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The EU Recovery Fund: Maybe not Hamilton, but hopefully a quiet summer on the beach

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The EU Recovery Fund is an imperfect compromise towards a more powerful central fiscal mechanism in the EU. While it would be misleading to see it as large-scale fiscal federalism, it creates the framework, and precedent, for substantial fiscal transfers. Investors are correct in seeing this as reducing euro sovereign credit risk. Along with substantial support from the ECB, we expect the Fund to help euro sovereign spreads test their tightest levels year to date.

The EU Recovery Fund: what was agreed

After a marathon negotiation session over the weekend, the EU Council reached a comprehensive deal on the EU Recovery Fund as well as the EU budget (MFF) for the next 7 years. Both are important but there was understandably more focus on the Recovery Fund given it is an innovation and was a source of contention leading up to the summit. On the Recovery Fund, the agreement was for:

- A EUR 750bn package, made up of EUR 390bn in grants and the rest in loans
- Funds to be allocated on the basis of the expected growth reduction from the COVID epidemic
- An emergency brake was introduced (to appease the "frugal" states), which means fund disbursements can be stopped if there are concerns about how they are being used
- The funds are to be disbursed through the course of 2021 and 2022, with the grants funded through a series of new taxes (on plastic, carbon taxes, a digital levy, etc.)

So how important is this?

Optimists hail the deal as a “game changer”, a “Hamiltonian moment” at which the EU has moved to a federal fiscal system in which there is now a strong central fiscal capability which can respond to economic shocks to the EU, strengthening EU unity and reducing the sovereign credit risk of individual member states. Others are not so positive, pointing out that the resistance from some member states to the proposals hardly looks like the desire for greater unity, that the planned EU plan doesn’t significantly shift the fiscal burden away from individual states and the agreement is a compromise to keep the EU project alive rather than a visionary project to reform it and take it forward. We think the truth is somewhere in between.

This is what the EU does

The reality is that significant moves towards greater EU integration have tended to come haltingly, in response to crises, through long and tedious negotiations, and always with someone in the room objecting. Negotiating through the night, at multiple summits, is what the EU does, but once a new precedent has been set, it rarely seems to be reversed. For example, support mechanisms, bail-out facilities and the greater ECB powers created in response to the 2010-12 euro sovereign crisis have become standard tools for the EU. There is a warning here as well, though: while the previous crisis did lead to significant changes, not all the reforms advocated for strengthening the euro have been implemented. In particular, the banking union remains unfinished business, with the impetus for reform fading once the crisis eases.

Nonetheless, the Recovery Fund not only sets the precedent for large scale fiscal transfers, it has also created the architecture for a fiscal federal system. Even if this was not the intention of the agreement, EU policymakers will now find some bright new tools in their toolbox, in particular the ability to issue joint and several bonds on a large scale to fund fiscal expenditure. The temptation will be to use it more often. The creation of large EU grants and loans will inevitably bind members closer together, as weaker states will have more positive incentives to remain in the union, and stronger countries will not want to see them leave (if that means they default on their obligations).

Why, and how much, does this matter for financial markets?

The announcement this week had only modest impact on government bond yields, but that’s because the agreement was broadly in line with previous proposals, so had largely already been discounted by investors. Nonetheless, it has helped contribute to a generally tighter credit spread environment, which has primarily been driven by the scale and aggression of the ECB’s QE programme (and also more recently by better than expected economic data).

The elephant in the room

The reason for this is it helps answer the question that has been the elephant in the room for European fixed income investors for the last 8-10 years: when the next recession hits, will the fiscally weakest members of the Eurozone be able to carry on funding their deficits in the market at affordable interest rates? Will investors be prepared to carry on buying a country’s bonds if its debt/GDP rises above 150% and its economic outlook is challenged? Especially if the member state is a large one, the economic and financial disruption from a sovereign credit event would be so severe that one would anticipate the rest of the EU would be prepared to provide support, but, as we witnessed with previous crises, the EU can be slow in providing a compelling response.

Even if the purpose of this week's agreement is not to provide large-scale fiscal transfers between member states on an ongoing basis (which it most certainly wasn't), the market sees the EU Recovery Fund as setting a precedent for providing fiscal support to members who would otherwise experience fiscal stress. As currently agreed, it does not transform the funding position of any sovereign, but on the margin is still helpful.

What we expect

While most euro sovereign credit spreads are close to where they were at the beginning of the year, completely reversing the widening seen in March at the peak of the market stress, we do not think this compression is unwarranted. The combination of very accommodative monetary policy, along with the potential for far more EU-wide fiscal support, justifies the market's pricing of reduced sovereign credit risk. If anything, over the coming summer months, when sovereign bond issuance tends to dry up, we expect to see spreads to fall further to at least the tightest levels seen this year. Declining government credit risk should also help euro corporate bond spreads tighten due to the decline in systemic risk.

Our hope is that proactive monetary and fiscal policies, along with an effective public health response to COVID-19, will allow Europeans to enjoy a peaceful summer on the beach.

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