ODDO BHF
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Economy

A one-legged Europe no more?

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To move forward, it is preferable to have two legs than one. To stabilise the business cycle, it is better to be able to intervene from two angles - monetary and fiscal. Europe's framework up is such that fiscal policies are decentralised and therefore uncoordinated and suboptimal. EU-wide fiscal stabilisation does not exist. In emergencies, (almost) everything lies on the ECB's shoulders. This can pose problems, as we were recently reminded by Germany's constitutional court. The crisis means that we need to rethink how the EU policy-mix is organised. In this article, we review the fiscal proposals advanced by Germany and France and taken up by the Commission, along with their implications for the ECB.

Rebalancing the policy mix in Europe

We hesitate to start with Jean Monnet’s quotation about Europe being forged during crises[1]. It has been wheeled out so often over the past ten years that it seems somewhat outworn now. But we must acknowledge that it suits the current circumstances. First, Europe is going through a dire economic crisis, unprecedented in peace time. Next, this crisis highlights the extent to which the policy-mix is incomplete and unbalanced. Everywhere else, in emergencies, fiscal and monetary policies are combined. Europe lacks a central fiscal mechanism designed to stabilise the business cycle, to such an extent that to move forward, it needs to walk on just one leg. In other words, it needs to rely on the ECB alone, which is the subject of much criticism[2]. Two recent events have prompted the ECB’s role to be reconsidered, and, by extension, Europe's policy-mix. One is the German constitutional court’s ruling of 5 May. The other is the fiscal initiative proposed by Germany and France on 18 May, forming the cornerstone of the Recovery Plan proposed by the European Commission yesterday.

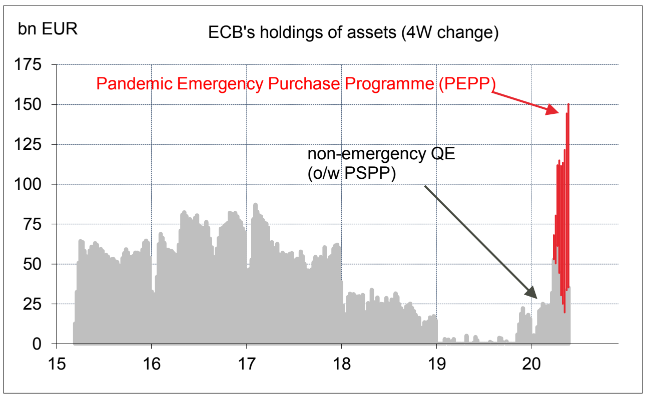
➢ **The ECB in the current crisis** – the ECB truly grasped the gravity of the situation on 18 March. In an unscheduled meeting, it created the € 750bn Pandemic Emergency Purchase Programme (PEPP) intended to prevent spreads widening within the zone and the fragmentation of financial conditions[3]. Since the start of March, the ECB’s balance sheet has inflated by almost € 900bn (table lhs). This mainly involves extending liquidity lines for banks and buying securities on the credit markets, principally via the PEPP (chart rhs).

ECB: Eurosystem’s simplified balance sheet

Eurosystem consolidated statement (bn€)

Assets	6 Mar.20	22 May	Liabilities	6 Mar.20	22 May
Gold	471	510	Banknotes	1280	1348
FX Reserves	346	361			
Lending to EZ banks	617	979	Deposits	2475	3228
- o/w (T)LTRO	616	979	- o/w held by banks	1910	2245
- o/w MRO	1	0	- o/w EZ residents	384	631
			- o/w non EZ residents	181	353
Securities	2875	3198			
- o/w gov.bonds (PSPP)	2134	2217			
- o/w corp.bonds (CSPP)	196	213			
- o/w covered.bonds	271	281			
- o/w PEPP (emergency)	0	212			
Other assets	394	507	Other liabilities (incl.capital & reevaluation account)	947	979
TOTAL	**4702**	**5555**	**TOTAL**	**4702**	**5555**

ECB: asset purchases

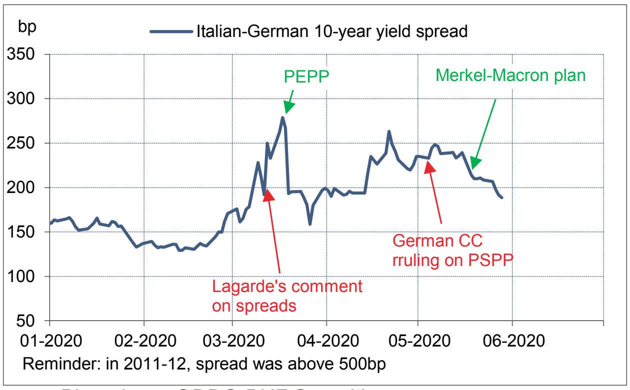


Sources: ECB, Oddo BHF Securities

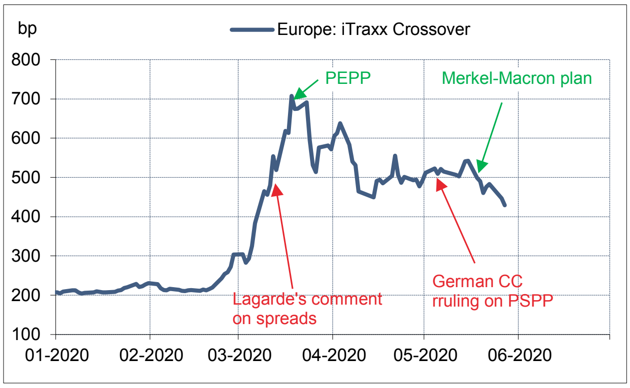
[1] *"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises." (Memoires, 1976)*
[2] *See our* Eco Note *of 10 October 2019: “*ECB: a critique of the critiques*”.*
[3] *See our* Eco Note *of 19 March 2020: “*From Draghi’s big guns to Lagarde’s PEPP-Show*”.*

Since end-March, the ECB's purchases have totalled € 212bn for the PEPP and € 301bn if we add the other programmes. Even if the situations are not identical, note that the Fed's asset purchases were around five times higher over the same period. An increase in the PEPP's envelope was discussed at the meeting of 30 April, and there is every reason to expect this to be decided at the meeting of 4 June. The general opinion of the ECB's officials is that the PEPP is the most effective instrument to answer market stress because it offers greater flexibility than all the others. It has helped to compress the credit spreads (charts). It would be inappropriate to float the idea that the ECB's interventions are limited by an arbitrary ceiling. In an emergency situation, there are, by definition, no longer any limits.

Sovereign credit spread (Italy-Germany)



Corporate credit spread



Sources: Bloomberg, ODDO BHF Securities

➢ **The ECB after Karlsruhe** – Imposing limitations on the ECB's actions is an obsession for some, and their favourite playing field is Germany's constitutional court in Karlsruhe. On May 5, in a judgement on the purchase programme launched in 2015 (PSPP), the court ruled that the ECB had not properly established the proportionality of its actions, and called for clarification within three months, failing which the Bundesbank could be obliged to no longer participate in Eurosystem interventions. From a legal standpoint, that this judgement contradicts another, prior, ruling issued by the European Court of Justice, is a problem in itself. In economic terms, the judgement makes absolutely no sense. A simple look at the minutes of the ECB's meetings shows that the question of proportionality was always taken into account. The supposed distinction which these constitutional judges seek to draw between monetary policy and economic policy has no precise basis. Lastly, there is a clear violation of the ECB's independence, which is as a rule respected above all else, and rightly so, in Germany. **When all is said and done, there is little if any risk of the ECB modifying its policy in response to the Karlsruhe judgement. We could even question whether this ruling might have indirectly prompted the German government to clarify its stance on the future of the EU and the euro and, in the process, set the stage for the joint fiscal initiative presented by Angela Merkel and Emmanuel Macron on 18 May**.

➢ **The ECB and the EU's stimulus plan** – At the European Summit on 24 March, heads of state and government were unable to agree on solidarity between countries. The stumbling block was the question of "coronabonds", with the emergence of two camps, the so-called virtuous or frugal countries and the others[4]. The proposed solution addresses the problem not at the level of the states but at the level of the EU. By expanding the EU's budget, the idea is to create a joint capacity for expenditure, financed through borrowing from the EU with the backing of member states. Taking its inspiration largely from the Franco-German joint proposal, the European Commission yesterday put forward a € 750bn recovery plan, based on the extension of the European budget for the period 2021-2027[5].

- The amount will be spent in the four years from 2021 to 2024.
- The plan is expected to break down as follows: € 560bn for a recovery fund financing the national stimulus programmes; €50bn for investment in the capital of companies; and €140bn to back various programmes already managed by the EU.
- How the money will be split by country has still to be debated and finalised. The EC's proposal is based on an allocation key that takes account of population, differences in income per capita and unemployment compared to

[4] *See our* Eco Note *of 8 April 2020: "At* Café de l'Europe, no corona(bonds) on the menu*"*
[5] *To recap, the other existing tools to regenerate European economies are € 240bn (at most) in the form of emergency lines of credit which the ESM could grant, € 200bn of loans guaranteed by the EIB, and € 100bn in the EC's SURE programme which aims to help countries finance their short-time working system.*

the EU average. This gives the advantage to countries with low income and/or that are already heavily indebted. In absolute terms, the main beneficiaries are likely to be Italy (€ 153bn) and Spain (€ 149bn). In relative terms, Poland, Romania, Greece or Portugal would benefit the most from this plan. As always when the EU budget is at stake, there are myriad considerations, given that by definition some receive more than their contribution and others less, with a complicated system of rebates. Some countries (Austria, Netherlands, Sweden) have already voiced their opposition to the Franco-German plan.

- The financing of this plan is the most interesting part. Rather than an increase in the contributions to the budget made by each country (which would reduce the fiscal multiplier), the € 750bn would be borrowed by the commission with repayment deadlines ranging from 2028 to 2058. Of the stimulus package of € 560bn, € 310bn will be direct in subsidies and € 250bn loans. The remaining € 190bn will be paid in the form of subsidies. All told, this breaks down as two-thirds in subsidies (€ 500bn) which would not affect national debt/GDP ratios and one-third in loans. For the subsidies and common expenditure, the terms and conditions for reimbursement are yet to be determined. Since this will not be an issue before 2028, the Commission remains vague on this point, alluding to new resources (low amounts in any case).
- Estimating the multiplier effect of this plan is, clearly, highly speculative for the time being. We could estimate that the fiscal stimulus will be 0.9 points per annum in the EU between 2021 and 2024, although it could be as high as 1.4 points in Italy and 2 points in Spain. Given the severity of the economic shock and the resulting uncertainty, it appears clear that this spending will not crowd out that of the private sector. Instead it should help to offset the loss of investment capacity at businesses when the crisis is over.
- The time frame for the plan's adoption is also yet to be determined, but the EU summit of 19 June could already give rise to an agreement between governments, or failing that, reveal the last zones of resistance. A vote by the European parliament is not anticipated before the end of the year, at best.

There remain a number of unknowns on the eventual form of the EU recovery plan, but if it comes to fruition, it would add an as yet untested tool for economic stabilisation. This was never the primary vocation of the EU budget until this crisis. All told, the European policy mix would be more balanced between ECB measures, on the one hand, and fiscal measures, national or at the European level, on the other. This is an ambition that is frequently expressed by ECB officials, previously by Mario Draghi and now by Christine Lagarde. The ECB would be all the more likely not to spare its current efforts if it knows that in the medium term the slack will be taken up by other echelons of economic policy.

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