LETTER FROM BERLIN

Europe's Covid-19 Battle

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The leaders of Europe's two largest countries, Germany and France, are determined to respond to the challenge of the coronavirus pandemic and save the increasingly disintegrating European Union at all costs.

At least German Chancellor Angela Merkel's success as a crisis manager during the pandemic has impressed her voters. As *The Economist* observed, "If any big European country can be said to have so far had a good corona crisis, it is Germany. Deaths are fewer than in other countries, the state helps ailing firms, and workers and the politicians seem level-headed and competent. Places with more erratic leadership have noted the contrast."

This response by Merkel and her ruling Christian Democrats could very much improve their standing in the opinion polls against the Social Democrats, although SPD ministers in the coalition—especially Finance Minister Olaf Scholz and Labor Minister Hubertus Heil—have also been doing a good job.

A FRAGILE EUROPEAN UNION

The unprecedented Covid-19 lockdown in Germany and most other European countries was rather chaotic and uncoordinated, with border closings in a bloc where most countries are under the Schengen Agreement of 1985 which abolished their national borders.

The leaders of Italy and Spain—with France in the background—have used the crisis to wage a bitter campaign pressuring Germany and the Netherlands to capitulate in the decade-long struggle over sovereign debt mutualization. To accept issuing sovereign debt through Eurobonds—now called "corona bonds"—is proclaimed as the litmus test of European solidarity.

Both Italian Prime Minister Giuseppe Conte and Spanish Prime Minister Pedro Sánchez put the stakes of coping with the coronavirus pandemic even higher. "The EU is in danger if there is no solidarity" Sánchez warned.

To complicate this precarious state of the European Union, in early May 2020 the German Constitutional Court in Karlsruhe—after half a decade deliberating the issues and after asking for a judgement from the European Court of Justice—ruled essential aspects of the European Central Bank's asset purchase program, first introduced in March 2015, "to be unconstitutional under German law."

The court demands that the Bundesbank stop participating in ECB asset purchases and work together with the ECB within three months to come up with the required legal remedies. The ECB must demonstrate how its policies are "proportionate" to their goal. Under the concept of

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proportionality which is rooted in German basic law, the ECB has to explain that the benefits of the asset purchase program outweigh the negative impacts on certain groups, including German savers. Also, the ECB's asset purchases will need to have an embedded end date and exit strategy.

Because the EU Commission—in reaction to the German court's ruling—is considering starting legal proceedings against Germany over the bond purchasing ruling and over ignoring the ruling of the superceding European Court of Justice, the bloc is drifting into a full-blown open-ended crisis regarding the legal foundations of the European Union's major institutions.

SLOW EU REACTION

There has been a wide range of reactions by the twenty-seven members of the European Union to the spreading of the coronavirus. Journalist Alessio Perrone reported through *Wired UK* how, "On January 29, when Italy detected and isolated its first coronavirus cases—two Chinese tourists—authorities were sure they had put together the safest protection system in Europe."

But the coronavirus pandemic spread rapidly in Europe and ravaged large countries including Italy, Spain, France, and the United Kingdom, the damages in terms of the economies and societies reaching unprecedented dimensions.

As the horrible conditions in Italian hospitals—shortages of intensive care beds and respirators, patients often being cared for in military tents—dominated the news, Italy called for more "European solidarity." As Friedrich Merz, one of the contenders to succeed Merkel as chancellor, alleged, under pressure from the anti-European populists, the Italian leaders were using the country's health care catastrophe to call for the long-aspired-to introduction of Eurobonds.

At the EU level in mid-March, the European Council started discussing by videoconference how to coordinate EU efforts, stressing the need for a joint European response to the Covid-19 outbreak and close coordination with the European Commission.

HISTORIC ECONOMIC SHOCK

The European Commission's spring 2020 economic forecast predicted "a deep and uneven recession, an uncertain recovery." Maarten Verwey, the Commission's director general of economic and financial affairs, gave a poignant description of the economic and social catastrophe. The virus, he said, had "completely modified the outlook for the European and world economy. To contain the virus, EU Member States have had to take drastic measures that have put their economies into a state of hibernation. Economic activity in the EU dropped by around one-third, practically overnight."

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The EU economists, however, caution in their report, "The variety of estimation strategies, the number of assumptions taken, and the large magnitude of the fallout are all testament of the uncertainty surrounding any point estimates at this point in time."

In closing, the report predicts, "Overall, the euro area economy is likely to experience a severe recession this year. … The economy is not expected to return to its pre-crisis level in 2021."

No wonder the calls of European business leaders are getting louder. Talking about the crucial issue of what large and small companies expect from governments and international institutions, the three largest European business organizations from Germany, Italy and France—BDI, Confindustria, and MEDEF—made an appeal in mid-May.

Their key message to their governments and to the European Union: "The current situation will require a level of public support unprecedented in peacetime. The EU response must be of unprecedented scale. In order to minimize the damage to the economy and society in this crisis, a strong fiscal response with a high degree of solidarity for the most affected countries is needed."

Germany—which spends each year about a billion euros for its highly developed model of a "social market economy"—was and is able to soften the disruptions to the living standard of its population. In response to the crisis, Germany has adopted a series of economic relief and stimulus measures totaling well over €1 trillion. German Finance Minister Scholz has spoken of Berlin's state aid as a "bazooka" in support of the German economy. In order to finance the record assistance in the coronavirus pandemic, Germany had to take on so far €156 billion in new government debt.

Already, there are warnings from Brussels, where Margrethe Vestager, the EU commissioner for competition, points to the huge discrepancies among member states in the amount

of state aid for companies damaged by the coronavirus pandemic. These subsidies could undermine competition in the European single market. Germany, with a 27 percent share of the EU budget, accounts for over half of the corona-related state aid to companies so far. This compares with much smaller shares of corona-related assistance of 17 percent for France, 16 percent for Italy, and 2.5 percent for Poland.

AGAIN, THE ECB IS AHEAD

At the outset of the coronavirus crisis, the ECB, under its new president Christine Lagarde, launched a €750 billion Pandemic Emergency Purchase Programme of additional asset purchases until the end of the year to stabilize European bond markets. To make this new program more broad-based, the ECB did not set issuer limits and assured markets that capital limits will be applied with more flexibility. The ECB also made its collateral requirements more flexible. The program was expanded in early June by €600 billion to a total of €1,350 billion.

Acting before EU leaders and Eurogroup finance ministers could get their act together—very much in the tradition of how former ECB

The European Commission's spring 2020 economic forecast predicted "a deep and uneven recession, an uncertain recovery."

President Mario Draghi at the height of the previous crisis promised "to do whatever it takes to preserve the euro"—the ECB under Lagarde responded to the crisis quickly and resolutely. "The Governing Council will do everything necessary within its mandate. … The ECB will not tolerate any risks to the smooth transmission of its monetary policy in all jurisdictions of the euro area."

But the German court ruling raises doubts about these new ECB asset purchases. The editors of *Eurointelligence* warn, "The German constitutional court has effectively killed the ECB's open-ended version of QE [quantitative easing] as a policy instrument. Future programs will have an embedded end date and exit strategy. We argue that the ruling will place severe restrictions on the ECB to address solvency issues under the cloak of monetary policy."

NO CORONA BONDS, BUT A RECOVERY FUND

Covering the virtual EU summit at the end of March on how to cope with the social and economic fallout of the Covid-19 crisis, *Eurointelligence* reported, "Italy and Spain, for the first time, have formed a *de facto* coalition" and "are now in open confrontation with Germany and the Netherlands on the controversial issue of resorting to Eurobonds, now called "corona bonds."

Nine EU leaders, including Emmanuel Macron of France, Giuseppe Conte of Italy, and Pedro Sánchez of Spain, wrote a letter to European Council President Charles Michel making a formal request for a mutualized Eurobond. Notes Wolfgang Munchau in the *Financial Times,* "It is no accident that the nine countries seeking a shared bond—Portugal, Ireland, Greece, Slovenia, Luxembourg and Belgium are the others—are largely connected geographically in the eurozone's south and west." The crucial difference this time is that France put itself in the south-western camp.

By demonizing the northern and financially strong Germans and Dutch for a lack of European solidarity, Italy's populists in particular were able to substantially raise their standing in opinion polls. In its May 14, 2020, issue, *The Economist* warns, "As countries cushion the effects of lockdowns, their debts are rising sharply. Because governments in the euro zone borrow in a common currency but must finance themselves, these debts could rise to unsustainable levels. The problem is severe in Italy, which was in trouble even before Covid-19 struck and had gross public debts of €2.4 trillion, or 135 percent of GDP. Italy's Eurosceptic firebrand, Matteo Salvini, is hammering the EU for doing too little to help; his party may yet ride this crisis to power, where it would thrive on creating outrage and exploiting divisions with far-off Brussels."

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As the leaders from the South—with French Finance Minister Bruno Le Maire in a supporting role—appeared in leading newspapers calling for a speedy introduction of corona bonds as the needed "innovative new instrument" for coping with Europe's economic and financial crisis, Berlin's movers and shakers also argued their case.

A letter from German Foreign Affairs Minister Heiko Maas and Finance Minister Scholz appeared in leading newspapers in Europe making their case for an alternative to mutualized corona bonds, which cannot be introduced without lengthy and uncertain treaty changes.

Together with German Chancellor Merkel, they proposed using the existing European Stability Mechanism, the bailout fund established following the financial crisis,

which could provide up to €240 billion to finance short-term financial needs in countries such as Italy and Spain. This would mean that Italy and Spain could get immediate fresh injections of €39 billion and €28 billion respectively for all necessary expenditures to fight coronavirus needs. And they made clear: "We don't need a troika, inspectors, and a reform programme for each country drawn up by the Commission. What we need is quick and targeted relief."

A second component of the short-term support program, a pan-European guarantee fund through the European Investment Bank, would be made available to secure loans. This would assure liquidity for small- and medium-sized enterprises in the EU countries. It would enable national commercial and development banks to underwrite bridging loans, longer repayment terms, and new loans.

As the third part of the short-term assistance package, the European Commission would establish SURE (Support mitigating Unemployment Risks in Emergency), a program to support EU member states who want to help the workforce through the downturn caused by the pandemic using methods like Germany's well-established short-time work scheme. This is an initiative of Commission President Ursula von der Leyen, a new EU instrument for financial assistance of up to €100 billion in the form of loans to member states facing a sudden increase in public expenditure to preserve employment. Spain already has indicated that it will use SURE but will not need funds from the European Stability Mechanism. All in all, short-term support packages are supposed to reach €540 billion.

How Macron Came Back to Merkel

Despite initially siding with the EU leaders calling for the introduction of corona bonds, French President Macron and his finance minister Le Maire must have continued working with Berlin on an alternative "innovative financial instrument" to secure the financing of an EU recovery fund that would come up with grants to EU countries impacted by the economic fallout of the coronavirus crisis.

On May 18, 2020, to the surprise of many, Macron and Merkel presented their proposal for a €500 billion recovery fund for which the European Commission would borrow on financial markets, then distribute money as grants to EU countries impacted by the economic fallout of the crisis. The recovery fund would be aimed at helping to kick-start all EU economies and lessen the divergences in the bloc's single market.

The Franco-German €500 billion recovery fund proposal "is a big deal, but it's not a done deal yet."

Von der Leyen proposed a further new recovery fund of €750 billion on May 27. All EU governments will need to agree in order for any plan to take effect. In this respect, keep in mind that at the outset of the Brussels discussions about a long-term large recovery effort for the European Union, Merkel offered to raise substantially the German contribution in the coming multi-annual financial framework for 2021–2027. Currently, the total ceiling is 1.2 percent of European Union's gross national income at market prices.

According to *Eurointelligence,* the Franco-German €500 billion recovery fund proposal "is a big deal, but it's not a done deal yet," because Austria, the Netherlands, Denmark, and Sweden still object to money being disbursed as grants. If implemented in full, it would constitute a fiscal relief of around 1 percent of GDP for three years—the first macroeconomically relevant number ever to come out of Brussels.

Merkel's eventual acceptance of a €500 billion recovery fund to support corona-damaged EU economies not with loans but with direct transfers met with fierce opposition from Germany's liberal Free Democrats, and also objections from the Bavarian part of the CDU/CSU alliance. The French-German rescue mission for the European Union "represents a "180-degree-turn," criticizes Germany's largest daily, *Frankfurter Allgemeine Zeitung.* The increasingly influential digital *Steingarts Morning Briefing* makes the point that the €500 billion recovery fund comes down to a new mechanism to facilitate direct contributions from the EU budget to some EU countries' budgets using the high creditworthiness of northern member countries such as Germany to pay very low interest. "That exactly was the idea of Eurobonds."

Another popular German newsletter published by Joachim Jahnke comes up with what the new rescue mission for the European Union will cost. Germany's share in the form of contributions to new the EU budget will amount to €135 billion, or €3,400 for every household in Germany.

We give last word to the editors of *Eurointelligence.* "The Frugal Four—the Netherlands, Austria, Denmark, and Sweden—are planning a counter-proposal for a €500 billion fund to disburse credits. We see a political compromise that will dilute the fund in two important respects: the proportion of grants will be lower, and so will the north-south transfer component. We note a material shift in the German position, but don't see the recovery fund as a Eurobond icebreaker." ◆