‘Corona bonds’ and Europe’s north-south divide

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The Eurogroup’s decision to reject corona bonds will leave destabilising political scars.

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It is a cruel twist of fate that the Covid-19 crisis has exposed the basic faultline in the eurozone between north and south. The resulting debate about how to craft a joint response has been bitter.

The compromise agreed provisionally by the Eurogroup meeting of finance ministers on April 9th was a relief. For the Eurogroup to have broken up a second time in a week without a deal would have been a disaster. It would probably not have resulted in a bond-market panic—massive interventions by the European Central Bank have neutralised that possibility for now. But in political terms it would have sent a terrible signal of disunity.

The three-pronged package—with funding for health expenditure via the European Stability Mechanism, loans for businesses from the European Investment Bank and €100 billion for the European Commission’s unemployment fund—is modest in scope. It is disappointing to those of us who support the ‘corona bonds’ position. But it is a relief at least that it was a compromise, rather than a humiliating capitulation inflicted on the coalition of the nine advocates of corona bonds by the stubborn and short-sighted egotism of the Dutch and Germans.

Indeed, in political terms the Dutch may have done their cause more harm than good with their demand that ESM loans should be conditional on structural adjustment. Rather than as allies of the Dutch, the Germans now prefer to be seen as mediators.

Admission of incapacity

In relation to the current crisis, even if we take the generous headline figure of €540 billion for the support package at face value, the deal is an admission of European incapacity. In light of the trillion-dollar hit to the global economy, its modest dimensions amount to an admission that priority in crisis-fighting remains with the nation-states.

The best that can be said is that it provides a framework for further negotiation. There is the commitment to establish a temporary reconstruction fund, to be financed with ‘innovative tools’—what that means remains to be seen. Unfortunately, given our

experience in the last few weeks, short of a change of government in the Netherlands there is little reason to be optimistic.

When the immediate health crisis has passed, when 'all' that is at stake is the misery of mass unemployment in Spain or a further shock to Italy's growth prospects, why should we expect the northern states to act any more co-operatively than they have since 2010? The ratios of public debt to gross domestic product will be worse. Expect the discourse of debt sustainability and fiscal responsibility to be as relentless as ever.

Of course, one should never say never. Sophisticated polling reveals an openness on the part of the German public towards corona bonds, which could be exploited by creative and brave political leadership. Expert opinion has shifted quite markedly; the broad-based calls for joint action from German economists are new and extremely welcome. Both in Germany and the Netherlands a large part of the public is frankly embarrassed by their government's positions.

The political argument is not over. It will resume when the heads of government next meet. But one thing is already clear: crisis-fighting proposals based on the ESM are, in practice, a dead letter. The path to an agreement on April 9th was only cleared when the Dutch finally abandoned their demand that the main form of support be ESM loans with conditionality. Even in the attenuated form in which it is included in the current package, the mere mention of the ESM is enough to trigger outrage in Italy.

Mean-spirited intention

In fairness to the Dutch, their position on the ESM was not anomalous. What they were asking for was true not just to the letter but to the mean-spirited intention which gave birth to the ESM in the first place. It was always intended to be a tough financial workout that forced as much structural adjustment for as little credit as possible.

But at least the ESM existed. And until last week we could pretend that that mattered. Many complex and not at all mean-spirited designs for a joint corona response were drawn up which proposed that funding should be offered by way of the ESM. The ESM was advanced as the anchor for the very good reason that it was the one facility immediately available.

The ESM has an established role as the trigger for another of the eurozone's putative stability devices, the outright-monetary-transactions facility of the ECB. OMT emerged in August 2012 after the then bank president, Mario Draghi, made his daring *démarche* on 'whatever it takes'. One of the conditions that made OMT acceptable—if not to the German *Bundesbank* then at least to Angela Merkel's government—was the provision that ECB bond-buying should be conditional on a country being approved for an ESM programme, complete with a memorandum of understanding.

Even at the time, it was clear to anyone who wanted to go beyond Draghi's words that these conditions made OMT very unlikely ever to be activated. Nevertheless, it was convenient to pretend that OMT-ESM was the substance behind 'whatever it takes'. It has

never been tested because the ECB, since 2015, has bought bonds in the guise of 'quantitative easing'.

That is what the ECB did in 2019 and again in response to the coronavirus crisis in March. Those were general economic-policy interventions that inched around the question of risk-sharing and the asymmetric impact on stronger and weaker members of the euro area. In the background there was always the suggestion that, if Italy really got into trouble, there was OMT to fall back on.

Fig-leaf removed

What the Eurogroup impasse of recent weeks has done is remove that fig-leaf. What has now been made clear is that recourse to the ESM is very unlikely to be acceptable.

Fundamentally, this is because the ESM has not escaped its origins in the tumultuous and bruising history of the eurozone crisis of 2010-12. It continues to be seen as a humiliating disciplinary device, through which northern-European euro-area members impose their policy agenda on the wayward south.

It is easy to be impatient with such invocations of history. Of course, it is convenient for politicians in indebted southern-European countries to blame their troubles on Brussels and Frankfurt. But neither of the current governments in Rome or Madrid can be accused of populism of this variety. Both are calling for more Europe, deeper integration. But they are no less clear about the fact that the ESM, as a legacy institution of the eurozone crisis, is political poison.

That should give Europe pause for thought.

Lasting scars

It is one of the European Union's great truisms that it is 'forged in crisis'. What this underplays is that crisis can also leave lasting scars. Indeed, crises can create not just disfiguring marks but neuralgic points which trigger acute pain even years later. The eurozone crisis has in memory become almost akin to a European civil war—a moment in history that generates unreconciled and divisive narratives, whose intensity does not ebb predictably with time.

What we have learned over the last few weeks is that the ESM, the eurozone's designated crisis-fighting mechanism, is caught up in that war of narratives. And that has real effects.

Those who argued against corona bonds on the ground that this was not the moment for such a gratuitous innovation and, instead, favoured ESM-based solutions, because the mechanism was already available, got the wrong end of the stick. It was the ESM route that was unrealistic, precisely because it was an institutional inheritance of the

eurozone crisis era. One of the things that makes corona bonds attractive to their proponents is that they would be new and would thus not bear the odium of the euro area's bitter history.

Unfortunately, history is made constantly anew and the fraught debates of the last couple of weeks will themselves have a legacy. With the Dutch and the Italians having dug in their heels, it will in future be even harder for anyone to avail themselves of the ESM's support. What kind of shock would it take for any prospective candidate to turn to it now? What was only a few weeks ago seen as the basic institutional frame of a true crisis-fighting capacity has been shunted off into the marginal role of paying for healthcare spending, specifically excluded from any macroeconomic stabilisation function.

Damage done

Of course, there is the new reconstruction fund, with details and financing yet to be worked out. Perhaps something innovative will emerge. But no one should be under any illusion about the damage done since the idea of corona bonds was launched in March.

Merkel and her finance minister, Olaf Scholz, no doubt wish that the nine heads of government had never put the question so clearly and so urgently. Did they not understand that Berlin was bound to say no? Would it not have been better to muddle along?

Perhaps. But in history there are no reruns. The proposal cannot be unmade. The question has been put, an answer given. It will cast a shadow. It may overtake Europe in future—in the same way memories of 2010-12 overtook the ESM this spring.