Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report
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Could the Coronavirus Pandemic Break Up the EU? – Part II

(Note: Due to the Easter holiday, our next report will be published on April 20.)

In Part I of this report we examined the history of the European Union (EU), how it works, and the political, economic, and social fissures that had already rendered it unstable when the COVID-19 pandemic took hold. This week, we look at several recent policy moves that various EU countries have taken in response to the pandemic, and we explain why those policy moves could potentially push the EU over the tipping point toward disintegration if they are carried too far. As always, we'll wrap up with a discussion of the possible economic consequences of a break-up and the ramifications for investors.

The Temptation to Barricade

As we discussed in Part I, the founders of the EU believed that preventing another major war on European soil could be accomplished, in part, by an "ever-closer union among the peoples of Europe." The EU is often seen mostly as an economic arrangement (i.e., a customs union coupled with a free-trade area), but its founding principles are broader than that. The EU aspires to the free movement of virtually all people, goods, services, and capital. Unfortunately, the COVID-19 pandemic has tempted EU leaders to erect barriers in these areas.

People. Like countries across the globe, all EU members have restricted people from entering their countries in order to cut the risk of "imported" coronavirus infections. The surprising thing was how readily some national leaders moved to unilaterally close their borders with other EU countries. For example, on March 15, the German government said it would close its entire border, shutting off Denmark, the Netherlands, Luxembourg, France, Austria, the Czech Republic, and Poland, as well as Switzerland. France responded in kind, as did a wide range of other EU countries. The restrictions threaten a deep breakdown in the EU's commitment to free movement.

- **Nationalist Discrimination?** The unilateral cross-border travel bans typically apply only to foreign citizens, even if those citizens are from countries that have signed the Schengen Treaty allowing visa-free travel among signatory states. The countries imposing the bans generally continue to allow their own citizens and legal residents to enter without restriction, in what amounts to a policy of discrimination against foreigners.

- **EU-wide Travel Ban.** In an effort to short-circuit the move toward unilateral, intra-European border closings, EU Commission President Ursula von der Leyen on March 16 proposed a 30-day ban on all travel into the EU as a whole. As with the individual country restrictions, exemptions would be granted to EU citizens, their family members, legal bloc residents, and

workers in economic sectors deemed "essential."

Goods and Services. Also similar to countries all over the world, each European nation has now imposed at least some restrictions on domestic business activities to enforce "social distancing" and slow the pandemic's spread. Although each country has explicitly allowed cross-border trade in essential goods and services, the reality is that the restrictions constitute either implicit or explicit trade barriers.

- **Border Checks.** Checking the health of transport workers and other border crossers has created massive queues. For example, German truck drivers trying to deliver goods to Poland in mid-March faced lines of up to 24 miles and had to wait as long as 18 hours to cross the frontier (see Figure 1).

Figure 1.

Truck backup on the German-Polish border. (Source: *stuff.co.nz.*)

- **Medical Export Restrictions.** More ominously, some European countries facing dwindling supplies of key medical goods have resorted to hoarding. In early March, both Germany and France barred their manufacturers from exporting surgical masks, gloves, and other protective medical equipment to other EU countries, creating shortages in hard-hit Italy and elsewhere around the union.

Capital. Both direct investment and portfolio investment have been less affected by actual policy moves so far, but some EU leaders have hinted at policies that could place barriers to capital down the road. In each case, the potential policy moves would aim to help local companies weather the pandemic-related disruptions. The problem is that in doing so they could give those companies an unfair advantage in international trade or investment. Depending on how the policies are structured, they could also shield the assisted firms from takeover by foreign companies.

- **Nationalizations?** In mid-March, French Finance Minister Bruno Le Maire said French financial assistance to local companies could entail the government taking them over in order to save them. Politicians in other countries have also hinted that financial aid to companies might come with strings attached. The most obvious "string" would be for the government to be granted an equity stake in the firm as is being considered in countries such as Germany. However, even without an equity stake, the aid might be granted only with market-distorting restrictions on the firms' future operational methods. For example, they might require higher payrolls or wage rates that would weigh on their profitability and value.

- **Eased Subsidy Rules.** The possibility that strings might be attached to state aid in the EU is even more important given that the EU leadership in Brussels has proposed easing its strict rules against such aid. With governments around the world rushing to bolster private companies, there seems to be little effective restraint on such state-aid policies. Accordingly, without restraint on financial aid, there will be little

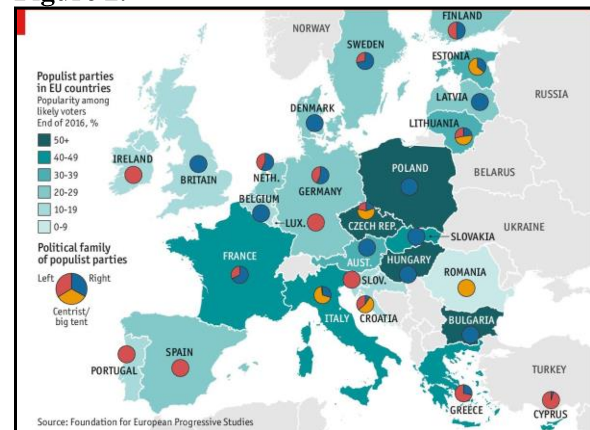
restraint on the strings that go along with that aid.

- **Monetary Policy.** Finally, even the EU bureaucracy's own rescue policies have the potential to unfairly advantage one group of EU members at the expense of others, at least among those EU members that use the euro. The issue arises from the European Central Bank's emergency program to buy an additional €750 billion worth of public and private-sector bonds, including the bonds of debt-strapped, periphery countries like Italy and Greece. The move quickly generated pushback by creditor nations in northern Europe, such as Germany. More broadly, the move highlighted the chasm between the north and south as the northern creditor nations despise the perceived financial profligacy of the debtor countries in the south, while the debtor countries resent how the north's high savings rates and export surpluses weigh on their economies.

What Would a Break-Up Look Like?
As shown above, national governments in the EU have already shown that in the face of a crisis like the COVID-19 pandemic, they may prioritize protecting their own citizens and firms at the expense of the EU's foundational commitment to the "ever-closer union." Even if the every-man-for-himself attitude hasn't yet gotten extreme, it's remarkable how quickly these governments moved to restrict the flow of goods, services, people, and capital with other EU members. This is not to say that a break-up of the EU is inevitable. EU leaders have also limited their more anti-EU steps. All the same, the EU's political, economic, and social fissures that we described in Part I last week are probably wider now than they were at the end of 2019.

Perhaps the key risk is that the EU's widened fissures could now be exploited by the region's populist, nationalist, Euro-skeptic political parties (See Figure 2; and, for a fuller discussion of European populism, see our *WGR* from January 12, 2015). The widening fissures play into the hands of parties like the Alternative for Germany (AfD) in Germany and the Rassemblement National in France. Those parties now have at least partial validation for their argument in favor of strengthening borders and devolving power back to Europe's historical nation states. If the pandemic worsens enough, these parties could make a plausible argument that their countries are being hurt by other EU countries and should therefore take their sovereignty back.

Figure 2.



The economic and financial divisions in Europe are especially dangerous. One way to interpret the EU's history as laid out in Part I and Part II of this report is to say that European leaders sold the EU to their citizens as a way to substitute economic prosperity for nationalism. Recent events like the European Debt Crisis and Germany's regional economic hegemony call into question that tradeoff. Whatever the economic benefits of the EU, they haven't been so overwhelming as to snuff out the parochial identities and interests of

European nationalists. Now, during the COVID-19 pandemic, perceived disparities between the financial subsidies offered to different EU members could spark a backlash. Within the Eurozone, if the northern creditor nations are able to limit the monetary aid to the southern debtor nations, then one or more southern nations could potentially leave the currency bloc. Coupled with Britain's exit from the EU this year, such a split from the Eurozone might encourage other countries to follow suit.

Ramifications

To reiterate: it's probably still too early to assume the COVID-19 crisis will split up the EU. However, the risks are rising. If it appears that such a break-up is becoming likely, the prospect of renewed trade barriers and severed supply links would be extremely negative for EU equities. In fact, the disruptions would probably be so great that spillover effects would be noticeable all over the global economy, so equities, in general, would likely suffer in the short term. However, if disintegration resulted in the weaker, heavily indebted countries abandoning the euro and launching depreciated new currencies, those countries could recover relatively quickly. Post-crisis currency devaluation has historically been a powerful source of recovery (our *WGR* from January 30, 2017, provides a fuller discussion of this phenomenon and how it could arise in a Eurozone collapse). That could make their equities especially attractive after the initial chaotic selloff.

The implications for European bond investors would probably be negative as well. The renewed trade barriers and severed supply links would likely boost corporate bankruptcies and weigh on public fiscal balances, so European bonds would probably sell off. On the other hand, that sell-off would boost the yield on surviving European bonds, ultimately supporting their value.

Within commodities, any disintegration of the EU would be momentous enough to spark heavy safe haven buying of gold and other precious metals. However, the drag on global economic growth would probably undercut most other commodity values. Naturally, the euro would suffer a catastrophic sell-off, but the U.S. dollar and Europe's other currencies, such as the British pound and the Swedish kroner, would likely benefit.

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