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The European monetary union at risk

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Abstract

This paper analyses the recent ruling by the German Federal Constitutional Court against the backdrop of increasing risks of debt unsustainability in the Euro Area. It concludes that an unresolved trade-off between discipline and risk sharing in the European monetary union will jeopardize the survival of the euro.

Keywords: Fiscal policy, Public debt, Monetary policy, Euro

The European Monetary Union at Risk

The lockdown of most EU countries in response to the Covid-19 pandemic has produced disruptions in the production process and brought consumption and investment to a halt. Against the backdrop of these supply and demand shocks, EU Member States have implemented different public policies, deferring or waiving tax payments and social security contributions, raising spending on the health sector, and providing more generous welfare payments to short-time working schemes.

Euro Area (EA) countries have not been equal *vis-à-vis* the intensity of the health crisis, and they are not equal in terms of their fiscal capacities to cope with the lockdown shock. The scars of the former global financial crisis and ensuing so-called "European sovereign debt crisis" remain in some countries where public debt-to-GDP ratios are still very high. Larger public deficits in these countries raise the fear of a higher risk of default.

Quite strikingly, EU fiscal cooperation has long stalled. In the early days of the lockdown, the escape clause of the Stability and Growth Pact was activated, giving rise to a temporary lifting of European fiscal constraints. There was also a softening of State Aid regulations. Then, it took a month for European Member States to go a step further. The European Stability Mechanism will include a Pandemic Crisis support of no more than 2 percentage points of country-specific GDP. The European Investment Bank will extend its financial support to small and medium sized companies by €200 billion. The Commission will also devote €100 billion to a temporary support on unemployment risk in an emergency. Creel et al. (2020b) have calculated that these three measures would provide a net gain to Italy and Greece of less than 0.1 percent of their respective GDP, while the gain would be even less for all other EA Member States.

The European Central Bank (ECB) has also committed to being the lender of last resort of banks, through a favourably-priced long-term refinancing operation (LTROs) at the negative deposit facility rate or below, and it extended its Asset Purchase Programme by €120 billion, then by an additional €750 billion a few days later with the temporary Pandemic Emergency Purchase Programme (PEPP).

This paper highlights two important issues related to the macro management of the Euro Area (the ability of the ECB to pursue its PEPP and the fiscal margins for manoeuvre of EA Member States) and concludes on the necessity to solve the trade-off between discipline and risk sharing in the European monetary union.

Has the German Federal Constitutional Court announced the end of the PEPP?

The German Federal Constitutional Court (FCC) ruling on the Public Sector Purchase Programme (PSPP) on 5 May 2020 sparked new uncertainty at a moment when uncertainty was already high. Yet the FCC did not oppose a former judgment by the Court of Justice of the European Union (CJEU): "(it) did not find a violation of the prohibition of monetary financing of Member States budgets". Therefore, it disagrees that PSPP "effectively circumvents" provisions of the Treaty on the Functioning of the European Union (TFEU).

Meanwhile, the FCC considers that the judgment of the CJEU is "incomprehensible" for it was not based upon a clear and prior diagnosis of the economic policy consequences of the implementation of PSPP. More importantly, the conformity of PSPP with the TFEU relates to the conditions that the ECB has put forth and fulfilled so far in the implementation of the purchase programme. Let me briefly comment on the latest points.

Not surprisingly, many macroeconomists have been puzzled by the FCC's distinction between "monetary policy objective" and "the economic policy effects arising from the programme". It looks as if the FCC thought that achieving the monetary policy objective of the ECB did not require interactions with other macroeconomic and financial variables. Actually, monetary policy can deliver its objective via the good functioning of monetary channels of transmission. The most direct one is the interest rate channel: if consumer price inflation goes up and above the target, the central bank can raise its policy rate and it will in turn push the long-term interest rate up and dampen aggregate demand. What works when consumer price inflation goes up works symmetrically when it goes down and below the target... unless the policy rate has reached a lower bound, like a zero-policy-rate. If it happens (and it did!), the central bank must resort to other instruments and transmission channels to deliver: credit, asset price, exchange rate, and balance sheet channels. Hence, "the economic policy effects arising from the programme" are the very reason behind the implementation of the PSPP. It should be remembered that disentangling monetary effects from economic effects is not easy, for the interrelationships are many. Moreover, the "monetary policy objective" that the FCC isolates is the price stability objective. In so doing, the FCC fails to give due consideration to the secondary objectives that the TFEU attributes to the ECB, like "aiming at full employment and social progress" and "the promotion of economic, social and territorial cohesion, and solidarity among Member States".

Now, on monetary financing of Member State budgets. A first remark: the TFEU provision prohibiting monetary financing underpins the independence of the ECB *vis-à-vis* governments. It is therefore a bit puzzling that the FCC ruling weakens the ECB's independence by challenging the CJEU rulings and demanding that the ECB argues that its policy fulfilled the principle of proportionality between the monetary policy objective and the economic policy effects. While the independence of the ECB does not rule out control of its actions (these controls exist), its actions will be made impossible if 19 different Constitutional Courts rule on its decisions.

Second, the FCC judgment argues that "a manifest circumvention of the prohibition of monetary financing is not ascertainable , especially because (...) the purchase limit of 33% per international securities identification number is observed (and) purchases are carried out according to the ECB's capital key". The FCC goes on and argues that "the PSPP does not provide (...) a risk-sharing programme – which would (...) be impermissible under (German) primary law – in relation to bonds of the Member States purchased by national central banks".

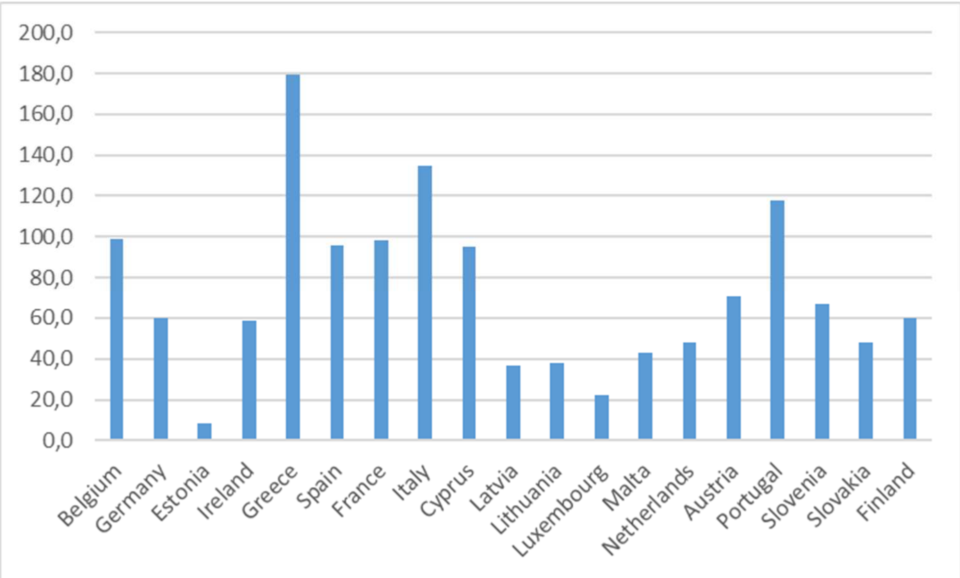
While these arguments leave the PSPP innocent of bypassing the prohibition of monetary financing, they will act as a Damocles' sword on the PEPP. The FCC's ruling of 5 May 2020 comes as a threat to the capacity of the ECB to implement the measures it has taken in the context of the coronavirus crisis. Actually, on 18 March 2020, the ECB announced that, "while the benchmark allocation across jurisdictions will continue to be the capital key of the national central banks, (PEPP) purchases will be conducted in a flexible manner. This allows for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions". It continued arguing that "to the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the (ECB)

Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks that we face". It is clear that the FCC implicitly objects to these new monetary settings. As for the requirement of European solidarity, as laid down in Article 3 of the Treaty of the European Union (TEU), the FCC also rules out a risk-sharing mechanism. This latter outcome may be another hurdle to the management of the current coronavirus crisis.

Fiscal space in the Euro Area

Since the inception of the lockdown policies in Europe, governments have resorted to higher public spending and tax deferrals and exemptions to limit the real costs of the crisis. They have had to raise domestic public debt, although some of them had not yet fully recovered from the previous crisis and its consequences on their public finances. In 2019, half of the EA Member States had a debt-to-GDP ratio above the 60 percent threshold, some with debt way above 100 percent (Greece, Italy and Portugal).

Figure 1. Public debt in the Euro Area in 2019 (in percent of GDP)



Source: Fiscal Space World Bank Database

It is possible to study the sustainability of public finances in the Euro Area against the backdrop of predictions on the long-term interest rate and future economic growth rate, under different public debt targets. Kose et al. (2017) recall that one simple indicator of the ability of governments to pay the interest on their debts and to pay back these debts is the difference, call it the fiscal space, between their actual fiscal policy and the fiscal policy that would stabilize their debt-to-GDP ratio at a given target. For instance, if the difference between the GDP growth rate and the long-term interest rate is equal to 5 percent, a public deficit equal to 3 percent of GDP is sufficient to stabilize debt at 60 percent of GDP. Well, a difference of 5 percent between economic growth and the interest rate did happen, in the late eighties maybe, but the situation has worsened much since. If GDP drops by 8 percent and the long-term interest rate remains low, say at 0 percent, the public *surplus* necessary to stabilize debt at 60 percent of GDP is 4.8 percent of GDP. This is enormous and unachievable in the midst of a crisis like coronavirus. Hence, the issue of debt sustainability.

Drawing on the Kose et al. (2017) method and data, I have made numerical simulations of fiscal space in the euro area under 12 different situations (low growth, high growth, low interest rates, high interest rates, debt target at 60 percent of GDP or higher, and a mix of them, see Creel, 2020 for details). Overall, simulations point to great uncertainty surrounding the capacity of Member States to pay back their public debts. Unless nominal long-term interest rates remain low and economic growth resumes at its pre-Covid-19 median level, most EA countries will fail to address debt sustainability without fiscal consolidation. In the worst-case scenario of high interest rates and long recession, even Germany would lack sufficient fiscal space to stabilize its debt-to-GDP ratio.

It therefore appears that debt stability is a shared concern for most EA Member States, with the exception of Cyprus, Luxembourg and Malta.

Conclusion

The latter outcome shows the tensions between, on the one hand, the crucial necessity to use fiscal room for manoeuvre to dampen the lockdown shock on supply and demand and, on the other hand, the absence of fiscal room for manoeuvre if interest rates go up. Hence, it is necessary that the ECB should be able and allowed to cancel interest rate pressures, wherever they may happen in the Euro Area, with conventional and less conventional policies, otherwise debts will sky rocket. The ruling by the German Federal Constitutional Court has fuelled this risk.

It is also of the utmost importance to understand that the former tensions also relate to the trade-off between risk-sharing and fiscal discipline that has spoiled European intergovernmental negotiations for so long. Without some forms of risk-sharing, such as Coronabonds or Perpetual Bonds (see Creel et al., 2020a), some Member States of the Euro Area will not be able to exit the coronavirus crisis and they may be forced to exit the Area. Can the European monetary union afford that? I do not think so.

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