The Big Read Eurozone economy

EU rescue package: borrowing to prevent a north-south split

After feeling betrayed by Brussels' initial pandemic response, Italians have welcomed the new fiscal deal

Sam Fleming in Brussels, **Miles Johnson** in Rome, and **Ian Mount** in Madrid JULY 24 2020

Italian prime minister Giuseppe Conte was unrestrained in his triumphalism about the deal he secured at this week's crisis summit in Brussels. The unprecedented pan-European rescue package, he boasted, "would change the face of Italy".

Even Mr Conte's most hardened domestic critics found it difficult to dismiss the agreement by EU leaders to create a €750bn pandemic recovery fund.

Giorgia Meloni, leader of the hard-right Brothers of Italy party, who had blasted Mr Conte and EU's response early in the crisis, came the closest she has ever to outright praise. "I want to say that Conte came out [of the talks] on his feet," she acknowledged, before quickly adding "he could have and should have done better".

The Eurosceptic League leader Matteo Salvini, who had hoped to replace Mr Conte as prime minister last year and who now languishes in opposition, was forced to accept that "if there is something good for Italy then we will all be happy". The government-friendly daily Il Fatto Quotidiano duly ran a front-page picture depicting the prime minister as a Covid mask-wearing hero holding a comedy-sized cheque.

EU leaders at the historic summit earlier this week where they agreed on a €750bn recovery fund for member states © Francisco Seco/Pool/EPA-EFE

For a country that has spent the bulk of the past five months grappling with a national tragedy, the burst of optimism was understandable. Faced with its worst recession in modern times, and reeling from the loss of more than 35,000 lives to the virus, the Italian public felt betrayed by the EU's hesitant early response to the crisis.

During the spring even normally pro-European elites started to warn that the country, one of the EU's founding members, would turn its back on the project.

The EU has been battling ever since to reverse this dangerous mood. The European Central Bank was first to the table with its massive bond purchases, followed by finance ministers who in April set up a €540bn economic safety net.

In the early hours of Tuesday came the most politically seismic moment of all: a decision by the EU27 member states to permit the European Commission to undertake large-scale borrowing for the first time in its history, and to hand out €390bn of the proceeds to member states as non-repayable grants.

Even Eurosceptics such as Giorgia Meloni, leader of Brothers of Italy, and the League's Matteo Salvini accept that some parts of the deal are positive for Italy © Riccardo Antimiani/EPA-EFE

The package reflected a realisation by EU leaders, led by Germany's Angela Merkel, that if they did not act boldly, economic divergence within the eurozone could become irreversible, threatening the currency's viability while feeding populism and public disaffection with the EU across much of southern Europe.

"In historical, symbolic and political terms this is a huge step forward by the European Union," says Pascal Lamy, a former head of the World Trade Organization who was cabinet chief to Jacques Delors when he led the commission. "It will give the pro-European constituency in Italy and other states a lot of ammunition against their critics — provided that in two or three years' time voters have actually seen the colour of the EU's money."

Italy will be one of the biggest winners out of the Next Generation EU programme, under which member states agreed to authorise borrowing by the commission of €750bn. The commission has not released details of how the money is expected to be distributed, in part because just under a third of the funding will be determined by economic data in 2020 and 2021.

But member states have been running their own forecasts. Calculations from one, seen by the FT, suggest Italy could be in line for grants from the core Recovery and Resilience Facility of around €65.5bn, making it the largest beneficiary, followed by Spain which could get €59bn and France with €37.4bn.

Once estimated receipts from the broader package of grants are added in, Mr Conte is expecting to get upwards of €80bn.

Italy is expected to be the largest beneficiary of the EU recovery fund, which aims to reconstruct the region's pandemic-stricken economies © Riccardo Antimiani/EPA-EFE

The money will be handed out over a number of years, and Italy will bear a share of the burden of paying off the debt over the payment period which runs until 2058. But analysts still see the package as significant for a country forecast by the commission to face a slump in gross domestic product of over 11 per cent this year.

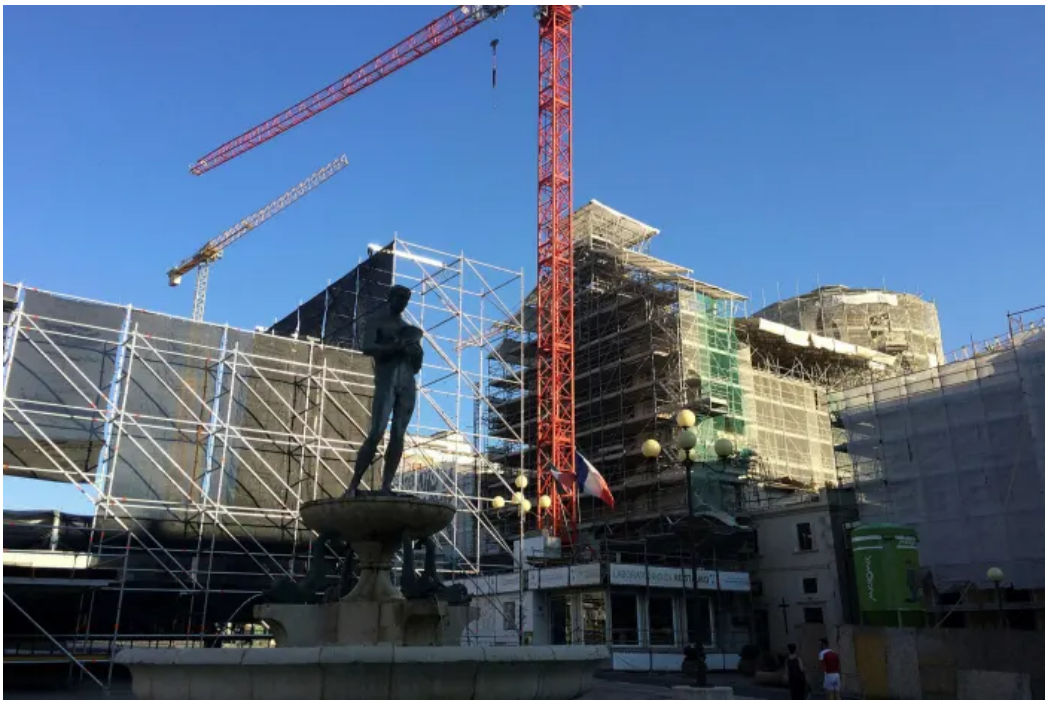
"There are many unknowns as to when exactly the money will land in the economy, but I expect the greatest positive economic impact to come in 2022 and 2023," says Loredana Federico, chief Italian economist at UniCredit Research.

Delivering on pledges

Mr Conte still lacks his own political bloc in the Italian parliament — the prime minister was plucked from obscurity in 2018 to lead a then-coalition of the Five Star Movement and the League and retained the position when the League was replaced in the coalition last year by the centre-left Democratic party. But his position appears significantly strengthened by the package. The prime minister was ranked by a poll published in La Repubblica earlier this week as Italy's best prime minister since 1994.

Yet agreeing the package at EU leaders' level is one thing — it is another to see the plan through to a successful conclusion. Italy has one of Europe's worst records when it comes to quickly absorbing EU funds, according to Zsolt Darvas of Bruegel, the think-tank.

Take the city of L'Aquila, in Italy's central Abruzzo region. Visitors immediately notice the scars the city still bears from an earthquake in 2009 that killed over 300 people and left more than 50,000 people temporarily homeless.



L'Aquila in central Italy is still rebuilding after an earthquake in 2009 destroyed much of its historic centre © Gavin Jones/Reuters

Eleven years on, and despite funds from the EU, large parts of the city remain a ghost town © Andrea Pirri/NurPhoto/Getty

Following the earthquake Silvio Berlusconi, then prime minister, said he wanted the rebuilding to be completed in six months. Seven years later Matteo Renzi pledged that every town in the region would be restored to its original state.

Eleven years on, large parts of the city's historic centre remain a ghost town, with construction scaffolding supporting empty buildings as part of a reconstruction effort paid in part by funds from the European Commission. The time it has taken to reconstruct the city has become emblematic of the difficulties Italy has encountered using rescue funds, as bureaucracy and vigilance against corruption result in painfully slow progress.

L'Aquila, like the rest of Italy, is now facing a fresh crisis as the country suffers the economic consequences of the Covid-19 outbreak. Franco Pizzirani, 76, runs a bed and breakfast in L'Aquila and was born in the city. "It took a lot of money and energy to rebuild things here. Now, because of the virus we are going to have to rebuild again," he says.

Italy will also battle against the perception that it has repeatedly failed to implement the reforms it has pledged to its EU partners and the commission, leaving it with a moribund growth record and unemployment rates exceeding 10 per cent for much of the past decade.

Tests of new-found unity

Under the proposals from the commission, countries will put forward strategies for how they plan to turn around their economies. But this implies Rome will actually follow through with its pledges. Northern European member states are sceptical, to put it politely.

In April, Dutch prime minister Mark Rutte was confronted by a waste lorry driver who urged him not to give money to the "Spaniards and Italy" — an encounter which underscored the hostility among some Dutch voters about sending taxpayer money across the EU. Mr Rutte was filmed giving the man a thumbs up and saying "no, no, no".

Italy's prime minister Giuseppe Conte, centre-left, with Dutch prime minister Mark Rutte. Some northern European member states are sceptical that southern countries will follow through with promised reforms © Sem Van Der Val/EPA-EFE/Shutterstock

After the summit, Mr Rutte said he would tell the same man that the Netherlands had secured assurances from Italy that the country will embark on the path of difficult reforms. A so-called emergency brake agreed in the summit, which allows a single country to stall recovery fund payments, would ensure governments "really keep each other true to their reform promises", he claimed.

In Spain business leaders say they are counting on that same mechanism to prevent Madrid's government from reneging on its own reform pledges. Spain is expected to suffer the second biggest slump this year in the EU after Italy, in part because of the impact of the Covid-19 crisis on its large tourist sector.

Socialist prime minister Pedro Sánchez was one of the strongest advocates of a big EU recovery package funded through common EU debt. Egged on by his junior coalition partner, the far-left Podemos party, he fought against strong conditions on spending.

Spain's business community is now welcoming the prospect of EU pressure to push the government to reform the country's expensive pension system and to stop plans to overturn the 2012 labour reform, passed under the previous centre-right government, which made it less expensive to lay off employees. Reversing the reform is a key aim of Podemos.

Rome's Spanish Steps. Italy is forecast to face a slump in gross domestic product of over 11 per cent this year © Hope Ghell/Bloomberg

Pedregalejo Beach in Malaga. Spain's tourism sector has been hit hard by the coronavirus crisis © Jorge Guerrero/AFP/Getty

John de Zulueta, chairman of Spain's Círculo de Empresarios (Business Roundtable), calls the €750bn fund the "biggest news since the founding of the euro", but he saves his strongest praise for the "logical" conditionality of the grants and loans, which he says need to be spent on transforming Spain's economic model.

Félix Eguía, whose holding company employs more than 500 people, puts matters bluntly: "I want to thank the members of the EU for their generosity, but I want to ask for something else: make sure that Spain complies."

How effectively the reforms are policed at the EU level remains to be seen. Capitalising on the opportunities presented by the recovery package will present a defining test not only to the member states, but to the commission itself. In Brussels officials will now have to oversee and distribute funding five times the sums they would normally allocate in a year, points out Mr Lamy. This will impose enormous administrative burdens.

"Whether it succeeds will depend on the capacity of the system — the commission and the member states — to implement this," he says. "It is a major challenge, and how it is handled will determine whether this step forward in integration ends up getting ratified by public opinion."

Additional reporting by Mehreen Khan in Brussels