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A Covid test for Europe

Somehow, the Eurozone governments have managed to patch some of their disagreements, but probably not yet enough to ensure safe passage through the difficulties that lie ahead. A column by Charles Wyplosz.

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«The founding fathers of the euro never imagined that a pandemic would create the economic disaster that we are witnessing.»

The euro was born in 1999. Its first test was the sovereign debt crisis in 2010. It passed the test with a pretty poor grade. It is now going through its second test and chances are that the performance will be no better, nor worse. In each case, the divided leadership delivers the minimum, the survival of the euro, but in a disorganized way and with imperfect solutions. Political disagreements survive, unchanged.

The pandemic is presenting Europe, especially the Eurozone, with two main challenges. The first one concerns the response to the question that every citizen has the right to ask: what is Europe doing for me? The answer is: not much. The

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fact is that the EU is not qualified to undertake most of what is needed. Indeed, health and social order (in this case social distancing including lockdown) are national prerogatives. The EU simply does not have any significant authority in these matters and cannot be blamed for its inaction. The best that it can do is to encourage cooperation among governments whenever cooperation is mutually beneficial. On that limited objective, it is not doing well.

A clear example is the timing of lockdowns and of exits from lockdowns, along with closures of borders. Clearly, there has been no coordination. Panicking governments have reacted late and each at its own speed, apparently without much consultation with each other. They may argue that the virus did not spread uniformly throughout the Union, so decisions had to be taken as a matter of emergency. This is not convincing. There was no doubt that all countries would be hit and, indeed, the lockdown decisions were made nearly everywhere within a few days. Coordination would seem natural when it comes to closing borders, since any decision always involves at least two countries. Strikingly, it did not happen. Are lessons being learned? Apparently not. Exits from lockdown are now taken in the same disorderly pattern.

ECB caught in political debate

The second major challenge concerns the financing of measures taken to alleviate the staggering economic costs of lockdowns. All governments pursue the same goal: preventing firms, big and small, from collapsing as they are forced to shut down, and keeping households above water as they are prevented from working. The measures may differ in their details, reflecting diverse administrative, legal and social frameworks, but the amounts involved are likely to be of the same order of magnitude. We do not know yet how expensive this will be, but something of the order of 10% of GDP, probably more, is probable. Some countries, like Austria or Germany, can afford to borrow that much. Others, like Italy or Spain, cannot without taking the risk of triggering another sovereign debt crisis.

The reason is that a sudden increase in government borrowing by an already highly indebted country is only safe if its central bank is known to be ready to guarantee all of the existing public debt. The Eurozone member countries do not own their central banks, they share a common central bank. Technically, the ECB can provide such a guarantee but it is politically hamstrung. The low-debt countries are reluctant to have their central bank, the ECB, take such a risk because any cost will have to be borne by their taxpayers. The high-debt countries scream for help. The ECB is caught in a purely political debate that reflects opposite national interests.

It is true that the Eurozone does not call for a «transfer union». Countries are supposed to clean their houses and the Stability and Growth Pact is designed to enforce such a virtuous behavior. But the founding fathers of the euro never imagined that a pandemic would create the economic disaster that we are witnessing. Even assuming that the architecture of the Eurozone is well designed, which it is not, it is unable to cope with a disaster of such a magnitude. The Covid test is to adapt the architecture in real time in a pragmatic way.

Remembering Mario Draghi

More than one month into the pandemic crisis – and, it seems, a few months after the virus reached Europe – a number of decisions have been agreed upon. After difficult negotiations, the Eurozone member countries have allowed their emergency funding arm created in 2012, the European Stability Mechanism, to lend without its usual conditions, which require quickly closing budget deficits precisely when they must be increased massively. Along with other measures, the agreement offers amounts (about 750 billions of euros 6% of GDP) that are likely to be too small to cover all borrowing needs but big enough to make a difference. But many details remain to be worked out and they may be very important. In particular, a part of this amount will not be cash but guarantees for borrowing by firms. A big advantage is that countries that take up the loans will become eligible to ECB purchases of their debts. That would come close to infinite support – the «whatever it takes» statement of Mario Draghi in 2012 – which brought the sovereign debt crisis to its end. The central banks of Japan, the US and the UK have effectively announced infinite support, the ECB is slugging behind.

A proposed EU recovery fund is under discussion. Little is known of what it could be. Large numbers are mentioned but the fact that it could be part of the Commission's budget, which has been so far about 1% of GDP, invites prudence rather excitement.

Many unanswered questions

In a way, therefore, the Eurozone is about to pass this Covid test. Yet, as the description above indicates, the agreement is complicated, if not confusing, and laden with unanswered questions. In comparison, in Japan, the US or the UK where public debts are big, the measures are comparatively larger and unambiguous, therefore more effective. Somehow, the Eurozone governments have managed to patch some of their disagreements, but probably not yet enough to ensure safe passage through the difficulties that lie ahead.

European institutions, such as the Commission and the ECB, cannot be blamed for the limits of their mandates. European governments care first about their own countries (and the next elections). In normal times, the European institutions, which represent the collective interest, are usually able to cox the governments toward an acceptable degree of cooperation. In a crisis situation, this arrangement is not functioning well. Yet, when the stakes become very high, for example the euro survival, it delivers. Getting there can be frustrating and the result may be unsatisfactory, but no other group of countries can dream to achieve that.