Eurozone: Alpha or Omega? (18/03/20)

The COVID-19 crisis is a trigger for an event that always had to happen at some time. That event is the decision by the 19 members of the Eurozone to either mutualise risk within the single currency or fail to do so, and risk the collapse of that currency. As they might say in North America, the time has now come to fish or cut bait.

The decision to be made by the 19 within the next days and weeks will tell us whether we are witnessing the final creation of the institutions needed to engineer a functioning single currency or the end of that single currency. In this Newsletter *The Solid Ground* looks at why that mutualisation must come within weeks, probably just days, or the euro will not survive as a single currency. Your author’s original opinion, extant since last September, that Mrs Merkel would eventually endorse Christine Lagarde’s call for the use of “helicopter money” is now at risk of being wrong. It is at risk of being wrong because, unless some form of mutualising comes very soon, the fragmentation of the euro will already be under way.

It has long been obvious that to run a single currency with a single monetary policy requires a co-ordinated fiscal policy and thus very probably an EU and not a national sovereign debt market. However, recognizing something and achieving it, particularly when it involves getting 19 governments to agree, is a very different thing. Many commentators have predicted the demise of the European single currency based upon economic or financial conditions. The euro has, however, weathered all economic and financial storms, albeit with massive debt write-offs, outside control of entire democracies, and in some states the use of capital controls, admittedly temporary in nature.

Having said that, the euro cannot ultimately weather the storm of the withdrawal of the consent of the people of a nation state, and/or its politicians, to the rules of a single currency. That distinction between an electorate and their politicians is important because arguably the people of Greece gave their politicians a mandate to leave the euro, but it was a mandate the politicians ultimately would not take the risk of implementing. Even at this early stage of the COVID-19 crisis it is becoming more apparent that the consent of the people of Italy to Eurozone membership, perhaps even EU membership, is being withdrawn. The growing withdrawal of consent can rapidly spread to other states.

There is now a simple choice for those who run the Eurozone - to mutualise risk at the EU level or not. This decision can no longer be avoided or fudged. Fiscal mutualisation would probably have to come through the European Stability Mechanism (ESM), the only major body in Europe that can issue debt that is backed by the EU and not by individual states. Bonds sold by the ESM could be used to keep the private sector of the Eurozone afloat while the impact of COVID-19 on the economy passes. The ESM funding is available to states requiring assistance but is only available if they sign a memorandum of understanding for reforms having been assessed by the so-called *troika* - the IMF, European Commission and ECB. It is highly unlikely that Italy would ever subject itself to the scale of conditionality that such ESM loans have come with. Of course, all such conditions could be waived in an emergency. The ESM has remaining authority to borrow and lend up to Euro 410bn but this of course can be increased. The authority to lend extends only to the 19 members of The Eurozone so for the other states of the EU it will have to be a national fiscal and not a EU fiscal answer to this financial crisis. While the focus is on Italy *The Solid Ground* would like repeat yet again that the real problem is in France. While Italy has a private sector debt-to-GDP ratio of 101% France’s private sector debt-to-GDP ratio is 201%. The scale of any ESM bond issuance, to solve a problem this size, will far exceed Euro 410bn.

The other route to the mutualisation of risk that a single currency demands is to use the ECB balance sheet to buy government debt directly from each of the 19 national governments and thus fuse the central bank and government balance sheets. The 19 have long shunned such moves because of the resistance to mutualisation by the so-called ‘frugal’ nations of the north. Frugality will not survive this emergency given its scale and consequences.
The ESM was created in the emergency of the 2011-2012 European sovereign debt crisis and it has not since been able to grow into a fully fledged EU sovereign debt issuer. The previous President of the European Central Bank may have been prepared to do ‘whatever it takes’ to save the euro, but ultimately the ECB still retains constitutional limits that prevent it funding the 19 national governments directly. The Eurozone must now jump these hurdles quickly or the euro perishes. Why is speed of the essence?

As regular readers will know, your analyst believes that it is through the imposition of capital controls, rather than any rapid move to the printing of a new currency by a euro nation state, that the de facto end of the euro is likely to arrive. The recent surge in government bond yields in Italy but also in Greece, Spain and Portugal, at a time when huge amounts of money will have to be borrowed by the state, will tempt national governments to press their savings institutions into ‘national service’ to fund such government support programmes.

While investors now recognize that across the world many commercial businesses will become wards of the state, they seem to believe that the institutions with all the money, savings institutions, will not be forced to contribute to this crucial support operation. If you run money for such an institution, you are now on the frontline of the rescue operation and the freedom to choose what you will and will not finance is no longer solely yours to make. As money flees national bond markets in key European states, the prospects rise dramatically that governments will act to stop the exodus and force the purchase of national government bonds by regulated savings institutions. You don’t need to own an institution to control it, as long as you can regulate it. Such action is the de facto fragmentation of the euro or at least the first step down a road to such a fragmentation.

For each national regulator to call upon their domestic savings institutions to buy national government bonds is to force those institutions to sell something. The least locally dislocative sale to force upon a local savings institution is the sale of foreign assets. In each of the 19 Eurozone members a ‘foreign’ asset increasingly incudes the assets in any state, whether a euro member or not. This need to press gang local savings institutions to buy local assets and sell foreign assets is likely to involve a move to capital controls to lock up the savings necessary for ‘national service’.

The next least dislocative asset sale to enforce on savings institutions is the sale of equities. Lower equity prices don’t drive a business to insolvency whereas choking off the supply of credit rapidly leads to bankruptcy and unemployment. This life-support credit can flow to businesses indirectly from government borrowing to companies or from the central bank through commercial banks to companies. It can also flow through purchases of corporate credit by savings institutions mandated by national governments to do so. In this emergency equity plays little role and can be dumped to support the flow of capital that keeps businesses alive - debt capital.

Keeping the capital account open while such policies are imposed is not impossible, but is very difficult. Capital is amoral and will fly to the highest return or greatest safety. Such movements of capital in the face of crisis will come to be deemed illegal and not just amoral. Last week The Solid Ground forecast that energy exporting emerging markets would soon turn to capital controls to shore up their external accounts and exchange rates. Unless the EU institutions wield their fiscal and monetary tools soon, through the ESM and/or the ECB, then we should also expect capital controls within Europe. Almost all the evidence to date is of national responses and not EU responses. The socio-political reaction to this in Italy shows just how dangerous the lack of an EU response is for the continuation of the single currency. The editorial of yesterday’s Corriere Della Sera spells out how quickly and dramatically the current tragedy has changed things in Europe:

Since the euro is also at stake, sometimes silences must be listened to as much as words. After the Christine Lagarde incident, that getting rid of any responsibility to support the countries affected by Covid-19, many corrected the president of the European Central Bank. Others have kept silent. For example, the Germans Jens Weidmann and Isabel Schnabel, president of the Bundesbank and member of the ECB executive, have not said a single word to rectify. Those silences reveal the political game being played under the tragedy of the epidemic.
In certain European circles the idea that this is the moment when Italy ends up in a corner and will have to accept what it has always refused: a rescue of the International Monetary Fund or of the European institutions. You will also have to accept the conditions, of course. In the meantime, just as it resists every European plan, Germany is moving forward on its own. It raises a boundary wall around all German companies guaranteeing them with hundreds of billions of public money and another wall at the borders - decided suddenly and alone - against all neighboring countries. Each for itself, just as it did in 2008-2009 with the banks laying the foundations for the euro crisis.

The German refusal to operate the euro as a real common currency lays the foundations for a new crisis in the area. Under these conditions, a rescue of Italy with conditions dictated from the outside would be morally toxic and politically destabilizing. Public opinion would see it as a hostile act and could elect a nationalist, anti-European government willing to exit the single currency at the first opportunity. So the future of the euro is at stake. It is in these weeks. Covid-19 is proof of the truth of a project that must really work now, or perhaps never again.

Corriere Della Sera, 17th March

Bloomberg report that on March 17th EU leaders did indeed discuss the mutualisation of debt through the issuance of ESM bonds. Mrs Merkel is said to be open to the idea and the German Finance Minister is open to discuss it. According to Bloomberg Mark Rutte, Prime Minister of the Netherlands, is a stronger opponent of the idea. Meanwhile Italy is in discussions with a third party for assistance – China. On the 16th of March the Italian Prime Minister discussed with Xi Jinping the creation of a new “Health Silk Road”. The ex mayor of Venice has called for a new ‘Marshall Plan’ for Italy to be led by Chinese investment. Whether simply seeking leverage in EU negotiations or not, such discussions between Italy and China show just how much is now at stake for Europe.

It’s either the beginning or the end and, as often happens in defining moments in history, the decision at a crucial pathway rests upon the shoulders of one individual. Will a German Chancellor, in her final days in power and in ill-health, endorse the mutualisation that might save the euro and with it the European project? If she does not endorse it within the next few weeks, perhaps even days, then it will be too late and the fragmentation of the euro will have begun.
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