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CIO Viewpoint

EU 'Next Gen' spending takes advantage of crisis to set precedent

Investment Solutions

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One of the impacts of the Covid crisis may be a lasting step towards closer European Union integration as the bloc invests in overhauling its infrastructure. The pandemic shock triggered an historic breakthrough in European fiscal cooperation with a mechanism for low-interest debt issuance, or debt mutualisation. That improves states' credit worthiness, and removes some of the euro currency's risks.

The Covid crisis started badly for the EU. As the crisis struck in March 2020, Italy was the first and hardest-hit European state. It imposed the first lockdowns and, faced with shortages of medical equipment, accepted supplies from Russia as shipments from its nearest neighbours were prioritised for national use. Those failures to provide support stoked criticisms of the EU's ability and willingness to coordinate in a crisis.

Criticisms of this lack of joint action faded when, on 21 July last year, the bloc agreed to a 'Next Generation EU' deal. The agreement provides EUR 750 billion in response to the Covid-19 crisis and the challenges of transitioning to zero-carbon economies. The package consists of EUR 360 bn in loans, EUR 312.5 bn in grants and another EUR 77.5 bn in other programmes and funds. The grants distributed to member states are subject to conditions: a minimum of 37% must be allocated to climate change and 20% to digitalisation infrastructure.

The biggest change in EU spending under the 2020 deal is in the loans. The European Commission can now issue low-interest debt on behalf of the 27 member states, backed by the European Central Bank.

Longer term that changes the financial function of the Commission by offering governments such as Italy access to lower borrowing rates. Prior to the pandemic, debt mutualisation through bonds issued in the name of the Commission was thought impossible. Since the July accord, the spread between Italian 10-year government bonds and the equivalent German bunds has reflected this, narrowing by 45 basis points to 1.2%.

Having set a precedent during the pandemic with the EU's 2020 deal, whether the loan and grant mechanism is ever used again depends on how well the spending is now implemented.

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Key takeaways

- EU member states have started submitting plans under the EUR 750 bn 'Next Gen' deal
- The post-pandemic rescue and investment package focuses on climate change and digital infrastructure
- The four largest EU economies - Germany, France, Italy and Spain - account for almost half of the budget
- The deal includes debt mutualisation, a significant step in fiscal cooperation in the bloc that improves the outlook for the euro.

International comparison

The budget is estimated to be worth as much as 5% of the EU's total gross domestic product. As the bloc's national vaccination programmes accelerate, we believe that the outlook for economic expansion across the region has increased and we have upgraded our expectations for eurozone GDP growth from 4.3% to 4.6% for 2021.

China, the UK and Switzerland are all spending a similar share of GDP on their respective recoveries (see chart). On the face of it, the EU stimulus is dwarfed by three US packages announced this year totalling USD 4 trillion in infrastructure, health and social support spending. However, a direct comparison overlooks that the US's need for public infrastructure investments and social safety nets are much higher than in the EU. Nor does the comparison take account of the EU's automatic budget stabilisers that balance the taxes and benefits available through economic cycles. Finally, in a direct comparison, the common European budget also excludes national spending on climate change. Nevertheless, the EU's package does not look ambitious enough to meet the bloc's commitments to cut 55% of carbon emissions by 2030, and reach its 2050 net-zero emissions target.

Big four budgets

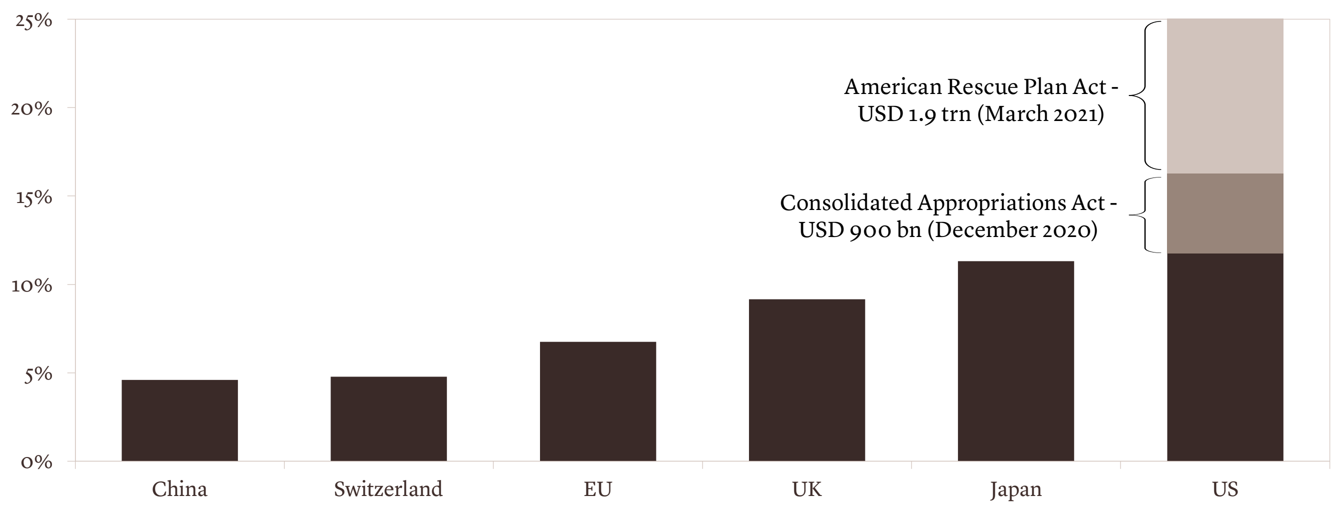
In April, member states began submitting their spending priorities to the European Commission. Taken together, the four largest EU members – Germany, France, Italy and Spain - will account for around 45%, or more than EUR 342 bn of the total budget. Disbursements are expected to start as early as mid this year.

Italy's planned spending is the largest. With total spending of EUR 205 bn, excluding a further EUR 30.6 bn in national funding, Italy is the only one of these four member states that plans to use the loan facility immediately. The worst Covid-affected EU state, Italy's economy reported a nearly 9% fall in GDP over 2020, compared with a 6.2% decline across the EU as a whole. It has suffered more than 123,000 deaths, the highest Covid mortality in the region after the UK.

In February, Italy appointed former ECB President Mario Draghi as a technocrat prime minister with the twin mandates of overseeing the country's vaccination programme and 'Next Generation' distribution. The government has estimated that the investments, which it values at EUR 261.1 bn in total or the equivalent of 15.1% of Italy's current GDP. That will provide a 3.6% lift to GDP within five years, the government says. In total, the investments and recovery spending through the crisis may increase government debt to as much as 160% of GDP, according to estimates.

Mr Draghi's spending plan underscores the economy's existing lag with its neighbours. In the two decades through 2019, Italy's GDP grew by only 7.9%, compared with 30.2% in Germany and 32.4% in France over the same period, says the plan. The country also recorded lower productivity, has invested less in its digital infrastructure and been slow to adopt technologies. In addition, says the government, Italy is especially vulnerable to climate-related change from rising sea levels, heat waves, drought and landslides.

Government spending in % of GDP



Sources: IMF, Bloomberg, Lombard Odier

Broad ambitions

Spain plans to spend EUR 70 bn in EU grants, leaving open the possibility of taking another EUR 70 bn in loans before 2026. The government's plan focuses on renewable energy and rail mobility, as well as healthcare and telecommunications investments. Of the budget, EUR 23 bn is earmarked to modernise and digitalise industries and support tourism while another fifth of its spending targets farming and rural depopulation.

France's 'Next Gen' spending plan, worth around EUR 40 bn, is also designed to integrate with wider reforms. The government plans to use half of the total EU grants on climate-related projects, including green hydrogen, lowering carbon emissions, retrofitting the energy network, modernising railways as well as spending on digital training, research and health. The French government is targeting improvements to economic growth, including through measures to accelerate reforms to its job market and unemployment benefits, pensions and housing policy.

Germany will spend 40% of its total EUR 28 bn focusing on climate policy and energy transition spending, including hydrogen infrastructure. Much of this spending on green infrastructure targets electric cars, including the charging network, buses and rail and EUR 15 bn goes to reinforcing digital infrastructure, singled out as particularly weak by research including the OECD, as well as 'digital education'.

Political urgency

There is some urgency to the spending. Political priorities over the coming 12 months in Germany and France, which have set the EU's agenda in recent years, will shift. In Germany, Chancellor Angela Merkel's successor will be elected in September. Armin Laschet became head of the Christian Democratic Union in January 2021, and is the Party's nominee for Chancellor. The risk there is not who will take over, as we expect some political continuity, but who is going to assume European leadership in the end. Without Mrs Merkel's support, French President Emmanuel Macron may struggle to drive the bloc's agenda.

In addition, a year from now, Mr Macron will stand for re-election for a second five-year term. His record on the Covid recovery is already the subject of debate. Next month, regional elections in France will give an indication of whether he will face a more serious challenge in 2022 from the far right's Marine Le Pen than five years ago. All of this may distract from broader EU questions.

The 'Next Gen' budget breakthrough was largely driven by Mrs Merkel and Mr Macron, and their finance ministers unveiled their national plans at a joint press conference on 27 April. Any evolution in this political partnership may create uncertainty for future projects including fiscal reforms, relations with China and the Biden administration, and tensions with Turkey.

Euro turning point

The Next Generation plan also marks a turning point for the euro. Risks of a euro area break up have haunted the common currency for the past decade. The July 2020 agreement on joint debt-issuance effectively put a floor under the euro/dollar exchange rate as it removes much of this break-up risk by increasing some states' credit worthiness. If effectively implemented, the spending's impact can also serve as a catalyst for future currency gains as the region attracts more portfolio and foreign investment flows. Successful implementation would also strengthen the case for deeper debt mutualisation across the EU, and in the long run, likely imply a higher equilibrium level for the exchange rate.

We continue to believe that European equities, especially in the energy and financial sectors, offer opportunities as the economic recovery takes hold.

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