Interview, Prof.Otmar Issing, president, Center for Financial Studies (Frankfurt), former board member for economics, European Central Bank and Bundesbank, with David Marsh, OMFIF chairman, 3 April 2020

David Marsh: How big is this shock?

Otmar Issing: As Chancellor Merkel and others have rightly said, this is biggest post-war crisis. First and foremost, the medical threat. Furthermore, Germany, along with many other countries, is suffering a negative economic shock on a scale far exceeding 2008.

DM: What is your forecast for German and European GDP this year?

OI: In view of extreme uncertainty, one cannot speak of forecasts. But we can put forward scenarios. The range for the 2020 German output drop extends from 5% to 20%.

DM: What fiscal measures are required?

OI: Millions of livelihoods are threatened. This requires immense financial resources, not just budgetary spending. There is a need for temporary exemptions and relief in tax policy, regulatory requirements and legal barriers. And there is a need for guarantees. Germany has moved at great speed and with very large sums. The most important employee measure is short-time working benefit. Companies need not lay off workers – which would be difficult anyway in Germany – but put them on short-time work, which can be zero hours. Workers get 60% of their normal salaries (67% if they have children) in payments from the social security system.

DM: What is the correct balance between European and national fiscal action?

OI: Dealing with this crisis is primarily a matter for national economic policy. But more is needed at the EU fiscal level. The EU is a community of solidarity in accordance with the Treaty. The president of the Commission has announced a number of financial support schemes. This includes financing short-time working benefit for member states and additional financial help from the EU budget. Access to the European Stability Mechanism will be alleviated. The rules on the stability and growth pact were already suspended. These are impressive measures. The Eurogroup meeting on 7 April may decide to do more.

DM: Is this Europe's 'Hamiltonian moment'? What is your feeling about 'corona bonds' and /or a separate fund for dealing with the pandemic as suggested by the French government?

OI: It's not the first time that a 'Hamiltonian moment' has been declared. However, the US case after the war of independence is not as simple as sometimes seen. Prominent historians regard the mutualisation of debt and the ensuing fiscal policies of several states as one of the causes of the civil war. The US example gives a reason to consider the risk of rising political tensions among EU member states and their people.

DM: Italian politicians say an ESM credit line, even involving very low conditionality, would impose a stigma on Italy and should be rejected. The German finance ministry says the ESM carries a 'negative stigma', i.e. going to the ESM would help Italian market credibility and drive down spreads. Who is right?

OI: I have difficulties with the 'stigma' argument. Imagine for a moment Italy would get a huge financial gift from EU member states. Relying on gifts from others might not imply a stigma?

DM: What is Germany's room for manoeuvre?

OI: Germany is in the enviable position of having a large financial margin after years of budget surpluses. The debt level will rise significantly. However it makes a big difference whether the foreseeable and necessary budget deficits start at around 60% of GDP, as in the case of Germany, or higher. Germany is now using its 'fiscal space' in a big way. Years of solid public finances – much criticised by our partners abroad – are now paying off. The main rule of the often neglected SGP is to run a balanced budget in normal times, so as to create fiscal space for crisis situations.

DM: Is Berlin concentrating too much on German national action? Some people say countries like Italy should have done more to build up national buffers against a crisis that we all knew would re-occur one day.

OI: Criticism comes mainly from those countries that have become increasingly indebted. The increase in the already high debt mountain, accompanied by the need to combat the crisis, inevitably brings a country ever closer to the point where it becomes extremely difficult to cope with the debt burden, despite long-standing low interest rates.

DM: Is Italy's debt now unsustainable? This has implications for a possible credit through the ESM.

OI: Unsustainable? No. But it will be a tremendous challenge to deliver a primary budget surplus for many years to come.

DM: What's your view of the ECB's new emergency bond-buying programme, the PEPP [pandemic emergency purchase programme]?

OI: The ECB bases this decision on its responsibility to defend the cohesion of the euro area , to guard against monetary fragmentation, and secure the transmission mechanism of monetary policy. The main objective is however to prevent interest rates from rising on the bonds of the highly indebted countries. Is this not monetary financing?

DM: The ECB action was a volte face compared with the more considered response on 12 March. What do you consider were the effects of the political process between 12 and 18 March? The ECB is independent of governments and cannot take 'instructions'. Do you expect to see the ECB publish an account of its extraordinary meeting on 18 March, in line with its transparency provisions?

OI: The ECB has to be transparent and I think it will be.

DM: What are the legal, economic and political implications of the 'temporary' PEPP and the decision to suspend practically all restraints? These include the self-imposed issuer/issuance limits , the capital key (which will be applied flexibly on a stock not a flow basis over what could be a considerable time), and the new flexibility on types of assets to be purchased. Some say this is 'OMT without the conditionality'. They also see the PEPP overwhelmingly favouring Eurosystem Italian government debt purchases, which on some accounts could rise to €1tn by end-2020.

OI: The European Court of Justice has decided that OMT is within the mandate of the ECB. At the same time it has set limits - limits which are now at least tested.

DM: Will the PEPP be extended into 2021? One central banker said to me: 'There's nothing so permanent as a temporary ECB measure.'

OI: It's too early to make a prediction. But we have seen in the past that exit from expansionary monetary policy is difficult to achieve.

DM: What will be the role of the German constitutional court judgement on the lawsuit against PSPP [public sector purchase programme], where the judgement has already been made, and was due to be announced on 24 March. This could have implications for PEPP too, because of the conditionality the court is expected to lay down. The announcement date is being postponed until 5 May because of the impossibility of holding a public gathering in Karlsruhe during the pandemic. What do you think about the legal uncertainty caused by delaying an announcement? Could the announcement be delayed again? Or should it be brought forward?

OI: I will not speculate on this.

DM: What are the chances that, after the announcement of the judgement, the plaintiffs will bring an injunction against the Bundesbank participating in the PEPP. Some German government officials now talk, in the case of the worst possible outcome, of a possible constitutional crisis.

OI: Your question indicates that the court is in an extremely difficult situation. This is anything but a purely technical decision.

DM: With much increased German and other European government borrowing after years of abstinence, will there not now be a competition for funds from EU governments on world capital markets that will drive interest rates higher and will also disadvantage more highly indebted states?

OI: Economists around the world are debating whether long-term interest rates will remain low. A majority sees the influence of factors like demographics dominating, which would imply the persistence of low long-term rates. I am not sure whether the dramatic increase in government – and private – debt will have an opposite influence. As long as the ECB is purchasing enormous quantities of bonds, we will not see an increase in interest rates.

DM: Do we not have fiscal union and a 'transfer union' (something you have long opposed) through the backdoor in Europe?

OI: It would be a political decision to transfer EMU into a fiscal union. Such a move in my mind would need a true European government and parliament. It would be irresponsible and undemocratic to try to do this through the backdoor of implicit transfers which are not democratically legitimised by national parliaments which are responsible to their voters. The corona crisis is not the situation for a 'hidden Hamiltonian moment'.

DM: So what is the role of national parliaments including the Bundestag?

OI: Many instruments are being discussed to try to conceal the transfer in favour of heavily indebted countries. If member states want to show solidarity, they must not shy away from parliamentary legitimacy. Anything else undermines confidence in the EU and the euro area as a community based on law – and promotes support, at least in northern creditor countries, for populist parties and movements opposing the political and economic integration of Europe.