SPOTLIGHT | DECEMBER 2021

RESHAPING THE EUROPEAN UNION

Key points

- The global pandemic has allowed the European Union to lay a new foundation upon which it can build to bring about greater integration in the years ahead.
- 2022 will present its first opportunity to confront those increasingly pressing fiscal questions which face the continent as Maastricht Treaty fiscal obligations are set to resume for member nations in 2023.
- While the continuing global pandemic could allow the EU simply to buy time and extend pandemic era fiscal accommodation, commitments under the 2015 Paris Accords combined with building stagflationary risks call for action to create a new fiscal landscape in 2022.
- Political compromises that create fiscal flexibility to support the investment in 21st century infrastructure and a technological foundation for the continent would help meet Europe's climate commitments and transform the EU fiscal process from an impediment to a catalyst for change in the eurozone.
- These reforms need not weaken the continent's commitment to ensuring the sustainability of its growing debt burden, especially in light of the pandemic-related spending of recent years. Indeed, a new fiscal framework is critical to help reverse the structural decline in potential economic growth in the decades to come.
- For investors, the next stage in the reshaping of the European Union should be most pronounced in its increasing leadership role in the new energy transformation on the continent as well as via beneficiaries from the EU Recovery Fund, like Italy seeking to lead its own transformation in the years ahead.

Global Investment Committee

UBP
Union Bancaire Privée

The global pandemic has laid the foundation for a new European Union

The European Union experienced a deep recession during the pandemic but also used it as an opportunity to demonstrate its ability to take strong, concerted action and to bounce back, all amidst the redrawing of Europe's economic and political landscape following the UK's departure.

Indeed, the global pandemic has laid the foundations for the eurozone in particular, to work in a new way, with the issuance of common debt and transfers between member-states. Although this collective action does not constitute a genuine fiscal union, it comes alongside national action and opens the way for further reforms. As a result, the euro area is at a turning point: if there is clear political will, then the principles of these actions could be redefined to see greater integration in the years ahead.

We expect European leaders to have the opportunity to demonstrate this political will in 2022 as they will need to confront important fiscal questions that lie ahead. It is worth remembering that to allow European governments to combat the pandemic effectively, Maastricht rules have been put on hold. However, compliance with fiscal discipline statutes and the European Commission's oversight are scheduled to resume in 2023.

Cyclically, with the global pandemic still ongoing, such a resumption would require countries to adopt excessive austerity and potentially derail the still fragile growth trajectory on the continent.

A new fiscal landscape is now required

More strategically, the return to the strict interpretation of the Maastricht rules might pre-empt the outcome of the European Commission's current strategic review of its own fiscal governance framework which is occurring as European governments face an entirely new landscape in which fiscal policy must be developed.

In particular, commitments under the Paris Climate Accords set not only environmental targets but also necessary expenditures for individual countries, leaving the historically rigid framework to set fiscal policy largely obsolete.

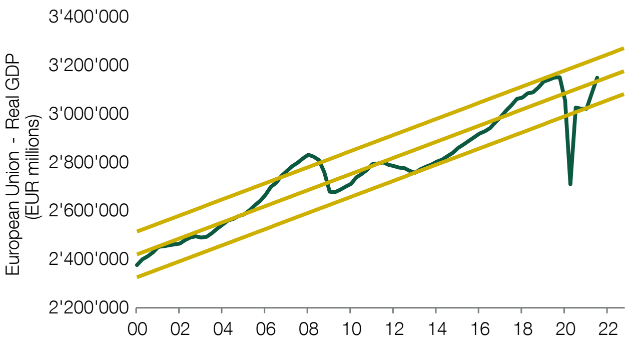
Beyond this, the low growth, low inflation economic backdrop of the past has given way to a new challenge facing European governments – higher inflation and the prospect of slowing post-pandemic growth, or stagflation.

Combined with the Stability and Growth Pact's complex rules, this means that the existing fiscal policy mechanism is increasingly pro-cyclical, making recessions worse while at the same time failing to restore surpluses when economies are growing strongly.

More importantly, as seen in the past decades, this framework has led to a reduction in public sector investment and in particular, an underinvestment in modern infrastructure and new technologies that leaves the continent lagging global rivals.

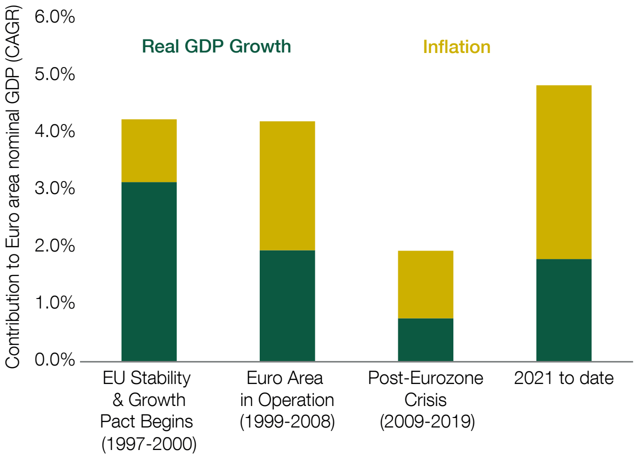
As a result, a compromise allowing a more flexible interpretation of the rules is a minimum requirement. Ideally, though, more clear-cut reforms should come as logical next steps in the wake of the Next Generation EU (NGEU) recovery fund to support the investment in 21st century infrastructure and a technological foundation for the continent.

EU GDP has rebounded back to above trend reaching near pre-pandemic peaks due to strong, concerted policy action…



Sources: Eurostat, Bloomberg Finance L.P. and UBP

…however, a new challenge lies ahead for EU governments following the pandemic era recovery: stagflation…



Sources: Eurostat, Bloomberg Finance L.P. and UBP

…without productivity enhancing investment to raise potential growth rates especially in the single currency area

Sources: Eurostat, Bloomberg Finance L.P. and UBP

Fortunately, 2022 will bring intense negotiations to redefine the framework of European fiscal policy. Work done by several European organisations has resulted in four themes for discussion, with a range of measures potentially emerging in the year ahead including:

1. A review of the criteria regarding deficits (3% of GDP) and debt (60% of GDP). These figures could be raised to take account of the current context, though this would involve the time-consuming amendment of European treaties.

2. Greater flexibility in assessing the deficit and debt criteria, and greater speed in making adjustments on a country-by-country basis. For example, by removing strategic investment from ordinary public spending when calculating the deficit, the rules could be loosened without restricting investment.

3. The NGEU fund could be turned into a permanent instrument. The aim would be to develop a European version of the IMF to provide a fiscal and monetary response with a customised medium-term convergence target, cyclical aid and the ability to respond to external shocks with its own, permanent resources, based on solidarity and transfers within the eurozone.

4. A greater role for the European Parliament in the budget process.

A combination of such changes will be important to emphasise the value of strategic public spending, as well as in transforming the fiscal process from an impediment to a catalyst for change in the eurozone.

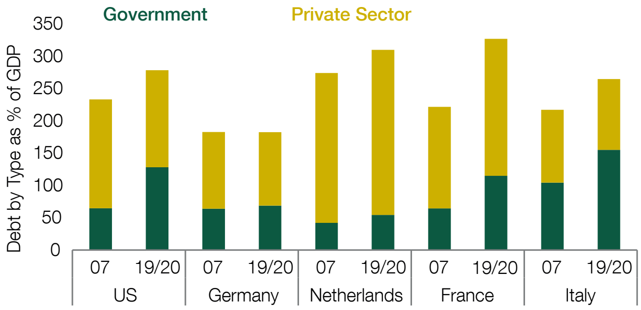
Moreover, as seen through the global pandemic era, such flexibility can bring resilience against external shocks and can help to facilitate the co-ordinated fiscal and monetary action that has helped Europe weather the storm of recent years.

Admittedly, all of these changes must be built upon the core foundation that exists today, that European debt and the debts of member states must remain sustainable in the eyes of both taxpayers and the markets.

Encouragingly, however, agreement and implementation of such a new approach have the potential to increase potential growth, end the decline in European productivity and allow the continent to overcome the challenge of its aging population, all crucial to ensuring both the sustainability of this debt as well as the transformation of the continent in the decade ahead.

With the Next Generation EU Recovery Fund and its Paris Accords climate commitments as the starting point for this re-shaping of the European Union, investors should focus on opportunities in Europe's growing leadership role in the global energy transformation combined with the immediate beneficiaries of the EU Recovery Fund investments as important anchors to their European allocations looking ahead.

Productivity-enhancing investment is key to ensure the sustainability of Europe's growing debt burden looking ahead



Sources: International Monetary Fund, Bloomberg Finance L.P. and UBP

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