

## What to expect from the EU summit?

As the EU summit kicks off, and the size of the EU recovery fund, its disbursement process, conditionality and the grants/loans mix is debated, our economists and strategists provide various scenarios of what a compromise could look like and its impact on FX and rates

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By Bert Colijn and Carsten Brzeski

## EU Summit – Market preview: The “bumps” are in the price

The bar for positive market impacts of the EU Summit this weekend is not too high, as there is little hope for a quick agreement among investors. If our base case – progress towards a compromise, but more time needed – materialises, we could see EUR/USD push towards 1.15, and the 10Y BTP-Bund spread pressure the 160bp level



Source: Shutterstock

### Our base case: Some progress, but more time needed

As discussed in detail in our economics team's note: [“EU summit preview: Is the impossible within reach?”](#), several different scenarios appear on the cards ahead of the EU Summit starting tomorrow.

Pressures from the so-called “Frugal Four” (Austria, Denmark, Netherlands and Sweden) around the size of the fund, disbursement process, conditionality and the grants/loans mix appears to have taken the original Franco-German proposal off the table. Still, intense bilateral talks and the mediation efforts of German Chancellor Merkel have helped create some room for compromise.

Our economics team thinks that such compromise may consist in something close to a €600bn 50/50 loans/grants fund, with annual reviews to determine the loans/grants mix depending on compliance with some conditions.

Still, with many sticky points (and not only those raised by the “Frugal Four”) still to be addressed, we do not see an agreement being reached as the base case ahead of this EU summit. Instead, we expect some progress towards a compromise being made, but some time for more negotiations is still required. This should allow a consolidation of the notion that the EU Recovery Fund will eventually come into existence – without having to be materially resized first. We therefore deem less likely that the negotiations will break up.

## Four scenarios for FX and rates

The chart below shows four different outcomes of the EU Council meeting, ranked from most to least market-friendly. On the right-hand side are displayed our estimations for the levels of EUR, Bunds and BTPs as markets re-open on Monday. We discuss our views on FX and rates in detail in the sections below.

|                       | Scenario  | Description  | Market impact<br>(Mon 20 Jul levels) |                              |                       |                    |
|-----------------------|---|--|--------------------------------------|------------------------------|-----------------------|--------------------|
| Most market-friendly  | ① Agreement found on grants                             | Merkel's mediation succeeds in bringing “frugal” members on board. Market reaction positive, but its magnitude will depend on how close the agreement is to the GE-FR proposal.  | EUR/USD<br>1.1550/<br>1.1600         | EUR/CHF<br>1.0900/<br>1.0950 | 10Y BTP-Bund<br>150bp | 10Y Bund<br>-0.35% |
| Market impact         | ② Compromise shaping up<br><small>ING base case</small> | The “Frugal Four” show openness to grants and Southern economies to some conditionality. More time is needed to iron out the details, but negotiations appear on the right path. A statement illustrating the principle agreement is released. | EUR/USD<br>1.1450/<br>1.1500         | EUR/CHF<br>1.0850/<br>1.0900 | 10Y BTP-Bund<br>160bp | 10Y Bund<br>-0.45% |
|                       | ③ Gridlock  | Negotiations stall as members cannot agree on the size/grants/conditionality mix. Calls for more negotiations, but markets starting to doubt the feasibility of the Fund. No official Summit statement released.                               | EUR/USD<br>1.1300/<br>1.1350         | EUR/CHF<br>1.0700/<br>1.0750 | 10Y BTP-Bund<br>175bp | 10Y Bund<br>-0.50% |
| Least market-friendly | ④ Negotiations collapse                                 | Irreconcilable divergences among member states generates hawkish comments and a break-up in negotiations. The Fund will have to be drastically revised or scrapped.  | EUR/USD<br>1.1200/<br>1.1250         | EUR/CHF<br>1.0600/<br>1.0650 | 10Y BTP-Bund<br>185bp | 10Y Bund<br>-0.55% |

Source: ING

## EUR: The bar for a surprise is not too high

EUR/USD is currently trading around the 1.14 level, not far from its 2020-highs. While the pair has been benefiting from hopes surrounding the EU Recovery Fund, its rally has largely been a function of a generalized USD weakness as risk sentiment has improved. In fact, we are of the view that the EUR is not pricing in a quick and seamless agreement on the Fund, nor that its final shape will be the one proposed by the European Commission (nor of the French-German proposal).

The resilience of EUR to a number of pessimistic comments – from the “Frugal Four” in the past couple of months and from Hungary (for instance) more recently – could be a case in point. While some optimism around the eventual realization of the Fund appears there, EUR seems to be fully pricing in the “bumps” of the negotiations.

In light of this, we expect that there is still room for the EUR to benefit from progress being made at the EU Summit this weekend, and the prospect of more negotiations should not scare EUR bulls. After all, the main factor driving EUR/USD higher in the coming months remains a weak-dollar environment. The simple notion that progress is being made on the EU Recovery Fund should be enough to maintain a benign environment for the common currency, which could unlock more upside in the pair.

Barring negative events hitting global sentiment next weekend, we could see EUR/USD push to the upper-half of the 1.14/1.15 range on Monday if our base case (scenario 2 above) materialises. EUR/CHF could make a decisive leap into the 1.08 region, also helped by a shrinking BPT-Bund spread, as we discuss in the rates section below.

## Rates: Cash is king

We view the EU Recovery Fund as acting on interest rates markets through two channels. The most straightforward one is the net monetary benefit (disbursement minus contribution, or net contribution) for each member state. In the absence of any certainty about either the size, allocation, timing, or nature (loans vs grants) of the disbursements, it is hard to reach a definitive conclusion.

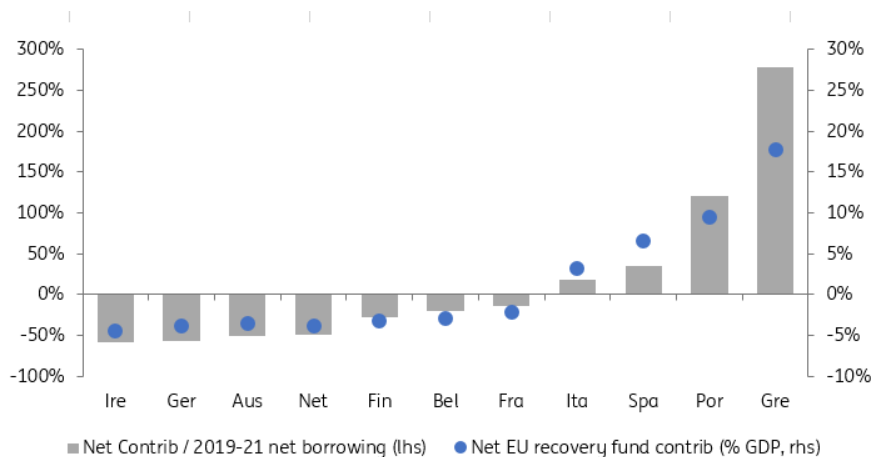
The European Commission’s proposal does offer an illustrative guide of the allocation key between member states however. Since the funds will in all likelihood be approved in the first three years of the Multiannual Financial Framework (MFF), we compared this net contribution to member states’ GDP and to their 2019-21 net borrowing.

There are a lot of caveats to this analysis. Firstly, we should stress here that the EC proposal is probably a best case scenario in terms of size. It is also likely that disbursements will be spread over the whole MFF, so 7 years, rather than just 3 years. Finally, the financial benefit of loans is mitigated by the fact that these need to be repaid out of a member state’s budget in subsequent years.

## Greece and Portugal debt issuance could shrink

On both measures, the beneficiaries are the same: Greece (net benefit of 17.8% of GDP, and of 279% of 2019-21 net borrowing needs) and Portugal (9.5%, 121%) top the list. The upshot for both countries is that, taken as such, the EC proposal would cover a significant portion of their financing needs in the coming years. Depending on how the states choose to use the funds, for additional spending or as a replacement for market funding, this could imply a sharp drop in debt issuance for both sovereigns.

## EU recovery fund net benefit vs GDP and vs net borrowing needs



Source: European Commission, ING

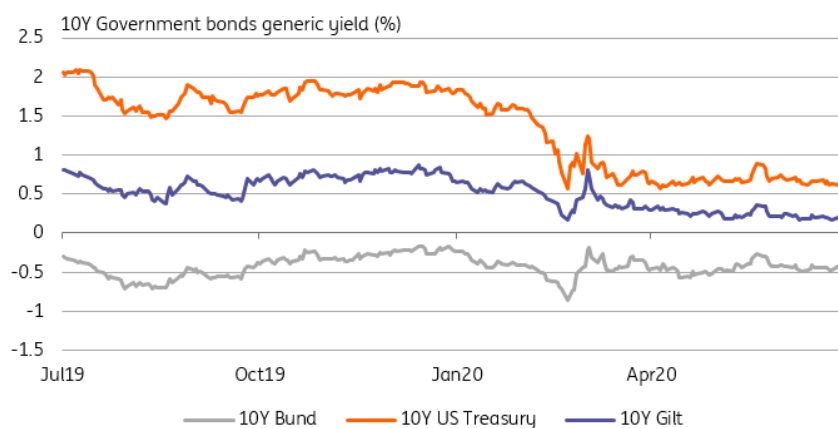
The second group of beneficiaries, Spain (6.6%, 36%) and Italy (3.2%, 18%) could also see a reduction of borrowing needs in financial markets. The magnitude and timing being uncertain, we expect their sovereign debt markets will find it hard to see this as a game-changer, however. This is particularly true as we are comparing the net benefit with deficits. In countries like Italy, gross borrowing needs, to refinance maturing debt, far exceeds deficits.

## A symbolic gesture

The second way an agreement could impact the rates markets is as a signal that more financial integration in the Eurozone is back on the agenda. In three out of the four scenarios we identified above, the agreement of an EU Recovery Fund is a matter of when rather than if, so we see that signal as a high likelihood event.

As we have shown above, the EU Recovery Fund should only be a complete backstop for the finances of small peripheral economies. For larger ones, it is more of a token of good faith. It remains that an agreement would be a milestone in the long-term process of financial integration.

## Eurozone breakup risk premium in Bund has already reduced



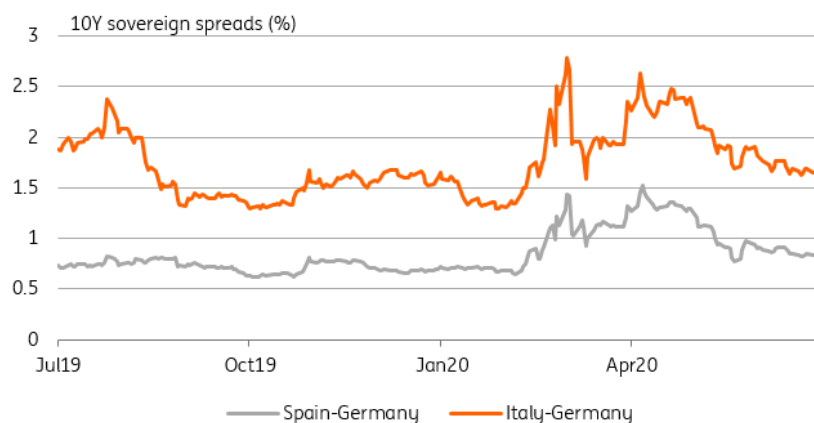
Source: Bloomberg, ING

In our view, some of the benefits of the EU Recovery Fund, namely a reduction in the Eurozone break-up risk, has already been priced in EUR rates markets. One prime example is the fact that Bund yields have failed to revisit their March lows despite the ECB adding to its QE programme in June. For comparison, US Treasury and Gilt yields have remained at or close to their all-time lows.

## The upshot: tighter peripheral spreads

The case for a strong market reaction in peripheral debt is clearer to us. If heavy Italian or Spanish debt issuance will continue in the coming years, we think the combined impact of ECB purchases in the near term, and EU financial support in the medium term, amounts to a license for investors to buy peripheral bonds.

## Room for tightening: Eurozone sovereign spreads



Source: Bloomberg, ING

In case of a swift agreement, we could see the 10Y Italy-German spread reaching our 150bp target this summer. In the event of a more protracted process, this target would likely only be reached towards the end of the year. In both cases, the carry benefit of peripheral debt, and lower prospective volatility thanks to the ECB intervention, make it a superior alternative to core bonds, in our view.

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## EU summit preview: Is the impossible within reach?

EU leaders are edging closer to a deal on a recovery fund. A lot is still at stake at the coming EU summit, but a deal does seem to be within reach



Source: Shutterstock

The lines between European capitals are very busy these days. In the run up to the European Summit on Friday and Saturday, several bilateral meetings between the key players have received media attention. However, very little has actually been said after these meetings.

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*Angela Merkel seems highly determined to bring the European Recovery Fund to life*

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In our view, probably the most important news of recent days and meetings is that Angela Merkel seems highly determined to bring the European Recovery Fund to life. She leaves very little doubt that this time around she really wants to do serious business and put her (and Germany's) entire political weight behind it.



Admittedly, there are still many open issues and some observers have cast doubt about the feasibility of any deal at all. We remain more optimistic. European leaders have come already a long way on some very sensitive issues. The fact that there now is broad agreement about support for the worst-hit countries in the crisis and that there should be European borrowing from the market is already an enormous game-changer. It was only in October last year that plans for a eurozone budget had been negotiated down to a meagre €17 billion fund for competitiveness and convergence as part of the multiannual budget 2021-2027. This weekend, there is a fighting chance that an agreement will be reached on an EU recovery fund that holds many multiples of that.

Don't forget that European leaders never hammer out any single detail of a deal. For this weekend, a political agreement on the basic principles of a European Recovery Fund is still feasible, although the final stamp of approval may need another round of negotiating as it will involve lots of horse-trading, including the negotiations on the European budget. A deal now would be huge, but any sign of further progress on the remaining contested issues would also still be positive.

## What are the make-it or break-it points on the table this weekend?

The European Commission plan for a €750bn recovery fund has been amended somewhat by the European Council, but overall the proposal that is now up for negotiation is roughly similar to the Commission plan. As is well-known at this point: the main opponents of the plan are Netherlands, Denmark, Sweden and Austria (Frugal Four) who are in general cautious on burden sharing. At the same time, remember that the initial French-German proposal foresaw a €500bn fund of grants only. Judging from the rounds of top-level tête-à-têtes this week, the main issues on the table now are size, conditionality, grants versus loans and control over disbursement.

- **Size:** the main opponents want the fund to be smaller than what is currently on the table. No amount was specified in the counter-proposal of the Frugal Four, but they do consider the €750bn amount unfounded. France and Germany had presented a 500bn euro fund, which would be exclusively grants. A possible compromise could be around €600bn with a mix of grants and loans.
- **Disbursement process:** According to the European Council's proposal, each disbursement should require a qualified majority vote. The European Commission had proposed a qualified majority vote to block disbursements, while the Frugal Four would like to see unanimity. Probably included in the ratio for unanimity is the proposal of national parliament approvals. However, this does not seem to stand a serious chance at the moment. It is hard to find middle ground here and this could be given to the Frugal Four as a sweetener.
- **Conditionality:** This may be the most difficult nut to crack at the moment, although there are several possible compromises with regards to conditionality. The current proposal of the council suggests an assessment of the plans according to consistency with the country-specific recommendations of the European semester, digital and green transition and economic potential and job creation. The opponents would like to see reform plans tied to the disbursement along the lines of the troika workings during the euro crisis. A possible compromise could be a model where the disbursement of the fund starts with grants to maintain the speed of disbursement and annual reviews would determine the mix between grants and loans based on reform conditions. Another possible compromise would be a model where disbursements from the fund start as loans but are turned into grants if conditions are met.



• **Grants versus loans:** This has been an ongoing discussion since the start. In the counter proposal by the Frugal Four, only loans were mentioned as the opposition to grants is large and Dutch PM Rutte has indicated that grants are a possibility under strict conditions. This is clearly a balance which provides wiggle room for a compromise. However, Angela Merkel this week said that a significant change would not make sense. In our view, this could be negotiated down to a fifty-fifty mix. At a size of €600bn, this would still allow for a sizable amount of grants.

|  | Size | Disbursement | Conditionality | Grants vs. Loans |
|--|------|--------------|----------------|------------------|
|  |      |              |                |                  |

Source: ING

## What would constitute success at the summit?

The above does look like a lot of work is still to be done over the weekend with a lot of possible outcomes still imaginable. If an agreement on basic principles of a deal is found though, it is hard to imagine one that wouldn't be considered a historical success. It would mark a new step in terms of burden-sharing with the purest form of Eurobonds seen so far. Only if the size of the fund would be minimised this could be seen as disappointing, but would after some time still be perceived as a new step in terms of European integration.

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*Financial markets have responded positively in the run-up to a possible agreement*

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That would be received very positively by financial markets, which have already responded positively in the run-up to a possible agreement. In terms of real economic impact, the devil would be in the details, but the proposals floating now would generate significant stimulus in some of the countries most vulnerable to a longer economic slump.

If no deal is reached at the summit, this is not necessarily a disappointment. It is well possible that more negotiations are needed over the summer, so this does not necessarily mean that a deal is out of reach. Signs of concern would be a postponed decision to a new summit at a later date without a statement on progress. That would suggest that there is much more to be done, especially if no new date is immediately put forward. This lowers the chances of an ambitious result and could make deadlines for the multi-annual budget more challenging.

A possible compromise in our view could include a graduation of grants and loans, starting with grants in the first year and then have an annual review of and for the right balance between grants and loans. As stated above, any kind of political deal this weekend would be seen as a success. However, Angela Merkel's comments this week that settling for a deal could take until the end of

the summer was a clear warning against too much optimism.

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