EU Orthodoxy at the Crossroads of COVID-19

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The COVID-19 pandemic is taking its toll on the global economy as countries shut down activity at a historic pace. The impact is hard to quantify a priori but will no doubt leave a large dent in its wake. Governments and central banks have moved quickly to provide fiscal and monetary stimulus to help offset a serious hit to global growth, but more fiscal help is needed. Heads of European governments had been discussing a joint European bond issuance, nicknamed “corona bonds.” Unfortunately, pushback to this joint fiscal action emerged March 26 at a virtual summit of elected leaders. Stalemate on this proposal risks destabilizing Europe’s most vulnerable countries and reigniting the Eurosceptic political movements.

To deal with the economic shock of the pandemic, the European Union (EU) waived a number of sacred fiscal cows of EU membership, including limits on member states’ deficits to 3% and total debt to 60% of gross domestic product. However, at the virtual summit, Europe’s leaders failed to reach an agreement on proposals for the joint bond issuance. The disagreement split between the northern countries, such as Germany, Austria and the Netherlands, which favored leaving each member state to its own fiscal devices, and the southern countries such as Italy and Spain, joined by France, which are calling for joint debt issuance to finance fiscal action.

It is worth noting the French position in siding with its southern neighbors. With France’s own deficit on the rise, Paris has an obvious self-interest in relaxation of budgetary constraints. However, the French also may see an opening to finally realize the elusive goal of the most ardent Europhiles: fiscal unification of all 19 countries on the euro currency. French President Emmanuel Macron may emerge as a winner from this crisis, both internally and externally. Internally, Macron has a chance to change his image from a strict reformer who sparked riots on the back of labor reform. Social instability remains a key risk for Macron; a strong response to the crisis could help to solidify his shaken electoral footing. Externally, shifting Paris’s alignment away from Berlin to side with the southern states could build political bridges helpful in creating a closer union after the crisis.

In my view, the single-country approach favored by the northern states would prove problematic beyond the near term. Once the crisis is over, the member states would lack clarity on how quickly the post-coronavirus large fiscal deficits would need to be reduced. Southern countries have been plagued by low growth, weak banking sectors and fiscal austerity for the past decade. Now, the COVID-19 austerity measures are making each of those problems worse.

In an attempt to offer an olive branch, the northern governments proposed that the southern countries enter into an agreement with the European Stability Mechanism (ESM). The ESM is a financial institution put in place to help euro-area member countries that face financial distress. The Italians, however, are well aware that any agreement with the ESM would come with strings attached, including austerity measures, in exchange for funds. The northern response outraged Italy’s politicians, including the leader of its coalition government. Prime Minister Giuseppe Conte, a political independent, warned the northern governments against committing a “tragic mistake. The whole European edifice risks losing its raison d’être.” Matteo Salvini, leader of the Eurosceptic, rightist Lega (“League”) Party, which quit the coalition government last year, called the EU “a den of snakes and jackals. First we defeat the virus, then remember Europe. And, if necessary, we say goodbye.” A European diplomat quoted by CNN described Spanish Prime Minister Pedro Sánchez as well as Conte as “outraged” by the inadequacy of EU measures to aid their countries.

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The European Central Bank (ECB) has been doing its part to help the situation by introducing a new €750 billion Pandemic Emergency Purchase Program (PEPP). The PEPP is an emergency asset-purchase program that waives some restrictions of previous ECB asset-purchase programs, expanding the range of eligible assets for purchase. The ECB is helping member states in their fiscal response in other ways as well. The fiscal packages include loan guarantees as well as reduction of capital requirements on banks to allow them to extend additional credit to their respective economies.

Compared to the United States, Europe relies more heavily on its banking system for credit. European banks, however, were in a weak position prior to this crisis, with Italian banks sitting on piles of bad debts. The ECB has relaxed its requirement on bank capital, which has freed up €120 billion of equity to help with the increase in bad loans. In another break with regulatory orthodoxy in its banking system, the EU has told member countries that bank bailouts would not require private sector participation.

While the ECB fiscal measures and EU banking relief are needed and constructive, these steps fall short of what is called for. Prime Minister Sánchez described the scale of southern states’ plight as necessitating a European Marshall Plan. The Marshall Plan was an American aid program credited with helping Western Europe rebuild its devastated infrastructure and economy in the wake of World War II. It is very hard to know today the size of the needed package, but it’s clear its magnitude will require the EU to set aside more tenets of traditional budgetary doctrine, including those especially dear to Vienna, Amsterdam and Berlin.

The EU has long maintained a keen focus on keeping fiscal deficits and spending in check. It would be myopic to maintain that focus to the point of ignoring the economic fallout. It is hard to imagine a more non-controversial reason for entering into a joint fiscal arrangement than a virus impacting the entire European continent and globe. If the northern states are serious about building a strong union, they will need to find a way to agree on a joint and large-scale fiscal action that does not unduly punish the southern states with austerity once the pandemic ends. The fallout of failure would likely be massive political, economic and social upheaval in the southern countries and reinvigoration of movements within those states to withdraw from the union and the euro.
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