# The Future of Europe: Crises, Choices, Consequences

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## COVID-19, Karlsruhe and the NextGenEU Package: Federation, Confederation or Nation-States?


**Jacek Rostowski**
Former Minister of Finance and Deputy Prime Minister of the Republic of Poland

**Arnab Das**
Global Macro Strategist, EMEA


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## Executive summary

- The joint COVID-19 health and economic crisis has hit all countries almost at once, demanding a shared "eurozonal" response. After initial missteps, the European Central Bank (ECB) has stepped up monetary support significantly. However, fiscal support reflects available space embodied in national public debt ratios instead of the severity of the downturn. The EU Recovery and Reconstruction Instrument (ERRI) and the Next Generation EU (NextGenEU) package help address this shortcoming through shared EU-level debt issuance and taxes to finance transfers to needy member states.
- Simultaneously, a full-blown constitutional crisis has been unleashed. Germany's Federal Constitutional Court (GFCC) has cast doubt on the independence of the ECB and the legitimacy of the European Court of Justice (ECJ).
- These combined crises may be the most dangerous ever to threaten the EU, whose members and institutions face critical choices and consequences:
  - The likely default option: The EU muddles through. Crisis management remains the modus operandi. The ERRI signals that the eurozone (EZ) will not disintegrate because of wayward shocks – nor equally be forced to fully integrate willy-nilly. Sovereign risk premia would be bounded but remain variable and volatile within ranges.
  - The best choice: The ERRI and the NextGenEU package bridge the creditor-debtor divide that prevents the ever-deeper union that European Economic and Monetary Union (EMU) needs to thrive. Full endorsement, entrenchment and enlargement of the ERRI over time would restore convergence in per capita incomes and productivity, alongside sovereign risk premia.
  - The bearish choice: The ERRI is seen as an error or a one-off. Inadequate resolve by the European Commission, the ECJ, the ECB, the Bundesbank or the German government — or further GFCC challenges — may entrench economic divergence or threaten eventual disintegration. Growth performance and country-risk premia could diverge severely. We see this as a small probability with significant downside impact.
- At the time of writing, the EU has agreed a major step forward with a joint fiscal response through a compromise with something for everyone:
  - The grant element is to be scaled down from the initial €500 billion to €390 billion;
  - There will be more rebates for member-states that put up a strong resistance; and there will be some oversight of disbursements – but no veto, and
  - Disbursements are to be front-loaded into 2021, amid other specific compromises.

All these decisions send a reassuring message that the euro will not be allowed to disintegrate as a direct result of the pandemic and the lockdown – at least not in the first wave. But in future crises or waves, the need to agree a joint fiscal response may yet arise again, meaning that the three broad options above, to muddle through, very positive or very negative outcomes will remain possibilities.

We expect country risk premia to be bounded, but still to vary with the size of the shocks or policy challenges facing national economies and governments as much as the Eurozone as a whole.

# 2. Introduction

In our Survivability of the Euro trilogy, centrepiece of our Future of Europe white paper series, we argue that the threat of existential crisis has been in effect refurbished as a feature of the architecture of EMU instead of fixing the design flaw by building a fiscal foundation to underpin ever-deeper union.

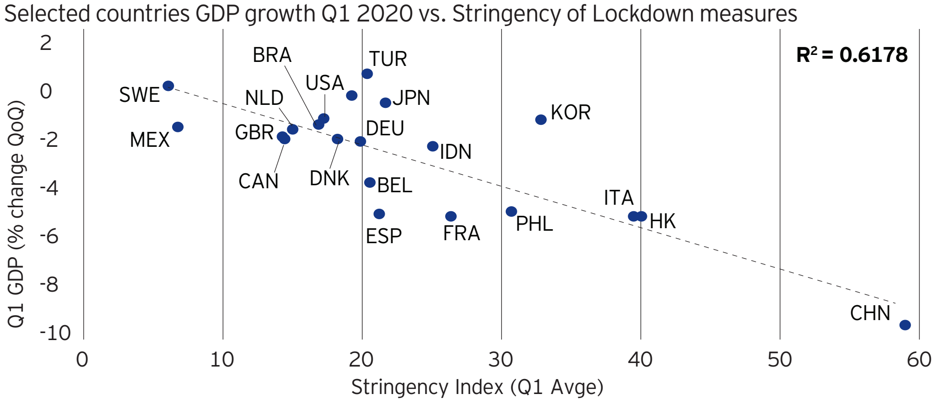
- On the one hand, the danger of member state fiscal or financial crises serves as an inducement to fiscal adjustment and structural reform in the distressed, debtor member states of the Periphery.
- On the other, creditor and debtor member states are bound together by the threat of mutually assured destruction (MAD) by interlocking central bank credits and debits in the trillions of euros.

In the event of exit by a debtor sovereign, redenomination would be tantamount to sovereign default, imposing massive losses on severed banking systems, runs on deposits and financial chaos, severely damaging northern Core creditors and the southern Periphery debtors. Meanwhile, the ECB stands in the middle of this EZ version of a Mexican stand-off, ready to prevent a fate worse than debt defaults.

We therefore concluded that the EZ would survive and perhaps even integrate – if in fits and starts, via crises. We also suggested that the European project is likely to withstand further purely economic or financial shocks but may not prove immune to other disruptive forces – especially the political blowback of crises[1].

**Figure 1: Lockdowns imposed a shared Great Compression across the EZ**

Selected countries GDP growth Q1 2020 vs. Stringency of Lockdown measures




Source: Oxford University Blavatnik School of Government COVID-19 Lockdown Stringency Index; national statistics agencies; Macrobond; Invesco.
Note: GDP data as at various release dates in April-May 2020.

We are now, for the second time in a decade, in the tumultuous midst of all of the above. COVID-19 is in many ways the ultimate symmetric shock for every EZ member – and all the world, for that matter. Rates of infection, illness and mortality vary across countries, but the severity of the economic impact reflects the similar duration and stringency of the lockdown to slow the virus.

Shared shocks demand shared solutions, especially in a monetary union, but the EZ's reaction to this unprecedented challenge has been typically ad hoc and disjointed. ECB President Christine Lagarde initially refused to do whatever it might take to ensure stability, insisting in mid-March that "other tools and actors" should assume the task of closing bond spreads. But within days, as markets plummeted and sovereign spreads surged, the ECB unveiled its Pandemic Emergency Purchase Programme (PEPP) to buy hundreds of billions of euros of debt this year to aid struggling governments and companies.

At that point, in the absence of any joint fiscal action, market participants and policymakers alike feared for the EZ's outlook. For two months of some of the most stringent lockdowns in the world, with economic activity in freefall in most major economies, fiscal efforts were limited and highly divergent. Many worried that some countries – especially Italy – would see another 20-40% of GDP added to already high debt burdens.

Then came the 5 May bombshell ruling by Germany's Federal Constitutional Court (GFCC) in Karlsruhe: the ECB's prior Public Sector Purchase Programme (PSPP) may violate German law and EU treaties by directly financing EZ governments. The Bundesbank might have to stop buying German government Bunds – its treaty-mandated obligation in executing ECB monetary policy – by August if the ECB does not provide an adequate "proportionality assessment" justifying the policy[2].

Thus the pandemic, beyond its manifest humanitarian, societal and economic costs, became compounded by a legal and political threat to the EU. The Karlsruhe judgment calls into question the independence of the ECB, the Bundesbank's subordination within the Eurosystem and the EU's treaty-based legal hierarchy. As well as jeopardising hopes of further monetary and fiscal integration, this threatens the very basis of the EU.

We have always argued that the EU's ever-deeper union has too often proceeded step-by-step, crisis-by-crisis, with too few truly transformational events, resulting in a patchwork of "make do and mend" measures. Although a precious few are major improvements, many achieve little or nothing – and some even weaken the construct. Here we assess whether the latest crisis-management efforts are likely to prove constructive, destructive or yet another instance of muddling through.

# 3. Anatomy of a constitutional crisis

### 3.1. The Karlsruhe ruling and the remit of EU law

According to Article 108 of the treaty establishing the European Community: "When exercising the powers and carrying out the tasks and duties conferred on them by this Treaty and the Statute of the ESCB [European System of Central Banks], neither the ECB, nor a national central bank, nor any member of their decision-making bodies, shall seek or take instructions... from any government of a member state or from any other body."

The GFCC has challenged this tenet, re-exposing underlying tensions among the three layers of the EU: the confederal Commission and Council; the federal Parliament, ECB and ECJ; and the nation-states at the coalface of democracy. By casting doubt on the independence of the ECB and the superiority of the ECJ over national courts in matters of EU competence, the Karlsruhe ruling threatens to trap the Bundesbank in a conflict of laws.

The ECB is not accused of improperly engaging in monetary financing as such. This would directly cast doubt on its independence. It is instead accused of failing to sufficiently assess and justify the impact of quantitative easing (QE) on issues including public debt, savings, economic viability and other concerns that reflect tensions between creditor and debtor member states.

In tandem, the ECJ is accused of acting outside its specific legal mandate – "ultra vires", to use the German judges' preferred Latin phrase – by approving the ECB's QE programme in the first place. The implication is not only that the ECB has gone too far but that the GFCC, rather than the ECJ, is competent to pronounce on this claim.

The GFCC acknowledges that EU law overrides national law for areas that are within the former's remit. Yet it reserves to itself the right to decide what is the remit of EU law. Thus the ECB and the ECJ are being required by a lower court to justify policies already executed and judged to be legal in the past by a higher court. Left unresolved, this might also throw the PEPP into jeopardy.

Furthermore, the ruling opens up a new front in the tensions between EU institutions and member states. These tensions have heretofore been primarily about politics and policy; now there is a constitutional threat to EU law and the treaties. By undermining the established hierarchy between EU institutions and member states, the GFCC may open the floodgates for national courts to rule on EU competences, with the very real risk of multiple conflicts of laws between domestic and European legislation, as well as between national legislation in different countries.

The ruling is therefore a major setback in EZ efforts to replicate the institutions and practices of a single, federal state. Unanswered, the precedent could undermine future attempts at deeper union; unresolved, it would undermine ECJ rulings and ECB independence. Yet if resolved legally and politically it could accelerate deeper union. And here, once again, US experience can be useful.

### 3.2. The US experience: Marbury versus Madison, 1803

We have often found inspiration in comparisons and contrasts between the US's successful federalist fix in "pursuit of a more perfect union" and Europe's on-again, off-again quest for ever-deeper union. None is more trenchant than Alexander Hamilton's successful push for political federalism in the Second Constitutional Convention of 1787 – and, for fiscal federalism, the assumption of states' revolutionary war debt by the new federal Treasury in 1790[3].

The Karlsruhe constitutional crisis also finds an incisive analogy in US history: the Supreme Court 1803 judgment in Marbury versus Madison. In 1801 the lame-duck Congress instituted many judgeships, to which outgoing federalist President John Adams nominated like-minded judges, in order to restrain the initiatives expected from anti-federalist President-elect Thomas Jefferson in pursuit of "states' rights" and "people power". Indeed, Jefferson instructed his Secretary of State, James Madison, to withhold judgeships. One of Adams's last nominees, William Marbury, petitioned the Supreme Court. It ruled both that Madison's inaction had been illegal and that Congress had acted unconstitutionally in creating the new judgeships.

This Solomonic judgment remains a cornerstone of US federalism, underpinning the separation of powers and "co-equal" status of the executive, legislature and judiciary. The court arrogated to itself the power to judge the constitutionality of decisions and actions of others – a move consistent with the spirit of the Constitution but perhaps not the letter and which therefore itself may be "ultra vires" since that day.

The ruling is illustrative for today's EU crisis, because the US Supreme Court:

- acted on its own rights and responsibilities in interpreting the Constitution – rather than submit to the co-equal Congress.
- subjected the co-equal executive and legislative branches to judicial review.
- gave the Constitution the full force of law by invalidating legislation it deemed unconstitutional.

In the Karlsruhe crisis, the analogous outcomes would be for the ECJ to rule that the GFCC action is inconsistent with the Treaties on the European Communities to which Germany itself is a signatory; the ECB has no obligation to answer to the GFCC, any more than the GFCC has the legal authority to consider such matters; and the Bundesbank must carry out its obligation to implement the monetary policy of the union as decided in the ECB Governing Council with the presence of the Bundesbank Governor representative. Anything less would mean that member states enjoy a privileged position vis-à-vis EU and EZ institutions, in violation of treaty law.

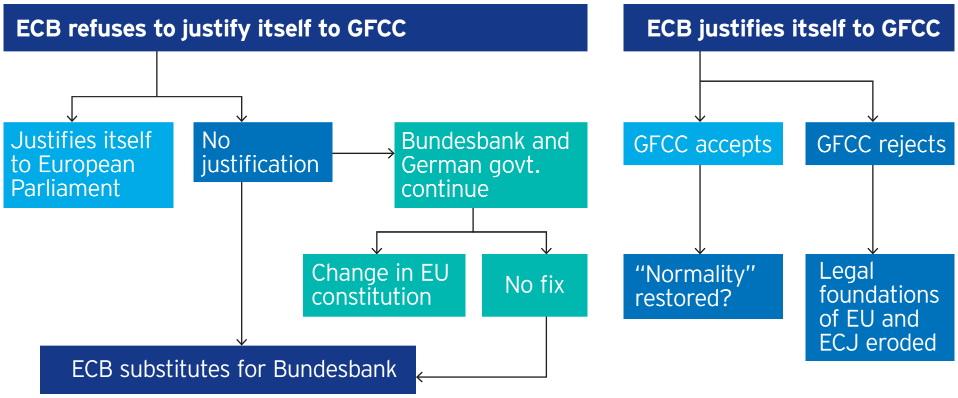
The EU is moving in the right direction, judging by the rhetoric of both the ECB and the ECJ and by ongoing ECB policies. But complex negotiations lie ahead, and any achievements may be limited in scope to the COVID-19 crisis rather than the sea change in the subordination of states' rights to eurozonal imperatives that the soaring rhetoric about a supposed "Hamiltonian moment" demands...

# 4. Critical choices and key deciders

The Karlsruhe judgment has presented several institutions with momentous choices. Their decisions, along with the sequence in which they unfold, will determine whether the crisis takes the European project further towards single-statehood, causes it to unravel or perpetuates muddle-through.

- The first decision fell to the **ECB** – whether to meet the request for a proportionality assessment of PSPP's impact. It could have ignored the demand completely, dealt directly with the German court or engaged via a third party. It chose the last option, sharing its assessment with the German government.
- The **ECJ** must decide whether to accept – or even acknowledge – any component of the "ultra vires" argument. Should it defend itself against the court's explosive assertion that parts of EU treaties are "incomprehensible" and must therefore be considered "arbitrary from an objective perspective"?
- The **German government** must decide if it can find its own solution – one by which, to put it bluntly, it can make all this go away.
- The **European Commission** must decide whether to continue standing back in the hope that others can resolve the crisis or to step in and reassert its authority. It has indicated that it is considering "all courses of action", including launching "infringement proceedings" against Germany[4].
- The **Bundesbank** must decide what it will do if, depending on events, it is ultimately ordered to cease participating in the PSPP.

**Figure 2: How critical choices might give rise to possible routes out of the Karlsruhe constitutional crisis**



# 5. Scenarios and implications

## 5.1. A shortcut to greater integration: if not now then when?

By fuelling innovation and unlikely alliances and making the unattainable at once imperative and achievable, crisis can be a crucible of positive change. Now could be the time to take radical steps towards genuine fiscal solidarity – and if not now, when all European nations are facing similar extreme economic and political turmoil, then when?

We believe that if the Karlsruhe crisis is to precipitate deeper European integration, giving Europe a "Hamiltonian moment" of achieving meaningful fiscal federalism, then the ECB and the ECJ must continue to stand firm. Lagarde has not only proclaimed the ECB "undeterred" – with sources ruling out engaging with Karlsruhe in any way, since that would imply accepting GFCC jurisdiction[5] – but the ECB has doubled down on the PEPP (which has not yet been questioned before the GFCC) by increasing it from €750 billion to €1.35 trillion. Equally, the ECJ has reiterated that it has sole power to "rule that an act of an EU institution is contrary to EU law"[6].

Meanwhile, the German government has joined France in proposing a €500 billion European Recovery and Reconstruction Facility (ERRF) to counter the economic crisis resulting from COVID-19. This move buttresses the unity of the EZ directly, as most of the funds will be disbursed as grants to sovereigns rather than debt-increasing loans; equally importantly, it also blunts the GFCC's criticism of ECB government bond-purchasing programmes. Once the German parliament approves the fiscal transfers of the ERRF, the German government will be able to argue before the GFCC that any fiscal effects of the ECB's PSPP and PEPP are merely byproducts of the ECB pursuing its monetary goals, while the fiscal transfers needed to cement the EZ are being provided by the democratically mandated ERRF.

Opinion on EU fiscal federalism is clearly in flux in Germany, just as it has shifted on the willingness to undertake massive countercyclical fiscal measures at national level. On the one hand, as Karlsruhe has shown, German conservatives remain obsessed with the perceived injustice of propping up member states that have overspent; on the other, the German government has not only endorsed the ERRF but its Finance Minister, Olaf Scholz, has called its creation "Europe's Hamiltonian moment" and indicated a willingness to make even higher contributions. Germany's leading business body, the Bundesverband der Deutschen Industrie (BDI), has joined its French and Italian counterparts in urging the EU to organise "an unprecedented and ambitious" response to the pandemic – one featuring "a strong element of true fiscal solidarity by common resources for those countries most strongly affected".

But is Germany ready to contemplate a new or suitably amended European treaty that would make fiscal federalism in Europe a reality? That is what is necessary for the EU and the EZ to tackle head-on the creditor-versus-debtor, us-versus-them, mutually distrustful divide that has thwarted convergence between northern and southern member states for a decade. Ultimately, what would be required is a joint EZ fiscal and political union – that is, a federal finance ministry with direct democratic accountability, which supersedes those of the member states.

Finally, there is the possibility that a dramatic showdown between the EZ and Germany would actually reinforce the latter's commitment to the former[7]. Imagine that the Bundesbank were to stop participating in the PSPP, as ordered by the Karlsruhe court, and the ECB were to plough on without it – either limiting its interventions to non-German sovereign instruments or maybe even purchasing German bonds itself. Would Germany secede from the euro, risking the EZ's total disintegration? Or might it rather conclude – possibly after carrying out a proportionality assessment of its own – that this is clearly an instance of "better the devil you know"?

## 5.2. The beginning of the end: from crisis to collapse

If the ECB or the ECJ were to legitimise the Karlsruhe ruling in any way, most obviously by dealing directly with the GFCC, a surrendering of supremacy – however slight – would be assumed. Such a display of weakness would mark the start of a slippery slope that could lead to chaos and, eventually, the collapse of the EU.

The signal to the EU, to Germany and to every member state is essentially this: "You decide cases of EU law, but we decide what is subject to EU law." This interpretation invites a free-for-all in which any national court could reject the jurisdiction of the EU and the ECJ and so erode the legal foundations on which the union is built.

This might not happen overnight, but the pendulum would swing from "ever-deeper union" in the direction of national governments and institutions in both the EZ and the EU as a whole. The European project's direction of travel would be reversed – perhaps fatally so. As former Belgian Prime Minister Guy Verhofstadt has warned, it could be "the beginning of the end"[8].

It is no secret that Karlsruhe's spanner in the works delights some member states. Hungary and Poland have been widely tipped to raise their recalcitrance to new heights. By way of a shot across the bows of Brussels and Luxembourg, Poland's Deputy Justice Minister, Sebastian Kelata, greeted the ruling gleefully by tweeting: "Member states are the masters of the EU treaties – this is what the German Federal Constitutional Court said today. Germans defend their sovereignty. The EU says only as much as we, the member states, allow it."

The dilemma of the Bundesbank is particularly acute here. Although the ECB and the ECJ may – and should – ignore it, the Bundesbank, as a creature of German law, might feel bound to obey the GFCC judgment. As Bundesbank President Jens Weidmann's tweeted shortly after the ruling: "While respecting the independence of the Governing Council, I will support efforts to meet this requirement."

1 See parts I, II and III (forthcoming) of our The Survivability of the Euro trilogy.

2 See Bundesverfassungsgerricht: "ECB decisions on the Public Sector Purchase Programme exceed EU competences", 5 May 2020, for a comprehensive but comparatively digestible summary.

3 See The Survivability of the Euro, Part II: Analysis, Analogies and Antecedents.

4 See, for example, FT: "Brussels weighs up politics of suing Germany over Karlsruhe", 11 May 2020.

5 See, for example, Reuters: "ECB 'undeterred' by German court ruling over bond buying", 7 May 2020.

6 See Court of Justice of the European Union: "Press release following the judgment of the German Constitutional Court on 5 May 2020", which was published three days after the ruling. It is extremely rare for the ECJ to issue such statements.

7 The role of the federal TARGET2 payment/settlement system in guarding against a member state's exit from the euro is explained in length in The Survivability of the Euro, Part III: The Architecture of EMU (forthcoming).

8 See, for example, FT: "What next in Karlsruhe vs ECB?", 6 May 2020.

### 5.3. Muddling through: more "make do and mend"

The EU and the EZ have done more in response to the COVID-19 crisis than might have been expected: (1) the usual structural reform requirements attached to loans from the €500 billion European Stability Mechanism (ESM) are to be waived; (2) the ECB is to inject liquidity to the tune of €1.35 trillion under the two tranches of the PEPP; (3) the Franco-German ERRI, now transformed into the European Commission's proposed Recovery and Resilience instrument, is to provide €310 billion of grants and €250 billion of loans to the sovereigns most impacted.

Furthermore, member states have undertaken stimulus measures that vary from small to massive. Germany's stimulus, some of which will be spread over a number of years, includes discretionary fiscal spending of 13.3% of GDP, tax deferrals worth 7.3% of GDP and guarantees covering loans worth 27.2% of GDP, giving a total short-term support to the economy and to German businesses worth almost 50% of 2019 GDP. Germany is thus providing sizeable balance-sheet support to its enterprise sector, as well as a boost to demand.

On the other hand, Italy has undertaken only minimal fiscal loosening (0.9% of GDP), resorting instead to massive tax deferrals amounting to 13.2% of GDP (almost twice as much as Germany) and guaranteeing loans to the tune of 29.8% of GDP (slightly more than Germany). Italian measures (which total 43% of GDP) are clearly mainly liquidity-oriented, aiming to sustain businesses during the crisis rather than generating demand, while at the same time keeping budgetary costs to a minimum.

**Figure 3: Discretionary 2020 fiscal measures adopted in response to coronavirus by 15 June 2020*, % of 2019 GDP**

| | Immediate fiscal impulse | Deferral | Other liquidity / guarantee | Last update |
|---|---|---|---|---|
| **Belgium** | 1.4 | 4.8 | 21.9 | 03/06/2020 |
| **Denmark** | 5.5 | 7.2 | 4.1 | 01/07/2020 |
| **France** | 4.4 | 8.7 | 14.2 | 18/06/2020 |
| **Germany** | 13.3 | 7.3 | 27.2 | 03/06/2020 |
| **Greece** | 3.1 | 1.2 | 2.1 | 05/06/2020 |
| **Hungary** | 0.4 | 8.3 | 0.0 | 25/03/2020 |
| **Italy** | 3.4 | 13.2 | 32.1 | 22/06/2020 |
| **Netherlands** | 3.7 | 7.9 | 3.4 | 27/05/2020 |
| **Portugal** | 2.5 | 11.1 | 5.5 | 04/05/2020 |
| **Spain** | 3.7 | 0.8 | 9.2 | 23/06/2020 |
| **UK** | 4.8 | 1.9 | 14.9 | 30/04/2020 |
| **United States** | 9.1 | 2.6 | 2.6 | 27/04/2020 |

Source: Breugel Datasets; Invesco calculations.
Note: we calculate the ratio of the 2020 measures to 2019 GDP, because the 2020 GDP outlook is very uncertain. The category 'Other liquidity/guarantee' includes only government-initiated measures (excludes central bank measures) and shows the total volume of private sector loans/activities covered, not the amount the government put aside for the liquidity support or guarantee (the amount of which is multiplied to cover a much larger amount of private sector activity).
* The cut-off date is earlier for some countries, see at the country specific descriptions.

Tax deferrals amount to public lending to businesses and do not show up as an increase in accruals-accounting public deficits or debt, unless not eventually repaid. Similarly, loan guarantees are a contingent liability and would show up in public debt ratios when and if there are substantial defaults, amounting to a balance-sheet swap between the public and private sectors.

We thus have the surprising fact of a cautious Italy and a spendthrift Germany. How well this will work depends on how quickly and to what extent European and national economies can recover as lockdowns are relaxed.

Recovery in the rest of the world also matters, given sizeable eurozone trade surpluses. However, most other countries are struggling to emerge from the Great Compression of the lockdowns, so recovery will most likely hinge on domestic demand. The effectiveness of the European response will depend first on German fiscal measures and then on those of Italy and France. The ERRI will be small compared to national measures, but its signal of fiscal solidarity may be more important than its direct fiscal impact in limiting pressures on country risk premia and national financial conditions.

Furthermore, after the initial robust response by the ECB and ECJ to the GFCC's challenge, the EU system has returned to its traditional modus operandi of kicking the can down the road. The ECB shared its analysis of the "proportionality" of the PSPP with the German government, which in turn informed its parliament that it considered PSPP "proportional".

The Bundestag accepted this view, with only the extreme right AfD party voting against, and the Bundesbank has given to understand that it will be participating in the PSPP. This allows the PSPP to proceed unhindered, while some Germans can consider that they retain a veto on ECB actions in the future. The AfD has already made clear that it will challenge the PEPP in Karlsruhe.

Hence, all this amounts to far less than the "Hamiltonian moment" trumpeted by Germany's Finance Minister, for a number of reasons. First, unlike in the US in 1790, there is no mutualisation of past national sovereign debts. Second, the mutualisation of future debt is very limited (it amounts to €410 billion – about 3.25% of 2019 GDP). Third, €100 billion of the ERRI is redlined for "cohesion" goals, so much of it will go to relatively less affected Central and Eastern European member states and will involve a counterproductive focus on investment rather than health, current expenditure and firm restructuring.

It also needs to be noted that the so-called "frugal five" small northern countries (Austria, Denmark, Finland, the Netherlands and Sweden) have opposed the very principle of any Hamiltonian joint debt issuance. Then there is the existential threat posed by the GFCC's questioning of the ECB's role as the informal "guarantor of sovereigns" within the EZ.

Finally, we need to acknowledge the hidden "grand bargain" at the heart of the ERRI: Germany is conceding a modest issuance of joint debt for the acceptance of massive state aid for German industry by the Periphery. Aid on such a scale would normally be forbidden under EU single market rules, as it would give German firms a competitive advantage that most other EU countries would be unable to match. However, this "hidden bargain" should be thought of not as a glitch of this EU Hamiltonian "mini-moment" but rather as a feature of it. It underlines something that is necessary in successful economic federations: the shouldering of joint fiscal responsibility in exchange for market access.

# 6. Conclusion

If crisis is to be the smithy in which the future of Europe is forged, why has Europe's Hamiltonian moment turned out to be relatively disappointing amidst simultaneous, severe crises? And, by extension, how will the EU and the EZ fare beyond the COVID-19 crisis and recovery?

The bottom line is simply that none of the EU member states (except possibly Germany) wants a true political federation in which Brussels could determine a large part of taxation and fiscal expenditure, and this applies as much to Italy and Spain as to the Netherlands and Denmark.

However, several factors suggest that what has already been achieved in Europe may well suffice to establish the EZ's survivability for the foreseeable future – at least in the eyes of the markets. The first is the extremely low real interest rate environment in the global economy. Even before COVID-19, this was likely to have continued for a long time due to demography and the capital saving bias of much technical progress. These effects will now be augmented by further rises in savings and falls in investment that seem likely after COVID-19.

Second, repeated crises in which the EZ "rises to the occasion" may cement a self-fulfilling view in the markets that "the EZ will always do what it takes", even if the institutions that would ensure that it will do so have not been created. This did eventually happen with then ECB President Mario Draghi's commitment to do whatever it would take to save the EZ, as well as the establishment of the ESM during the original EZ financial crisis. Certainly, the old "northern" view that only the threat of exclusion from the EZ for the wayward will prevent fiscal moral hazard seems to have been abandoned – at least during the pandemic.

Third, the capacity and willingness of states that have fiscal space to use it in an extreme crisis have been clearly demonstrated. This is likely to confer significant benefits via "spillovers" on the remaining states that do not have such space, reducing the pressure on the fiscally fragile members of the EZ.

Finally, the existence of very large national budgets, which can (and do) engage in fiscal stimulus even when they have high debts, offers a flexibility to the EZ's response to crises. This provides some substitute for a full fiscal federation, ensuring transfers to its hardest-hit members. Such policy, effectively daring the EZ's creditor countries to trigger an existential EZ crisis by thwarting them or trying to withdraw the ECB's implicit guarantee to sovereigns, has proved successful in the current crisis. This, too, is a lesson that will not be lost on markets in future crises.

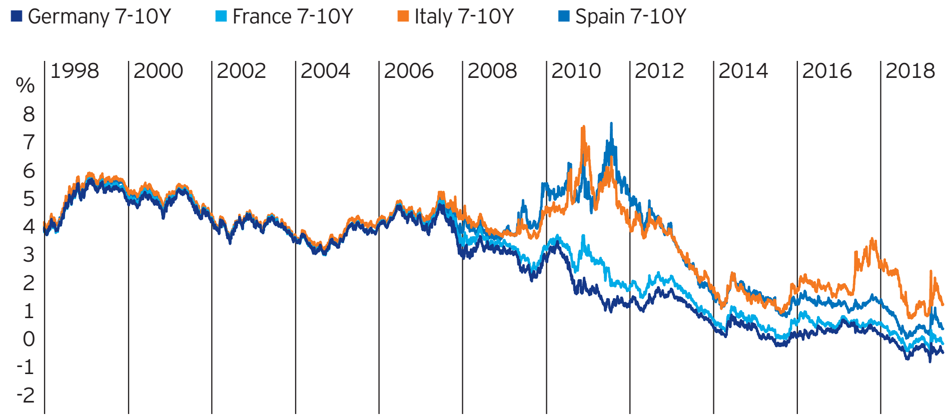
What, then, is the most likely effect of the COVID-19 crisis on EZ cohesiveness? The "make do and mend" approach continues to hold sway, with incrementalism and compromise establishing the least common denominator of what is politically acceptable for major member states, as opposed to what is economically essential.

The silver lining in this crisis is that, against the precedent of threats to the established legal order of the EU from the highest court in Germany, to some extent Italy but especially France and Germany are feeling their way forward. The cloud on the horizon is the risk that creditors and debtors will stay at loggerheads and maintain the threat of existential crisis in order to extract reform and adjustment.

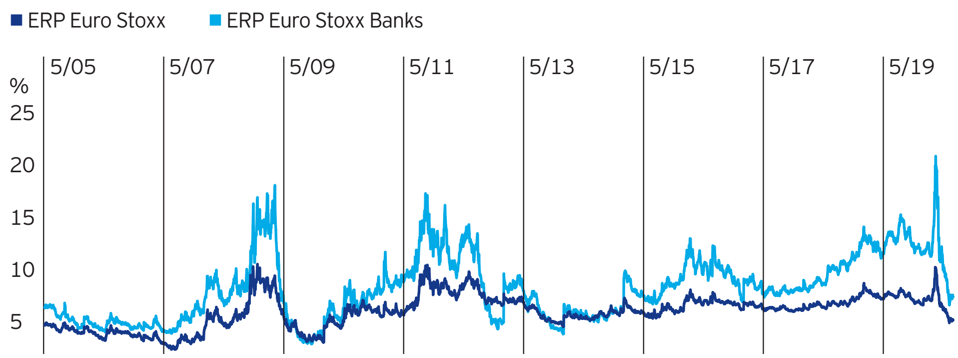
The single, federal super-state with a large enough political presence and federal fiscal budget that dominates the member states, obviating the us-versus-them question of some underwriting the solvency and income of others, seems likely to remain elusive. As such, frictions across the three-layer cake of the EU – confederal Commission and Council, federal ECB, ECJ and Parliament and national democratic accountability – may well persist. We therefore expect country risk premia to be variable and volatile but bounded, for sovereign credit risk will not be eliminated – though it seems likely to be limited.

**Figure 4: Bank equity risk premia converge more than credit risk premia**

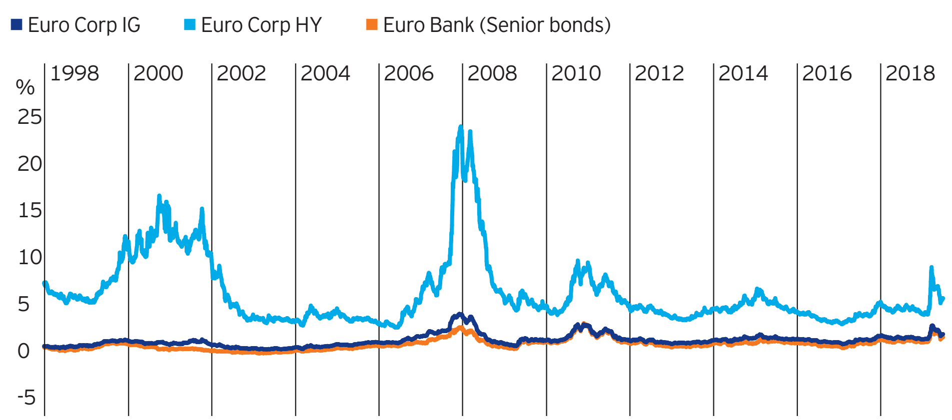
**Key Euro Government 7-10Y Yields to Maturity (%)**




**Euro Stoxx: ERP Euro Stoxx Banks equity risk premium**




**Spread YTM vs Germany Govt 7-10Y (%)**




Source: Bloomberg; Macrobond; Invesco calculations.
Note: Equity risk premium – earnings yield less 10-year bond yield (EZ government bond aggregate). The earnings yield is the reciprocal of the price/earnings ratio. "Euro Corp IG" = Intercontinental Exchange (ICE) Bank of America (BofA) Euro Large Cap Corporate Index, "Euro Corp HY" = ICE BofA Euro High Yield Index, and "Euro Bank (Senior bonds)" = ICE BofA Euro Senior Banking Index. Data as of 8 June 2020.

# 7. References

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# 8. Authors

**Jacek Rostowski**
Former Minister of Finance and Deputy Prime Minister of the Republic of Poland

Jacek Rostowski is a former Deputy Prime Minister of Poland. He was also the country's longest-serving Finance Minister, from 2007 to 2013. A Professor of Economics, he has held academic positions at the University of London; the London School of Economics; Central European University, Budapest; and Sciences Po, Paris. In 1991 he co-founded a Warsaw-based think-tank, the Centre for Social and Economic Analysis, to help Europe's former communist economies in the transition to capitalism. He studied international relations, economics and history at University College London and the LSE.

**Arnab Das**
Global Macro Strategist, EMEA

Arnab has 28 years of investment industry experience. He is a member of Invesco's Global Investor Forum Advisory Council with a focus on global macro and emerging markets, and previously served as Head of emerging markets macro research for Invesco Fixed Income. Prior to joining Invesco, he served as Co-head of Economic Research & Strategy at Roubini Global Economics; Co-head of Global Economics & Strategy, Head of Global FX Research, and Head of EM Economics & Strategy at Dresdner Kleinwort; and Head of EMEA Research at JP Morgan. He has also been a private consultant in global and emerging markets, as well as consulting with Trusted Sources, a specialist EM research boutique. Arnab's studies were in macroeconomics, economic history and international political economy. He received an AB from Princeton University and completed his postgraduate and doctoral work at the London School of Economics.

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