ECB & Eurogroup: sovereign liquidity risks reduced but real political test still to come

The ECB and the Eurogroup have taken significant decisions to ensure sovereigns can finance their deficits in 2020 at reasonable rates despite the Covid-19 crisis. This is an important and positive first step, which is also resulting in unprecedented co-ordination of European monetary and national fiscal policies. However, the European fiscal response in the form of *direct* investments and transfers to finance the economic recovery during and after 2020, rather than via loans that burden public sector balance sheets of sovereigns affected by the crisis, is the real political test today, with important credit implications over the medium-term.

So far, European authorities, and the ECB in particular, have agreed on and are implementing policy measures that will mitigate liquidity and funding pressures for euro area sovereigns during 2020. Specifically, the ECB's EUR 750bn Pandemic Emergency Purchase Programme (PEPP) announced on 18 March, and collateral framework changes announced on 7 April, will mitigate future tightening of financial conditions across the euro area.

There has also been a significant fiscal policy response at a national level as well: the aggregate amount of member states' discretionary fiscal measures amounts to between 2-3% of EU GDP while liquidity support consisting of public guarantee schemes and deferred tax payments are now estimated at 16% of EU GDP.

In addition, the Eurogroup's decisions of 9 April, including an European Investment Bank (EIB)-funded pan-European guarantee fund of EUR 25bn, which could support EUR 200bn of financing for companies and small and medium-sized enterprises (SMEs), European Commission loans of up to EUR 100bn to support national employment systems, and an European Stability Mechanism (ESM) credit facility of up to EUR 240bn, or 2% of member states' respective 2019 GDP levels, to support financing of direct and indirect healthcare related costs due to the Covid-19 crisis, constitute important first steps.

As a result, we do not expect a euro area sovereign liquidity crisis in 2020.

However, the medium-term impact on euro area public sector balance sheets from the crisis will be significant. Will the fiscal response to the Covid-19 crisis be financed in such a way that the adverse impact on public balance sheets is eased?

One of two broad scenarios could emerge after this crisis:

i) sovereigns ignore the provisions of the Stability and Growth Pact and pursue higher deficits and debt burdens in the hopes of faster economic recoveries, or

ii) sovereigns, observing the EU fiscal framework, consolidate public finances gradually, risking slower economic recoveries in turn.

A third option, which would likely mitigate the adverse impacts from either of the above two scenarios to an extent, could involve macro-economically relevant direct European transfers and investments to member states most adversely affected by the Covid-19 shock to finance economic recoveries without impacting their government balance sheets as much.

Several proposals implying greater fiscal risk-sharing already exist to operationalise such transfers, including via a re-oriented and significantly increased EU budget or a 'temporary economic recovery fund'. These instruments will all be challenged and heavily debated across Europe in the coming months.

The battle over the politically charged topic of fiscal transfers and greater fiscal risk-sharing and, specifically, the still-to-be-agreed volume and funding sources of the Eurogroup's so-called 'recovery fund' is of critical political and economic significance, and thus highly credit rating relevant for those euro area countries most affected by the Covid-19 crisis.

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Monetary response

The ECB has taken key decisions including:

Asset purchases and collateral rule changes mitigate tightening of financial conditions

First, on 18 March, the ECB announced the Pandemic Emergency Purchase Programme, with its significant volume of EUR 750bn until at least the end of 2020 and operational flexibility across time, instrument and jurisdictions, and including, moreover, a waiver of the eligibility requirements for securities issued by the Greek government.

Second, on 7 April, the ECB adopted an unprecedented set of collateral measures, easing the conditions under which credit claims are accepted as collateral for the ECB's liquidity providing operations and increasing risk tolerance to support the provision of credit in mitigating the tightening of financial conditions across the euro area.

There can be no doubt that these measures are forceful and effective as evidenced in an easing of pressures in government bond markets across the euro area in recent weeks.

National fiscal responses

There has been a significant fiscal policy response at a national level along with a commitment from authorities to do more if needed. The aggregate amount of member states' discretionary fiscal measures amounts now to between 2-3% of EU GDP while liquidity support for sectors facing disruption, consisting of public guarantee schemes and deferred tax payments, are now estimated at 16% of EU GDP.

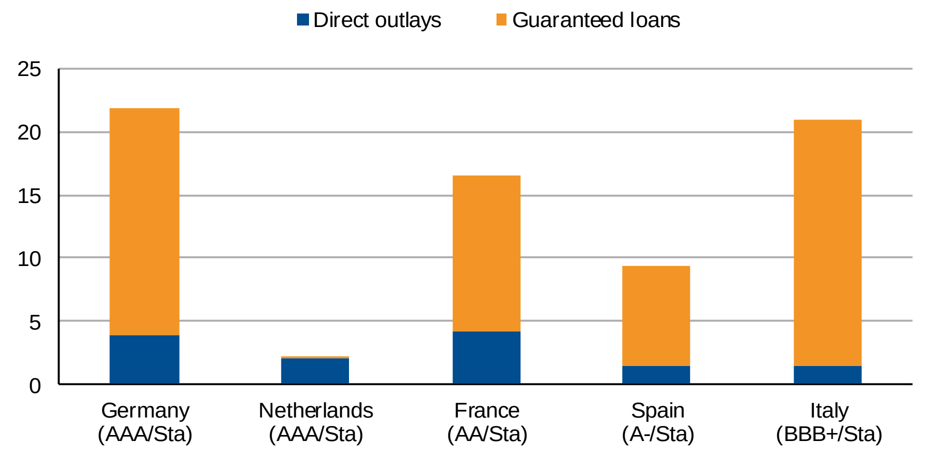
Significant national fiscal response but ample divergence across countries capturing different degrees of fiscal space

Already agreed fiscal stimulus measures vary widely, however, in terms of volume and types of support, reflecting, mostly, diverging fiscal capacities. Germany's measures total about 4% of GDP in direct fiscal injections and about 18% of GDP in the form of guarantees and liquidity support. By comparison, the figures are about 1.4% and 8% respectively for Spain. For a summary of countries' fiscal stimulus announcements to date, please see Scope's Q2 2020 Sovereign Update (published on 2 April).

These actions place a floor beneath the regional economy, prevent economic and financial system turmoil as the crisis endures, and raise prospects for economic recovery in the coming months, with this recovery expected to become more visible in GDP data by Q3.

However, significant stimulus also holds credit-negative implications over a longer-term window, given the material impact on government balance sheets and the likelihood that many sovereigns will not be able to unwind excessive deficits for a period beyond 2020.

Figure 1: Euro area national fiscal responses
% of GDP



Source: Scope Ratings

Eurogroup agreement an important first step

For this reason, a pan-European fiscal response is needed. The Eurogroup agreement of 9 April prioritises, in a first step, the institutions and instruments already available to deal with the crisis. These institutions include the European Union (AAA/Stable), the European Investment Bank (AAA/Stable) and the ESM.

On 9 April, the Eurogroup took the following five decisions:

i) emergency support of EUR 2.7bn from EU budget resources to provide grants for healthcare systems,

ii) an EIB-funded pan-European guarantee fund of EUR 25bn, which could support EUR 200bn of financing for companies with a focus on SMEs, including through national promotional banks,

iii) an ESM credit facility worth EUR 240bn providing member states funds of up to 2% of their respective 2019 GDP levels to support domestic financing of direct and indirect healthcare-, cure- and prevention-related costs due to the Covid-19 crisis,

iv) "SURE", the European Commission's temporary loan-based instrument of up to EUR 100bn in total to support national employment systems, and

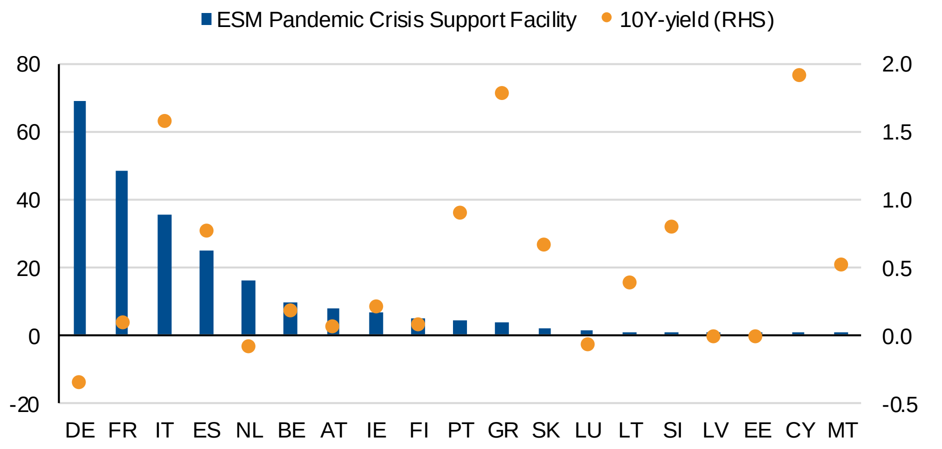
v) a recovery fund, which would be temporary, targeted and commensurate with the extraordinary costs of the current crisis and help spread them over time through appropriate financing, which, however, still needs to be defined and agreed upon.

However, while the ESM's Pandemic Crisis Support facility is a critical backstop, given the ECB's decisions and resulting lowered market yields probably over the run of 2020, the new ESM precautionary facility may not be accessed.

ESM facility may not be tapped in 2020 given ECB action

The cases of Italy and Spain are illustrative: Italy could obtain about EUR 36bn from the ESM and Spain around EUR 25bn. Would their governments accept available ESM loans even at an average rate of 0% so long as their respective 10-year government bond yields trade at around 1.8% and 0.8% respectively? While the conditionality for this facility is mostly gone, the stigma and feared political price – ultimately, loss of elections and the return of anti-establishment parties – is not. In that sense, the ECB's decisions and already contained bond yields might have attenuated the need to access the new ESM facility.

Figure 2: Access to new ESM facility for healthcare costs related to Covid-19 crisis
EUR bn (LHS) vs country 10-year bond yields, % (RHS)



Source: European Commission, Bloomberg, Scope Ratings. NB. Access amounts refer to 2% of 2019 GDP.

But financing the economic recovery after 2020 is the missing step

But what happens when the rationale for temporary programmes, particularly the ECB's EUR 750bn Pandemic Emergency Purchase Programme (PEPP), ends, which will be the case when policymakers conclude that 'the coronavirus Covid-19 crisis phase is over'?

Sovereigns making use of the ESM credit line would maintain access to funding sources at very reasonable rates. Should the 2% of GDP envelope available for financing direct and indirect measures related to the Covid-19 crisis not suffice, the remaining ESM facilities – albeit with stricter conditionality – would still be available even then.

Liquidity crisis in the euro area sovereign space unlikely over 2020

As a result, despite the political cost associated with accessing ESM facilities, we do not expect the Covid-19 crisis to become a liquidity crisis for euro area sovereigns in 2020. European authorities have created the institutions and instruments to reduce the likelihood of that scenario and stand ready to do more if needed.

However, the medium-term impact on public balance sheets from the crisis will be very significant. Specifically, will the economic recovery from the Covid-19 crisis be financed in such a way that the adverse impact on public balance sheets is eased? This question holds important credit implications for those euro area countries most affected by the crisis.

Medium-term impact depends on debt burdens, economic growth and European fiscal transfers

We see one of two options emerging after the crisis: either i) sovereigns will ignore the provisions of the (re-activated) Stability and Growth Pact and maintain higher deficits in the hopes of faster economic recoveries, or, alternatively, ii) sovereigns, observing the EU fiscal framework, consolidate their public finances gradually post-crisis, risking slower economic recoveries in turn. Both scenarios hold credit-negative implications given the ensuing limited fiscal space and/or extended periods it will take for countries to return to 2019 GDP levels, which may be well after even 2025 in some cases.

A third option, which would mitigate the adverse impacts in either of the above scenarios, would involve macro-economically relevant direct European transfers and investments to member states most adversely affected by the Covid-19 shock to finance their economic recoveries without impacting their government balance sheets as much. Several proposals, implying greater fiscal risk-sharing, already exist to facilitate such transfers, possibly through a re-oriented and enhanced EU budget and/or a new 'recovery fund'.

These instruments will all be challenged and heavily debated across Europe in the coming months. The crucial issue from a ratings perspective is thus the size and sources of funding for the Eurogroup's so-called 'recovery fund', which is of critical political and economic significance – and thus highly credit rating relevant.

A lack of solidarity could still fuel anti-EU/euro backlash in countries hardest hit

Economically speaking, a fast recovery in Spain and Italy is also in the Dutch and German interest given their openness to international trade. From a political standpoint, all European member states lose if any of the big five euro area countries – Germany, France, Italy, Spain and the Netherlands – ends up being governed by a nationalist, anti-EU party.

A perceived lack of solidarity could thus still fuel an anti-EU/euro area backlash in countries hardest hit by the crisis like Italy and Spain, potentially leading to the possible return to government of Lega in Italy while fears of debt mutualisation may risk the rise of Marine Le Pen's National Rally (formerly National Front) in France or even government participation of the Alternative für Deutschland in Germany or Geert Wilders' PVV in the Netherlands in years to come.

We will soon find out. The first important step of the evolving European policy response has been to mitigate the likelihood of a sovereign liquidity crisis in 2020, but the second step, focused on the politically charged topic of fiscal transfers and greater fiscal risk-sharing, holds significant credit implications for European sovereigns in 2020 and beyond.

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