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European Stimulus Delivers Vital Injection to Eurozone Growth

Following one of the longest EU summits in history, this week European leaders finally agreed on an unprecedented stimulus package worth €750 billion to finance the economic recovery from the coronavirus crisis, leading expectations that the Eurozone economy will return to pre-crisis levels by late 2021. The plan will see the European Commission issuing new debt in capital markets and then distributing the proceeds to governments through the next EU budget for the 2021-2027 period, with repayment of the new debt set well into the future. The program is expected to provide a meaningful cyclical boost to the recovery and reduce the economic damage from the pandemic, particularly for some of the countries hardest hit.

Historic Stimulus

The stimulus package was agreed in the early hours of Tuesday after more than four days of acrimonious negotiations, representing a victory for German Chancellor Merkel and French President Macron, who initially outlined the proposal in May. The emergency fund plans to give out €390 billion in grants and €360 billion in low cost loans in a bid to pull European economies out of the worst recession in memory and tighten the financial bonds among the EU-27.

The emergency funds will not only unleash vital financial support to economies worst hit by the virus, but serve as a validation that the bloc can offer meaningful solidarity to members in need. While the size of the fund is not large enough to be a game changer from a macroeconomic perspective, common issuance of this magnitude of debt is a historic step for Europe and represents a pivotal change in the way the EU tackles crises. Even as a one-off measure, it sets a precedent towards eventual much needed further fiscal integration.

Resistance to the Deal

While all agreed that stimulus was needed to support the ailing Eurozone economy, EU leaders faced challenges in getting the deal passed all 27 members. The proposal faced strong resistance from some EU countries, with the proportion of grants ultimately included in the plan much smaller than initially proposed, which will limit the benefit of the program for highly indebted countries. The resistance came from the so-called "frugal four" group of countries (Austria, the Netherlands, Denmark and Sweden), and resulted in plans for grants being lowered from the initial €500 billion proposed to €390 billion. Until recently, these countries were radically opposed to the inclusion of transfers within the recovery plan, so the final compromise can be considered a success given that the risk of a no deal was substantial and would have represented a major blow for markets and sentiment on the continent. The total size of the fund amounts to around 6% of the EUs predicted GDP in 2020, or 0.8% per year if evenly distributed.

A Combined Approach

The stimulus protects against the damage that a renewed crisis of confidence in the Euro could inflict across weaker members, and provides a fiscal reinforcement to the European Central Bank's efforts to shore up growth. The EU's improved monetary and fiscal response to this crisis is now much stronger than in previous

emergencies, confirming our view that further gradual integration rather than disintegration remains the more likely path forward for the bloc.

The macroeconomic impact is expected to be significant, however member states will still need to provide the bulk of the fiscal response to the pandemic and will need to follow the recommendations laid out in the European semester to receive the funds. These requirements will be strict and actively monitored by the EC.

Italy, the original European epicentre of the pandemic, will likely be the biggest beneficiary from the plan, and expects to receive about €82 billion in grants and €127 billion in loans according to initial estimates. Greece is also set to receive €19 billion in grants and €12.5 billion in loans, reinforcing the weaker economies within the bloc. Following efforts to get the deal across the line, the final compromise also included budget rebates for some fiscally hawkish northern countries, reducing Denmark, Germany, the Netherlands, Austria and Sweden's net contributions by more than €50 billion over the next seven years. The money will need to be repaid by the end of 2058 and will come out of the EU's budget, meaning countries that contribute more, like Germany, will be shouldering more of the financial burden

Potential Risks

While the approval of the plan represents a substantial boost to the Eurozone outlook, there are several caveats and risks worth highlighting. First, the approval process is likely to be lengthy and is unexpected to be completed until Q4 2020. This means that the disbursement of funds will not take place until next year, and that any meaningful fiscal boost is unlikely to materialise until 20201. Also, there is the risk of premature fiscal tightening in 2021. As funds are being disbursed, national governments may be tempted to hold back their national fiscal plans in upcoming budgets given that the recovery is materialising now while the EU funds are forthcoming. If this risk materialises, the early stages of the recovery could be weakened, putting pressure on the ECB to step up its response even further.

Additionally, the inclusion of the recovery fund within the broader EU budget means that it will require ratification from the EU parliament, and some MEPs have already expressed disagreement with the plan. That being said, a veto from the EU parliament remains unlikely at the moment.

Market Reaction

Financial markets in Europe rallied on the announcement of the stimulus package on hopes that the funds will boost the Eurozone growth outlook and speed up the recovery in the region. Italian bonds climbed on the deal, with the 10-year yield over Germany, a key gauge of risk in the region dropping as low as 151 basis points, the lowest level since February. The stimulus could take many months to start arriving in the continent's worst affected economies, however the assurance it shows to investors on the EU's common resolve is already aid in itself.

Our Outlook

Following an initially underwhelming response, Europe has now produced a fiscal and monetary response to the pandemic that exceeds most earlier expectations, and which represents a material improvement compared to previous crises. As a result, European equities are expected to rally in the coming months after lagging the recovery in comparison to other regions.