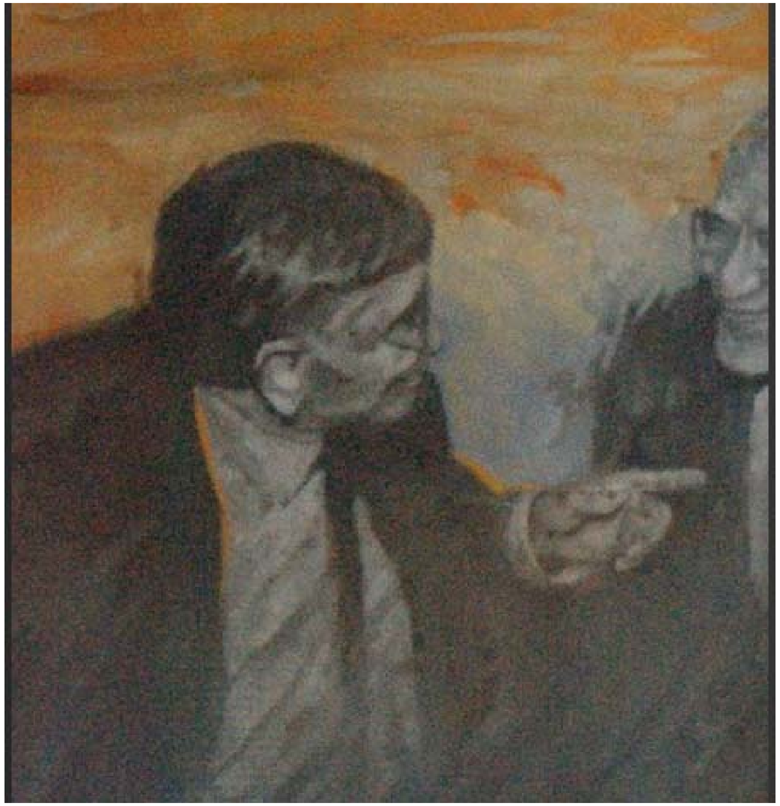

Europe’s Response to Covid-19

….*en ordre dispersé* or applied subsidiarity?

Webinar Centre Cournot

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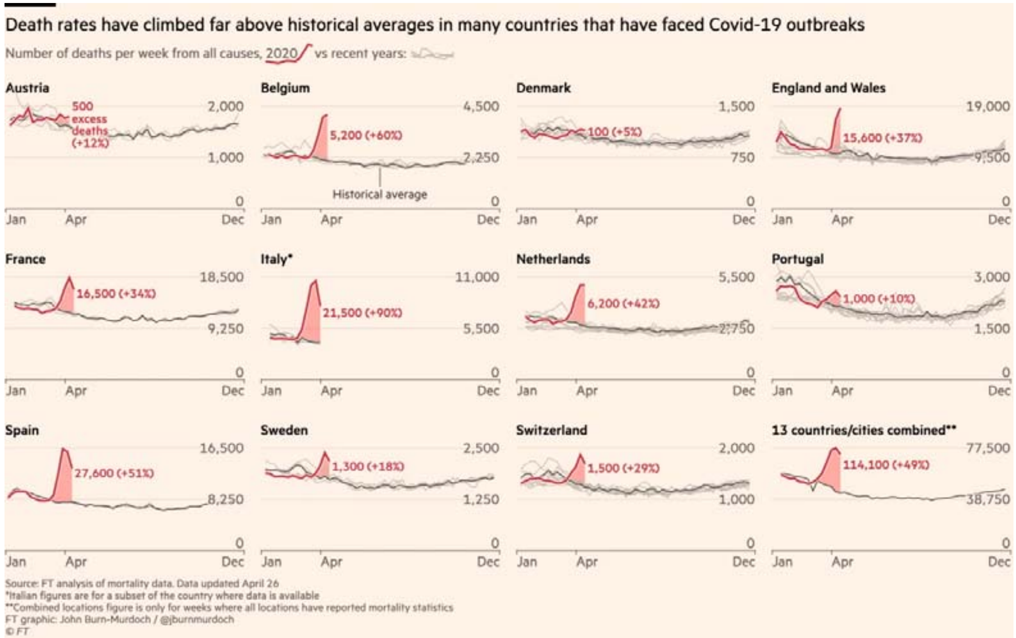
Disclaimer: Intended to animate our debate, in the spirit of Jean-Louis and Bob, this impulse sketches three aspects:

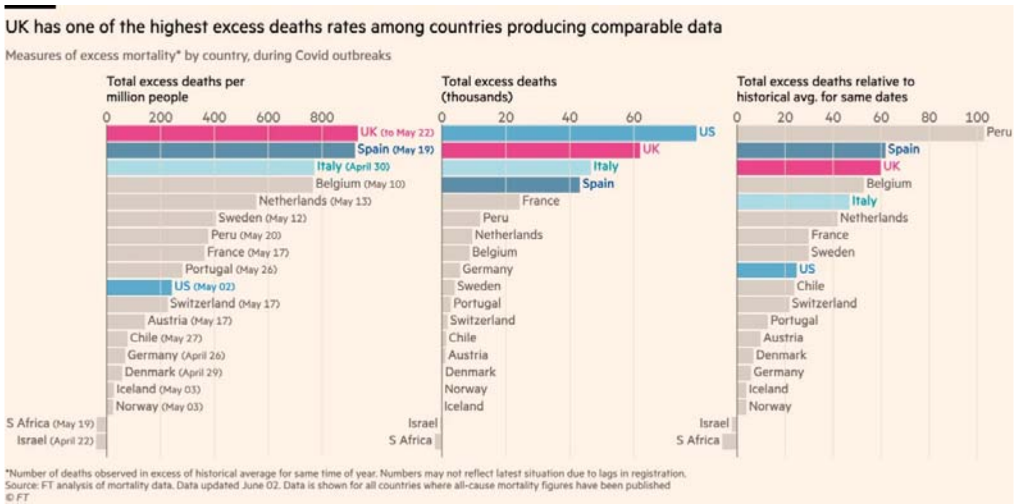
- economic background conditions against which EMU faces the Covid-19 shock
- the May 5 ruling of the German Federal Constitutional Court (FCC) on an ECB asset purchase program; while, for sure, very unfortunate timewise as well as deeply confused about a basic tenet of ‘modern’ central banking (‘independence’), the FCC highlights a crucial architectural lacunae: the ECB’s lack of a counterpart at EMU level, democratically legitimized
- finally, 2 ½ options, the Franco-German recovery plan (May 18; EU Com proposal, building on the Franco-German proposal, is not covered), the resistance of the “frugal four” as well as a return back to EMS

Obviously, this is all done in a very broad-brush way, unfortunately, prone to create misunderstandings. Might write some of this up for our Cournot blog, time permitting….

Main points

Point de départ





We start with Josselin Garnier's highly instructive Centre Cournot talk from Monday (May 25).

From that great presentation I took: we do not know by far enough about empirical parameters, fed into conventional (Imperial style) SEIR models.

However, if one adds a sufficient amount of heterogeneity (across S [susceptibility], some people highly prone to be infected, others much less so) things might turn out much less worse.

There are other obvious parameters which could produce heterogeneity (contact frequency etc.)

So, that's the positive note we take as point of departure. Buckle up, from now on it goes downhill, precipitously.

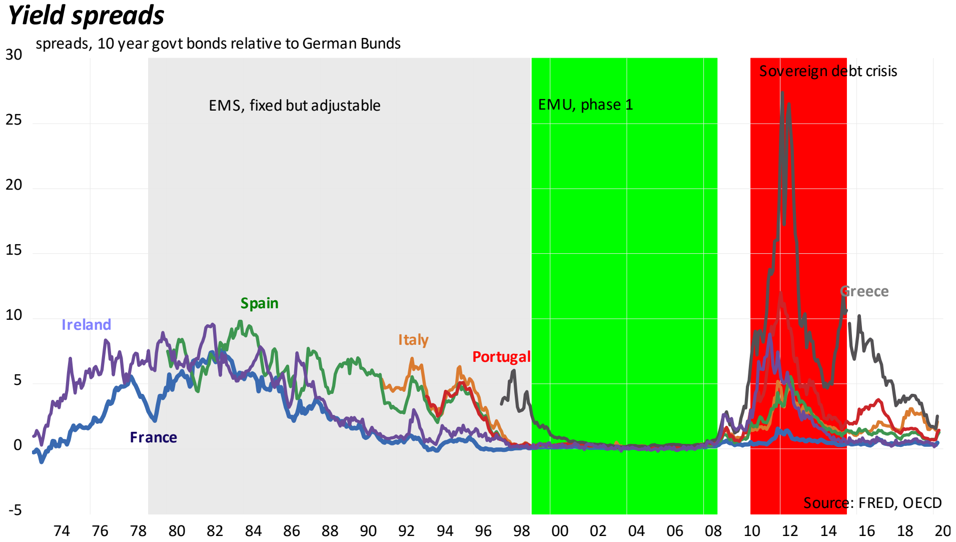
Main points (2)

Pour animer le débat

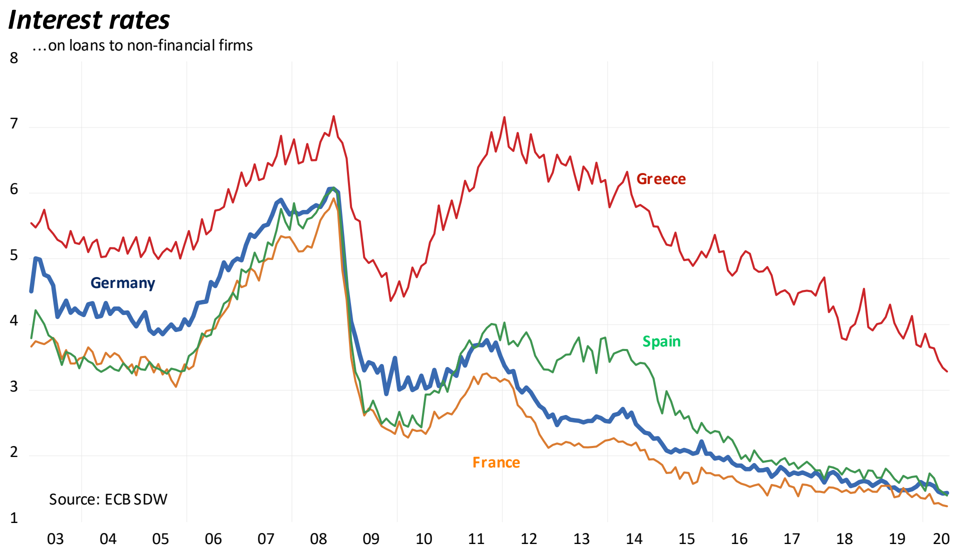
- Covid-19 shock: real, almost immediately fiscal and at some point (most certainly) financial, all of this: quite unprecedented
  - …is definitely for **real** (lockdown, quasi-physical limit on activity), unlike the Great **Financial** Crisis
  - …comes with enormous economic consequences: A few data on (1) where we come from plus (2) guesstimates on GDP, unemployment etc., potentially devastating – and most probably showing up in financial systems also
- European policy **responses**, of course, plural and, in the beginning, almost exclusively national
  - except for the **('stateless') ECB**: PEPP – however, (largely) one-sized, by definition
  - national fiscal authorities ("*en ordre dispersé*")
    - differentially sized, by design (and by fiscal capacity)
    - structural similarities – and flaws: up to now, mainly adding to debt (misery loves company)
- May 5, 2020 ruling of German Federal Constitutional Court: will it complicate or clarify things?
- Options, going forward
  - *Le couple franco-allemand*: German-French Recovery Plan ("applied subsidiarity/solidarity")
  - Ordre dispersé – the position of the "four frugals" (NL, AT, DN, SW)
  - Hopefully, a Monnet (= probably no Hamiltonian [whatever that may mean]) moment?

Background conditions

Responding to the last crises – *differentially* (1)



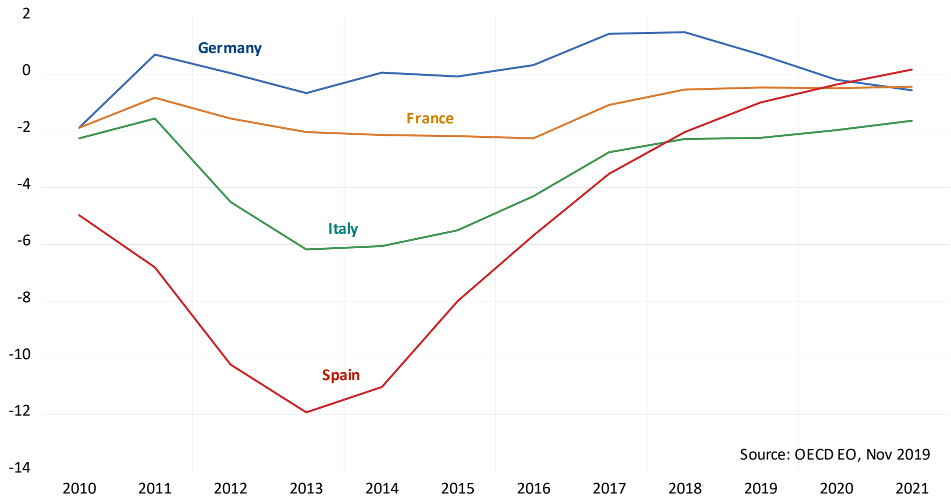
- The Great Financial Crisis and the Euro Area sovereign debt crisis were absorbed differentially across EMU member states.
- Interest spreads (vis-à-vis German government debt) widened very substantially during the EA sovereign debt crisis (shaded, in red).
- At times, they were higher than during the EMS period (in grey), the fixed-, but adjustable peg mechanism, the precursor to the common currency. Investors required a compensation for the exchange rate risk.



- Government yields provide the basis for the pricing of private sector debt.
- With a higher default probability of their respective sovereign, domestic non-financial firms had to clear a structurally higher hurdle rate, dampening capital expenditures as well as demand for credit-financed consumer durables of housing, ceteris paribus, of course.

Responding to the last crises – *differentially* (2)

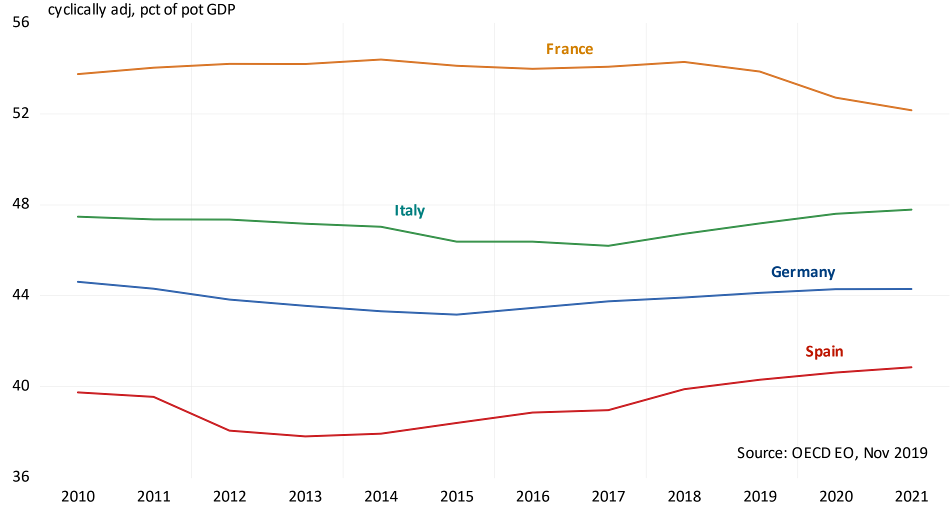
Output gap



- In response to policies pursued (and administered), output gaps widened, particularly strongly in Troika 'program' countries. But also in Italy – which never got back to its pre-GFC level of GDP. At least at first blush, austerity was not expansionary.
- Obviously, there are a number of 'confounding' factors. It's not only a lack of aggregate demand. Does not make sense, for example, to keep construction sector at full capacity when there's a glaring oversupply (consider Spain).

Government expenditures

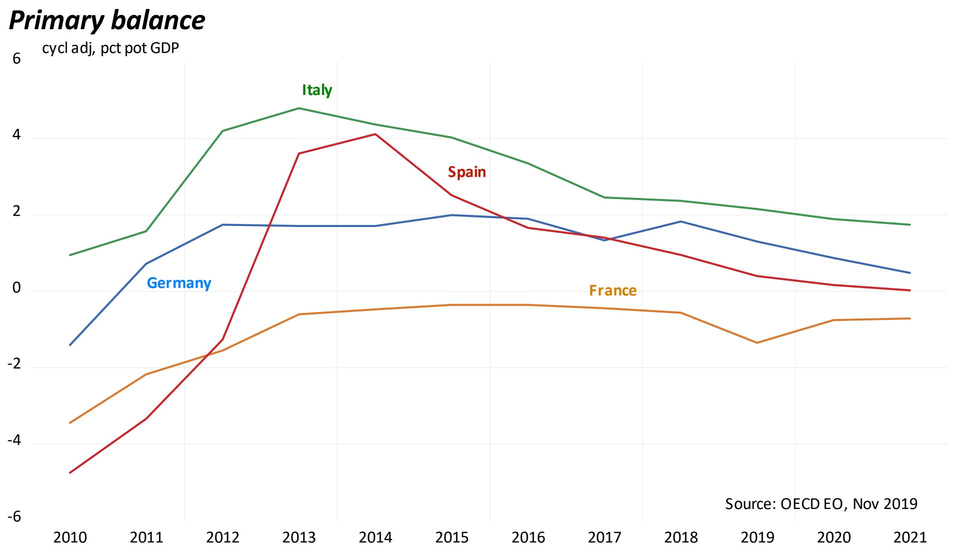
cyclically adj, pct of pot GDP



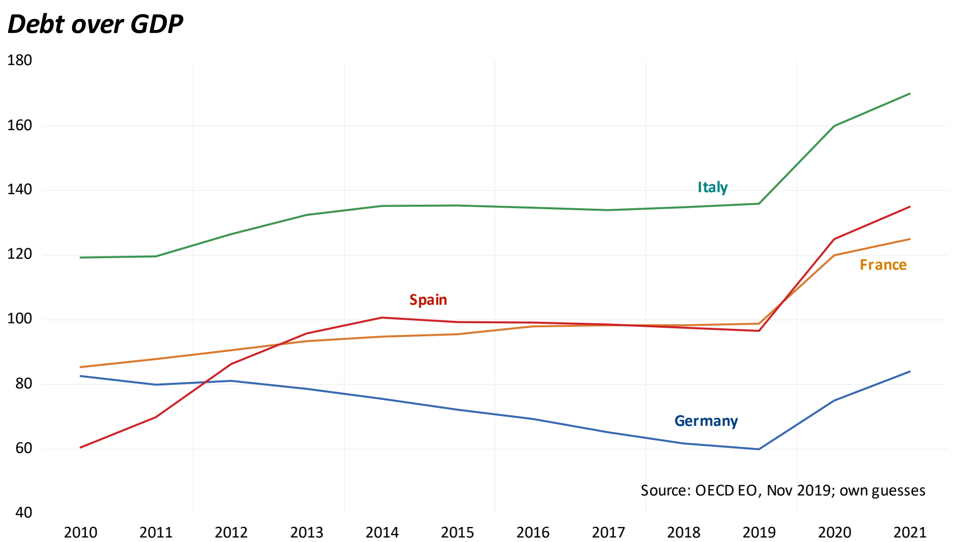
- Differential responses to rather similar shocks are the upshot of EMU's varieties of capitalisms (Amable 2005, Boyer 2015 et passim).
- One (of many) indicator(s) of 'variety', very coarse, is the share of the public sector in GDP.
- On top, France and the Nordics, at the lower bound the Southerners and, in between, Germany.

Background conditions

Responding to the last crises – *differentially* (3)



- While France has also the highest tax intake, and Italy is more 'taxing' than Germany (revenue graph not shown), the French primary deficit was ever since the GFC substantially higher (i.e. more negative) than anywhere else.
- Given the mediocre growth rates, a mechanical corollary was that French debt relative to GDP also rose substantially

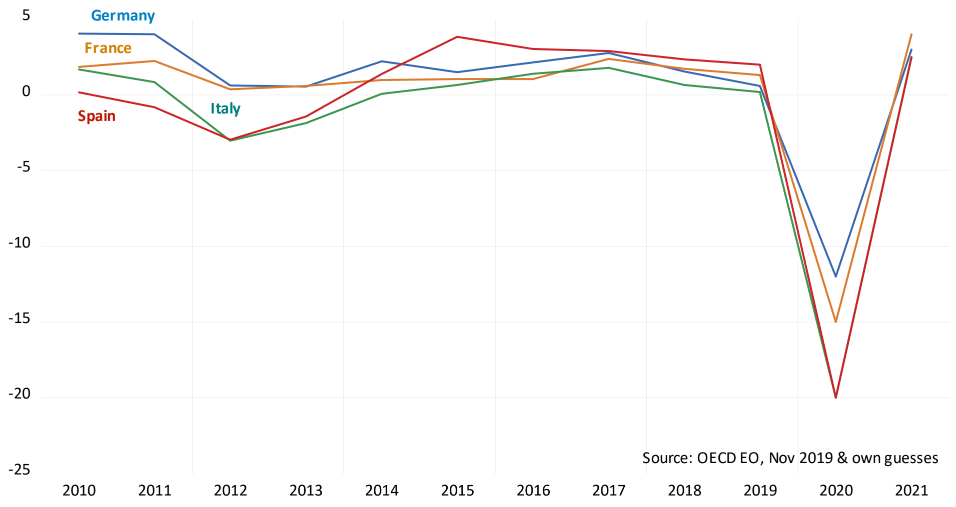


- This is the context against which the Covid-19 shock struck. Finding many EMU member states with a 'fiscal capacity' not in shape to respond as Germany, for example, did.
- Most evidently, no assessment of appropriateness/ quality of respective national policies implied (found Germany' *schwarze Null*, mainly implying public sector disinvestment, always indefensible (see here), as its unsustainable current account surplus) – just to illustrate what Xavier calls different ways of *civiliser le capitalisme* (Ragot 2019, ch. 4)
- The sharp upturn in debt ratios from 2020 onwards is based on my guesstimates about GDP and unemployment, see next page.

Background conditions

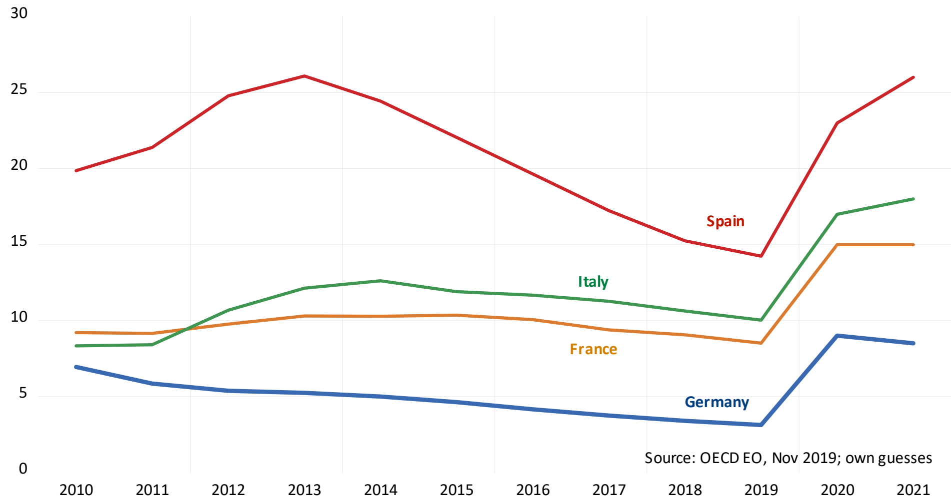
The Covid-19 shock: On impact

GDP growth



- Here are my guesstimates (OECD data until 2019, then my hunches) on the hit to EMU member states economies.
- They diverge substantially from official forecasts – which always have been too optimistic. Still, I really hope they (EU COM, IMF, OECD) are right and I am wrong.
- With the end of lockdown, very mechanically, a V-shape occurs. But this is arithmetic.
- Alas, what concerns the medium-run level of GDP, we are faced with massive uncertainty.

Unemployment



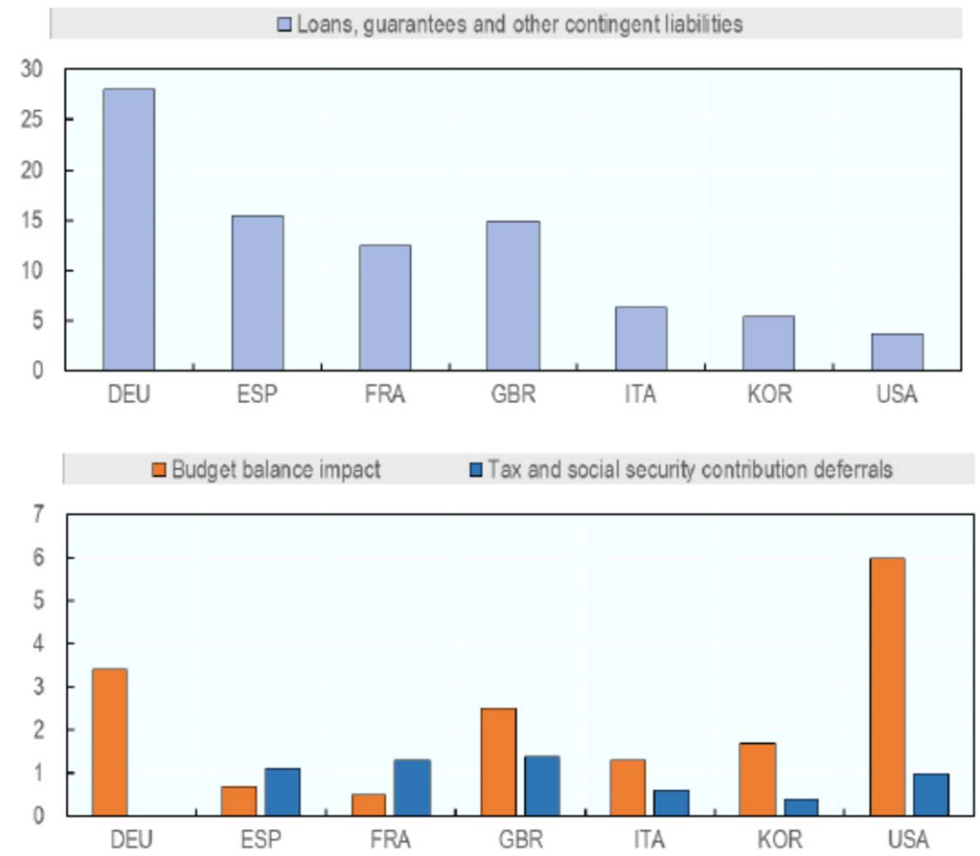
- … auguring badly for what we should expect. Inexorably, unemployment rates will jump. Almost all EMU member states have some version of *Kurzarbeitergeld* (Gazier, Petit 2019).
- But the threat of lasting scars (e.g. for job entrants) and hysteresis is massive. As is the challenge arising from structural adjustment needs…(automotive, tourism, airlines)
- Against this background, as regards capital expenditures and physically limited capacity utilization, the option to wait is too attractive.

Background conditions

The Covid-19 shock: First responses

Figure 2.1. Estimated scale of fiscal packages in response to COVID-19 in selected countries

As a percentage of GDP

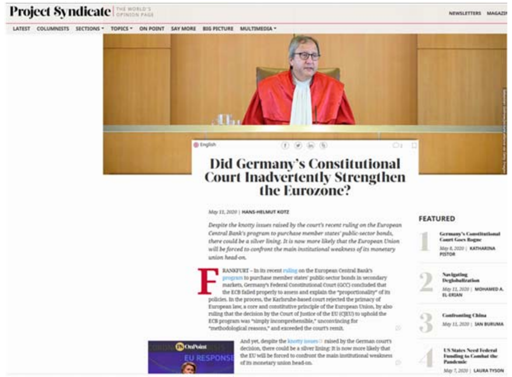


Note: Shows official estimates, when available, of financial help included in emergency packages announced by governments in response to the COVID-19 crisis, as of 31th March. In many cases, they are highly uncertain due to an unknown duration of the crisis and take-up of various programmes by the private sector, and may not be comparable across countries. Tax and security contribution value for Germany is zero.
Source: OECD compilation based on official estimates

- Responding to the shock, Germany pulled out all (alleged, surmised Ordo) stops.
- According to OECD figures, its fiscal package has double the size of Spain's and France's, and is five times as big as Italy's.
- These are data from early April. Meanwhile, further programs have been added and more is to be expected.
- This very much uneven capacity across EMU member states to respond should come with medium-run consequences.

- This threat of uncoupling combines with a re-nationalization of economic policy perspectives.
- Differential capacities to lend support (state aid) further unlevel the 'playing' field.
- Need for a European (coordinated) industrial policy – airlines, e.g.?

German Federal Court of Justice
ultra vires, beyond competency?



Judgement of FCC May 5, 2020 on ECB PSPP

- ECB program is "partially unconstitutional"
- ECJ decision beyond its competence (*ultra vires*)
- Missing "proportionality assessment" (assessing/balancing consequences for savers, real estate and other asset markets)
- Requesting German Government and Parliament to rectify this
- Otherwise, Bundesbank prohibited to participate in program as well as called upon to exit

Issues with FCC judgment (see my comments here)

- Theories, criteria to do "proportionality assessment"?
- Is the ECB entitled to do such a proportionality assessment?
  - Implications for ECB (and Bundesbank) independence
  - Implications for further ECB programs (in particular PEPP, March 22, € 750 bn)
- "National Courts Cannot Override CJEU Judgments" – is it that simple? (Reference to longstanding debate Habermas vs. Scharpf, Grimm et al.)

Karlsruhe's issues

- EU is not a federation but a **confederation** of nation states; only those tasks **explicitly** devolved to the higher, European level belong to its remit
- Basic understanding in federalist Germany: Its Länder have *Eigenstaatlichkeit* (enjoy the status of state-hood), federal level is **not** entitled to intervene in certain areas (education, cultural politics etc.). Even more: Art 30 Basic Law states a general competence of Länder to provide public goods. Bund has to be charged explicitly.
- FCC: The EJC is passing judgement in domains where it has no competence to do so, potentially violating "no taxation without representation principle" (fiscal consequences of ECB policies – there's no monetary without distributive effects…)
- ECJ rules mainly to protect the internal market, what Jan Tinbergen called 'negative' integration
- Subsidiarity is about acknowledging preference differences (consider debate about "Bolkestein" Directive as it was dubbed in France [le plombier Polonais] and the French referendum in 2004)

Options, pour simplifier/caricaturé

Ordre dispersé, subsidiarity?

Conceptual issues

- Do we need fiscal coordination across EMU member states? **Yes!** Because of substantial spillovers
- Old idea, I always agreed with Boyer 1999 (Plan), Muet et al. 1998 (CAE)
- What budget at Euro-Area level? Only a budget that provides for *European* public goods (cross-border externalities, economies of scale in provision etc.)
- **Richard Musgrave's perspective**: allocation, distribution, stabilization (von Hagen, Pisani-Ferry 2003; Alesina et al. 2002)
- Don't create an EMU budget for stabilization purposes (President Macron's initial proposal, Athens and Sorbonne speeches), this function is performed as a **by-product**.
- EU COM's €100 billion SURE program to supplement national short-time working schemes is a good start, barely conceivable before the crisis struck.

Two options, plus the exit one

- **Franco-German initiative**
  - € 500bn EU Fund very positive move, emphasis on grants (as opposed to loans), joint funding, helpful symbolism (*couple franco-allemand*)
  - scope of fiscal transfers rather modest, but door opener (temporary? Most probably not – think of EFSF and ESM)
- **Frugal Four alternative**
  - no grants, mainly loans
  - everybody keeps her own backyard in order (perhaps individually rational, but does not add up; also, two of this group of highly export-dependent frugals have an evident issue with free-riding on taxation, discussed in debates in NLD and AUT)
- **Back to EMS?**
  - option proposed by those frustrated with EMU's incapacity to deliver on positive integration (protective Europe, helping 'losers' to adjust)
  - would bring back dominance of Northern EMU central bank
- **'Sober realism (pragmatism)': keeping EMU going**
  - selfish solidarity….(prohibitive costs of implosion, including, most importantly, political economic), keeping EMU on the road.
  - another Monnet moment… hopefully!