

TOP *of* MIND

EUROPE AT A CROSSROADS



The Euro area's unprecedented program of fiscal risk sharing in response to the pandemic, and a new, likely less fiscally conservative ruling coalition in Germany, looks set to put the region on a path towards increased integration, higher growth, and better investor returns. But whether the current moment will go down as a seized—or (another) missed—opportunity for Euro area integration and growth is Top of Mind. We speak with our own Jari Stehn, who is optimistic that the fiscal shifts will move the region in the right direction over the medium term and remains constructive on the economic outlook despite China and energy risks, and former ECB Chief Economist Otmar Issing, who is more worried about the fiscal shifts and longer-term growth. We then ask former PM of Italy and President of the EC Romano Prodi and Oxford's Timothy Garton Ash whether these shifts will ultimately lead to a stronger EU. Prodi thinks the EU is past the point of existential danger, although integration from here will be slow. But Garton Ash warns that peak populism may not be behind us.



[Euro area] growth beyond 2022 will depend quite significantly on fiscal policies, and I'm afraid some countries may waste the opportunity to pursue productive investments.

- Otmar Issing

While I do think some progress [on integration] is possible... further progress in the most sensitive areas such as fiscal union will likely be very slow.

- Romano Prodi

Europe has seldom missed an opportunity to miss an opportunity over the last decade.

- Timothy Garton Ash



WHAT'S INSIDE

INTERVIEWS WITH:

Otmar Issing, Former Chief Economist of the European Central Bank

Romano Prodi, Former Prime Minister of Italy and President of the European Commission

Timothy Garton Ash, Professor, University of Oxford

Jari Stehn, Chief European Economist, Goldman Sachs

DON'T LET A GOOD CRISIS GO TO WASTE
Filippo Taddei, GS Europe Economics Research

EUROPEAN EQUITIES: A STRONGER CASE
Sharon Bell, GS European Equity Strategy Research

THE COSTS OF DECARBONIZATION
Jeff Currie, GS Commodities Research

SAFE ASSET SUPPLY IN THE POST-MERKEL ERA
George Cole, GS Markets Research

A NEW POST-MERKEL GERMAN FISCAL NORMAL
Sören Radde, GS Europe Economics Research

...AND MORE

Allison Nathan | allison.nathan@gs.com Gabriel Lipton Galbraith | gabe.liptongalbraith@gs.com Jenny Grimberg | jenny.grimberg@gs.com

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Macro news and views

We provide a brief snapshot on the most important economies for the global markets

US

Latest GS proprietary datapoints/major changes in views

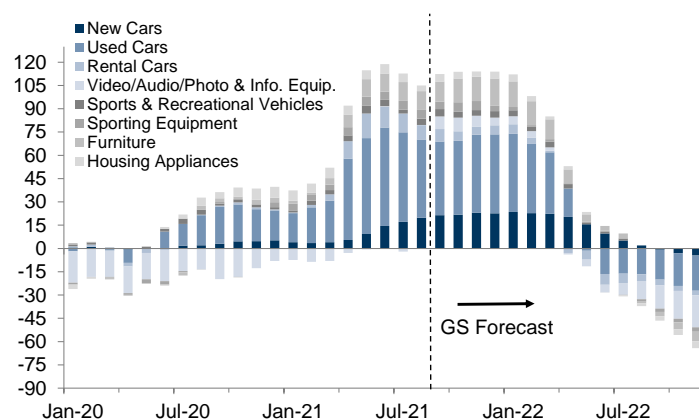
- We recently lowered our 2021 and 2022 growth forecasts to 5.6% and 4%, respectively, based on a slower recovery in consumer spending and a waning fiscal impulse.
- We raised our end-2021 core PCE inflation forecast to 4.25%.
- We lowered our expectation for the next round of fiscal spending to \$2.8tn over 10 years.

Datapoints/trends we're focused on

- Fed taper, which we continue to expect will be announced in Nov. despite recent Delta-related jobs misses.
- 2022 inflation; we see core PCE falling to 2% by end-2022, but wage growth and supply chain disruptions pose upside risk.

A gradually fading inflation boost

Contribution to yoy core PCE from supply-constrained categories, bp



Source: Bureau of Economic Analysis, Goldman Sachs GIR.

Japan

Latest GS proprietary datapoints/major changes in views

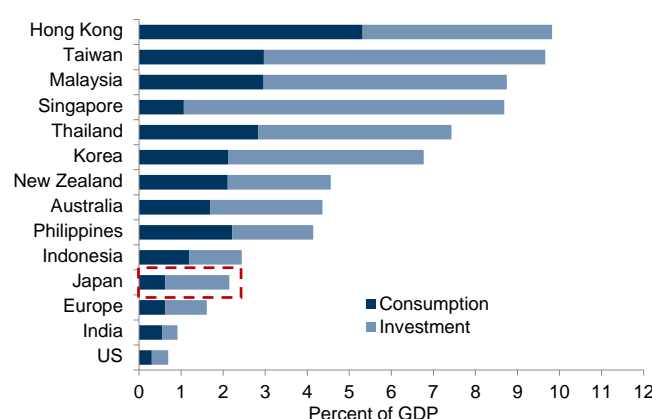
- We expect above-consensus growth of 8.4% qoq ann. in Q4.

Datapoints/trends we're focused on

- PM Kishida's policy platform, which calls for fiscal stimulus and highly accommodative monetary policy, as well as a focus on redistribution and digital transformation over the long term.
- China slowdown, which should have limited spillovers given Japan's smaller exposure to Mainland China demand.
- Virus outlook, which has improved after a sharp rise in cases in Sep., leading to the recent lifting of the state of emergency.

Limited China spillover risk

Exposure to final demand in Mainland China, % of GDP



Source: World Input Output Database (2016), OECD TiVA, Goldman Sachs GIR.

Europe

Latest GS proprietary datapoints/major changes in views

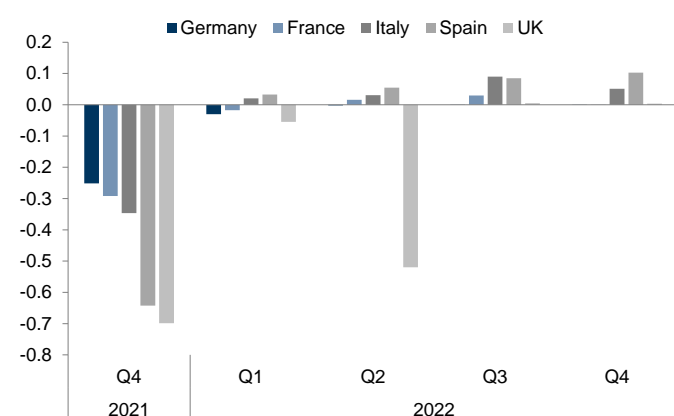
- We recently lowered our 2021 Euro area growth forecast to 4.9% on a small expected disposable income drag from rising energy prices and trade headwinds from softer global demand.
- We recently pulled forward our forecast for BoE Bank Rate lift-off to Nov. on stronger activity and rising inflation expectations.

Datapoints/trends we're focused on

- Energy shock, which should prove a short-lived growth drag.
- Inflation; we see Euro area core/headline inflation peaking at 2.3%/3.8% yoy, respectively, in Nov. before falling in Jan. 2022.
- Post-PEPP QE, we don't expect an open-ended APP increase.

A short-lived energy shock

Energy cost shock to households, % of 2019 disposable income



Source: Goldman Sachs GIR.

Emerging Markets (EM)

Latest GS proprietary datapoints/major changes in views

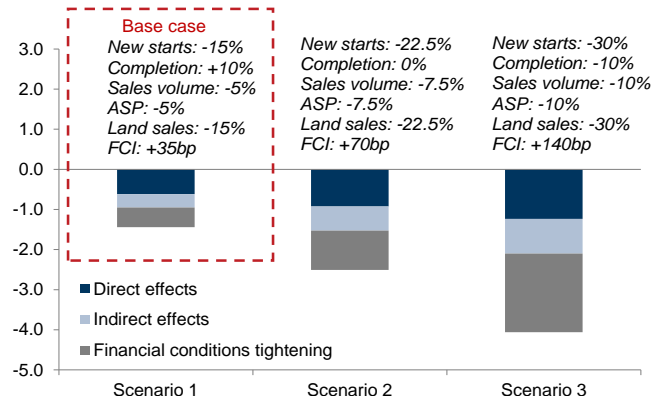
- We recently lowered our 2021 China GDP forecast to 7.8% yoy on sharp production cuts in energy-intensive industries.

Datapoints/trends we're focused on

- China property risks, which would weigh on 2022 GDP by 1.4%/4.1% in our base case and downside scenarios.
- EM inflation, which has risen sharply and is likely to persist through year-end, but should fade somewhat in 2022.
- Higher oil/gas prices, which benefit EM exporters (MENA, Russia, Colombia, and Indonesia).

China's property sector woes to weigh on growth

Impact of property sector slowdown on China GDP level in 2022, pp



Source: Wind, Haver Analytics, World Input-Output Database, Goldman Sachs GIR.

Europe at a crossroads

Europe's forceful pandemic response, including an unprecedented program of fiscal risk sharing, combined with a new ruling coalition in Germany that's likely to break from the fiscal conservatism of the Merkel era, looks set to put the Euro area on a path towards increased integration, higher growth, and better investor returns. Near term, the region's relatively high vaccination rates, large scope for catch-up growth and back-loaded fiscal stimulus reinforce the case for Euro area outperformance ahead. But the region is also particularly exposed to rising risks from a global slowdown and energy shortages, as well as the potential for the Next Generation EU Fund (NGEU)—and further economic and political integration prospects more broadly—to fall short of expectations. Whether the current moment will go down in the history books as a seized—or (another) missed—opportunity for the Euro area is Top of Mind.

We first ask whether recent progress on the fiscal front truly marks a turning point for fiscal policy in the region. Jari Stehn, GS Chief European Economist, believes the answer is yes. In his view, EU countries' strong fiscal response to the pandemic, aided by the EU's suspension of the Stability and Growth Pact (SGP) fiscal rules that limit member-states' deficit and debt levels, marked an important shift in the willingness to employ counter-cyclical fiscal policy within the region. And, he says, the historic €800bn NGEU that, through the EU Recovery Fund, provides large-scale grants to weaker economies and long-term loans backed by the issuance of common debt, represented not only a real turning point in the crisis, but also a big step forward in the evolution of the EU—after years of fighting over fiscal burden sharing, the EU is now set to become the largest supranational debt issuer in the world.

Although the Recovery Fund and other recent fiscal measures are temporary, Stehn expects greater flexibility around institutional rules going forward and believes some aspects of the Fund could become permanent, marking a more lasting shift in inter-governmental fiscal support. All told, Filippo Taddei, GS senior European economist, sees the NGEU as an opportunity not only for sustained higher growth in the region, but also for meaningful structural change, given its investment-focused structure targeted at supporting the region's green and digital transitions.

According to Stehn and Sören Radde, GS senior European economist, the outcome of the German election—while still unresolved—will further cement the shift towards increased fiscal flexibility in the region no matter which of the two most probable coalitions—a "Traffic Light" coalition between Olaf Scholz's SPD, FDP and Greens, or a "Jamaica" coalition between the CDU/CSU, FDP and Greens—ultimately prevails (see pages 22 and 23 for details on the German election and government.)

But what will this shift in the EU's longer-term fiscal mindset mean for near-term growth? Stehn cautions that the rising risks of a China/global slowdown and energy shortages centered in Europe are likely to weigh on growth in the near term, and we have recently lowered growth forecasts for the region, with 2021 growth now expected to be 4.9% yoy. Despite these challenges, he remains constructive on the region's growth outlook relative to other major economies next year in large part owing to the back-loaded fiscal stimulus provided by the Recovery Fund, as well as the still-large GDP shortfalls, high vaccination rates and the likely easing of supply chain bottlenecks that have held back

Euro area industrial production. And he's not too worried about the prospect of sustained inflationary pressures despite the current surge, because he doesn't see much evidence that current price spikes are becoming entrenched in inflation expectations or wages.

With these views in mind, George Cole, GS senior European rates strategist, expects higher European rates ahead. And Sharon Bell, GS senior European equity strategist, makes the case that these macro factors, as well as other important shifts in the composition and ownership of European and other equity markets, leaves European equities more attractive relative to other markets than in the past.

But Otmar Issing, former chief economist and member of the executive board of the ECB, is generally more concerned about the recent shift towards fiscal risk sharing. He argues that EU debt issuance wasn't legal under the framework of the Maastricht Treaty, and, without a fiscal authority at the EU level that can only be accomplished via a referendum-induced treaty change, fiscal policies must remain in the hands of those who are responsible to voters: national governments. In addition to these institutional concerns, Issing is less convinced that European leaders won't repeat the mistakes of the past by channeling funds towards consumption rather than investment—even in his own country of Germany. So he's worried about the region's longer-term growth prospects. And he also believes that the fight against climate change, demographic shifts, and the retreat of globalization mean that the world is on the cusp of a regime shift that points towards a permanently higher level of inflation.

Jeff Currie, GS Global Head of Commodities Research, shares these concerns about inflation—and ultimately growth—given the current energy shortages in Europe and China. He argues that as long as policymakers continue to pursue policies that support energy demand (like the expansionary fiscal policies we've been discussing) but constrain energy supply (via green initiatives), we're in store for higher energy and commodity prices, more inflation, and potential disruptions to economic activity (since you can't consume what you don't have.)

Amid all of these shifts, the larger question remains whether the cooperation between EU members that resulted in a decisive response to the pandemic can persist beyond the crisis, and push the EU towards a stronger and more effective union. Romano Prodi, former prime minister of Italy and president of the European Commission, believes the EU is "absolutely past the point of existential danger", and sees the potential for greater internal cooperation to tackle external threats, although he sees the requirement of unanimity around big EU decisions leading to only very slow—and ultimately incomplete—integration ahead. But Timothy Garton Ash, professor of European Studies at the University of Oxford, cautions that "Europe has seldom missed an opportunity to miss an opportunity over the last decade." And he's closely watching next year's French presidential election and potential political shifts in Italy, as he doesn't agree with Prodi that peak populism is behind us.

Allison Nathan, Editor

Email: allison.nathan@gs.com
Tel: 212-357-7504
Goldman Sachs and Co. LLC



Interview with Jari Stehn

Jari Stehn is Chief European Economist at Goldman Sachs. Below, he argues that the Euro area economic outlook remains constructive despite a number of challenges, given a more back-loaded fiscal boost.



Allison Nathan: Much has been made of a potential shift in the fiscal mindset of the Euro area given the strong fiscal response to COVID-19 and the potential for a new ruling coalition in Germany. Do you see this as an important turning point for fiscal policy?

Jari Stehn: We've seen an important shift in European fiscal policy over the last 18 months. Countries were quick to provide forceful fiscal support, aided by the EU's suspension of the Stability and Growth Pact (SGP) fiscal rules that limited member-states' deficit and debt levels. At the EU-wide level, European leaders agreed to a historic €800bn Next Generation EU (NGEU) Fund, which, through the EU Recovery Fund, provides large-scale grants to weaker economies and long-term loans backed by the issuance of common debt. The Recovery Fund was a real turning point in the crisis, and it also represents a big step forward in the evolution of the EU. After years of fighting over fiscal burden sharing, the EU is now on track to become the largest supranational debt issuer globally. The German election outcome will only further cement this shift. While the composition of the next government is still uncertain, it's not going to be a center-right coalition that would push for a swifter return to fiscal prudence. And the likely inclusion of the Green Party in any coalition suggests a move toward more public investment and expansionary fiscal policy.

It's also important to emphasize the ECB's critical role in buying time with their pandemic QE program, or PEPP, for the EU-wide fiscal response. They stepped up purchases on a large scale and in a more flexible way, which signaled a willingness to do everything necessary to protect the Economic and Monetary Union (EMU). This kick-started more coordination between fiscal and monetary policy, which was new and much more effective than the fragmented response to the Global Financial Crisis (GFC). These shifts are important and positive for the economic outlook because they help address the perennial problem of the EMU: a lack of risk sharing.

Allison Nathan: But are you concerned that many of these measures are temporary?

Jari Stehn: It's true that the SGP is only suspended until 2023, and the Recovery Fund is set to be wound down starting in 2027 through to 2058. That said, while a more permanent adjustment of the SGP remains unlikely because that would require a change to the Maastricht Treaty, we expect greater flexibility in the interpretation of institutional rules. This will likely give countries more time to execute fiscal adjustment, and shield some public investment from the rules. And even if the Recovery Fund as a whole is temporary, some of its provisions, such as the loan facility, may become permanent. But most importantly, the Recovery Fund sets the precedent for a meaningful EU-wide response in the event of a future

shock, because it showed that when it matters, European leaders can come together and act. So progress is incremental, as is often the case in Europe, but it's real.

Allison Nathan: Does the bending of the fiscal rules go against the EU's treaty framework and risk moral hazard?

Jari Stehn: Ensuring fiscal sustainability is important, but rules aren't helpful unless they're incentive compatible and there's buy-in at the national level. The EU fiscal rules were broken by Germany in the early 2000s and by Southern European economies after the GFC precisely because they weren't compatible with domestic political incentives. The Recovery Fund offers a promising way forward by using not only a stick, which evidence suggests hasn't worked well, but also a carrot, via a system that offers grants and loans in return for substantive policy commitments.

More broadly, the world has changed since the 3% and 60% of GDP deficit and debt targets, respectively, set by the Maastricht Treaty. At that time, the principal role for monetary policy was thought to be cyclical stabilization, and for fiscal policy, debt sustainability. But the sharp decline in the equilibrium interest rate, which is a structural and global phenomenon, means monetary policy cannot play the same role in cyclical stabilization as was intended when the EMU was created. This is even more critical when interest rates are at or below the zero lower bound. Lower interest rates also make running public deficits cheaper, meaning that the Maastricht criteria would be far less restrictive if recalculated based on today's interest rates. Interest rates probably won't remain this low forever, but they're also unlikely to return to the 5-10% range that prevailed when the EMU was constructed. In such an environment, there's a strong economic case for employing counter-cyclical fiscal policy and revisiting the interaction between fiscal and monetary policy.

Allison Nathan: Following a strong activity rebound in Q2, a number of cross currents have emerged. How do you view the near-term growth outlook for the Euro area?

Jari Stehn: We recently took down our near-term growth figures to reflect two headwinds that have emerged in recent weeks. First, the global activity outlook has weakened, as our US and China teams have cut their growth forecasts significantly. Northern Europe is very exposed to the global cycle through trade linkages, so the slowdown should weigh notably on industrial activity and we now expect net exports to weigh on growth in coming quarters. With regard to China, our base case of a 1.4% hit to China GDP next year from a slowdown in the property sector would likely prove manageable for the Euro area given that it's less exposed to this sector. But a deeper-than-expected downturn in China owing to property sector contagion, energy constraints and/or other regulations would present further downside risk to our growth forecasts, especially for the Northern economies.

Second, the energy crisis has deepened and is weighing on the European outlook. The most direct channel is through higher inflation; headline inflation in Germany is already at its highest level since 1993. Although higher energy prices weigh notably on household incomes, we expect government support measures and strong household balance sheets to limit the growth hit in coming months. In addition, we see risks of production disruptions in the industrial sector which could intensify with a cold winter. Taken together, we have cut our H2 (non ann.) growth number for the Euro area by about 0.25pp, which takes our 2021 growth projection down to 4.9%.

Allison Nathan: Why do you remain relatively optimistic on Euro area growth beyond these challenges?

Jari Stehn: We see three reasons why the broader Euro area outlook remains constructive relative to other major economies. First, pent-up demand is still high. In particular, Europe has the combination of high vaccination rates and a GDP shortfall relative to pre-pandemic levels. Second, the current supply bottlenecks that are holding back industrial production should moderate. Most of these bottlenecks owe to strong demand, and should become less acute as supply eventually responds and pent-up demand is met. Third, the strong fiscal support that we've discussed is more back-loaded than in other major economies. For example, the US fiscal impulse is expected to turn sharply negative next year, whereas it will remain notably positive in Europe because the Recovery Fund is still ramping up. So while there's less growth upside in the Euro area than earlier in the year, it still looks attractive on a relative basis because many other places will be slowing more rapidly. That's especially the case in Southern Europe, most notably Spain, where there's still substantial room for catch-up growth—given that it has one of the world's highest vaccination rates and largest growth gaps—and where the Recovery Fund should add 5-8% to GDP over the next 5 years. So, despite the near-term challenges, we remain constructive on growth next year and look for 4.3% growth in 2022 and 2.2% in 2023, at or slightly above consensus.

Allison Nathan: Are you concerned that the current inflation surge will prove persistent?

Jari Stehn: Not much. The main driver of rising prices is reopening effects, which have led to demand temporarily outstripping supply, but that should moderate as supply responds and demand normalizes. Technical factors, including tax changes and adjustments to the inflation indices, will also mechanically drop out in 2022. And energy prices won't rise 20% each year indefinitely. The more important question is whether these price surges become entrenched through second-round effects on inflation expectations and wages. But inflation expectations, while having risen slightly, remain below 2%, and wages have shown little sign of rising even amid the inflation surge. Overall, greater slack and a more entrenched low inflation trend suggest a smaller risk of second-round effects in the Euro area than in other developed economies.

Allison Nathan: What does this all mean in terms of your expectations for monetary policy?

Jari Stehn: Having already started to reduce its PEPP purchases, the ECB's next big decision will come in December around the post-PEPP QE outlook. PEPP is scheduled to end in March 2022, and the ECB wants to provide a bridge from it to the previous €20bn Asset Purchase Program (APP). Our highest conviction call, where we differ from other forecasters, is that the ECB won't commit to an open-ended increase in the APP in December. We hold this view because we see the ECB's commitment to maintain favorable financing conditions as a pandemic pledge that won't extend much beyond the crisis. They've also gained confidence in the inflation outlook, which has reduced the appetite for implementing a big step-up in QE. And such a step-up would be difficult when the Bank of England and the Fed are moving in the opposite direction.

Longer term, the ECB seems to want to tilt the instrument set from the pandemic purchases and QE towards the policy rate and forward guidance. Indeed, recent comments from Governing Council members have emphasized that as the recovery matures, it's more important to focus on the length of QE—because that informs the timing of liftoff—than on the volume of QE. To this end, we expect the first rate hike in 2025, which is later than consensus and market pricing, based on our view that the ECB wants to maintain a dovish stance to continue to support the recovery—which we think is appropriate given that the Euro area entered the pandemic with more slack than the UK and the US—but to do so via the policy rate as opposed to QE.

Allison Nathan: What risks are most worth watching?

Jari Stehn: Beyond the energy and global growth headwinds, COVID remains an important downside risk. Heading into the winter, Europe looks well-positioned in terms of vaccinations, but virus spread and the emergence of any new variants are risks. Looking further out to 2023, the classic issues of debt sustainability and politics will be back on the table. While there's an important election in France and political events in Italy next year, policy support will remain strong in 2022: fiscal rules will still be suspended and Recovery Fund spending will be peaking. But with Italy sitting at a debt-to-GDP ratio of 150%, Germany having rebounded quite strongly, and a more fragmented political landscape, those issues could resurface in 2023. That's not our base case, but it merits watching.

Allison Nathan: From an economic and institutional perspective, will the Euro area be in a better place in 2023?

Jari Stehn: In a way, yes. Although high debt will be a concern, scarring effects from COVID are likely to be limited, and institutional improvements and a more favorable political situation should prove helpful. A critical test will be whether the economic recovery goes smoothly from here. If our growth numbers prove correct, then Europe will be in a fairly strong position in 2023 and debt dynamics should be manageable. And if the Recovery Fund is seen as a success, Northern European countries will be more likely to support further integration. But if Europe stumbles on either of these fronts, it could easily fall into past patterns. So, it's very important to get these things right now to prevent backtracking on the substantial progress that has been made.

Interview with Otmar Issing

Otmar Issing was Chief Economist and Member of the Executive Board of the European Central Bank (ECB) from 1998 to 2006. He is President of the Center for Financial Studies at Goethe University. Below, he argues that the risk of slower growth and higher inflation in the Euro area in coming years is concerning, given the pressure on governments to spend on consumption rather than on investment, and that the ECB's highly accommodative policy stance is no longer appropriate since the crisis has largely passed.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.



Allison Nathan: Much has been made of a potential shift in the fiscal mindset of the Euro area given the strong fiscal response to COVID-19. Do you see this as an important turning point for fiscal policy in the Euro area?

Otmar Issing: Euro area fiscal policy at both the national and supranational levels is at a crossroads. At the national level, all member states have spent significant amounts of money trying to mitigate the negative economic consequences of the pandemic, and finding a way back to a sustainable path for fiscal policy without endangering the economic recovery will be a huge challenge, especially for countries with high debt levels.

At the EU level, two issues are urgent. First, the Stability and Growth Pact (SGP) is under severe pressure. Several Southern European countries have argued that investment should be excluded from the deficit limit, whereas Northern countries—the so-called “Frugal Four”—are resisting such requests. And second, the credit financing of the €800bn Next Generation EU (NGEU) fund is arguably a violation of the Maastricht Treaty in the sense that issuing credit at the EU level is forbidden. This was allowed as a temporary exemption of the law because the program was presented as a unique measure to tackle a unique event, although the uniqueness of the fiscal situation was hardly credible. And, unsurprisingly, there’s now strong pressure from many sides to continue with further credit financing at the EU level. Such a continuation would move the Euro area in the direction of a fiscal union, and calls its whole institutional arrangement into question.

Allison Nathan: Hasn’t the crisis shown that such steps towards European fiscal integration are desirable?

Otmar Issing: My answer to that isn’t yes or no. If the Euro area wants to move further in the direction of a fiscal union, which can ultimately only be done in the context of a broader political union, that requires a change to the Maastricht Treaty. Without that, such a “Europeanizing” of fiscal policy isn’t legally justified or democratic. I am a democrat, and I believe fiscal policies have to be in the hands of those who are responsible to voters. That still only exists at the national level. There’s no fiscal authority at the European level, and there can’t be unless the Treaty is changed. If Europeans want a fiscal union, they should hold a referendum to change the Treaty. But until then, there is no legal or democratic basis for fiscal integration at the European level.

Allison Nathan: With interest rates at or below the zero lower bound in most major economies—and remaining quite low since the Global Financial Crisis (GFC) in general—do you see the role of fiscal policy evolving? Is there a case for a greater use of counter-cyclical fiscal policy than in the past?

Otmar Issing: No, I don't think so. The pandemic warranted strong, timely and targeted fiscal intervention, which is exactly what was done. And monetary policy has just supported this fiscal stance. But as soon as we emerge from the pandemic, which appears close, and interest rates rise, we should return to the normal division of responsibilities between fiscal policy and monetary policy.

Allison Nathan: Euro area growth has a long history of disappointing expectations. Is there reason to be more optimistic about the growth outlook going forward?

Otmar Issing: There’s reason to be optimistic about growth over the near term. The recovery from the pandemic is underway, supported by fiscal spending from the NGEU program, and this recovery is likely to be stronger than during previous cyclical downturns given significant pent-up demand resulting from the pandemic. While supply constraints in a number of sectors will likely have a negative impact on growth this year, easing of these shortages will contribute to a stronger recovery next year.

But over the longer term, once the pandemic is behind us, growth may once again disappoint, mainly because many countries likely won’t spend the additional funds they receive from the EU Recovery and Resilience Facility (RRF) on productive investments like digitization or fighting climate change, but rather on public consumption, pension schemes, etc. Growth beyond 2022 will depend quite significantly on fiscal policies, and I’m afraid some countries may waste the opportunity to pursue productive investments.

Allison Nathan: But given that the disbursement of RRF funds requires member states to commit close to 40% of expenditures to green investment and 20% to digitization, why are you so concerned that funds will be spent on consumption rather than on more productive areas?

Otmar Issing: Past experience tells me to be cautious. In my own country of Germany, public investment has been very weak over the past several years, not due to fiscal austerity policies, as is commonly argued, but because public consumption and spending on pensions has always taken higher priority. And while European policymakers all agree that investments need to be made in digitization, innovation, and the fight against climate change, the test of the pudding is in the

eating—it's one thing to talk about doing something, it's another thing to actually do it. In Italy, so long as Mario Draghi is prime minister, things should go in the right direction. But as soon as he's out of office, which may be sooner rather than later if he becomes president of the republic next year, funds may once again be channeled toward public consumption. So, I've yet to be convinced that governments can take a longer-term view and make the necessary investments, especially as voters are now used to directly reaping the benefits of government spending. This is the permanent problem of democracies, but it's even more pressing in the Euro area because growth has disappointed so many times in the past.

Allison Nathan: Are you more optimistic that Germany will move in the right direction following the recent elections?

Otmar Issing: German economic and fiscal policy won't change dramatically regardless of the outcome of the ongoing coalition negotiations. That's disappointing because, as the pandemic recedes and the economy returns to normal, the structure of public spending should be changed in the direction of more investment and less consumption. Germany absolutely needs to invest more in areas like green technology and digitization. And as soon as growth picks up again, tax revenues will also rise, opening up fiscal space for further spending on investment. But more money can't be spent on investment if at the same time more and more taxpayer money is used to patch leaks in the country's pension and health systems. This is a real problem in Germany today. The low level of explicit public debt, roughly 70% of GDP, masks the magnitude of the issue—implicit public debt is roughly six times higher. In the absence of fundamental reforms, like raising the retirement age, an estimated 50% of tax revenues will be needed to support the country's pension system 20 years from now. Unfortunately, because this challenge won't come to a head for a number of years, politicians today may again be tempted to delay making decisive reforms to the pension system. So this could continue to eat into the country's fiscal space rather than channeling spending towards more productive investments.

Allison Nathan: Does the likely inclusion of the Green party in the next ruling coalition give you some hope that more public spending will be channeled into green investment?

Otmar Issing: A cornerstone of the Green party's policy platform is, of course, more green investment, so climate policy will play a much stronger role in German economic policy going forward. But the question isn't just how much money will be spent on climate policy, but also how the decarbonization of the German economy will be organized. Will the policy rely more on innovation or on restrictions of certain activities? This is a key area of disagreement between the Greens and the FDP, which will be the partner of the Greens in any coalition, and it's unclear how this will play out.

Allison Nathan: Even if countries invest appropriately in growth areas, are you concerned that a return to austerity as SGP fiscal rules are reapplied starting in 2023 will have a negative effect on the Euro area growth outlook?

Otmar Issing: While it's difficult to say at the moment because the fiscal rules are currently being debated, I wouldn't expect fiscal policies to be significantly constrained by the SGP. The EU

has always looked the other way when countries have violated the Pact, so the rules are one thing, but the reality has and will likely continue to be quite different. And even if the rules were to strictly reapply, that wouldn't necessarily hamper fiscal spending. In Germany, for example, public expenditures have always increased, but because growth was relatively strong, public debt declined in spite of the fact that government spending rose. And studies have found little truth to the story that countries with higher deficits have higher growth anyway, which calls into question the idea that fiscal austerity automatically means lower growth.

Allison Nathan: The latest inflation prints in the Euro area have surprised significantly to the upside, yet the ECB seems confident that the recent rise in prices will prove transitory. Should they be more worried?

Otmar Issing: The current high inflation rate owes to a number of factors, including the return of the German value-added tax (VAT) to its former level following a lowering of the rate during the pandemic, which has had a substantial impact on the German inflation rate as well as the Euro area inflation rate due to the large weight assigned to Germany in the Euro area's Harmonized Index of Consumer Prices (HICP). However, inflation will fall at the beginning of next year as such base effects drop out of the calculation, so there's no question that the current spike in inflation is temporary.

The question is what happens later. ECB Executive Board Member Isabel Schnabel has predicted that the ECB will once again be confronted with too low inflation in the near future, which, to me, goes too far; the ECB's view on medium-to longer-term inflation is too benign. Policies to fight climate change will likely contribute to higher energy prices for many years to come as the price of carbon continues to rise. And, as Charles Goodhart and Manoj Pradhan have shown in their book *The Great Demographic Reversal*, the deflationary impact on prices from globalization and favorable demographic trends is starting to disappear as populations age and globalization retreats. The world is on the cusp of a regime shift that points in the direction of a permanently higher level of inflation. And the longer inflation remains elevated, the more risk that workers will demand higher wages as compensation, leading to a more prominent rise in inflation.

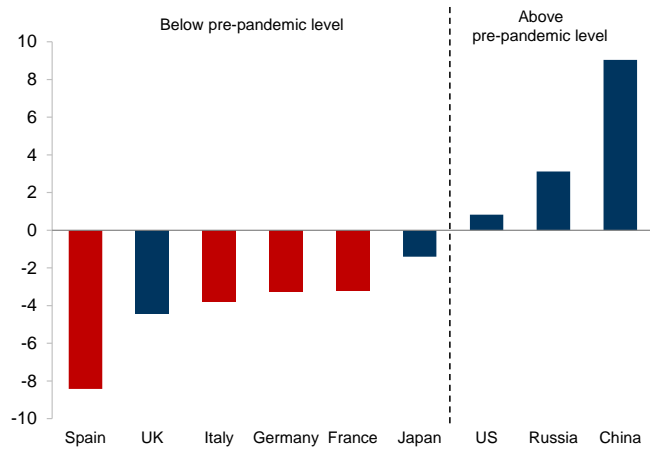
Allison Nathan: Given these growth and inflation expectations, does the ECB's current policy stance look right to you?

Otmar Issing: The ECB's monetary policy is still in crisis mode, and they have made it clear that they intend to keep their foot on the accelerator. But the crisis is over, and this mode is no longer appropriate. While some downside risks argue in favor of a very slow and moderate exit from this very expansionary monetary policy, the longer the ECB delays its exit, the higher the risk that a much stronger exit in the form of a sudden reduction in QE and possibly even interest rate hikes will be needed. This would create a very difficult situation for the ECB, not least because of the potential negative impact of higher long-term interest rates on highly indebted countries. So I am concerned that the ongoing expansionary stance of the ECB will create problems down the road.

A snapshot of the Euro area outlook

The Euro area has more room for catch-up growth

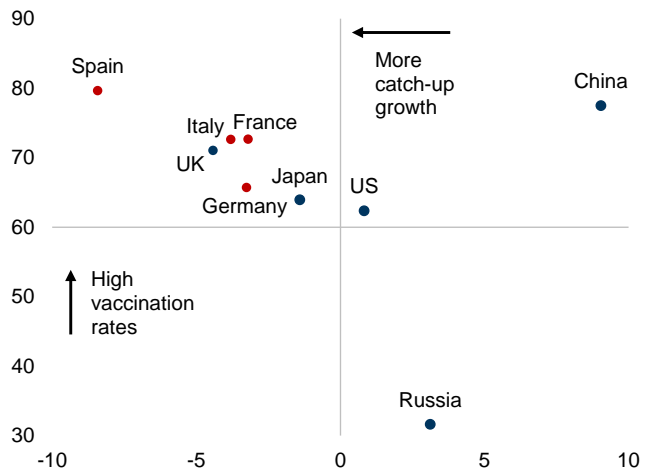
Real GDP shortfall in 2Q21 relative to 4Q19, %



Source: European Commission, Goldman Sachs GIR.

Vaccination rates are high in Euro area economies

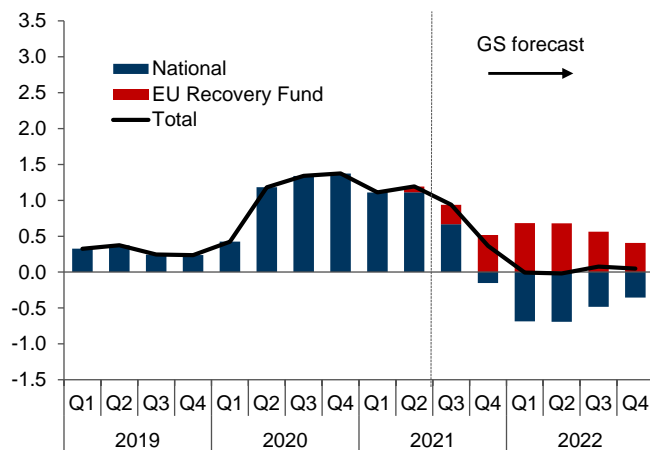
Real GDP shortfall (x-axis), %; vaccination rate (y-axis), % pop



Note: GDP shortfall reflects 2Q21 real GDP level relative to 4Q19; vaccination rate refers to share of total population with one dose. Source: Our World in Data, Goldman Sachs GIR.

Recovery funds will provide a small boost in the north...

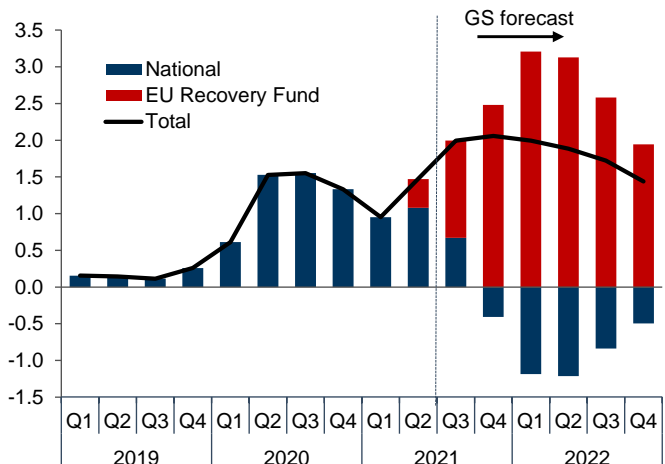
Effect of fiscal policy on real GDP growth, 3QMA pp ar



Source: Eurostat, Goldman Sachs GIR.

...and a substantial one in the south

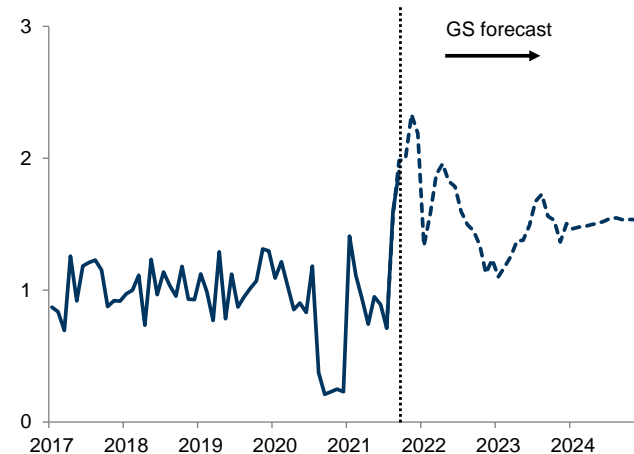
Effect of fiscal policy on real GDP growth, 3QMA pp ar



Source: Eurostat, Goldman Sachs GIR.

Euro area inflation should moderate throughout 2022

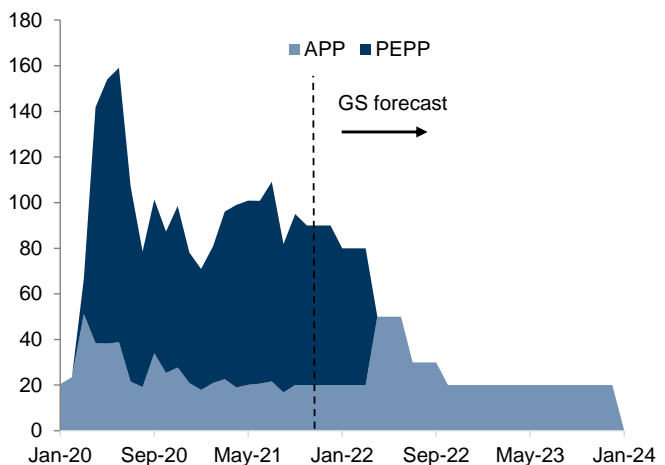
Euro area core HICP inflation, % yoy



Source: European Commission, Goldman Sachs GIR.

We expect a temporary bridge from the PEPP to APP

ECB QE purchase path, €bn



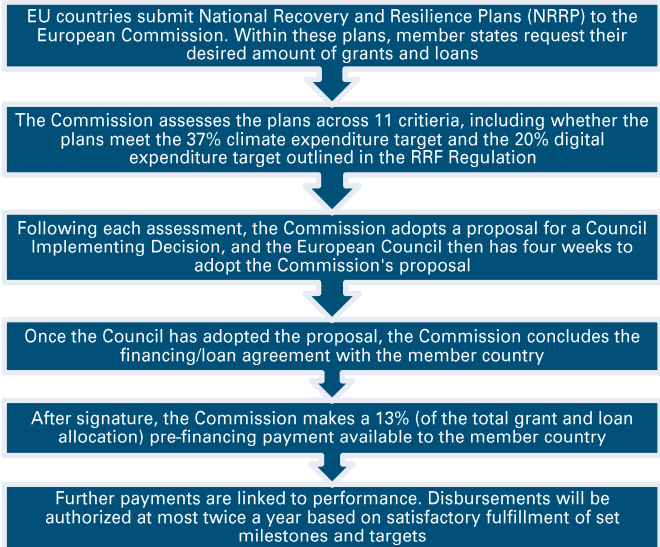
Source: ECB, Goldman Sachs GIR.

EU Recovery Fund explained

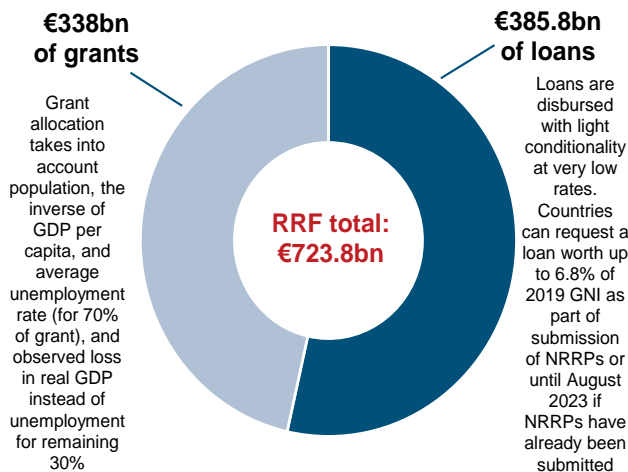
What is it?

The Recovery and Resilience Facility (RRF) is the centerpiece of the Next Generation EU (NGEU) fund, a €807bn (in current prices) temporary recovery instrument aimed to help repair the economic and social damage to the EU from the COVID-19 pandemic. Beyond repairing the immediate damage from the pandemic, the RRF is designed to make EU economies more sustainable, resilient, and better prepared for the green and digital transitions underway around the world. As a part of this, each country that is approved to receive funds from the RRF must commit to spending a minimum of 37% of expenditures on climate investments and reforms, and a minimum of 20% to support their digital transitions.

How are funds disbursed to member countries?



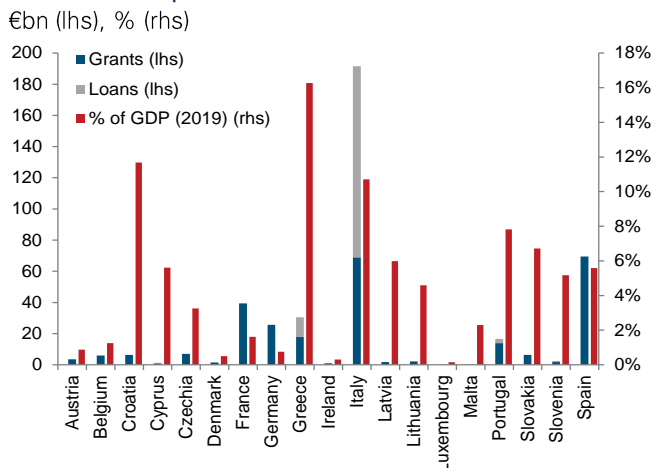
Funding mix



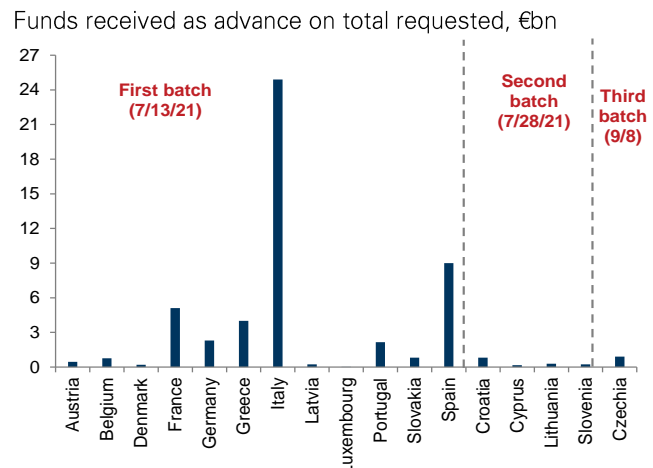
How will this be paid for?

To finance NGEU, and the RRF by extension, the European Commission, on behalf of the EU, borrows money on the capital markets at more favorable rates than individual member states. Net borrowing operations are scheduled to end by 2026, and repayment to start in 2028 and continue until 2058. The loans will be repaid, through the Commission, by the borrowing member states, and the grants by the EU budget (any grants requested over the maximum amount allowed per country will be financed by that country). To do so, the Own Resources Decision (ORD), which establishes how the EU budget is financed and was ratified on May 31, 2021 by all member states, raised the maximum level of resources that can be called for from member states from 1.2% to 1.4% of EU GNI. It also provides for a temporary increase in the ORD ceiling by an additional 0.6%, to be used exclusively for servicing the RRF debt. Additional sources of revenue are expected to be linked to a carbon border adjustment mechanism, a digital tax, and the EU Emission Trading System, although these have not yet been approved.

Southern European countries at the forefront



19 countries have been authorized to receive funds so far*



*Ireland was approved to receive funds at the same time as Czechia and Malta was approved to receive funds on 10/5/2021, but no funds have yet been disbursed. Source for all exhibits: European Commission, European Council, Goldman Sachs GIR.

Don't let a good crisis go to waste

Filippo Taddei argues that the EU Recovery Plan provides an opportunity for sustained economic growth and meaningful structural change in the region, but implementation and under-execution risks remain

While the EU Recovery and Resilience Facility (Recovery Fund), and its parent program the Next Generation EU (NGEU) fund (Recovery Plan), were created to help the EU tackle the economic crisis caused by the COVID-19 pandemic, their scope goes well beyond containment of the cyclical downturn. The Recovery Plan aims to support structural change in EU countries by increasing the level of aggregate investment in the economy, especially in the sectors most connected to the green and digital transitions.

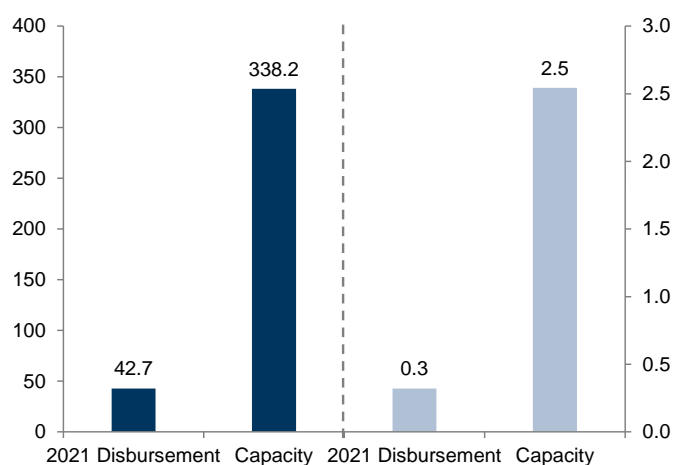
The EU Commission has endorsed 19 [National Recovery and Resilience Plans](#) (NRRP) from the 27 EU member states, and these plans are ready to be implemented. Each plan includes remarkably detailed information, from the timeline of every investment project through 2026, to the specific structural reforms that will facilitate their implementation. And they set the stage for sustained economic growth and meaningful structural change. But this unique opportunity doesn't come without risks. The under-execution of the NRRPs or delayed implementation may turn out to be more costly for the European economy than anticipated.

Persistent and regionally focused

Like most fiscal support centered around [investment](#), the Recovery Plan is likely to impact GDP growth over many years. The Recovery Fund's economic effects should be particularly persistent as the program is scheduled to run through 2026, and funding is substantially back-loaded—only around 10% of the plan's total resources are scheduled to be disbursed this year (grants worth 0.3% and loans worth 0.2% of EU GDP).

Only a small amount of grants to be disbursed this year

Recovery Plan grants, €bn (lhs), % of GDP (rhs)



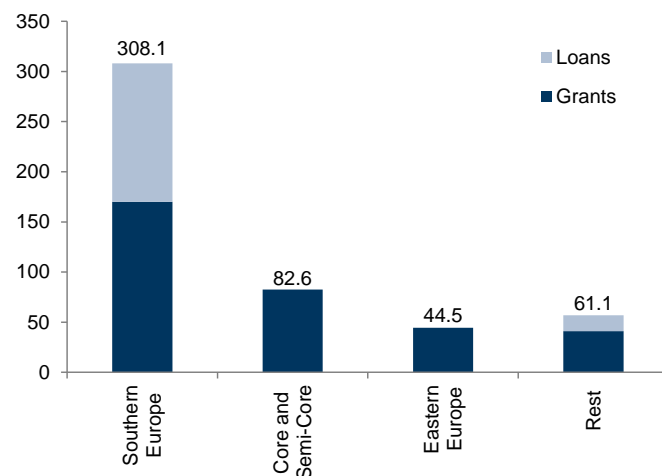
Source: European Commission, Goldman Sachs GIR.

The second distinctive feature of the Recovery Plan is its regional concentration. Since the program's initial funding allocation to individual member states took into account both the country-specific severity of the economic downturn and the

difference between national per capita income and the EU average, Southern European and, to a slightly lesser extent, Eastern European countries have received more than proportional shares of the available €807bn (in current prices). Southern Europe (Italy, Spain, Portugal and Greece) in particular will receive 62% of the current allocation of the Recovery Fund.

Southern Europe at the forefront

Loans and grants from the Recovery Plan by region, €bn



Note: Southern Europe includes Greece, Italy, Spain and Portugal, Eastern Europe includes Poland, Czechia, Slovakia and Slovenia, and Core and Semi-Core includes Austria, Belgium, Finland, France, Germany and Luxembourg.

Source: European Commission, Goldman Sachs GIR.

Creating a global safe asset

Even though Southern and Eastern European countries will be the main beneficiaries of this extraordinary fiscal support, almost all member countries are set to receive the full pre-financing amount of 13% of their respective total envelope (grants and loans). This [pre-financing](#) funding is the only unconditional part of the Recovery Plan—the EU Commission is legally bound to disburse these funds to every member state that requests them. These disbursements, together with the funding allocated to two other NGEU programs—React-EU (which supports the early stage of the recovery) and SURE (set up to mitigate the socioeconomic consequences of the pandemic)—are estimated to require over €100bn in total funding just in 2021.

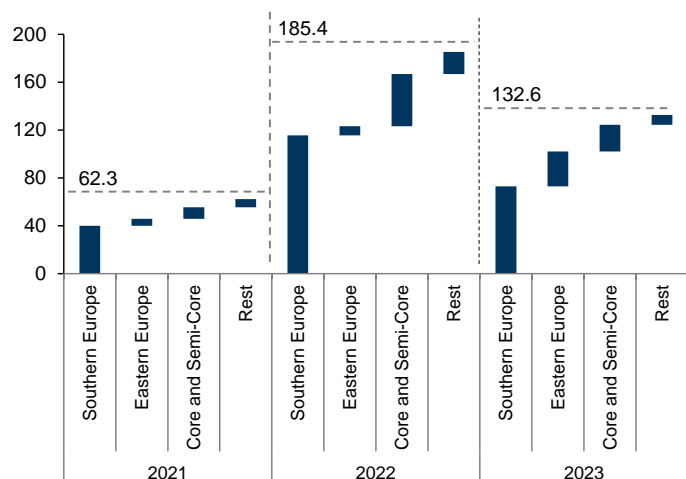
In order to meet current and future obligations, the EU Commission has created a large [multi-year issuance program](#) of its AAA-rated debt. This will establish the EU as the largest supranational issuer in the world and, more importantly, could make the continent the provider of a €800bn pool of safe assets with long maturities. The participation of international investors in the first issuances suggest that EU debt has already become a [globally appealing](#) asset.

While the NRRPs give some sense of the EU funding needs and the related debt issuance to be expected in 2022 and 2023, these are difficult to estimate given that any additional EU disbursements beyond the initial round are governed by the principle of conditionality. This means that, while the EU Commission commits the annual amount stated in the NRRPs, it can't make additional disbursements unless the recipient country hits the investment and reform milestones agreed upon in the plans. Therefore, the pace at which EU debt will be issued depends on the success of implementation at the

country level. That said, we expect EU debt issuance related to NGEU to increase from here, to over €150bn in 2022 and around €130bn from 2023 onward. Since every member state has until August 2023 to amend its NRRP and request an increase in the amount of loans they can draw from the program, we expect Recovery Plan disbursements and the ensuing EU debt issuance to continue to build at a solid pace until 2026.

A global asset in the making

Funds currently committed under the Recovery Plan by region, €bn



Source: European Commission, Goldman Sachs GIR.

Well begun may not be good enough

The Recovery Plan is an extraordinary fiscal program set up with the ambitious goal of supporting the structural transformation of the European economy over the next five years. The persistent and investment-focused structure of NGEU sets apart the European initiative from those in other regions of the world, and provides clear potential upside to growth and productivity. Moreover, the program enjoys unusual political support. The likely new German Chancellor and ruling coalition (see pgs. 24-25), President Macron, [who is seeking re-election in the spring](#), Prime Ministers [Draghi in Italy](#) and [Sanchez in Spain](#) are a strong combination of European leaders that share a renewed conviction to enhance fiscal coordination across the EU.

Whether the Recovery Plan can serve as a stepping stone or becomes a stumbling block in the process of European integration clearly depends on its future success. While the program sets the stage for a solid economic recovery, three risks threaten its prompt and widespread implementation and, ultimately, its success.

The first risk is that structural weaknesses in the recipient countries derail its implementation. Southern Europe in particular doesn't hold the most promising record when it comes to implementing European-funded investment programs. That said, the severity of the downturn and the lack of co-financing typically required in standard European programs provide reasons to be more optimistic in this case.

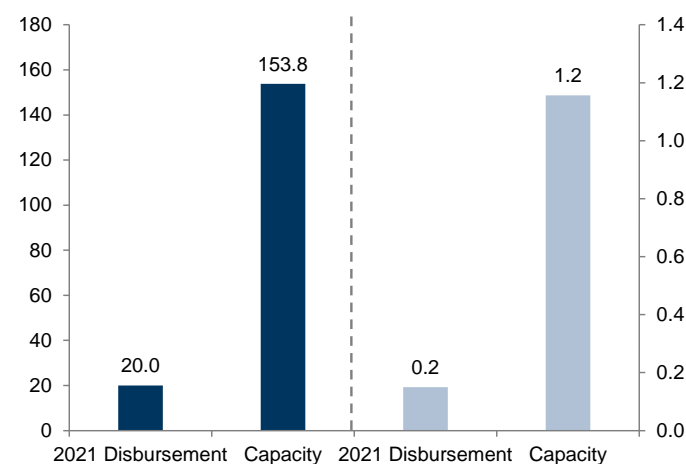
The second risk is that the rule-of-law conditionality, requested by the EU Parliament as a necessary condition for EU disbursements, delays the adoption and the implementation of the Recovery Plan in Eastern Europe, most notably in Poland and Hungary. The two countries are among the top five

beneficiaries of the plan's allocation in terms of percentage of GDP. Their diminished engagement in the program would reduce the scope of fiscal support specifically designed to bring member states closer together.

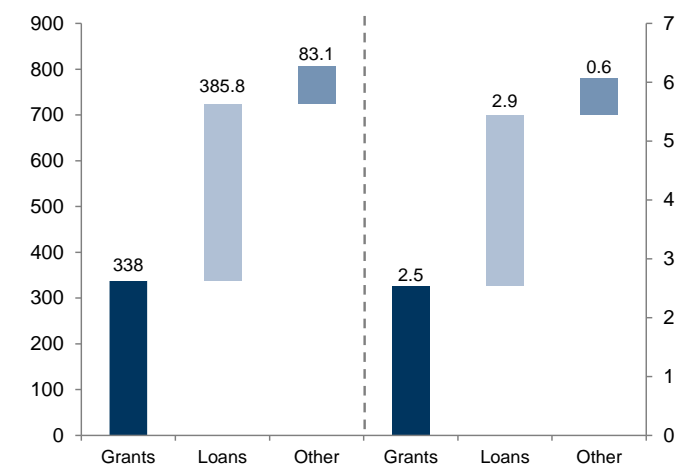
And the final risk is that the program is ultimately under-executed. A large part of the effectiveness of the Recovery Plan relies on its size. While grant-funded projects are very likely to be fully implemented, the loan component of the program still has €230bn of spare capacity that no country has yet applied for. While Italy exhausted its loan allocation, 19 member countries, including Spain, Poland and Hungary, still haven't applied for any loans.

Room to grow within the program

Recovery Plan loans, €bn (lhs), % of GDP (rhs)



NGEU funding, €bn (lhs), % of GDP (rhs)



Source: European Commission, Goldman Sachs GIR.

Together, these risks imply that NGEU allocations could fall €200bn short of their maximum potential. However, member states can update their plans and scale up their investment until August 2023, and we are optimistic that close to full execution will ultimately be achieved. But it remains to be seen whether Europe will seize this unique opportunity or continue to be stuck in its challenges.

Filippo Taddei, Senior Europe Economist

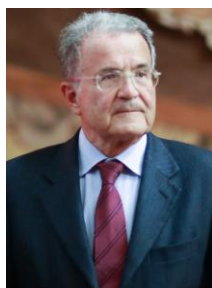
Email: filippo.taddei@gs.com
Tel: 44-20-7774-5458

Goldman Sachs International

Interview with Romano Prodi

Romano Prodi served as Prime Minister of Italy from 1996 to 1998 and again from 2006 to 2008, President of the European Commission from 1999 to 2004, and is the former UN Special Envoy for the Sahel. He is President of the Foundation for Worldwide Cooperation and the Robert Abernethy Professor of the Practice at SAIS Europe. Below, he argues that while the European project has moved in a positive direction since its founding, further progress on European integration will likely be very slow.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.



Allison Nathan: You've been referred to as the first prime minister of the European Union, and have long been an enthusiast of European integration. Are the prospects for further integration stronger or weaker today than they were before the COVID-19 crisis?

Romano Prodi: Objectively, Europe's response to the pandemic began poorly, but then European countries came together in a miraculous way. Vaccine distribution has been fair and uncontested by individual member states, which wasn't necessarily a given, and incredible progress has been made on economic integration over the course of the crisis. Two years ago, nobody could've imagined EU countries cooperating on the €800bn Next Generation EU (NGEU) fund, which entails the large-scale joint issuance of common debt bonds.

I see three reasons for this progress. First, the nature of the pandemic itself, as nobody could blame any individual EU member state for the traumatic health crisis and subsequent economic downturn. Second, Brexit, because this integration could never have happened if Britain was still part of the EU, although Brexit will likely be a problem for both the UK and the EU over the longer term. And third, Germany's growing satisfaction with its place within the EU; German policymakers have become more and more aware that Germany's economic strength owes in large part to its EU membership, and have therefore increasingly embraced the integration of the German economy with the European economy.

But for all the progress made on economic integration, little progress has been made on political integration. Few instances of military cooperation have occurred, and the EU has no common foreign policy. That's a missed opportunity on several fronts, one of which is the fact that Russia and Turkey have played a leading role in Libya, which is in Italy's—and therefore Europe's—backyard.

Allison Nathan: But even if political integration hasn't made much progress, it feels like there was more momentum towards fragmentation and Euroskepticism a few years ago, with events like Brexit and the election of the Five Star Movement/Lega in Italy, etc. than there is today. Do you agree?

Romano Prodi: Yes, the 2019 European parliamentary elections kicked off a new wave of pro-European sentiment. They demonstrated that when voters are asked to choose between saying "yes" or "no" to Europe, they choose "yes".

The British case was different because the UK has always seen an alternative route to global influence outside of the EU, especially through its special relationship with the US. Populist parties have lost ground in all recent elections across the EU. In Germany, while the shape of the next government is still very uncertain, the leading party will certainly be a pro-European one, so any danger from that perspective has disappeared. In Italy, pro-European parties recently gained ground in the local elections, with the center-left winning in the big cities of Milan, Naples and Bologna. And in France, the winning candidate in next spring's presidential elections will no doubt be pro-European due to the two-round structure of the country's electoral system. It's difficult to say at this point who might oppose President Macron outside of the far right, and so Macron continuity cannot be guaranteed. But, in any case, an anti-European candidate cannot win. So the EU is absolutely past the point of existential danger.

“The EU is absolutely past the point of existential danger.”

Allison Nathan: Are you optimistic or pessimistic about the prospects for EU integration going forward?

Romano Prodi: On the economic side, technical dialogues on banking and capital market integration are ongoing and have made some headway, and more progress is likely going forward. European member states have accepted the role of the ECB on banking control, and while a sudden leap forward in terms of further banking and financial market integration is unlikely, the progress on integration that we've seen up until now will not be interrupted or reversed.

On the political side, I am firmly convinced that significant progress on integration of defense policy could be made if France would share its military and nuclear capabilities with the EU. However, France likely won't agree to do so barring a serious event, so I'm not optimistic that we'll see much progress there. But we could see more cooperation on defense in other areas, specifically when it comes to the southern border. All of the Mediterranean countries—Greece, Italy, Spain and even France—are very concerned about what's happening in Africa. This preoccupation wasn't historically shared by the countries of Northern Europe, but African politics are becoming a common European preoccupation. And because of that, we'll likely see closer cooperation among EU countries on the issue of Europe's southern border.

Allison Nathan: What reforms—if any—are needed to achieve further integration in the areas where it's most lacking, like on the political and fiscal fronts, and do you see the potential for progress there?

Romano Prodi: The biggest obstacle is unanimity. The EU Council is required to vote unanimously on matters that member states consider to be sensitive, including fiscal and foreign policy decisions. That's a real stumbling block to further integration, and I don't see a realistic possibility of unanimity being eliminated or replaced with a majority rule. So while I do think some progress is possible, for example, on a common defense of the southern border, further progress in the most sensitive areas such as fiscal union will likely be very slow and start with only partial agreements that don't involve all member states.

“The biggest obstacle is unanimity. The EU Council is required to vote unanimously on matters that member states consider to be sensitive, including fiscal and foreign policy decisions. That's a real stumbling block to further integration, and I don't see a realistic possibility of unanimity being eliminated or replaced with a majority rule.”

Allison Nathan: So, overall, is the close integration that was arguably envisioned at the start of the European project ever really likely to happen?

Romano Prodi: Proper integration ultimately means total agreement, which isn't likely to happen, but the European project has certainly moved in a positive direction since its founding. Italian, French, and German bankers have all come to understand that the degree of control and necessary dialogue with the ECB or Brussels is growing everyday. It's now taken for granted that the responsibility for banking policy lies at the EU level rather than at the national level. When an important decision needs to be made in the banking system today, the first question is what Frankfurt and Brussels is thinking, not Rome and Paris. This is not a small step, and speaks to the success of the European project, even if its union is—and will likely remain—incomplete.

Allison Nathan: Broadly speaking, are you optimistic or pessimistic about the Euro area's economic outlook?

Romano Prodi: I'm more worried about inflation than the ECB and other observers seem to be. My nightmare is that the current squeeze in energy supplies strangles Europe, and my sense is that the damage that energy shortages could inflict on the European economic recovery is being underestimated. But if the inflation and energy-related economic disruptions that I fear don't materialize, I would be relatively optimistic about the EU's growth outlook. The pandemic-related stimulus has kick-started significant positive cooperation among Euro area countries, especially on green investment. As part of the

NGEU, the EU has allocated a large amount of funding to green projects, which will move the needle on economic growth, although I would caution that Europe shouldn't go too far beyond the US and China in its environmental ambitions as that would lead to sharply higher costs, and ultimately prove counter-productive for growth. And despite ongoing trade tensions between the US and China, which Europe is substantially exposed to given its large trade linkages to both, but especially to China, international trade remains strong. While the Euro area needs to catch up in the high-tech space, where it's not yet competitive and US and Chinese companies dominate, the EU is very strong in the middle-tech space, not only in Northern countries like Germany but also in parts of Southern countries like Northern Italy. So the Euro area has a strong engine of growth, and looks well-positioned to achieve greater growth in the future.

Allison Nathan: How confident are you that Southern European economies, like your own country of Italy, that are receiving the lion's share of NGEU funds, will use these funds productively—in ways that will improve the longer-term potential of the economy?

Romano Prodi: Italy suffered one of the worst economic slumps among EU countries during the pandemic, but the rebound has already been very remarkable, in large part because of the support provided by the NGEU fund. However, it's not yet known whether such high growth there, or in other Southern economies, will prove sustainable over the long run. In the case of Italy, Prime Minister Mario Draghi is currently pursuing reforms that could lead to more stable and higher growth than in the past, and I'm absolutely convinced that such reforms could set Italy on a different growth path than the one it has been on for the past few decades.

But the reforms have yet to be completed, and further progress will depend significantly on the country's political stability. It's notable that 12 million people voted in the recent local elections, and they voted overwhelmingly in favor of stability. Now comes the second step—the Italian presidential election in January of next year. In the run-up to that election, Mario Draghi faces the choice of remaining prime minister, and utilizing one more year of full power in that role before the 2023 general elections to disburse the initial NGEU funds, or to move over to the role of president of the republic for a seven-year term. In either case, he will play a vital role in answering the question of whether or not Italy will be able to successfully manage its economy over the longer term.

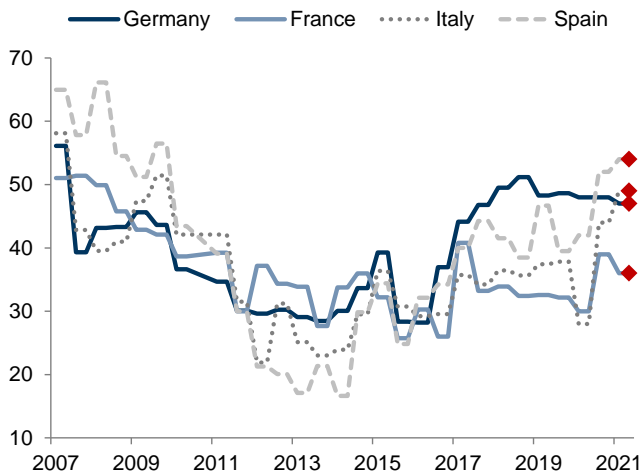
Allison Nathan: What choice for Draghi would better serve Italy?

Romano Prodi: While the prime minister directly manages the country's political issues, the role and authority of the president of the republic, coupled with the fact that it would last for seven years without interruption in a country in which the position of prime minister has been so unstable, could send a reassuring message. So the answer to your question is unclear. But with elections around the corner, Draghi must make his choice very soon.

The state of EU public opinion

Trust in the EU has risen during the pandemic

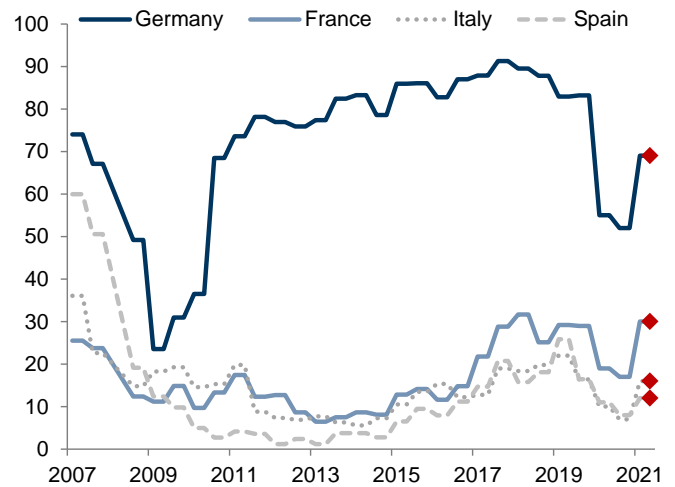
Tend to trust the European Union, % respondents



Source: European Commission (Eurobarometer).

But stark divides remain in terms of the economic outlook

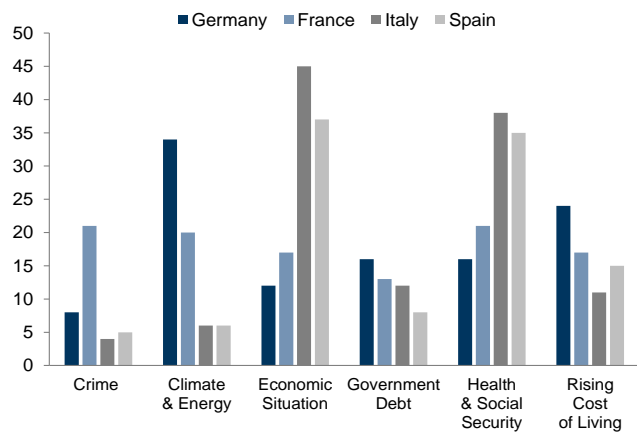
Domestic economic situation good/very good, % respondents



Source: European Commission (Eurobarometer).

Top domestic priorities differ between north and south

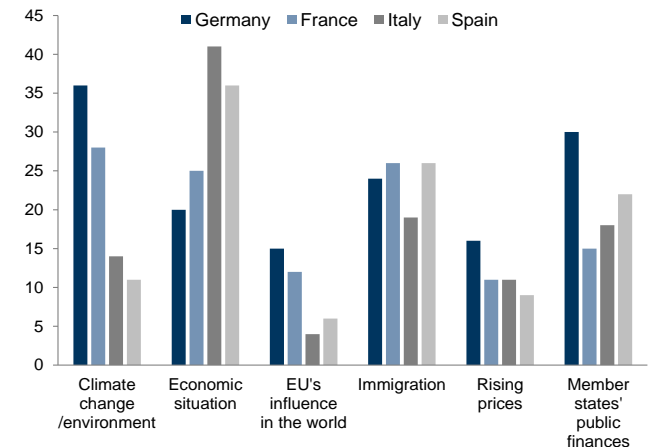
Most important domestic issue, % respondents



Note: Doesn't sum to 100 because respondents asked to pick top two issues.
Source: European Commission (Eurobarometer).

And citizens remain divided on the key issues for the EU

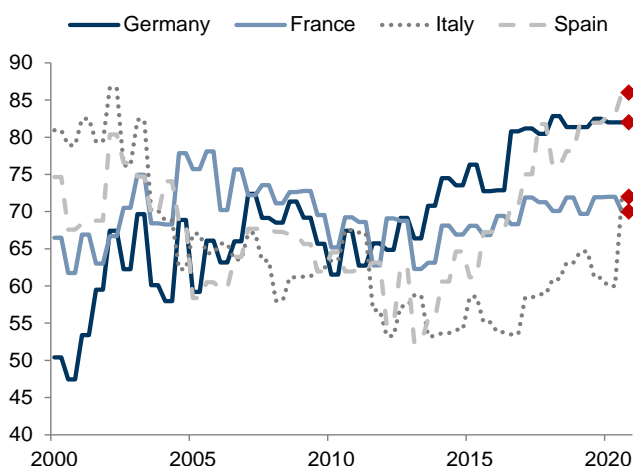
Most important issue for the EU, % respondents



Note: Doesn't sum to 100 because respondents asked to pick top two issues.
Source: European Commission (Eurobarometer).

Euroscepticism has retreated in recent years

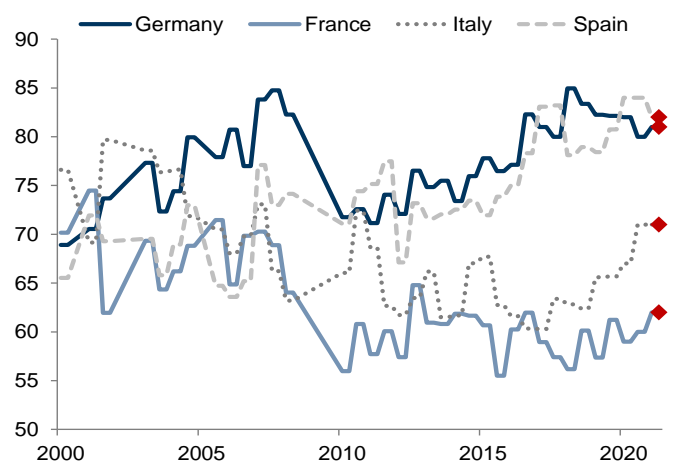
Support for Euro, % respondents



Note: Question asks for opinion on EMU with single currency, the Euro.
Source: European Commission (Eurobarometer).

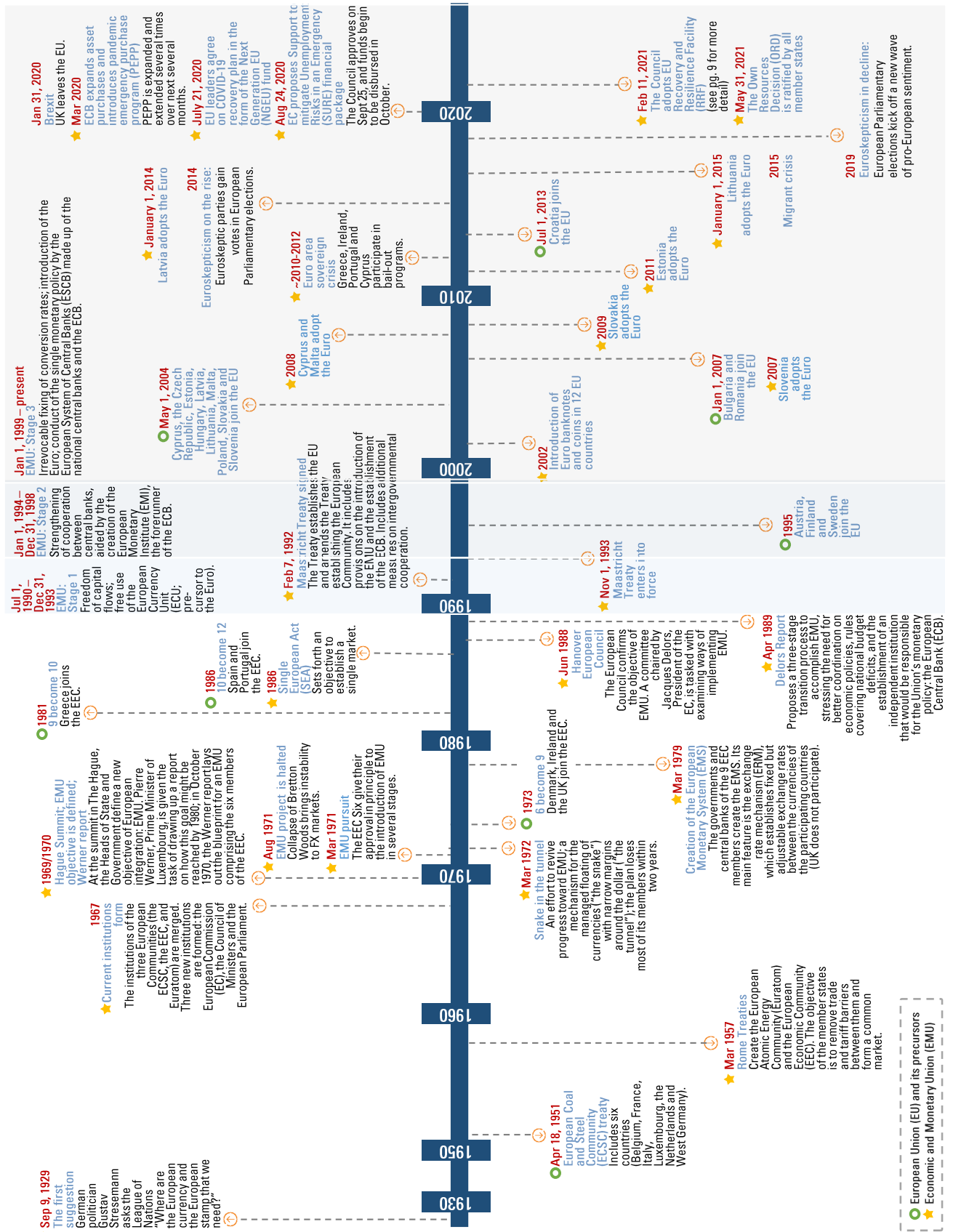
EU citizens are aligned around a common foreign policy

Support for common EU foreign policy, % respondents



Source: European Commission (Eurobarometer).

A history of European integration



Source: ECB, European Commission, European Council, Europa, Goldman Sachs GfR.

Interview with Timothy Garton Ash

Timothy Garton Ash is Professor of European Studies, University of Oxford, and a Senior Fellow, Hoover Institution, Stanford University. His books include *The Magic Lantern*, his eyewitness account of the 1989 revolutions, and *In Europe's Name*. Below, he argues that the post-pandemic recovery offers a window of opportunity for Europe, but warns that populist political risks remain.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.



Allison Nathan: Recognizing that coalition negotiations are still ongoing, what are your main takeaways from the German election so far?

Timothy Garton Ash: I have two immediate takeaways. First, Germany remains at the center not just geographically, but also politically, in

Europe. Among the possible coalitions, all would be comprised of centrist parties. Second, German politics have become more complicated with what is almost certain to be a three-party coalition. There's a fascinating new dynamic where the two smaller parties—the economically liberal FDP and the environmentally-friendly Greens—for which young Germans voted overwhelmingly, are not just the "kingmakers" in terms of the outcome of the negotiations, they're also the furthest apart politically. The immediate issue is whether there's sufficient common ground between the fiscal conservatism of the FDP, including its extremely pro-business stance and preference for lower taxes, and the Greens' agenda, which demands significantly higher taxes or other revenue increases to facilitate Germany's green transition. Substantial disagreement also exists around the issue of EU integration, where the Greens advocate further steps towards a fiscal union while FDP leader Christian Lindner is dead set against it. These will be the key points of contention as the negotiations continue.

Allison Nathan: Are you optimistic that these parties can come together to form a coalition despite their differences, and would such a complicated coalition really be able to take decisive action to move Germany/Europe forward?

Timothy Garton Ash: So far, the three most likely coalition partners—the SPD, FDP, and Greens—otherwise known as the "Traffic Light" coalition given their red, yellow and green colors, respectively, have executed brilliant joint-branding casting themselves as a "progressive" coalition. Progressive is a wonderful word because it's more capacious than a British duffle coat; it can mean almost anything you like. But the fact that they're talking in these terms is promising and shows a will to find a shared narrative. At this point, the Greens and FDP seem to be genuinely trying to find common ground, although that will take some creativity. Instead of raising taxes, for example, they may look for innovative ways to raise and spend money—e.g., a large climate transition fund outside of the fiscal rules—to facilitate the Greens' agenda. It's also important to note that despite the tight election result on a party level, German voters overwhelmingly voted for SPD leader Olaf Scholz as chancellor. That suggests Scholz has the legitimacy to lead the next government, which is helpful because, at least on the question of fiscal union, his stance lies somewhere in between the FDP and the Greens. Finally, the fact that efforts

to form a three-party coalition in 2017—in that case led by the CDU/CSU rather than the SPD—failed because Lindner walked out of negotiations, also suggests it would be more difficult for him to jump ship again now.

So there's some reason to be optimistic about the formation of a ruling coalition, and potentially relatively soon. Coalition negotiations took about six months in 2017, but the sense in Berlin is that there may be a government by Christmas. The timing is crucial for Europe because France will assume the EU presidency at the start of 2022, but the two countries will only have about three months to put their initiatives on the EU agenda before France itself moves into election mode.

All that said, it remains to be seen how effective such a coalition would be. The critical question of our time is whether democracy can deliver against authoritarianism. Germany is a fine democracy, but it's a democracy that achieves change through consensus, and whether that model can deliver decisive action going forward has yet to be seen.

Allison Nathan: Are any other coalition formations possible at this point, and what would the main policy differences between the possible alternatives be?

Timothy Garton Ash: The tide is running very strongly in favor of the Traffic Light coalition, but never say never. The FDP's original preference was for a Jamaica coalition with the CDU/CSU and Greens. But the CDU/CSU is in deep crisis, demonstrated by the recent resignation of the CDU's leader and election candidate, Armin Laschet, and is frankly exhausted after Angela Merkel's 16 years in power. I've never seen a political party more in need of a break than the CDU/CSU. So, it looks somewhat unlikely that they stay in power either via a Jamaica coalition or a continuation of the Grand Coalition with the SPD. And if they did, a sense of disappointment would envelop Europe as a whole.

That said, unlike British, American, Polish or French politics, the policy differences between these coalitions wouldn't be that stark because, again, they're all centrist parties. But an important difference does exist in their position on the Economic and Monetary Union (EMU), which lies at the heart of the future of the EU. A Jamaica coalition would likely take a harder line on fiscal policy, closer to the status quo, driven by a tough faction within the CDU aligned around Friedrich Merz, who has said in private that he would resign from any government that made the EU Recovery Fund mechanism permanent. Scholz is quite firm, but much more pragmatic and flexible, when it comes to fiscal union. He's talked about the EU Recovery Fund as a "Hamiltonian moment". It's clearly not actually such a moment; even on Scholz's watch, we should have no illusions of a permanent fiscal union happening anytime soon. But the fact that he's talked about it in this way shows that a Traffic Light coalition would likely be open to

extending the Recovery Fund, or to finding another version of the same thing if necessary. This would be critically important for the European and world economy.

Allison Nathan: Beyond German political dynamics, has the pandemic increased the likelihood of greater European integration, or is this moment more likely to go down in the history books as another missed opportunity for the European project?

Timothy Garton Ash: The history of Europe over the last decade is one of crisis after crisis, starting with the Eurozone crisis, then the Ukraine crisis, the migrant crisis, Brexit and of course, most recently, the COVID-19 crisis. And what we can observe is that the latest crisis produces the answer that should have been given to the last crisis but three. The pandemic response was hugely consequential because Germany effectively accepted both mutualized debt and grants alongside loans, which was almost unimaginable only a few years ago.

The key questions now are how these funds are used and what happens once they've been exhausted. The current German position is that this was a one-off initiative, but it's never until the next crisis that crisis solutions are needed again. If German voters and taxpayers can be persuaded that the money has been used effectively, and has benefited them as well as countries such as Italy receiving the funds by expanding German export markets, then a Traffic Light coalition may agree with its EU partners to extend the arrangement.

But Europe has seldom missed an opportunity to miss an opportunity over the last decade. Indeed, in my view, Angela Merkel's single greatest mistake was her failure to take the initiative at the beginning of the Eurozone crisis to say, as former German Chancellor Helmut Kohl would have, that we must do whatever it takes—in which case, it would have taken much less than it did. To be fair, the EU Recovery Fund was a big response to a big crisis. But a great deal now depends on its consequences. Europe could face more inflation, or even stagflation, and suffer a tough time economically. The pandemic has been a bad time for populists, but the post-COVID years might be a good one for them, which could dramatically shift the politics of Europe.

Allison Nathan: How likely is such a populist resurgence, and where is the risk the largest?

Timothy Garton Ash: Anyone who talks about peak populism being behind us should stop at once. The politics and opinion polls show that the forces of nationalist populism and Euroskepticism remain strong. Just under a third of EU citizens still say that their country would be better off outside of the EU. Populists are still in government in several countries like Poland and Hungary. And they're a formidable force in France and Italy. In France, the far-right populists Marine Le Pen and Éric Zemmour are running neck-on-neck with President Emmanuel Macron ahead of April's elections. We thank heaven for the intelligent two-round electoral system for the French presidency. But if French voters end up rejecting Marine Le Pen in favor of a centrist candidate like Macron in the second round, that would be the third time that they've had to do so. They did it for Chirac against Jean-Marie Le Pen, Marine's

father, in 2002, and then again for Macron against Marine Le Pen in 2017. A political environment that repeatedly forces voters to hold their noses and vote against, rather than for, a candidate, is not ideal. And given France's repeated experiences with terrorist attacks, anything could happen if an attack occurred just before the second round vote.

The other country to watch is Italy. Although he has denied it, there's widespread speculation that Mario Draghi would ideally like to fill the seat of the Italian presidency that's set to become open next year. But doing so would require him to vacate his premiership, which could trigger fresh elections or, at the very least, the formation of a new government before most of the recovery funds have been disbursed. Were he to decide to vacate the premiership and become president next year, that would open the political game once again to Matteo Salvini and other populists who might well come storming through the door. That would have critical implications not only for Italy, but also for the European constellation. The EU only makes significant moves forward when there's a coalition of the willing of key member states. If you ended up with Chancellor Scholz in Germany, President Macron in France, Prime Minister Draghi in Italy, and a sensible government in Spain, real dynamism could take hold in the EU.

Allison Nathan: What are the biggest challenges and opportunities for Europe going forward?

Timothy Garton Ash: As for someone with repeated health issues, the series of recent crises in Europe have taken their toll. The EU remains a troubled union with many internal challenges and is in several ways weaker and more divided today than in the past. But, after a very lackluster beginning, it responded decisively to the COVID pandemic. Events, as with buildings, always look larger the closer we are to them, so we shouldn't be too quick to overstate the scale of the impact of the pandemic. But, for now, it appears to have kick-started real positive momentum in Europe.

That said, on top of its internal challenges, Europe faces giant external challenges, including climate change, the rise of China, and increased migration. In this environment, a key question is whether Europe can become a more effective external actor at its frontiers and beyond. This depends on the agenda of so-called strategic autonomy or European sovereignty, also in relation to the US and the Biden administration. Right now, the European external agenda is purely rhetoric, as we saw with the withdrawal from Afghanistan when real strategic autonomy would have meant replacing withdrawing US troops with European ones, but Europe had neither the military capacity nor the political will to do so.

European orders typically last between 20 and 90 years before giving way to another. The current European order, which is basically the Western European order extended to the east after 1989, has now existed for more than 70 years. That's a long time in historical terms. Everyone always says, "well, this time is different." There's now a need to prove, through substantive and decisive action, that this time is actually different from all those that came before that ultimately ended in gradual disintegration or sudden collapse.

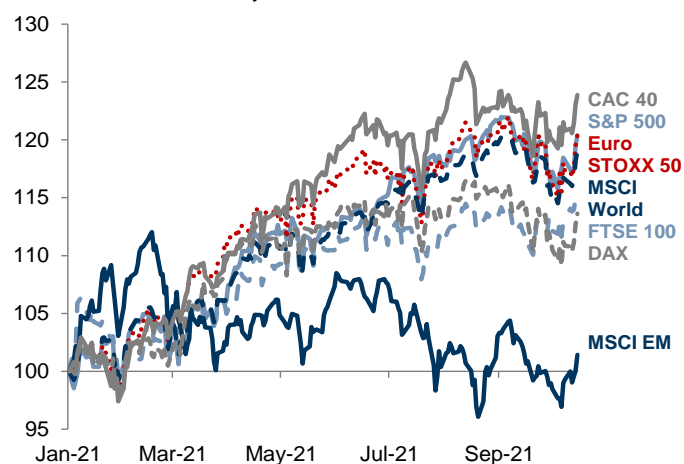
European equities: a stronger case

Sharon Bell argues that the case for European equity exposure has improved relative to the past, and recommends a barbell strategy of select growth and value sectors

The European recovery has been quite successful so far, especially when compared to the recovery after the Global Financial Crisis (GFC). Economies have rebounded, vaccine programs have succeeded and investors have enjoyed strong stock market returns. Positive earnings revisions have supported equity markets this year, with the 1H earnings seasons providing the best results in at least 20 years. Accordingly, STOXX Europe EPS is likely to end this year about 9% above its pre-pandemic level, which is remarkable given that it took 11 years to get back to the previous peak in EPS following the GFC. While equity returns have differed across Europe, the broad indices such as Euro STOXX 50 have generally kept pace with the US in total return terms, and have significantly outperformed the TOPIX and MSCI EM.

European equity has kept pace with the US

Total return, local currency



Source: Datastream, Goldman Sachs GIR.

The case for Europe

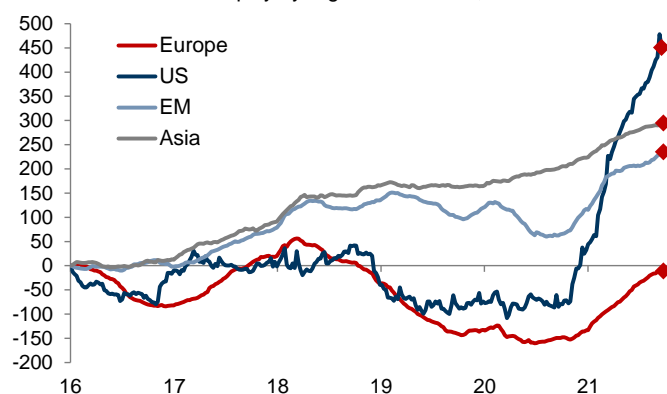
Investors have long questioned the rationale for European equity exposure when the US market arguably provides greater growth and innovation, and Asian and Emerging Markets offer more cyclicality and longer-term economic potential, relative to the European market that has generally been characterized by slow growth, unfavorable demographics and low inflation/pricing power. Adding to this argument is a lack of growth companies in European equity indices and a high weight of old economy sectors such as financials and commodities. Indeed, for all of these reasons, [Europe underperformed the US](#) in more or less a straight line in the decade after the GFC.

But we think this narrative is subtly shifting, as evidenced by both the performance and flows into European equities so far this year. After experiencing net outflows for most of the past 4-5 years, European equities have enjoyed consistently positive inflows over the past year, for several reasons. **First, European companies are no longer concentrated in low-growth sectors.** Industry weights in the major indices have changed significantly: luxury goods companies are as important as Energy stocks, Technology is larger than Banks and sectors

such as Fintech, Medtech and Renewables comprise a more sizable share. Indeed, [the largest listed companies in Europe have changed](#) more than in the US over the last decade.

Inflows to Europe have improved over the past year

Cumulative flows into equity by region since 2016, USD bn



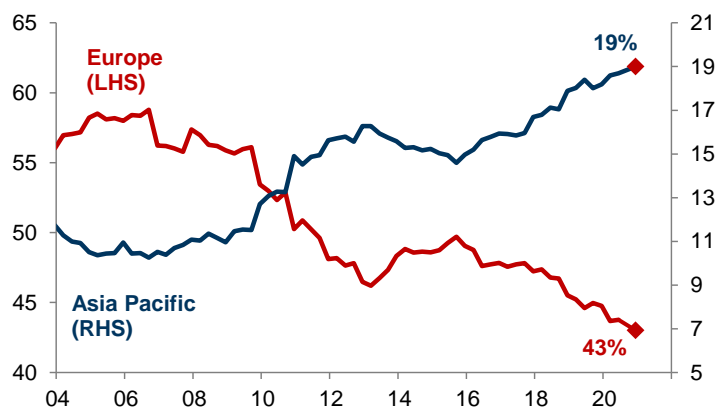
Source: EPFR, Goldman Sachs GIR.

Second, European indices have become more exposed globally.

While this arguably increases their vulnerability to problems in global supply chains or more protectionism, it also means that European companies are less exposed to European countries that have typically low steady-state economic growth potential. The US is the largest single country exposure for companies in the STOXX Europe, and the importance of Asia has risen significantly.

European companies are increasingly globally exposed

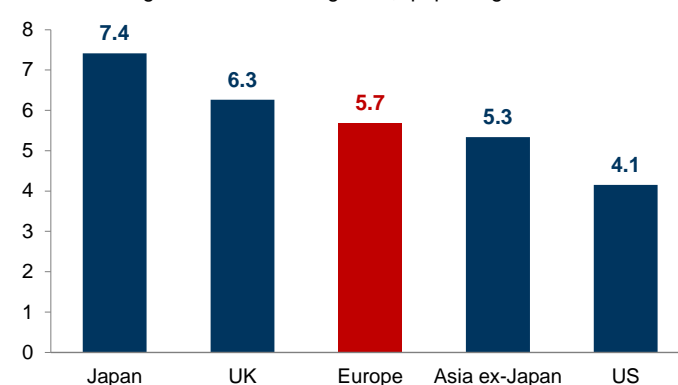
Geographic revenue exposure of STOXX Europe 600, % of total



Source: FactSet, Goldman Sachs GIR.

Europe has a high beta to World growth

Beta of earnings to nominal GDP growth, qoq changes since 1993



Source: Datastream, Worldscope, STOXX, Goldman Sachs GIR.

Third, European policymakers are increasingly perceived as having had a "good" crisis.

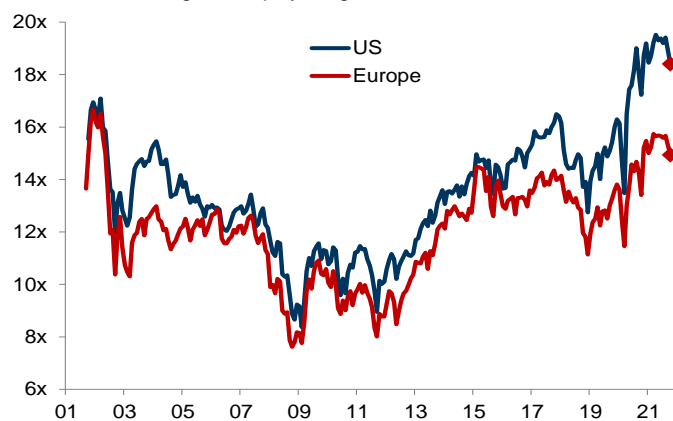
Policy support from the ECB, including the Pandemic Emergency Purchase Program (PEPP) and strong forward guidance, has been instrumental in keeping sovereign spreads low and preventing a rehash of the sovereign crisis of the early 2010s. Bank supervision has proved a success with banks' capital positions providing a strong buffer in this crisis, though the requirement to cut dividends, even for those banks that could conceivably pay, was controversial. On the fiscal side, the EU Recovery Fund was a radical departure both politically, given that Northern and Southern countries agreed to share the fiscal burden, and financially, by breaking the loop between Euro area banks and sovereign spreads.

Fourth, Europe offers diversification away from the concentrated exposures in the US stock market.

The share of very long duration stocks that are vulnerable to rising rates is higher in the US. And relatively high US market index levels and valuations sit on top of record-high corporate margins that have been boosted by low US taxes, which could soon be raised. Our US strategy team expects higher taxation will leave S&P 500 EPS growth at just 2% in 2022, while we expect 7% EPS growth for STOXX Europe. In contrast, the valuation of the European equity market remains deeply discounted to the US market. While that's driven in part by different sector exposure, that's not the whole story. Indeed, weighting the sectors in each market equally still leaves Europe at a large discount.

Even accounting for sector differences, European valuations remain well below those of the US

24m fwd P/E with global equity weights, MSCI indices



Source: FactSet, Goldman Sachs GIR.

Lastly, private equity and corporate interest in European public markets has picked up,

owing to the sharp economic recovery, high savings level and low cost of borrowing. Annualizing the number and size of deals so far this year would make 2021 the largest year for private equity bids for UK and Europe-ex UK shares. [M&A has also picked up materially](#), with many of the deals involving North American buyers acquiring less expensive European assets that have the potential to be restructured.

A possible (green) fiscal boost

The recent German election result is also good news at the margin, in our view. While negotiations are ongoing, a center-

left coalition would likely allow more fiscal expansion in both Germany and elsewhere in Europe. The ills of the last cycle were arguably exacerbated by painful fiscal austerity in Southern Europe and fiscal reticence in Germany given strict adherence to balancing the budget and limited focus on investment. The inclusion of the Green party in the next coalition would likely increase the focus on green investments and should benefit companies with exposure to Renewables. In general, European equities should benefit from greater flows into ESG funds and the conversion of current mandates to being ESG-adherent because European companies tend to score higher on these metrics than companies in other regions.

Plenty of risks remain

Although the narrative around Europe is shifting more positive, risks remain. Europe's vulnerabilities in terms of its [energy supply](#) have come into focus given the recent sharp rise in gas prices and concerns about power outages or demand rationing if the winter is colder than average. Supply chain issues and semiconductor shortages have hit industrial production, as evidenced by a sharp fall in German IP in August. European economies still suffer from low potential growth and European equities lack high growth/innovative companies on the same scale as the US. Europe also hasn't lost its political vulnerabilities; in a continent of more than 27 countries, the scope for political division is large, and high government debt levels emerging from the pandemic add to existing fragilities. Italy's debt-to-GDP ratio is around 150% and its sustainability will come back into question if growth slows and bond yields rise. France's presidential election next April will be incredibly consequential for the prospect of further integration. And, in the UK, the evidence suggests that Brexit has [damaged the path of UK growth](#) and remains an issue for the flexibility of the labor market. Finally, Europe's higher exposure to global economic growth than the US could flip from a positive to a negative if global growth slumps more sharply than expected.

So where to invest in Europe?

Despite these risks, overall, we see a stronger case for European equities exposure in the post-pandemic cycle given the macroeconomic backdrop, our expectation for a more "fat and flat" cycle ahead and positive recent developments at the EU level. We recommend a barbell approach over the next year given growth will be good but slower modestly and yields will no longer be falling. Below the index level, companies and sectors that are investing for growth, such as Tech, Healthcare and Renewables, look attractive. We also like Commodities companies (Energy and Basic materials) with strong cash flows that should benefit from rising prices as a result of tight commodities markets. Financials also look well placed given slightly higher interest rates, good capital ratios and low valuations.

Sharon Bell, Senior European Portfolio Strategist

Email: sharon.bell@gs.com
Tel: 44-20-7552-1341

Goldman Sachs International

The costs of decarbonization

Jeff Currie argues that the energy crisis in Europe is a product of the green transition, which is setting the stage for higher commodity prices and inflation ahead

After a decade of inflation and growth remaining firmly in the doldrums, Europe was perceived as the one region where inflation couldn't happen, despite central banker's best efforts. Yet today, it faces an energy crisis so acute that it is beginning to disrupt economic activity and threaten the still-fragile economic recovery. How did Europe get here and where are we headed next?

Policies boosting demand and constraining supply

In our view, the energy shortage stems from a policy tug-of-war in Europe between the directorate-general for the environment, fiscal policymakers and the courts. For years, environmental policymakers have focussed on phasing out fossil fuels, tightening their Emissions Trading Scheme (ETS) and raising carbon prices that are currently hitting record levels of \$80/t. To that end, they have been relatively successful—coal consumption and carbon emissions have dropped 63% and 29% since 1990, respectively, and UK coal-fired generation has declined from 22GW 10 years ago to 5GW today. Yet, at the same time, fiscal policymakers have raised the continent's power demands, through massive COVID-driven fiscal stimulus and a focus on subsidizing lower-income households' energy consumption in order to meet social needs and protect demand. While the demand surge is cyclical, the supply constraints are structural, leaving such shortages, and their associated price pressures, a likely persistent feature of the move to net zero.

At a deeper level, this lack of energy investment is driven by a fundamental mismatch in the power requirements for the green transition. Investment in old economy energy supply is long cycle—a deepwater rig will run for 40 years—and requires a positive long-term demand outlook. Yet demand for such "brown" energy is increasingly short cycle; policymakers are mandating the phase-out of petrol-powered cars within 15 years. No investor is willing to privately bear the social cost of stranding these assets when demand dries up. Moreover, the courts are ratcheting up the legal liabilities associated with owning and running such assets. A recent Hague ruling that Shell was liable for Scope 3 emissions (those created by the end users of its oil) marks a watershed for the emissions risk in producing oil, further disincentivizing investment. While this ruling could be overturned, the appeals process will take years, and the current ruling will stand in the meantime.

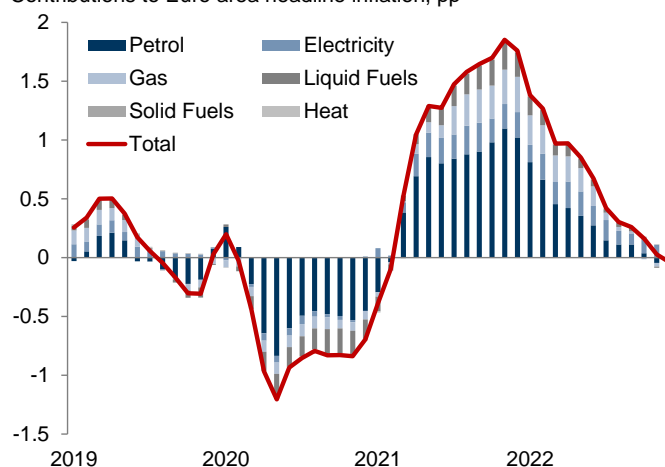
Revenge of the old economy (again)

It's important to remember the cause of this crisis isn't only Europe, and it isn't only ESG. It's the direct result of the chronic underinvestment in the old economy globally—long out of favor for its poor returns and the uncertain macro outlook in the years following the GFC. As the economy became more data-driven and service-based, short cycle investments in tech and the green economy were prioritized at the expense of the old economy—think of Tesla and the iPhone vs. coal mines in

Germany or North Sea oil rigs. As a result, the old economy, most acutely oil and gas, but also trucking, logistics and shipping, were starved of the capital required to expand their capacity. Investment in energy assets has been subpar outside of Europe, too. Russia, for example, is unable to hit its OPEC+ production quota, while gas production growth has long stagnated. While the new Nord Stream 2 pipeline—a natural gas pipeline running from Russia to Europe across the Baltic Sea—can relieve some of the acute tightness in the European gas market, in the medium term it will only redirect Russian supply from Ukraine to Europe—a political move, not a structural increase in overall supply. So it won't solve chronically tight gas supplies in the region.

Europe faces a surge in energy driven inflation

Contributions to Euro area headline inflation, pp



Source: Haver Analytics, Goldman Sachs GIR.

This underinvestment is just as problematic in China, which suffers from its own energy crisis. As the country shunned coal production growth in a bid to decarbonize, China unwittingly started an energy race to secure what "green supplies" of energy remained. While a foreign policy rift between China and Australia reduced Chinese coal imports, it was the lack of investment that drove China to more gas-intensive industrial production and a bidding war with Europe for the LNG required to ease shortages. With no new investment for the next three years and limited LNG expansions, the global LNG market will likely remain tight for the foreseeable future.

Thus, while the catalyst for this crisis has been seasonal—cold weather in Europe and Asia last year that has left inventories at low levels heading into the upcoming winter—the drivers of this crisis are deeply structural. That is, while the peak pricing and shortages of power and gas will likely recede into 2022, such crises will become an increasingly common feature of a world unprepared and underinvested in requirements for the green transition. Indeed, with Europe likely to remain at the forefront of both decarbonization and green inflation for the next decade, investors should update their expectations—and portfolios—accordingly.

Jeff Currie, Global Head of Commodities Research

Email: jeffrey.currie@gs.com
Tel: 44-20-7552-7410

Goldman Sachs International

Safe asset supply in the post-Merkel era

George Cole argues that a looser German fiscal stance in coming years will provide a tailwind for European yields and the Euro

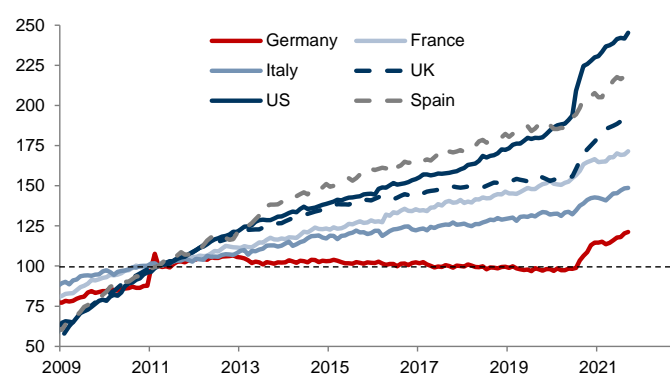
With Germany's election in the rear view mirror, the spectrum of possible policy outcomes has narrowed despite the ongoing coalition negotiations. Whether the next government is made up of a Traffic Light (SPD, Greens, FDP) or Jamaica (CDU, Greens, FDP) coalition, a progressive tilt will take place in several policy areas. From a macro markets point of view, the most important consequence will be a looser fiscal stance relative to the status quo, which will increase the supply of safe assets, boost domestic and Euro area growth, and provide an expansionary example for area-wide fiscal policy.

The Merkel era saw shrinking safe asset supplies and declining Bund yields...

Throughout the Merkel era, and particularly in the post-crisis period 2012-2019, Germany led from the front with a much tighter fiscal stance than other major economies. The CDU/CSU commitment to not only the constitutional debt brake, which limits deficits to 0.35% of GDP in normal economic circumstances, but also to the *schwarze Null* balanced budget requirement, saw the German debt-to-GDP ratio fall rapidly after the European sovereign crisis. Indeed, the German Bund market was the only major global bond market to shrink in size between 2010 and 2020. At the same time, the European sovereign crisis revealed that a huge chunk of sovereign bonds, hitherto considered safe, were in fact risky assets.

The German bond market was shrinking into 2020

Nominal bond market size, indexed to 2010=100



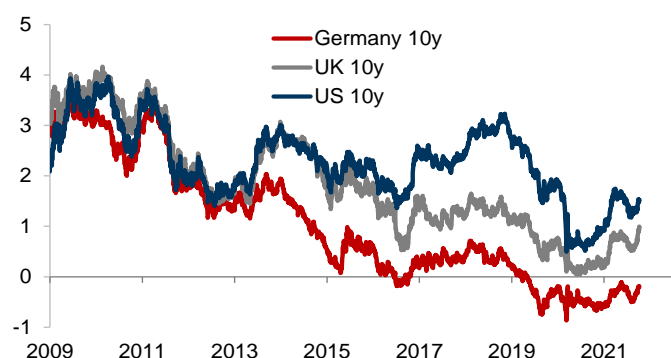
Source: Haver Analytics, Goldman Sachs GIR.

As a result, the European financial system faced a dramatic decline in the supply of safe assets as economic uncertainty increased. ECB asset purchases compounded this scarcity because adherence to the ECB capital key—the weighting of each Euro area country's capital contribution based on GDP and population—saw the largest purchase share go to Germany, the only member state whose bond market was shrinking. These dynamics substantially contributed to the large absolute and relative decline in Bund yields since 2010.

...and the post-Merkel era is likely to see the reverse

A looser fiscal stance following the German election heralds a shift away from the fiscal orthodoxy of 2010-2019, and should contribute to higher German yields in coming years. We see three main channels through which this will impact markets.

A looser fiscal stance will act as a tailwind to higher yields 10-year yield, %



Source: Goldman Sachs, Goldman Sachs GIR.

First, additional issuance. Our expectation is that a Traffic Light coalition will boost spending by around €75bn, or 2pp of GDP, over four years, and that public investment will likely be exempted from the constitutional debt brake. A rule of thumb would suggest 1pp of surprise issuance is worth around 10bp of 10y Bund yields, suggesting additional issuance alone should boost yields. Even under a slightly more conservative Jamaica coalition, we would expect issuance effects worth around 15-20bp relative to the status quo. Additional Bund issuance would complement the expected €700bn increase in EU bonds from 2020-2026, another source of safe asset supply that should act as a tailwind for yields.

Second, higher growth. We estimate a growth boost for the German economy of 0.5-1pp from the additional spending under either a Traffic Light or Jamaica coalition. Over a four-year period, this boost is relatively modest, but would typically be associated with a rise in yields, risk assets and the Euro.

Third, Euro area-wide fiscal policy. Following the European sovereign debt crisis, Germany's fiscal stance set the tone for other member states, and ensured a strong emphasis on fiscal rules at the area-wide level. It follows that a relaxation in Germany's fiscal stance could condition the debate on fiscal rules, create more space for fiscal spending across the Euro area, and potentially even signal more tolerance for explicit north-south fiscal transfers, such as in the EU Recovery Fund. The presence of the FDP may limit optimism on this dimension, but we see the election outcome as a small positive to Euro area sovereign risk, for example, in sovereign spreads.

Muted market reaction so far, but more to come

The market reaction to the election itself was relatively muted, but in our view the recent selloff has been supported by the shift in polls towards a more progressive coalition that began in August. Similarly, the formation of the coalition may not trigger a substantial market reaction, but we do expect that ongoing upward revisions to German deficit projections will boost yields and cyclical assets in the Euro area over coming quarters. On net, we expect Bund yields to rise back to 0% in 2022, with risks skewed to the upside.

George Cole, Head of European Rates Strategy

Email: george.cole@gs.com
Tel: 44-20-7552-1214

Goldman Sachs International

German parties and coalitions

PARTIES

Social Democrats (SPD) "RED"	<p>Center-left</p> <p>Candidate: Olaf Scholz</p> <p>Won 26% of votes and 206 out of 735 seats in the Bundestag</p> <ul style="list-style-type: none"> • Founded in 1875; traditionally represents the interests of the working class • Rejects austerity; seeks to leverage the fiscal room allowed constitutionally • Supports wealth tax, financial transaction tax, digital tax, and international minimum corporate tax • In favor of sustaining EUR 50bn of central government investment annually • Aims to reduce carbon emissions by 65% by 2030 and 88% by 2040; aims for carbon neutrality by 2045; wants to enhance green transportation • Aims to increase minimum wage to EUR 12/hour
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Christian Democratic Union of Germany/Christian Social Union of Bavaria (CDU/CSU) "BLACK"	<p>Center-right</p> <p>Candidate: Armin Laschet</p> <p>Won 24% of votes and 196 out of 735 seats in the Bundestag</p> <ul style="list-style-type: none"> • CDU has roots in the Catholic Center Party that was founded in 1870 • CSU is the Bavarian sister party of the CDU • Committed to debt brake; wants a swift return to balanced budgets and the 60% debt ratio • Against raising taxes, as well as wealth or inheritance tax • In favor of maintaining an elevated level of infrastructure investment • Aims to reduce carbon emissions by 65% by 2030; aims for carbon neutrality by 2045 • Committed to pension age of 67 by 2030
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GREENS	<p>Left</p> <p>Candidates: Annalena Baerbock</p> <p>Won 15% of votes and 118 out of 735 seats in the Bundestag</p> <ul style="list-style-type: none"> • Roots in the 1970s; historically focused on pacifism and environmental activism • Supports constitutional change to debt brake to allow for public investment with a specified limit • In favor of raising highest income tax rates; supports wealth tax, 25% corporate tax, digital corporate tax • Supports EUR 50bn of annual additional public investment until 2030 • Aims to reduce carbon emissions by 70% by 2030; aims for carbon neutrality well before mid-century • Supports increasing unemployment benefits
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Free Democratic Party (FDP) "YELLOW"	<p>Liberal</p> <p>Candidate: Christian Lindner</p> <p>Won 12% of votes and 92 out of 735 seats in the Bundestag</p> <ul style="list-style-type: none"> • Founded in 1948; traditionally pro-business/small government • Committed to debt brake and wants swift return to 60% debt ratio • In favor of raising the corporate tax rate to at most 25% • Aims for gross investment at 25% of GDP • Aims for carbon neutrality by 2050, mainly achieved through carbon pricing • In favor of more flexibility in the working week, more support for families, and more adult reskilling
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Alternative for Germany (AfD)	<p>Far-right</p> <p>Candidates: Alice Weidel and Tino Chrupalla</p> <p>Won 10% of votes and 83 out of 735 seats in the Bundestag</p> <ul style="list-style-type: none"> • Figureheads are mostly former members of the CDU; party was formed to oppose policies of the Eurozone • Anti-Euro and anti-migration, far-right nationalist • First gained seats in the 2017 election
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LINKE	<p>Far-left</p> <p>Candidates: Janine Wissler and Dietmar Bartsch</p> <p>Won ~5% of votes and 39 out of 735 seats in the Bundestag</p> <ul style="list-style-type: none"> • Founded in 2007 as a merger of the Party of Democratic Socialism (PDS) (successor to the Communist Party that ruled East Germany) and the Electoral Alternative for Labor and Social Justice (WASG), comprised of trade unionists and disgruntled former members of the SPD • In favor of a progressive wealth tax • Aims to reduce pension age to 65 • Aims to reduce carbon emissions by 70% by 2030; aims for carbon neutrality by 2035
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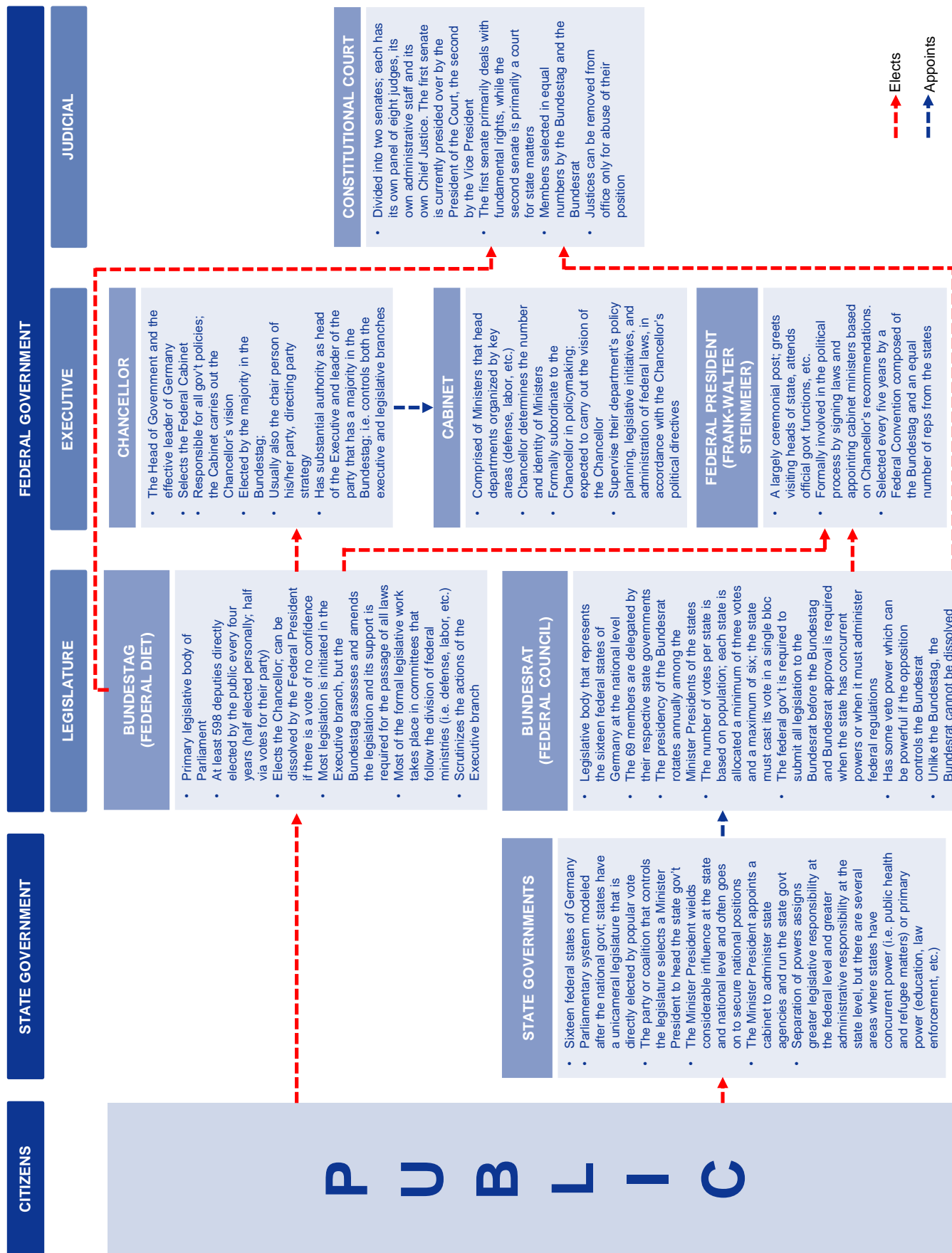
POTENTIAL COALITIONS

<p>Traffic Light (GREENS + FDP + SPD)</p>	<p>We believe a Traffic Light coalition is the most likely outcome</p> <p>Latest developments: The SPD, Greens, and FDP all voted to enter into formal coalition talks.</p> <p>Potential policy implications: We look for a more expansionary fiscal stance compared to current policies, and the digital and green transitions to be at the core of the government's agenda.</p> <p>Potential market response: The market reaction to the election itself was relatively limited, and the eventual formation of a coalition may not trigger a substantial reaction, but we expect that a looser fiscal policy stance will provide a tailwind for European yields and the Euro over coming quarters.</p>
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<p>Jamaica (CDU/CSU + GREENS + FDP)</p>	<p>We believe a Jamaica coalition looks increasingly unlikely</p> <p>Latest developments: Formal coalition talks between members of the Traffic Light coalition are set to begin.</p> <p>Potential policy implications: We look for a more expansionary fiscal stance compared to current policies, although a Jamaica coalition would feel most committed to fiscal rules. Similarly to the Traffic Light coalition, we expect the digital and green transitions to be at the core of the agenda.</p> <p>Potential market response: Similar to the Traffic Light coalition, we expect that a looser fiscal policy stance will provide a tailwind for European yields and the Euro over coming quarters.</p>
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Note: Parties ranked by most to least seats in Parliament.
Source: Party manifestos, compiled by the GS Europe Economics team, various news sources, Goldman Sachs GfR.

The German government



Source: Russell J. Dalton: Politics in Germany, Goldman Sachs G/I/R.

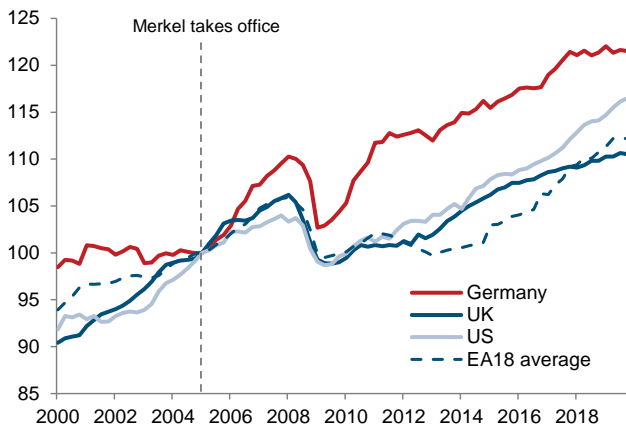
A new post-Merkel German fiscal normal

Sören Radde discusses the main structural challenges facing Germany as Chancellor Merkel prepares to step down, and anticipates a change in fiscal orthodoxy as she does so

Chancellor Angela Merkel presided over strong growth compared to Germany’s neighbors and a [resilient labor market](#) during her 16-year term in office. This is all the more remarkable given that her government has weathered an unusual number of crises, including the Global Financial Crisis (GFC), the European sovereign debt crisis, the 2015 refugee crisis and, in her final two years as chancellor, COVID-19.

Germany has become significantly wealthier under Merkel

GDP per capita, 2005=100



Source: Haver Analytics, Goldman Sachs GIR.

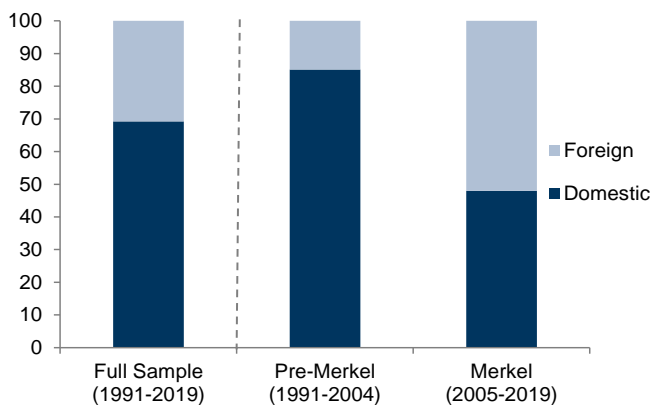
As Merkel is preparing to step down once a new government has been formed following the September federal elections, the German economy is emerging from this latest crisis thanks in large part to generous fiscal support. But while Chancellor Merkel rose to such cyclical challenges, she leaves the country exposed to a number of [structural challenges](#). Her successor will determine how Germany approaches these challenges in the post-Merkel era.

The challenges ahead

Germany faces three important structural challenges. First, the German economy relies heavily on global demand as an engine of growth, and is deeply integrated into global supply chains.

Germany relies heavily on external demand for growth

Sources of volatility of German GDP growth, %



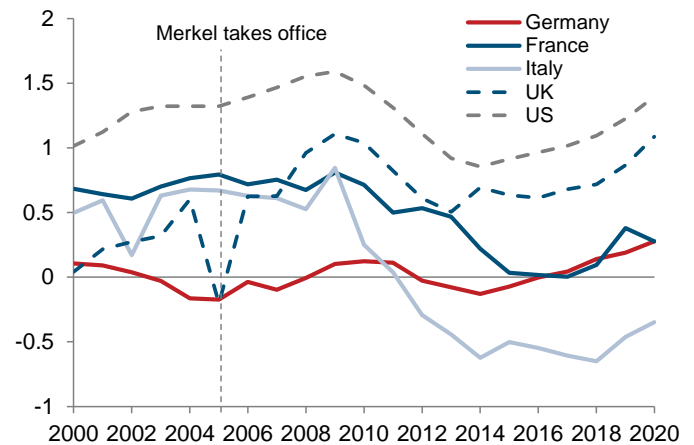
Source: Goldman Sachs GIR.

The pandemic has exposed this [vulnerability](#) as global supply chain disruptions are holding back the German recovery more than that of other economies in the region. This exposure is particularly pronounced for the [auto industry](#)—which contributes around 4.5% directly to Germany’s GDP and almost 10% once indirect effects are taken into account—with production still more than 25% below pre-crisis levels, partly due to shortages of input goods.

The state has also underinvested notably in public infrastructure, such as public buildings and climate-friendly rail transport, with a lower share of net public investment than other major advanced economies over the last 16 years. The constitutional debt brake and slow administrative processes are often cited as reasons for this underinvestment. Cumbersome public planning procedures are also a major impediment to more private investment into, for example, the renewable energy generation capacity and power transmission grids required to achieve Germany’s ambitious climate goals. Studies suggest that additional annual investment worth around 2% of GDP will be needed on average over the next few decades to manage the green transition—compared to current net investment of less than 1% of GDP.

Germany has underinvested notably in public infrastructure

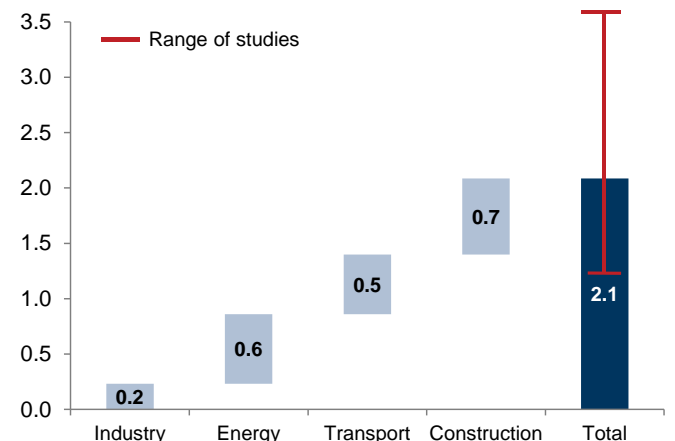
Public net fixed capital investment, % of GDP



Source: OECD, Goldman Sachs GIR.

The green transformation requires a surge in investment

Avg. annual investment needs under climate neutrality scenario, % of 2021 GDP

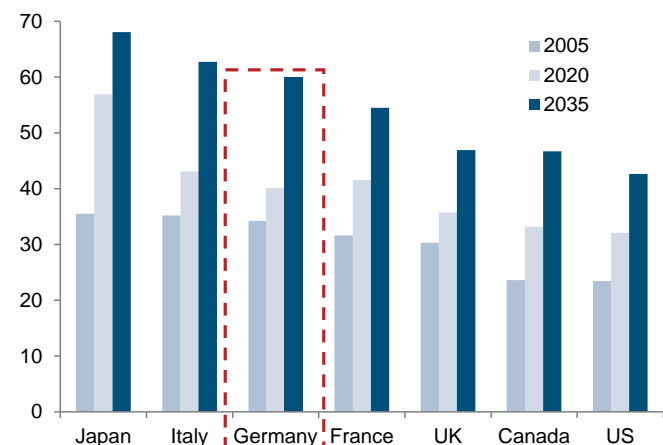


Source: Prognos and BCG (2018), acatech (2018), McKinsey & Company (2021), Goldman Sachs GIR.

Third, demographic headwinds are looming large as the German population is aging. The dependency ratio—the ratio of people 65+ to the prime-age population—is set to rise from around 40% currently to 60% by 2035. Besides being a drag on the labor force and hence potential growth, aging will directly affect the country’s amount of fiscal space, as a rising share of government revenues will be absorbed by the public pension system in the absence of deep reforms.

Demographic headwinds loom large

Old-age dependency ratio



Source: UN, Goldman Sachs GIR.

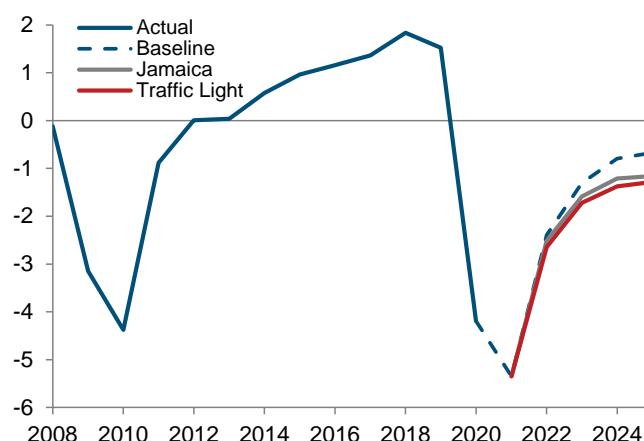
Solving them: the next government

Part of the answer to these structural challenges is more active fiscal policy—not least to promote stronger domestic growth. We expect the digital and green transitions to be at the core of the [new government’s agenda](#), be it under the likely outcome of a “Traffic Light” coalition—led by the social democratic SPD—or the increasingly unlikely alternative of a “Jamaica” coalition—headed by the conservative CDU/CSU—both with the Greens and liberal FDP as joint kingmakers. Specific policies could include faster depreciation rules for green and digital capital goods, pay-outs of receipts from CO2 emissions trading to taxpayers, streamlined planning procedures for investment projects, particularly in the renewables sector, and more public investment into network infrastructure.

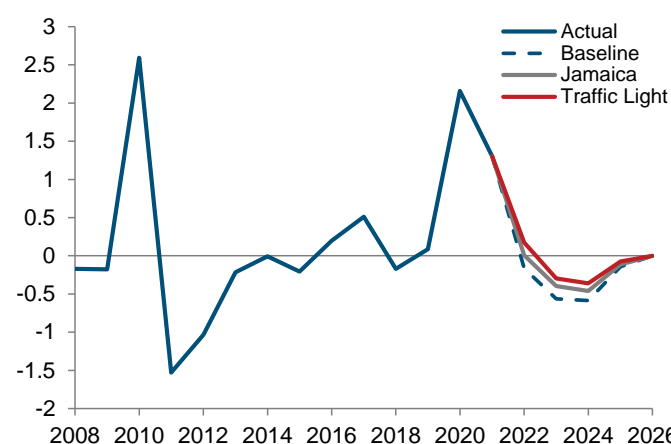
These policies imply notably higher government spending at a scale that we think is inconsistent with the debt brake, which is scheduled to be reinstated in 2023. But we expect that a fiscal cliff edge will be avoided by exercising flexibility around the debt brake, for example by using off-balance sheet investment vehicles that are excluded from the deficit. Our [fiscal scenarios](#) envision additional debt issuance worth EUR 75bn (2.1% of GDP) under a Traffic Light coalition over the next four years, lifting GDP by around 1% compared to current policies. By comparison, we think a Jamaica coalition would be more committed to fiscal rules and hence less expansionary, and we therefore anticipate less debt issuance of EUR 50bn (1.5% of GDP) and a smaller boost to the level of GDP of only 0.5%.

Towards more expansionary fiscal policy

General government balance, % of GDP



Fiscal growth impulse, pp



Note: Baseline paths correspond to fiscal plans under current government policy. Source: Goldman Sachs GIR.

A shift in fiscal orthodoxy

Even such enlarged deficits would be small compared to those run during the COVID-19 crisis and pale in comparison with Germany’s southern European neighbors. But we think they represent a shift in Germany’s fiscal orthodoxy away from ironclad budget discipline as the overriding political goal towards a more investment-friendly stance.

This shift has the potential to affect EU fiscal policy despite uncertainty around the new government’s course. On the one hand, the FDP, which doesn’t favor closer fiscal integration—rejecting common debt issuance beyond the EU Recovery Fund (see pg. 9)—looks likely to clinch the finance ministry in a Traffic Light coalition. On the other hand, a new fiscal normal at home would make it harder for Germany to prescribe a strict course of budget consolidation elsewhere as the [EU’s fiscal rules](#) are being reset. And under a Scholz-led government, we think the door to an area-wide risk-sharing mechanism in the spirit of the EU’s “Hamiltonian Moment” would remain open.

Sören Radde, Senior Europe Economist

Email: soeren.radde@gs.com
Tel: 44-20-7774-1105

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Summary of our key forecasts

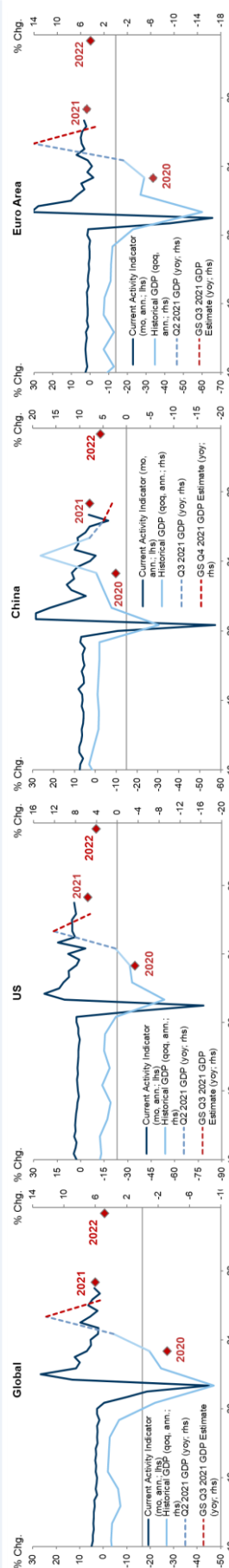
GS GIR: Macro at a glance

Watching

- **Globally**, we expect full-year growth of 6% in 2021 and see a somewhat less favorable mix of slower growth and higher inflation ahead on less virus-sensitive consumer spending and a slower resolution of supply bottlenecks. We expect growth will slow further next year as the fiscal policy impulse turns negative, monetary policy starts to normalize, and further reopening gains require more significant medical improvements as well as behavioral adaptation, although these shifts should also see inflation moderate.
- **In the US**, we expect full-year growth of 5.6% in 2021, and think slower recoveries in consumer spending and semiconductor supply suggest a less front-loaded recovery. We expect the unemployment rate to fall to 4.2% by year-end, and we believe that core PCE will likely peak this quarter and end the year at 4.25%, before falling back to 2% by year-end 2022.
- **The Fed** has provided advance notice that tapering is coming, clearing the way for a formal announcement of the start of QE tapering of \$15bn per month at its November meeting. We don't expect liftoff until Q3 2023 given our growth and inflation forecasts. On the fiscal policy front, we expect the passage of additional spending focused on infrastructure, social benefits, and long-term investment totaling around \$2.8tn and tax hikes of around \$1.5tn over 10 years.
- **In the Euro area**, we expect full-year growth of 4.9% in 2021, and see the near-term risks as two-sided given generous government support and the prospect of a larger hit to growth from rising energy prices. But we remain constructive on the Euro area outlook into next year given COVID-sensitive services sectors still have significant catch-up room, supply issues should ease as demand moderates and fiscal policy will stay expansionary. We expect core inflation to peak at 2.3% yoy in November, before falling sharply in January 2022 as base effects wash out.
- **The ECB** recently strengthened their forward guidance on interest rates to align with their new strategy, which we view as consistent with the first rate hike in 2025. We expect the PEPP pace will fall this quarter and anticipate a temporary PEPP "bridge" consisting of two further reductions in the purchase pace in 1H22 before the program is exhausted. We expect the Governing Council to use the APP to reinforce its rate forward guidance, but stop short of a large, open-ended increase in APP.
- **In China**, we expect below-consensus 2021 real GDP growth of 7.8%, reflecting growing headwinds from increased regulatory pressure on many provinces to meet energy consumption and intensity targets, a smaller fiscal deficit and a slowdown in the property sector. We see considerable uncertainty around the pace of growth heading into year-end, with upside and downside risks both possible based on the government's approach to managing Evergrande, the strictness of environmental target enforcement and the degree of policy easing.
- **WATCH CORONAVIRUS**. The recent Delta wave has continued to retreat around the world. Our base case assumes that high and rising effective protection rates against hospitalization owing to a combination of prior infection, vaccination, and booster shots will drive a continued recovery in global economic activity. We find that effective protection rates against hospitalization have risen to around 75% in the US and UK, 70% in the EU, 65% in India, 60% in China and Japan, and 70% on a global-GDP weighted basis.

Goldman Sachs GIR.

Growth



Source: Haver Analytics and Goldman Sachs Global Investment Research. Note: GS CAI is a measure of current growth. We have recently revised our methodology for calculating this measure. For more information on the methodology of the CAI please see "Lessons Learned: Re-engineering Our CAIs in Light of the Pandemic Recession." Global Economics Analyst, Sep. 29, 2020.

Forecasts

Economics	2021				2022				Markets				Equities													
	GS	Mkt.	GS	Cons.	GS	Mkt.	GS	Cons.	Last	E2021	E2022	FX	12m	S&P 500	E2021	E2022	GS	Cons.	Returns (%)	12m	YTD	E2021 P/E				
GDP growth (%)	6.0	5.9	4.8	4.5	6.0	5.9	4.8	4.5	1.59	1.60	1.80	EUR/\$	1.16	1.17	1.25	Price	4,700	--	4,900	--	S&P500	8.0	19.0	22.7x		
US	5.6	5.8	4.0	4.0	-0.18	-0.15	0.05	0.05	GBP/\$	1.38	1.39	1.49	EPS	\$207	\$203	\$212	\$220	2%	8%	Topix	14.0	12.0	21.3x			
China	7.8	8.2	5.6	5.5	0.08	0.10	0.20	0.20	\$/JPY	114	110	106	Growth	45%	43%	2%	8%	2%	8%	STOXX 600	11.0	18.0	17.0x			
Euro area	4.9	5.0	4.3	4.3	1.00	1.20	1.45	1.45	\$/CNY	6.4	6.4	6.15	Credit	6.4	6.4	6.15	6.4	6.4	6.15	6.4	6.4	6.15	6.4			
Policy rates (%)	0.13	0.30	0.13	0.73	85	90	80	USD	IG	85	89	97	US	5.4	4.2	2.3	3.5	4.4	1.9	3.4	--	--	--			
US	-0.50	-0.47	-0.50	-0.37	5.41	3.65	3.45	3.45	HY	289	290	360	Euro area	2.3	8.4	2.0	7.9	--	--	--	--	--	--			
Euro area	2.20	2.48	2.20	2.58	10,538	10,500	11,500	EUR	IG	100	99	103	China	0.8	--	1.4	--	12.1	--	--	--	--	--			
China	-0.10	-0.04	-0.10	-0.04	1,773	2,000	2,000	2,000	HY	322	297	330	Wage Tracker	2021 (%)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Japan	0.10	0.10	0.10	0.10	1,773	2,000	2,000	2,000	HY	322	297	330	Wage Tracker	2021 (%)	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4

Source: Bloomberg, Goldman Sachs Global Investment Research. For important disclosures, see the Disclosure Appendix or go to www.gs.com/research/hedge.html. Market pricing as of October 15, 2021.

Glossary of GS proprietary indices

Current Activity Indicator (CAI)

GS CAIs measure the growth signal in a broad range of weekly and monthly indicators, offering an alternative to Gross Domestic Product (GDP). GDP is an imperfect guide to current activity: In most countries, it is only available quarterly and is released with a substantial delay, and its initial estimates are often heavily revised. GDP also ignores important measures of real activity, such as employment and the purchasing managers' indexes (PMIs). All of these problems reduce the effectiveness of GDP for investment and policy decisions. Our CAIs aim to address GDP's shortcomings and provide a timelier read on the pace of growth.

For more, see our [CAI page](#) and [Global Economics Analyst: Trackin' All Over the World – Our New Global CAI, 25 February 2017](#).

Dynamic Equilibrium Exchange Rates (DEER)

The GSDEER framework establishes an equilibrium (or "fair") value of the real exchange rate based on relative productivity and terms-of-trade differentials.

For more, see our [GSDEER page](#), [Global Economics Paper No. 227: Finding Fair Value in EM FX, 26 January 2016](#), and [Global Markets Analyst: A Look at Valuation Across G10 FX, 29 June 2017](#).

Financial Conditions Index (FCI)

GS FCIs gauge the "looseness" or "tightness" of financial conditions across the world's major economies, incorporating variables that directly affect spending on domestically produced goods and services. FCIs can provide valuable information about the economic growth outlook and the direct and indirect effects of monetary policy on real economic activity.

FCIs for the G10 economies are calculated as a weighted average of a policy rate, a long-term risk-free bond yield, a corporate credit spread, an equity price variable, and a trade-weighted exchange rate; the Euro area FCI also includes a sovereign credit spread. The weights mirror the effects of the financial variables on real GDP growth in our models over a one-year horizon. FCIs for emerging markets are calculated as a weighted average of a short-term interest rate, a long-term swap rate, a CDS spread, an equity price variable, a trade-weighted exchange rate, and—in economies with large foreign-currency-denominated debt stocks—a debt-weighted exchange rate index.

For more, see our [FCI page](#), [Global Economics Analyst: Our New G10 Financial Conditions Indices, 20 April 2017](#), and [Global Economics Analyst: Tracking EM Financial Conditions – Our New FCIs, 6 October 2017](#).

Goldman Sachs Analyst Index (GSAI)

The US GSAI is based on a monthly survey of GS equity analysts to obtain their assessments of business conditions in the industries they follow. The results provide timely "bottom-up" information about US economic activity to supplement and cross-check our analysis of "top-down" data. Based on analysts' responses, we create a diffusion index for economic activity comparable to the ISM's indexes for activity in the manufacturing and nonmanufacturing sectors.

Macro-Data Assessment Platform (MAP)

GS MAP scores facilitate rapid interpretation of new data releases for economic indicators worldwide. MAP summarizes the importance of a specific data release (i.e., its historical correlation with GDP) and the degree of surprise relative to the consensus forecast. The sign on the degree of surprise characterizes underperformance with a negative number and outperformance with a positive number. Each of these two components is ranked on a scale from 0 to 5, with the MAP score being the product of the two, i.e., from -25 to +25. For example, a MAP score of +20 (5;+4) would indicate that the data has a very high correlation to GDP (5) and that it came out well above consensus expectations (+4), for a total MAP value of +20.

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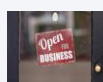
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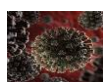
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