Insight INVESTMENT

GLOBAL MACRO RESEARCH
EU: INTEGRATION OR DISINTEGRATION?

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- In an attempt to repair the economic and social fallout from the pandemic, the European Commission, European Parliament and European Central Bank (ECB) have embarked on an ambitious recovery plan
- This contains elements of both common debt issuance and large-scale transfers, supported by €1.85 trillion of asset purchases from the ECB
- The plan contains very innovative instruments, and even though it is meant to be temporary, it could represent a step towards fiscal union within the eurozone – a step which could remove a perceived fragility for the region

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- The fiscal and monetary response to the pandemic has been significantly different to the policies enacted in the wake of the global financial crisis and eurozone crisis
- Furlough and job retention schemes have been adopted, and unemployment levels have been kept far below their previous peaks
- Politically, euroscepticism no longer appears to be such a vote winner, potentially paving the way for deeper reforms and integration

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- Attempts to implement a unified pan-European health strategy have reinforced perceptions that the EU is bureaucratic and slow to act
- This has exacerbated conflict around ‘rule of law’ rules and the ongoing dispute between Poland, Hungary and more affluent EU states
- Cohesion across the EU will need careful management to stop long-term fragmentation

CONCLUSION // 11

- Time will tell whether this was a one-off reaction to an unprecedented crisis, or the start of a deeper programme of integration, but by issuing a sizeable amount of joint debt, the EU is sending out a strong signal to the world and financial markets that they are ‘here to stay’

IN OUR VIEW, THE PANDEMIC APPEARS TO BE A POTENTIAL CATALYST FOR AN EFFECTIVE RELAUNCH OF THE EUROPEAN UNION (EU) – PROVIDING THE POLITICAL MOMENTUM TO REFORM AND ADDRESS HISTORICAL WEAKNESSES. THE EXPECTATION OF APPROXIMATELY €1 TRILLION IN EU BOND ISSUANCE OVER COMING YEARS IS A SIGNIFICANT STEP TOWARDS FISCAL UNION AND COULD BRING FEARS OF EURO BREAKUP TO AN END. HOWEVER, WE ALSO CAN'T IGNORE THE RISKS AND CHALLENGES THAT THE EU FACES. THE PANDEMIC RESPONSE HAS BEEN PERCEIVED AS DISJOINTED AND SLOW, WHILE INTERNAL CONFLICTS HAVE BEEN EXACERBATED BY ARGUMENTS AROUND ADHERENCE TO EU RULES.

AN AMBITIOUS RESPONSE TO THE CORONAVIRUS CRISIS

Although the EU has been broadly impacted by the COVID-19 crisis, the economic consequences have varied considerably between countries. As with previous crisis, Italy has once again found itself in the list of countries most impacted, limited in its fiscal response by its high debt burden. In contrast, German prudence in the pre-crisis period has allowed the country to launch a significant stimulus package, cushioning the economic damage it has faced.

In an attempt to repair the economic and social fallout from the pandemic, the European Commission, European Parliament and European Central Bank (ECB) have embarked on an ambitious recovery plan. This contains elements of both common debt issuance and large-scale transfers, supported by €1.85 trillion of asset purchases from the ECB.

The plan contains very innovative instruments, and even though it is meant to be temporary, it could represent a step towards fiscal union within the eurozone – a step which could remove a perceived fragility for the region.

RADICAL REFORMS PACKAGED WITHIN A RECORD FISCAL STIMULUS PACKAGE

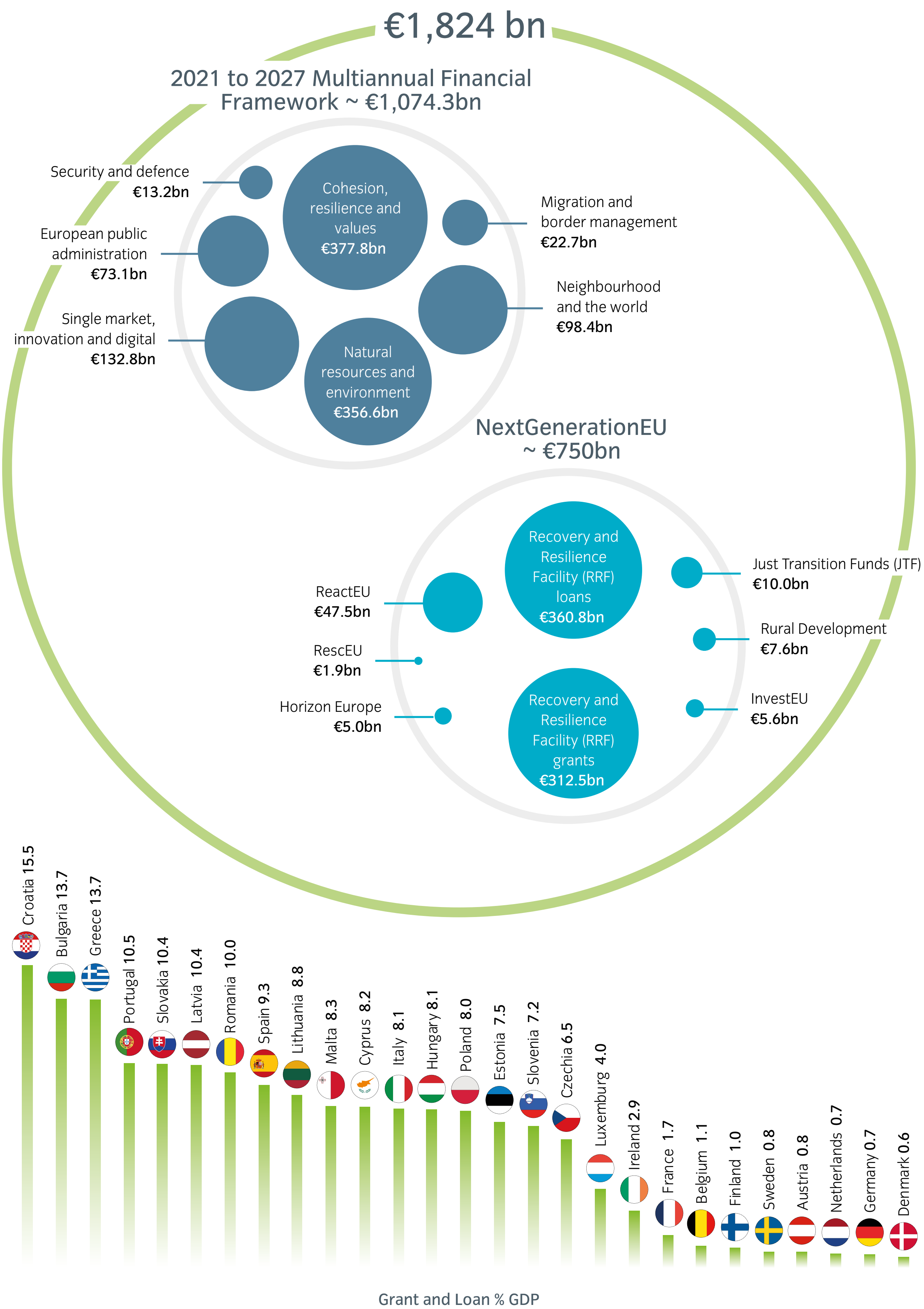
The European Parliament and EU Member States in the Council, with the support of the European Commission, have agreed a record €1.8 trillion stimulus package, financed through the EU budget. This combines €1.074 trillion in the long-term 2021 to 2027 budget with a temporary €750bn instrument – 'NextGenerationEU' (NGEU).

Figure 1: The 2021 to 2027 Multiannual Financial Framework[1]

	MFF	NextGenerationEU	TOTAL
1. Single market, innovation and digital	€132.8 billion	€10.6 billion	€143.4 billion
2. Cohesion, resilience and values	€377.8 billion	€721.9 billion	€1 099.7 billion
3. Natural resources and environment	€356.4 billion	€17.5 billion	€373.9 billion
4. Migration and border management	€22.7 billion	-	€22.7 billion
5. Security and defence	€13.2 billion	-	€13.2 billion
6. Neighbourhood and the world	€98.4 billion	-	€98.4 billion
7. European public administration	€73.1 billion	-	€73.1 billion
TOTAL	€1 074.3 billion	€750 billion	€1 824.3 billion

[1] Source: European Commission. All amounts in € billion, in constant 2018 prices.

Figure 2: An ambitious fiscal package to address the crisis[2]



[2] Source: European Commission. All amounts in € billion, in constant 2018 prices.

Critically, the stimulus package, and the way that NGEU will be financed, is heavily focused on addressing structural problems – in aggregate, more than 50% of the long-term budget and NGEU will support modernisation of the EU across a range of programmes:

- **Recovery and Resilience Facility**: €672.5bn in loans and grants to support reforms and investment in individual member states.
- **Horizon Europe**: A €5bn, seven-year EU scientific research initiative that will replace the Horizon 2020 programme and aim to increase EU science spending by 50% over the 2021 to 2027 period.
- **Just Transition Fund**: €10bn to support economic diversification within countries most impacted by climate change
- **Digital Europe Programme**: Will support a digital transformation within the EU, investing in supercomputing, artificial intelligence, cybersecurity and a range of other areas designed to improve digital competitiveness.
- **RescEU**: A €1.9bn programme designed to strengthen EU disaster response capabilities including the stockpiling of medical supplies
- **EU4Health**: A new EU health programme to strengthen health systems, improve medicine affordability and improve EU preparedness for future cross border health threats

Traditional policies such as cohesion and the common agricultural policy will also be modernised with the objective of supporting the green and digital transitions.

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FINANCED BY NEW EU BONDS

To finance the NGEU, the EU will borrow in the markets using EU bond issuance, which can generally be done at more favourable rates than issuance by individual member states. This could be a significant step towards fiscal union within the eurozone – potentially removing a problematic fragility for the region.

> **EU bond issuance**[3]
>
> The EU is expected to significantly increase its direct debt issuance over the coming years, taking total direct EU issuance to around €1 trillion. EU bonds are issued exclusively in euros, with a maturity range of 3 to 30 years. EU bonds rely on a Council regulation which allows the EU to draw on member state funds beyond their annual budget contributions to repay debt. EU bond issuance is expected to ramp up in the second half of 2021, but the size and speed of issuance tied to grants and loans is not known at this time.

BACKED BY SIGNIFICANT CENTRAL BANK SUPPORT

Reinforcing the fiscal package, the ECB has put in place a set of monetary policy and banking supervision measures to mitigate the impact of the coronavirus pandemic on the eurozone economy:

- The ECB have signalled their expectation that interest rates will remain at their present level[4] (0% for the main refinancing operations, 0.25% for the marginal lending facility and -0.50% for the deposit facility) or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2 per cent within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.
- The €1,850 billion pandemic emergency purchase programme (PEPP) was put in place to purchase both government and corporate debt and will continue until at least March 2022, with maturing principal payments reinvested until at least the end of 2023.
- Supporting access to credit for firms and households: the ECB has increased the amount of money that banks can borrow from and made it easier for them to borrow specifically to make loans to those hardest-hit by the spread of the virus, including small and medium-sized firms by easing collateral standards.

LONGER-TERM, FINANCING WILL COME FROM NEW CENTRALISED REVENUE STREAMS

To increase financial resilience and reduce the amount of financing that each country has to provide based on their GDP levels, new centralised revenue streams will be sourced:

- a new national contribution based on non-recycled plastic packaging waste was introduced in January 2021

The Commission will put forward proposals by June 2021 on sources of revenue linked to:

- a carbon border adjustment mechanism
- a digital levy the EU Emissions Trading System

By June 2024, the Commission will propose further sources of revenue, such as:

- Financial Transaction Tax
- financial contribution linked to the corporate sector
- a new common corporate tax base

[3] https://ec.europa.eu/info/strategy/eu-budget/eu-borrower/investor-relations_en#investor-presentation
[4] https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

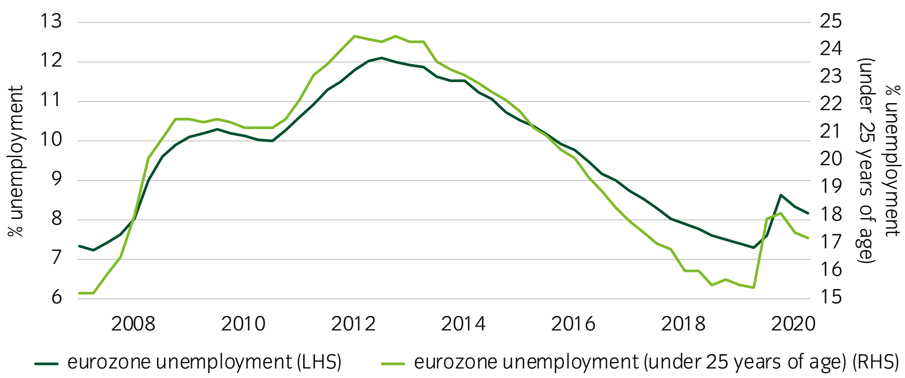
DEEPER INTEGRATION IS NO LONGER SO POLITICALLY DIVISIVE

LESSONS HAVE BEEN LEARNED FROM PREVIOUS CRISES

The fiscal and monetary response to the pandemic has been significantly different to the policies enacted in the wake of the global financial crisis and eurozone crisis. Austerity caused soaring unemployment across the continent, particularly amongst young people and disaffected workers were driven to populist politicians, exacerbating the divide between Northern and Southern Europe.

With politicians learning from past mistakes, austerity has been noticeably absent in the COVID-19 response. Instead, furlough and job retention schemes have been adopted, and unemployment levels have been kept far below their previous peaks. HSBC estimate that without short-term employment schemes, eurozone unemployment would have risen from around 8% to 13% by Q1 2021.

Figure 3: Eurozone, unemployment (SA)[5]



Consumption has also been significantly stronger, led by Germany which abandoned its policy of balanced budgets and suspended its debt brake. The IMF estimates that the German government enacted $316bn (8.3% of GDP) extra spending with additional liquidity support of $1.2trn (30.3% of GDP) in its relief package. France also increased it's spending by €300bn (13.8% of GDP) with €350bn (14.2% of GDP) in liquidity guarantees and the EU suspended members' Stability and Growth Pact obligations.

[5] Source: Insight and Bloomberg. Data as at 31 March 2021.

POLITICALLY, EUROSCEPTICISM NO LONGER APPEARS TO BE SUCH A VOTE WINNER

In Italy, the populist, anti-immigrant, anti-EU Lega party has suffered falling approval ratings since it was in government in 2019. Matteo Salvini's pledge in 2021 to support Mario Draghi's technocratic government could indicate that Lega is shifting away from its Eurosceptic past and moving into the mainstream – with speculation that it could even join the European People's Party, a broad organisation of centre-right parties.

In France, Marine Le Pen's Rassemblement National moved away from its hard-line Eurosceptic message in 2019, dropping calls for France to exit the EU as Brexit, and the difficulties faced by the UK in their negotiations, reduced the appeal to French voters. Although she is leading the polls for the 2022 presidential election, it is also unlikely that Le Pen will win the 2022 Presidential election as voters coalesce against her in the run-off stage.

In Germany, the AfD's polling numbers have remained low and stagnant ahead of the election in the autumn. The ruling CDUs handling of the pandemic is no longer being positively perceived and support has shifted to the pro-EU Green party.

POTENTIALLY PAVING THE WAY FOR DEEPER REFORMS AND INTEGRATION

A recent paper from Blesse et al. (2020)[6] on the future of the European project analyses the appetite for reforms in the bloc at the national parliament level for France, Germany and Italy. In general, French and Italian centrists share similar policy preferences, whereas in Germany there is moderate opposition to further integration. Also evident is the fragmentation of populist policy aims – Germany's AfD hold stronger Eurosceptic viewpoints than their populist counterparts in Italy.

The research also finds that party allegiance influences policy objectives more than nationality, meaning that the makeup of individual national parliaments drives the bloc's policy direction. As such, the elevation of Draghi, the former ECB President, to Italian Prime Minister is a boon for pro-Europeans as he is deeply committed to further integration and will add impetus to enacting reforms. Outlining his policy priorities, Draghi stated that "supporting this government means sharing the view that the decision on the euro is irreversible, sharing the vision of an increasingly integrated European Union, moving towards a common budget capable of supporting countries in times of recession". The desire for increased European integration is shared too by France's Macron; the two leaders may well work together to build on this common ground and shape the direction of fiscal and governance policy in Europe.

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It is also unlikely that Le Pen will win the 2022 Presidential election as voters coalesce against her in the run-off stage.

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[6] https://voxeu.org/article/next-steps-european-project

BUT PRESSURE FOR DISINTEGRATION HAS NOT ENTIRELY DISAPPEARED

THE PANDEMIC RESPONSE HAS NOT BEEN COHERENT

Although the EU fiscal response via NGEU is arguably a path towards deeper integration, the bloc's wider COVID response has not been as coherent. There have been attempts to implement a unified pan-European health strategy: early in the pandemic, the Joint Procurement Agreement ensured member states were able to access vital PPE supplies as the first wave spread throughout the continent. In a similar vein, the European Commission created strategic stockpiles of key medical equipment which members could access at 90% discounts under the rescEU initiative. More recently, the European Commission announced the creation of the European Health Union, an effort to coordinate the COVID-19 exit strategy and to install a robust framework for responding to future pandemics and public health emergencies.

In spite of this, there has been no EU-wide pandemic containment policy, with member states taking markedly different tacks in suppressing the virus. Stringent lockdowns during spring 2020 in Italy, Spain and France contrasted with a more liberal approach in Sweden. The EU's vaccine acquisition strategy has also been heavily criticised – and supply contracts with major pharmaceutical firms agreed months after the UK, reinforcing perceptions that the EU is bureaucratic and slow to act.

CONFLICT AROUND THE 'RULE OF LAW' FRAMEWORK HAS IF ANYTHING BEEN EXACERBATED

When EU countries struck the deal on the MFF and the recovery fund in July 2020, some member states such as Poland and Hungary wanted to avoid any conditionality regarding 'rule of law' breaches and threatened to veto the deal unless their demands were met. From 1 January 2021, when a member state is in breach of EU rules (rule of law), it can be excluded from accessing EU funds.

The European Commission has worked on establishing an effective framework to promote, strengthen and protect the rule of law in the EU in recent years. This framework is designed to protect the fundamental values of the European Union (as stated in Article 2 of the EU Treaty) and in particular issues such as the independence of the press and judiciary system.

An investigation under the rule-of-law framework started against Poland in January 2016 and led to the European Commission initiating the Article 7 procedure[7] against it on 20 December 2017. An Article 7 procedure against Hungary was initiated by the EU Parliament on 12 September 2018. However, both processes are still under way, as sanctioning requires unanimous support by EU members – and Hungary and Poland have effectively prevented the other one being sanctioned.

Under a new mechanism proposed by the European Commission, decisions on rule of law issues would be made by qualified majority vote – removing the ability of individual states to veto and giving the European Commission much stronger powers than it currently enjoys. The ongoing dispute between the European Commission and Hungary and Poland could ultimately result in two of the largest recipients of EU funds being cut off from funding, with consequent political fallout.

[7] Article 7 of the Treaty on European Union allows the suspension of certain rights from a member state.

EU COHESION WILL REQUIRE ATTENTION

The level of cohesion varies across the EU – and where cohesion is weak, there are a wide range of underlying reasons. These will need to be carefully managed to stop long-term fragmentation:

- **The southern challenge**: Countries such as Spain, Greece, and Italy – as well as Bulgaria, Romania, and Croatia – have been among the worst affected by the crisis in economic terms. Given their pre-existing economic vulnerabilities, they are at particular risk of stagnation, rising unemployment, and diverging further from wealthier member states. This could lead to growing frustration among their populations, and scepticism about the EU project – unless they feel that the EU has responded to the crisis effectively and with solidarity.
- **The northern challenge**: Countries like Austria, Denmark, Finland, the Netherlands, and Sweden – possibly also Germany – could lose patience with less affluent member states, seeing them as constantly needing bailouts, or suffering from corruption and weak rule of law. Having sustained less economic damage from the crisis, and enjoying stronger economic performance overall, they might struggle to understand the perspectives of other countries. All this could lead to the northerners growing more detached from the EU project – unless the other member states can prove their concerns wrong.
- **The central European challenge**: The crisis has weakened not just national economies and European solidarity, but democracy, human rights, and the rule of law within certain member states. In some countries in the region – especially Hungary and Poland – values such as judicial independence and protection of minorities are under greater strain, while media pluralism has suffered. This does not necessarily make these societies less attached to Europe: on the contrary, they score higher than average on this metric. However, if these problems are not addressed – for instance, if the EU is sluggish or ineffective on the defence of the rule of law – it could become a major problem for these countries' cohesion with the rest of the EU. It could also further damage the region's image in the bloc. Not all countries in central Europe are suffering from a deterioration in the rule of law, and some – like Slovakia and Romania – have strongly supported the new budget's rule of law conditions. But the entire region could suffer if the EU's more affluent member states, annoyed with rule of law problems in central Europe, approach the region with a growing reserve. It could also give rise to new resentments among societies of central Europe, particularly if they feel unjustly punished, stigmatised, or abandoned by the rest of the EU.

CONCLUSION

The pandemic has led to the introduction of new and important tools at an aggregate EU level to fight the common emergency and support the countries that are hit hardest by the crisis. While it's true that these tools are only temporary, the scale of the crisis has overcome reluctance within some member states to implement common instruments such as joint debt or EU unemployment benefits.

In our view the EU's response has both improved its image and strengthened public trust. COVID-19 has revived Franco-German cooperation, which had been languishing, and which used to be seen as the locomotive of European growth. Eurosceptic populists have also had a bad epidemic. Migration, their core issue, is no longer a primary issue for many voters, as arrivals have fallen because of the crisis. Anti-EU populists have been left trying to reposition as opponents of COVID-19 restrictions, with little success.

This also suggests that the political support for deepening European integration in the long-term might be easier to build via the creation of truly European fiscal institutions. However, as the debate on the EU own tax shows, European countries are still very far from comprehensive agreement on this solution.

We also acknowledge the risks and the challenges outlined in this paper, including the risk of more frugal Northern European countries blocking future integration as the immediate crisis dissipates and Hungary and Poland's fierce opposition of rule-of-law-conditionality.

Time will tell whether this was a one-off reaction to an unprecedented crisis, or the start of a deeper programme of integration, but by issuing a sizeable amount of joint debt, the EU is sending out a strong signal to the world and financial markets that they are 'here to stay'.

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