The Franco-German Council of Economic Experts
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A coordinated COVID response

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It is in the interest of every EU member state that countries in the Union hit by the coronavirus are very quickly able to take the necessary measures to control the pandemic, help the economic recovery and prepare the transformation to a more sustainable and resilient European economy. In this context, the Franco-German Council of Economic Experts strongly endorses recent proposals made to respond at the European level in a coordinated manner to the COVID crisis. We believe that France and Germany should support them within the EU.

These measures include:

i) The **Covid Credit Line (CCL)** of the European Stability Mechanism (ESM) with minimal (ex post) conditionality that offers long maturity grants allocated across member states proportionate to the respective severity of the public health and economic challenges encountered.

ii) The **SURE proposal** (temporary Support to mitigate Unemployment Risks in an Emergency) released by the European Commission that provides a channel for long-term lending, to finance partial unemployment schemes and the related expenditures during the crisis – without further conditionality.

iii) A **Post Covid Investment Fund** that would help financing investments to build a more sustainable and resilient European economy in particular with respect to the issue of climate change. The Fund could be financed through joint recovery bonds with very long maturities issued by the European Commission, the European Investment Bank, or the ESM, backed by the joint capital of these institutions, respectively.

We also support, for the private sector, the increased capacity of the European Investment Bank to extend guarantees to banks lending to SMEs.

Background

The Corona pandemic poses an unprecedented dilemma to societies and economies around the world. Policy makers need to trade off possible increases in the number of bankruptcies and of unemployed workers with an effective reduction of new infections. Opening the economy will offer no sustainable economic benefits if the pandemic bounces back as a result. Currently, in lieu of other choices most of the world has gone into lockdown. At the present stage this is the only option left to avoid overburdening the intensive care units of hospitals, which would result in large losses of human life.

Inevitably, this approach comes at severe economic and human costs. These costs should be socialized and smoothed over time which implies a high degree of risk-sharing. In the present crisis, where the shock is fully exogenous, the argument of moral hazard against insurance does not apply.

Since a noticeable fraction of economic activity is currently prevented from happening by obligatory social distancing, all major economies experience a drastic and simultaneous shock to demand and supply, and have consequently entered a severe recession. Our assessment is that France and Germany will likely experience negative growth rates beyond –5% in 2020.

Immediate response: Intervention

The current virus-related pandemic requires a coordinated European approach involving actions that show a strong sense of solidarity towards the member states most affected by the pandemic. On the economic front, France and Germany have both enacted a remarkable series of policy measures for the support of households and firms.

Most importantly, though, the size of the shock affecting all European countries is unprecedented and the ability of each European economy to manage an appropriate response to this shock will jointly determine the common prosperity of all European countries. The crisis will require a very large fiscal response that will imply massive public debt issuance. There is a risk that due to self-fulfilling expectations countries lose market access at the time where they urgently need financing. The Eurozone cannot take the risk of another sovereign debt crisis. The decision of the ECB to launch a "Pandemic Emergency Purchase Programme" (PEPP) helps in that matter, but all cannot and should not rest solely on the shoulders of the ECB.

Fiscal policy needs to provide an equally determined response. Fiscal instruments at the European Union and at the Eurozone level will be required to deal with the many dimensions of the crisis. As different challenges need to be addressed with different time-frames, several instruments need to be deployed: financing very short-term measures such as work-sharing arrangements, financing medium-term economic measures to help kick-start the economy, and financing more long-term investments. Timely implementation is important. European financing solutions should be in place by the summer at the latest. We also stress the importance that all borrowing should occur on long maturities.

We welcome the following financial proposals that have been made recently and believe that France and Germany should support them at the European level.

(i) The proposal for a **Covid Credit Line (CCL)** of the European Stability Mechanism (ESM) which rests on three important conditions:

- Avoiding stigmatization: France and Germany – ideally all Eurozone countries – should apply to the Enhanced Conditions Credit Line of the ESM. This would avoid any sort of stigma both on markets and in domestic politics.

- Long-term maturities: The ESM should grant to all member states long-term (say, 30 years) credit lines allocated proportionately to the respective severity of the public health and economic challenges encountered. The use of the credit line should be designed with sufficient flexibility so as to be able to answer to present and future contingencies.

- Minimal conditionality: The ESM rests on the principle of conditionality. In the present case, this should be ex post (transparency in the use of the Covid Credit Line in particular) and minimal.

(ii) The **SURE proposal** (temporary Support to mitigate Unemployment Risks in an Emergency) was released by the European Commission on April 2, 2020. It provides a channel for long-term lending, preferably for longer maturities (say, 30 years), of up to EUR 100 bn to the national governments to finance partial unemployment schemes and the related expenditures during the crisis – without further conditionality. This important stabilization and risk-sharing scheme will help reduce the social and economic impact of the crisis.

Gradual reduction of the lockdown: Stabilization

Currently, policy makers face a crucial dilemma. They need to manage a gradual return to economic and social life, but at the same time cannot risk a reversal to exponentially growing numbers of new infections. This gradual return to normality requires imperatively that all European countries follow a strategy to control the number of new infections. Along the way, European countries should share medical resources, such as testing material or protective gear, and coordinate their efforts of data gathering and analysis aimed to inform the necessary epidemiological projections. While the European Commission could usefully coordinate and finance this endeavor, France and Germany could jointly initiate this process.

The macroeconomic exit strategy needs to be matched to the different stages of this gradual return to normality, relying on the same financing instruments as in the immediate response stage. Because the crisis is both on the demand and on the supply side, the economic strategy needs to be prepared and coordinated on both sides. On the supply side, the gradual withdrawal of restrictions on economic activity should be coordinated, due in particular to the large amount of cross-border economic activity that will be key to re-start the European value chains. This should be done in coordination with the private sector. On the demand side, a stimulus is likely to be required and if so should be done forcefully and targeted so as to be most effective from a macroeconomic and social point of view.

This crisis will imply a large increase in national public debts that eventually will need to be addressed. However, it will be important that fiscal adjustment programs do not come and derail the recovery too soon as was the case during the Eurozone crisis.

Supporting long-term recovery: Resilience

The recovery should not only be strong and rapid, it should also involve the transformation to a more sustainable and resilient European economy. This should not be prevented by the high debt ratios which some European countries will have accumulated during the immediate Corona crisis. It will be necessary to conduct and provide financing for large investments with substantial European added value on the basis of a coordinated European effort. Candidate issues for these investments are European digital sovereignty and cyber security, preparation for future pandemics, asylum migration, protection of European borders, terrorism and defense, research, and very importantly climate change in accordance with the Green Deal.

The details on such a **Post Covid Investment Fund** would have to be worked out in further analysis in order to ascertain that the principle of aligning liability and control is upheld. One avenue to finance this Fund would be joint recovery bonds with very long maturities (up to 50 years), issued by the European Commission, the European Investment Bank, or the ESM, backed by the joint capital of these institutions, respectively. The setup of such a fund will also imply a deep re-evaluation of priorities in the EU budget. The use of these funds for issues involving substantial European value added should be monitored closely.

Meanwhile, the economic recovery should not be based on a low CO_2 price so that Europe does not retract on defossilization efforts. A first step would be to introduce a minimum price for CO_2 at the pre-crisis level.