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A big step forward in Europe

Deal on recovery fund makes the region more resilient economically

The recent EU leaders summit deal on the recovery fund will help make Europe more resilient to economic shocks and therefore reduce the risk premia attached to local asset markets. In particular, it should support Eurozone equity and bond markets, especially periphery bonds, as well as the euro. It marks another step forward in the European project and brings the Eurozone closer to an optimal currency area.

Source: Istocks

A deal at last

After a marathon four days and nights of intense negotiations, dubbed by some a "double-summit" (as it was only due to last two days), EU leaders finally agreed on a revised "Next Generation EU" recovery package on July 21 in the early morning.

Total spending maintained at EUR 750bn

The total amount to be disbursed over the next few years will remain at the originally planned EUR 750 bn (around 5.5% of EU GDP). However, the grant allocation has been reduced to EUR 390bn from the original Franco-German proposal of EUR 500bn and the loan amount has been increased from EUR 250bn to EUR 360bn.

In terms of the details, the core element of the package will be the "Recovery and Resilience Facility" that includes EUR 312.5bn of grants and 360bn of loans. These will be disbursed with a focus on promoting the transformation of the European economy towards improved environmental sustainability. Another focus will be accelerating the digitalisation of the European economy. The remaining allocation of grants will be via other programmes such as Invest EU, which will finance infrastructure projects across the region.

Momentum shifts in Euro`s favour versus the USD

Source: Bloomberg

The EU can borrow substantial amounts for the first time

The EU will be allowed to borrow on the international capital markets by issuing bonds in order to finance the EUR 750bn of loans and grants. The plan is for the EU to borrow over a long time period, with repayments continuing up to 2058. The EU will also be given extra revenue raising powers, beginning with an EU-wide tax on plastics in 2021, in order to pay back the interest and principal on these bonds issued over time. The spending of the fund will be front-loaded, with 70% spent (or at least committed) in 2021-22 and 30% in 2023.

Minimal conditionality

There will be some conditionality applied to the grants and loans but compared to previous rescue packages that have involved oversight from the IMF, such as the European Stability Mechanism (ESM), the conditionality seems relatively relaxed.

Countries will have to submit annual recovery and resilience plans to show how they intend to use the funds disbursed. EU leaders and the council of EU finance ministers will be given the right to vote down the plans or halt the disbursements through some form of qualified majority voting (the precise mechanism of how this will be decided is not yet clear at this stage).

Seven-year EU Budget also agreed

As well as agreeing on the recovery package, the summit also saw agreement on the EU budget for the next seven years, the multiannual financial framework (MFF) for 2021-2027, of around EUR 1tn of regular spending by the EU.

Next steps: parliamentary ratification

In terms of next steps, the deal needs to be ratified by the respective parliaments of all the EU members states and the European Parliament by the end of the year at the latest. While there are some risks, we expect that the required ratifications will take place, especially as countries with large Eurosceptic segments in their parliaments, such as the Netherlands, were given important concessions during the four days of negotiations. (For example, the Netherlands will keep a generous rebate on payments into the EU budget.)

The EU will have additional green revenue raising capabilities

As mentioned earlier, the EU will also be given additional revenue raising tools, which will also focus on promoting an environmentally sustainable economy. EU leaders agreed at the summit to introduce an EU-wide tax on non-recyclable plastic in 2021. In addition, leaders agreed to put in place more EU-wide green and digital taxes within the next few years, and to enhance an existing carbon emissions trading system to give the EU extra revenues.

Large green element to spending as well

What`s more, the EU leaders committed that 30% of the total expenditure of the bloc's EUR 750bn recovery package and EUR 1tn of the long-term budget will support the region's 2030 green targets, as well as the long-term goal of delivering a net-zero carbon economy by 2050. The 2030 green targets include 40% cuts in greenhouse gas emissions from 1990 levels, a 32% share for renewables in energy production and at least a 32.5% improvement in energy efficiency.

An important step forward in the European project

Overall, the deal is an important step forward for the EU and the Eurozone. In particular, it will help make the Eurozone more resilient to the current coronavirus induced recession as well as to future shocks, thereby reducing the actual and perceived risk of another Eurozone debt crisis.

Indeed, one of the most important steps forward was actually agreed before the summit, when Germany shifted its position at the Franco-German leaders meeting on May 18. German Chancellor Angela Merkel indicated that she would support the EU being allowed to borrow significant amounts of money for the first time, rather than relying simply on annual contributions from member countries to finance its spending. This is a partial mutualisation of government debts, which we regard as necessary to make the Eurozone more resilient economically.

Fiscal risk sharing

Sharing fiscal risks and burdens across countries should help insulate Eurozone sovereign bond markets from speculative attacks or a loss of confidence in a government's ability to repay its debt. In other words, it should make a repeat of the Eurozone debt crisis of 2010 to 2015 and/or a renewal of concerns of a Eurozone break-up less likely.

In addition, allocation of funds will be according to a key based on a calculation of economic variables such as population, GDP per capita, the unemployment rate and GDP growth in future years. In practise, this means that Southern and Central and Eastern European (CEE) countries will benefit disproportionately. This thereby provides a mechanism for a fiscal transfer from North Europe to Southern and Eastern Europe. In economic theory, fiscal transfers have been recognised as a necessary condition to make a region a so called 'optimal currency area' (i.e. a region where it makes economic sense to have just one currency). They allow for automatic stabilisers when a shock hits an economy or one area or sector in an economy.

Conclusions and asset market implications

In terms of the overall implications for asset markets, the agreed recovery package marks another important step forward in the construction of the European project. In particular, it brings the Eurozone institutional framework closer to that of an optimal currency area. It should therefore reduce the risk premia attached to Eurozone assets, especially the risk premia that may have existed because of the perceived tail risk of another Eurozone debt crisis emerging. Therefore, both the euro, and regional equity and bond markets should be supported by this development. Over time, we may even see a greater rotation towards Eurozone assets by international investors.

Periphery government bond markets should be well supported as countries such as Italy and Spain, which have substantial debt issuance needs in 2020 and 2021, will receive large amounts of grants from 2021 and will also be able apply for loans at more favourable rates of interest than if they were borrowing on a stand-alone basis. The ECB's commitment to buy EUR 1.35tn of securities (mainly Eurozone government bonds) by June 2021 is another important support for these markets.

However, core government bond yields may see some modest upward pressure, as richer countries such as Germany and France are effectively providing a fiscal transfer to other European countries.

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