Pandemic Borrowing

With the EU member states agreeing to borrow together to combat the impact of the COVID-19 pandemic, the issue of sovereign debt has reared its ugly head once again—and with it the unresolved tensions between the eurozone and the EU.

By Helen Thompson

The coronavirus pandemic has forced the European Union to confront again the long troublesome issue of sovereign debt in the eurozone, as governments borrow to fund stimulus programs needed to stave off the worst economic effects of the pandemic. While the agreement on a Recovery Fund in July 2020 seems to have shown a move toward more European solidarity, navigating a way through the difficulties national debt causes in a transnational monetary union continues to create existential questions for the EU.

In immediate terms, the situation is not nearly as bad as it was a decade ago, during the global financial crisis of 2009-12, because for now no eurozone state faces being shut out of international capital markets. Even when European Central Bank president Christine Lagarde told a press conference on March 12 that it was not the job of the ECB to reduce the spreads, the spike on Italian bonds was extremely modest compared to the borrowing rates confronting Italy during former Prime Minister Silvio Berlusconi's last weeks in office in the autumn of 2011. Now, Italy's 10-year bonds have fallen to all-time lows.

But Lagarde's slip and the fury in Rome at her remark did draw attention to the crucial importance of both what the ECB does and how the ECB is perceived in making a number of eurozone members' debt serviceable, starting with Italy's. The eurozone crisis ended in 2012 because the then ECB president, Mario Draghi, found a way of establishing an asset purchase program in Outright Monetary Transactions (OMT) acceptable to the German government that investors believed could be used, even if in fact it never has been. In January 2015, when the far-left Syriza party won the Greek general election and there appeared a serious risk of a second all-encompassing eurozone crisis, Draghi took the opportunity of a setback for those challenging OMT in the German Constitutional Court, the Bundesverfassungsgericht, to announce the ECB's first Quantitative Easing (QE) program. Without question, this move prevented "contagion" from Greece to the rest of southern Europe before the third Greek bailout. As his term of office came to an end last year, Draghi also gave the Italian government a parting gift by resuming that QE program. Any suggestion that the ECB doubts the wisdom of buying Italian debt still risks disaster, a reality effectively acknowledged when, a few weeks after Lagarde's statement, the ECB announced its pandemic QE program, with fewer rules constraining bond purchase from individual member states.

It was in this context that the Bundesverfassungsgericht's ruling in May that the ECB had acted outside its competences by failing to conduct an adequate proportionality assessment took on the significance it did. If the court had ruled between December 2018 and October 2019 when QE appeared to have come to a definitive end, then its decision would have mattered rather less. But coming as it did with one QE program in operation and another more ambitious one—to deal with the COVID-19 pandemic—having just begun, the court's decision threatened the ECB's ability to act as a lender of last resort to Italy.

In any normal circumstances, this would have constituted a trial for the eurozone. But again, the pandemic magnified the problem several times over. Until March 2020 Italy's new borrowing had been to service old debt. But Italy has since then also needed to borrow to finance its stimulus program. Moreover, once the German government quickly moved to scrap the debt brake prescribing a balanced budget in order to pursue its own fiscal stimulus to combat the effects of the pandemic, Italy faced being left behind in the recovery stakes because its space for new borrowing was much smaller than that enjoyed by many other eurozone states. The part of the German recovery plan that relied on taking advantage of the European Commission suspending the EU's state aid legal regime to provide support for corporations like Lufthansa also opened the prospect of borrowing inequalities making themselves manifest in the Single Market.

Even before the decision from Karlsruhe, French President Emmanuel Macron had seen the pandemic as an opportunity to revisit the issue of joint eurozone debt. But without a real risk that the ECB would be stopped in its tracks tempting investors to push Italian yields back toward crisis levels, he could not shift German Chancellor Angela Merkel's position. Only when the German Constitutional Court pushed back did the calculus confronting the chancellor change. If the original QE program fell short of the ECB's legal authority, then pandemic QE would have no chance of satisfying the court. The existing alternatives to the ECB commitment were unpropitious. Although the European Stability Mechanism (ESM) provided an institutional mechanism for a bailout, it was abundantly clear in the spring of 2020 that any Italian government would regard the prospect of utilizing the ESM as unacceptable.

No Hamiltonian Moment

But in moving toward Macron's starting position that there must be some common eurozone debt, if only to strengthen national fiscal capacity, Merkel only exposed the predicaments that the EU as a political and legal entity now creates for the eurozone and, in turn, the eurozone as a subset of EU member states poses for the EU. These problems begin with the relationship between debt and tax in the Recovery Fund first proposed by the German and French leaders and then agreed to in slightly different form by the EU heads of government in July.

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Since the Recovery Fund will allow the European Commission to borrow in the EU's name and since some of the funds raised will then be distributed as grants, some EU observers heralded the move as a transformative moment for the eurozone, comparable to Alexander Hamilton's first efforts to make the debts of the 13 original American states the debt of the federal American union. But Hamilton's move to create the federal assumption of individual state debt in 1790 required the prior ratification of the American federal constitution in 1788, giving the American federal government the authority to impose taxes. Nothing proposed by Merkel and Macron or agreed at the EU summit in July approaches such a political change. In the short term the EU is looking no further than to place a new common tax on plastic bags.

Merkel gave the non-eurozone member states an effective veto

Without much in the way of revenue constituting the EU's own resources, the common debt must rely on taxes coming from the member states. Rather than representing the Hamiltonian moment, relying on member states pledging taxes from their national tax-raising authority to service shared debt risks running into the exact same problem that in its disastrous consequences finally led to the Hamilton moment in the United States. It was because investors lost confidence in the debt issued by the US Continental Congress—when the individual states were reluctant to make the requisite fiscal transfers to the treasury—that the American federal government acquired tax-raising powers. It was because state governments' struggles to service state debt undermined federal creditworthiness that Hamilton proposed the federal government take responsibility for all state debts.

However, the eurozone's difficulties here go well beyond those that afflicted the American republic. The early American republic was not a monetary union and, consequently, did not have issues around a single currency. That the EU is a multi-currency union in which a majority of states nonetheless share a currency has long been a particular burden for the EU. But the EU Recovery Fund turns it into a direct problem for the eurozone, too.

In insisting that grants and loans from the Recovery Fund be funnelled through the Multiannual Financial Framework, Merkel gave the non-eurozone member states an effective veto over what is now the means by which Italy's fiscal latitude can be enhanced. Moreover, the very fact that the allocation structure decidedly benefits two non-euro members, Hungary and Poland, under Article 7 proceedings, gives the governments keenest to discipline these two eastern European states (among them the non-euro members Sweden and Denmark) an opportunity to demand more on rule of law compliance. This then increases the incentive for the

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Hungarian and Polish governments to use their effective veto power. These dynamics caused the drawn-out tangle between the European Council and European Parliament and veto threats by Budapest and Warsaw that risk delaying the Fund's planned start in January 2021.

Recontesting the Agreement

This difficult process underlined the fact that political consent to the Recovery Fund from the governments of some eurozone members has been weak from the start. To reach any agreement at all in July, the southern Europeans had to concede that individual eurozone member states could increase surveillance powers over their budgets on top of those already formally given to the European Commission and in practice required to maintain access to the ECB's asset purchase programs. Now demanding strong provisions on rule of law conditionality that cannot be accepted by Hungary and Poland is an opportunity to recontest the July agreement, especially when there are genuine difficulties ahead for some in procuring parliamentary ratification for whatever Council-Parliament compromise eventually emerges.

Yet Merkel's rejection of new eurozone institutions of the kind Macron has advocated arises from an ingrained political realism. The Commission will acquire the right under existing legal authority to borrow in the EU's name to deal with the COVID-19 pandemic and the recovery from that emergency. Any eurozone fiscal authority or a eurozone parliament would, by contrast, require a new treaty. Treaty change is a long and arduous process, are there are no guarantees that all member states would agree to a ratification.

The fact that utilizing the Multiannual Financial Framework can be accommodated within existing treaties does not, however, ensure that national democratic politics can be kept at bay. The very fact that governments with a working parliamentary majority should be able to push through an EU agreement that in net terms will use future taxes from some member states to repay debt acquired to finance expenditure in other member states is prompting some opposition parties to make an issue of democratic consent to the agreement. This impulse appears to be most consequential in Finland, where activists from the Finns Party have secured enough signatures in a citizens' initiative to demand a referendum, so that the process by which ratification should proceed must now be debated in the Finnish Parliament.

The cumulative political difficulties generated by the moves to strengthen the emergency fiscal capacity of the weaker eurozone states strike at the heart of the very issues that complicate the EU-eurozone relationship. After 2010 the United Kingdom's position inside the EU was structurally weakened because the eurozone crisis politicized London's position as the eurozone's offshore financial center, and then, when the British economy began to recover as southern Europe remained mired in recession, the Single Market turned the United Kingdom into an employer of last resort for a monetary union to which it did not belong.

Once these dynamics were in play there was little former Prime Minister David Cameron could do to minimize them. On the one hand, eurozone matters had to have priority for eurozone member states and no other non-eurozone member state was experiencing the same problem. On the other hand, any significant change to freedom of movement that could have been contemplated would have required revisions to the EU treaties. That the EU-27 could not move after Cameron formally asked that they did, served to demonstrate to British voters that the Single Market is a protected constitutional order, unresponsive to national democratic politics.

Demarcations Breaking Down

Now similar dynamics generated around the EU's internal politics as a multi-currency bloc with a single currency center are in play. But this time the difficulties concern more than one non-euro member. As after 2010, demarcations that kept issues from spilling between the eurozone and the EU's legal order are breaking down, and this is happening just as the demands—tax-wise—that EU governments must ask of electorates as citizens of national states, and not as citizens of the EU, is growing.

There have always been paths down which the EU can muddle through its apparently centrifugal contradictions. The great advantage of confederations—if, with some crucial caveats, that is what the EU is—is the issues they can leave unresolved because there is no sovereign that can impose supposed remedies. But one of those caveats is the ECB's authority, and the ECB cannot leave individual member states to their own devices where debt is concerned at the same time that its pandemic purchasing program is subject to a constitutional challenge in Germany. In Berlin, the point of the Recovery Fund was to take the pressure off the ECB. But thus far it has only ended up demonstrating just why the ECB is the only part of the EU equipped to deal with the predicaments sovereign debt creates for the eurozone. IP