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EUROZONE: HOW TO TACKLE THE POLITICAL TAIL RISK

Berenberg Macro Flash

Every day, the Sars-CoV-2 virus is claiming thousands of victims around the world. Unless European policy makers rise to the challenge fast, it may also deal one of the worst blows ever to the political outlook for the Eurozone. A perceived lack of sufficient solidarity could even fatten the otherwise remote tail risk that some countries may want to leave the Eurozone in a few years' time.

Solidarity undersold: Whereas the European Central Bank and governments of member states moved into "whatever it takes" mode early on, the common fiscal response is not yet fit for its political purpose. In terms of fiscal substance, the Eurozone and the EU are doing roughly the right thing. The €500bn support package which Eurogroup finance ministers approved last Thursday may well be the most generous case of cross-border solidarity ever. However, Eurozone leaders are delivering this impressive solidarity in almost the worst possible way:

- Because the key question of how to finance an additional "recovery fund" remains unresolved, the ongoing dispute continues to make headlines.
- Italy's government last night rejected a key part of the package. As one of the two coalition parties in Rome, the 5Stars, objects to the stigma effect of a credit line from the European Stability Mechanism (ESM), Italy wants to forego the €39bn which it could have drawn from the ESM. Southern Europe does not harbour fond memories of the times in which a "troika" of official lenders oversaw reform programmes after the euro crisis. It explains the overdone aversion even to programmes with ultra-light conditionality in some relevant parts of the political spectrum.

THREE POINTS TO REMEMBER

To get out of the mess, Eurozone leaders should start with an honest assessment.

First, the time for solidarity is now. For better or worse, the way in which countries help or do not help each other in the acute phase of the pandemic can shape perceptions of European integration for a long time to come.

Second, in one way or another, the pandemic will lead to a significant rise in debt issued by European institutions and held by the European Central Bank and its member central banks. Some significant risk sharing is baked in the cake anyway. The key issue is how to best manage the joint risk while sending a strong political signal of solidarity.

Third, those who fear that joint bonds to combat a shared emergency would open the Pandora's box of ever more mutualisation of debt should think again. The European Union and the Eurozone are not virgins when it comes to mutual debt and bonds backed by joint guarantees. As ESM boss Klaus Regling explained in an article in German FAZ newspaper on 3 April, the ESM, the EIB and – to a lesser extent – the European Commission already issue joint European bonds with a total outstanding volume of roughly €800 bn. In one way or the other, the initiatives which Eurogroup finance ministers finally endorsed after a tortuous dispute on 9 April will largely be backed jointly by member states and financed by what are de facto joint bonds issued by these three institutions and/or some other joint special purpose funds. This holds for more firepower for the European Investment Bank, for access to credit lines from the European Stability Mechanism, for European labour market support schemes as well as for a potential "recovery fund". The pandemic will – hopefully – remain a one-off emergency. In the same vein, the response to this emergency could be constructed in a way that emphasises and safeguards its one-off nature.

On 25 March, leaders of nine European nations proposed "corona bonds" to jointly finance some of the costs of the unprecedented health emergency that is hitting Europe as a whole. The ideal response for Northern Europe would have been for its leaders to take up the idea immediately and enthusiastically – and then let their finance ministers see to it that the facility is time limited and geared exclusively towards meeting the cost of the pandemic. See here for a corona bond proposal.

Europe has missed the opportunity to send such a strong signal of solidarity early. It could still contain the damage if it now constructs and finances the envisaged "recovery fund" the right way. Ideally, the fund with sufficient member country guarantees to back a lending volume of €500bn would be organised like the ESM. Participating countries could draw credits from the facility up to three times of what their share in the €500bn would be according to a "capital key" rule. For such lending to members, the fund should charge a premium of, say, 5bp per year of duration. For example, Italy would thus have to pay 35bp or 50bp above ESM funding costs for loans from the fund with a seven- or 10-year maturity, respectively. Only countries with higher borrowing costs than that would access the money. Some of the money could also be given to the hardest hit members as grants.

To emphasise the one-off special purpose nature, the fund should automatically cease to approve any new lending or grants after a pre-set time of, say, two years. The potential exposure of each member state should be limited in the same way as is the case for the ESM. Through the qualified majority rules that also apply to the ESM, Germany, France and Italy could reserve for themselves a veto over each significant use of the funds.

With every week in which the current dispute makes headlines in Europe, the risk of an anti-euro backlash in public opinion is rising. According to Tecne poll from 9-10 April, the share of Italians that would vote for "leave" in a EU membership referendum was up by 20ppt to 49% relative to a previous poll from late November 2019 (51% voted for "remain" with the 14% share of the "don't knows" excluded). At their next summit on 23 April, EU leaders have another chance to defuse the dispute and send a strong and visible signal of solidarity instead. If they fail to do so, future historians may even rate this as the worst policy mistake the Eurozone has made since the 2011 decisions that turned a Greek debt crisis into a confidence crisis for the Eurozone as a whole. Better to get it right soon.

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