The Eurozone's Hamiltonian Movement

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The European Recovery Instrument is Neither a Hamiltonian Moment nor a non-Hamiltonian Muddle

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We answer key questions about new EU proposals for a joint fiscal cushion in response to COVID-19: Are these plans a "Hamiltonian Moment" – after Alexander Hamilton's federalization of US states' Revolutionary War debts in 1790? What's on offer; what will the bargaining be about; will it get through? What might it all mean in the long term for the euro, euro assets and the choice between the euro and the dollar as international and reserve currencies?

Is this per the bulls, a "Hamiltonian Moment" or a "non-Hamiltonian Muddle", per skeptics?

Neither. We see the European Recovery Instrument (ERI) and the NextGenerationEU package as an initial Hamilton movement – a down-payment rather than a federally backed mortgage. The original Franco-German proposal for a joint fiscal fund for transfers of €500 billion is now a European Commission plan, topped up with €250 billion of lending capacity, all supported by enlarged ECB asset purchases. Taken together, all this represents significant progress both in size and concept, combining grants, loans and monetary policy support. Even so, it's still way too early to celebrate a full-fledged Hamiltonian moment.

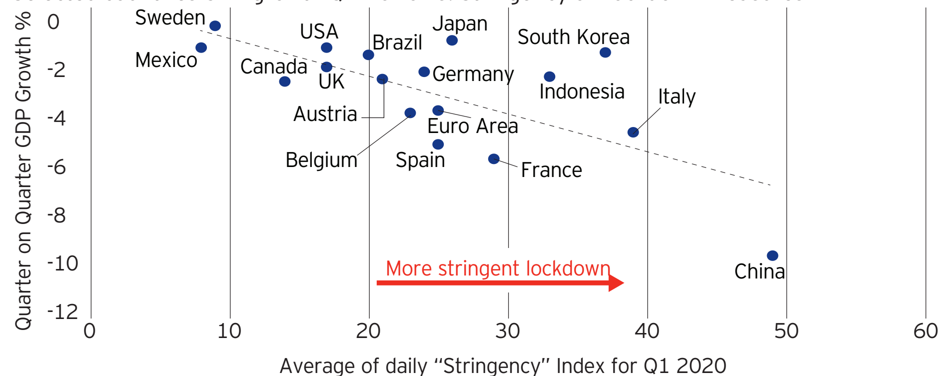
The good news: The ERI sends a clear message that the European Leaders are committed to furthering the EU project, thereby also ensuring that the Eurozone (EZ) will not be allowed to collapse as a direct result of this pandemic and ensuing great compression in economic growth, resulting from lockdowns, thanks to a sizeable fiscal response by the EU and member states. Plus, the ECB is no longer the only game in town; both national and EU budgets will be put to work.

The not so good news: The bulk of budgetary burdens, deficits and debt ratios will need to be borne at the national level, rather than being mainly shared at the "Eurozonal" or EU level.

Wouldn't common fiscal and monetary policies support a shared EU recovery?

The ERI, as currently structured, cannot prevent major differences in the economic consequences of the pandemic, nor very different recovery paths across countries. EU member states, like other countries, are all suffering very different health crises – diverging infection rates, mortality rates and impact on public health systems. Yet, most are facing similar economic pressures, because of stringent lockdowns across most member states, as per Figure 1.

Figure 1: The greater the lockdown, the greater the economic compression



Source: ONS/Oxford COVID-19 Government Response Tracker (OxCGRT), National Statistics Institutes of selected countries. Data as at 31 May 2020.

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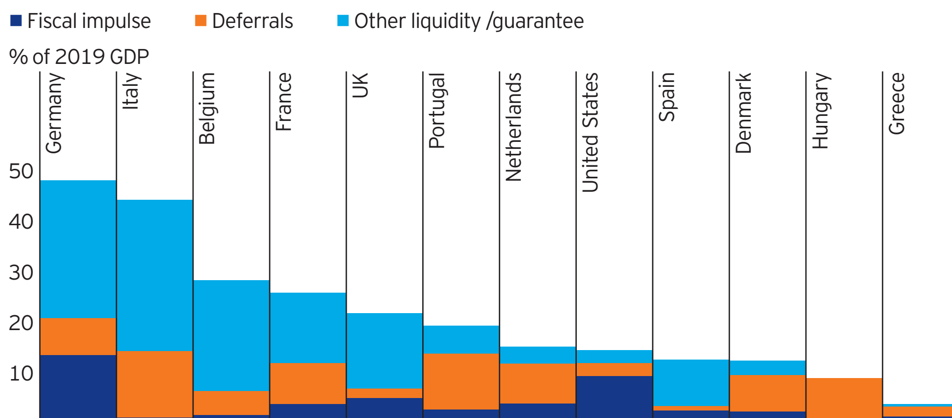
Given a shared economic shock, ideally there would be a shared budgetary response. But national fiscal responses vary a great deal across countries, largely as a function of debt loads and "fiscal space" – perceptions and fears of market willingness to finance national budget deficits, given existing public debt loads, growth rates and borrowing costs.

Indeed, Germany has more generous direct fiscal support than any other major economy in Europe or anywhere else, for that matter. Figure 2 shows that Germany's direct, discretionary fiscal spending – aside from "automatic stabilisers" like unemployment benefits – will be 10 times Italy's. It's total fiscal support including loan guarantees deferred taxes and fees dwarf those of any other large economy in the world and is on track to be four times that of Spain. Aside from Germany and the United States, most other Western governments plan direct, fiscal spending in the low single digits as a percent of GDP, and loan guarantees and deferrals are multiples of direct spending.

Figure 2: National fiscal responses vary significantly across Europe



Note: "Fiscal Impulse" refers to direct fiscal spending. "Deferrals" refer to temporary delays in tax filings and payments, and other fees to governments. "Guarantees" refer to loan guarantees and related vehicles. Indirect refers to measures that do not involve direct fiscal revenue or spending, including guarantees, deferrals and other measures.
Source: Bruegel Data Sets, Invesco. Data as at 4 June 2020

Guarantees and deferrals are crucial. Loan guarantees will help underwrite the solvency of the corporate sector and tax deferrals, with managing corporate and household cashflow - with no direct, immediate fiscal cost. The combination, together with worker furloughs and traditional forms of unemployment insurance will help reduce the damage to household finances and consumption. Put all this together with ECB support for the financial system and the banking sector and the very real threat of cascading defaults, which could otherwise cause a depression, is greatly reduced.

However, all these efforts are intended to cushion the great compression of economic activity from the lockdowns. Beyond stabilization, supporting recovery is the next step, to be led by reopening, the return of confidence, consumption and investment. All along the way, further fiscal support will very likely be required and probably more in say Italy, Spain and France than in Germany, judging by the impact of the lockdowns on Q1 GDP (see Figure 1).

Looking forward, these major differences in fiscal support, along with major differences in national economic structure point to varied growth performance on the way up. For example, Spain, Italy and the Southern EU Periphery depend much more on summer tourism than the Northern EU Core. If public confidence is weak, cross-border tourism – including use of restaurants, cafes, bars and services that suffer from social distancing – may recover only slowly.

In contrast, the German economy is more manufacturing heavy than many other large EU economies. Plus, Germany has had far lower mortality and infection rates. Confidence is likely to recover faster – indeed all the signs are that life and business are going back to normal fairly quickly. And manufacturing seems likely to recover faster than services and travel.

Thus, Germany is likely to recover faster than Italy, for example, just as it did after the Great Recession and the EZ crisis. If so, it would again be able to manage down the increase in public debt faster and to a greater extent. Many Northern EU Core member-states are likely to perform similarly better than their Southern, Periphery partners. Indeed, divergences between the Core and Periphery may well widen after COVID-19.

Why does the ERI fall short of the real McCoy?

All the chatter about a Hamiltonian Moment focuses on the shared debt, backed by a shared tax to fund part of a budgetary response that will be doled out to many member states by some formula as a one-off, rather than as a matter of course in future cycles. But this ERI falls far short of the soaring rhetoric of a "European Hamiltonian Moment" because it lacks the key features of the original, which largely established the United States as we know it.

The original Hamiltonian moment was about much more than a shared, possibly temporary tax and a single piece of federal debt, and indeed even more than the US Treasury and a fiscal union. Hamilton, co-author of the Federalist Papers, first and foremost led the way in forging a full political federation out of what had been a confederation – quite a bit like the EU, with voluntarily pooled sovereignty – by pushing forward the new Constitution in 1787. Furthermore, he more or less ensured that the federalization of the United States was irreversible by having a newly created federal government and US Treasury assume all of the states' war debts, creating a national debt with an attached, permanent source of federal tax revenue, through the Assumption Act of 1790.

As it stands now, the ERI is proposed as a one-off, temporary measure to deal with part of a once-in-a-lifetime shared shock. As such, it is a major step towards federalization – a movement, but it is not guaranteed to be irreversible; nor is it designed to be continuous. Only part of the national response to the COVID compression in the economy will be mutualized, not all of it.

Other than the ECB's monetary policy, international trade and regulatory standards, most key areas of politics and policy will remain at a national, rather than EU – including most areas of government spending, unemployment and health insurance, labor laws and the like.

Still, it is a step, and a big step, but it's a start, not the completion of EU or Eurozone fiscal union. It's a major step because it is a signal that there will be further steps in future, especially in crises. And the repetition of incremental steps towards greater fiscal integration - such as the European Stability Mechanism introduced during the EZ financial crisis and now the ERI - should reduce both the political risk of disintegration and the risk of speculative attacks in financial markets or runs on banks forcing exits.

Furthermore, it is conceivable that if the ERI works well, it could be the first step in creating a permanent pool or joint borrowing facility of shared fiscal resources which could be shared out in future severe crises. This time around, and in future crises, such an arrangement would reduce both market and political pressures for "internal devaluations" - which really means deflation that exacerbate debt burdens - and excessive fiscal austerity under crises that also bear down on private spending.

However, there would still be a risk not present in other monetary unions, of reversals or no further progress if some member-states feel that others are not pulling their own weight and trying to transfer their problems to other countries' taxpayers and voters. Equally, heavily indebted member states may feel that the less burdened are demanding too much change, belt-tightening and reform. As such, the risks of crises that threaten the euro's survival are being reduced, but not eliminated.

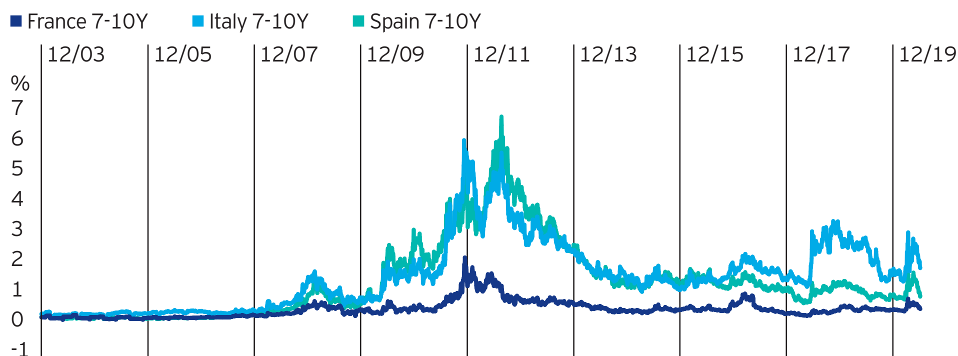
How do you see the market impact?

We expect the full combination of macro policy support – ECB asset purchases and shared budgetary support together with continued national responsibilities that are increasing national budget deficits and public debt ratios – to reduce the size and limit the range of risk premiums like sovereign spreads and equity risk premiums across the EZ, yet to maintain a high degree of variety and variability within these ranges.

As such, we do not expect a full repeat of the convergence that occurred in the first decade of the euro, when market participants saw all EZ sovereigns as equal and therefore treated their bonds as fungible – a perception the ECB in effect encouraged by treating all sovereign bonds as equivalent collateral for repo agreement and lending to banks. But against that, we do not expect the unbounded divergence of the euro's second decade when the single currency almost disintegrated, thanks to this joint budgetary response and continued ECB asset purchases.

If the idea of a joint fiscal policy were to gain traction, to become permanent and grow in size and responsibilities, relative to national budgets and debts, we would expect both a much greater degree of convergence as well as less variability in country risk premier across asset classes.

Figure 3: ERI prompts EZ sovereign spreads to tighten but still higher than pre-COVID
Key Euro Government 7-10Y YTM Spreads vs Germany



Source: Invesco calculations. Data as at 8 June 2020.

Why now, what do you think is at stake and what's driving this proposal?

The European Commission proposal was largely built on the Franco-German compromise. We believe that two key issues precipitated this surprise proposal by French President Macron and German Chancellor Merkel: The potential for a constitutional crisis and conflict of laws between Germany and the EU. Plus, Germany's fiscal support program against the COVID-19 crisis has faced a political backlash because it is multiples of what other EZ economies can possibly afford.

First and foremost, the ERI is a major step in defusing a new constitutional crisis that threatens the Eurozone – a 5 May 2020 ruling by Germany's Constitutional Court (GCC) at Karlsruhe has threatened the independence of the ECB by requiring it to justify its monetary policy and the jurisdiction of the European Court of Justice (ECJ), which is supposed to have the only say on all EU laws and institutions (including the ECB). If the ECB justification is not deemed sufficient, the GCC would ban the Bundesbank, Germany's national central bank, from participating in QE.

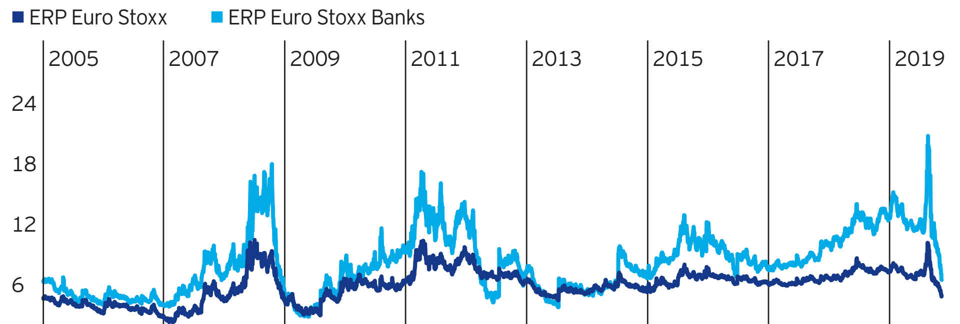
In our view, the GCC ruling cannot be allowed to stand on either count – its implicit challenge to ECB independence or ECJ superiority. They could each lead to a conflict of laws that could pose a renewed threat to the survival of the EZ, the EU itself and the entire European project of economic and financial integration as a way to avoid interstate conflict. Unanswered the challenge to ECJ jurisdiction would allow any Supreme Court to challenge the ECJ and cherry pick EU laws to its own liking.

The good news here is that this threat to the status quo has propelled an effort to take the burden off the ECB, by Germany taking direct responsibility to provide a more politically acceptable and democratically accountable approach to a shared macro support policy.

A close second: Germany's planned fiscal response to the COVID-19 downturn is off the charts larger than those of other member-states. Germany alone of all the major European economies is providing direct fiscal spending approaching double digit percentage points of its GDP. EU state aid rules have been suspended in response to the crisis, but even though the legality of this degree of fiscal support is now beyond reproach, the political pressures remain high.

Thus, the fiscally-challenged members of the EZ Periphery needed something as a quid-pro-quo - an inter-governmental political imperative for fiscal coordination, which has in our view coincided with constitutional and domestic pressures against excessive reliance on the ECB. We believe the combination has in effect conspired to compress bank equity risk premiums far more than all the talk about banking union (Figure 4) and more than sovereign spreads (Figure 3), because it would help to reduce the risk that a fiscal challenged sovereign cannot backstop or recapitalize a crisis hit domestic banking system.

Figure 4: EZ bank equity risk premium now meaningfully lower than pre-COVID levels



Source: Invesco calculations. Data as at 8 June 2020.

What's on offer here, and how is the money to be raised and spent?

The NextGenerationEU package proposed by the European Commission is made up of the "Recovery Instrument", which lifts the fiscal headroom of the EU Budget to enable the European Commission to issue debt in capital markets of up to EUR 750bn, and a number of proposals about how to money will be spent. The money raised would be disbursed primarily as grants (500bn) but also as loans (250bn). The European Commission has also announced that it will propose four new EU-level taxes (socalled "own resources") that would be used to pay down the interest on the debt incurred. These would include environmental taxes on single use plastics and carbon emissions, a digital services tax and a socalled "Single Market tax" on large corporates based in Europe. All told, these taxes could raise an additional EUR35-40bn to finance interest payments on the debt.

The majority of the additional financing raised under the NextGenerationEU programme (260bn of grants and 250bn in loans) would be distributed through a new Recovery and Resilience Facility which would target the money to those Member States most badly hit by the crisis in order to finance long-term investments. In order to tap the fund, Member States would need to submit recovery and resilience plans that demonstrated how the money would be spent to boost the economy and how the proposed investments are aligned with the twin political priorities of the EU to deliver the green and digital transformations. The process would be embedded within the European Semester, whereby the European Commission marks Member States fiscal homework, in the hope of encouraging Member States to make reforms as part of the process. The share of grants to loans and the level of conditionality are both points of contention between the frugal four and periphery countries.

The European Commission has already identified a number of investment opportunities in the green space, including financing a building renovation wave, renewable energy production, smart mobility including electric cars and charging infrastructure and environmentally friendly agriculture. The investment targets in the digital space are less clear, but the European Commission is known to want to spur innovation in the area of Artificial Intelligence, quantum computing and 5G.

The rest of the money will be used to top up existing programmes, such as the ESM, the InvestEU Programme, the Just Transition fund and Horizon EU.

What will the bargaining be about, will it pass and when will it go live?

We expect politicking over the next several months and 2-3 EU Summits to thrash out a deal. The funds will likely be deployed to assist recovery from 2021, over several years across countries hardest hit by the pandemic itself, by the great compression of economic activity due to lockdowns and by a weak recovery — Italy and Spain stand out as likely major beneficiaries. But we would also expect other countries to demand some of the money too.

We expect a deal along these lines eventually to be hammered out, because France and Germany have led the way, and the Franco-German axis is the core of the European project. But that doesn't mean it will go forward without a fight or further modification.

The "Frugal Four" — Austria, Netherlands, Sweden and Denmark — originally objected to the ERI on principle and have recently been joined by Finland. These frugal few want to add conditions for reform and to remove the grant element, which of course are the key enhancements of the ERI compared to the European Stability Mechanism, which would lend to Eurozone sovereigns in distress in exchange for structural reforms and macroeconomic performance criteria.

What if negotiations fail and the proposal is rejected?

We would emphasize that we think the chances of explicit rejection are very low. The intra-EU and -EZ balance of power is shifting from the North towards France and the Periphery, which makes approval in some form ultimately very likely after some negotiation and revisions.

If somehow a bargain cannot be struck, we would expect a return of significant financial pressures on country risk premiums led by sovereign spreads to Germany; a sharp widening of bank equity and credit risk premiums especially in the Periphery; and meaningful weakening of the euro against the dollar, the Swiss franc and the yen (and to a significantly lesser degree the pound sterling, given Brexit uncertainty). This would in effect replay the early stages of the pandemic lockdown impact on EZ and global financial markets. And in a replay of the Eurozone Financial Crisis, we would expect the ECB to step in once again to stabilize risk premiums, providing time to renegotiate a new deal. We do not expect the EU to permit euro exits or a disintegration due to market reactions to events - though we fully acknowledge the risk remains that a sovereign state could decide to exit.

The way the EU works allows each and every member state a veto in principle. But in practice, the large countries generally have called the shots — especially France and Germany. However, Spain and Italy's relative influence is increasing, now that the UK is very much out of the EU in principle and in the transition phase on its way out in practice, France is already gaining in the balance of power as the swing player between the relatively liberal Northern Core, centred on Germany; and the relatively more economically traditional and restrained Southern Periphery.

Rather than a complete rejection, we would therefore expect measures to make the proposal more palatable to the frugal few. Indeed, the Commission's layering on top of a loan element with a degree of conditionality probably reflects just such a goal.

Further changes could include making this a Eurozone only fund, into which non-EZ members of the EU could opt in, thus eliminating the vetoes of Poland, Hungary — which are seeking concessions for themselves, and Sweden. The issue with this approach is that it would make the ERI explicitly an EZ rather than EU idea, more strongly crystallising the idea of EZ debt mutualisation, which in turn might face more resistance from fiscal hawks in the Core as well as within Germany itself. So this could yet be a fallback if the bargaining becomes difficult. Other ploys could include further topping up the size, to provide more resources to newer EU members, such as Poland or Hungary, which tend to have far lower per capita income levels than say Italy or Spain.

Could EU ERI debt represent an EU benchmark bond to rival US Treasuries?

Not really in any conventional sense. €500 or €750 billion are significant amounts, but pale in comparison to the size of US Treasuries (US$20 trillion — and growing fast) or Italian BTPs (about €x trillion and also growing fast, perhaps too fast). Furthermore, each of the major government bond markets has a consistent yield curve across the maturity spectrum with regular new issues and secondary market pricing.

Until and unless the EU or EZ offer something similar to the United States, complete with a sizeable federal tax base and an independent collection and enforcement authority, as well as budgetary spending power, the EU and any EU debt will remain creatures of EZ member-states, particularly the Franco-German core.

How do you see ERI against Bunds in official international reserves?

A full-fledged Hamiltonian transformation including fiscal and political federalism would be required for EZ debt to rival US Treasuries.In time, if the ERI proves permanent and ERI bonds become a much larger, more liquid asset class that is backed up by a full-fledged EU fiscal union, underpinned by a meaningful political union, we could see the euro offering a real alternative to the dollar, and ERI or similar bonds as an alternative to US Treasuries. But as currently conceived, we don't see ERI debt as an alternative to Treasuries.

ERI debt might be more akin to a supranational obligation with specific funding and backing, though with an earmarked source of revenue, it would probably be treated as a relatively unusual. Earmarked tax revenue would make it safer than ESM debt.

We would expect significant interest from many categories of official investor, and if in long term maturities, from pension funds and other institutional investors. Since the credit quality and rating would probably be quite high, we would expect it to be treated as an alternative to bunds, but with a higher yield since the credit quality of the EU and EZ as a whole might be seen to be weaker than Germany on a standalone basis.

Could the ERI debt serve as an EU "safe" asset for domestic banks and investors?

We doubt that ERI debt could serve as the holy grail of the EU financial system — a EU "safe" asset until and unless there is a full-fledged EU Treasury with significant taxing and spending power akin to the US Treasury.

That said, we think it would have more success and utility in the EU financial system, especially for banks — if it grows in size, depth and liquidity over time — than say Princeton Professor Markus Brunnermeier's proposed Sovereign Bond-Backed Securities, which has been promoted actively by ECB chief economist Philip Lane as safe asset for the banking system. The SBBS, is a synthetic combination of EZ government bonds weighted according to the ECB capital key (a blend of national weights in EU GDP plus national populations).

The SBBS would very likely lack the critical characteristic of a perceived safe asset — counter cyclicality: "Safe" assets rise in value in bad times, when risky or growth geared assets fall in value; and vice versa. But the SBBS, which would be made up of a blend of all EZ sovereigns would have some bonds likely to go up in value (like German Bunds); others that go down in value (like Italian BTPs); and still others that might be pulled either way (like French OATs). Such price movements might cancel each other out, defeating the point.

For the ERI debt to be fit for purpose as a EU "safe" asset, it would have to be both a deeper and more liquid market than any other EUI alternative, such as Bunds; and also seen as senior to any such alternative – once again, Bunds.

Thus, none of these financially engineered or fiscal halfway houses can fully stack up as reserve assets, though the ERI debt could eventually get there. Meanwhile, central banks might find useful diversification benefits in ERI debt, which would probably have a higher yield and volatility than Bunds but lower than Italy or Spain. Thus, even though ERI debt might not have the depth and liquidity to serve as reserve assets, they might improve the risk and return characteristics of investment portfolios of EU government bonds held by private institutional or official investors like sovereign wealth funds or central banks.

Why is the original Hamilton moment so important and relevant?

The term Hamilton Moment was coined by the late Paul Volcker, former Fed Chairman, at the height of the EZ debt crisis, reflecting the extent of the parallels in the crisis and challenges to its resolution. The American economist Thomas Sargent, in his 2011 Nobel prize lecture, United States Then, Europe Now recounts the political, economic and financial logic of Hamilton's 1790 Assumption Act, offering it as a template for solving the EZ crisis of contradiction between a shared money and separate national fiscal politics and democratic politics. Hamiltonian federalism is the full range of political, legal, fiscal, economic and financial unions established in the United States by the Second Constitutional Convention in 1787, the establishment of the federal government, and in 1790 the US Treasury – and in many countries with similar federal institutional structures throughout the world.

Alexander Hamilton was a "Founding Father" of the United States, an original signatory of the Declaration of Independence. In many respects, the modern United States, particularly the strength of its union and relationship between the federal and state governments, is his creation.

Hamilton also had a profound influence on the US economy and financial system, by encouraging early US manufacturing and industrialisation with import tariffs to provide protection against Great Britain's larger economy and competing firms, while encouraging trade liberalisation among the states of the American union, and therefore ever deeper economic and financial integration.

Some historians see Hamilton as among the most important, early modern proponents of political federalism, fiscal federalism and import substituting industrialisation. There are few monuments to Hamilton in the entire country, but so profound are his continuing influence and legacy that some have said the United States itself is a monument to his vision.

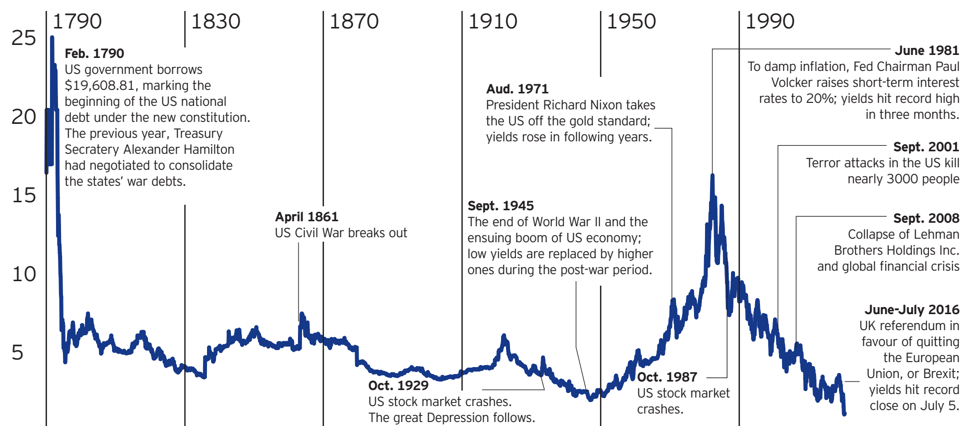
Hamilton's ideas have has come to be known as "Hamiltonian Federalism" — a strong central government to which constituent members are politically, legally and fiscally subordinated. Fiscal federalism — the formal sharing of budgetary revenue and spending responsibilities among different levels of government, together with the taxes and debt required to finance these shared responsibilities, were one of his main contributions to the modern structure of federal states. These ideas find institutional, economic and financial echoes in political and fiscal federations well beyond the US, such as Argentina, Brazil, Mexico, India, Russia — even within the EZ itself, Germany, Austria, Spain.

What's even more telling, Hamilton's vision of political and fiscal federalism was itself the policy response to a US sovereign debt crisis with striking similarities to the EZ debt crisis of 2010-12. In 1787, the state of Massachusetts lost access to credit markets because it had overspent. It had to make a massive fiscal adjustment that prompted Shay's Rebellion, the first American Civil War. Other states of the fledgling United States lost access to credit markets. Rich states in the South did not want to bail out debtor states in the North.

Hamilton, an arch Federalist, made a bargain with Jefferson and his Democratic Republican party preferred people power and states' rights to federalism: A strong federal structure but with limitations on government through separation of powers within the federal government, a strong federal Treasury and central bank — as well as repayment in full of state debts — all balanced with state level responsibilities and constitutional limitations on executive and congressional authority. The US – at the time known in the plural as these United States convened a constitutional convention and within three years transformed itself from an EU-like pooling of state level sovereignty under the Articles of Confederation, into a full-fledged federation by 1790. En route to an ever more perfect union, the US has since come to be known as the United States.

The market impact of Assumption Act was immediate and exceptionally powerful. US spreads to Great Britain collapsed, and interest rates for US sovereign risk collapsed from the high teens to the mid single digits within days. US creditors realized that the federalization of state debts was a practical application of Hamilton's insight that the whole could be much greater than the sum of the parts of the union on a standalone basis. And that, of course, is one of the main reasons for the European project – to ensure that union helps both to avoid political and economic conflict and to provide greater size and the opportunities that come with integration.

Figure 5: Hamilton Moment drove US bond yields down by 15% within months from their historic highs of 230 years



Source: Global Financial Data, L/S blog; Invesco. Data as at 8 June 2020.
Notes: 10-year, constant-maturity US Treasury nominal yield. Official US business-cycle dating by the NBER reaches back to 1854.

In conclusion, will this Hamiltonian Movement lead to an eventual Hamiltonian Moment?

The all-at-once approach has never been the method in the European project; instead, as EU founding father Jean Monnet said, the EU will be forged in crisis. It remains to be seen whether the EU can continue to incrementally integrate through repeat crises into what Churchill famously proposed – a United States of Europe, rather than going the whole way all at once in response to an initial crisis, the way Hamilton did. The US transformation took three years; the EU is still working on it a full decade after the EZ financial crisis. At a minimum, though, the ERI is a major step in that direction and we would expect to see more of these incremental Hamiltonian movements in both politics and fiscal affairs, to support the economic and monetary union.

Along the way, we would expect continued frictions and crises which are likely to be complicated by the EU's triple structure — One, the EU confederation in which sovereignty has been partly and voluntarily pooled particularly in areas of inter governmental relations, trade and competition policies. Two, the EZ monetary federation in which the ECB is supposed to reign supreme and which is now being extended into a financial federation through banking and capital markets union. And three, the member-state focus on fiscal and structural economic policies, including many areas of regulation, labor markets and social safety nets, including public health – all the key areas of politics.

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