Amid worsening economic downturn, European Union moves to set up bailout fund

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The European Commission, the executive branch of the European Union, has set out a €750 billion economic recovery plan to try and counter the impact of the COVID-19 pandemic on its economy amid fears that unless action is taken the bloc could disintegrate.

Under the plan, set out in a speech by the commission president Ursula von der Leyen to the European Parliament in Brussels on Wednesday, the money would be raised by the commission in capital markets and then distributed to member nations in order to finance stimulus packages. It would be financed either by a special tax or increased contribution from EU member states.

Of the €750 billion, €500 billion would be in the form of non-repayable grants with a further €250 billion issued as loans.

But there is no guarantee that the proposal, which requires the unanimous approval from the 27 member nations of the EU, will go ahead because of substantial divisions within the organisation.

The proposal to make grants has been opposed by the Netherlands, Austria, Denmark and Sweden. Dubbed the "frugal four," they have insisted that there should be an emergency fund financed by loans only. But this has been rejected by southern states because it would only add to their already high levels of government debt.

The move to establish the new fund comes amid warnings that the effects of the pandemic on the European economy are far more serious than had been initially anticipated. In a webinar with students on Wednesday, European Central Bank (ECB) President Christine Lagarde said the euro zone would shrink by between 8 and 12 percent this year.

This recession, twice as deep as that resulting from the global financial crisis of 2008, was the outcome of the "sudden stop of activity" due to the pandemic. It had slowed down the "pace of life, the pace of growth, the creation of value" and would have "lasting effects despite all the measures we are taking," she said.

The ECB launched a €750 billion bond buying program in March and is predicted to increase its purchases by a further €500 billion when its governing council meets on June 4.

In its biannual financial stability review, issued earlier this week, the ECB warned that rapidly rising government debt levels could lead to a reassessment of sovereign risk and "reignite pressures on some countries where debt levels are already high."

Overall aggregate government debt in the euro zone is predicted to rise from 86 percent of GDP to more than 100 percent. Public debt is already at record levels in a number of countries, approaching 200 percent in Greece, 160 percent in Italy, 130 percent in Portugal and just below 120 percent in France and Spain.

The ECB warned that a more severe downturn than expected could set public finances on an "unsustainable path in highly indebted countries" and that a "negative feedback loop" could re-emerge where a downgrade in ratings for banks holding large amounts of government debt feeds into sovereign debt ratings. This so-called "doom loop," which appeared in the euro zone in the financial crisis of 2012, could affect Italy, Portugal and Spain, "where bank ratings are closest to non-investment grade."

The proposal for an EU-funded bailout mechanism was only made possible by a surprise decision by Germany on May 18 to agree with France on a proposal for a €500 billion fund to be made available in the form of grants.

The decision was taken against strong internal opposition in Germany against any measures in which

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the richer EU countries would fund the economies of the poorer ones. This opposition was given expression in a ruling by Germany's constitutional court on May 5, which challenged the legality of the country's Bundesbank taking part in the ECB's asset purchasing program.

The court said the government had to carry out a "proportionality assessment" of the ECB's asset purchases to ensure their economic and fiscal policy effects were within the ECB's mandate, that is, the purchases did not involve funding the debt of other governments. It threatened to order the Bundesbank to block asset purchases unless this assessment was done within three months.

The decision raised wide concerns about the future of the European Union and the ECB. *Financial Times* economics commentator Martin Wolf wrote that the court decision had "launched a legal missile into the heart of the EU." The "extraordinary judgement" was "an attack on basic economics, the central bank's integrity, its independence and the legal order of the EU."

It opened the way for courts in other countries to decree that their national central banks could not take part in policies they disliked and "pretty soon, the ECB will have been sliced and diced into a nullity."

The German court decision appears to have been at least partly responsible for the switch by the government of Chancellor Angela Merkel to throw its support behind an EU-backed bailout fund. Previously Berlin had opposed any suggestion that money from a fund should be distributed in the form of grants rather than loans.

But according to a "senior German official," cited in a report by the *Financial Times*, the "moment of reckoning" came when the court cast doubt on the legality of the ECB's bond buying program so far as the Bundesbank was concerned and some other policy had to be developed.

In April, as the effects of the pandemic were spreading, French President Emmanuel Macron warned in an interview with the *Financial Times* that the euro zone and the "European idea" would fail if the EU did not set up a fund to issue common debt and finance member states according to their needs rather than the size of their economies.

These sentiments were echoed in recent comments by Merkel that the economic impact of the virus was so great that it could "endanger the European Union's cohesion" and "the national state alone has no future."

The proposal for the bailout measures has nothing to do with meeting the needs of the mass of the European population, now confronted with the worst economic and social conditions since the 1930s.

It appears that Paris and Berlin, which both utilise the EU to enhance their economic and political power globally, have made the decision that economic and financial stops have to be pulled out to try to save it.

But whether the plan even goes ahead in the face of opposition within the EU itself is another question.

The Austrian chancellor, Sebastian Kurz, told *Politico* on Wednesday: "We need to take everyone's interests into account and there are very different interest groups: the southern countries, who fundamentally always want more; the East Europeans, who have an interest in preventing everything from flowing south; and, of course, those who have to pay for it all, the net payers."

A diplomat from the Netherlands, along with Austria a member of the "frugal four," told the *Wall Street Journal*: "Negotiations will take time. It's difficult to imagine this proposal will be the end-state of those negotiations."

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