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The rationale behind the Italian-German rift

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The rationale behind the Italian-German rift:
The EU needs a new Intergovernmental Conference now

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Acrimony among European states is getting harsher today than during the euro crisis a decade ago, jeopardizing the integrity of the EU and of the euro. Against the backdrop of tens of thousands of people who have died, the lack of a common initiative appears as a dramatic failure to many European citizens. Unsurprisingly, a strong anti-European sentiment is taking hold in many countries.

Claiming that this sentiment is wrong or ungrounded is a vain exertion, unless we shed light on the rationale of what is going on. In fact, the issue at the origin of the incomprehension revolves around one question: how long will the economic consequences of the health crisis last? If people are able to go back to work before this summer, the European toolbox will be suited to smooth over the recession that has already set in everywhere. On the contrary, if the European economies plunge into a deep recession and remain there for a longer period of time, much more powerful instruments will be needed.

Unfortunately, while some countries, such as Germany, can wait until the summer to see whether or not the available resources will be enough, others cannot. France, Italy, Spain or Ireland, among others (all countries whose public debts are close to or above 100% of their GDP), cannot wait and run the risk of incurring serious financial troubles. Even a relatively short recession might bring those financial positions to the brink of unsustainability, thus justifying the call for common instruments for the issuance of public bonds. A symptom of the different attitudes is the size of the fiscal response offered by Germany (4% of its GDP), France and Spain (2%) and Italy (1%), so far. This clearly indicates that the effects of the crisis will be asymmetric and illustrates the lack of consensus within the European Union: not moral attitudes, but financial leeway.

Nine less fiscally solid countries urged the EU Council to immediately embrace ambitious instruments in order to support the European economy. In fact, in the midst of the worst humanitarian crisis in the last 75 years, the European Council, gathering the heads of government and state of the EU countries, could not agree on anything other than assigning to the Eurogroup (the body composed of the euro-area finance ministers) an indefinite "open mandate" to come up with some reflections on what to do within a fortnight. The open mandate and the postponement were dramatic disappointments for many who are shocked by the immediate humanitarian and economic effects of the crisis. In fact, the postponement should be interpreted as a way to buy time before sorting out who is right between optimistic and pessimistic long-term forecasters.

Unfortunately, until the issue of the time needed to choose the right strategy is transparently discussed, we will be trapped in the same trade-off that characterized the euro crisis: "too late, too little" vs "moral hazard". Eventually, this will morph into moral categories (the Netherlands' cynicism vs Italy's unreliability), making consensual solutions harder to agree upon.

The sense of failure at the European Council was exemplified by the emotional reaction manifested by Italian Prime Minister Giuseppe Conte, who said that his country was "ready to go alone". Whatever he really meant, there is no doubt that this attitude is going to spell trouble for the EU and for the euro. The same happened during the euro crisis: national moralism and prejudices delayed consensus. At least two years were lost, from January 2010 to July 2012, and in the end there was so much mistrust that it morphed into cumbersome governance rules of little use.

Conte's strategy at the EU Council was wrong since it was based more on a confrontational sentiment than on well-studied proposals, but his emotionality needs to be understood. When the Covid-19 crisis arrived in Italy, policymakers in several countries expressed the idea that the problem was an idiosyncratic occurrence probably due to Italy's mismanagement. In fact, the outbreak of the contagion occurred in the most advanced Italian regions that boast world class health systems. When hospitals were overwhelmed by an unexpectedly huge number of patients, Italy asked to buy sanitary equipment from Germany, until then spared by the contagion, but Berlin refused to deliver. Immediately, bordering countries Slovenia and Austria closed their frontiers with Italy. On the contrary, the Russian, Chinese and Albanian governments, among others, stepped in to help Italy with their own limited means.

A few days later, during a press conference, ECB president Christine Lagarde announced that the Central Bank would not be there to help Italy contain its financial burden, regardless of the health crisis. In a matter of hours, Italy's debt costs went through the roof. During the critical EU Council meeting, German Chancellor Angela Merkel, quarantined at home, intervened in the teleconference through a bad quality audio connection that seemed to perfectly express what the other heads of governments were perceiving: a clear sense of "distance" among countries. A few days later, European Commission President Ursula von der Leyen, whose role is supposed to be impartial, derided Italy's requests for new common financial instruments as "slogan". Given what happened, it is sad but not entirely surprising that nationalist temptations are now gaining ground in Italy. The same had happened ten years ago, when the EU mismanagement of the crises in Greece, Spain, Ireland, Portugal and Cyprus caused severe troubles in Italy, nurturing a widespread sense of victimization.

As already mentioned, the current issue – the economic impact of the health crisis - should be framed differently: is the current crisis a serious but temporary bump? or will the European economies be structurally affected for years, maybe decades, by the current crisis?

In the first case, the European Union has put on the table sufficient means to tackle the recession: the ECB has corrected its initial stance and announced copious credit lines and a program for purchasing government bonds (Pandemic Emergence Purchase Program) that completely covers the funding needs of all member states. The European Commission has loosened the criteria that restrained state aid and this will allow some countries to save firms of critical interest. The European Investment Bank is being geared and recapitalized so that small and medium enterprises can receive direct funding. The European Stability Mechanism, an

institution created in 2012 to support countries that were at risk of losing market access, can lend up to 2% of a country's GDP under "conditionalities" that can be redesigned and lightened vis-à-vis the original punishing spirit of its interventions. Moreover, the ESM intervention, through the certification of public debt sustainability, allows the ECB to intervene through its Outright Monetary Transactions, an instrument that has been watched with awe by financial market participants since its first announcement by Mario Draghi in conjunction with his famous "whatever it takes" statement. Eventually, reflections on the flexible use of the European Budget (Multi-annual Financial Framework) could provide countries in need with more resources.

All in all, even the loss of 15% of GDP, concentrated in a few months this year, could be bridged through state subsidies and guarantees backed by EU funds and other financial sources, if the recession is perceived as temporary.

Different will be the case if the economy does not recover in a matter of a few months. In that circumstance the European economies would be faced with a structural shock, permanently lowering the level of potential growth in all the affected countries with spill-overs trough the euro area. A myriad of firms would collapse (according to my tentative simulations on the Cerved database, one third of Italian firms would incur liquidity crises before the end of 2020) and the banking system would follow suit. At the macro level, the whole system of global supply chains will be disrupted and a complex process of repatriation is likely to occur, scaling down production to continental levels rather than global ones under the direction of state ownership. Public debt levels will go through the roof and state finances might become sustainable only once national savings are forcibly invested in national government bonds. A reduced level of economic liberty would likely reverberate in the quality of our democracies (with Hungarian Prime Minister Viktor Orbàn as a precursor). Economic and financial isolation might reinforce the nationalist temptation (the "going alone" mentioned by Conte) and eventually lead to the collapse of the European Union and of the euro. To prevent this from happening is maybe the most important rationale behind the call for a euro area-wide bond, weakening the monopoly of the nation state over the economy.

Who is right between the short-term catastrophists and the long-term optimists it is still hard to say. It is more understandable why the European Council has agreed to a postponement: although things are unlikely to be much different, maybe in two weeks the alternative will be clearer. Given the different opinions of virologists, it should not be surprising that even national economists cannot agree on the economic consequences and that their differences can be substantial. Munich research center Ifo's forecast of a 15-20% fall in the German economy is much gloomier than that of the German "Wise men", who maintain that the GDP loss could stay in the ballpark of 4-6%. Italy's Prometeia delivered a forecast of a fall above 6% of GDP, while the SEP-LUISS document on "Italy's response to the health crisis" mentions estimates of a decline that goes far beyond 10%. Currently, the Italian economy is working at 60% of its potential. If nothing changes, even a 20% fall of GDP in 2020 cannot be excluded. This would automatically bring the existing debt to 160% of GDP without even counting the fiscal countermeasures. The Parliamentary Budget Office estimates the cost of direct subsidies to firms and workers (Cassa integrazione) at 13bn per month, implying that ten months would cost almost 10% of the revised GDP. Similar costs would derive from other state guarantees and subsidies, bringing Italy's debt-to-GDP ratio to around 180% at the end of the year. Even if the ECB initially stabilizes the markets, financial investors would eventually challenge the public debt sustainability and the stability of the euro.

Given the risks at play, preparing for the worst scenario – rather than waiting too long and doing too little - could be the safest bet. This does not mean that we need new instruments today, but rather that we now need a serious commitment for tomorrow.

We may analyze the current state of the EU negotiations against the backdrop described above. Point 14 of the European Council (EuCo) communique of March 26 invites the Eurogroup to present proposals within two weeks. The use of the plural form "proposals" came as a surprise. Before the meeting it was well understood that the issue of economic interventions to support the level of activity boiled down to the activation of the European Stability Mechanism, either through loans to the countries in need, or through the issuance of new common bonds. The lack of compromise at the EU Council implies that governments are now considering a wider range of options to address the gravity of the socio-economic consequences of the Covid-19 crisis.

Negotiators, mainly at the European Commission and the EU Council, are indeed testing various options: the first is to assign a more important role to the European Investment Bank (EIB) in financing Europe's small and medium enterprises. In order to do this, the EIB will require a capital increase provided either by the EU Member States or by the EU itself. A reasonable way to use that money would be to create "European guarantees", rather than national ones, for banks to keep credit lines open for small and medium firms of all countries. Similarly, the European Investment Fund (EIF) could mobilize resources such as to compensate the different ratings at national levels affecting national private debtors and ultimately tarnishing the European level playing field.

A second option is the revision of the EU multiannual budget (Multiannual Financial Framework), either by drawing resources more flexibly from its current amount, but without changes in the budget structure, or by working on a longer perspective through the enhancement of the resources included in the financial framework complemented through a combination of financial guarantees at either the national or the communitarian level.

The third and most delicate option consists in the activation of the European Stability Mechanism, a crisis management institution set up in 2012 during the most critical phase of the euro-area crisis. This third option was the reason for the hard-nosed confrontation among the heads of governments, leading the European Council to postpone any action. In a confidential debriefing by the German government, the chancellor indicated that the ESM is the only game in town and that Germany will preserve the right of "ultimo veto" - through the needed approval of the German Parliament - on any engagement of the Luxembourg body.

The gist of the discussion about the ESM concerns the "conditionality" attached to its precautionary Emergency Conditional Credit Lines (ECCL). The European institutions are attempting to redesign those conditionalities in the lightest possible form, corresponding to expenditures directly caused by the health crisis and thus non-discretionary and estranged from concerns about moral hazards. However, interested countries are concerned because any call for ESM funds and any conditionality would provoke a stigma that would prove politically costly and could worsen the funding conditions on the markets. To little avail would be the request that all countries formally apply for ESM funds because eventually few would actually draw those credit lines. The critical position in this regard is the French one, but the French government made it clear that it does not intend to request the ESM money. Therefore, with the connected stigma the distinction between core Europe and periphery Europe would remain in place. Moreover, a very light conditionality could elicit

objections about the viability of the ESM intervention as preliminary to the ECB's enacting of OMTs. All in all, the ESM engagement is unlikely: a program with light conditionality would limit the amount of its contribution to 2% of each appealing state GDP, far too little to represent significant aid for a large country. On one hand, considering how toxic the ESM issue has become in Italy, there is little hope that such a limited amount of money could be worth the political mortification. On the other, the ESM does not have the resources for a full program with full conditionality for Italy and Italy does not have the political stability to support a full program. Relying on the unlimited resources of the ECB is much more convenient for everybody.

A fourth option is the Corona-bond. Although the instrument is not clearly defined, even the eventuality of a common issuance of debt instruments has elicited very negative reactions from some countries. The incomprehension was aggravated by the lack of any technical detail, so the option was discussed as a moral pretext dividing the camp between those who called for solidarity and those who refused it. The lack of details, particularly in respect to the well-prepared ESM option, has substantially weakened the French-Italian-Spanish position and proved to be a major mistake by the Italian government in particular. Conte now appears cornered between the political inability to accept the ESM intervention and the refusal of the Corona-bonds by a number of governments. As is well known, the EuCo needs to act according to unanimous decisions in these cases. The harshness of the Corona-bond confrontation has reduced the possibility of France and Germany finding a compromise.

Unless a clear indication about the future consequences - bad or good - of the health crisis emerges, it is highly unlikely that a game-changer solution will come from the negotiations that followed the European Council flop. To avoid a loss of credibility of the ECB intervention, the focus on the ESM and on other options needs to be toned down. Too much focus on other funding would raise the mistaken sense that the ECB interventions are insufficient. They are not and this is what is important so far.

A different issue concerns the future. The risk of disruption in the economy and in the European institutions is far too big to legitimate a "wait and see" stance.

The debate among member states needs to rise to the existential challenge. A more ambitious reflection on the future of Europe needs to be made now in parallel with an often evoked new "Marshall-Plan". Putting money on the table is far from enough. European leaders need to design a "Future of Europe" that is not the ridiculous exercise enacted by the European Commission in the past year. Technology, digital economy and automation need to be handled as common challenges whose fall-outs are of common interest. Education and inclusiveness need to be extended homogeneously through the EU, together with some form of universal basic income and common welfare. Finance and banking need to play a constructive role in the integration of national economies, rather than the opposite. The enforcement of anti-trust rules at European level needs to be kept alive in times in which the abuse of national powers is going to limit the citizens' individual freedom. A reflection on the geopolitical role of Europe is long overdue. Defense and security need to be shared; this was the original aim of the founding fathers. An initiative along these lines will give a sense of future perspective to firms and households that are now struggling to keep afloat. No doubt this will require an enormous stash of money, belittling the amounts that are now on the table. It will also require a common way of funding the future of Europe, which is likely to morph into a common public debt governed by a common fiscal authority. To this aim, an intergovernmental conference needs to be summoned immediately. Delaying all this is lying to the face of Europeans, those living and those passed away.