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EUROPEAN UPDATE: GROWTH, FISCAL DEAL, ECB, BREXIT

Berenberg Macro View

Ahead of another but now almost final Brexit deal deadline tonight (see Brexit section at the bottom), let us lean back and take a look at the bigger European picture. Although the economic situation looks set to worsen near-term due to a renewed rise in Sars-CoV-2 infections, the medium-term outlook remains unusually bright. Strong support from monetary and fiscal policy and a much calmer US foreign and trade policy under Joe Biden bode well for European growth once the second wave of the pandemic has been brought under control, which we expect to be the case by spring 2021 at the latest. Relative to these factors, the terms of the UK's exit from the EU single market will have only a modest impact on the continental European economies. The four and a half post-referendum years in which the UK economy mostly underperformed that of the EU have reduced the relative importance of the UK market for the EU a bit. More importantly, a potential accident that has been discussed for a long time already would no longer come as much of a shock to the EU. One way or the other, the end of Brexit uncertainty may even unlock some investment into pan-European supply chains that had been put on hold by uncertainty about future terms of trade with the UK. In case of a hard Brexit, such investment would mostly be diverted to the continent.

GDP FORECASTS: PANDEMIC IMPACT

After significant progress in November and a stabilisation in early December, the number of recorded corona infections is edging up again in the Europe. Last week, increases in Germany, the Netherlands, the UK, Sweden, Switzerland and – to a lesser extent – in France more than offset the ongoing progress in other countries such as Italy, Spain and Austria. Having opted for comparatively mild restrictions in November, **Germany** looks set to announce a harsher lockdown later today including the closure of non-essential shops, probably as of Wednesday. In-store retail would thus lose much of the traditional peak shopping season ahead of Christmas.

Due to the looming restrictions, we have adjusted the time profile of our **GDP forecasts** to show a sharper contraction in late 2020 offset by a faster snapback in Q2 2021 when we expect life to return to much more normal. Warmer and sunnier weather and vaccination programmes should help to contain the pandemic more decisively by April at the latest. For Germany, we now project a 1.8% qoq instead of a 1.0% qoq drop in GDP in Q4. Together with other more minor adjustments to our calls, this takes our Eurozone GDP forecast to -3.6% from -3.4% qoq for Q4 2020. After a still very mediocre Q1 (+1.3%qoq), we now expect gains in Eurozone GDP of 3.8% qoq (instead of 3.7%) for Q2 2021 and of 1.5% instead of 1.2% for Q3 next year – see Forecasts at a Glance for details. Our call for 5.0% (instead of 5.1%) Eurozone growth in 2021 as a whole remains above the 4.6% Bloomberg consensus

ECB: WHATEVER IT TAKES

For once, the ECB did not exceed expectations on Thursday when it announced an extra €500bn of bond purchases and lengthened the time horizon for such purchases by three quarters to the

end of Q1 2022 – see extending a helping hand for longer. In a lively debate, some council members reportedly objected to a proposal to do more and argued for a smaller increase instead. As a result, the ECB emphasised the flexibility of its programme in its statement: the ECB may not fully use the room for purchases it has granted itself. That could be seen as hawkish. But the **flexibility** runs both ways. The ECB may also raise its purchases if required to ensure a smooth transmission of its monetary stimulus to the real economy across the entire Eurozone. De facto, the ECB pledged to do what it takes to ensure sufficiently favourable financing conditions for consumers, businesses and sovereigns. If it turns out that the ECB does not need to buy a further €500bn of bonds to achieve that, fine. It would not be a problem for economies and markets. In mid-2012, Mario Draghi's original "whatever it takes" pledge ended the euro crisis although the ECB never actually bought any bond under the "OMT" programme that formalised the promise. If the ECB fully utilises its new room for asset purchases, it will gobble up roughly the entire net issuance of sovereign bonds in the Eurozone in 2021 and early 2022.

EU FISCAL DEAL: ON TRACK
Last Thursday and Friday, the compromise machine of Brussels did its job once again. At its summit, the EU overcame the Hungarian-Polish veto against the EU's €1.07trn seven-year financial framework and the €750bn corona recovery fund roughly as we had outlined on 18 November - see €1.8trn deal at risk?. The EU did not back down on the substance of the new "rule-of-law" conditionality: payments can be withheld if two thirds of EU members believe that a country breaches its "rule of law" obligations in a way that could affect the use of the funds. However, the EU de facto delayed the implementation of the clause. In a compromise brokered by Berlin, the EU will wait until the European Court of Justice has checked the conditionality clause before applying it. Depending on the speed of the judicial process, Hungary may not get a first potentially negative verdict and hence a cut in its receipts from the recovery fund before the next Hungarian election in 2022. First substantial payments from the corona recovery fund will likely flow to member states on schedule, that is roughly by June 2021. With some noise, the EU got its act together. Let us hope that US policy makers follow suit and resolve their own fiscal disputes fast.

Separately, the EU summit signed up to an ambitious plan to reduce carbon emissions to 55% rather than 40% below the 1990 level by 2030. The EU's €750bn corona recovery fund ("NextGenerationEU") will partly finance green investments. To what extent a faster cut in carbon emissions over the next decade could be a costly drag on economies will depend on the – yet to be decided – way in which the EU wants to get there. EU leaders will take up this issue at a further summit in March before the EU Commission comes up with detailed proposals next summer. Once again, the discussion will likely be noisy. But a faster transition to a less carbon-intensive economy may also open up growth opportunities for the future if the EU takes a technological lead in a field that seems likely to become more important across the globe.

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BREXIT: THE CORE OF THE DISPUTE
The Brexit deal newsflow has been negative since UK Prime Minister Boris Johnson and European Commission President Ursula von der Leyen failed to resolve their differences over dinner last Wednesday. They merely set tonight as a new deadline for negotiations. Both Johnson and von

der Leyen suggested after the dinner that a "no deal" outcome seems more likely that a deal. As seen from Brussels, it is now less a question of negotiations but of a political decision in the UK to accept or reject the terms under which the EU would continue to grant the UK privileged access to its internal market.

As a condition for trade deals, the EU demands that close neighbours such as Switzerland, Norway and now the UK, with whom the EU interacts a lot, compete on a "level playing field". As a concession to the UK, the EU softened its initial demand that the UK would have to follow future EU changes in relevant standards and regulations to maintain tariff- and quota-free access to the EU market. A mere "equivalence" to future EU norms would suffice. However, the UK seems to reject two specific aspects of this: First, the EU would determine whether or not UK norms are still equivalent to those of the EU in the future. Second, either side could activate a "ratchet clause" and raise barriers against the other side if that side is deemed as gaining an "unfair" advantage by not following a tightening of standards. In such a case, the EU could impose tariffs on UK goods that may not be affected by these regulations (or vice versa).

In a somewhat misleading way, this dispute is sometimes portrayed as a matter of sovereignty. In my view, that misses the point. The UK has the sovereign right to set its own rules and standards and to lay down the terms for access to its market and its rich fishing grounds. By the same token, the EU has the sovereign right to set the terms for access to its vast internal market. If the UK wants to preserve preferential access, it needs to sign up to terms which the EU is ready to accept - and vice versa. In treaties between sovereign entities, the parties typically agree to exercise their sovereignty in specific ways as laid down in the treaty. At a similar stage in the negotiations about the Withdrawal Agreement last year, Johnson made a major last-minute concession (on the issue of Northern Ireland) to unlock the talks. Whether or not he will now do something similar to clinch a deal on post-Brexit UK-EU relations seems to be a very open question, to put it mildly.

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