CIO Memo

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COVID-19: EU agrees a three pillar fiscal response

Key take aways

- Last night the European Union agreed on a joint response to the COVID-19 crisis consisting of three pillars.
- These pillars are an EIB guarantee fund, the SURE labour market programme, and ESM credit lines.
- The EU agreed to work on a Recovery Fund but differences remain on debt mutualisation, which could pop up again.

1. What happened?

The EU agreed yesterday on joint initiatives in an effort to combat the consequences of the COVID-19 induced economic slowdown, following lengthy failed discussions earlier in the week. The critical issue of debt mutualisation, a key proposal by southern European Member states, was not addressed directly, but the conditions for usage of the ESM will be relatively relaxed. The package consists of three pillars, as detailed below. In addition the EU agreed to work on a Recovery Fund, which should be funded via the EU Budget. This fund aims to ensure "EU solidarity with the most affected member states". After guidance from EU leaders, there will also be discussions on "its sources of financing and on innovative financial instruments". This diplomatic wording has been interpreted differently in the various EU member states. Debt mutualisation is likely to be brought up again.

The three pillars of the agreement consist of the following:

First, the European Investment Bank (EIB) will create an EU-wide guarantee fund of EUR25bn to support EUR200bn of company financing, focusing on SMEs.

Second, SURE (in full, Support to Mitigate Unemployment Risks in an Emergency), an EU Commission initiative, was agreed to and will provide loans from the EU to member states of up to EUR100bn on favourable conditions to support national unemployment and short-time work schemes during the COVID-19 crisis.

Finally, the ESM (European Stability Mechanism) can provide credit lines of up to 2% of the respective member state's GDP at standardised terms. As opposed to the usual ESM terms there is no macroeconomic conditionality – a topic that was an issue in the previous discussions. Member states requesting such credit must however commit themselves to use the ESM "to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID 19 crisis." This is a condition which should be easily met by requesting countries. Overall these three pillars could sum up to more than EUR500bn in loans and guarantees.

2. How did markets react?

European and U.S. markets are closed for the Good Friday holiday. Positive stock market developments in the past week are an indication that markets are increasingly reacting to the monetary and fiscal measures taken across the globe, as well as to initial signs of a slowdown in the spread of the virus (at least in some regions) as a result of containment measures.

3. What does it mean for investors?

Markets continue to respond to both news on the spread of the coronavirus and the announcement and implementation of monetary and fiscal policy measures. The European Central Bank (ECB) has already launched a Pandemic Emergency Purchase Programme (PEPP) worth EUR750bn. Together with additional easing, temporary deviation from the capital key and the potential inclusion of all Eurozone economies, the ECB is following the "whatever it takes" approach, but this time not only to defend the Eurozone as a whole, but also to allow the member states to do "whatever it makes" to minimize the economic damage from the crisis. The EU Commission estimates that the governments have initiated around 3% of GDP in fiscal measures and 16% of GDP in liquidity guarantees. These numbers however differ substantially by country. The new EU programmes should be complementary to the national programmes. Both the ECB as well as the EU will make use of a high degree of pliability with regards to conditions around the various programmes. This includes a very flexible way to use EU funds, as well as the suspension of the EU's Stability and Growth Pact, making use of the general escape clause.

As a consequence of the crisis, debt levels will rise significantly and the topic of debt mutualisation within the EU may be brought up again, maybe as early as during the negotiations around the recovery fund. Funding of individual EU countries is not an issue at present, however, as the ECB programme provides a credible backstop. Due to high debt levels, member states will potentially continue to rely on ECB support well into the future.

With political discussions always challenging, this agreement may not have delivered everything that some participants were looking for, but its size should help should support EU economic recovery once the virus spread is contained and the lockdowns start to be dismantled. Markets seem increasingly willing to look through these challenges but will remain volatile. This is why we continue to think that a disciplined and sequential approach of adding risks to portfolios is useful to avoid the potential traps around market timing.

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Glossary

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Commission (EC) is the executive body of the European Union (EU) representing the interests of the European Union as a whole. It consists of 28 Commissioners (one from each EU Member State).

The European Investment Bank (EIB) uses financing to further EU policy goals; its shareholders are the EU member states.

The European Stability Mechanism (ESM) is intended to provide financial assistance programs to Eurozone members experiencing financial difficulty.

The European Union Stability and Growth Pact defines and monitors limits for EU members' deficits and debt.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

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