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What is the outlook for Europe following the pandemic and Brexit?

| Kamran Moghadam |

As has been the experience since WWII, Europe has tended to grow stronger and more integrated following successive crises. Today, despite or perhaps as a result of the twin shocks of COVID-19 and Brexit, European integration is accelerating. This is evident in the nascent steps taken towards fiscal mutualisation as part of the pandemic response. Experts suggest Brexit will result in a 4-5% cumulative contraction in potential output in the UK over the next 10-15 years (-0.30% to -0.40% per annum), particularly if its large services sector is constrained in trading with the EU. The direct impact to the EU will be more benign but not costless, as the UK leaving is equivalent to 17% of it's GDP walking out of the door. The EU is also losing a leading free-market advocate.

On the political front, European populist parties have either ceded support or have shifted their policies closer to the centre. The risks from upcoming European elections appear relatively mild despite the departure later this year of Angela Merkel as Europe's longest-serving leader. Progress on structural reforms has naturally stalled as pandemic support has taken priority. Such reforms may now be more palatable given that they will be accompanied by significant fiscal stimulus, particularly in Italy with Mario Draghi as the new prime minister. In light of the above developments, the IMF forecasts that the Eurozone will grow at 4.2% in 2021 and 3.6% in 2022. Private-sector (e.g., bank economists) forecasts point to an additional percent higher growth each year. The key risks to this outlook, aside from the trajectory of the pandemic, are the timely and effective release of recovery funds, a decision on the permanent relaxation of fiscal spending limits and political stability across the region.

What progress has there been on fiscal integration?

The pandemic has nudged Europe closer to fiscal integration with the creation of the European Fiscal Recovery Fund (EFRF) and the suspension of the European Stability and Growth Pact. While these are positive developments, they are small steps towards fiscal integration. Ultimately, it may take another crisis to see more substantial progress towards EU fiscal integration.

Europe has been in crisis for much of the past decade, mostly related to the aftershocks of the Euro sovereign debt crisis. The Achilles heel of monetary union design has been that it did not incorporate fiscal unity. The budgetary rules, the Stability and Growth Pact, were meant to promote fiscal prudence and were tailored for Germany who had just implemented major labour market reforms. They gave little consideration to the counter-cyclical crisis spending that might be necessary for countries that had yet to adopt such reforms.

The lack of fiscal unity has meant that the transmission of monetary policy has not been effective in the Eurozone, particularly in times of crisis. German bond yields have fully reflected the ECB's monetary policy, but peripheral bonds have always carried a risk premium. Figure 1 shows that the resolution of each crisis has led to some, at least temporary, erosion of this risk premium. The introduction of quantitative easing in 2015 effectively provided some mutualisation on an implicit basis via the Target II balance system. The PEPP (Pandemic Emergency Purchase Programme) announced in March 2020 went further by softening the asset purchase rules around the capital key (i.e., strictly in proportion to each country's GDP), creating the prospect of fiscal transfers. Fiscal segregation has, however, meant that debt mutualisation remained implicit rather than explicit.

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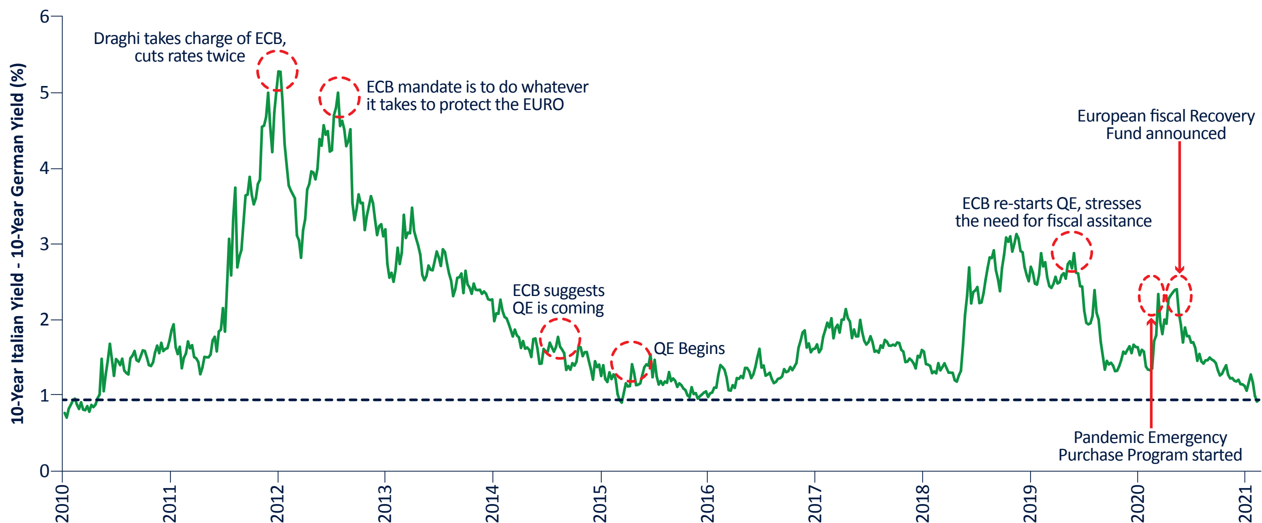
Figure 1: The instability of the 10-yr Italy/Germany government bond (BTP/Bund) yield spread shows that fiscal segregation has made effective transmission of monetary policy difficult to sustain.



Source: Bloomberg

That was until the announcement of the European Fiscal Recovery Fund.

The pandemic arrived at a moment of introspection for Europe. Its traditional allies, the UK and the US, had drifted towards more isolationist policies while years of fiscal austerity had only led to more fractious relations between Eurozone countries and the rise of extremist anti-establishment parties. There had been a growing acknowledgment, even prior to the pandemic, that co-ordinated fiscal policy was the way forward and the pandemic catalysed this into action. In July 2020, the European Council agreed upon the European Fiscal Recovery Fund (Next Generation EU), a €750B support package[1] to help member countries recover from the exogenous economic shock of the pandemic. The European Commission estimates that the recovery fund has the potential to deliver 2% incremental cumulative GDP growth between 2021 and 2024 and to create 2 million jobs if implemented effectively.[2] Vitor Constancio, the former vice president of the ECB, stated the fund establishes three key principles. Firstly, it establishes a mechanism for the co-issuance of debt which makes a degree of debt mutualisation explicit. Secondly, the proceeds from the issuance will not be distributed in line with the capital key but rather as a function of spending requirements, thereby making fiscal transfers from richer countries such as Germany to peripheral countries an explicit policy tool. Finally, it has occurred in response to a crisis which sets a precedent for its use as a policy tool. The instrument was approved as part of the 2021-2027 EU central budget, with combined funds totalling c. €1.8T. The pandemic has also led to the suspension of the European budgetary rules with a recognition that the rules are outdated and inappropriate given the structural nature of the problems facing the Eurozone.

There are, however, several limitations with the recovery fund. First, it is only a temporary instrument, lasting from 2021 - 2027. Second, there will be no mutualisation of pre-existing debt, no creation of new shared liabilities, nor the creation of tax revenues for European institutions. Third, the funds raised through the recovery plan, which comprise €390B in grants and €360B in loans, will be bound to specific purposes such as environmental transition (37% of funds) and technological innovation (20% of funds). Finally, experts believe there will be significant obstacles to pass when the time comes to draw down funds with significant layers of bureaucracy and political gamesmanship anticipated.

[1] https://www.consilium.europa.eu/en/infographics/recovery-plan-mff-2021-2027/
[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020DC0575&from=en

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Implications: More explicit fiscal integration should allow for faster economic growth, higher inflation and possibly fewer populist tendencies. From an investment perspective, it suggests that that the yield premium on peripheral debt over German bonds, most notably Italian, should trade at a structurally lower level, perhaps below 100bps which has been the lower limit over the past 10 years. Experts believe that market volatility should be more muted going forward.

What impact will Brexit have on both the UK and remaining EU members?

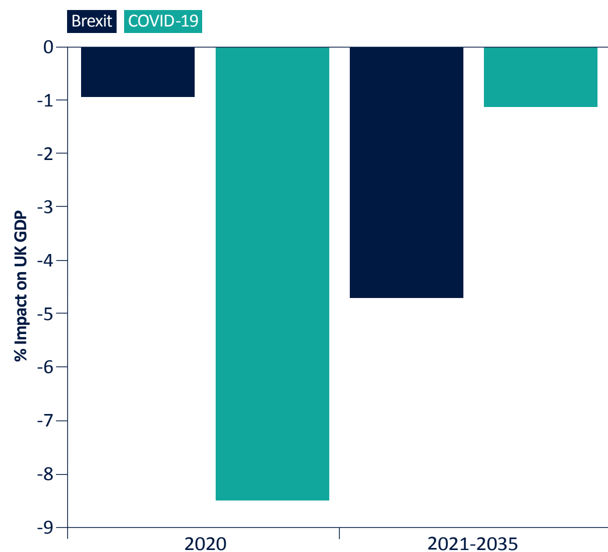
Most experts agree that both parties are weaker as a consequence of Brexit. UK growth will be structurally lower with no deal on services. Future negotiations with the Eurozone are unlikely to come from a position of strength. From a European perspective, the impact on GDP growth is expected to be minor, but the key change will be the loss of the UK's pragmatic and free-market voice within the union and the additional geopolitical clout that came with its membership (about a quarter of EU defence spending came from the UK, but remains under the shared NATO umbrella).

On the 24th of December, the European Union and the United Kingdom finally agreed to a Brexit deal, the Trade and Cooperation Agreement (TCA), officially putting an end to what former head of the World Trade Organisation, Pascal Lamy, described as "the first negotiation in history where both parties started off with free trade and discussed what barriers to erect." Analysis from Morgan Stanley and the UK Treasury suggests that while COVID-19 had a much more significant impact in 2020, Brexit will have a far greater structural impact reducing UK economic output by a cumulative 4-5% over the next 15 years as shown in Figure 2 (or 0.3% to 0.4% per annum).

Trade in Goods

While the UK retained its ability to trade goods with the EU free of tariffs under the approved free trade agreement, several non-trade barriers (NTBs) have been erected between the two markets. The first to feel the effects have been UK businesses exporting perishable goods to the EU, notably farming and fishing. Delays at custom borders, as

Figure 2: Brexit will have a long-lasting structural impact on the UK economy relative to COVID-19



Source: Morgan Stanley, UK Treasury. Note: Short Term = 4 quarters, Long Term = 15yrs

a result of newly required checks and paperwork, have effectively made their products unsellable. Full border checks will not be imposed on European producers exporting to the UK until July 2021 in order to limit shortages in the UK. UK businesses selling non-perishable goods into Europe are rapidly discovering that a zero-tariff deal does not help in importing goods from non-EU countries for re-sale into the EU as the final customer will have to pay the EU's external tariff. Even more importantly, if the product is tariff-free, the recipient in Europe will still need to pay VAT in the local country and other handling charges. The UK government estimates that EU NTBs alone will have a cumulative long-term negative impact of -4.9% on the UK's GDP. However, part of this may be offset by new trade deals achieved outside of the EU, estimated to be worth between 3.4% and 6.4%[3] of cumulative long-term (over 15 years) GDP.

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760484/28_November_EU_Exit_-_Long-term_economic_analysis__1_.pdf

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Trade in Services

While the TCA covers trade in goods, the service sector, which represented 79%[4] of the UK GDP in 2019 with the EU as its largest export market, has been mostly excluded. This was the price that the UK had to pay to rescind the free movement of people. UK businesses will need to comply with each of the different countries and sector's regulations which they operate in, meaning a marked increase in complexity and uneven terms across the economic block. Fortunately for the UK, its major trading partners, the Netherlands, Germany, Ireland and France are among those with the least restrictive trading rules within the block according to the OECD[5]. The sectors that will experience the largest increase in restrictions will be transport and professional services. The financial services industry, which is Britain's dominant industry and makes up 7% of the country's GDP, has lost its 'passporting' rights, which allowed firms to operate anywhere within the EU without restrictions. Now firms will be only allowed to operate across the border thanks to the 'equivalence' designation, which, so far, has been recognised by the EU only with respect to the UK clearing industry. This could be revoked at any time. This places the UK in a precarious position in future negotiations. In 2019, the UK had a -£79B trade deficit with the EU, a -£97B deficit in the trade of goods, where a free trade agreement has already been reached, and a more modest +£18B surplus in the trade of services, where most conditions of the future relationship still have to be defined.

People

Another lasting impact of Brexit could result from a substantial decrease in immigration to the UK. The ESCoE[6] estimates that the UK's working age population declined by around -1.8% during the pandemic as migrants, who are disproportionately likely to work in COVID-19 sensitive industries that involve face-to-face interactions, returned home. In 2018, the UK government estimated that a zero net inflow of workers from the European Economic Area (EEA) would further reduce the country's long-term economic growth by c. -1.8% (over 15 years) compared to a scenario where no change was made to migration arrangements. In 2019, net migration from the EU to the UK turned negative for the first time in over 10 years[7]. However, the decrease in net migration from the EU was more than offset by increased migration from outside the EU. Migration from outside the EU has been increasing steadily since 2016 maintaining stability in overall migration since the referendum. The UK, is however, implementing a tighter immigration framework post Brexit and the stability of overall migration going forward will come into question.

European Perspective

From a European perspective, the direct impact to growth is not expected to be significant. Daniel Sturm, Professor of Economics at LSE, notes that "less trade with the UK is not a substantial negative shock for the EU and maybe fully compensated by firms relocating from the UK to the EU." However, to suggest that the EU will not be impacted at all is too simplistic. Several experts have noted that it is the indirect externalities that UK membership brought to the EU that will truly be missed. The UK provided a pragmatic, pro-free market voice in the union and the EU will likely become more protectionist without it. The loss of geopolitical clout cannot be understated either, with the UK having accounted for approximately 17% of European Union GDP in 2019. It is also important to note that approximately 25% of the EU defence spending came from the UK.

Implications: The near-term impact to Eurozone growth from Brexit is negligible but a less market-friendly, more protectionist approach may damage longer-term potential growth. The pound has rallied strongly since the turn of the year with a huge amount of uncertainty lifted following the Brexit deal. This has undoubtedly led to capital inflows after years of uncertainty and underinvestment. Significant further upside for the pound is less likely with the UK economy weaker as a result of Brexit and further trade restrictions coming into place in July. Experts suggest in their most bullish scenarios, the pound could reach $1.45 within 12 months, just +2.5% above the levels at the time of writing[8].

[4] https://commonslibrary.parliament.uk/research-briefings/sn02787/#:~:text=Services%20are%20the%20largest%20part,is%20down%204.9%25%20on%20February.
[5] https://trade-knowledge.net/commentary/services-the-neglected-part-of-brexit/
[6] Economic Statistics Centre of Excellence
[7] https://migrationobservatory.ox.ac.uk/resources/briefings/long-term-international-migration-flows-to-and-from-the-uk/
[8] Goldman Sachs, Deutsche Bank, Capital Econmics see $1.45 as their bullish scenario on a 12 month horizon.

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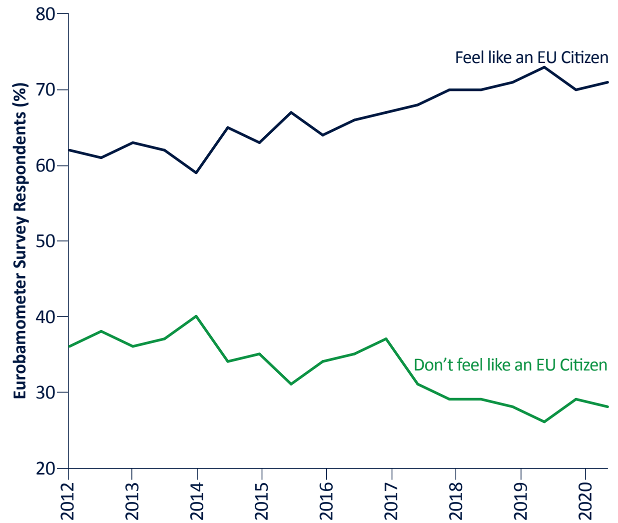
To what extent do national politics continue to support the union?

National politics appear to have stabilised more in support of the European Union in recent years. European populist parties have either ceded support or have shifted their policies closer to the centre. The risks from upcoming European elections appear relatively mild despite the departure later this year of Angela Merkel as Europe's longest-serving leader. Italy has yet another technocratic government, but one charged with more fiscal expansion rather than the imposition of austerity. Finally, there is some potential for contagion from a Scottish independence vote.

Broadly speaking, sentiment of Europeans towards the union has improved since the Brexit vote and remained resilient during the pandemic as illustrated in Figure 3.

[9] https://www.theguardian.com/world/2021/jan/16/germany-cdu-vote-successor-to-angela-merkel

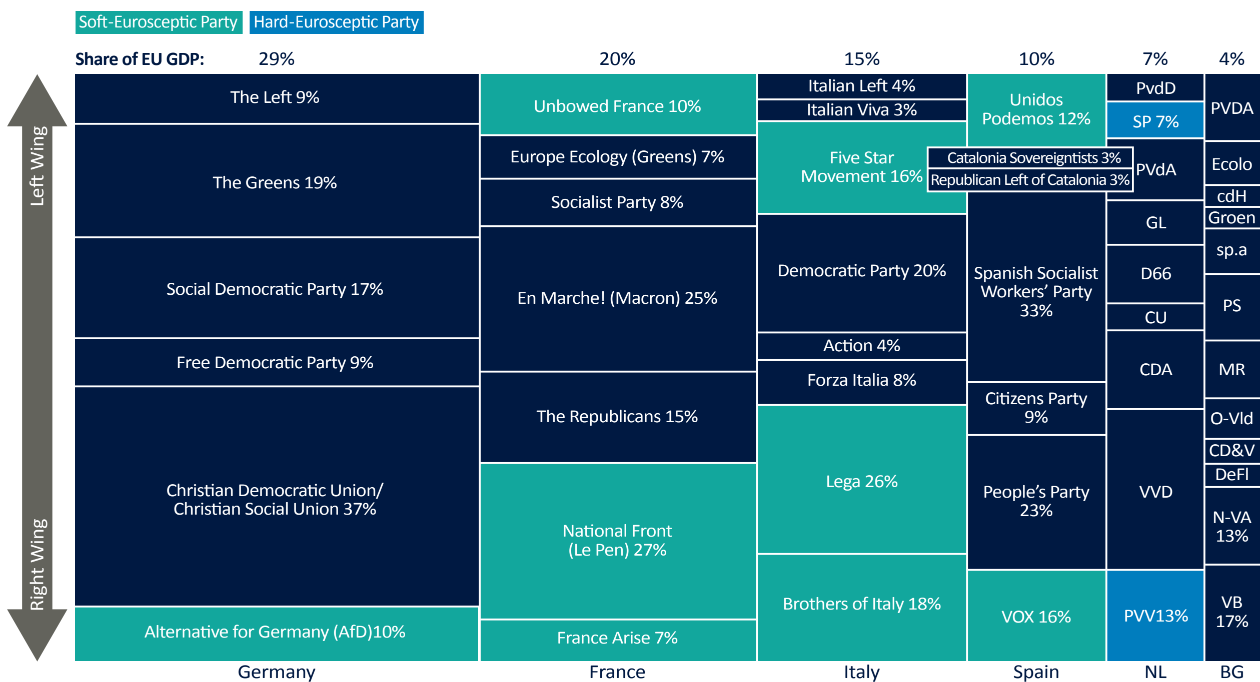
Figure 3: Eurobarometer Survey (August 2020) shows that citizens' support for the EU has not wavered during the pandemic



Source Eurobarometer

As shown in Figure 4, support for populist, anti-establishment parties has broadly receded from its peak. In Germany, support for the far-right AfD party has declined from 14% in 2016 to 10% today.

Figure 4: Support for anti-establishment parties has receded



Source: Politico, Partners Capital

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In Italy, the anti-establishment parties, Five Star Movement and Lega had enjoyed combined support of over 60% in 2018 but this has dropped to just 41% at present. In the Netherlands, support for PVV has dropped from 18%, at its peak, to 13%. Marine Le Pen's National Front party has maintained its support base in France but at the cost of dropping its hardcore anti-euro stance.

Germany

After serving as German Chancellor for over 15 years, Angela Merkel will not be seeking re-election in September 2021. With her departure, analysts are looking towards the German election to assess where the world's fourth-largest economy and anchor of the EU will stand on the issues that will define the future of the bloc. In January, a Merkel ally, the centrist Armin Laschet prevailed in the Christian Democratic Union (CDU) leadership election, winning a second run-off vote by 53% - 47% against Friedrich Merz. Laschet is expected to follow in the footsteps of Ms Merkel and adopt a centrist approach both at home and in Europe. A CDU – Green alliance is seen as the most likely outcome of September's election9.

Italy

Italy has just installed another technocratic government, its fourth such government in the last 30 years. In early January former Prime Minister, Matteo Renzi, withdrew support for the coalition government of Prime Minister Giuseppe Conte. After Conte failed to garner support for another coalition, the Italian President, Sergio Mattarella, decided that rather than dissolve the Italian parliament in the middle of a pandemic, he would opt for a technocratic government with former ECB President Mario Draghi at the helm. The Draghi government enjoys the support of all of the major political parties except for the far-right "Brothers of Italy", providing it with a strong platform to carry out an ambitious reform agenda against the backdrop of the pandemic. Draghi's reform programme, the "New Reconstruction", will focus on the roll-out of the vaccine, finalising the use of the recovery fund (financed by the EU), environmental and judicial reforms, alongside other measures to try and protect employment[10]. The previous technocratic government led by Mario Monti in 2011 was tasked with imposing severe spending cuts in the midst of a recession. Draghi's chief concern, by contrast, will be the allocation of the historic European Recovery fund. The timeline for the agenda is aggressive with Italy's next Presidential Elections scheduled for February 2022. Draghi's government could in theory be extended until the next general elections in December 2023 if public support remains strong[11].

France

In France, President Emmanuel Macron's approval rating is 40%, up from the lows of 25% in 2019. Despite missteps around facemasks and vaccine rollout, his popularity has improved as unpopular structural reforms that had led to the 'Gilets Jaunes" protests were put on hold. Even with a 40% approval rating, he remains highly likely to be re-elected in May 2022, primarily because the opposition is divided. The previous mainstream parties, the Socialist Party and the Republicans, all but collapsed after Macron's victory in 2017 and have been unable to find any national support base other than small regional hubs that were historically loyal to the parties. Macron's most likely run-off opponent will once again be Marine Le Pen, the far-right, anti-immigration populist whom he beat convincingly in the 2017 runoff. Le Pen has abandoned her opposition to the euro, but retains the loyalty of her base. So, despite Le Pen enjoying a slender lead in the polls, 27% to Macron's 25%, France's run-off election system means that the opposition will unite behind Le Pen's opponent in the second round and that opponent looks likely to be Macron.

Spain

The next national elections in Spain are not scheduled until December 2023. However, the risk of the current coalition collapsing prior to this date is elevated. Prime Minister, Pedro Sanchez, heads an unstable coalition that relies on implicit support from the ERC[12], a pro-independence Catalan party, and explicit support from the far left Podemos

[10] https://www.nytimes.com/2021/02/17/world/europe/italy-mario-draghi.html
[11] Goldman Sachs
[12] Esquerra Republicana de Catalunya

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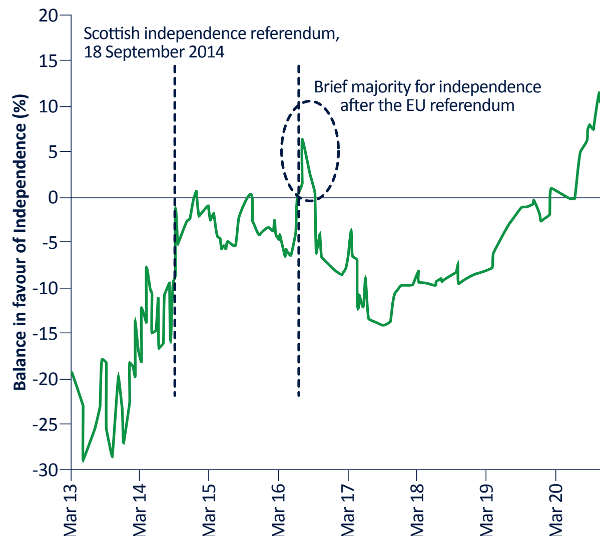
party. Podemos are reluctant to agree to many of the crucial reforms that the EU has insisted upon as conditions for unlocking recovery funds. Independence for Catalonia could easily be back on the agenda as well with secessionist parties having clinched more than 50% of the popular vote for the first time in the February regional elections[13]. All of this means that a coalition that is already displaying fractures is likely to face obstacles that could lead to structural damage.

Scotland

The Brexit deal has left the union divided, both formally, with a trade border separating Northern Ireland, and philosophically, with Scotland and Northern Ireland forced to leave the EU after voting overwhelmingly ro remain in the EU in 2016. The situation is particularly delicate in Scotland due to the upcoming Scottish Parliament election in May 2021. The ruling Scottish National Party (SNP) announced that if they were to win a majority of seats in the chamber, they will take steps to hold a new independence referendum, effectively turning the vote into a plebiscite on the future of the union. Scotland last held an independence referendum in 2014 and voted 55% - 45% in favour of remaining in the union. Polls have been showing a pro-independence majority consistently for months now as shown in Figure 5, but the UK government has been quick to make clear its intention to oppose a new referendum which risks alienating Scottish voters even more. Bookmakers put an 85% probability of the SNP winning a majority and 'Leave' voters appear to have a 7% lead in opinion polls. The question then becomes how Boris Johnson would react to an 'independence' outcome. He has previously stated that another independence referendum should not occur for another 40 years, but it is likely he will have to adopt a more conciliatory attitude. Options include promising the devolved administration more powers or offering an official vote on independence after the passage of some time. Thus, it seems unlikely that Scotland will depart the union any time soon but there is a high probability of geopolitical tension that could spill over into other regions of Europe looking for independence, most notably Catalonia.

[13] https://www.bloomberg.com/news/articles/2021-02-14/catalan-separatists-on-for-majority-in-regional-vote-poll-shows?sref=ABAoJC7B

Figure 5: Support for Scottish independence has been increasing



Source: What Scotland Thinks? Morgan Stanley Research

Implications: Lower political risk in Europe, particularly in Italy, should mean more stability in peripheral bond yield spreads. The potential extension of Draghi's government beyond 2022 and, possibly, until general elections in 2023 could sharply increase the likelihood of comprehensive Italian reforms and improved growth prospects both for Italy and the Eurozone. The Scottish election may lead to some volatility in the pound or perhaps in Spanish government bonds (Catalonia contagion), but this should prove transitory.

What progress has there been on structural reform?

The pandemic has led to the fiscal rule book being thrown out in Europe, at least temporarily. Reform is still on the agenda but it is now accompanied by a more laissez-faire attitude towards individual nation's fiscal spending plans. There is a recognition that ten years of austerity have effectively failed to restore financial stability as longer-term debt metrics have continued to deteriorate due to slow growth exacerbated by COVID-19. In late March 2020, the European Stability and Growth Pact rules were suspended. These rules prohibited a greater than 3% of GDP fiscal deficit on a cyclically adjusted basis. The rules had been regarded as outdated and far too blunt an instrument to account for the structural

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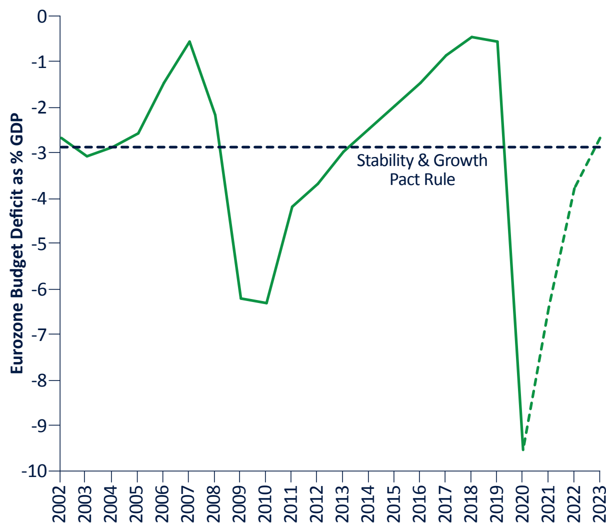
reforms that were necessary across the spectrum of Eurozone nations[14]. The rules have been suspended until the end of 2021 but a decision on a longer-term suspension or a complete re-write is expected in Q2 2021 . Citigroup published a report in February 2021[15] which suggested that the EU was unlikely to go back to the restrictive budget rules given the painfully slow progress in reforms over the past decade. Data from Bloomberg in Figure 7 shows that the Eurozone is expected to record budget deficits in excess of -3% until 2023.

Figure 7: Eurozone fiscal deficits are not expected to comply with the Stability and Growth Pact rules until 2023

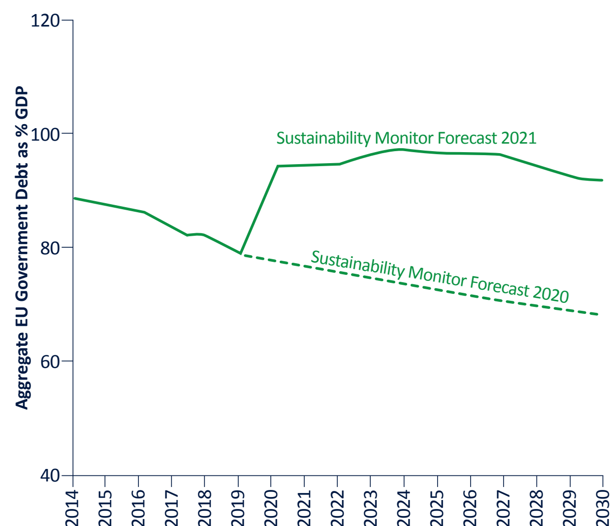


Source: Bloomberg

The European Debt Sustainability Monitor was published by the European Commission in February 2021[16]. It noted that while there had been a large deterioration of public finances in 2020, due to the COVID-19 crisis, the overall situation appeared to be less critical than during the GFC, thanks to lower debt servicing costs. The report suggested that the extraordinary monetary policy interventions together with decisive EU actions in 2020, contributed to stabilising sovereign financing conditions, significantly lessening risks of short-term fiscal stress. The updated projections, in Figure 8 below, show higher ratios of debt to GDP, and less favourable trajectories for the debt ratios over time, compared with the report published in 2019, owing to the pandemic.

Some countries, such as Greece or Portugal, are highly indebted but the relative size of their respective debt means that a bailout by their fellow Europeans is at least feasible, if necessary. Others, like France, Spain or indeed Germany, have large debt in absolute terms, but thanks to the size of their economies and a reasonable track record of growth they can cope with hiccups without unduly spooking rate markets. However, as the Economist magazine states, “Only Italy has the triple whammy: a big debt stock in both relative and absolute terms, plus an economy that was stagnant even before the pandemic struck”. In their January 2021 Fiscal Monitor, the IMF estimate an Italian budget deficit of -10.9% of GDP in 2020 and -7.5% of GDP in 2021. When combined with the expected decline in real GDP of -9.2% in 2020 and modest recovery of +3.0% expected in 2021, Italy’s debts relative to the size of the economy will reach new heights.

Figure 8: The pandemic has led to a deterioration in the long-term fiscal health of the EU



Source: European Debt Sustainability Report

[14] https://www.bloomberg.com/news/articles/2021-01-20/big-government-is-back-in-europe-as-the-eu-prepares-for-post-covid-economy?sref=ABAOJC7B
[15] https://www.macaubusiness.com/eu-presidency-stability-growth-pact-rules-to-be-assessed-in-q2/
[16] https://ec.europa.eu/info/sites/info/files/economy-finance/ip143_en.pdf

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Debt net of intragovernmental holdings is expected to increase to 146% of GDP in 2021. Our modeling in Figure 9 suggests that Italy's debt problem is manageable provided nominal growth remains above debt servicing costs. I.e., it is manageable provided the ECB continues to purchase Italian government bonds and suppress the countries long-term borrowing costs – which it will do in the interest of financial stability. Based on current estimates of growth and debt servicing costs, the debt relative to the size of the economy should gradually decline over the next decade but will not return to pre-pandemic levels.

Structural reforms will gain momentum post-COVID. From a broad European perspective, the pandemic and the associated loosening of the fiscal rules will be used as an opportunity to structurally reform and upgrade the economy by setting more aggressive climate targets and upgrading technological infrastructure.

— **Italy.** The new Draghi government has an ambitious recovery plan. In a speech to parliament in February, Draghi outlined a plan to reform taxes, the courts and public administration, whilst promising not to bail out unviable firms. It is also expected that he will make labour market reform a key part of his agenda particularly female and youth participation rates.

— **France.** In September 2020, Emmanuel Macron outlined his new reform plan for France. He plans to utilise the increased EU fiscal freedom to enact a large-scale tax cut for corporations operating in France worth €20B[17]. Mr Macron has long wanted to ease the tax burden on French companies in the hope of boosting investment and job creation. As part of his stimulus plan,

[17] https://www.ft.com/content/a4048ee3-ae8b-4c03-be93-edbc4ac4ca3e

Figure 9: Italy's national balance sheet will take a long time to recover from the pandemic

Italy	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
	Actual	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.
Net Debt-to-GDP (end of year)	123%	144%	146%	144%	143%	142%	142%	141%	140%	140%	139%	138%
Real GDP growth	0.3%	-9.2%	3.0%	3.6%	1.7%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%
Inflation forecasts	0.9%	1.2%	0.9%	0.9%	1.0%	1.2%	1.4%	1.4%	1.4%	1.4%	1.4%	1.4%
Nominal GDP growth	1.2%	-8.0%	3.9%	4.5%	2.7%	2.1%	2.2%	2.2%	2.2%	2.2%	2.2%	2.2%
Weighted average interest rate on total outstanding debt	2.6%	2.9%	2.3%	2.2%	2.1%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Debt servicing cost as percent of GDP (int rate x debt level)	3.2%	3.5%	3.4%	3.2%	3.0%	2.9%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%
IMF baseline forecast of government primary balance, % GDP	1.6%	-7.4%	-4.1%	-0.7%	0.3%	0.4%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%

Notes:
1. Forecasts from 2020-2025 are from IMF October 2020 World Economic Outlook and January 2021 Fiscal Monitor.
2. Growth, inflation and cost of debt held constant at expected trend rate after 2025.
3. Net debt is debt held by public, which excludes intragovernmental debt but includes debt held by the ECB.
Source: IMF, Partners Capital

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he will also inject €30bn into reducing carbon emissions. His hope is that with this investment programme France will be able to meet its climate goals without the kind of punitive carbon taxes that triggered the 'Gilets Jaunes' anti-government protests of 2018.

— **Spain.** The Spanish government is looking at enacting labour market reforms with regard to collective bargaining and "gig economy" workers. The real issue of concern, however, is that Brussels is demanding significant Spanish pension reform as a condition for unlocking recovery funds. Podemos, the radical left junior partner in Pedro Sánchez's Socialist-led government, insists it will not support changes to the calculations for payments that it says will reduce future pensions for millions of contributors. José Luis Escrivá, Spain's social security minister, suggested that this was a mischaracterisation of the pension reform plans stating that the government would move forward with the plans with a united front.

Implications: The recognition that austere budgetary rules have been damaging may finally improve the structural growth prospects for the Eurozone. However, post-2021 the European commission has noted that the key risk is "a mechanical re-introduction of the pre-COVID-19 rules which would entail sharp consolidation requirements for national budgets". Goldman Sachs estimates that a full re-introduction of budget rules in 2022 would lead to France, Italy and Spain having to cut their debt to GDP ratios by 6-9% more than the current consensus forecast for 2024. This would entail dramatic budget cuts. Italy is currently forecast to run a budget deficit of c. -3% in 2023, a tightening of this magnitude would likely require Italy to be running a surplus greater than +2% by 2023.

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

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