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Forged in crises

The Eurozone bailout fund takes center stage as coronavirus spreads

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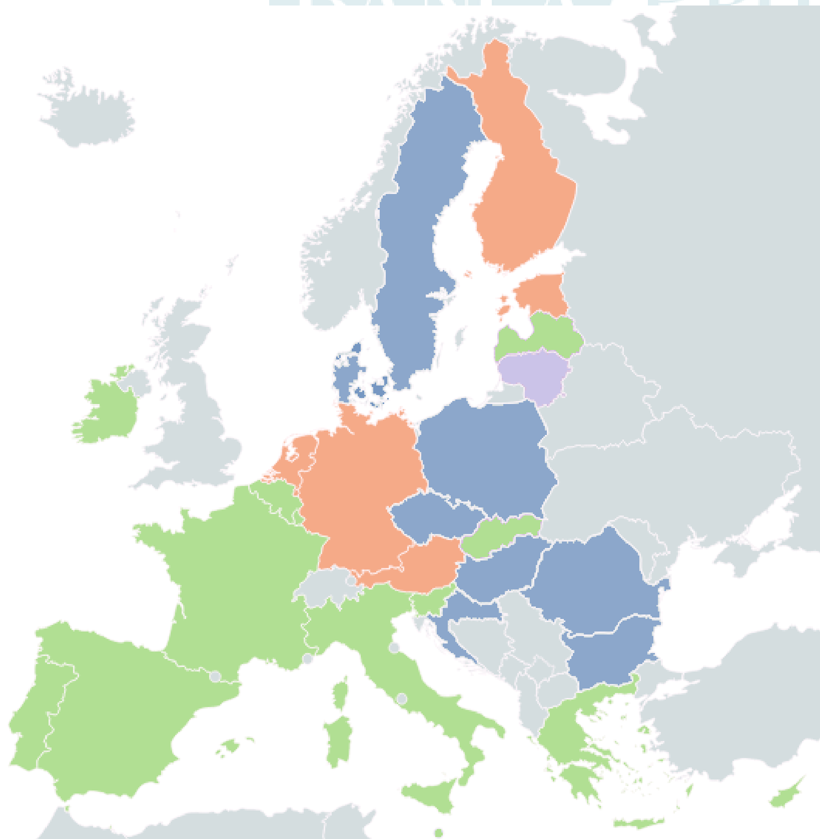
When at the end of 2019 European leaders decided to postpone the completion of the reform of the European Stability Mechanism for another six months -- thus calming down the noisy quarrel that almost monopolized Italy's political debate for weeks -- **it was quite clear that the controversy about the ESM was poised to explode again**.

However, **no one could have imagined that the clash** on the Eurozone bailout fund **would reappear in a context like the current one** -- with the Old Continent and the whole world grappling with a spreading coronavirus epidemic -- and with the debate focused on whether and how to use the ESM to counter the economic consequences of the pandemic.

Coronabond: supporters and opponents



Note: For, Against, Others Eurozone, Others EU

Source: Bloomberg

European supranational issuers

European Stability Mechanism

Lending capacity
- €500bn
- Utilised: €89.9bn
- Outstanding: €89.9bn
- Available capacity: €410.1bn

Shareholders
All 19 euro area member States

Support to bondholders
- Callable capital: €624.25bn
- Paid in capital: €80.55bn

Ratings
AAA/Aa1/-/AAA/-

European Investment Bank

Lending capacity
- Loans disbursed: €429bn
- Loans to be disbursed: €101bn

Shareholders
EU member States

Support to bondholders
- Callable capital: €221.6bn
- Paid in capital, reserves, and surplus: €72.6bn
- Subscribed capital: €243.3bn

Ratings
AAA/Aaa/AAA/AAA/-

EU (European Commission)

Lending capacity
- EFSM: €60bn, utilised €46.8bn, outstanding €46.8bn
- BoP: €50bn, utilised €13.4bn, outstanding €0.2bn
- MFA: no ceiling, outstanding €4.73bn

Shareholders
EU member States

Support to bondholders
EU Budget (2020): €153.6bn in payments (€168.7bn in commitments)

Ratings
AAA/Aaa/AA/AAA/AAA

Note: Fitch/Moody's/S&P/DBRS/Scope

Source: European Commission

Stepping back

On 13 December 2019, the leaders of the 19 countries of the euro area decided to postpone the long-debated reform of the ESM, agreeing to give their Finance ministers time until June to reach a compromise.

An agreement on the sovereign bailout fund was to be achieved already by the end of 2019, but the opposition of the Italian government to some parts of the reform, which would have increased the probability of a restructuring of the country's debt, had made the deferment inevitable.

As the weeks go by, **the distance between member States remains**. On 15 January 2020, Reuters reported that, according to a source with knowledge of the matter, the reform would remain "frozen" until at least March.

Since then, the ESM basically disappeared from radars, until, on March 11, Italy's Minister of Finance Roberto Gualtieri says that **the reform of the Mechanism is likely to undergo a new postponement**. At the moment, the main concern of EU's top financial officials is of a different kind: the continent's economy is rapidly sliding into a deep recession caused by the lockdown measures put in place to stem the spread of the coronavirus.

Ursula von der Leyen
President of the European Commission

We are looking at all instruments and whatever helps will be used. This also applies to coronabonds: if they help and if they are correctly structured, they will be used.

March 20

Brainstorming

Over the past few weeks, **European governments have announced massive fiscal measures** to cushion the impact of the lockdown on their economies. **Such efforts will inevitably widen budget deficits** and raise sovereign debt levels at a time when countries' GDP (the denominator of public finance ratios) is sharply contracting.

Italy, for example, currently has a government debt equal to 135% of GDP, but **the debt ratio could easily climb to 145%**, according to estimates by rating agency Scope. Therefore, the risk is that the epidemic could lay the foundations for a new sovereign debt crisis, after that of 2010-2012. Hence the need for coordinated interventions at a continental level.

The debate among European leaders about the joint economic measures to put in place to deal with the crisis has gone through at least two distinct stages, both characterized by **the traditional north-south opposition between fiscally conservative and less frugal countries**.

In a first stage, Italy, France, and Spain pushed for the deployment of all the firepower of the ESM, facing the opposition of Germany and the Netherlands according to which the intervention of the fund would have been premature and in any case would have required the authorization of some national parliaments, including the Bundestag.

In the face of this resistance and of the worsening of the health crisis in Italy and Spain, the demands by peripheral countries have scaled up and **the debate has intensified on the possibility of a joint issue of coronabonds**. However, northern leaders firmly rejected the new proposal, at the same time expressing openness to the use of the ESM, but only on condition that it would make use of already existing tools and ask beneficiary countries to respect some degree of conditionality.

Valdis Dombrovskis
Vice President of the European Commission

One of the issues is the size of ESM programmes, which may be limited given it was primarily created to respond to asymmetric economic shocks and here we have a symmetric shock which affects all member States.

March 21

1st proposal: the ESM

Unlike coronabonds, ESM's precautionary credit lines are a ready-made tool. However, according to some countries (Italy and France in the lead), it is precisely for this reason that the facility should be suitably modified to adapt to the features of the ongoing crisis.

Created at the height of the sovereign debt crisis, **ESM's credit lines are designed to deal with asymmetric shocks** and are therefore aimed at individual countries facing troubles as well as accompanied by stringent fiscal adjustment conditions. **However, the coronavirus emergency is an exogenous and symmetrical shock** that is affecting all member countries regardless of policy mistakes made by individual governments.

As a consequence, **such credit lines should be made available to all States** (eliminating the stigma that would arise if only a few countries resorted to them) and **with a de-facto elimination of the conditionality** that usually accompanies them. Indeed, according to some governments, it would be unthinkable to ask for structural reforms and austerity measures with an ongoing epidemic; the only acceptable conditions could be linked to the obligation of using the funds received exclusively for the purpose of fighting the coronavirus.

Wopke Hoekstra
Netherlands Finance Minister

It is prudent not to say, 'let's just start there' with the largest piece of ammunition that we still have in reserve. And that goes for all member states, that you shouldn't do it so easily, whether that member State comes specifically from the north, the south, the east or the west.

March 25

As for the size of the facility, a certain consensus has emerged at European level for the provision of credit lines **equal to 2% of the GDP of each member State**. If drawn, the funds should be repaid over 5 or 10 years, with the payment of a properly reduced service fee.

However, while the credit lines would be available to all Eurozone's States, in fact, only a few of them could actually have the need to draw them, presenting again the problem of stigma and of sending negative signals to the market. For this reason, the facility should be designed to **reassure investors in such a way that it should never actually need to be drawn**. To use the words of ECB President Christine Lagarde and of the President of the Eurogroup Mario Centeno, their role should be akin to that of an insurance policy.

FOCUS: ECCLs

Precautionary credit lines are one of the six instruments of the ESM's lending toolkit. Designed as a tool of early intervention, to be activated before a country hit by an adverse shock experiences difficulties in raising capital on the market, they have never been used so far by any member State.

There are two types of precautionary credit lines: **Precautionary Conditioned Credit Lines** and **Enhanced Conditions Credit Lines**.

Both require the beneficiary country to sign a Memorandum of Understanding, within which the conditionality imposed on the government is specified. These conditions are generally less stringent than those required for ESM loans, for which a macroeconomic adjustment program must be agreed upon.

Antonio Costa
Portugal Prime Minister

If we don't respect one another and if we don't understand that in the face of a common challenge we must have the capacity to respond to it together, no one has understood anything about what Europe is all about.

March 26

PCCLs can only be obtained by countries that meet specific prerequisites:

- Respect of the commitments under the Stability and Growth Pact;
- Sustainable general government debt;
- Respect of the commitments under the Excessive Imbalance Procedure;
- Track record of access to international capital markets on reasonable terms;
- Sustainable external position;
- Absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system.

All member States that do not meet one or more of the aforementioned eligibility criteria (think, for example, of Italy) **can only access ECCLs** (characterized, on the flip side, by broader conditionality than PCCLs).

Once granted, both types of credit line remain available for a period of 1 year (renewable at most twice, for 6 months each). When an ECCL is granted or a PCCL is drawn, **the member State is subject to enhanced surveillance by the European Commission**.

With reference to PCCLs, the reform of the ESM (which was discussed until December last year) provides, on the one hand, an even more precise and stringent indication of the requirements to receive them and, on the other hand, the possibility for the requesting State to sign a Letter of Intent (LoI) instead of a stricter Memorandum. No substantial changes are expected for ECCLs.

2nd proposal: Coronabonds

As recalled by Ferdinando Giugliano on Bloomberg, Jean Monnet, one of the founding fathers of the EU, said that Europe will be forged in crises and will be the sum of the solutions adopted for those crises. The idea of the promoters of coronabonds is that the Covid-19 crisis can (indeed has to) allow to **overcome the historical resistance and distrust of northern countries towards the joint issuance of sovereign bonds**.

The group of coronabond supporters is quite large: indeed, 9 countries (Italy, France, Spain, Ireland, Portugal, Belgium, Luxembourg, Greece, Slovenia) signed a letter, addressed to the President of the European Council Charles Michel on the eve of a Council's meeting on March 26, calling for its adoption.

Support for the proposal also came from Christine Lagarde, who invited Eurozone's Finance ministers to seriously consider the joint issuance of coronabonds, emphasizing that **it would be a one-off operation aimed at fighting the epidemic**.

Both French President Emmanuel Macron and European Commissioner Paolo Gentiloni have suggested that the ESM could be the most suitable institution to issue those securities. However, there is nothing to prevent this task from being entrusted to the European Investment Bank (EIB) or directly to the European Commission.

At present, the most organic proposal presented on the matter (at least publicly) is probably the one detailed by Carlos Costa. According to the Portuguese central banker, the **funds raised through the issuance of coronabonds by the ESM** -- via securities with a sufficiently large size and with an adequately long maturity to avoid rollover risk -- should be “channeled” to member States to finance their fight against the virus and **would then be reimbursed using resources from the EU's long-term budget**.

Although the idea of coronabonds seems to be appreciated by a good share of ECB's policymakers, there is no lack of more critical voices (even among the "Mediterranean" members of the Board). Vice President Luis de Guindos, for example, said that coronabonds are neither the only line of defense against the pandemic nor the most effective one. **"The most powerful (tool) is undoubtedly the European Central Bank**," the Spaniard said.

Pedro Sanchez
Spain Prime Minister

We cannot repeat the mistakes of the 2008 financial crisis, which sowed the seeds of disaffection and division with the European project and provoked the rise of populism. We need to learn this lesson.

March 26

Olaf Scholz
Germany Finance Minister

I don’t think that (the issuance of coronabonds) is an appropriate tool because we simply don’t have a unified State (in Europe) in which this would work properly.

March 26

FOCUS: OMTs

As discussion among European governments on how to use the bailout fund was (slowly) moving on, one aspect has become increasingly clear: **actually, the key theme of the debate is not the ESM but the European Central Bank**.

Indeed, however substantial, **the resources of the Stability Mechanism may prove insufficient to deal with a symmetrical shock** such as the current one and therefore the intervention of the fund may, on a standalone basis, not be able to reassure markets should the situation further worsen.

It's enough to consider that **the Pandemic Emergency Purchase Program** announced by the ECB on March 18 **has a size** (€750bn) **that is almost double compared to the current unused lending capacity of the ESM** (€410bn). Not surprisingly, some observers argue that the launch of the PEPP (and the elimination of the 33% cap on the purchases of each country's debt) has already achieved the result that governments are trying to obtain with precautionary credit lines -- namely, to maintain the yields on Italy's government bonds (and not only) at manageable levels.

However, only the opening of an ECCL by the ESM can pave the way for the use of the most powerful tool available to the ECB: Outright Monetary Transactions.

Announced in September 2012 following then President Mario Draghi's commitment to do "whatever it takes" to preserve the euro, **OMTs allow the Frankfurt-based central bank to make**, in a fully discretionary way, **unlimited purchases of government bonds** (with maturities between 1 and 3 years) on the secondary market, but only if beneficiary countries have applied either for a loan with a macroeconomic adjustment program or for an ECCL from the Stability Mechanism, provided that they include the possibility of ESM primary market purchases.

The strength of OMTs is demonstrated by the fact that, in the 7 and a half years since their creation, they have never been used, precisely because **their very existence has so far been sufficient** to make Draghi's pledge to preserve the monetary union a credible one.

But there is also another element that links the intervention of the ESM, and even more a potential issuance of coronabonds, to the measures announced by the ECB. As highlighted by economist Melvyn Krauss, **a decision by Germany's Constitutional Court on the legitimacy of the Quantitative Easing program of the European Central Bank is expected on May 5**. According to experts, the Karlsruhe-based Court will bind the legitimacy of QE to the existence of stringent constraints on asset purchases; but these limits have been recently lifted by the Frankfurt-based institution (at least in part, as the constraint dictated by the capital key has remained untouched, at least for now). According to Krauss, the only way to make the Court's ruling a non-event for markets is for Eurozone governments to adopt coronabonds before the verdict is announced.

Mark Rutte
Netherlands Prime Minister

It is only logical that if a certain country needs a particular support, that you also collectively then agree on how that country will be more resilient if a situation like that or another systemic shock were to occur in the future.

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Opposition

Both in the debate about the use of the ESM and in the discussion on coronabonds, **the approach of northern countries has been based on prudence and gradualness of intervention**.

First of all, there is the consideration that, at present, **no Eurozone member State is facing difficulties in accessing capital markets** (unlike what happened during the sovereign debt crisis). Extraordinary interventions by the ESM or with coronabonds could, according to some, prematurely deplete the tools available to fight a crisis that may not yet have reached its peak and, according to others, even prove to be counterproductive, sounding as an alarm to (so far, relatively quiet) markets.

Opposers -- specifically Germany, the Netherlands, Austria, and Finland -- argue that **the EU has already undertaken many significant emergency measures** (unthinkable until just a month ago), such as the suspension of the constraints of the Stability and Growth Pact and the loosening of State aid rules.

As for the additional measures under discussion, **it is** first of all **considered unacceptable for ESM's credit lines to be granted without any conditionality** to requesting States, due to moral hazard. With reference to coronabonds, it's pointed out that their creation could only take place after a rather long process (definition of the legal basis of the issue, obtaining of ratings, roadshow) and **would set a precedent for future placements of fully-fledged eurobonds** (historically opposed by northern hawks).

Angela Merkel
Germany Chancellor

Some member States suggested those coronabonds. We said that this is not the point of view of all member States. And that's why the ESM is the preferred instrument for me.

March 26

Sometimes, the underlying reasoning is that **if less frugal countries had properly managed their finances in unsuspected times, now they would not be forced to appeal for the solidarity of their partners** with stronger fiscal positions.

But there is also a political consideration: if in Italy and France populist parties could strengthen in the absence of Europe-wide relief measures, in Germany and the Netherlands eurosceptics would thrive if aid to weaker countries is perceived as excessively generous.

What now?

On March 26, **a six-hour videoconference was not enough to bring the leaders of the European Council to a solution that could be satisfactory for everyone**. It turned out to be a complex task even to achieve an agreement on the contents of the final statement, because of Italy's fear that any explicit reference to the ESM could definitively remove other options from the table, including coronabonds.

Giuseppe Conte
Italy Prime Minister

If Europe does not prove to be up to this historic challenge, the whole European building risks losing, in the eyes of our own citizens, its raison d'etre.

March 28

Since then, the push for issuing eurobonds to counter the virus seems to have lost some of its initial momentum.

On the one hand, because of the contents of a letter sent by **Mario Centeno** to the Eurogroup of Finance ministers, **asking them to focus their attention on "concrete, well-justified, effective proposals"**, which would include the ESM, the European Investment Bank and also the EU's long-term budget, but not divisive eurobonds (despite calling for an open discussion on this topic).

On the other hand, due to the words of the Managing Director of the Stability Mechanism Klaus Regling who, in an interview with the Financial Times, has said that the issuance of coronabonds by a new ad-hoc institution could require from 1 to 3 years to see the light of day, whereas **more than €800bn of mutualized debt is outstanding at the European level, issued by already existing institutions such as the very ESM, the EIB and the European Commission**.

Europe's Finance ministers will hold a new conference call on April 7. As ideas on the table multiply, the impression is that, in the end, an "envelope" approach could prevail, with the simultaneous use of multiple tools (instead of just one), to face a crisis that, everyone agrees, has no precedents.