EU SUMMIT PREVIEW: RISING TO THE CHALLENGE?

Berenberg Macro Flash

At a video summit this Thursday, EU leaders will try to finally sort out their common response to the worst post-war recession in living memory. Unless they rise to the challenge, the fallout from the Covid-19 pandemic may deal one of the worst blows ever to the outlook for the Eurozone and the EU as a whole. The risk of further economic and political divergence poses a non-negligible tail risk. In this note, we discuss a potential policy response at the Eurozone level that would suit both the economic and political purpose.

STILL NOT ENOUGH

In many respects, policy makers have already responded in an unprecedented way to the economic fallout of the Covid-19 pandemic. Together with the costs of ample automatic stabilisers, the discretionary fiscal stimuli, tax deferrals and loan guarantees that governments have announced on the national level could drive up public debt by 15-30ppt over the next two years relative to – a lower – GDP (see our latest economic forecasts here).

As the major central banks in the advanced world are hoovering up big chunks of the bonds which governments are issuing to fund their pandemic response, most governments can borrow at terms more favourable than before the crisis. 10-year US, Japanese, German and UK sovereign bond yields are lower than at the start of 2020. Southern European peripheral bond yields are, however, higher – by roughly 50bps on average.

Spreads tightened after the ECB announced on 18 March that it will buy assets worth €750bn via a new Pandemic Emergency Purchase Programme (PEPP). The Eurogroup’s €500bn package of 9 April may well be the most generous case of cross-border solidarity ever. However, yield spreads widened shortly afterwards. The ongoing dispute about the financing of a “recovery fund” and Italy’s rejection of a credit line from the European Stability Mechanism (ESM) obscured the signal of solidarity which ministers should have sent.

Most worryingly is the case of Italy. The Italian economy is as big as those of Spain, Portugal and Greece together. Due to very low trend growth that reflects ingrained structural problems, Italy entered the Covid-19 recession with GDP 5% below its pre-financial crisis level. It has been hit particularly hard by the Covid-19 pandemic. EU-sceptic forces are strong in Italy. According to a Tecne poll from 9-10 April, the share of Italians who would vote “leave” in a potential EU membership referendum has risen to 51%, up by 20 points relative to November 2019.

To soften the hit to the economy and speed up its rebound across the Eurozone while preventing a rising anti-EU backlash and building a stronger European identity instead, policymakers have a lot of work to do, in our view. They need to get both the 1) substance and 2) perception of their policy response right.

1. SUBSTANCE – FIT FOR ECONOMIC PURPOSE

The policy response has to rest, roughly speaking, on three pillars of burden-sharing.
PILLAR 1: TEMPORARY ASSET PURCHASES WITHOUT PRE-SET LIMIT BY THE ECB
The amount of debt issued by Eurozone governments could dwarf the ECB’s plan to purchase €1.1trn this year. Unlike the US Fed, the ECB has not announced unlimited asset purchases yet. The ECB may sooner than later have to expand its programme explicitly to effectively control the yield curve of all Eurozone sovereign bonds. ECB President Christine Lagarde said at the IMF e-meeting last week that the ECB would do everything necessary.

The ECB does not foresee reinvestments of the proceeds of maturing assets as part of PEPP and wants to tilt its purchases towards short-term paper. These aspects underline the temporary nature of these asset purchases. Of course, the ECB could extend its programme in every possible direction if it had to do so. Upon doing so, however, the ECB would probably run into more legal and political hurdles than other central banks. As a result, it would be better for the Eurozone to add a common fiscal response to the monetary response of the ECB. The Eurozone should not leave the task of keeping financing costs suitably low for hard-hit countries such as Italy and Greece to the ECB alone.

PILLAR 2: LONG-TERM CREDIT LINES WITH LIGHT CONDITIONALITY BY ESM
The obvious candidate to offer funding at favourable terms to hard-hit Eurozone members is the ESM. On 9 April, finance ministers agreed that the ESM should offer Pandemic Crisis Support (PCS) based on an existing precautionary credit line with light conditionality (“support domestic financing of direct and indirect healthcare”) of roughly 2% of a country’s GDP. The light and uniform conditionality of the PCS should reduce the stigma of asking the ESM for help.

So far, it is unclear how much the PCS will help member states looking for big, longer-term funding. The PCS is available for one year and is renewable twice, each time for six months. The repayment deadlines are, however, still being discussed, according to ESM Managing Director Klaus Regling. For the PCS to be effective, the maturity of the loans should be sufficiently long. The lending limit of 2% of a country’s GDP also looks a little on the low side.

To accommodate the approach by a number of member states including a state as big as Italy, Eurozone governments may think about raising the ESM’s lending capacity (maximum is €500bn, of which currently €410bn could be lent) to €1trn. A better option, especially, if the perceived stigma were to remain an insurmountable obstacle for ESM credit lines to be of any use, would be for Eurozone governments to think about a special-purpose fund structured like but separate from the ESM. The fund should issue joint bonds and pass on the proceeds as long-term credits at favourable terms to member countries hard hit by the pandemic. Decision making should be structured as in the ESM, whose rules for a qualified majority give Germany, France and Italy a de facto veto. A Bundestag veto should rule out any risk that the one-off special purpose fund could turn into an instrument for a broader mutualisation of debt.

If Italy’s demand for credit surpasses that of the (current or increased) ESM’s lending capacity, or that of a newly established special-purpose fund, the almost unlimited fire power of the ECB’s OMT programme could, of course, come into play, that is purchases of public bonds of a specific country with one-to-three years maturity without a pre-set limit – the ultimate lender-of-last-resort tool.
But even long-term loans would still drive up debt-to-GDP ratios. This may prevent some hard-hit countries from pursuing a sufficiently expansionary fiscal policy during and immediately after the corona recession.

**PILLAR 3: DIRECT TRANSFERS**
Beyond temporary asset purchases without a pre-set limit by the ECB and long-term credit lines with light conditionality by the ESM or a special-purpose fund, the policy response should thus, in our view, also involve direct transfers within the Eurozone.

These transfers would work similar to the EU budget’s system of net payers and net recipients of cohesion funds. They should, however, be dealt with separately from the EU budget to underline the Eurozone, temporary and well-defined scope of the transfers.

Direct transfers to hardest-hit countries should allow for an economic rebound in the Eurozone as fast and broad-based as possible. Member states would jointly finance such transfers in line with their share in ECB/ESM capital.

**2. PERCEPTION – FIT FOR POLITICAL PURPOSE**
A policy response along these three-pillars of burden-sharing would be a policy response fit for the economic purpose. But beyond substance, policymakers also have to get the perception of their policy response right.

First of all, if the policy response is fit for the economic purpose, it should, of course, also be easier to sell it politically.

Secondly, the perception depends on what expectations you have before an agreement on a policy response as much as what policy response you ultimately agree on. Northern governments may need to re-consider what they are willing to offer. They should come to the conclusion that a Southern European recovery programme could be as much in their economic and political self-interest as the Marshall Plan directed at Western Europe 70 years ago was for the US. At the same time, Southern peripheral countries have to think twice what they are asking for. Have they raised expectations too high? Could a refusal to consider alternatives to joint bonds fuel an anti-EU backlash in parts of Northern Europe? Italians should better focus their energy on getting what they need now (investments), instead of what they want (investments and the signal from Eurobonds). Long-term credit lines with light conditionality and some direct transfers could be a face-saving compromise for all sides.

Thirdly, after an agreement, the way leaders communicate a deal matters as much as the substance of the deal in order to contain the risks of an anti-EU backlash in public opinion. EU leaders should really speak with one voice and not undersell any agreement to their home audience. Some finance ministers and EU leaders have done a poor job selling the last – and previous – agreement(s) to their voters at home. Fortunately, Italian Prime Minister Giuseppe Conte last week called for his country’s governing parties to stop bickering over the Eurogroup’s agreement. He should strive to seal a deal acceptable across Europe on 23 April instead of insisting on specific details as to how support for Italy will be funded.
BETTER TO GET IT RIGHT SOON
Hopefully, EU leaders will rise to the challenge on Thursday and agree on a policy response fit for economic and political purpose. The time to send a strong signal of solidarity is now. For better or worse, the way in which Eurozone countries work together in the acute phase of the pandemic can shape perceptions of European integration for a long time to come. Better to get it right soon.