# the day after

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# Covid-19 crisis, a catalyst for change and strengthening the EU

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The *Conference on the Future of Europe,* planned earlier this year, will probably open in September in a very different context than initially expected. Who will chair it and whether a new treaty for the union will be on the agenda remains unclear, but the need to address repositioning Europe post the Covid-19 pandemic is clear. Indeed, the EU is suffering from a risk of fragmentation along several lines that could deeply undermine its ability to deal with the challenges to be seen in the next decade. The *asset* purchase programs (APP) of the European Central Bank, the emergency package via the ESM, and now the European Commission (EC) proposal 'Next Generation EU' are powerful tools to address these risks.

Covid-19 is a symmetric shock with asymmetric impacts. It exacerbates tensions within the EU — and outside the union as well. Geopolitical tensions, which involve Europe directly or indirectly, are rising across the globe. Cracks developing between the US and China are affecting Europe, which itself is changing strategy concerning relations with China. The outcome of the US elections could also have significant impacts in the upcoming four years. A re-election of President Trump would bring further tensions on trade, defence, sanctions, etc. Obviously, Brexit opens a new era for the union, the epicentre of which is now the Eurozone (EZ). It is therefore in a complex and strained context that European institutions have to deal with such a large and significant economic shock.

Crisis pressures in the past have been the main catalysts for change in Europe. Although tensions between member states seem to lead to a renationalisation of the decision-making process, it is actually the opposite which prevails, with a European response eventually emerging. One could actually hypothesise that the more severe the crisis, the more significant the policy reform. This chaotic path historically led to more integration, the strengthening of institutions or the emergence of new ones, and the transfer of competencies. However, it is unlikely that Europe will evolve differently or according to a pre-set plan simply because when there are no reasons for change, change just does not happen.

## The risk of fragmentation

The Covid-19 crisis has turned differences into divergences, imbalances into fragmentation risks, which could, if they are not addressed, become irreversible. The forces in play are more complex than the classic north/south public debt imbalance, as economic models and visions for the EU are two other axes of discord. ECB policies and the EC proposal 'Next Generation EU' partially deal with those risks, but they require political support in order to help the union to move forward.

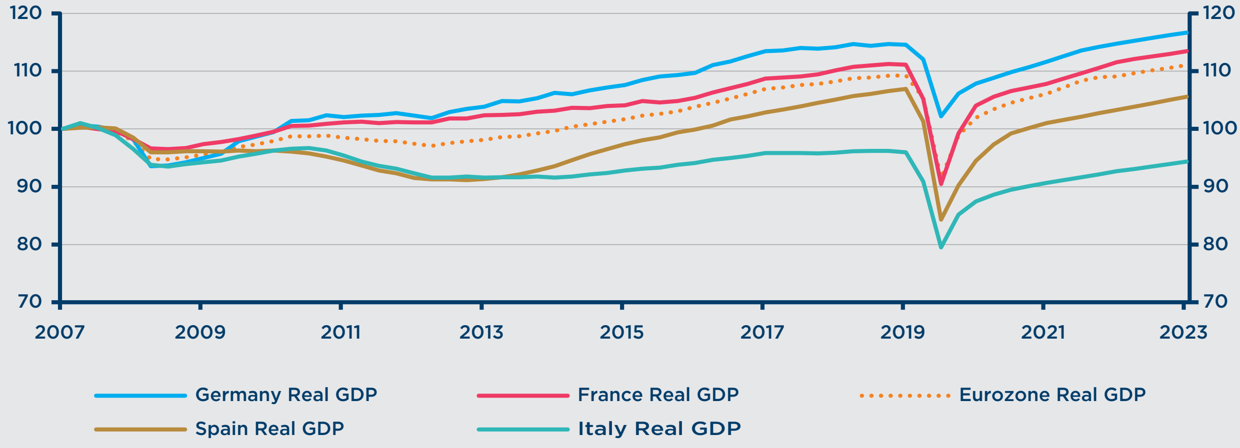
## Debt and growth fragmentation

After more than 20 years post the inception of the euro, northern countries' GDP per capita is nearly twice that of the south. Monetary union proved to be conducive to economic convergence between 1999 and 2008. However, since the Global Financial Crisis (GFC), economic fragmentation has increased, particularly in the EZ, as a result of the sovereign debt crisis. To put it another way, Europe functioned well when 'everything was going well', but shortcomings emerged in times of crisis, especially on the EMU side.

As a consequence of economic fragmentation, national debt levels are increasingly diverging. The decoupling between France and Germany is striking in this respect and shows that fragmentation is not confined to the north/south axis. Since the EZ crisis, the level and management of public debt is the major source of tensions and mistrust among member states. North vs south public debt imbalances structure the bond market breakdown between core vs periphery, and spread movements incorporate a remainder of convertibility risk, which never fully disappeared.

The Covid-19 crisis has amplified the real economic fragmentation of the EZ. By an unfortunate accident of history, it is indeed the countries with the highest debt levels, and which had suffered most economically

**Figure 1: Italy, unlike Spain, never fully recovered from the GFC**



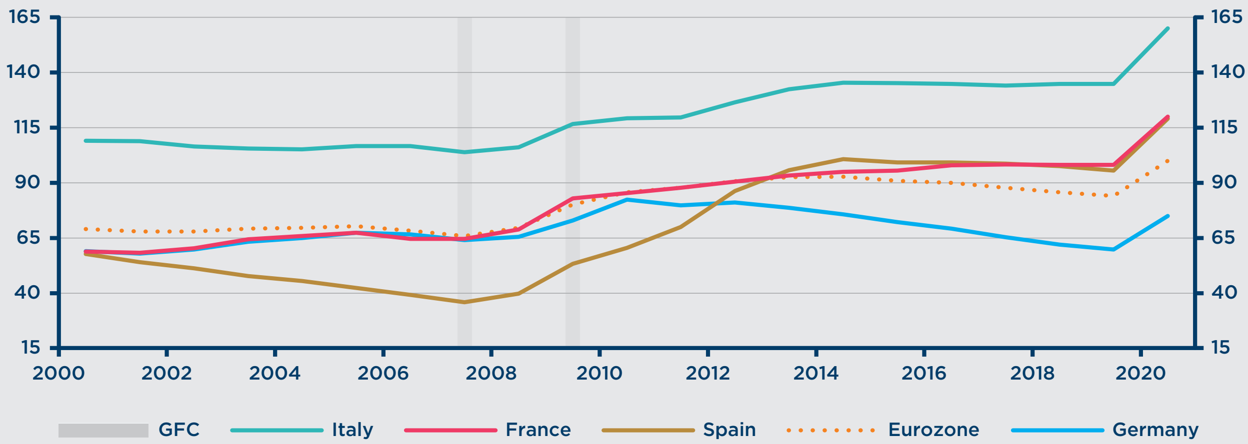

Source : Amundi Research, Data as of 22nd June 2020.

from the sovereign debt crisis, that were most affected initially by the current crisis (Italy and Spain). Large deficits post-Covid-19 will lead to further divergences between north and south, and subdued real growth in the south will raise the issue of debt sustainability at some point in time. The ECB's asset purchase programmes play a key role in avoiding increased financial fragmentation (sovereign debt, corporate debt). Nevertheless, this can only be a temporary fix to a structural problem. Pan-European transfers and national reforms are the only way to deal with these imbalances and thus to strengthen the EZ's resilience to future shocks. This crisis (like the previous one) shows the shortcomings of EMU's financial and institutional architecture.

## Economic model fragmentation

The second fragmentation risk comes from another factor, which can be summarised as internal vs external dependency and type of economic model. Some countries rely more on external demand than others. The EZ has an external trade surplus of 7% of GDP (2019). All EZ countries except France are currently showing a surplus, but several countries have a larger surplus extra EZ such as Germany (6%) or the Netherlands (+11%). This illustrates that the surplus savings of northern

**Figure 2: Spanish debt/GDP has tripled since the GFC**




Source : Amundi Research, Eurostat, Data as of 22nd June 2020.

**Table 1: Trade balance: intra and extra EU**

| Trade Balance | 2019 GDP | Intra Eurozone Balance | Extra Eurozone Balance |
|---|---|---|---|
| 9 Countries* | (EUR Bn) | % GDP | % PIB |
| Germany | 3 435 | 7% | 0% |
| France | 2 419 | 1% | -4% |
| Italy | 1 788 | 3% | 0% |
| Spain | 1 245 | -3% | 0% |
| Netherlands | 812 | -12% | 20% |
| Belgium | 473 | -2% | 5% |
| Austria | 399 | 4% | -5% |
| Ireland | 347 | 12% | 6% |
| Portugal | 212 | -2% | -8% |

*9 countries which represent 95% Eurozone GDP.
Source: Amundi Research, Eurostat.

European countries are not used to finance the investment needs of southern countries. Moreover, the northern countries' reliance on global trade is greater (autos, industrial goods) than is the case for the rest of the EU-27. Other countries rely more on internal demand, particularly those with stronger services sectors, like France or Spain. The Covid-19 crisis has shown that these differences are a source of vulnerability, since a symmetric shock brings asymmetric outcomes — hence, the European Commission's Recovery Fund proposal to address this issue.

## Visions for the EU

The third fragmentation derives from the national vision for the EU, which is more complex than the traditional federalists vs nationalists dualistic debate. Whereas the EU project was considered, still a decade ago, to be a positive way forward in bringing peace and wealth to Europeans, diverging aspirations have arisen among and within member states. It should be remembered that when the euro was launched, all EU countries were expected to join the monetary union. Today, the European project has become ambiguous.

*"Brexit requires a rethinking of objectives beyond the EZ's economic and financial dimensions."*

European institutions, such as the ECB and the ECJ, are being challenged by the German Constitutional Court, illustrating a deeper divide regarding the axis of the political legitimacy of the institutions. In addition, many countries are keen to maintain a degree of sovereignty over sensitive issues (such as foreign policy and migration policy), which is reflected in the rise of 'anti-establishment' parties in national elections. The debate between federalists vs nationalists has shifted into globalised elites vs 'the people'. These tensions should not be underestimated, as they were at the heart of the Brexit vote. That said, the difficulties encountered by the British government related to Brexit (and the economic cost associated with it) appear to be a deterrent. It can be observed that the anti-establishment parties (in France and Italy) no longer put an exit from the euro on the agenda. Ironically, Brexit could even open up new prospects for the EU project. Indeed, the Eurozone's share of EU GDP rose from 72% (EU-28) to 86% (EU-27). France and Germany, taken together (accounting for more than 50% of the Eurozone's GDP), are de facto becoming Europe's new centre of gravity, which could make it easier to set up a 'new project'.

The Covid-19 crisis has increased economic fragmentation in the EZ and illustrates once again the need to strengthen the Eurozone's financial architecture. The debate on risk sharing goes far beyond the debate on fiscal federalism, which northern countries refuse to implement. The crisis illustrates the need to forge 'tools' that can absorb asymmetric shocks without putting taxpayers in the north in a position of having to pay off the south's debts one day. There are many ways to better share risks and opportunities. But, like any compromise, it will require concessions from the countries that will potentially benefit from or contribute to transfers in times of crisis.

## Covid-19 crisis: a catalyst for change

Over the last 30 years, the EU has shown resilience during difficult times: eg, the Balkans war, the Asian crisis, the tech bubble, the GFC, the Eurozone crisis, the Syrian civil war, Crimea annexation or Brexit, just to name a few. Crises are catalysts that push the European project forward, not backward. One of the main features of EU integration is actually this sequence — crisis - deadlock - institutional reforms — which confirms decade after decade the view from Jean Monnet that *"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises"* (Jean Monnet, Memoires 1978). It actually cannot be otherwise, since European institutions are not challenged during stable periods. It's only when troubles appear, causing unexpected outcomes, that the EU is faced with unanswered questions or a lack of tools and rules to deal with the problem. *"People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them"*, Jean Monnet also wrote in his memoirs (1978).

*"European authorities have only been able to cope with the current crisis thanks to the tools forged in the aftermath of other crises."*

The ESM or the ECB asset purchases under PEPP would not be possible today without the decisions and policy tools designed during the Eurozone crisis. The Covid-19 crisis is a 'Jean Monnet' moment, just like the GFC and the Eurozone crises were.

Historically, the same has been true for the United States. The GFC led to an immediate response from the Federal Reserve in 2008, unprecedented in US history. In practice, the Fed was able to act forcefully by invoking section 13(3) of its statutes. Many people are unaware of what the Fed's proactivity owes to the Great Depression of the 1930s. Section 13(3) of the Federal Reserve Act was introduced in 1932 at the initiative of the Hoover administration. The purpose was to take steps to prevent a cascade of bank and corporate failures (several bank failures had occurred by December 1931). The section 13(3) — the adoption of which at the time was highly controversial in Congress — authorised (under exceptional circumstances) the Fed to extend its emergency-lending measures to a broader set of institutions, and in practice to all players in the real economy[1]. In the end, it can be said that the Fed's status as Lender of Last Resort was not really acquired until 1932, almost 20 years after the creation of the central bank. Ironically, Section 13(3) had never been fully mobilised before the GFC, to the extent that some openly questioned its usefulness. So, in a 2002 study, David Fettig, from the Fed of Minneapolis noted: *"To some this lending legacy is likely a harmless anachronism, to others it's still a useful insurance policy, and to others it's a ticking time bomb of political chicanery"*[2].

## Dov'é l'Europa?*

The European institutions' response to the current health crisis has been perceived as weak, slow and inadequate in countries that suffered the most. Comments from a few political leaders blaming bad management, disorganised or inefficient health infrastructures added tensions among member states. Confronted with the unexpected, the

1. It was also under Section 13(3) that the Fed intervened to prevent the bankruptcy of Bear Stearns and AIG, which were deemed *"too big to fail"* (the Fed could also have invoked it to prevent the bankruptcy of Lehman Brothers, but that is beyond the scope of this comment). Another crisis (the 1987 crash) led Congress to authorise - under this section - the extension of emergency loans to broker-dealers.
2. David Fettig, Lender of More than Last Resort, Federal Reserve Bank of Minneapolis, December 2002.
*Where is Europe?

EU backed off behind national governments, leading to an uncoordinated and uneven response[3] to a common risk. Several episodes illustrate this: availability or lack of masks, respirators and sanitary tools across the union; the Schengen area with partially closed borders; uncoordinated lockdown measures, leading de facto to economic competition. The lack of common fiscal instrument led to suboptimal fiscal policy responses, mainly at the national level, and therefore caused economic constraints due to imbalances described earlier. For example, Italy entered the crisis with a 135% debt/GDP level and therefore had little room to support its economy. Going forward, low growth prospects in over-indebted member states undermine the recovery of European economies.

## New tools for new policies from renewed institutions

If European history is a guide, we should expect the Covid-19 crisis to act as a catalyst for reform. When it comes to policy changes, we can identify at least four levels or steps[4]: (1) adjustment to or improvement of existing instruments; (2) new or significant changes to instruments and policies; (3) amended goals or priorities for key policies; and, finally, (4) a new paradigm, leading to the development of new institutions. The last level is the most difficult to reach as it requires a full commitment from policy makers and is a function of the intensity and nature of the crisis.

We believe there are at least four policy changes post Covid-19 that would shape the future of the EU: a European resilience mechanism, a bad bank, the much bigger EU budget, and a strengthening of the European Parliament.

### 1. Recovery Fund: a permanent tool to promote real convergence

The European Commission called for a €750bn recovery plan that would use an unprecedented scale of joint debt incurred by the EU-27 countries in a bid to revive economies.

> *"The EU proposal is an opportunity to enhance the capital market union and risk-sharing mechanisms."*

At the time of writing, EU members disagree on the size of the fund (€500bn vs €750bn), the balance between grants and loans, the breakdown of transfers, start date and the time horizon, and, more importantly, the conditions (investment or reforms) and monitoring of the subsidies. A European Council is scheduled (17-18 July) to discuss the fund's modalities, including the split between transfer expenditures (accounted for as an EU debt) and loans (accounted for as national debt). The principle of this plan seems to be accepted by all despite the reluctance of the *Frugal 4* (the Netherlands, Austria, Sweden and Denmark). But, the core of the debate relates to the amounts and conditions of these grants. Since the plan requires a unanimous vote of member states, it may take time for countries to converge on a proposal that is acceptable to all. This represents *level 1* and *3* policy changes, since the institution and equivalent plans exists already, but the goals and priorities of the recovery plan are new.

**The EC proposal is not a zero-sum game.** For the first time, the EC would issue debt on behalf of the EU with the objective of convergence and redistribution between countries. Indeed, the poorest countries in the EU and those most economically affected by the Covid-19 crisis would be able to obtain up to 15% of their national income in grants and guarantees from EU funds. Yet, the proposal would represent a net benefit for all EU countries. According to the EC's draft document, allocations between countries have both an insurance element (countries hardest hit receive more EU funds) and a redistribution element (countries with lower per-capita income receive more EU funds).

3. *"Pursuant to the principle of sincere cooperation, the Union and the member states shall, in full mutual respect, assist each other in carrying out tasks which flow from the Treaties".* Article 4.1 of the Treaty of the EU.
4. The EU's current crisis and its policy effects: research design and comparative findings. G. Falkner, Journal of European Integration, 2016 Vol. 38 No 03 219-235.

The programme also foresees a redistribution from rich to poor countries: for a similar shock[5], the lower the per-capita income, the higher the allocation would be.

The calculation of the net contributions of member states is misleading in that it suggests that there is no solidarity for the countries of Southern Europe, which is inaccurate[6]: (1) Italy and Spain would receive 5% and 7% of their national income, respectively, and would be the first recipients of grants in terms of amount; (2) the funds will be borrowed on a long-term basis on exceptionally advantageous terms thanks to the EU's signature[7], terms that no small or Southern country could obtain on its own; and (3) the allocated funds will be mostly spent between 2021 and 2026, and the debt contracted by the EU will not be repaid until 2028 at the earliest and 2058 at the latest. Therefore, state contributions over this horizon cannot be estimated as a percentage of GDP since they will themselves depend on the growth path over this horizon!

*"The Recovery Fund is not a zero-sum game, with winners and losers. It is likely to have a positive impact on all EU countries."*

Indeed, they are highly integrated in terms of trade, so we have to rely on the dynamic effects of fiscal multipliers, which will be amplified in the coming years through intra-zone trade.

**The EC plan is a powerful crisis-mitigation tool.** Ultimately, the European Recovery Plan is an instrument for real convergence rather than for cyclical stabilisation. Although, it would play a key role in anchoring medium-term growth expectations, which may help to reduce precautionary behaviour (both for households and companies) in the short term, it creates a tool to deal with future exogenous asymmetric shocks. Finally, the emergence of a common-debt instrument in times of crisis can be an interesting source of diversification for European banks, which hold excessive proportions of their national sovereign debt, and enhance the status of the euro. However, we do not believe it is the EU Hamiltonian moment[8] because there are no transfer of debt and fiscal competencies on a large-scale basis. However, this fund will set an historic precedent, in the same way the creation of the ESM did. It could become a permanent mechanism available when the EU is facing a significant economic shock. This will significantly improve the resilience of the monetary union going forward and strengthen the role of the euro as an international reserve currency.

## 2. A European *bad bank* to manage rising NPLs

European authorities have been able to learn the lessons of past crises by implementing the most counter-cyclical European policy mix ever seen. However, neither the EU Recovery Fund nor national fiscal policies or the ECB monetary policy alone can absorb the increased fragmentation risks that will result from the Covid-19 crisis. EU authorities must in addition avoid regulation that can prove itself pro-cyclical — in particular, when it comes to state-aid rules to banks.

**NPLs will rise on the back of the deep recession Europe is going through.** Although total NPLs have halved in four years (€500bn for the 121 largest banks in the EZ, 3.2% of outstanding loans at the end of 2019), they still account for more than 6% of loans in many peripheral countries (for instance, 6.4% in Italy). For the time being, the credit channel works well within the EZ, thanks to the ECB's

5. Thus, the economic shock is almost the same in France, Slovenia, Hungary, Romania and Latvia. However, Zsolt Darvas estimates that France would only receive subsidies and guarantees for about 2% of its income (vs 10% for Latvia or Romania).

6. The EU's recovery fund proposals: crisis relief with massive redistribution, Bruegel, Zsolt Darvas 17 June 2020.

7. The nominal interest rate at which the EU can borrow is around -0.15% per annum for 10 years and 0.3% per annum for 30 years.

8. The historical context and the outcomes are very different. Washington had won the war of independence as Commander General of the Continental Army and was the first president of a new nation, the Constitution of which was less than a year old, when he gave Alexander Hamilton (his aid and first Treasury secretary) the task of avoiding a full-blown default. Hamilton transferred the states' and local debts to the federal government, issued new taxes, and created a national bank to manage the federal debt.

LTROs. Nevertheless, southern European economies will have an extended recovery path since they are dominated by SMEs, which are resorting to debt to 'survive' the crisis. Some of them will inevitably default or go bankrupt at some point in time. Bank balance sheets will therefore deteriorate further. The accumulation of NPLs represents a real risk for macrofinancial stability and may constrain the volume of bank credit over time, with a marked asymmetry between banks and countries. This could further increase the growth and debt fragmentation illustrated earlier.

**To solve this problem, Europe is not starting from scratch:** a set of proposals had already been discussed in great depth in 2017 (see European Economy, Banks regulation and the real sector, 2017.1). In practice, the proposal that has received the most attention is the creation of an Asset Management Company (AMC) which would absorb bad loans, securitise them, and sell them to investors[9]. Most of these involve some form of government support or guarantees from the ESM, but proposals exist to limit risk sharing. It should be remembered that it was Andrea Enria (currently Chair of the ECB's supervisory board) who advocated for an EU 'bad bank' when he was still head of the European Banking Authority. This is a *level 2* change, since the instrument does not exist, but the institutional framework does (EMU, ECB, Eurosystem).

However, state-aid rules had prevented the project from materialising. Indeed, since the GFC, the EU has introduced the Bank Recovery and Resolution Directive, which prevents governments from creating bad bank structures (except through a formal resolution process). There are good reasons to believe that this rule could be bypassed in the present circumstances. Indeed, in March 2020, the Commission adopted a temporary relaxation of the state-aid rules[10]. The official texts ultimately leave much to the discretion of the competent authorities. It is therefore a matter of negotiating on a European scale a new financial body.

### 3. Debt substitution, Eurozone Treasury and European parliament oversight

Debt transfers are complex to achieve and potentially unfair since the reference or transaction price can be far from fair value. It would quickly become a question of who takes the loss or pays an inflated price. Debt cancellation would put the ECB or national central banks into negative equity or will lead to a cancellation of central banks reserves and therefore a partial or full nationalisation of local banks. Cancelling sovereign debt would deeply undermine the Euro-system itself, and it might only be a last resort solution for a country which would have already left the euro-area (and the EU) if that ever happens. Debt sharing brings to governance risks and requires fiscal harmonisation which is difficult to achieve. But a debt substitution meaning incremental debt being issued at the EU level instead of national level for investment purposes (basically what the EU Recovery Plan offers) could be implemented over time and become an efficient convergence mechanism. More importantly, a smooth transition towards mutualisation is a way

9. The bad bank in question could take the form of a centralised pan-European structure or a network of national bad banks. This structure would take loans at their "real economic value" and then have three years to sell them to investors. The shareholders of the banks would immediately incur an initial loss on the transfer of the claim (if the trade-in value is lower than the value recorded in the bank's accounts) and would then have to absorb the entire loss if the bad bank failed to sell its claim at the discounted price.

10. *"Aid granted by Member States under Article 107(3)(b) TFEU under this Communication to undertakings, which is channelled through banks as financial intermediaries, benefits those undertakings directly. Such aid does not have the objective to preserve or restore the viability, liquidity or solvency of banks. Similarly, aid granted by Member States to banks under Article 107(2)(b) TFEU to compensate for direct damage suffered as a result of the COVID-19 outbreak does not have the objective to preserve or restore the viability, liquidity or solvency of an institution or entity.* ***As a result, such aid would not be qualified as extraordinary public financial support*** *under the Directive 2014/59/EU of the European Parliament and of the Council (the BRRD) nor under the Regulation 806/2014 of the European Parliament and of the Council (the SRM Regulation), and would also not be assessed under the State aid rules applicable to the banking sector".* ***If due to the COVID-19 outbreak, banks would need direct support in the form of liquidity recapitalisation or impaired asset measure****, it will have to be assessed whether the measure meets the conditions of Article 32(4)(d) (i), (ii) or (iii) of the BRRD. Where the latter conditions were to be fulfilled, the bank receiving such direct support would not be deemed to be failing-or-likely-to-fail. To the extent such measures address problems linked to the COVID-19 outbreak, they would be deemed to fall under point 45 of the 2013 Banking Communication6, which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors"* (European Commission, *Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak,* 19 March 2020).

to reach a higher debt funding optimum. Today the ECB asset purchase programs provide a similar outcome but it is temporary (supposedly).

However, this leads to a much bigger EU budget, and therefore the need for a Eurozone Treasury as well as more oversight from the European Parliament. A step change in the Own Resources Decision and significant increase of the resource ceiling beyond the 2% limit i.e. 8 to 10% of the EU Gross National Income[11] will allow long-term investment funding at an optimal cost of borrowing, but will also require more policy coordination. A Eurozone Treasury, headed by a Eurozone Finance Minister whose function would be to manage the common budget and the "surveillance" of the area's economic policies, will significantly enhance common policies. Yet, this can only be achieved if there is clear accountability. As it is the case in most countries, it is the duty and right of the parliament to vote taxes and monitor the budget. Therefore, the European Parliament has to oversight this new institution.

In that context, a *Spitzenkandidaten* system where the president of the European parliament is designated by the majority and transnational lists for European elections are also required. Otherwise, the Eurozone Treasury will not act on behalf of the European people and its operational independence will be challenged on an ongoing basis. This clearly is a *level 4* change which requires a full commitment of all member states.

The unanimity rule is an obstacle that should not be underestimated. The difficulty in setting up the Recovery Fund demonstrates once again the ineffectiveness of this rule, which continues to prevail in several of the most sensitive areas, including taxation. Most of the time, when a proposal emanates from the Commission, the decision-making rule is the so-called double majority rule (55% of the Member States representing at least 65% of the population).

*"In addition, a proposal can only be blocked if four countries representing at least 35% of the EU population oppose it."*

Eighty percent of Council decisions are taken by this qualified majority[12]. The extension of the qualified majority rule to European taxation would require a change of treaty[13]. But, the paradox is that unanimity is required to change the treaty (and ratification by parliaments). In the current context, it is hard to see why the 'frugal four' would agree to give up their negotiating power, especially in such a sensitive and symbolic matter.

## Investors should focus on the long-term political impact of this crisis

### Financial markets and European politics are on different time scales

The architecture of the monetary union is still in the making. The complex governance of the EU leads to a much longer time dimension (from a few years to a decade) than markets (from months to years) which can create entry points for long-term investors. Markets sometimes focus on the short-term clashes, which eventually have a limited impact, and forget the structural progress made on the financial, fiscal and institutional architecture where we see several improvements going forward:

- *Financial architecture:* Further progress is needed on Capital Market Union (CMU) and Banking Union. Europeans must deepen and fully integrate the capital markets of the EU. Most of the actions have been focused on shifting financial intermediation towards capital markets and breaking down barriers that are blocking

11. "In addition to Next Generation EU, the Commission is proposing a revamped EU budget, amounting to some €1 100 billion between 2021-2027."European Commission Europe's moment: Repair and Prepare for the Next Generation {SWD(2020) 98 final} Brussels 27 05 2020.

12. If such a rule applied to fiscal matters, the Recovery Fund proposal would already have been adopted by the European Council (the 'frugal four' represent less than 10% of the population of the EU-27).

13. The last amendment to the EU Treaty dates from 2009 (Lisbon Treaty) and precisely increased the fields to which the qualified majority voting procedure applies.

cross-border investments[14]. But the task is not over. Larger intra-EU portfolio flows would help move the EU towards realising its full economic potential. Many studies show that increasing cross-holding of capital in monetary unions helps to absorb asymmetric shocks. The first two pillars of the BU — a single supervisory mechanism (SSM) and a single resolution mechanism (SRM) for banks — are now in place and fully operational. However, there still isn't a common system for deposit protection and measures are needed to tackle the remaining risks of the banking sector (in particular, those related to NPLs, or the initiatives to help banks diversify their investment in sovereign bonds).

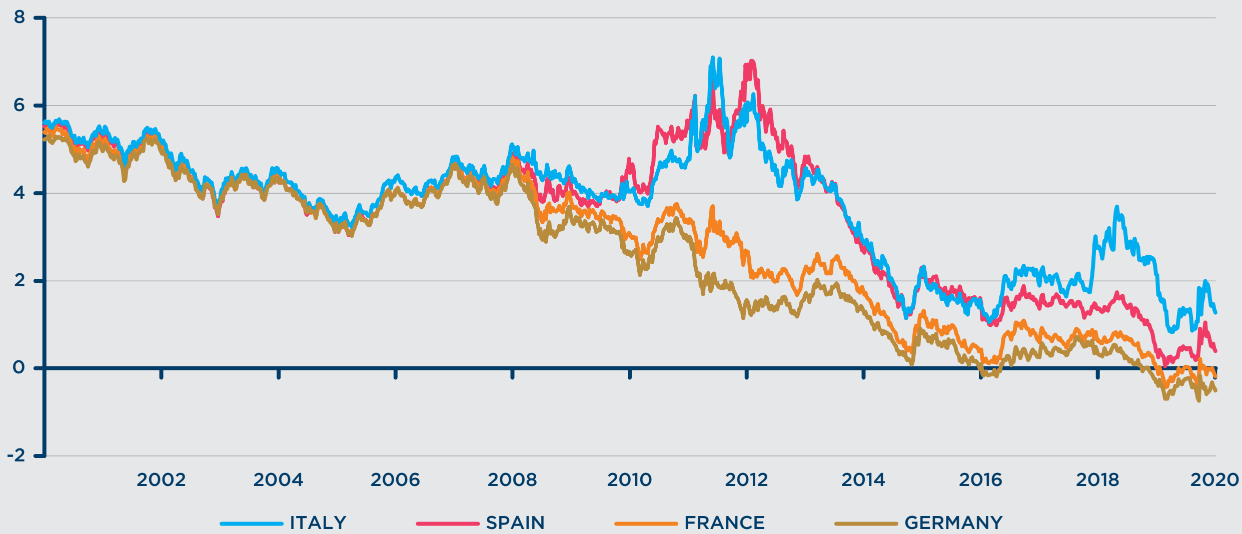
- *Fiscal architecture:* Fiscal rules should be reconsidered, as they have proven to be excessively pro-cyclical and ultimately ineffective and they have not prevented public debts from diverging. The rules of the Stability and Growth Pact have been temporarily suspended. When the economic and financial situation normalises, there will naturally be a debate on the nature of these rules: proposals exist to target public spending directly rather than the structural budget deficit.
- *Institutional and political architecture:* Eventually, Europeans should agree to create a Eurozone Treasury, headed by a Eurozone Finance Minister whose function would be to manage the common budget and the "surveillance" of the area's economic policies. Europeans are still a long way from taking this step, which implies a "right of scrutiny" over national budgetary and fiscal policies.

### The Recovery Plan should foster convergence and discipline

At inception of the euro, there was the idea that yield spreads between sovereign bonds issued in a common currency would mark the divergence or convergence of economic fundamentals (debt, deficits, GDP, growth). Market forces would supposedly constrain governments so that they keep on complying with the Maastricht criteria overtime. If these yield spreads were small and mean reverting,

14. More precisely the CMU aims to: (i) provide new sources of funding for businesses, especially for SMEs; (ii) reduce the cost of raising capital; (ii) increase options for savers across the EU; (iii) facilitate cross-border investing and attract more foreign investment into the EU (homogenise insolvency practices); (iv) support long-term projects; and (v) make the EU financial system more stable, resilient and competitive.

**Figure 3: Main Euro-Areas countries 10Y sovereign bond yields since 2000 (weekly, yield%)**




Source: Amundi Research as of 22 June 2020.

governments would fund deficits at slightly higher costs during fiscal expansion phases while investors would expect that growth and debt differential would eventually diminish. However, markets failed to act that way and discipline governments.

As figure 3 shows, from 2000 until the GFC, 10Y bond yields for Spain, Germany, Italy and France (as well as other EZ countries) were quasi-identical. Post the GFC and the EZ crisis, QE and the famous *"whatever it takes"* principle from the ECB have contained the bond market sovereign risk pricing and therefore the discipline stemming from markets. However, it's a global phenomenon (see Fed, BoE, BoJ), not something specific to Europe. Since it is reasonable to assume that the ECB will maintain a big balance sheet for a long time, and if debt substitution happens as described earlier, the market vs government lack of discipline conundrum will not be solved any time soon. The discipline has to come from a democratic (European parliament) and/or technocratic (European Commission) decision-making process. Hence, the importance of a convergence mechanism, such as the EC *Next Generation EU,* which was welcome by markets (positive impact on the Euro, periphery bonds and equities).

## Long-terms investors will benefit from the new European landscape

We believe there are at least four reasons why investors with a long-term horizon will benefit from the impact of the post Covid-19 European landscape:

### 1. Scepticism about Europe continues to dominate investor sentiment

This is particularly true for non-European, for various and good reasons: repeated crises, institutional complexity, incompleteness of the EMU, the EU's failure to put in place a coordinated economic policy in timely manner when compared to the US in particular. However, it is clear that, by putting the history of Europe into perspective, crises have strengthened the European edifice. Where market participants focus on fragmentation (real, financial and political fragmentations), we focus instead on the progress that each crisis allows Europe to achieve. The euro crisis ultimately enabled the ECB to acquire the status of lender of last resort. It was not until 2015, when the first QE was put in place, that the ECB confirmed its status of lender of last resort. And, the Covid-19 crisis enabled the ECB to free itself temporarily from the capital key. The ECB is no longer ruling out the possibility of acquiring 'fallen angels' corporate bonds if necessary. These two developments were unthinkable just a few months ago. One could even argue that the UK's exit from the EU not only provides an opportunity to clarify the European project, but also gives the EZ countries a leading role[15]. In particular, we do believe that the EC's proposal on the Recovery Fund (and even the Franco/German proposal) would never have been made if the UK had still been a EU member!

### 2. The EU is not a one-legged body

A common view is that the EU is walking on one leg — ie, the ECB — while the rest of European institutions are sub-scaled. This is missing a second significant achievement which is the Single Market. Brexit has shown how precious it was for member states. The EU Single Market (EUSM) account for 450 million consumers and more than 22 million SMEs (source: European Union). Its rules, regulations and standards, enforced by the EC and ultimately the European Court of Justice (ECJ), apply to an extensive number of products, materials, services and processes, and are respected inside and outside the EU. The Commission proposal relies on New Own Resources, which are new taxes on the Single Market. Therefore, the EUSM should be considered as the second leg of the EU alongside the euro. Hence, the

15. Regarding non-Euro countries: all EU member states have or will join the EZ except Denmark which has an opt out although it can join in the future if it wishes so. Post Brexit, the population of the EZ relative to the EU-27 increased from 66% to 75%. Denmark accounts for 1.3% of the total EU 447 million people (2.2% of EU27 GDP 2019) and will therefore have a marginal influence on the future of the union. Poland with 38 million inhabitants and a GDP of around €500 bn is a lot more influential on top of its geostrategic position.

need post Brexit for all EU member states to eventually be part of the EZ.

### 3. The resilience of the EZ should not be judged on the sole basis of fiscal/ budgetary criteria

Measures that allow savings to circulate more freely within the zone are a fundamental element of Europe's future resilience. From this point of view, the progress made on the CMU are significant — not to mention the BU, which has yet to be completed. It is true that in the meantime, the ECB has a leading role to play in buying the time needed to reform and consolidate the institutions on all dimensions. This does not mean that monetary policy is the only game in town, far from it.

### 4. The EU is heading towards a common debt instrument

The Covid-19 crisis will probably enable the EU to equip itself with a common debt instrument which represents a real step forward for the euro for at least three reasons: (1) because de facto the only debt instrument to play this role in the EZ is the German Bund (and its scarcity has contributed to pushing its yield into negative territory); (2) because in fact the world is 'short of safe assets' and therefore a large and liquid highly rated debt will meet investors demand; and (3) because the issuance of a large volume of common debt should encourage foreign investors to consider the EU as a whole and not as the puzzle of single issuers. When comparing Europe with the US, it is clear that the EU has fewer imbalances (less public debt, a large external surplus) while imbalances are growing fast in the US (notably the public debt/GDP ratio). In other words, this new debt issued by the Commission on behalf of member states should consolidate the international reserve status of the euro at a time when the role of the US dollar could be called into question due to the drift in public finances.

## Conclusion: learning the lessons of European history

The Covid-19 crisis has increased the European fragmentation risk. It is an opportunity for change in Europe, just like the GFC and the sovereign debt crisis have been. Post Brexit, the risks and solutions are mainly at the EZ level. At this stage, we see three outcomes that would improve the EU and Eurozone resilience: (1) the EU Recovery Plan, which eventually would become a permanent economic crisis and convergence instrument; (2) a European bad bank dealing with the adverse effects of increased NPLs in exceptional circumstances; and (3) a Eurozone Treasury overseen by a strengthened European Parliament.

The complexity of the European institutions and the (unanimous) decision-making process reduces the possibilities for progress in normal times. Demanding conditions are needed to force Europeans to come to an agreement. The EZ is still an incomplete monetary union in many respects. The best-known aspect of this incompleteness is the lack of a federal budget to stabilise the union in the event of asymmetric shocks. The incompleteness is also on the side of market mechanisms. To increase the EMU's resilience, discipline and risk sharing must be promoted. Crises can have multiple origins, fiscal (unsustainable debt accumulation) or financial (correction on overvalued assets/ bursting of bubble). A fiscal crisis can provoke a financial crisis and vice versa — not to mention that asymmetric exogenous shocks can occur (the Covid-19 crisis is one example) and jeopardise the entire European edifice. The mistake would be to believe that a common budget is all that is needed to meet these challenges. Increasing the resilience of the EZ (and therefore the EU) requires reforms of a different nature: the architecture of the EZ (financial, fiscal, institutional and political) needs to be strengthened.

> *"The status of the euro as an international 'reserve currency' should be enhanced on the back of the Covid-19 crisis."*

The structure of European debt markets with a well-rated common debt embryo will limit the risk of local crises. Combined with the strengthening of the financial and political architecture, this should enable the EU to become a pole of stability, particularly in the face of the US, whose crisis is exacerbating fragilities (inequalities) and imbalances.

Finally, it should be noted that if a ‘bad bank’ were to be created, this would be very good news for the European banks, which could open up new prospects for sector consolidation. It is clear that none of these changes will happen overnight.

*“However, long-term investors seeking to diversify their portfolios will have to take a closer look at the opportunities offered by the European continent.”*

In the end, when Europe goes through another crisis, the European budget will probably be quickly mobilised (in the same way as during this crisis, the QE was immediately put in place by the ECB). Where investors see lasting weakness in Europe (linked to macroeconomic, market and political fragmentation), by putting things into perspective, we see a more resilient model being gradually built. In this regard, it is worth recalling that the US federal budget was not built smoothly and that the Fed did not acquire its lender-of-last-resort status until 1932, at the cost of highly controversial debates. Slowly but surely, the EU authorities are learning the lessons of history, and so should investors. The range of tools at the EU authorities’ disposal becomes clearer with each crisis, bring further resilience, and therefore lowers investor risks.

**Important Information**



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