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Karlsruhe we have a problem: a new challenge to the EU recovery fund

Once again, the German Constitutional Court is at the root cause of potential market tension

Karlsruhe hits pause on the German EU recovery fund ratification

Last Friday, the European flagship project demonstrating solidarity took a severe hit. The German Constitutional Court ordered German President Steinmeier to stop the ratification of the Next Generation EU project, also known as the European Recovery Fund. Steinmeier was about to sign into law the German legislation to enable the EU to borrow in the capital markets and to widen its own resources. The reason for this order was a group of Eurosceptic professors, led by AfD founder Bernd Lucke, which asked the Court to issue an injunction to stop the law. This motion followed on a report from the German Federal Audit Office more than two weeks ago, which had been very critical on the Next Generation EU. Interestingly, the Court didn't provide any justifications for its injunction.

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The decision could be another episode in the long saga of how the German Constitutional Court is (trying) to shape European integration. It could also be an episode of the even longer saga of how Eurosceptic Germans try to stop or undermine European integration. At this stage, it is impossible to tell how the injunction and a possible lawsuit will evolve. The fact is that last Friday's decision bears a high risk of delaying, if not derailing, the crown jewel of the EU's fiscal reaction to the current crisis.

The way forward

It is not the first time that the German Constitutional Court asked the president to delay signing new legislation. Back in 2012, the Court asked President Gauck to delay the ratification of the ESM Treaty by a few weeks. Informally, though. It did not stop the president from signing the Treaty.

Based on past experiences, there are several possible ways forward.

- the Court will not issue the injunction, will give the green light for the president to sign but will start the case. In this scenario, there would only be a delay of a few weeks but the chances for the European Recovery Fund to become a more structural element of European crisis fighting will drop
- the Court issues the injunction but as in the case on the ECB's QE immediately sends the case to the European Court of Justice. This could allow the German president to sign off on the law but would diminish confidence in the instrument as such
- the Court issues the injunction and a long waiting game will start, hurting the eurozone recovery and the belief in European solidarity

The way this latest challenge to the implementation of last year's EU recovery fund decision will play out could have very different ramifications for financial markets, from the inconsequential to the more momentous.

A temporary delay would fail to register in EUR bond markets

The most benign scenarios are those where the delay to the German EU recovery fund (NGeu) ratification process only extends to a few weeks. It is fair to say that no-one expected the implementation of NGeu to be a walk in the park. With the end of 2Q21 as the effective deadline for the ratification process, there is a few months' buffer to allow for the legal challenge to be resolved.

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This chimes in with our expectation that NGeu-related issuance would only start in 3Q, possibly as early as July. Under a scenario where a temporary delay is followed by a green light, our expected timetable doesn't come into question. This would imply no significant market reaction either in core or peripheral eurozone debt markets. There has been no shortage of adverse developments for European market sentiment in recent months. We expect them to drown out the impact of a short ratification delay.

Optimism to prevail in case of longer delays

A green light with some reservations, or a referral to the ECJ could imply longer delays, potentially putting the 2Q ratification deadline at risk. Either way, we think the market assumption would be that the eventual outcome remains a swift implementation of the NGeu funding and disbursement plan. At most it would require recipient countries to bridge the financing gap versus the original timetable, not a major challenge.

More broadly, one has to keep in mind that the benefits of the EU recovery fund will accrue to Eurozone economies over several years. A delay of a few weeks or months compared to the original timetable is entirely manageable. At most, we do envision a period of fleeting performance in peripheral debt markets, where investors hesitate in chasing spreads lower until the legal uncertainty dissipates. Using the 10Y Italy-Germany spreads as a gauge, we'd expect a loss of tightening momentum below 90bp.

90bp Italy-Germany 10Y spread

should remain the floor as long as legal uncertainty lingers

Back to the drawing board? Buckle up bond markets

The more momentous scenario is one where the legal spat hampers ratification until well after the 2Q deadline. It is difficult to say at this stage how serious the threat to the original plan is but in the unlikely event that Germany's participation, the largest net contributor, is suspended, we would see an adverse reaction in European debt markets.

Starting with core markets, our forecast of 10Y German yields converging to 0% later this year could be at risk. Near-term, if it emerges that the suit is a serious threat to German ratification, a revisit of the -0.40% area is probable, as safer bond markets are likely to attract a greater proportion of fixed income investment until the design of the fund is modified to address the legal challenge.

The impact is likely to be most visible in sovereigns that stand to benefit the most from the fund, however. Greece and Portugal are top of the list in the eurozone, but larger sovereigns such as Italy could be impacted too. Relative to Germany, we expect the 10Y spread to trade durably above 110bp until a solution is in sight.

0%

Our 10Y German yield forecast for year-end

would be at risk if NGeu's design was called into question

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com