SPECIAL EUROPE
Q&A

You asked, we answered

by Global Research Team

As a complement to the Special Europe report, we try to answer some of the key questions often asked.

Q1. German elections. What can we expect?

No party seems to be able to secure a majority in the Bundestag

With less than a month to go before legislative elections (26 September), the game is particularly wide open. The Greens have gained ground, but no party seems to be able to secure a majority in the Bundestag. It will probably take a coalition of three parties to form a majority. At this stage, the central question is whether or not the conservatives will be part of the future coalition.

There is no natural successor to Angela Merkel. The most popular candidate to succeed her is Olaf Scholz, the current Social Democrat finance minister. However, the chancellor is not directly elected but chosen by parliament. Armin Laschet, president of the CDU, has less experience but will have a larger pool of votes in the Bundestag and therefore has a better chance of succeeding Angela Merkel than Olaf Scholz or Annalena Baerbock, the Green candidate.

To date, the two most likely scenarios that are emerging are: (i) a so-called Jamaica coalition (between the conservatives (black), the Greens and the liberals (yellow); or (ii) a coalition between the Reds, the Greens and the liberals. A "leftist" red/green/left coalition is much more unlikely.

It will probably take time to form a new coalition. Let's remember that after the September 2017 elections, it took more than four months to reach a "coalition contract" between the CDU and the SPD and another month to get it ratified by SPD, something that hadn't happened in Germany since WWII!

Moreover, Europeans have too many illusions about the Germans' ability to change their strategy following an election. Important decisions are taken by consensus in Germany, and change must unambiguously reinforce the country's stability to be approved. And, in addition, major changes in European affairs must be adopted by both houses of parliament (the Bundestag and Bundesrat). The SPD and the Greens certainly support the idea of greater financial solidarity in Europe. This argues in favour of more risk sharing within the EU. But the participation of the Greens in a coalition would not change the situation radically, as they have moved closer to the centre. Moreover, the liberals have a notoriously tougher position on financial risk sharing.

To sum up, the elections on 26 September are an important step for Germany (with the end of the Merkel era) but will not lead to an upheaval, either in terms of economic policy or even at the level of the European institutions. At the margin, however, the German doctrine on the new fiscal rules under the Stability and Growth Pact could evolve, depending on the coalition in power and the new chancellor.

Q2. Central banks: what's next?... Wait and see!

The Fed and the ECB continue to see the acceleration in inflation as a temporary phenomenon

For the Fed and the ECB, the terms of the debate have changed little since June. It is true that inflation forecasts for 2021-22 have been revised upwards in the US and the Eurozone. But overall, the Fed and the ECB continue to see the acceleration in inflation as a temporary phenomenon.

Following their strategic review, their reaction functions have changed. Both CBs are able to justify a more accommodative monetary policy than in past recoveries, at least as long as inflation expectations remain well anchored.

The Fed and the ECB are more concerned about economic activity than inflation, with the possibility of a premature slowdown in growth, due to a resurgence of the pandemic. There is a loss of momentum in global growth. In the US, the Jackson Hole meeting confirmed expectations. The Fed will start tapering before the end of the year, but at a gradual pace, in line with expectations. The Fed aims to reduce the degree of monetary accommodation as the US output gap closes. But the Fed intends at the same time to dissociate tapering from rate hikes. It clearly does not want to tighten monetary and financial conditions. It has learned the lessons of the 2013 taper tantrum and its impact on the markets. Hence its particularly cautious communication.

In the Eurozone, the terms of the debate are somewhat different. Firstly, because the economy as a whole is less advanced in the cycle in the Eurozone than in the US; second, because inflationary pressures are less pronounced in the Eurozone than in the US; and third, because the asset purchase programmes are calibrated on different criteria. In particular, PEPP was designed as an emergency programme, directly linked to the pandemic and its impact on the economy. The uncertainty about the Covid and the Delta variant will reinforce the ECB's caution in the short term. PEPP continues until March 2022, and it may seem premature for the ECB to specify what it will do afterwards. It will probably want to leave the door open for several options (such as an extension of PEPP if the health situation requires it). However, the drop in sovereign issuance expected next year will allow the ECB to reduce its securities purchases in 2022 without causing a tightening

of financial conditions. One way or another, the ECB will manage to justify a rebalancing of its securities purchase package in order to carry out a smooth tapering. Financial fragmentation remains high in the Eurozone and it is essential to maintain accommodative financial conditions to complement the NGEU stimulus fund. The prospect of a rate hike remains very remote.

Central banks have an even more accommodating bias as without their monetary policies fiscal policies on both sides of the Atlantic would be difficult to sustain. Whatever central banks may say, they have entered an era of fiscal dominance.

At this stage, the only thing that could change the situation in the US and Europe is a sharp revision of inflation expectations. While it appears that inflationary pressures may last longer than expected, due to disruptions in value chains, we do not see upward pressure on wages at this stage. This is probably the most important variable to watch.

Q3. Will Europeans' excess savings turn into consumption?

Savings are unlikely to fall far below pre-crisis levels

Much has been written about the potential of excess savings and the upside risks to growth posed by stronger household consumption. According to data as of Q1 21, excess savings in the Eurozone amount to 8.8%-9% of 2019 GDP. We may expect some normalisation of the savings rate to close to pre-crisis trends. Yet, the assumption of a strong and persistent boost from excess savings into consumption would require a savings rate significantly below pre-crisis trends over a sustained period – which is highly unlikely.

The distribution of excess savings created during the crisis has been skewed towards higher-income households, which are slower to spend savings and more prone to move excess savings towards asset investment rather than consumption, putting at risk the overly optimistic outlooks already highlighted for several countries. Moreover, the fact that the virus is becoming a persistent source of uncertainty in the medium-term is adding to the fact that households are less confident in their personal financial situation, due to the uncertain timing of the withdrawal of furlough schemes and employment outlook. Given the low visibility around future social restrictions, we are assuming that the release of pent-up demand will play a positive, if moderate, role in boosting the recovery in the quarters ahead.

Finally, consumption may be limited by the so-called "Ricardian equivalence effect" which may play an even greater role, with households becoming less inclined to consume their excess savings in light of the expected (or announced) tax increases in the years ahead. This is particularly true in countries with high public debt levels, which will eventually have to comply with EU fiscal (new) rules.

Q4. What are the implications of EU issuance for the Eurozone bond market?

The EU will be one of the biggest players in the European primary markets

On the year to date, the EU has issued more than €100bn, €50bn of which was under the SURE programme, €45bn under NGEU, with the rest under other standard programs (EFSM/MFA). While SURE bonds kept the primary markets busy in the first five months of the year, the start of NGEU issuance proved very successful and intense, with the EU placing four NGEU issues with much higher outstandings than SURE or other EU issues in just one month between mid-June and mid-July.

The EC plans to issue at least €80bn of EU bonds under NGEU, most of the expected issuance left for the remainder of the year (roughly €35bn). In the September review of planned funding for the year, this target could be revised up following the recent quick disbursement delivered to countries under the RRF programme. In terms of maturity, issues have been fairly well distributed across the curve, although the 10y area dominated, thanks to the €20bn issue in June: the longest segment of the curve has been targeted the most, as three of four NGEU bonds issued so far were in the 10yr-30yr maturity bucket. Although no dates have been set yet, in terms of issuance format, auctions should start in September, as the EU plans to combine syndications with auctions. As we know, NGEU bonds will see larger outstanding volumes than SURE bonds and will benefit from an auction system that will provide them with more secondary market liquidity.

In the remaining months of 2021, the EU will be one of the biggest players in the European primary markets, and high-rated sovereigns mostly ahead with their gross and net planned yearly funding. According to the figures for end-July, Germany and France have made good progress in yearly net funding, particularly in long-dated supply.

A look into 2022 sees the EU likely to play another remarkable role in the issuance of new debt, as most of the cash flows for the grants and loans of NGEU's RRF are expected to be concentrated in 2022 and 2023. The volume of issuance next year is estimated to be close to this year, in the region of €140/150bn, meaning that net issuance in absolute terms will be stronger in relative terms vs. the sovereign segment, as public deficits and net funding are likely to fall from their 2020-2021 peaks. At the same time, we expect the ECB to continue allocating an adequate share of its overall QE to supranationals and agencies in 2022, and to continue targeting high average duration in its purchases of EU bonds, in line with the recent trend shown, ultimately supporting this segment.

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