CEPS EconPol Europe Lunch Debates
Friday 5 June 2020, 12.30 CEST

Eurozone After the Coronavirus Pandemic: What are the Likely Scenarios?

Luigi Bonatti

University of Trento

Questions

Will the functioning of the Euroarea (EA) be irreversibly transformed by the current crisis?

Will we see the substantive—if not even formal—infringement of principles such as those preventing the ECB from monetizing public deficits, the EA members from mutualizing their debt and the EA from becoming a transfer union?

To what extent these infringements are necessary and sufficient to avoid the Eurozone’s implosion? And are they going to be purely temporary or are likely to be long lasting?

Is there enough political consensus in support of these policy shifts in both EA’s core and peripheral countries?

Why Italy matters

My perspective will be Italo-centric, since in this phase developments regarding Italy have strong systemic implications. In particular, any event and announcement of financial, economic and political nature with an impact on market perceptions regarding Italy's public debt sustainability has relevance also for the rest of EA. This is because:

1) **THE STOCK OF THE ITALIAN GOVERNMENT DEBT IS LARGE** (≈€2.5 trillion; ≈135% of Italy GDP before the pandemic). Hence, an Italian debt crisis will have serious effects for the entire EA.

2) **NO GROWTH**. Italy's GDP has stagnated in the last 25 years (see Fig. 1) and went on stagnating in spite of fiscal easing since 2014 (see the Appendix). As a result, Italy is the only EA country whose public debt-to-GDP ratio has not declined in recent years (even Greece has reduced it, see Fig. 2), thus making Italy quite vulnerable to shocks.

3) **HIGH POLITICAL RISK**. This is primarily associated to the majoritarian support enjoyed by Italy's 3 populist parties (now stabilized at around 55% of voters, although with a reshuffling among them), whose attitudes towards the EU range from the open anti-euro fundamentalism of a fringe of Salvini's League and the declared intention by the post-fascist Brothers of Italy to use Italexit as a threat in negotiations with EU institutions and governments to the ambiguous stance of most 5Star representatives.

Italy, EU and the Covid-19 crisis: Key events*

- **End of February/beginning of March - Italian government recognition of the Covid-19 outbreak → beginning of national lockdown (March 8)**

- **March 12 – ECB chief Ms Lagarde 'not here to close spreads' comment**

- **March 18 - ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)**

- **May 5 - German Constitutional Court (Bundesverfassungsgericht or BVerfasG) judgment on the legality of the ECB's Public Sector Purchase Programme (PSPP)**

- **May 18 - Mr Macron and Ms Merkel unveiled a Recovery Fund that--via EU-level borrowing—is supposed to distribute €500 billion in the form of grants**

- **May 27 – EU Commission chief Ms von der Leyen discloses €750 billion «Next Ge EU» (Next Generation EU) plan (€500 billion of grants and €250 billion of loans)**

- **June 4 – ECB increases PEPP to €1.35 trillion, extending it until June 2021 at the earliest, with a pledge to reinvest proceeds until at least the end of 2022**

*Key events are those that triggered significant movements of Italy's spreads, CDS prices, capital (and Target2 balances)...

Ms Merkel's turnaround

• Let's focus on the May 5th's decision by the German Constitutional Court, that followed the ECB announcement of PEPP, which on March 18th—by promising up to €220 billion purchases of Italian debt by the end of 2020 and possible deviation from the capital key—had calmed investors. As IFO Director Clemens Fuest promptly noticed, the Court's ruling *de facto* restraints the scope for the ECB to buy Italian government bonds, thus putting «pressure on euro-area governments to provide assistance to individual member states in the form of fiscal policy».

• Therefore, it's hard to think that the BVerfasG's ruling has not played a major role in convincing Ms Merkel to abandon her long-lasting opposition to debt mutualization & inter-country transfers within the EU and to announce with Mr Macron the €500 billion Recovery Fund.

•But what are the pros & cons that Ms Merkel might have considered in deciding this turnaround?

Is Germany still the «reluctant» EU hegemon, or is it becoming the «willing» EU hegemon?

1) In a world where the current pandemic will accelerate the so-called de-globalization, i.e. higher protectionist barriers, disruption of value-added chains & reshoring of production, regional retrenchment and prevalence of trade blocs over multilateralism, support of national champions by governments…, it becomes more valuable for Germany to preserve the EA as its economic bloc even at the cost of investing resources for avoiding the implosion of its weak EA partners.

2) Geopolitical risks are an additional motive for preventing destabilizing crises in the EA: look for ex. at the international links of Italy's populist parties (Salvini's League connections with Putin's Russia, Brothers of Italy's liason with Trump or 5Stars' ties with China…). EU solidarity weakens souverainists in countries where they may be the Trojan Horse of hostile powers.

Beside financial costs, this policy shift has political costs & risks for Germany:

3) Split with traditional allies such as the so-called «Frugal Four», since the latter—being small—can free ride on the German efforts to rescue the weakest EA members

4) Increased and more direct exposure to the risk of an Italian default & Italexit: in addition to its growing Target2 liabilities and the rapidly increasing holdings of its debt by the ECB, Italy's exposure towards EU institutions will be increased by the amount of money that it will get through the various emergency funds. Will Italian governments utilize this increased exposure as a lever for future negotiations over additional grants & loans & bailouts?

EU emergency funds: not game changers for Italy, but precious for buying time

For a country like Italy with a high government debt, grants represent a relief since they don't add to debt. Although a part of them will have to be repaid in the form of increased contribution to the EU budget (see Table 1), still this repayment is supposed to begin in 2028, thus contributing to buy time for a much needed structural adjustment.

The ESM, Sure, EIB and Next Ge EU loans can help Italy getting highly needed front-loaded money at a cost lower than the market rate (at an average annual rate of 0.2% rather than 0.7%) and with a much longer maturity (about double the average maturity of Italian debt that is currently 7 years). Even if debts to EU institutions have senior status, the availability of these loans should reduce market pressure and the dependence on ECB's purchases.

Moreover, to **be indebted to EU institutions rather than to private investors allows countries in trouble to use political leverages in order to obtain better terms in matter of debt restructuring & lenghtening of maturities & negotiating lower interest rates.**

The access to the ESM special credit line for health expenses connected to the pandemic is hotly debated in Italy, since ESM is taboo for Italian populists, thus preventing the country from the possibility of benefiting from potentially unlimited OMT interventions by the ECB in case of crisis, which is allowed only to countries that agreed upon a memorandum of undestanding with the EMS. **Therefore, requesting such a credit line would be particularly significant, since it would signal to investors a reduction of Italy's political risk.**

Is Italy trapped into a populist doom loop?

Productivity and income long-lasting stagnation imply that a growing number of people see a deterioration of their living conditions and ask for assistance and subsidies. At the same time, they express discontent & frustration, thus feeding the demand for populist politics. Populist politicians respond to these demands by promising more spending and/or lower taxes in favor of this and that group. Once in power, they do everything possible for circumventing budget constraints and fiscal rules that prevent them from keeping their promises. Structural reforms that may enhance the country's growth potential are rejected since unpopular.

Clearly, this strategy is bound to fail as a way to bring about a sustainable improvement in the country's growth performance and standard of living. This notwithstanding, the substantial failure of populist policies does not seem to discredit populist attitudes to policy making once and for all. On the contrary: the resulting disillusion may feed even more aggressive forms of populism, thus giving rise to a sort of populist spiral or doom loop.

An important part of this process is the dominance of narratives that reflect populist hegemony in public discourse, which have convinced many Italians that their problems come from Europe (and its Italian accomplices) that has imposed austerity on them, while their solution will arrive when finally «the government will put money in the pockets of Italians».

Is this time different?

Will the monitoring by the European Commission be sufficient for insuring that Italy will use the EU funds so as to boost its growth potential and make its public debt more sustainable?

There are reasons to be skeptic:

The structure of incentives to which political & social actors respond has not changed. Political short-termism and intense competition for votes by promising any kind of favor to various sub-sections of the population will still be overwhelmingly dominant: recent Italian experience has shawn that fiscal responsability and painful structural reforms are not much rewarded by voters (paraphrasizing Gresham law, the advent of populist politics has driven out good policies and distorted narratives are driving out accounts of events more respectful of the evidence).

Widespread perception that after years of fiscal austerity it is now time to start again satisfying needs that have long be compressed.

The abundance of funds of the next two years is seen by lobbies and special interests as an irrepetible window of opportunity.

Resurgence of hard statalism: under the label of «industrial policy», the bail out of zombi firms will combine with state dirigism.

Temporary, permanent or time inconsistent?

Not only the "**Frugal four**" want that the recovery fund be temporary and one-off, with a sunset clause after two years, but also the German government stresses that the measures that are going to be implemented by the EU are exceptional and strictly associated to the Covid-19 emergency (see, for instance, the recent remarks of Lars Feld, chairman of the German Council of Economic Experts).

In contrast, EU federalist think/hope that Next Ge EU will be only the first step towards a genuine (and permanent) transfer union with much higher common budget and European taxes, thus completing the monetary union with a full-fledged fiscal union.

Who's going to be right?

It is likely that the same dilemma that the German government is facing now, that is, accept some form of debt mutualization & inter-country transfers or let the EA implode, will be faced again by the core EA countries in the next future (possibly, with more money at stake). **Hence, the same reasons that have led the German government to support Next Ge Eu now are likely to prevail in the future**, and it's hard to believe that the financial assistance to the heavily indebted EA countries won't be any longer necessary and hence will be removed once the pandemic will be over: **any commitment or statement to the contrary is bound to be time inconsistent.**

Figure 1: Evolution of real GDP per capita in major EA countries

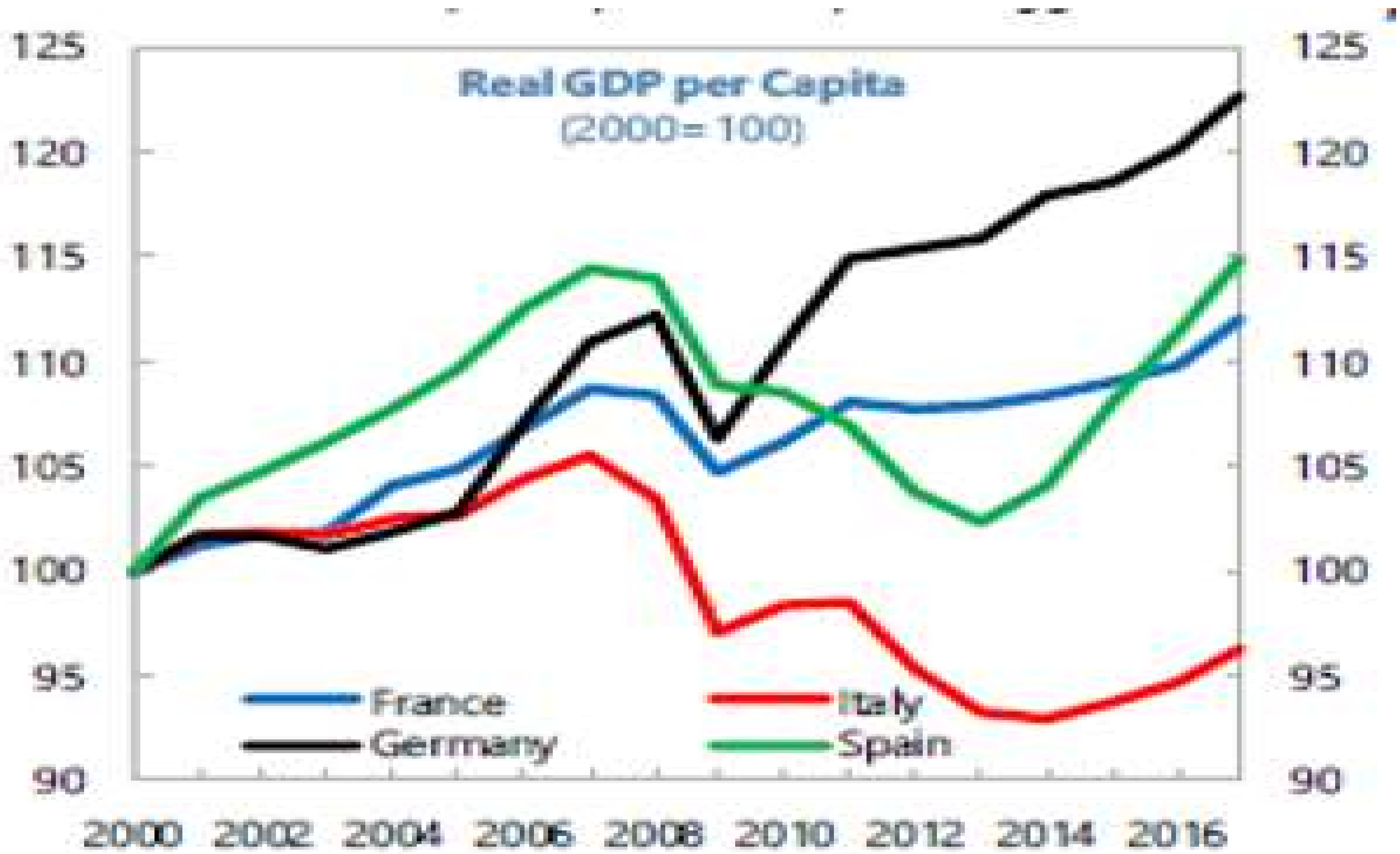


Figure 2: Public debt-to-GDP ratio, 1980-2019

Belgium	all indicators / country page	101
Italy	all indicators / country page	133.2
Portugal	all indicators / country page	117.6
Spain	all indicators / country page	96.4
Greece	all indicators / country page	176.6

Source: IMF

Italy is the only EA peripheral country whose public debt-to-GDP ratio went on increasing in the aftermath of the European debt crisis

Figure 3

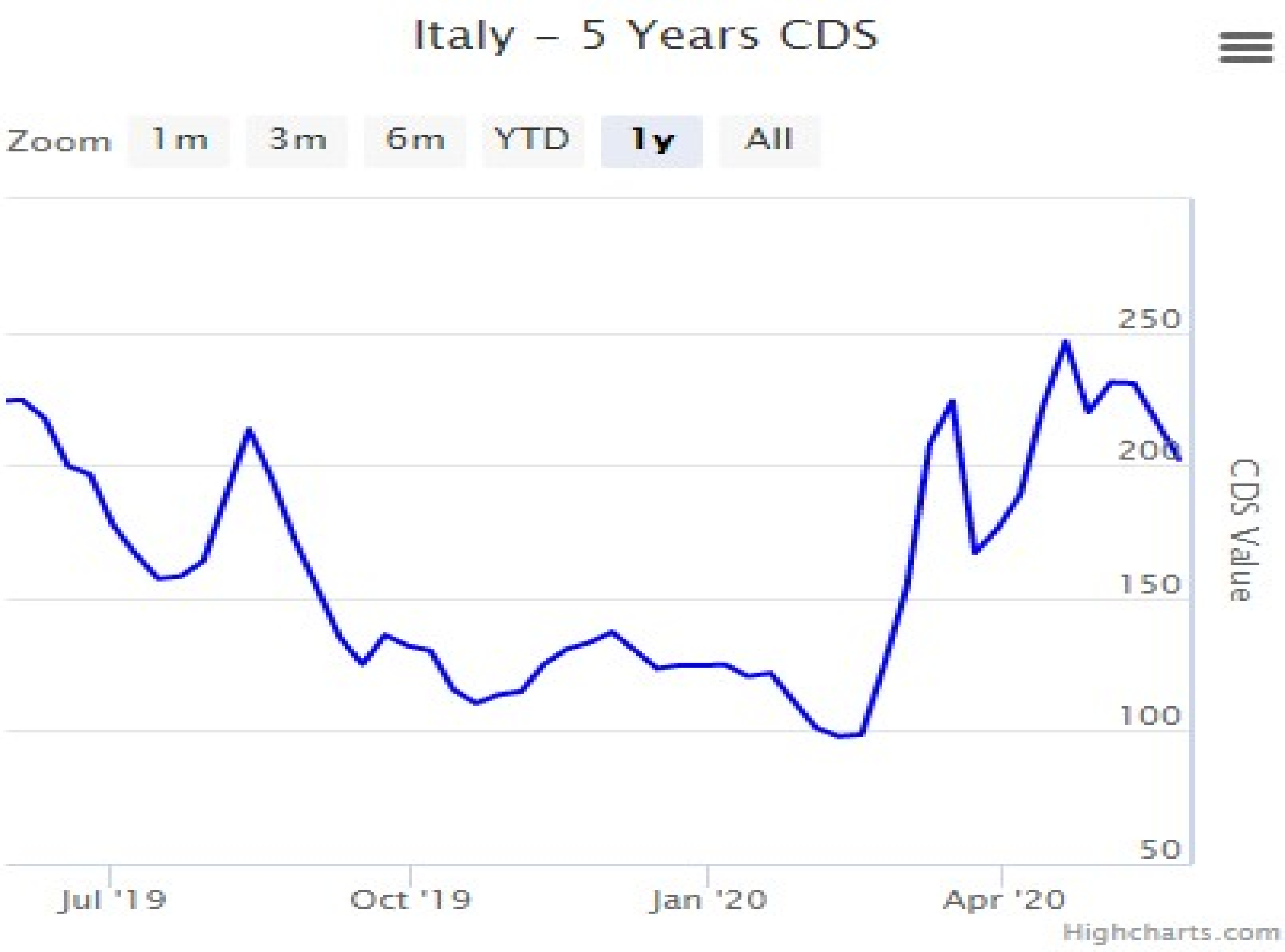
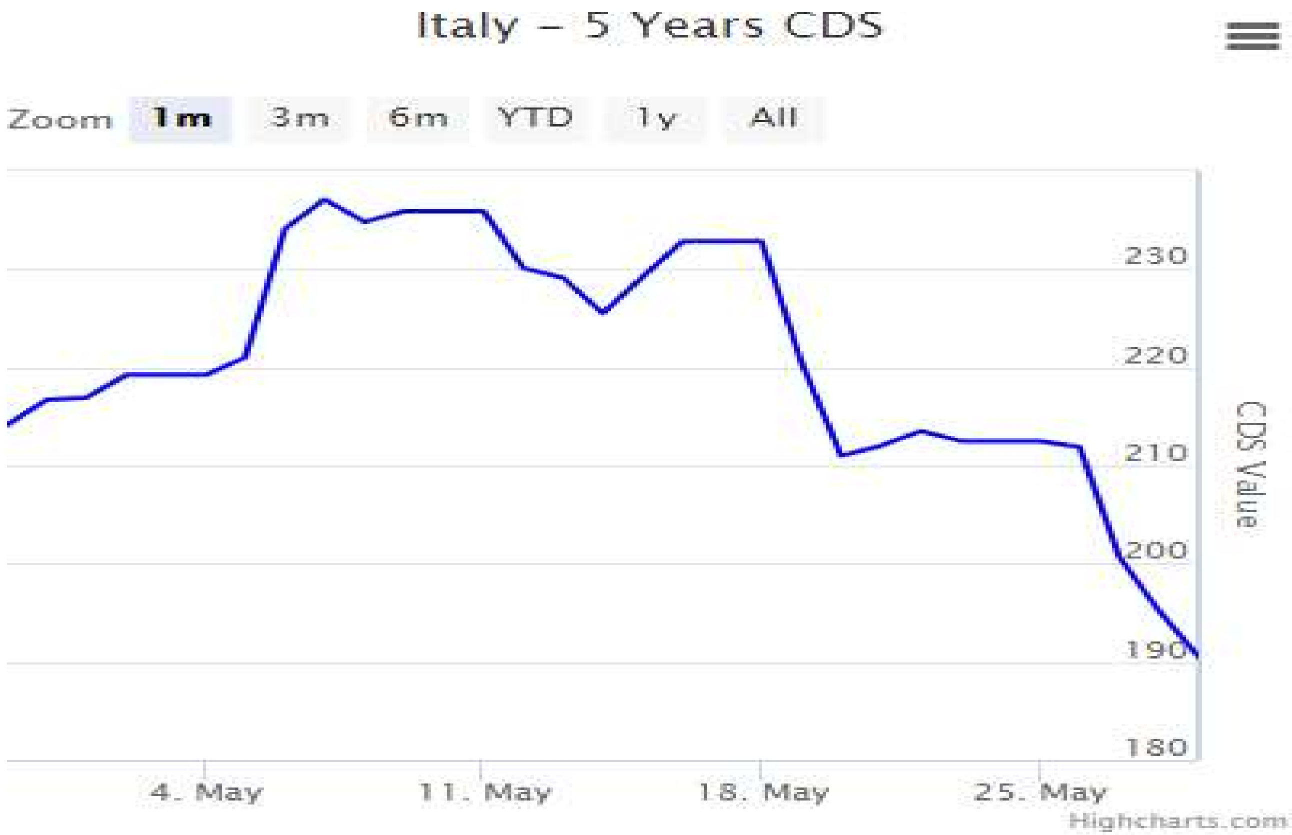

Italy – 5 Years CDS
Zoom
1m
3m
6m
YTD
1y
All
250
200
150
100
50
CDS Value
Jul '19
Oct '19
Jan '20
Apr '20
Highcharts.com

Figure 4



Italy – 5 Years CDS
Zoom
1m
3m
6m
YTD
1y
All
230
220
210
200
190
180
CDS Value
4. May
11. May
18. May
25. May
Highcharts.com

Table 1

"NEXT GENERATION EU": PROPOSED ALLOCATION OF FUNDS ACROSS COUNTRIES

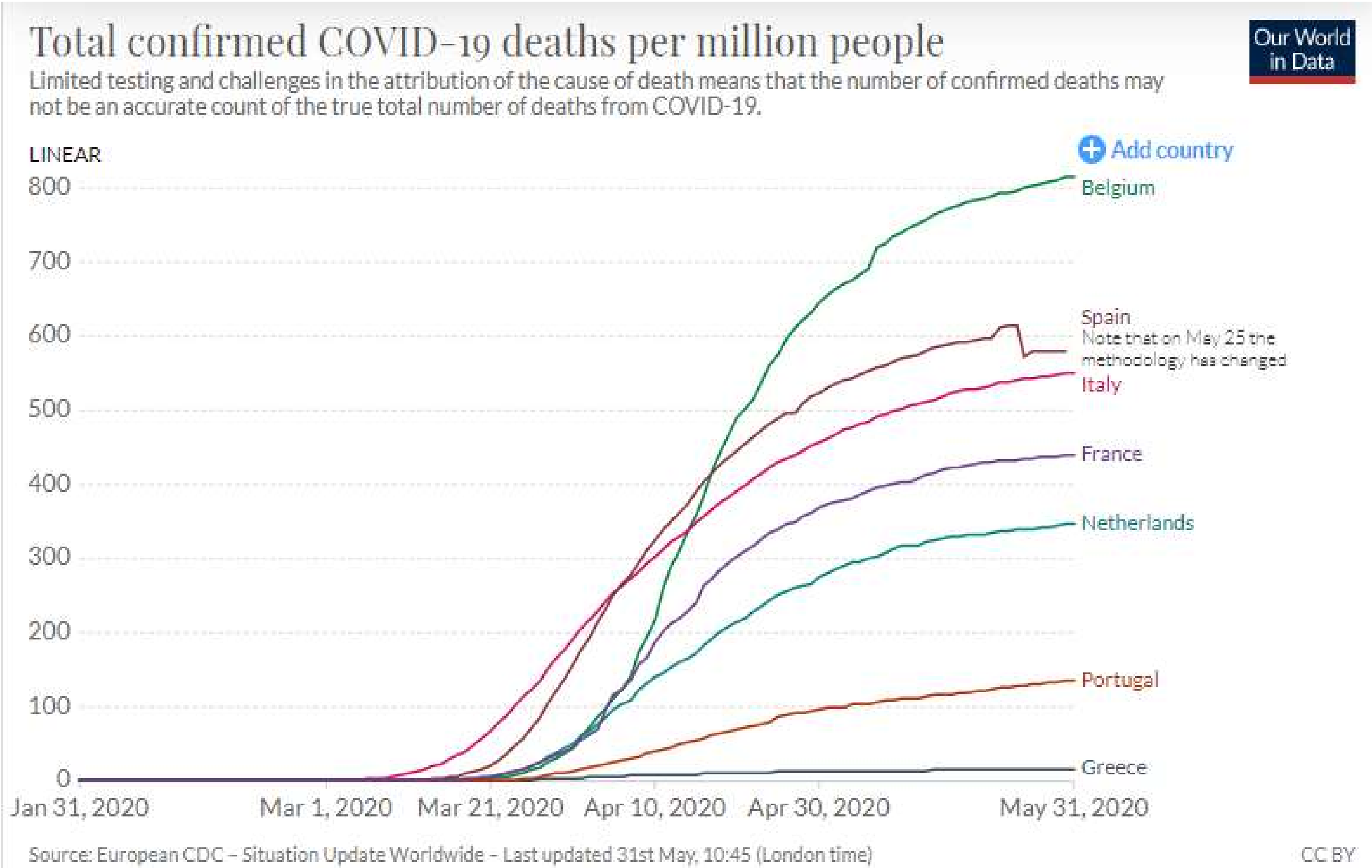
(billions of euro)

Country	Grants	Contributions to the EU budget*	Net benefit**	Loans
Belgium	5.5	17	-11.5 (2.43%)	0
France	38.8	87	-48 (1.98%)	0
Greece	22.6	6.5	16.1 (8.90%)	9.4
Germany	28.8	123.5	-94.7 (2.76%)	0
Italy	81.8	64	17.8 (1.00%)	90.9
Hungary	8.1	5	3.1 (2.23%)	7
Netherlands	6.8	29	-22.2 (2.75%)	0
Poland	37.7	19	18.7 (3.54%)	26.1
Portugal	15.6	7.5	8.1 (3.88%)	10.9
Spain	77.3	44.5	32.8 (2.65%)	63.1

* 500 X fraction of the country GDP in EU GDP

** Grant – contribution. In parenthesis, net benefit as a percentage of the country's annual GDP

Appendix



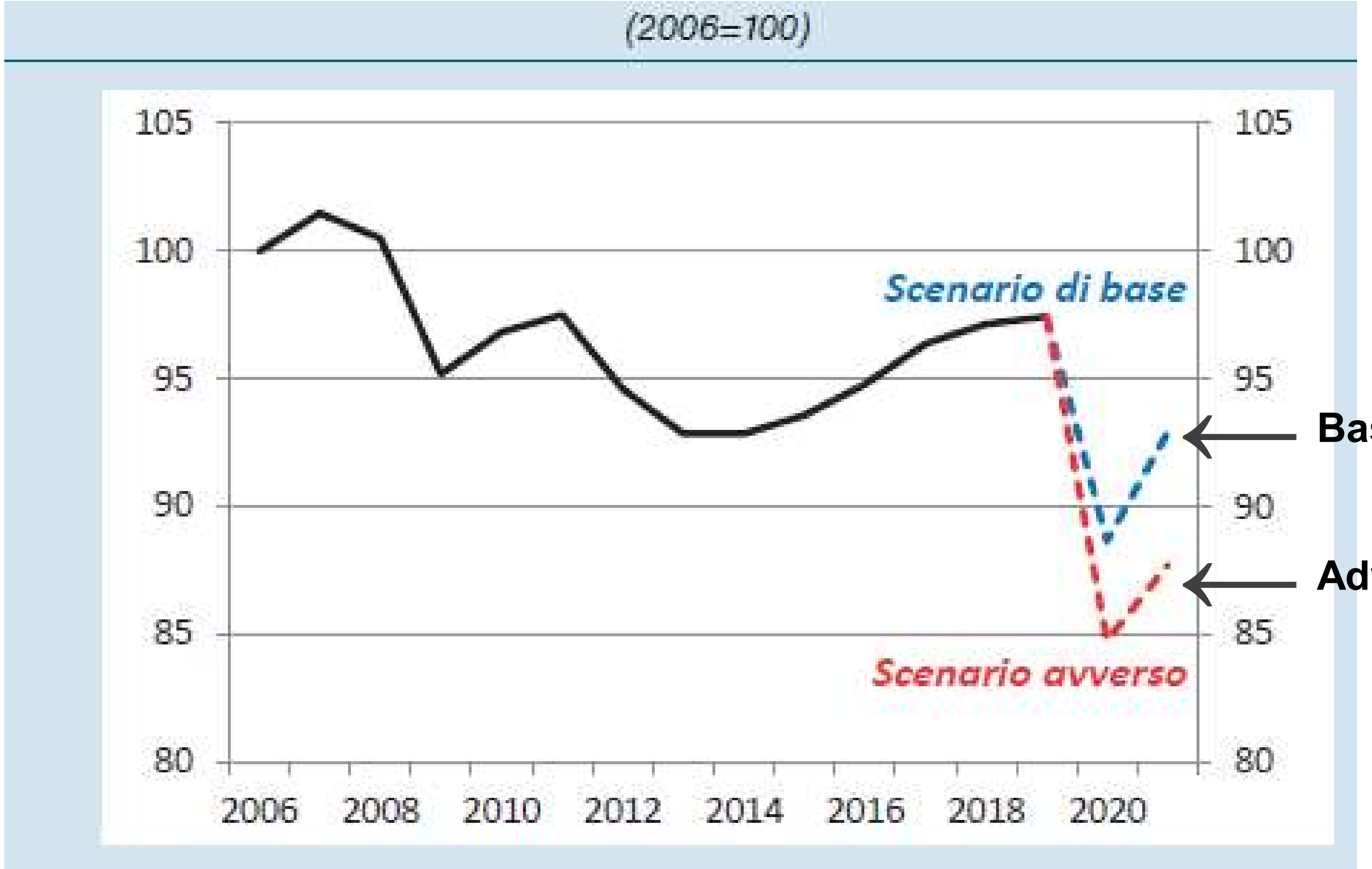
Relatively to its population, Belgium had more Covid-19 deaths than Italy or Spain and has the same public debt-to-GDP ratio as Spain (see the table in the next slide), but it is supposed to be a net contributor to Next Ge EU (see Table 1).

European Commission Economic Forecasts – Spring 2020

country	GDP growth 2019	GDP growth 2020*	GDP growth 2021*	Budget balance 2019	Budget balance 2020*	Budget balance 2021*	Gov.nt debt/GDP 2019	Gov.nt debt/GDP 2020*	Gov.nt debt/GDP 2021*
BELGIUM	1.4	-7.2	6.7	-1.9	-8.9	-4.2	98.6	113.8	110.0
FRANCE	1.3	-8.2	7.4	-3.0	-9.9	-4.0	98.1	116.5	111.9
GERMANY	0.6	-6.5	5.9	1.4	-7.0	-1.5	59.8	75.6	71.8
GREECE	1.9	-9.7	7.9	1.5	-6.4	-2.1	176.6	196.4	182.6
ITALY	0.3	-9.5	6.5	-1.6	-11.1	-5.6	134.8	158.9	153.6
NETHERLANDS	1.8	-6.8	5.0	1.7	-6.3	-3.5	48.6	62.1	57.6
PORTUGAL	2.2	-6.8	5.8	0.2	-6.5	-1.8	117.7	131.6	124.4
SPAIN	2.0	-9.4	7.0	-2.8	-10.1	-6.7	95.5	115.6	113.7
EUROAREA	1.2	-7.7	6.3	-0.6	-8.5	-3.5	86.0	102.7	98.8

*Forecasts

Italy's GDP: Bank of Italy's scenarios for 2020-21



Basic scenario

Adverse scenario

The Italian governments' eternal call for fiscal «flexibility»

Recent Italian governments looked at the country's long-lasting stagnation through the lens of insufficient demand, thus calling for fiscal expansions (a permanent source of tensions with the EU's authorities).

Structural reforms have come to a complete halt (or, more precisely, counter-reforms have been recently implemented, for ex. by re-introducing the possibility of early retirement).

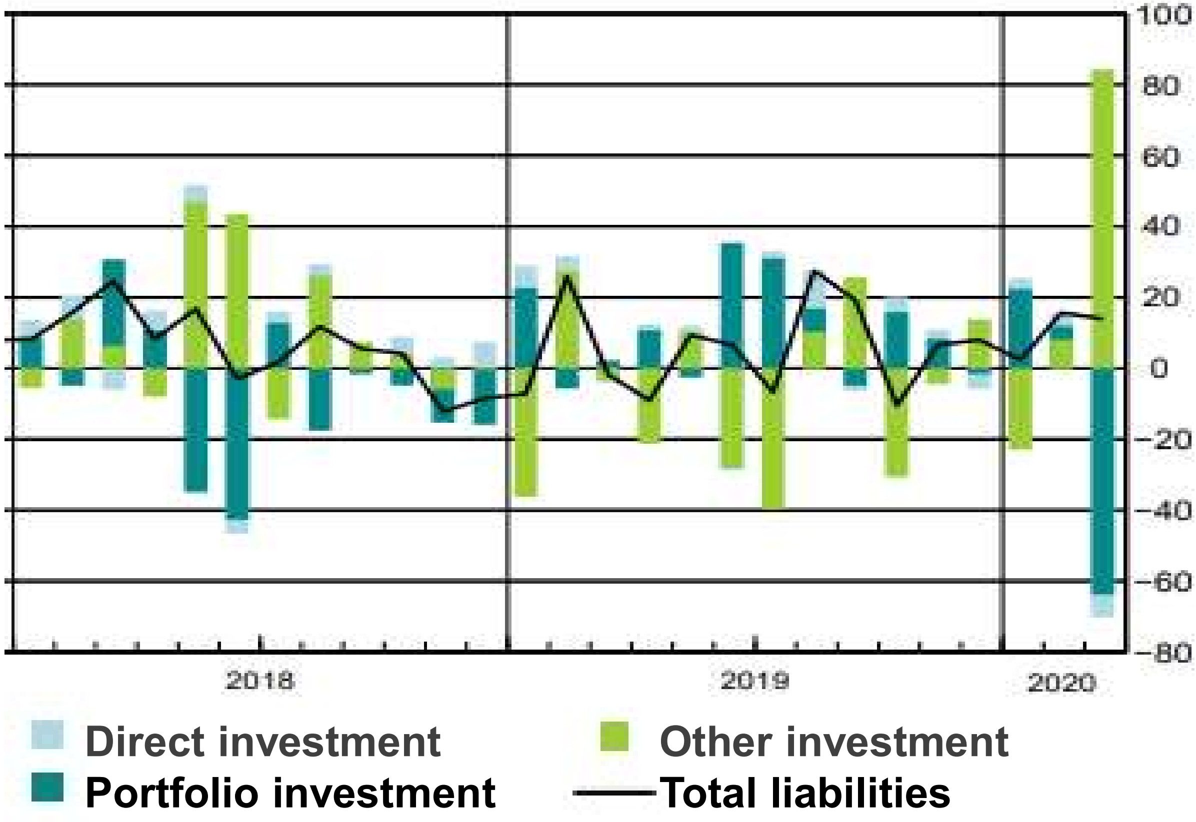
Actually, in a longer time perspective, Italian fiscal policy has not been particularly tight. As noticed by the IMF (2018): "During 2000–05, Italy eased fiscal policy—in structural primary terms—by 5½ percent of GDP versus 1 percent in the rest of the euro area. When the global financial crisis struck, it eased fiscal policy further by nearly 2 percent of GDP, before sharply tightening the stance in 2012–13. During 2014–17, it again eased fiscal policy by over 2 percent of GDP and spent entirely its considerable interest savings that emanated from accommodative monetary policy". Results in terms of GDP growth have been meagre…

SPREAD ITALY BTP - GERMANY BUND 10 YEARS
(December 2019 – May 2020)

SPREAD ITALY BTP – GERMANY BUND 10 YEARS

(2015-2020)

Italy: Net liabilities in the financial account
(monthly flows in billion of euro)



In March 2020, net foreign liabilities increased by 14.0 billion. The increase in net liabilities in "other investment" (84.2 billion), due to the expansion of the debt balance on Target2 (106.9 billion), was partially offset by the reduction in direct investment (6.5 billion) and in portfolio investment (63.8 billion). The latter was due to foreign divestment mainly regarding public debt (51.5 billion, with a prevalence of long-term bonds).