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INSIGHT

Europe at a Crossroad

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Key takeaways

- Angela Merkel and Germany have realized that the imbalance between the north and south of Europe threatens the existence of the euro and have made a U-turn on approving the French ideas and a joint European debt issuance.
- It is the beginning of the political and economic union – brought to us through the back door, while most of Europe only had eyes for COVID-19.
- In the short term, this is good news for the stability of financial markets in Europe but longer term, the question is whether joint debt issuance might become the new platform for populist parties in the North.

These are interesting times for Europe. The next six months will be a milestone for whether COVID-19 will accelerate the fragmentation of the EU or the virus will make the federalists' dream of a common fiscal union come true.

COVID-19 threatens to break the monetary union. The pandemic has, with surgical precision, highlighted the euro area's biggest problem, namely the imbalance between the north and south of Europe and the lack of a fiscal superstructure of the monetary union, which has been the Achilles heel of all EU cooperation since the beginning of the euro 20 years ago. Italy is in the middle of an economic depression owing to an uncompetitive business sector and a demographic collapse. Italy has been the second worst affected country by COVID-19 in Europe, but instead of showing the European solidarity, the pandemic has confirmed the Italians' perception of being Europe's forgotten province. The situation is not much better in Spain with citizens at the lower end of society, who used to be able to support themselves working in the service industry, now living in extreme poverty and hunger that only the Catholic Church seems to have resources to mitigate. The COVID-19 crisis is affecting southern Europe after a period of more than 10 years of economic slump on top of the financial crisis and risks adding fuel to more populist trends in both countries.

Merkel's U-turn

Angela Merkel has shown strong leadership throughout the crisis and has made a remarkable comeback. She did not waste time but used her new strengthened position to announce, with President Macron, the creation of an EU Recovery Fund to be linked to the EU budget to support businesses, sectors, and countries most affected by the virus. These means will be partially provided without any repayment claims, but what is truly revolutionary is that the fund is supported with taxing powers to the EU as an institution. The idea is that taxation of CO_2, financial transactions, or (US) internet companies will be the security for the issuance of bonds to finance the fund.

This is a great idea in many ways and has been compared to the beginning of the federal system in the US in 1790. With its very high credit rating, the EU can issue huge amounts of long-term bonds at interest rates close to 0%, thus enabling an almost "free" debt-financed spending policy. Earlier this year, negotiations on the EU budget broke down, but it would be much easier to reach a budgetary agreement if each country did not have to pay even more to the budget. This is being met with requests as to what the EU should do for member countries, including helping to get the southern European countries back on their feet after their already weak economies shut down. The issuance of EU bonds may do just that.

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It is said to be a temporary measure, but temporary measures have a way of becoming permanent when involving the transfer of power to politicians and bureaucrats. This may be the beginning of the European political and economic union – in effect, brought to us through the back door, while most of Europe only had eyes for COVID-19. Today's challenge is the financial impact of COVID-19, and when this crisis is behind us, there will be other noble investment areas such as digitalization, the transition to a green economy, etc., that can justify joint debt-financed European investments.

Historically, Germany has opposed joint liability for debt and always believed that loans should be repaid, so why this U-turn? Because it is in Germany's own interest that the euro does not collapse, and Merkel probably felt that it was too close for comfort. The coronavirus has highlighted the structural problems in southern Europe and the need for economic solidarity, as they are not able to get out of their debt trap themselves. 10-20 years of narrow-minded economic dictation by the EU has nourished national and populist leaders, who use the fight against Brussels as their political leverage.

The euro trumps economic sovereignty

However, a more critical situation in the short term has been the development in the capital markets. Unlike other parts of the stock market, European bank stocks have continued to decline. The situation is particularly bad in southern Europe, where Spanish and Italian banks have fallen 40-70% this year. In general, banks are trading at much lower levels today than at their worst point during the financial crisis 11-12 years ago. This is because many European banks – especially in the south – will suffer large losses on loans to small and medium-sized businesses that are collapsing in large numbers. Current market valuations reflect the fact that banks will need new capital but not be able to raise it and therefore be nationalized. But the real threat is not as in previous banking crises, e.g. in Sweden in 1992, when a strong state could take over the banks, take the losses and move on. The southern economies are unable to handle the losses and due to new regulation after the financial crisis, we now have bail-in requirements for large deposits and foreign capital in the banks. This means that capital will flee to the north creating a real risk of capital flight and therefore a need for capital control within the euro zone, which will be the death of the euro. Merkel has done a U-turn, because protecting the euro is more important than losing economic sovereignty.

To the "Frugal Four" – Sweden, the Netherlands, Austria, and Denmark – the cost of Brexit is now becoming visible. These countries have struggled on small EU budgets and against deeper economic integration and have now lost the key player, Great Britain, in the fight against the federalists, though with Germany already choosing sides, the resistance is probably more symbolic than real. The euro has been able to survive during a boom but will very quickly require a fiscal superstructure to survive in times of crisis, and small players in the EU will not be allowed to raise questions. They will be paid off with the green and digital profile promise on the aid package and get to celebrate this as a victory. However, this does not change the fact that the underlying structural problems still exist, namely that southern Europe is uncompetitive and should not have been part of the euro without prior structural adjustment of their economies.

To us Danes (and Swedes), the issue is particularly precarious as we are outside the euro but will be asked to participate in the federalization of the EU that is taking place due to the structural problems created by the implementation of the euro.

The question whether this development is good or bad is not only limited to whether you are a citizen of the north or the south of Europe. The derived effects of a breakdown of the euro caused by an economic collapse, e.g. in Italy, would immediately create a collapse far outweighing the last financial crisis more than 10 years ago and hit northern Europe just as hard as the south. One might ask if this once again is sending good money after bad? Will it reduce the structural differences between the north and south? And what is the risk that southern Europe will still not implement the necessary structural reforms, while populist trends will grow in the north because the people will not agree to subsidize the south?

Investment implications

The short-term investment implications of Europe moving closer to a fiscal union are that the southern European government bond markets and banks will be supported by a financial safety net. Until recently it seemed that banks would be the big losers in this crisis, but European banks will most likely perform well in the short term and the euro might strengthen, as the EU shows a sense of solidarity that is highly unusual.

In the longer term, the question is whether further borrowing and "bail-out" of uncompetitive economies are conducive to long-term sustainable growth in Europe, and whether transfers to the south (the so-called Transfer Union) will become a new platform for populist parties in the north.

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