Insight INVESTMENT

GLOBAL MACRO RESEARCH
THE RESURGENCE OF SOUTHERN EUROPE

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GLOBAL MACRO RESEARCH

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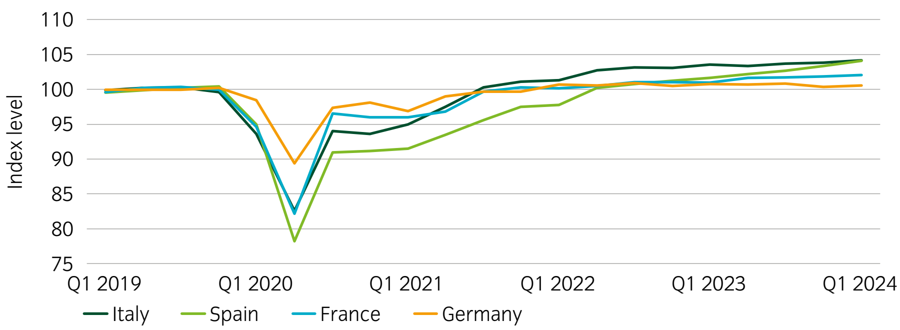
EXECUTIVE SUMMARY

- Southern European countries have grown more rapidly than expected, outperforming core European economies such as Germany. We believe this economic outperformance should continue for some years to come.
- Although the initial period of outperformance has been driven by short-term factors, there is significant investment and modernisation occurring in the background that should underpin a longer-term positive story. Key to this is the funding from the NextGenerationEU (NGEU) programme.
- Italy is the primary beneficiary of NGEU funds, with an allocation of €194.4bn. So far Italy has received just over €100bn of this allocation, with the rest to follow once key milestones have been achieved. Spain has so far received €38bn of its allocation. This should raise potential growth for both countries. Critically for Italy, higher growth could allow the country to slowly manage down its high debt/GDP.
- The ability to absorb such vast sums of money is one risk to the outlook. The number of companies able to execute the underlying projects is limited and there are time limits on when the money has to be spent. Ultimately, we believe politicians will find a way, as this is too good an opportunity to give up.
- In the long-term, the issuance of joint EU debt appears to have been a huge success. This should increase the resilience of the eurozone going forward and provides a framework for future joint initiatives.

SURPRISE GROWTH OUTPERFORMERS

It is hard to believe that many investors in 2019, knowing what would happen subsequently, would have picked Southern European countries as the growth winners for the years ahead. Few would have believed that these countries would have been able to weather such a rapid rise in interest rates, with the European Central Bank hiking from -0.5% to 4% in less than 18-months, without dire consequences. But that is exactly what has happened, with GDP in Spain and Italy outpacing core European countries such as France and Germany (see Figure 1).

Figure 1: Southern European GDP outperformance[1]

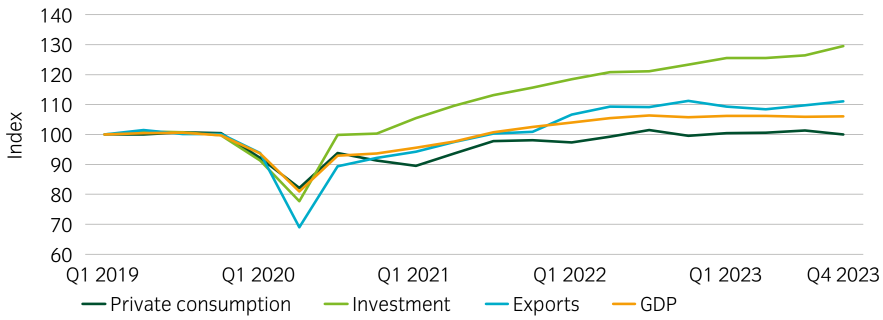


THE INITIAL PERIOD OF ECONOMIC OUTPERFORMANCE HAS BEEN DRIVEN BY SHORT-TERM FACTORS

In Italy growth has been driven by rising investment (see Figure 2), which has boomed following the introduction of the Superbonus 110 tax credit in 2020. This tax credit allowed the cost of home improvements to be deducted from income taxes over time, with up to 110% of the cost claimable for energy-efficiency-related improvements.

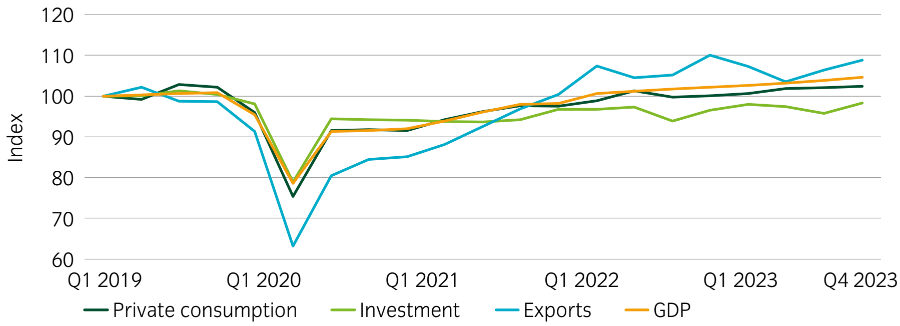
In Spain, growth has been driven by the service sector (see Figure 3), which has benefited from an unexpectedly high number of tourists. A marketing campaign by the Spanish tourism board has proved highly successful in capitalising on a post-pandemic return to foreign travel, and the number of overseas visitors grew by 19% in 2023, spending 24% more than in the prior year[2].

Figure 2: Italy – driven by investment[3]



[1] Source: Macrobond. Data as at 31 March 2024. GDP data indexed to 100 at end Q1 2019.
[2] Source: https://etias.com/articles/2023-spain-tourism-success-story
[3] Source: Macrobond. Data as at 31 March 2024.

Figure 3: Spain – driven by services[4]



Forward indicators suggest continued momentum

Forward-looking indicators such as manufacturing and service purchasing managers indices (PMIs) would suggest continued economic outperformance in Spain and Italy (see Figure 4 and 5). However, the boost from home improvements is likely to fade in Italy during 2024, with the taxable benefit declining to 70% from 1 January, before declining to 65% in 2025. The tax credit also became applicable only to condominiums, excluding houses.

In Spain, the boost from tourism appears more sustainable, with Spain and other Southern European countries set to benefit from the European Travel Information and Authorization System (ETIAS)[5] which launches in 2025. ETIAS is a visa-waiver system that will expedite travel for tourists from 60 countries, including the US.

Figure 4: Eurozone – manufacturing PMIs[6]

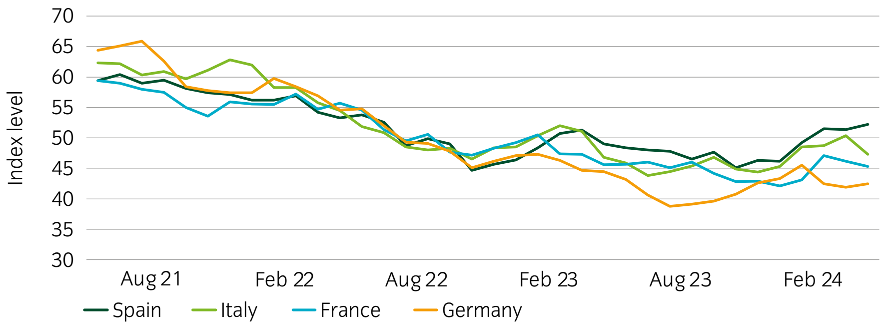
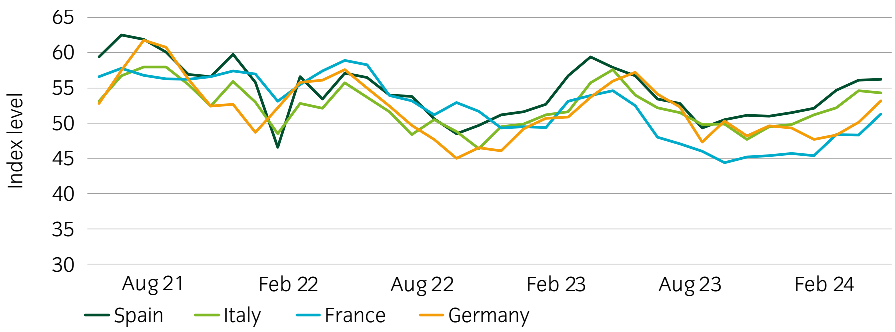


Figure 5: Eurozone – service PMIs[7]



[4] Source: Macrobond. Data as at 31 March 2024.
[5] Source: https://etias.com/what-is-etias
[6] Source: Macrobond. Data as at 30 April 2024.
[7] Source: Macrobond. Data as at 30 April 2024.

INVESTMENT IS KEY TO THE LONGER-TERM STORY

NGEU funding is benefiting Southern and peripheral European countries

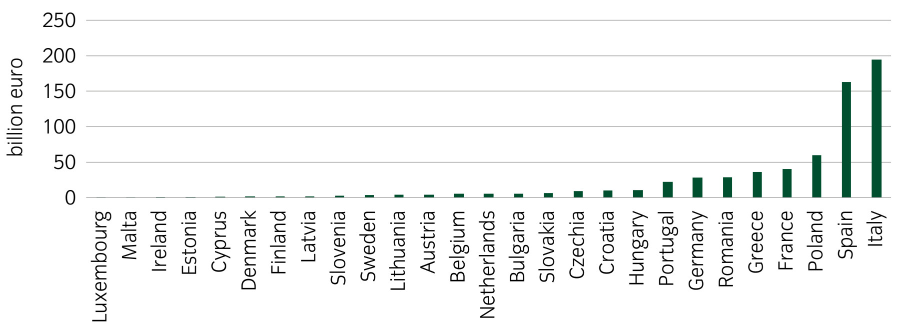
Adopted in December 2020, NGEU is an economic recovery package launched by the European Commission to help member states recover from the impact of the pandemic. The package provided funding of up to €750bn, financed by debt jointly guaranteed by EU member states, and operates until 2026. It includes loans and grants aimed at modernising the economies of EU member states for the next generation. This included enhancing education and skills, creating greener economies, and reforming common policies such as the Common Agricultural Policy.

In February 2024, the European Commission provided a mid-term evaluation[8] of the Recovery and Resilience Facility, the key instrument within the €750bn NGEU plan. The Commission found that, as a result of NGEU, public investment in the eurozone increased from 3% of GDP in 2019 to an estimated 3.3% in 2023, and it is expected to rise to 3.4% in 2024. The European Commission economic modelling suggests that NGEU has the potential to increase real GDP across the EU by 1.4% in 2026 relative to where GDP would have been had the programme not been implemented.

Italy and Spain have benefited the most from NGEU funding

Italian Prime Minister Giorgia Meloni, voted into office in October 2022, quickly embraced the Italian National Recovery and Resilience Plan (NRRP), which was drafted by the previous Mario Draghi-led government and approved by the European Commission in mid-2021. This provides Italy with €191.6bn in grants and loans from the NGEU instrument, making it the largest beneficiary of funding in nominal terms (see Figure 6), representing over 10% of Italian GDP[9]. These payments are made in tranches, and at the current fourth tranche of funding Italy has received just over €101bn, with Spain in second place, receiving over €38bn of its allocation.

Figure 6: Italy has been the primary beneficiary of NGEU funds[10]



Higher potential growth in Italy could fix a long-standing vulnerability

Italy has long been seen as a weak link within the eurozone, with high debt to GDP and low growth leaving the country in a debt trap from which it has been unable to escape. This has historically resulted in significant political instability, with the country lurching from one crisis to another. The tranche system of the NGEU has been designed to ensure that new tranches of funding are only approved once specified milestones within the country's recovery plan are implemented. This has ensured that progress is consistently made. To access the funding in entirety, Italy would need to meet 271 milestones and 346 targets[11].

[8] Source: https://ec.europa.eu/commission/presscorner/detail/en/ip_24_943
[9] Source: https://ec.europa.eu/commission/presscorner/detail/en/IP_22_5663
[10] Source: https://www.ngeutracker.org/
[11] Source: https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698847/EPRS_BRI(2021)698847_EN.pdf

This is already starting to have an impact.

In its 2024 Economics Survey[12], the OECD noted that "the plan with its mix of structural reforms and investment represents a major opportunity to reinvigorate growth and improve the prospects of public finances. Overall, the progress in the implementation of the plan thus far is assessed as significant, including on the basis of the adoption of ambitious reforms in the areas of public administration, civil justice and competition."

From a eurozone-wide perspective, if Italy is able to become a more resilient and competitive economy, it should be a key step to increase the resilience of the bloc as a whole.

The seven key missions of the NRRP[13] address specific areas of investment and reform that the Commission has identified as beneficial for long-term growth. The objectives of the missions, as laid out by the Commission are:

1. **Digitalisation, innovation, competitiveness, culture and tourism:** aims to strengthen the Italian public administration's administrative capacity at central and local levels, support the digital transformation and the innovation of the production system, and invest in the competitiveness and resilience of two key sectors for the Italian economy, namely the tourism industry and the creative and cultural sector.
2. **Green revolution and ecological transition:** seeks to increase the sustainability and resilience of the Italian economy, by supporting a fair and inclusive transition. Relevant measures relate to sustainable mobility, the production and use of renewable energy, energy efficiency of private and public buildings, the circular economy, and management of water and waste as well as hydrogeological risks.
3. **Infrastructures for sustainable mobility:** focuses on developing and reinforcing a high-speed rail network connecting all Italian regions, strengthening the regional network and improving the competitiveness and sustainability of Italian ports. Relevant initiatives should support modal shifts from road and air to rail, by improving rail capacity, connectivity and quality of service in key connections.
4. **Education and research:** aims to promote a knowledge-intensive, competitive and resilient economy, by strengthening the entire education and training system, enhancing digital and STEM (science, technology, engineering, and mathematics) skills, and supporting research activities and technology transfers.
5. **Inclusion and cohesion:** seeks to enhance employment opportunities, as well as social and territorial cohesion. Its measures are designed to facilitate participation in the labour market, strengthen active labour market policies and vocational training, support women's empowerment and foster social inclusion.
6. **Health:** seeks to strengthen prevention and health services in Italy, modernise and digitalise the healthcare system and ensure fair access to care, with a view to responding to the increasing demand for healthcare stemming from the country's demographic and epidemiological trends.
7. **REPowerEU:** focuses on accelerating the green transition, improving the regulatory framework that enables the rollout of renewable energy sources, and meeting immediate security of energy supply needs in line with REPowerEU[14] objectives.

[12] Source: https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-italy-2024_78add673-en
[13] Source: https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/698847/EPRS_BRI(2021)698847_EN.pdf
[14] REPowerEU is a European Commission proposal to end reliance on Russian fossil fuels before 2030 in response to the 2022 Russian invasion of Ukraine

CONCLUSION

In our view, although there are almost certain to be bumps along the way, the economic outlook for the two largest Southern European countries is on an improving trend. The NGEU programme was a significant and well designed experiment in EU-wide policy, and its full impact should become clearer over the longer term.

If Italy fully implements its recovery plan, then the investment and modernisation that occurs should slowly raise potential growth, allowing the country to emerge from the debt trap that has dominated Italian politics for decades. With growth in core economies such as Germany expected to continue to struggle, we could see an extended period of economic outperformance for Italy and Spain in the years ahead. Although an inability to absorb such a huge amount of investment is a risk, the governments of both countries are likely to do everything possible to ensure that funding is received.

Critically, the issuance of joint bonds, issued by the European Commission and underwritten by the 27 EU member states, has been a clear success in underpinning the NGEU project. This is an important step towards eurozone integration and sets a precedent for future projects. We believe this increases the resilience of the eurozone, and that over time there will be political pressure to deepen the pool of joint debt to fund specific projects, with a European defence force an obvious potential candidate.

CONTRIBUTORS

Hassiba Ait
Portfolio Management
Insight Investment

Simon Down
Co-Head of Investment Content
Insight Investment

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com

European Business Development
europe@insightinvestment.com

Consultant Relationship Management
consultantrelations@insightinvestment.com

North America Business Development
inquiries@insightinvestment.com

Australia Business Development
insightau@insightinvestment.com

company/insight-investment

www.insightinvestment.com

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