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EU SUMMIT: WHAT WOULD COUNT AS A SUCCESS?

Berenberg Macro Flash

When EU leaders hold their video summit this afternoon, the task is clear: they need to contain the tail risk that the Covid-19 recession triggers a creeping euro crisis which would deepen and lengthen the downturn for all of Europe. EU leaders will talk about big money. However, the political signal they send counts for more than the money. As before, the European Central Bank (ECB) could probably see to it that Italy and other hard-hit countries can finance themselves at reasonable costs as long as the issues at stake are largely financial. The ECB decision ahead of an S&P rating review on Friday to accept some junk-rated debt as collateral as long as the bonds were rated investment grade on 7 April helps nicely. But if the leaders of the EU and Italy once again fail to counter the mounting anti-EU backlash in Italy, markets may still price in a higher risk that Italy may at some time in the future want leave the euro. The risk remains remote, in our view, but less so than before the serious dispute about the common response to the pandemic erupted in late March.

Chances are that EU leaders will not manage to defuse the conflict tonight. That could be a costly mistake. It is easier to impair than to repair trust. The longer the dispute rages, the bigger and the more generous would a future package have to be in order to achieve its political purpose.

Ahead of the summit, EU leaders seem to largely agree that they need to go beyond the €500bn package that Eurogroup finance ministers endorsed on 9 April. However, they still seem to disagree on the most crucial aspects of a potential package:

- Should it be partly financed by joint or jointly guaranteed bonds?
- Should beneficiaries receive mostly low-interest credits or grants?
- Should it be separate from or part of the European Union's budget, either its 2021-2027 multiannual financial framework or a special budget?
- What should be the overall size and duration of any recovery fund?

The EU is a proven compromise machine. After serious huffing and puffing, the end result will probably be a mix of all major options. Unfortunately, we may not get close enough to a deal tonight already. Ahead of the summit, the German position against joint bonds seems to have softened. Chancellor Merkel is reportedly ready to let the European Commission issue bonds under Article 122.2 of the EU treaty to finance the €100bn labour market subsidy scheme already agreed by finance ministers and – possibly – some aspects of an additional recovery fund. A key bone of contention now seems to be the extent to which beneficiaries should receive grants. In this context, financing a support scheme partly by very long-term or even perpetual bonds could make it easier to extend more grants. To make it more palatable for Italy to request a credit line from the European Stability Mechanism (ESM), leaders may try to find a group of smaller countries to do so jointly with Italy.

WHAT WOULD COUNT AS A SUCCESS?

It seems unlikely that EU leaders will manage to settle the major disputes tonight, even if they turn it into a long night. Citizens and financial markets could probably count the result a success if

- EU leaders announce at least some progress on key principles of a big recovery fund,
- the Italian, Dutch and German leaders confirm that they have defused their conflict somewhat,
- EU leaders agree in principle that the European Commission and/or another jointly guaranteed institution will be able to issue a significant amount of bonds which would de facto be underpinned by member state guarantees,
- the payouts to beneficiaries are supposed to involve both loans and grants, and
- Italian prime minister Giuseppe Conte suggests that Italy will request an ESM credit line, which would be worth some €37bn for Italy.

Hammering out a comprehensive agreement about the post-pandemic recovery facilities may take months even in the best of cases. Narrowing the differences on some key aspects would make it easier for the European Commission to present a draft 2021-2027 fiscal plan next week as a further step ahead.

A failure to make and confirm at least some progress on these issues beyond saying that talks must continue would be a bad outcome. In such a case, spreads may widen despite heavy ECB intervention. If so, EU leaders could be forced into a new meeting soon.

THE NUMBERS GAME

Judging by the various proposals and non-papers discussed beforehand, some EU leaders want to present a package of up to €1.5trn. Including the €500bn from 9 April, the EU might even claim that it is trying to prepare a €2trn deal. A big package would probably involve a higher ceiling for the EU's 7-year budget (for example, raising the envisaged budget ceiling from c1.07% to 1.27% of EU GDP would be worth some €200bn over seven years). It would likely include EU member state guarantees that would enable the European Commission and/or other European institutions to raise serious amounts of money, say €300-500bn, on the bond market.

If the EU were to present progress towards a big package, we should look at the political message more than the precise numbers. The EU has a time-honoured tradition of coming up with big numbers in a creative way. For example, the €500bn (or even €540bn) package finance ministers agreed on 9 April includes €200bn (or €240bn on some counts) as ESM credit lines of roughly 2% of member countries' GDP. But for most euro members, borrowing costs are so low that they would have no reason to request and draw on such a credit line. If we count only Italy and other countries that may lower their funding cost with ESM help, the size of this component shrinks to €70-75bn. The EU also tends to re-classify or re-direct some already planned expenditures. It may do so again by attaching the "corona" label to some of its cohesion and regional development funds. In addition, Brussels sometimes scales up numbers by suggesting that its loans or grants would mobilise significant amounts of private investment, as it had claimed in its 2016 “Juncker plan” for more investment.

LIFE PUNISHES THOSE WHO COME LATE

Whatever the outcome of the debate, the EU and the Eurozone have already damaged themselves through the loud dispute of the last five weeks. To contain the anti-EU political backlash in parts of Southern Europe, the EU now needs to send a stronger signal than would have been required in March. For example, if Germany and the Netherlands had taken up proposal such as the one made by us and some other observers for a limited amount of “corona bonds” to be issued this year to finance cheap long-term credits to hard-hit countries, they could have achieved the political purpose with minimum risk. As more political damage needs to be repaired now, the proposals now on the table are bigger and the funds likely to be more permanent than, say, a one-off issuance of €500bn in bonds to partly finance the direct costs of a one-off emergency would have been.

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