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Medium-term Impact of COVID-19 on the Future of the European Union

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A prior note explored some of the short-term consequences of the coronavirus crisis for the European Union. While there are many possible medium-term consequences, three important ones stand out.

1. EU Trade Deals Will Be Tougher to Conclude

In the wake of the economic destruction caused by the coronavirus crisis, European member states will be under even greater popular pressure to avoid substantial trade liberalization initiatives. In this environment, specific interest groups that stand to lose out will be even more outspoken, drowning out those interest groups that stand to benefit. It is highly significant that even the EU's free trade deal with Canada was ratified with a small majority in the lower chamber of the Dutch parliament and may face difficulty in the upper chamber, despite the fact that the Netherlands is one of the most fervent supporters of free trade in the EU. It is also significant that the EU's proposed free trade deal with Mercosur has run into widespread opposition because of objections regarding Brazil's treatment of the Amazon rain forest.

A new Franco-Dutch initiative on free trade is a sign of the changing times. Until now such an alliance, between countries on opposite sides of the free trade debate, would have been unthinkable. While the initiative's call for free trade agreements to enshrine strict labor and environmental protections is not new, it goes further by proposing that any future agreement guarantees respect for the Paris climate change agreement and ensures tougher enforcement (that has been lacking). While the initiative may well be in tune with the EU's Green objectives and popular sentiment, it will complicate the EU's ability to continue signing ambitious trade accords, as it has recently done with Canada, Japan, Singapore and Vietnam. A renewed effort to negotiate a transatlantic trade agreement under a Biden administration will necessarily have to recognize the new reality. An agreement to eliminate tariffs on industrial goods trade may be the most feasible option.

2. Italian Financial Crisis May Become More Likely

Italy entered the coronavirus crisis with a very high debt to GDP ratio (134%). Worse still, the country has suffered more than a decade of economic stagnation and has been unable (unlike Spain and even Greece) to bring its unit labor costs under control, making many of its exports uncompetitive. Italy's debt burden is manageable as long as the cost of servicing the interest cost is low, as it has been recently.

Italy will be one of the countries hardest hit by the coronavirus, due in part to its very high proportion of elderly citizens (23% of the population is over the age of 65), its reliance on tourism (7% of its economy) and its backbone of small and medium-sized businesses (often family-owned) with limited ability to withstand shocks. Some analysts are talking about a "10-10" scenario in which this year's growth rate shrinks by 10% and budget deficits worsen by 10%. In such a scenario, Italy's debt would rise to 158% of GDP this year and then to 167% in 2022. One of the three big credit rating agencies has already characterized Italian public debt as "junk." If a second one follows suit, there could be a wave of forced selling by holders who require an investment grade rating. At some point the markets might start to question whether the fairly low spread

between Italian and German sovereign debt is justifiable. If the ECB is unable to "do whatever it takes" to buy Italian sovereign debt essentially without limits, then the sustainability of the debt load might become problematic.

Moreover, the coronavirus crisis may aggravate the weakness of Italy's banking sector. The crisis will likely eliminate (and probably reverse) all of the progress that Italian banks have made since the financial crisis to reduce the very elevated levels of non-performing loans weighing down their balance sheets. Many Italian banks will emerge even weaker from this crisis, with reduced equity capital buffers and price-to-book ratios well below one (reflecting the market's view that a large chunk of their assets may eventually be worthless). The self-reinforcing "doom loop" – in which weak Italian banks buy Italian government debt in return for state bailouts – has not been addressed since the financial crisis (they still own €380 billion in public debt, roughly one fifth of the total).

3. European Central Bank Might No Longer Be Able to Do "Whatever it Takes"

European Central Bank President Christine Lagarde had a rough debut in March when she stated at a monthly news conference that the bank was "not here to close spreads" between the borrowing costs of member states. That comment immediately sent Italian bond yields sharply higher and triggered harsh criticism, especially in Italy. Lagarde was forced to backtrack, later saying that "There are no limits to our commitment to the euro" – echoing her predecessor Mario Draghi's famous promise that the ECB would do "whatever it takes" within the ECB's mandate to save the euro. A recent ruling of the Germany Constitutional Court has raised doubts about whether the ECB can respect its commitment. This matters because the ECB has been in the invidious position over the past decade – largely because member state governments have shirked their political responsibilities -- of being the only EU institution capable of acting swiftly and decisively in the past decade to defend the euro.

On May 5, the German Constitutional Court ruled on the legality of the European Central Bank's 2015 quantitative easing program to buy sovereign bonds. Although the Court did not find the program illegal, as some observers had feared, it did require the ECB to justify its actions and threatened to block the German Central Bank from buying bonds under that program. The ruling's true significance, however, lies in how it may constrain the ECB's future role in purchasing bonds as part of its new stimulus program to deal with the coronavirus crisis. It is highly likely that new court cases will be filed to challenge the legality of the ECB's recently launched Pandemic Emergency Purchase Programme (PEPP) to buy €750 million in eurozone government bonds. That program is critical to calm nerves about the sustainability of debt loads in some member states, especially Italy. Some observers worry that the PEPP is even more legally vulnerable than the 2015 ECB stimulus program because it features fewer limits and could therefore be criticized as illegally financing governments.

The constitutional repercussions of the decision may be even more significant than the financial ones. Although the German Constitutional Court didn't question the supremacy of EU law over national law or even the ability of the ECJ to be the supreme arbiter of EU law, it did appear to question whether the ECJ had overstepped its powers in deciding what is a matter of EU law for it to decide. That has emboldened several euro-sceptic governments, such as Poland and Hungary, that have repeatedly invoked national sovereignty to question the jurisdiction of the ECJ. Both countries have faced infringement proceedings before the ECJ brought by the European Commission for their failure to implement EU law regarding the independence of the judiciary and the media.

The ECB has testily noted that it need not (and will not) justify its actions to the German Constitutional Court because it -- unlike the German Central Bank -- is not subject to German law. Lagarde has noted that the ECB is "undeterred in delivering on our price stability mandate" and that there are "no undue constraints on our policy response." The mere fact of issuing such a statement, however, indicates concern. The European Commission shares that concern: it is considering bringing an infringement proceeding against Germany (even though the court is independent from the German government). No matter what the outcome, the fact that two of the EU's highest courts are sparring at a moment of global pandemic and economic crisis can only weaken the EU, especially by undermining the ECB's ability to hold the currency union together. One

consequence may well be to make more likely an enhanced role of the European Commission itself in addressing the economic crisis by issuing significant quantities of debt (€1 trillion is rumored) guaranteed by the EU.

Please note: A future note will address longer-term consequences.

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