costs to be assessed? The terms and conditions of the ESM loan are completely different to those of the Draghi Plan. Is it sufficient for the central bank's OMT purchases if a country heading towards sovereign default proves that it has spent the ESM loan on healthcare? If that was to be the case, there would be only little

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[7] Harbarth, *Münchener Kommentar zum GmbHG*, 3, § 53 p 44 (2018); Zöllner/Noack, *Baumbach/Hueck GmbHG*, 22, § 53 p 40 (2019).

[8] *Directorate General Communications*, *Technical Features of Outright Monetary Transactions*, ECB (Sep. 6, 2012), https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

[9] Peter Gauweiler and Others v. Deutscher Bundestag, ECJ C-62/14. In the judgment it says "Accordingly, the fact that the purchase of government bonds on the secondary market subject to a condition of compliance with a macroeconomic adjustment programme could be regarded as falling within economic policy when the purchase

remaining of the ban of state financing by the central bank as laid out in Art. 123 (1) TFEU. It is not possible today to predict how the European Central Bank will react should debt crises of individual states occur in connection with the high demand for public loans caused by Corona. It is to be feared, however, that targeted purchases of the debt instruments of these states will then be made within the framework of the OMT programme, although these states have not agreed to strict macroeconomic stabilisation in accordance with Art. 3, Art. 12(1) ESM Treaty. By deciding to use the ESM as a finance instrument for corona-related loans, the finance ministers may have taken a further step towards a central bank that acts as a financial policymaker, ironing out the shortfalls of member states in acting appropriately in terms of financial policy.

4. CORONA BONDS WITH VARYING RISK POTENTIAL AND MORAL HAZARD

Many leading German economists and politicians have suggested Eurobonds in recent weeks.[10] They emphasized that the situation is different from the one 10 years ago, at the outbreak of the financial crisis, when Eurobonds were also proposed. There are 2 reasons for this. Firstly, the Corona crisis is a catastrophic shock and an exceptional case for everyone in the European Union, which obliges us to show solidarity. This word appears 7 times in the Treaty on the Functioning of the European Union. Article 222 (1) TFEU states: "The Union and its Member States shall act jointly in a spirit of solidarity if a Member State is the object of a terrorist attack or the victim of a natural or man-made disaster. The Union shall mobilise all the instruments at its disposal...". This current situation is exemplary for this requirement. Secondly, the proposals on corona bonds currently under discussion are not joint government bonds as proposed during the financial crisis, for which the member states would be joint and severally liable, and which were rightly criticised and rejected.

Bonds with joint and several liability, which entail a high and confusing risk for the guarantor state, are questionable with regard to constitutional law. They pose a risk for democracy and parliamentarianism as international or European obligations may give rise to financial risks that undermine the significance of general elections and parliamentary decisions. The German Federal Constitutional Court has stressed this connection in its decision on the

is undertaken by the ESM (see, to that effect, judgment in Thomas Pringle v. Government of Ireland and Others, C-370/12, EU:C:2012:756, paragraph 60)…" (para. 63).

[10] Jens Südekum, Gabriel Felbermayr, Michael Hüther, Moritz Schularick, Christoph Trebesch, Peter Bofinger & Sebastan Dullien, *Europa muss jetzt finanziell zusammenstehen*, FRANKFURTER ALLGEMEINE ZEITUNG, (2020).

conformity of the German participation in the European Stability Mechanism with German constitutional law. It concluded that the highest possible risk of 190 billion euros that the Federal Republic of Germany is bearing with its quota in the ESM does not pose a threat to the democratic state given its economic strength.[11] It also stated that the assumption of such risks by the Bundestag, the Federal German parliament, are unconstitutional only if they not only restrict the financial leeway but can almost completely drain it.

The Eurobond models discussed and politically proposed today lead either to limited pro rata liability or to no liability at all for the debts of other states. Mixed forms in which the liability ratio of a state is smaller or larger than its payout ratio are also being discussed.

Least problematic with regard to constitutional law would be a Corona Bond, which covers the credit demand of all eurozone states arising from the epidemic. Each member state would then only be liable for the amount of the total credit it takes out itself. In that case, no repayment obligations on the part of one state can arise for another state. The result would be an average interest rate of between 1.6 percent for Italian government bonds and -0.35 percent for German government bonds because the financial markets would price in the risk of state insolvency for individual debtors according to their share. This average interest rate currently stands at 0.53 percent. If such corona bonds amounting to 1 trillion euros were issued, and Germany received a payout of 20 percent, it would pay 0.9 percent higher interest - compared to German government bonds. This would lead to an annual additional burden and, in the case of a corona bond with a term of 10 years, to an indirect transfer payment of 18 billion to the financially weaker countries, which would pay a lower interest rate than for national government bonds. After 10 years, the bond could be repaid and revolved into national government bonds. This would not constitute any guarantee risk, but would result in a moderate and temporary transfer of EUR 18 billion within 10 years.[12] Such a proposal is currently being put forward by Italy, according to an interview with Italian Prime Minister Conte[13]. The proposal of a corona bond of this kind is sometimes met by the argument that a

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[11] *See* German Federal Constitutional Court Cases 2 BvR 1390/12, 2 BvR 1421/12, 2 BvR 1438/12, 2 BvR 1439/12, 2 BvR 1440/12, 2 BvE 6/12, published in the official report BVerfGE, vol. 132, pp. 195-287, pp. 251 ff. and Cases 2 BvR 1390/12, 2 BvR 1421/12, 2 BvR 1438/12, 2 BvR 1439/12, 2 BvR 1440/12, 2 BvR 1824/12, 2 BvE 6/12, published BVerfGE, vol. 135, pp. 317-433, pp. 408 ff.

[12] In comparison the German Federal budget includes an annual amount of 20 billion euro for covering the basic costs of living and protection for refugees who are not from Europe and with whom we do not share a legally binding common destiny. In 2017 this figure amounted to 21 billion euro, in 2018 23 billion euro.

[13] SÜDDEUTSCHE ZEITUNG (Apr. 20 2020), https://www.sueddeutsche.de/.

corona bond only serves as an entry into a European transfer union and cannot be reversed.[14] But special situations require special measures, and nobody can force Germany to permanently subsidise the national budgets of other Member States of the European Union with Eurobonds. This variant of Eurobonds not only has the advantage of being constitutionally innocuous. It also leaves the liability risk exclusively with the debtor and thus reduces moral hazard.

By contrast, financing via the ESM results in a guarantee of 26.9 percent, the German capital share. This would also apply to models such as the one proposed by Felbermayr, Hüther and others, which suggests only providing corona bonds for those states which have difficulties in carryint out the corona-induced expansion of national debt on their own.[15] However, the proposal of these scholars would have the advantage that, because all the states in the euro zone assume the liability risk in accordance with their quota, a high corona-induced increase in the debts of financially weaker countries will not trigger a speculative attack by the financial markets on these countries.

The mantra-like argument of the need for unity of liability and decision-making in this context fails to recognise the fact that some of the most important and successful institutions of capitalism allow risk spreading, insurance, risk shifting and shielding against external shocks. Their introduction has always brought changes to the relationship between liability and decision and was accompanied by moral hazard. Without the invention of the partnership, which enabled merchants to pool risks,[16] without the invention of the legal entity, which effectively protects companies against risks to their existence posed by creditors of the shareholders, without the limited liability company, which allows parts of the private assets of shareholders and partners to be withdrawn from creditors' access through the principle of separation, there would be neither capital markets nor large companies. The fact that these developments carry moral hazard problems only demonstrates the need to strike a balance between the principle of risk diversification and the principle of liability. Only this enables individuals, companies and entire societies to take risks that would otherwise be avoided as unacceptable.

[14] Lüder Gerken & Bert Van Roosebeke, *Solidarität ja, aber nachhaltig*, SÜDDEUTSCHE ZEITUNG, (2020).
[15] FRANKFURTER ALLGEMEINE ZEITUNG, https://www.faz.net/aktuell/.
[16] H.-W. Sinn, *Gedanken zur volkswirtschaftlichen Bedeutung des Versicherungswesens*, *77* ZEITSCHRIFT FÜR DAS GESAMTE VERSICHERUNGSWESEN, 1.