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MACRO NEWS

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EUROZONE: DANGEROUS FISCAL STALEMATE

Berenberg Macro Flash

Two days ago, German chancellor Angela Merkel called the Covid-19 pandemic the biggest test of European integration ever. Unfortunately, the Eurozone still seems to be at risk of failing the test. After late night talks about a common European fiscal response, Eurogroup finance ministers remain gridlocked over two key aspects of a potential package, namely the conditionality for any credit line from the European Stability Mechanism (ESM) and the prospect of joint “corona bonds” to cover some of the costs of the common health emergency. While the Dutch, Austrian and Finnish finance ministers reportedly insist on some minimum conditionality for ESM credit lines, Berlin and The Hague reportedly continue to oppose anything that comes close to “corona bonds”. An Italian “all or nothing” approach to the talks does not seem to help either. While finance ministers have displayed an admirable „whatever it takes“ attitude in their domestic responses to the worst postwar recession in Europe, they are still failing to do so at the EU/Eurozone level.

The talks may well yield a result to be announced this morning. Long nights are part of the game in Brussels. If so, the result will probably be along the expected lines: three pillars of support (ESM credit lines for sovereigns of up to 2% of GDP, a bigger capacity for the European Investment Bank (EIB) to lend a further €200bn to companies and a €100bn EU programme to support workers along the lines of the German “Kurzarbeitergeld” subsidy for underemployment on the job). This would probably be coupled with some hint that a joint recovery fund financed by joint bonds may be decided later and/or that [EU leaders will take up the issue shortly](#).

If so, such a package would be substantial even if the question of “corona bonds” remains unresolved. Together with the ECB’s “whatever it takes” approach, it should suffice to keep borrowing costs for hard-hit Italy, Spain and Greece at tolerable levels. If need be, the ECB could simply hoover up all the extra debt which these countries may have to issue. The ECB could stretch its flexible interpretation of the “capital key” distribution of purchases between member countries to the limit and end up buying more German bonds than necessary in order to buy all the Italian paper it needs as they seemingly have done in the first week of the Pandemic Emergency Purchase Programme (PEPP) with purchases very skewed towards Italian and Spanish bonds.

However, amid an unprecedented health emergency, the political signal matters more than any technical detail of how exactly Eurozone sovereign debt ends up on the ECB’s balance sheet. The way in which the EU and the Eurozone are perceived to react to the unprecedented emergency of the Covid-19 pandemic can shape attitudes to European integration for decades to come. Visible solidarity could strengthen the European project, a perceived lack of such solidarity could undermine the political foundations of the project instead. The prospect that Italy may eventually leave the EU and the euro remains remote. After all, Italy needs ECB support more than ever before. But the tail risk that – some years from now – dangerous right-wing populists could win a political majority in Italy and pursue such an idea could soon be less slim than it used to be.



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It is the nature of the institutionalised cross-country cooperation within the EU and the Eurozone that the process takes time. While the ECB can take decisions fast and against serious dissent from significant members, finance ministers cannot. As in national politics, occasional gridlock is part of the process – just think of the US Congress and Britain’s autumn 2019 Brexit debate. However, even if a deal is finally reached, as it probably will, the noisy way in which it would have come about is dangerous in itself. The loud dispute threatens to overshadow the substance, making it more difficult for national leaders to finally present the result at home as impressive solidarity in action to shape their domestic public debate.

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