Corona Bonds: A brief introduction and explainer

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Background

On March 25th, leaders of nine eurozone countries, including Ireland, wrote to the President of the European Council expressing the need for a coordinated and unified response by the EU to the COVID-19 pandemic.[1] In this letter they endorsed the creation of a common debt instrument for Euro area member states to ensure stable long-term access to funds during this crisis. This idea of an EU common debt instrument to fund emergency spending due to the COVID-19 outbreak, has been called 'Corona bonds'.

The idea of a common EU debt instrument is not new. During the financial crisis, the idea of 'Eurobonds' were regularly discussed as a way for countries which were hardest hit by the financial crisis to access additional funds at a cheaper rate of borrowing. Some Euro area member states strongly opposed Eurobonds on the back of potential 'moral hazard' incentives and they were never established due to this opposition. However, due to the shock that the COVID-19 outbreak has caused to the European economy, the discussion around a common Euro area debt instrument has reappeared.

What are Corona Bonds?

In general, sovereign bonds are debt or loans that are often used by governments to raise money. National bonds are issued or created by individual countries and are sold on the capital market. The issuing country is then responsible for paying interest payments periodically and for repaying the face value on the maturity of the bond.

Corona bonds would be issued at an EU level by an EU institution[2] **instead of each individual member state.** This would mean that all Euro area member states would be responsible for the debt issued and all are responsible for repaying the debt.

Corona bonds would allow for a "mutualisation" of risk among nations, which would result in a lower cost of borrowing for many Euro area countries. The cost of borrowing is country specific reflecting each nation's credit rating. This means that for some countries with poorer credit ratings, such as Italy, borrowing additional funds is relatively expensive compared to countries with higher credit ratings, such as Germany. If Euro area bonds were created, they would benefit from the stability of the EU and countries within the Euro area with good credit ratings, making borrowing cheaper for other countries.

It is envisaged that these bonds would be linked to a specific objective to raise funds to combat the impact of the COVID-19 outbreak and therefore would only be available for a limited amount of time. This is the main difference to the Eurobonds proposals.

What is the Purpose of Corona Bonds?

Corona bonds can improve fiscal integration in the EU and enable all Eurozone members to raise large amounts of long-term funding at a cheap cost. This would help to minimise the economic damages from COVID-19 on the whole Euro area.

Fiscal measures are needed to combat the negative impact caused by the COVID-19 pandemic to the Irish and European economy. Due to the containment measures in place to slow the spread of this virus, a large number of businesses have closed resulting in a sharp increase in unemployment and a decrease in demand.

1 Letter to President of European Council (25th March 2020)
2 It is currently being debated whether a current EU institution could hold this function or whether a new EU institution would have to be established to issue corona bonds.

Significant spending measures are being introduced by governments to help minimise the impact on individuals and businesses. At the same time, tax receipts will fall as a result of lower people in employment and reduced consumer spending.

Accordingly, significant borrowing will be needed to fund these measures. The Irish Government has committed to an additional €6.7 billion in new fiscal measures, and more spending may be required in the coming months.[3] A surplus of approximately €2.5 billion was originally expected for 2020, however when account is taken for the cost of the announced measures and the expected drop in tax revenues, we now expect a deficit significantly larger than €4 billion.

Many Euro area countries will also be required to borrow money to fund national fiscal measures, particularly in the south of Europe where COVID-19 outbreaks have been more widespread. **Failure to implement sufficient fiscal measures can lead to larger permanent damages to the economy.** Due to interconnectedness of states within the Euro area, an economic threat as large as the spread of COVID-19 in a small number of countries will have a negative economic effect on the whole Euro area. It is therefore crucial that Euro area countries have access to affordable funds to help introduce an appropriate fiscal response. Corona bonds are one measure which can support this.

Why do Some Oppose Corona Bonds?

In order to create a shared debt instrument such as corona bonds, all Euro area states have to agree to establish them. While many states have expressed their support for them, some 'fiscally conservative' states, such as Germany and Netherlands, are opposed to them.

Their opposition is largely due to the problem of 'moral hazard'. Moral hazard could arise when risks are shared across a group, as individuals in that group may engage in more risky behaviour than if the risk wasn't shared.

With corona bonds, the potential risk is that certain nations will borrow more and engage in irresponsible fiscal policies because the debt is shared across Eurozone countries and therefore less risk is placed on the individual country. If nations with high debt levels and low credit ratings have access to cheaper money, there is a lower incentive for them to improve their public finances, and access to corona bonds would exasperate these risks.

Are there Alternative Options?

Other options are available to fund Ireland's coronavirus related spending such as issuing Irish government bonds or using other lending mechanisms available through the EU.

The cost of borrowing might be kept low thanks to the intervention by the European Central Bank (ECB), which has announced plans to buy €870 billion in sovereign bonds in what is being called the Pandemic Emergency Purchase Programme.[4] However, it is difficult to predict the extent to which more funds will be needed and the potential limits to the amount of bonds the ECB could buy.

There is also the option to borrow through the European Stability Mechanism (ESM). The ESM, with a current lending capacity of €410 billion, was established in 2012 to provide emergency loans to Euro area countries in severe fiscal distress. The ECB also has the power to buy sovereign bonds through the Outright Monetary Transactions (OMT) which would be linked to financial assistance from the ESM.

3 Parliamentary Budget Office (2020) Ireland's Fiscal Response to COVID-19

4 European Central Bank (18 March 2020)

The key issue with using the ESM is that there is conditionality to funds borrowed through the ESM. This means that nations are required to put in place reform programmes and progress is monitored by the ESM. This may not be a politically popular option among many Eurozone countries, particularly as this economic shock is due to factors largely outside government or national control.

There are other tools that can be used by EU institutions to provide additional funds during this pandemic. The European Commission has already announced a €25 billion fund[5] to support national measures and the European Investment Bank has created up to €40 billion in credit to businesses affected by the crisis[6]. An additional €37 billion of cohesion money from the EU budget will be made available through the Coronavirus Response Investment Initiative[7] to help member states strengthen healthcare systems, supporting small and medium-sized enterprises, short-term working schemes, and community-based services.

Finally, the European Commission has announced a €100 billion lending scheme to support workers in countries that have been hit hard by coronavirus (Support to mitigate Unemployment Risks in an Emergency (SURE))[8].

When will there be a Decision on Corona Bonds?

An EU Council meeting took place on March 26th in which the concept of corona bonds was discussed between Euro area leaders, without resolution. The group has committed to meet again before April 10th to discuss the different options available to the Eurozone and potentially agree on a unified approach to fiscal issues arising from the COVID-19 outbreak.

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5 European Commission (10 March 2020)
6 European Investment Bank (2020)
7 European Commission (30 March 2020)
8 European Commission (02 April 2020)