

Desk Strategy

European Macro Strategy

7 April 2020

(Euro)group therapy

Looking for the political “whatever it takes”

The Euro area finance ministers (the Eurogroup) should decide today on an additional package of measures to respond to the Covid-crisis. Nothing is fully finalised yet – and yesterday night Italy’s PM sounded still lukewarm at least towards one element of the package (i.e. the ESM credit line). But, on balance, we expect an outcome in line with what we discussed in our Eurogroup [preview note last week](#) – see also the box below.

Box 1. What’s on the Eurogroup’s table?

1. **ESM credit lines:** we already discussed this option in our [Coronabonds vs. ESM](#) note: the intention would be to offer cheap loans of up to 2% of GDP (so e.g. around 35bn for Italy) to countries requesting it, with low conditionality.
2. **European Commission (EC)’s SURE programme:** similar to the ESM, SURE would offer cheap credit to countries for up to 100bn overall – with even less stringent conditionality – to fund together with national governments technical unemployment benefit schemes. As for the ESM, these loans would increase a country’s national debt, but of course the nature of the debt will be different and longer-term than the countries’ stock of marketable debt.
3. **EIB’s increasing firepower:** the European Investment Bank has suggested getting a €25bn capital increase (pro rata per EU member, according to the capital key), to mobilize a further 200bn in loan guarantees and direct equity in European companies. This action will support the private sector directly and have a minimal impact on each country’s national debt.
4. **A mini solidarity fund (Dutch proposal).** A 20bn fund for the health emergency. Countries would participate as per their relative share in the euro area GDP, and sums will be distributed as per needed – so a net support, via outright grants and not loans, to the countries most hit by the pandemic.
5. **A – limited, temporary – solidarity fund (French proposal)** that would be financed by issuance of euro area bonds backed by a future dedicated European “solidarity” taxes and that will deal with the reconstruction phase more than with the immediate emergency needs. The size of the fund could be of a few pp of GDP.
6. **Use of the 7-year financial framework of the EU** (worth €1 trillion, but of largely already committed expenditure) to redirect at least some funds away from usual spending destinations and onto recovery and post-virus reconstruction projects.
7. **There are other ideas**, including using the European Commission’s issuance capacity to do the same as option 4 or 5, directly within the EU framework. But these options are at best embryonic for the moment.

Strategists

Giovanni Zanni

Chief Euro Area Economist
+44 20 7085 7473
giovanni.zanni@natwestmarkets.com

Giles Gale

Head of European Rates Strategy
+44 20 7085 5971
giles.gale@natwestmarkets.com

Imogen Bachra, CFA

European Rates Strategy
+44 20 7085 8381
imogen.bachra@natwestmarkets.com

www.agilemarkets.com
Bloomberg: [NWMR<GO>](#)

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All these proposals can be seen as alternatives but also complementary. Some imply cheaper funding, other ‘proper’ mutualisation of the spending side; some are related to the immediate crisis response, others to the recovery phase. Our view is that the emergency phase has been pretty well covered by the ECB’s PEPP and European Commission’s relaxation of fiscal rules. Support should now focus much more on the recovery phase.

Somewhat underwhelming, the first three options above - ESM credit lines, European Commission’s SURE plan and EIB expansion – are the ones most likely to be agreed today. Support for the recovery phase with some form of mutualisation is likely to happen too, though, in our view, in the not so distant future.

Progress, but no Eurobonds (yet). This new emergency package is not strictly needed, in our view, but would be a “nice to have”. Indeed, today’s Eurogroup decisions, barring any major surprise tonight, should be seen as “phase 1.5” of the European policy response, after [the game-changing ECB decision to launch the PEPP programme](#) last month – which is large, flexible and scalable – , and ahead of “phase 2”, which we believe will involve some kind of debt mutualisation at the European level to finance the post-lockdown recovery. Today’s decisions will still essentially be for the emergency phase, with support for workers (EC’s “SURE” plan), companies (EIB guarantees) and for immediate COVID-related expenditure (the ESM ECCL credit line). The only potentially key addition could be to add further, targeted, ECB firepower through the OMT instrument – which is accessible through the ESM credit line, as we argued in our [Coronavirus vs. ESM](#) note. The other key ingredient of today’s Eurogroup meeting should be its capacity to show (or not!) European cohesion and prepare for the more political “phase 2” mentioned above.

Implications for debt sustainability

How should investors interpret debt sustainability in light of the policy response? What does our [assessment of the economic prospects](#) and of the policies being agreed, not just at the European but also at the national level (the latter are currently estimated at 3% of GDP in fiscal measures and nearly 20% of GDP in financial guarantees), imply for the supply & demand of government paper?

We already [wrote on this last week](#). We further explore and illustrate the issue below in light of the likely announcements from the Eurogroup – which could provide an extra source of weaker market pressure for the most vulnerable countries of the euro area.

Let’s take Italy as an example. We currently assume a deficit of around 9% of GDP this year for the country, considering the initial deficit situation at the end of last year, the impact of automatic stabilisers, fiscal measures already pledged and likely new measures to be announced for the recovery phase. Our deficit estimates would imply roughly €150bn of net new issuance requirements. The debt would rise from just over €2.4T to around €2.55T. In GDP terms, the debt/ratio would rise more than implied by the deficit, from 135% to c.155%, given the large expected fall in the denominator.

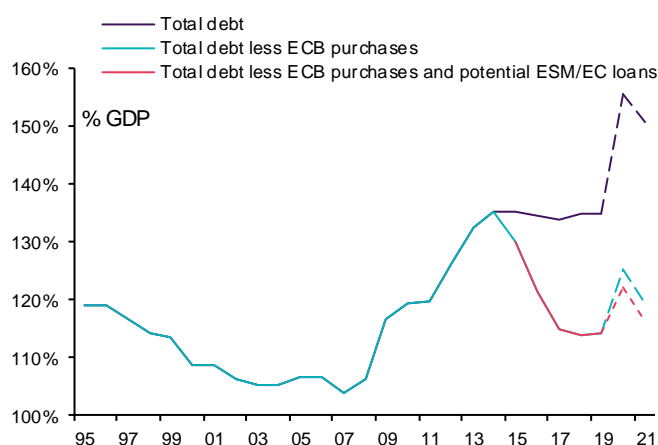
Would such increase in fiscal dynamics be considered “unsustainable”? From a purely arithmetic viewpoint, the added supply will be fully neutralised by policies. Indeed, we have tentatively decomposed the new funding requirements in additional €45bn of BTPs, €45bn BOTs and €60bn of ESM and EC loans: indeed, Italy could in principle (if our expectations regarding today’s proposals and their final approval are met) tap 2% of GDP of the ESM facility, i.e. more than €30bn, and – theoretically – a large share of the €100bn available under EC’s SURE program.

Even without these added facilities, all and more of this year’s net issuance could be absorbed by ECB’s QE/PEPP alone – and more so if we also include ESM/EC loans – plus there could be extra demand from the so-called [Sarkozy trade](#)... In other words, even if the debt is high and rises further by 15- 20pp of GDP, as should be expected, the net increase in “marketable debt, net of ECB acquisitions” should be muted if not

outright negative. We illustrate the same calculations for Portugal, Spain and France in the appendix.

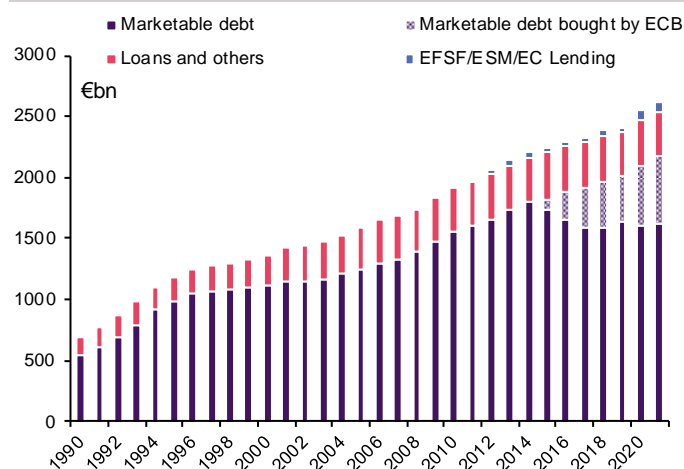
Italy's debt/GDP may well rise to ~155% this year...

Source: NWM, EB, Bloomberg, Haver



...but the stock of "marketable debt" remain broadly stable

Source: NWM, EB, Bloomberg, Haver



So the European policy response is so far sufficient to match this year's extra supply... But of course deficits will likely stay high for several years, and there could be at some point implications from the implicit liabilities gained through the massive guarantee schemes put in place in the various countries. ECB's PEPP (and possibly OMT) is a very powerful tool, and could be extended into 2021, we believe. It will be a temporary measure of course, but we expect that it will reinvest the purchases made over a long period, unless there is a political decision to mutualise the programme (or from a central banker's perspective 'sterilise' it) in another more formal way.

...but we need a political decision to deal with the medium-term, and to really assess fiscal sustainability. We are at a bifurcation, and today's Eurogroup should be the beginning of the answer to understand where Europe is going: persistent divergence of views between the north and the south, or necessary progress towards mutualisation – not in abstract and for legacy debt, but for the consequences of this exogenous, common shock (the virus) on the economies of all member states.

We are constructive and see goalposts being moved, as can be evinced by key leaders' declaration in the past 24 hours. From the high-level words of Angela Merkel – "Everyone is just as affected as the other, and therefore, it is in everyone's interest, and it is in Germany's interest for Europe to emerge strong from this test", "the answer can only be: more Europe, a stronger Europe and a well-functioning Europe." – to the more concrete proposal from the French government - France is proposing a fund worth 3pp of the euro area GDP (so over €350bn) to boost the European economy after the coronavirus crisis, focusing on three areas: public sector healthcare; the sectors most hit by the crisis, such as tourism, aeronautical industry; technology. Funding could take the form of joint issuance or guarantees based on each country's GDP share, and could be backed by a new reconstruction tax.

An agreement, even if in principle, on that front would be a better than expected outcome in today's Eurogroup meeting, we believe, even though it isn't our expectations and furthermore we believe it is an issue better handled by the Heads of State rather than by the finance ministers (so more ` theme for next week's EU summit). In any case, this would be what we see as "phase 2" – which will anyway have to start soon: some countries are already planning the end of their (stricter version of) lockdown from after Easter (e.g. Austria, Switzerland, Norway,...), with probably most others seeing this happening at some point in May at the latest.

Implication for ratings

Debts levels are high, and for countries such as Italy the debt ratio will reach historical levels.. It is a fact. But it is also true that a combination of lower rates and specific policies implemented at the European level imply that debts are not less sustainable than before, on measures such as debt servicing and the effective size of true “marketable debt” (see charts above).

So the sustainability will depend on the growth dynamics post emergency, but also on the “phase 2” support – if it is indeed delivered. In other words, there is a need for a political validation of the current support in place, and ultimately for the viability of the European project. If we have the latter, Europe will be reinforced and ratings shouldn't be affected. In the opposite case, there is not only an economic and financial rationale for a downgrade, but also a political one through the “willingness to pay” – a key concept of any analysis of debt sustainability. League's leader Salvini already seemed to suggest as much, arguing that if Europe is unable to deliver support to a country in this difficult phase, conclusions will have to be drawn... Nationalisms in the North could also be an issue for symmetric reasons if the crisis is mishandled.

Rating agencies should also draw their conclusions from the Eurogroup's and more in general from European actions in the coming weeks. Although Fitch notes that [multi-notch downgrades were likely](#), [we don't think it is entirely justified](#) if ECB and more general political support is there and some form of mutualisation materialises in the coming weeks.

Conclusion. The possible is not the best, but more Europe is gradual

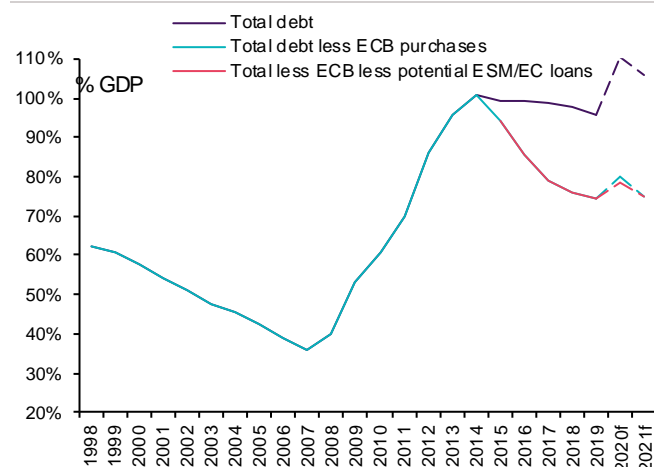
The best policy option at the moment, would be to create a mutualised instrument to fund the recovery – sufficiently large, targeted, but limited in the fiscal exposure of each country. The French proposal mentioned above (as well as that [of European Commissioners Gentiloni and Breton](#)) is probably what comes closer to what's needed, in our view – although as we said the Eurogroup is unlikely to be the place where such a new tool is delivered. The creation of such an instrument would reinforce the idea of intra-euro area support and reduce further the probability of default – representing a second political leg of the “whatever it takes” of Draghian memory.

The end of the euro or Europe's “Hamiltonian moment”? A crisis should never be wasted and there is the potential to go even beyond Draghi's whatever it takes, from a political perspective. But a return to nationalism is of course possible and has often happen after a major shock. The way European politicians rise up to the challenge in the coming days and weeks will likely have profound consequences for markets but also more broadly for the economy and prosperity of the euro area and European Union.

Appendix

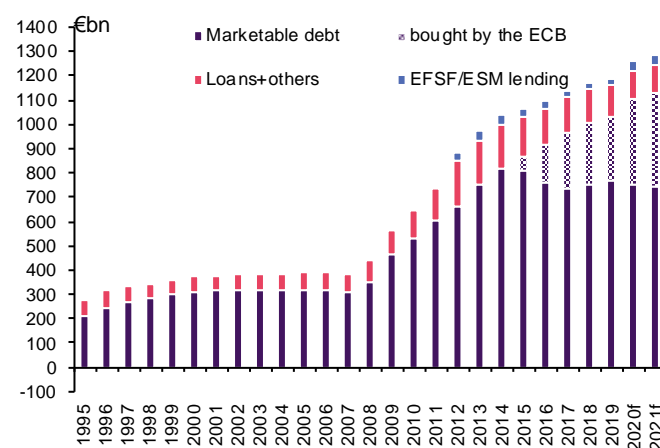
Spain's debt/GDP could reach 110% this year...

Source: NWM, EB, Bloomberg, Haver



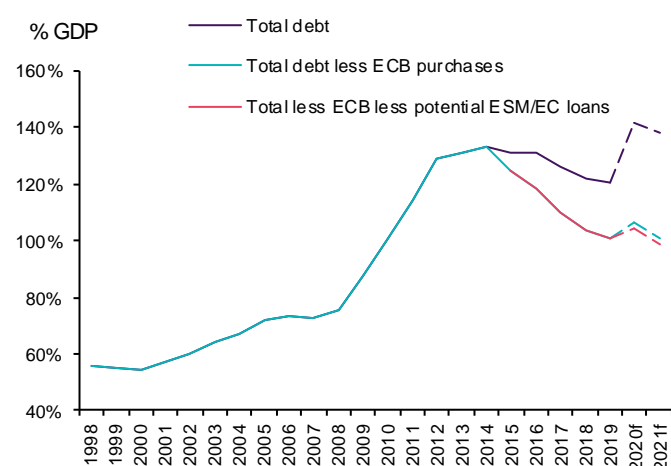
...but "marketable debt" (net of ECB) will fall

Source: NWM, EB, Bloomberg, Haver



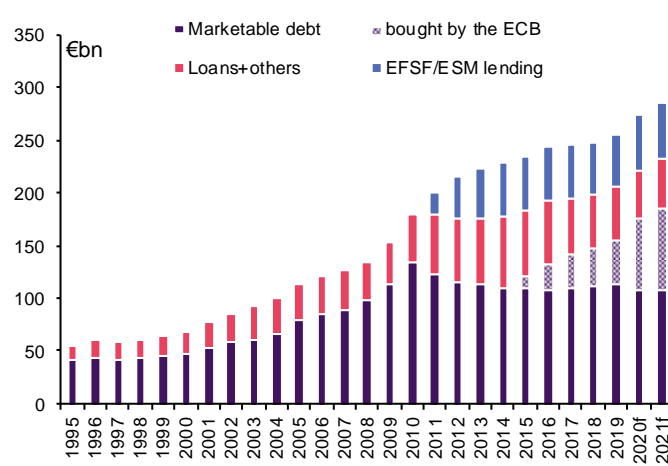
Portugal will likely see a record high in debt/GDP...

Source: NWM, EB, Bloomberg, Haver



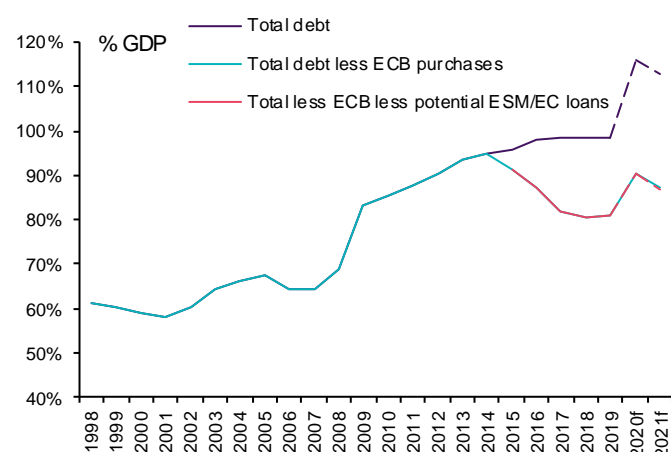
...but policy responses could reduce the marketable debt

Source: NWM, EB, Bloomberg, Haver



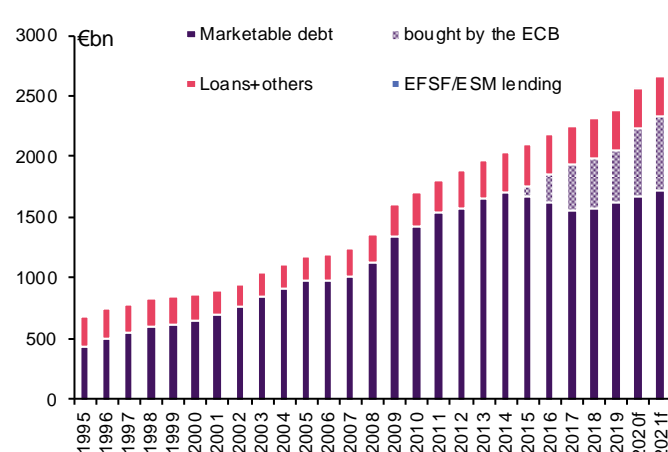
France's debt/GDP could exceed 110%...

Source: NWM, EB, Bloomberg, Haver



...but the ECB will mop up a large portion of the increase

Source: NWM, EB, Bloomberg, Haver



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