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What to watch: Chocoflation, third time's the charm for the EU CMU, no such thing as a free gun and India taps new trade opportunities

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Executive Summary

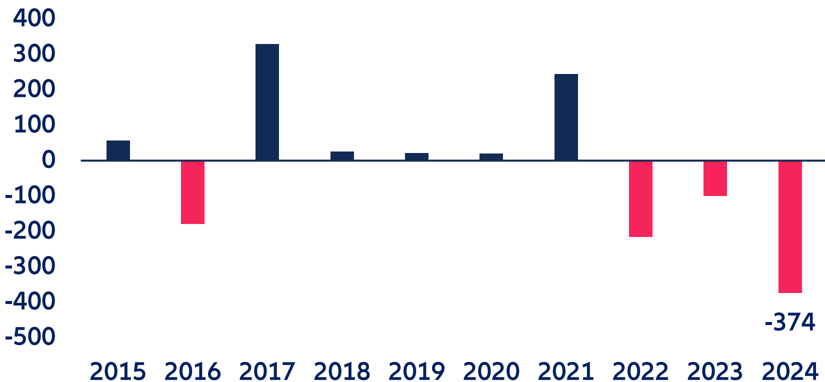
This week we look at four critical issues.

- **Chocoflation: another price gouging moment ahead of Easter?** Cocoa futures prices have skyrocketed above USD6,000 per ton as supply looks set to fall short of demand for the third consecutive year in 2024. However, the outlook for chocolate makers' profitability remains solid, suggesting that consumers will be paying the higher price. With price increases still lagging behind the increase in cocoa prices, more pain is looming for chocolate lovers. To untighten cocoa markets, higher prices need to reach West African farmers to incentivize more and better production.
- **Capital Markets Union: Third time's the charm?** In the 10 years since its launch, the CMU project has made very limited progress. Now EU leaders are discussing a new proposal for a CMU 3.0 to prepare the ground for the next EU legislative agenda (2024-2029). A CMU has never been more urgent as competition for capital intensifies amid higher interest rates and immense investment requirements. While single supervision remains out of the scope, it includes measures to reduce the regulatory burden and improve financing conditions for EU businesses, as well increase access to capital markets.
- **There's no such thing as a free gun.** European governments have pledged to increase defense spending but meeting 2% of GDP by 2028 will require EUR470bn in additional expenditure (including EUR150bn in Germany, EUR55bn in Italy, EUR48bn in Spain and EUR17bn in France). So far, governments have been reluctant to spell out how exactly they will increase defense spending amid aging populations and immense needs for the green transition. To put it in perspective, it would require either: (i) expenditure cuts of -8.6% in Spain, -7.7% in Germany, -6.5% in Italy and -4.8% in France; or (ii) an additional interest burden of around EUR12.1bn in 2028, if relying on debt financing alone; or (iii) if betting only on increasing tax revenues, VAT rates for instance, to go up by 0.6pps across the EU. Combining the three would distribute the financial burden between generations and within society but having guns, butter and batteries anyhow comes at a heavy price.
- **India: Tapping new trade opportunities.** India just signed a free-trade agreement with Switzerland, Norway, Iceland and Lichtenstein, which is likely to be ratified in early 2025. While the total boost to trade of goods is likely to be limited, Indian exports of services, chemicals, transport equipment and textiles, and Swiss exports of pharmaceuticals and metals, should benefit. Investments amounting to 0.2% of GDP per year in the coming 15 years and R&D spillovers are also expected, helping to strengthen India's position in global supply chains. Amid rising geopolitical tensions, further FTAs could position India as an alternative to China, and unlock its significant trade potential.

Chocoflation: another price gouging moment ahead of Easter?

Cocoa prices are skyrocketing as supply will fall short of demand for the third consecutive year in 2024. And consumers will be paying the price. Between 2015 and 2019, a ton of cocoa was priced at about USD2,500 on average. Now, cocoa futures prices have shattered a 46-year record, trading above USD6,000 per ton, as consumption is expected to outstrip production with a shortfall of 374,000 tons (Figure 1).

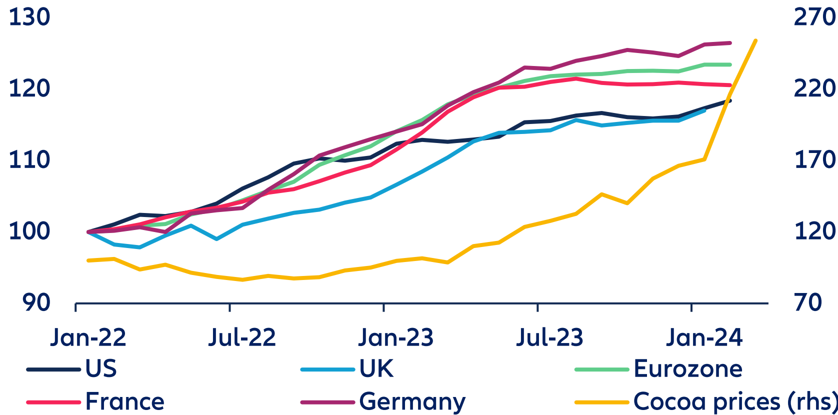
Figure 1: Cocoa market surplus/deficit (in thousand tons)



Sources: ICO, Allianz Research

To protect margins, confectioners are likely to explore cost-saving measures such as reducing the cocoa content of their products, substituting cocoa for cheaper alternatives or reducing quantities (i.e. shrinkflation). Alternatively, they may simply increase prices or implement a strategic shift towards premium, high-margin products to counterbalance rising input costs. As of today, the profitability outlook for major candy/chocolate makers remains solid, with earnings per share expected to slightly increase by +1% on average for the largest listed ones. This suggests that the immediate consequences of surging cocoa prices will be felt by consumers rather than companies' profits (Figure 2). It is worth noting that the rise in retail prices is still much lower than the rise in cocoa prices, suggesting more pain to come for chocolate lovers.

Figure 2: Cocoa prices vs chocolate/sweets CPIs (Jan-22=100)



Sources: LSEG Datastream, Allianz Research

The supply shortfall highlights the long-running structural challenges in the cocoa industry. Global cocoa production depends on a handful of West African countries – Ivory Coast, Ghana, Cameroon and Nigeria – which collectively account for nearly 75% of the world's output. The sector has largely operated on the backs of smallholder farmers whose selling prices have always remained persistently low – regardless of market conditions – as pricing mechanisms are often government-controlled and below market value. In the meantime, traders, processors and manufacturers of chocolate products have enjoyed improved margins in times of tight supply. This situation has resulted in a vicious cycle of poverty, underinvestment and declining yields for cocoa farmers. The

ongoing shortfall should act as a wake-up call to the sector and governments to address the longstanding issues of underinvestment and poor farming practices. Higher prices reaching farmers would incentivize the necessary investment in replanting and modernizing cocoa farming, thereby ensuring the sustainability of cocoa production and meeting the growing global demand for chocolate.

Capital Markets Union: Third time's the charm?

At the ongoing Euro Summit, EU leaders are discussing a new proposal from the Eurogroup[1] for a CMU 3.0 to prepare the ground for the next EU legislative agenda for 2024-2029. The proposal is focused on the ABCs of a future CMU – architecture, business and citizens. Among others, it includes measures to reduce the regulatory burden and improve financing conditions for EU businesses by reviving the securitization market, increasing harmonization in various areas (insolvency law, accounting, listing requirements) and strengthening supervision. Nonetheless, single supervision remains out of the Eurogroup proposal, despite the push from the ECB[2] and France's Finance Minister Bruno Le Maire, though it does encourage the introduction of national tax incentives to boost investments in EU equity markets. The new proposal also aims to increase citizens' access to capital markets by expanding investment options for savings and pensions and boosting financial literacy.

Figure 3: Quantity-based financial integration composite indicator

Sources: ECB, Allianz Research

It's no wonder the EU is trying to breathe new life into the CMU project: in the 10 years since its launch, there has been very limited progress (Figure 3)**.** This is evident in the number of providers currently[3] offering the pan-European Personal Pension Product (PEPP), which was launched in mid-2020 to much acclaim: only one. A key promise to offer non-financial companies (NFC) more financing options beyond bank loans has also been at a standstill in recent years (Figure 4). At the same time, mobilizing private savings for the capital market remains a concern. Indeed, securitization and loan portfolio sales have posted a downward trend. Only 1.8% of outstanding bank loans are passed on to the capital market in this way. In the US, this figure has averaged over 10% in recent years and at its peak over a fifth of loans were placed on the capital market (2021). But there are big differences between countries: In Greece and Ireland, for example, the share is between 6% and 10%, while in Germany, with its tradition of the *Pfandbrief*, it is less than 1%. Moreover, the share of private savings mobilized for the capital market as a percentage of GDP currently stands at 90%. Ten years ago, it was still just over 100%. For comparison, in the UK, this figure hovers around 200%, while in the US it exceeds the 300% mark. However, here again there are major differences between countries: In the Netherlands, Denmark and Sweden, this figure is twice as high as the EU average. This once again underlines the fact that the EU is not a uniform capital market; the national differences are enormous and difficult to eradicate.

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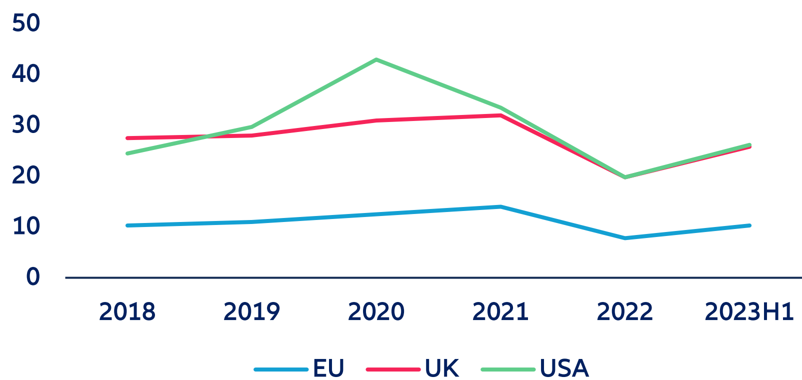
[1] Statement of the Eurogroup in inclusive format on the future of Capital Markets Union - Consilium (europa.eu)
[2] Statement by the ECB Governing Council on advancing the Capital Markets Union
[3] As of August 2023. Source: AFME (2023), Capital Markets Union. Key performance indicators.

Figure 4: Market finance indicator: NFC equity and bond issuance as a % of total NFC annual finance



Source: AFME (2023), Allianz Research

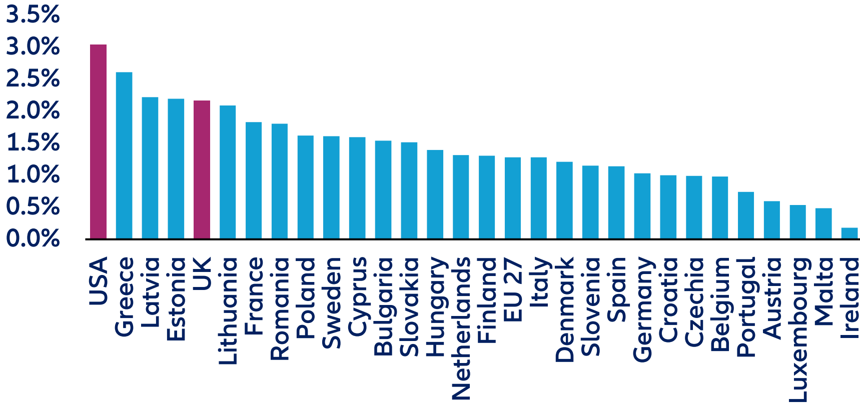
A CMU has never been more urgent as the competition for capital intensifies amid higher interest rates and immense investment requirements. But it is still unclear whether the new proposal can overcome the standstill of recent years. With the years of the "savings glut" coming to an end, a deep and broad capital market is an invaluable competitive advantage. While the new proposal is a step in the right direction, further progress can only be achieved through genuine harmonization, which would require deep cuts in national legislation, fiscal and social frameworks. As with the Banking Union, which was created in the wake of the global financial crisis but has remained piecemeal to this day, this will require pooling sovereignty rights. But the question remains, are all 27 member states ready for this? As a start, much would already be gained if best practices were introduced in the EU. After all, some members are quite capable of keeping up with the US and UK in certain areas. If the EU laggards could close these gaps, this would also be a boost for the European capital market.

There's no such thing as a free gun

Faced with an aggressive Russia at the border, EU governments have pledged to increase defense spending not least to fulfill the NATO target of 2% of GDP. Since 1995, general government expenditures for defense[4] in today's EU 27 have increased from EUR 104bn to EUR 204bn in 2022. However, they have not kept pace with general GDP and total expenditure growth: In 1995, defense expenditures corresponded to 1.6% of GDP compared to 1.3% of GDP in 2022, ranging from 0.2% of GDP in Ireland to more than 2% in Greece, Latvia, Estonia and Lithuania (Figure 5).

[4] Source: Eurostat (2024): General government expenditure by function (COFOG) [gov_10a_exp]. These figures refer to the defense expenditures according to the Classification of the Functions of Government (COFOG), which differ from the NATO definition of military expenditures. While under the COFOG classification, expenditures for pension schemes for military personnel are recorded as social security expenditures they are included as part of military expenditures in the NATO statistics for example. Furthermore, NATO calculates the expenditures and shares in GDP based on 2015 prices, while the defense expenditures given in the COFOG tables are nominal figures. There are also differences in terms of the time when expenditures are recognized. See for example Statistisches Bundesamt (2022): Entwicklung der staatlichen Ausgaben für Verteidigung seit 1991, Pressemitteilung Nr. 104 vom 9. März 2022, Wiesbaden 2022, Eurostat (2019): Manual on sources and methods of the compilation of COFOG statistics, Luxembourg 2019 and NATO (2023): Defence Expenditure of NATO Countries (2014-2023), press release, 07 July 2023, Brussels 2023.

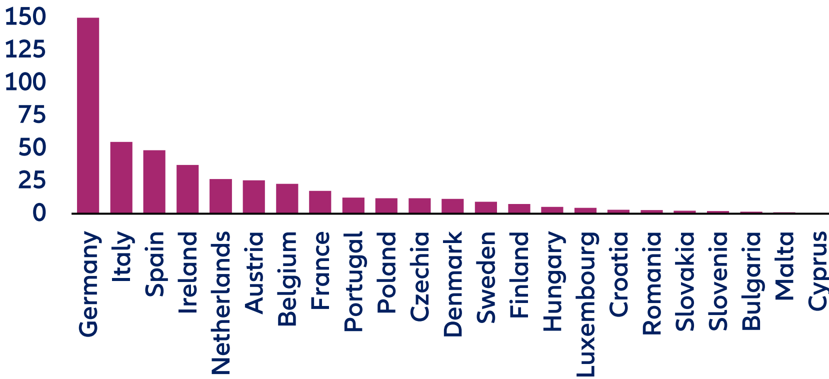
Figure 5: Defense expenditures, COFOG (in % of GDP)



Sources: Eurostat, OECD

However, gradually increasing the share of defense spending to 2% of GDP in all EU member states until 2028 would require a total of EUR 470bn in additional general government expenditures, compared to a scenario with constant current levels. This would include EUR150bn in Germany, EUR55bn in Italy, EUR48bn in Spain and EUR17bn in France (Figure 6). Reaching the share of 3% of GDP that is spent by the US today would need additional defense expenditures of EUR1110bn over the next five years.

Figure 6: Additional defense spending, 2% (COFOG), 2024 to 2028 (accumulated, in bn EUR)

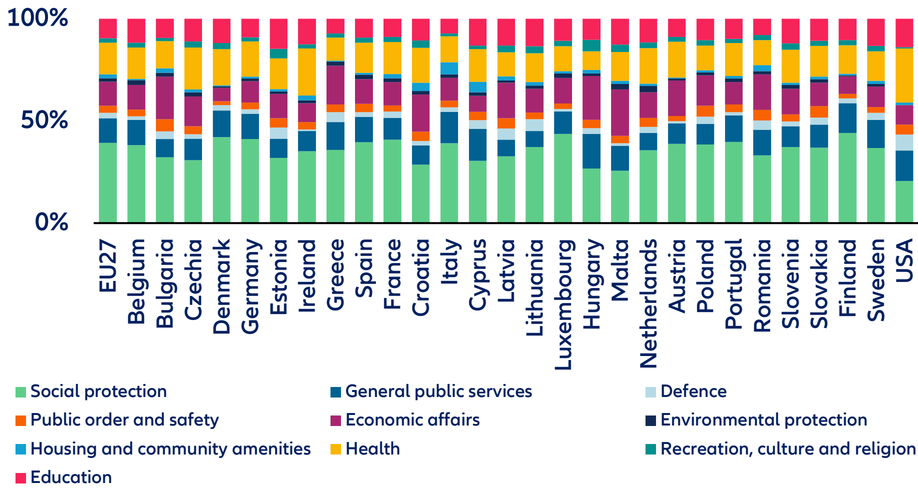


Sources: Eurostat, Allianz Research

The question is, how will these increases be financed? In general, there are three options to fund increased defense spending: cutting expenditures in other functions, debt financing or increasing taxes.

To keep the overall expenditure level stable would require expenditure cuts of -8.6% in Spain, -7.7% in Germany, -6.5% in Italy and -4.8% in France. The largest single expenditure item in EU countries' budgets are expenditures for social protection. In 2022, they accounted for 39% of total general government expenditures in the EU 27, with 54% of the social protection expenditures being expenditures for old-age provisions; 15% of total expenditures were spent on health and 12% each on general public services and economic affairs (Figure 7).

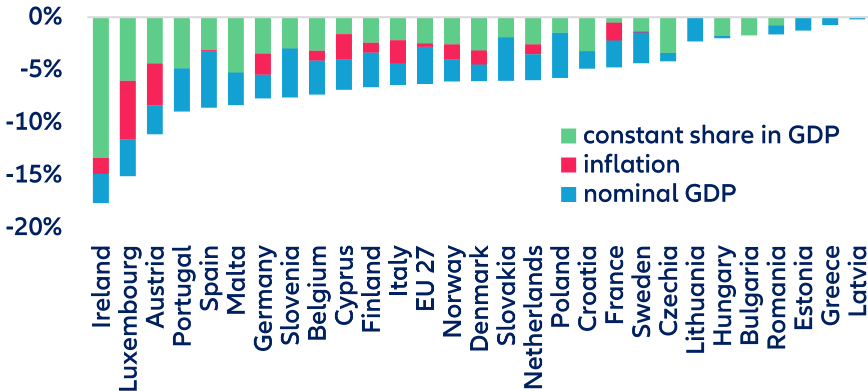
Figure 7: Expenditure split 2022 (in percent)



Sources: Eurostat, OECD

To keep total general government expenditures stable at today's level of GDP despite the increase in defense expenditures would require cuts in other government functions. However, these would most certainly be limited to the non-defense- and non-social-protection government functions since cutting social protection, and especially old-age expenditures, is not an option for many governments – if not prohibited by law then at least by political considerations. In the best-case scenario, old-age expenditures per capita could be kept constant, which would imply a decline of benefit levels and real income losses for the increasing number of people aged 65 and older. A second option to dampen the increase of old age spending in many countries would be to raise pensions only in line with inflation. In the third scenario, pension expenditures per capita increase in line with nominal GDP. Only in the first case would it not be necessary to cut expenditures in other government functions in most countries to finance the additional defense expenditures and at the same time keep the share of total general government expenditures in GDP constant. If total social protection expenditures increased in line with GDP, non-defense- and non-social-protection expenditures would need to decline by an average -2.5%. However, in general, pensions are either inflation-indexed or are raised in line with wages or nominal GDP. Furthermore, with the baby boomers reaching retirement age, the number of people aged 65 and older is set to increase markedly[5]. Against this background, funding additional defense spending could require expenditure cuts in other governments functions of up to -8.6% in Spain, -7.7% in Germany, -6.5% in Italy and -4.8% in France in 2028 (Figure 8).

Figure 8: Cuts in non-defense- and non-social-protection expenditures needed to keep the share of total expenditures in % of GDP constant, 2028 (in %)



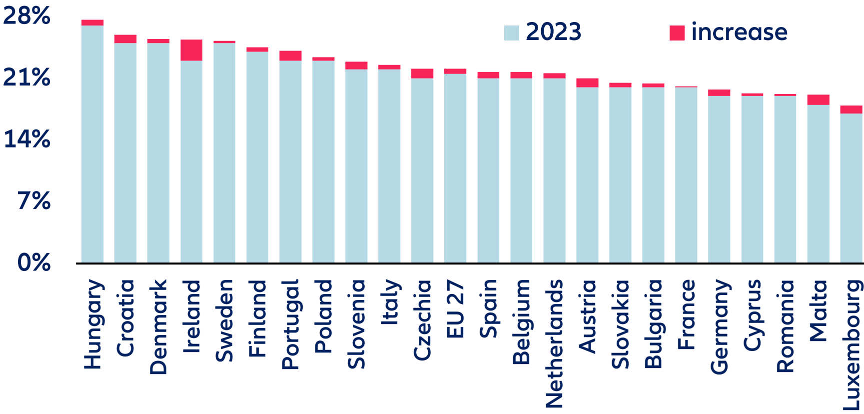
Sources: Eurostat, Allianz Research

[5] Between 2023 and 2028 the number of people aged 65 and older in the EU 27 is set to increase from 96.5mn to 105.1mn, see UN Population Division (2022): World population prospects 2022, medium variant.

Relying on debt financing would result in a total additional interest burden of around EUR12.1bn in 2028. This is roughly equivalent to the amount spent on biodiversity and landscape protection[6] in the EU 27 in 2022.

Another option would be to increase taxes to cover the additional defense expenditure. Assuming there are no shifts in the tax income structures, according to our calculations the VAT rate would have to increase by 0.6pps on average across the EU-27 in 2028, ranging from 0.1pp in France, 0.5pps in Italy and 0.7pps in Germany and Spain to 2.4pps in Ireland (Figure 9).

Figure 9: VAT rates required to cover the additional defense expenditures in 2028, 2% of GDP (COFOG)



Sources: Eurostat, Allianz Research.

So far, most governments have been reluctant to spell out the real cost of increasing defense spending, or how exactly they will manage to do so in a context of aging populations and immense investment needs for the green transition. Combining the three options could distribute the financial burden of the increase in defense expenditures between generations and within society. But it will require acknowledging that there is a big price to pay to have both guns and butter.

India: Tapping new trade opportunities

Looking beyond its usual partners in Asia, India signed a free-trade agreement (FTA) with the European Free Trade Agreement (EFTA) states Switzerland, Iceland, Norway and Liechtenstein. In our previous report[7], we highlighted that liberalizing reforms to attract foreign investments as well as reducing protectionist measures and making stronger alliances to unlock significant trade potential are among the game-changers that can shape India's mid-term economic outlook. In the past, India has been cautious in negotiating FTAs and has primarily focused on its Asian partners. But in recent years it has started to venture towards Western and developed economies (Table 1). With the addition of this deal to India's trade artillery, the economy has concluded 14 FTAs as of today. Official sources state that the new FTA with the EFTA states broadly covers 99.6% of India's exports, excluding products such as dairy, soya, coal and other sensitive agricultural products. In return, India is expected to lift duties on 95.3% of the EFTA's industrial exports, excluding gold. The EFTA states and India now have to ratify the deal before it comes into effect (likely to be in early 2025).

[6] According to latest available Eurostat statistics, total general government expenditures for protection of biodiversity and landscape amounted to EUR 12.8bn in 2022. See Eurostat (2024): General government expenditure by function (COFOG) [gov_10a_exp].
[7] See our report: India: A rising star.

Table 1: List of India's free trade agreements

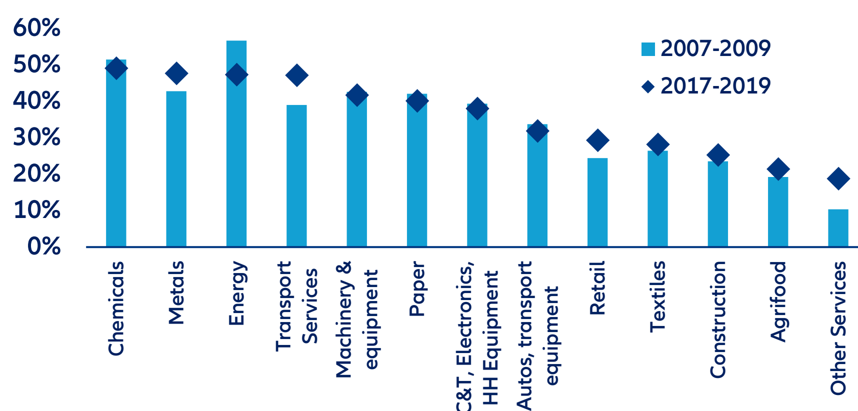
Region	Names of FTA	Date of Signing	In Effect
ASEAN	India - ASEAN FTA	August 13, 2009	January 1, 2010
	India - Singapore CECA	June 29, 2005	August 1, 2005
	India - Malaysia CECA	February 8, 2011	July 1, 2011
	India - Thailand FTA	October 9, 2003	September 1, 2006
Japan	India - Japan CEPA	February 16, 2011	August 1, 2011
South Korea	India - South Korea CEPA	August 7, 2009	January 1, 2010
SAFTA	Agreement on SAFTA	January 6, 2004	January 1, 2006
	India - Sri Lanka FTA	December 28, 1998	March 1, 2000
	India - Nepal Treaty of Trade	October 27, 2009	October 27, 2009
	India - Bhutan Agreement on Trade, Commerce and Transit	July 28, 2006	July 29, 2006
Mauritius	India - Mauritius CECPA	February 22, 2021	April 1, 2021
UAE	India - UAE CEPA	February 18, 2022	May 1, 2022
Australia	India - Australia ECTA	April 2, 2022	December 29, 2022
EFTA	India - EFTA Trade and Economic Partnership Agreement	March 10, 2024	

*Sources: Official sources, WTO, Allianz Research. * Abbreviations: FTA – Free trade agreement, CECA – Comprehensive Economic Cooperation Agreements, CEPA – Comprehensive Economic Partnership Agreements, CECPA – Comprehensive Economic Cooperation and Partnership Agreement (CECPA), ECTA – Economic Cooperation and Trade Agreement.*

However, the total boost to trade of goods is likely to be limited, given the smaller share of trade between the signatories. But the deal could also indirectly enhance India's services exports to the EU market. India's highly competitive services sector can increase its access to the EU market via Switzerland as more than 40% of Switzerland's services exports are to the EU. Other key sectors that could benefit from an additional boost include Indian exports of chemicals, transport equipment and textiles, and Swiss exports of pharmaceuticals and metals. EFTA states will benefit from the outperformance of India's economy and its attractive domestic market with a growing middle class. In addition, in the context of global supply-chain diversification and the 'China plus one' strategy, cost benefits and a young labor force make India an attractive alternative production base.

Investments amounting to 0.2% of GDP per year in the coming 15 years and R&D spillovers are expected, helping to strengthen India's position in global supply chains. Over a ten-year period, India has not significantly improved its position in global value chains, with the exception of the services and metals sectors (Figure 10). There is further room for improvement in the manufacturing sector, particularly in pharmaceuticals and machinery, which can be helped with foreign investment as well as R&D spillovers[8]. Thanks to a binding commitment in the FTA with the EFTA states, India will benefit from USD100bn of foreign direct investment in the next 15 years. Assuming that it is fully used for the financing of capital formation, this could translate to a cumulative gain of close to 3% of GDP over the 15 years, i.e. 0.2% per year. Officials also estimate the deal to generate 1mn direct jobs in India.

Figure 10: Share of Indian gross exports participating in global value chains, 2007-2009 and 2017-2019 averages

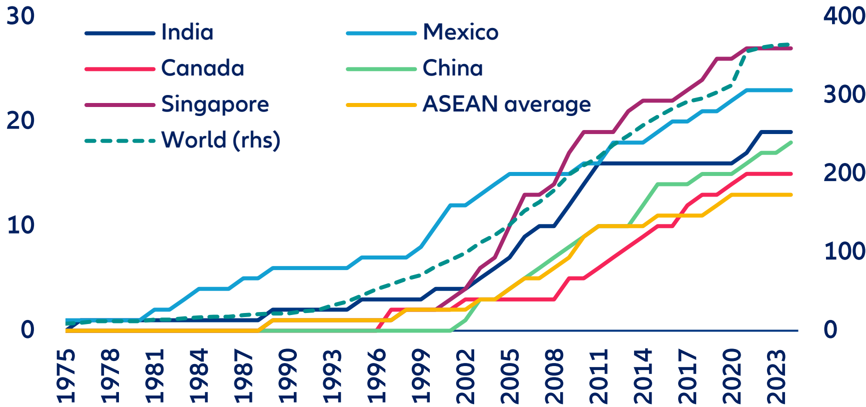


*Sources: ADB, Allianz Research. *Abbreviations: C&T - Computers and Telecom, HH – Household*

[8] 30 Swiss companies already have research and development centers in India, in high value-added sectors such as ICT and software, pharmaceuticals, and financial services.

More FTAs are on the cards, which will help unlock the country's significant trade potential. Indian authorities seem ready to tap into the growing opportunity arising from geopolitical concerns as multinational firms look for alternatives to China. Since 2021, India has signed three other FTAs (with Mauritius, the UAE and Australia) and is in the process of negotiating deals with the UK and the EU. Notably, India has managed to establish more FTAs than its peers in ASEAN and Mexico, which are the main candidates poised to benefit from friend-shoring (Figure 11). In addition, based on Global Trade Alert data, we find that India was one of only eight nations in Asia-Pacific to have implemented more measures to liberalize trade in 2023 rather than putting in place barriers. This is also the case for Malaysia and Vietnam, while South Korea, China and Japan implemented more measures that harmed trade. These positive developments stand out amidst growing trends of fragmentation and geopolitical division at the international stage. Still, India has the potential to unlock and accelerate growth through greater trade liberalization as it remains below the levels of its Asian peers in terms of trade openness – trade as a percentage of GDP remained at 50% in 2022, compared to over 100% in Vietnam, Malaysia, Thailand and Cambodia.

Figure 11: Cumulative number of regional trade agreements in force



Sources: WTO RTA Database, Allianz Research.

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