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How COVID-19 is widening the Eurozone's fault lines

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Introduction

After barely recovering from the 2010-12 sovereign debt crisis, the Eurozone is now entering another major economic downturn. In the first three months of this year alone, its economy shrank 14.4% on an annualized basis, much worse than the 4.8% contraction recorded by the U.S. economy over the same period.

This COVID-19-induced recession has also widened the Eurozone's political fault lines, pitting mostly the southern European countries against their wealthier northern counterparts. The likelihood that the latter are likely to recover faster and see a smaller increase in debt levels will only exacerbate tensions between the two groups. Indeed, while GDP declined at an annualized rate of 9.6% in Austria in the first quarter of 2020, it fell 17.6% in Italy and 19.2% in Spain.[1]

The disagreement over pooling debt within the Eurozone bloc

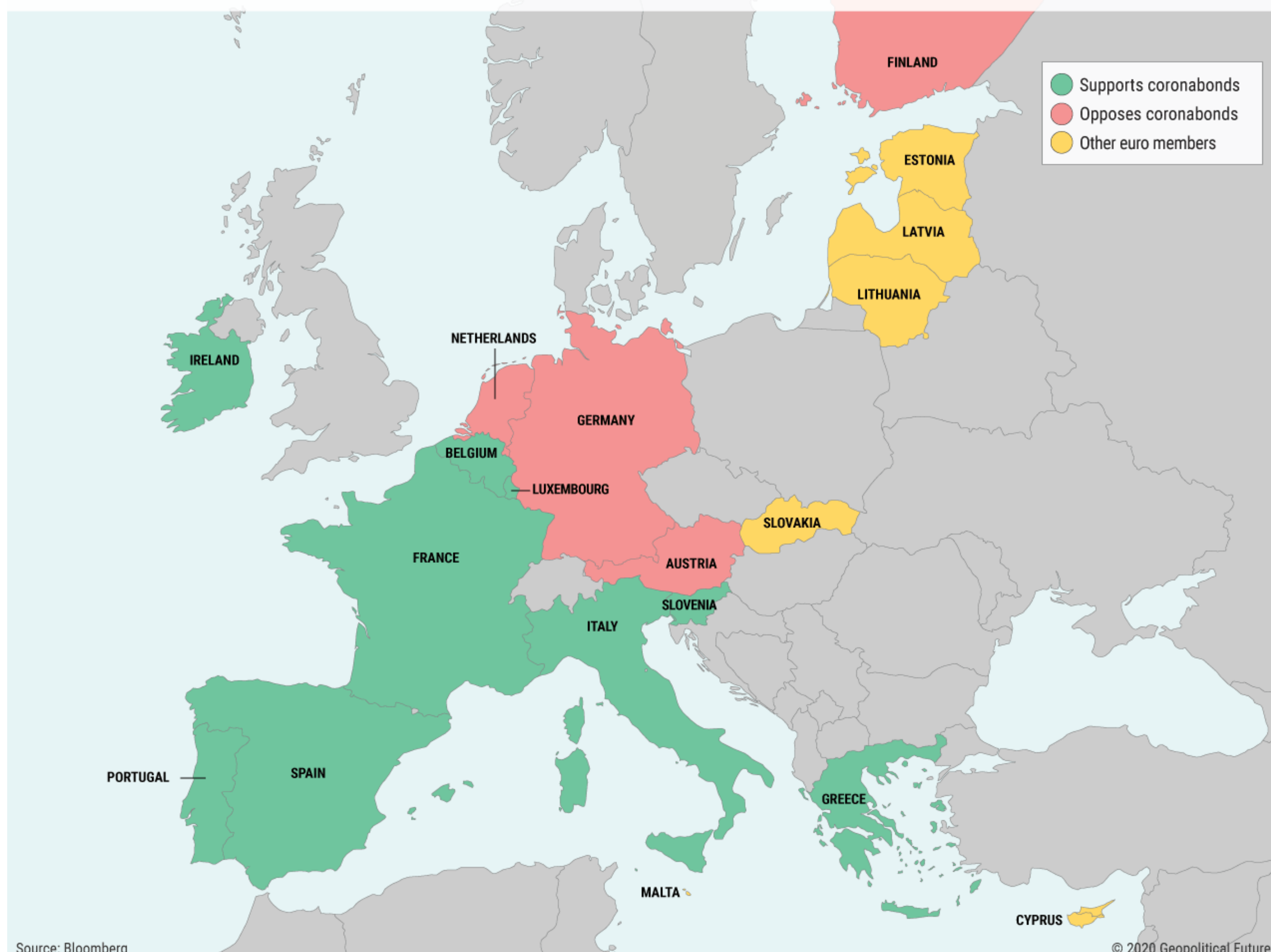
In March, Italy, Spain and seven other countries once again brought up their long-standing demand for the creation of a common debt instrument. This time around they have labelled it the Coronabond, vowing that it would be used only for the COVID-19 downturn.

The logic behind bonds backed by the Eurozone as a whole is relatively straightforward. If high-debt countries such as Greece, Spain and Italy could borrow money with the backing of all the member countries, investors would consider them less of a credit risk. These countries want to avoid a repeat of the harsh austerity measures they feel were unjustly imposed on them during the last economic crisis. In their view, this not only led to several years of economic stagnation, it also sparked a surge in support for formerly marginal political forces on the far right and left of the political spectrum.

While pooling debt makes economic sense for the Eurozone as a whole, fiscally stronger countries have one major reason for opposing it. They worry that Eurozone bonds would leave them on the hook for other countries' debts and that bonds supposedly dedicated only to the COVID-19 downturn would set a precedent for future bailouts. Worse still from their perspective, northern European taxpayers would be expected to shoulder this burden at a time when they are entering a deep economic downturn.

Successive leaders of the Netherlands, Germany, Austria and other countries have also repeatedly told their citizens that they would not be compelled to financially support the governments of poorer states. In 2012, German Chancellor Angela Merkel went so far as to tell a group of German parliamentarians that there would be no euro bonds "as long as I live".[2] If most Germans are opposed to mutualizing debt, it is because they know how expensive it is to support a poorer country. Since the fall of the Berlin wall in 1989, the cost of reunifying East and West Germany is estimated at over two trillion euros.[3] To put this figure into perspective, Germany's annual nominal GDP in 2019 was about 3.5 trillion euros. One can only imagine the long-term costs involved in financially supporting the Eurozone's more indebted members.

[1] "Eurozone Economy Suffers Record Contraction, Steeper Than the U.S.," Wall Street Journal, April 30, 2020
[2] "Merkel Vows 'No Euro Bonds as Long as I Live'," Der Spiegel, June 27, 2012
[3] "Thirty years after it fell, the Berlin Wall still divides Germans," Reuters, October 24, 2019



Source: "Not Another Eurozone Crisis," Geopolitical Futures, April 3, 2020

The deadlock over Eurozone bonds leads to compromise measures

While European finance ministers failed to reach a deal to mutualize debt, two major stopgap measures have been adopted. First, in an effort to keep the bond spreads between richer and poorer members from widening too much, the European Central Bank launched a 750-billion-euro bond-buying quantitative easing program. Unlike the previous QE initiative, the requirement to buy bonds roughly in proportion to each country's capital contribution to the ECB has been lifted. However, Germany's highest court complicated matters in early May by ruling that European Central Bank exceeded its mandate when it first launched its quantitative easing (QE) program back in 2015. The court, which is worried that Germany has illegally ceded tax and spending power to the ECB, has given the government three months to prove the bond-buying program is legally justified. While the ECB will no doubt be able to provide many studies supporting its actions, this ruling is indicative of the strong opposition that exists in Germany to not only QE, but further economic integration with the EU in general.

Second, the finance ministers agreed to create a 540-billion-euro rescue fund. The only requirement is that these loans must be used for items related to COVID-19. They also began discussing the contours of an additional trillion dollar recovery fund. The more indebted countries want these funds to be distributed mostly in the form of grants, while the northern countries insist that the majority of the funds be given out in the form of loans with commitment to fiscal responsibility. In typical EU fashion, the members have left it up to the European Commission to determine the mix of grants and loans. Whatever the scheme decided upon, we can expect both sides to criticize it for being either too stingy or too generous.

The widening gap between the haves and have-nots

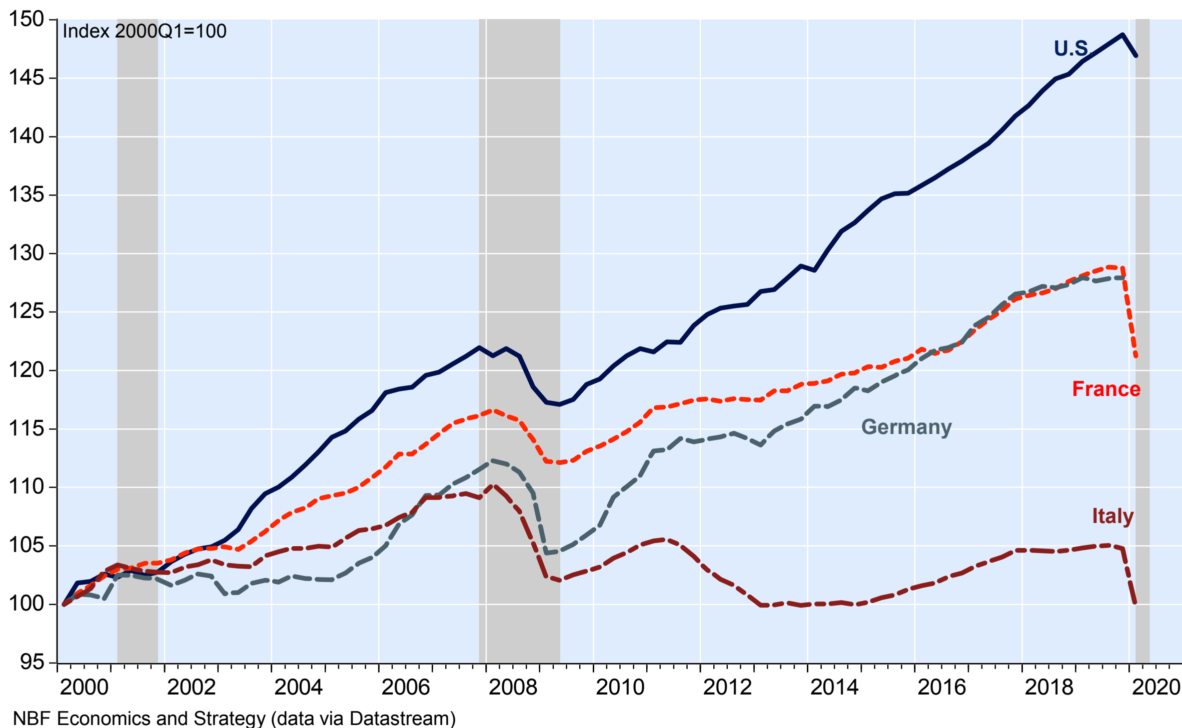
The resistance to Eurozone bonds is stiffened by the high debt levels of certain members. The IMF has projected that Italy's national debt as a percentage of GDP will swell from 135% in 2019 to 156% by the end of this year, while Spain's debt will rise from 96% to 113% over the same period. In comparison, it is estimated that Germany's debt will increase from 60% in 2019 to only 70% in 2020. Germany and other low-debt countries are also able to borrow at lower interest rates.

The less debt a country has, the more it can afford to spend on financial aid.

For example, Spain has guaranteed up to 100 billion euros to banks providing loans to companies hit by the COVID-19 lockdown. However, the guarantee covers only 70% to 80% of each loan, meaning banks must bear the rest of the risk. In contrast, the German government has implemented a 100% guarantee on all loans extended to impacted mid-size firms.[4]

Tensions particularly high between Italy and EU

Italy, the Eurozone's third-largest economy and one of the countries hardest hit by COVID-19, has now slipped into recession for the fourth time in 12 years.



Its often tense relations with the EU took a turn for the worse in early March when Rome's requests for healthcare equipment were initially ignored. Italy's EU ambassador, Maurizio Massari, tensely commented on the situation at the time: "Italy has already asked to activate the European Union Mechanism of Civil Protection for the supply of medical equipment for individual protection. But, unfortunately, not a single EU country responded to the Commission's call. Only China responded bilaterally."[5] To be fair, France and Germany began donating millions of masks to Italy in late March, but by then the political damage had already been done.

Tensions rose another notch in late March when, in response to the deadlock over mutualizing debt, a group of Italian politicians took out a full-page ad in the German newspaper Frankfurter Allgemeine Zeitung. They accused the Dutch of lacking solidarity and reminded Germans of the solidarity Europe showed them after World War II, when Germany's debts were significantly reduced in 1953.[6]

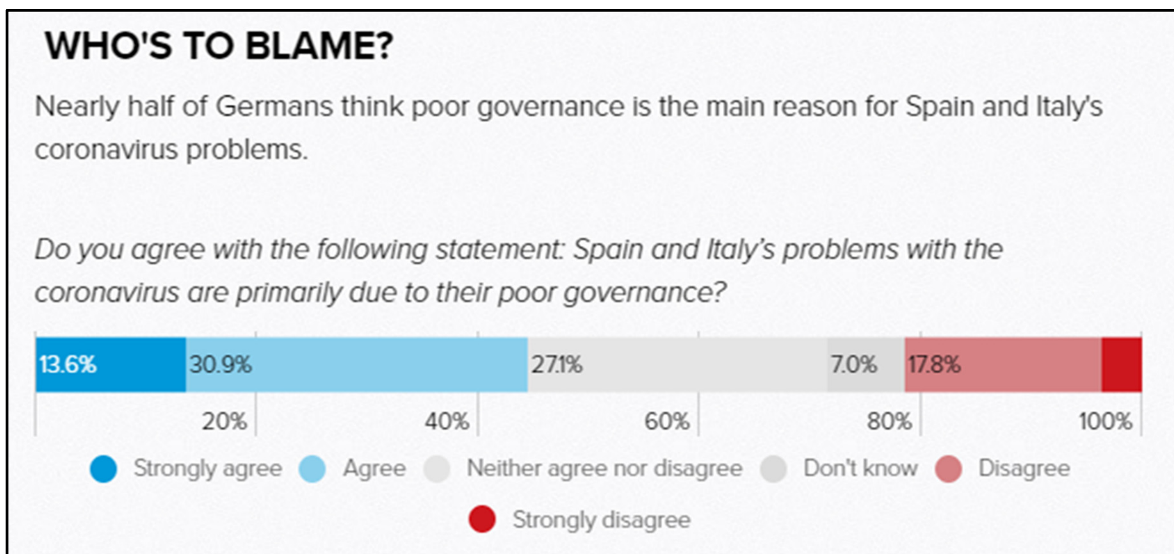
[4] "The Bank Backstop: Can Europe's Lenders Weather the Coronavirus Crisis?" Wall Street Journal, April 14, 2020
[5] "Italian ambassador to the EU: Italy needs Europe's help," Politico, March 10, 2020
[6] "Coronavirus: Is Europe losing Italy?," Financial Times, April 6, 2020

London Conference of 1953 saw Germany's external debts substantially written off

Source: The Telegraph, 2015

Not surprisingly, Italy's view of the EU has soured. A news agency Dire poll conducted March 12-13 found that 88% of Italians felt that Europe is failing to support Italy in the crisis,[7] Another poll in early April, this time by the firm Techne, found that 42% wanted to leave the EU versus only 26% two years earlier.[8]

These polls contrast sharply with the views of many Germans. One recent poll found that nearly 45% of Germans felt that Italy and Spain's troubles with the COVID-19 crisis were largely due to poor governance.



Source: "Half of Germans blame Italy, Spain pandemic woes on 'poor governance': poll," Politico, April 8, 2020

[7] "Whatever it takes: Italy and the Covid-19 crisis, European Council of Foreign Relations, March 18, 2020
[8] "EU's amorphous recovery fund bails out Italian PM, for now," Reuters, April 24, 2020

Conclusion

Even before the massive impact of COVID-19, the EU was struggling with the challenges of sluggish economic growth, high debt levels, migration, Brexit, the rise of anti-establishment political forces, increased protectionism, and tensions between richer and poorer members. COVID-19 has rendered these challenges all the more difficult to manage.

On the political front, while most political parties have put aside their differences and people have rallied around their national leaders for the time being, the longer their economies remain mired in deep recession, the greater the risk of a political backlash. As they did at the time of the 2010-2012 sovereign debt crisis, Eurosceptic parties will inevitably attack their governments and the EU for their alleged mistakes. Eurosceptic parties based in southern Europe will blame the north and the EU for their lack of solidarity, while nationalist political forces in the north will criticize the EU for being overly generous with countries that they claim made very little effort to control spending and reform their economies during the good times.

Further, the deadlock over mutualized debt places the EU in a very difficult position. On the one hand, if Eurozone bonds are not approved, southern countries, which are suffering the deepest economic contraction in Europe, will feel abandoned by the EU and the north. On the other, if these bonds are approved, northern citizens will feel penalized for having gotten their fiscal houses in order. In their view, the advent of Eurozone bonds would make it even less likely that highly indebted countries would take serious measures to control spending and/or agree to any financial controls.

The widely divergent views on economic integration will remain one of the main reasons that the Eurozone will continue to underperform the United States and Canada. Unlike Eurozone members, both of these countries benefit from having their own currency, a unified debt market, and a system of automatic transfer payments to struggling regions. Lastly, it would take a stronger sense of European identity to achieve greater integration without igniting a major political backlash. Unfortunately, as recent events have shown, many people still consider themselves German, French and Italian first, and European second.

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