Europe: Never Let a Good Crisis Go to Waste

15th March 2022

Summary

- **Crisis in the Ukraine provides European Federalists with leverage**
- **National fiscal easing and mutual EC off-balance-sheet borrowing mooted**
- **European Defence spending set to rise sharply alongside Energy substitution initiatives**
- **ECB is facing rising inflation and fiscal expansion**

Early last week, as the world was grappling with the prospect of losing access to Russian raw materials, the LME was scrambling to avert an existential crisis, and we were being assaulted by distressing images of destruction in Ukraine, it was easy to overlook events in Brussels. Yet buried within the Eurozone's crisis response was a potentially game-changing event, the prospect of permanent debt mutualisation. Yes, it is true that the door was cracked open on this taboo subject for the Covid response funds. However, with Europe arguably facing its biggest test in the post-war period and under the auspices of a French Presidency of the EU that is always keen to present a united front, we believe material change is about to happen with profound consequences for markets.

The fiscal proposals were aired at the EU leaders' meeting at Versailles at the end of last week. Naturally, some resistance still needs to be overcome and details agreed upon. For example, will some of the spending be treated as "investment" and thus be off balance sheet? Just how will funds be disbursed and when? But the direction of travel appears to be clear and when you think of a number, double it. This is the future. The Stability and Growth Pact (SGP), already suspended during Covid, is the past. Brits among you of a certain age will recall Monty Python's Dead Parrot sketch. The SGP is the parrot.

With new clarity and resolve, Europe wants to move forward on two (expensive) fronts simultaneously. Energy and defence. So as not to turn this into a country-by-country political analysis, we will just highlight Germany as our avatar. Starting with energy, reduced reliance on Russia for gas and oil will go hand-in-hand with an acceleration plan to achieve net-zero carbon by 2035. On the supply side, this will require a further commitment to renewables, together with massive investments in LNG and ironically, given the prior decisions, embracing nuclear as "green". On the demand side, the exact measures to conserve energy usage have yet to be determined. However, none of this will be cheap. Indeed, the weekend press was full of demands that German industry and (possibly) consumers need to be cushioned from the deleterious effect of the energy shock. Expect fiscal jiggery-pokery here too. For instance, as far back as 2008, when we had the last energy shock, there were discussions at a national level in a number of EU states to introduce a tax inhibitor for gasoline. Tax is a huge part of Europe's pump prices, based, as it is, as a percentage of price. Changing it to a volume-based fixed tax or scaling the percentage up and down in response to price were two suggestions that never made it to the statute books. Maybe this time they will.

As far as defence goes, Germany had a relatively expansive defence budget in the 1980s (2.5%+ GDP) but became one of the major beneficiaries of the peace dividend as the Iron Curtain fell and Germany unified. Indeed, over the next 40 years, defence spending collapsed to barely half the 2% of GDP expected under NATO, and the German military became a laughing stock with stories of painted broomsticks replacing machine guns. Yet, within a week of Putin invading Ukraine, Putin achieved what 20 years of NATO cajoling and periodic US threats had failed to do: spur Germany to step up to the plate for self-protection and turn 30 years (arguably 70 years) of foreign policy on its head. Thus, Germany has announced a EUR 100bln military modernisation fund and expected defence spending for 2022 is pencilled in at more than 2% GDP. Multiply this across the whole of the Eurozone, and it's not hard to see how the numbers can add up rather quickly.

That brings us to monetary policy. Over the last few months, we have seen a dramatic about-face by the ECB. Gone is Lagarde's insistence on patience and the narrative that inflation is fleeting. Instead, while it would be a stretch to claim that the Board has returned to the Teutonic roots of the Bundesbank, recent meetings have been hawkish, and for now at least, the ECB seem to acknowledge that they are paid to fight inflation.

This about-face with the prospect of a reduction in various QE programmes has finally enabled markets to start to price risk into European fixed income. Now, don't get us wrong, given our belief that Eurozone inflation could easily hit double digits, these moves are still pathetic ("Ask Me Anything" 10th March 2022). Nevertheless, since mid-December, 10-year Bund yields have risen 70bps. More importantly, they have been unable to hold the dip we saw as events in Ukraine accelerated. We believe this is indicative of a sea-change as European fixed income wakes up to the implications of a generalised loosening of fiscal restraints in an already supercharged inflation environment. This suggests to us that our 1.55% technical target for Bunds is reasonable. What's more, if it actually turns out that we are heading for loose fiscal and relative tight monetary policy, it will be even more bullish for the Euro.