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The EU must agree to mutualize and monetize some of the costs of this crisis

The Covid-19 crisis increases the disparities between European economies and threatens the integrity and sustainability of the single currency. Economist Shahin Vallée analyses the choices made at EU level and reasserts that governments must allow a level of fiscal mutualisation, and that, without political endorsement, the Eurozone's sustainaibility is at stake.

The cost of this crisis will prove to be the biggest economic shock in a century and given our levels of debt, it will be a testing moment for European economies and for European politics. While the crisis was a purely symmetrical crisis affecting all European countries and highlighting their interdependence, the response has been largely uneven and national. This has the potential of turning this crisis into asymmetrical crisis. So far, the fiscal response in Germany has been substantially larger than that of Italy or Spain, and its health response will allow to restart its economy sooner. The consequence of that is that this crisis could further accelerate economic divergence between European countries. This is particularly important in the euro area where it could fuel again economic divergence that could threaten the integrity and sustainability of the single currency.

Need of a level of fiscal mutualisation

So far, the European Central Bank has been undertaking buying large amounts of European government debts and de facto played the role of mutualizing the fiscal response that European governments have shunned. But this is not a sustainable construct. Indeed, the central bank cannot durably effectively mutualize and monetize the costs of this crisis without political endorsement. Governments must allow a level of fiscal mutualization, which will enable the ECB to underwrite parts of the costs of this crisis. Whether we allow collectively this to take place over the next few months will determine to a large extend the shape of the European economy and European politics for the next generation. In the absence of mutualization and monetization, Europeans will agonize with Scharibde of austerity and consolidation and the Scylla of debt restructuring that could simply destroy the single currency and the European Union.

As it stands, the debate on these matters have echoed the tensions of the Euro Crisis and raised similar concerns against the backdrop of two powerful changes in public opinion in Germany and in Italy. In Germany, a broad coalition of economists has called for a common fiscal response, which has been supported by a large part of the press and seemingly backed by public opinion polls. Unlike during the Greek crisis, Germans understand the need of solidarity or for enlightened self-interest. In Italy, a decade of fiscal challenges, migration crisis, political challenges have exhausted the public opinion such that after this epidemic the support for the EU and for the single currency has collapsed. Unlike Greece in 2015, there is now a majority of Italians who believe that Italy would be better off leaving the single currency. In France, after three years and numerous fruitless attempts to Franco German initiatives, there is a growing sense of fatigue. Whether it be on the military front, where Germany has just announced its plan to buy a new fleet of American F18 fighter jets, or on the monetary union front, there seems to be very little progress towards integration and certainly little influence of French initiatives. In Spain, after a traumatic euro crisis and enduring political crisis that left the country with fractured politics and no political consensus, there is a desire for a great European push but few allies to carry it out with: France is disenchanted, and Italy enfeebled and divided. Meanwhile, northern European countries have increased their cooperation, which they see as increasingly necessary after the departure of the UK. Whether it takes the form of the Hanseatic league or the frugal four in the budget negotiations, the reality is that the EU is increasingly divided and without leadership. This raises a fundamental medium-term challenge to the Euro Area.

A leap in European integration

All in all, this crisis, like the previous one raises fundamental questions about the political agreement underpinning the Maastricht Treaty. After a first decade of great moderation, the last decade has highlighted the profound vulnerability of the single currency. Rewriting the Maastricht Treaty so as to allow genuine fiscal risk sharing will however be challenging. For the time being, Germany demands control of national fiscal policies in exchange for fiscal risk sharing. This is understandable and is the logic that was enshrined in the European Stability Mechanism, but it is politically deadly. In Italy, the use of the ESM would certainly provoke a political crisis, topple the government and fracture further the affectio societatis that is required to keep the EU alive. There is an alternative to this model that is both economically more effective and politically more sustainable, but it requires a leap in European integration. It requires a form of European fiscal federalism that truly endows the EU with a real power to tax, borrow and spend under the control of a European executive democratically controlled by the European Parliament. There is a path to this solution that be found now under duress during this crisis, but it will require profound treaty revisions down the line. Indeed, as it stands the German Constitutional Court has been reluctant to transfer more fiscal and political powers to the EU because it considers that the Lisbon Treaty and in particular the European Parliament offer insufficient democratic safeguards. European will therefore not escape the democratic and accountability question that is rightly posed by Germany. But before we get there, we will have to agree to a form of fiscal mutualization now. Because the stakes are so high, it is unlikely that the answer will be entirely binary and, the compromise is likely to leave a lot of room for interpretation and path dependency. However, if a constructively ambiguous agreement is not reached, financial markets will consider that the European commitments to mutualization is weak and therefore sustainability of the euro and the EU is compromised.