17 May 2021

# Research Euro Area

## Decoding Europe's recovery plans

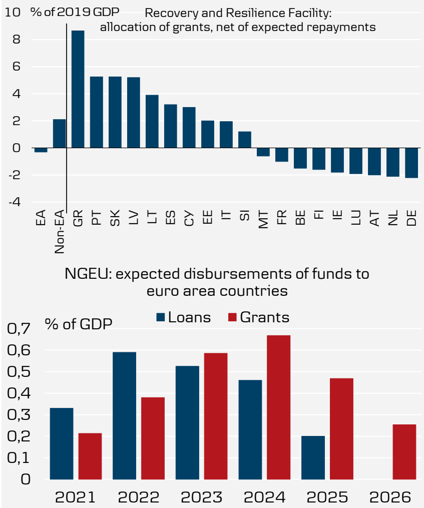
- **'*Next Generation EU'* plays a crucial role in alleviating the risk of an asymmetric recovery and allows hard-hit countries in Southern Europe to support their economies while avoiding a significant rise in public debt levels.**
- **The focus of Germany's recovery plan lies on investments in digitalisation and climate protection, but the sums involved pale in comparison to the country's substantial investment needs.**
- **France's recovery package represents a good mix of structural reforms and investments to future-proof the economy. Time will be of essence for President Macron in reaping the benefits of the economic revival plan, as his re-election chances in 2022 will crucially depend on it.**
- **Italy's recovery plan ticks all the right boxes and constitutes an ambitious overhaul of the economy. Especially untying the two Gordian knots of an inefficient public administration and opaque legal system will play a key role in whether EU funds can be absorbed and utilized effectively on the ground.**
- **Spain's recovery plan is among the best when it comes to the green transition and the clear focus on diversifying the economy away from (low productivity) services could raise potential growth.**

### Alleviating the risk of an asymmetric recovery

**The *'Next Generation EU'* (NGEU) post-coronavirus recovery fund of EUR 750bn represents not only an important milestone in European integration but also plays a crucial role in alleviating the risk of an asymmetric recovery between Northern and Southern Europe.** For NGEU, the European Commission has been authorised to raise up to EUR750bn on the capital markets, which means the EU will become one of the largest issuers in Europe over the coming years in our view. To receive financial support from the fund, countries need to prepare national recovery and resilience plans, setting out their reform and investment agenda (with a minimum 37% of expenditures linked to green investments and 20% to digital investments). The Commission's plans currently expect financial support to be fully committed by the end of 2023 and largely disbursed over the period from 2021 to 2024. The lastest *EU Commission spring forecasts* project an economic impact of approximately 1.2% of 2019 EU real GDP generated by the NGEU *Recovery and Resilience Facility* until 2022. Overall, we expect the largest boost from the NGEU funds to the euro area economy to materialize from 2022-2024 (see chart to the right).

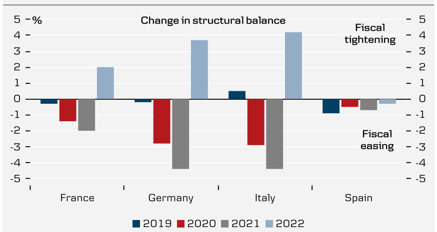
**The funds provided by NGEU lower the risk that fiscal support will be withdrawn prematurely at the national level**, especially for countries that already face fiscal sustainability concerns. Although NGEU will not help the euro area recovery much in the short term, we see it as an important element of 'bridge-financing', supporting public investments at a time when some national fiscal initiatives might otherwise be scaled back. This is especially the case for hard-hit countries in Southern Europe, as the EU grant financing creates room for supporting their economies while avoiding a significant rise in public debt levels.

**Most of the NGEU boost will only materialise from 2022 onwards...**




*Source: ECB, European Commission, Danske Bank*

**... But change in structural balance still implies net fiscal tightening in 2022 for most economies**




*Source: European Commission, Danske Bank*

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**Currently it seems that Eurostat and the European Commission do not plan to allocate the new EU debt to national debts**, as it would be very difficult to make accurate predictions of relative GNI developments in EU countries over the next four decades, which determine relative NGEU country repayment shares starting from 2027 and running up to 2058. Furthermore, some of the money for repayment is also supposed to be raised via new EU-wide taxes, which yet have to see the light of day. This exception, however, does not apply to the NGEU loans, which need to be repaid in full by the specific borrower country and hence will contribute to the national debt and deficit numbers.

**Once countries have submitted their recovery and resilience plans, the European Commission has two months to analyse and approve them**. Thereafter, its conclusions will also need the sign-off of the EU Council. Once the green light is given by both, pre-financing of 13% of the plans are disbursed to the countries. Thereafter, and until 2026, the NGEU funds will be released according to implementation milestones.

**One key question remains how strict the Commission will be in policing countries' compliance with targets**. Some EU officials have suggested that Brussels was ready to freeze payments if a member state misses important deadlines. However, such a move to suspend payments could be politically explosive, given the enormous importance NGEU plays in helping the EU overcoming the deepest economic crisis in its history.

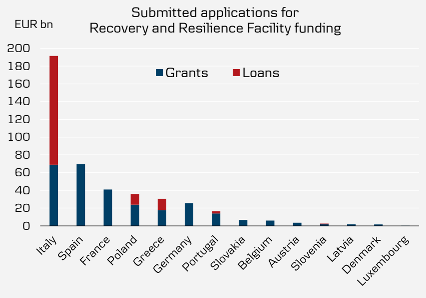
As more euro area countries have now started to submit their recovery and resilience plans to access NGEU funds, in the following we take a closer look at the individual country plans submitted by Germany, France, Italy and Spain and assess the economic and fiscal implications (see pp. 3-6).

## Recovery plans with different spending priorities

**Comparing the four recovery plans is a tricky business as they have rather diverse structures and spending priorities.** Digitalisation seems to be the clear focus of Germany's recovery plan, with half of the NGEU funds earmarked for this component, while the other three countries spend around a quarter on digital priorities. On green investments, France seems to be the front-runner planning to spend 50% of funds, while the other three countries will spend around 40%. Furthermore, the plans also exhibit different priorities on climate-related spending.

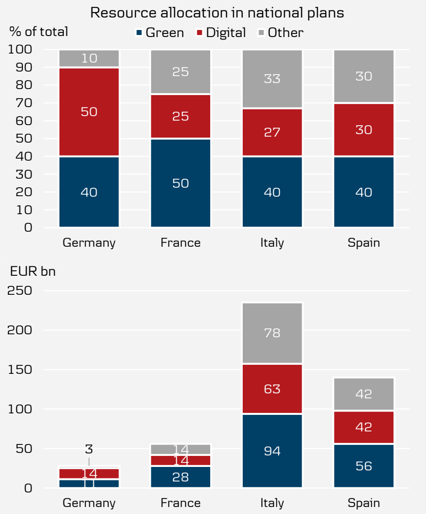
While Germany's green infrastructure and mobility investments are entirely focused on the development of electric mobility, the Spanish plan also foresees investments in public transport and in both France and Italy half of the investment focuses on the development of the railway system. Regarding green energy investments, Germany and France focus strongly on the development of a hydrogen economy, while Italy and Spain also plan sizeable investments in renewable energy and smart grids. The plans of France, Italy and Spain also include an emphasis on social inclusion, education, research, health and culture. The German plan in contrast foresees little spending on non-climate and non-digital related policy areas, possibly also because Germany will receive less NGEU funds than the other countries.

### Italy, Greece, Portugal, Poland and Slovenia have also applied for NGEU loans




*Source: European Commission, Danske Bank*

### EU recovery plans have different spending priorities




*Source: National recovery plans, Danske Bank*

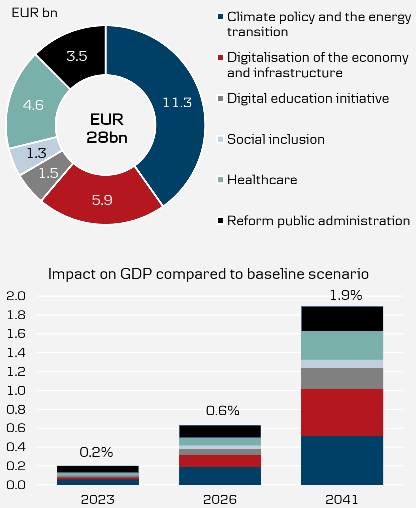
## Germany: Mind the (investment) gap

- **Recovery plan:** 90% of Germany's EUR 28bn *recovery and resilience plan* (0.8% of GDP spread over six years) focuses spending on climate action and digitalisation. 40% of funds will be targeted towards climate policy and the energy transition and measures include investments in the development of hydrogen technologies, purchase incentives for electric cars, buses and rail vehicles as well as subsidies for energy-efficient building renovation. A second focus of the plan (50% of resources) is on the digitalisation of the economy and infrastructure, where measures seek to strengthen digitalisation efforts in public administrative services, the public health system as well as the rail and vehicle manufacturers. The plan also foresees a digital education initiative that provides schools and teachers with a better digital infrastructure and skills. *Important Projects of Common European Interest (IPCEI),* that were jointly initiated by Germany and France in the areas of hydrogen, microelectronics, communication and data technologies, round off the German recovery plan. According to *analysis* from the German Institute for Economic Research (DIW), the recovery plan's measures are expected to boost GDP by around 2% and employment by about 0.5% in the long term.

- **Financing:** Germany's recovery plan amounts to EUR 28bn, of which EUR 25.6bn will be financed via NGEU grants and the remainder from own budgetary resources. The latest *budget projections* from the German Finance Ministry foresee a deficit of -9.0% in 2021 (after -4.2% in 2020), that is gradually declining to a balanced budget by 2025. The debt to GDP ratio is estimated to peak at 74.5% in 2021 and decline back to 69.3% by 2025. That said, Germany's constitutional 'debt brake,' that will likely apply again from 2022 onwards and which only allows a maximum structural deficit of -0.35% of GDP, is complicating things. According to the current projections, the structural deficit will exceed this threshold in 2022-24, implying a tightening of fiscal policies in the absence of new revenue raising measures.

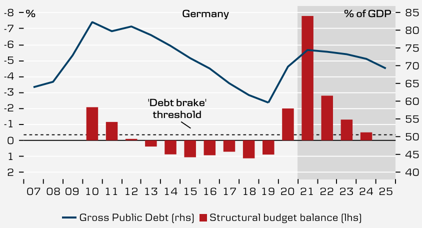
- **Conclusion:** The focus of Germany's recovery plan lies clearly on investments in digitalisation and climate protection, but the sums involved (0.8% of 2020 GDP) pale in comparison to the country's substantial investment needs in these areas. Structural reforms play a more subordinate role. Still, initiatives to reduce investment barriers stemming from an opaque public administration provide a good start in addressing implementation bottlenecks for infrastructure projects, that are particularly prevalent at the local government level. In that respect, debt relief for highly indebted municipalities (not mentioned in the recovery plan, but suggested by Finance Minister and SPD chancellor candidate Olaf Scholz) could be another sensible measure to boost fiscal multiplier effects. This will be even more important if the next German government - which will likely assign a prominent role to the Green party - has a strong focus of increasing public investments even further (for more details see *Research Germany: End of the "era Merkel" leaves German politics in unchartered territory*, 27 April 2021). Future-proofing Germany's manufacturing sector will be crucial for maintaining the competitiveness of the economy in the long-term. The important car industry in particular has long remained dormant with regard to technological changes and it remains yet to be seen whether the transition of its business model will succeed, even with the help of public subsidies (see also *Euro Area Research: Europe's car sector: back on the road again?*, 10 September 2020).

### Digitalisation takes centre stage in Germany's recovery plan



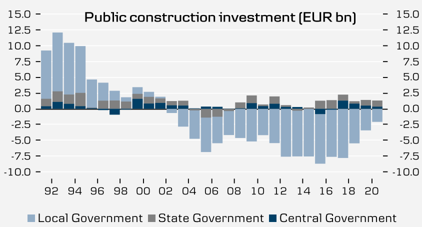

Source: *German Finance Ministry*, DIW, Danske Bank

### 'Debt brake' to restrict German fiscal policy room from 2022 onwards




Source: Macrobond Financial, European Commission, *German Finance Ministry*, Danske Bank

### The root of Germany's infrastructure decay lies at local government level




Source: Destatis, Macrobond Financial, Danske Bank

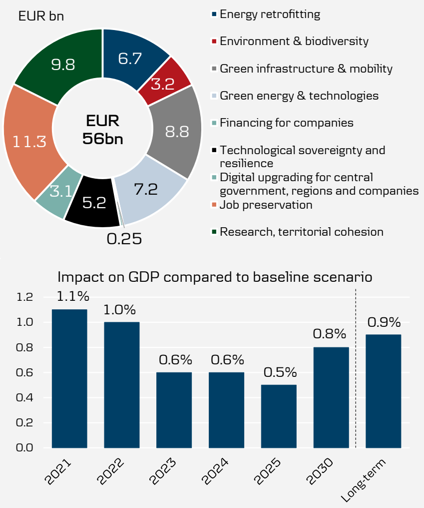
## France: Haunted by fiscal and political sustainability concerns

- **Recovery plan:** France's EUR 56bn *recovery and resilience plan* (2.5% of GDP spread over six years) is part of the EUR 100bn '*France Relaunch'* plan unveiled by President Macron in September 2020. It focuses on three key priorities: the environment, competitiveness, and social and territorial cohesion. 50% of investments focus on the climate transition and 25% of investments on the digital transition of the economy. Initiatives to step up the green transition include investments in the retrofitting of public buildings, businesses and private housing, hydrogen technologies, plastic substitution solutions and biodiversity. With an allocation of over EUR 10bn, the digital transition of the economy focuses on high-speed broadband access, digitalisation of the public administration, investments in quantum technologies, cybersecurity and AI, as well as digital training programmes of teachers. A long-term furlough scheme combined with training for idled workers and bonuses to promote the hiring of young people aim to improve social cohesion. On the reform agenda, the government aims to conclude reforms of the unemployment insurance and pension systems that were postponed during the corona pandemic. Overall, the government estimates that the plan will raise GDP by ca. 4% by 2025 and create ca. 240,000 jobs by 2022.

- **Financing:** France's recovery plan aims to mobilize EUR 56bn in funds, of which EUR 41bn stem from NGEU grants and the rest from own budgetary resources. The latest *multi-annual budget projections* by the French government foresee a budget deficit of -9.0% in 2021 (after -9.2% in 2020) and only by 2027 will the deficit fall back below the 3% Maastricht criteria. This slow fiscal consolidation pace also causes some worrying trends in the debt to GDP ratio, which stabilizes around 118% of GDP according to the projections (up from 98% of GDP before the COVID-19 crisis). While France's ambitious plan to relaunch the economy creates opportunities to raise potential growth in the long-term, the persistent budget deficits could increasingly raise fiscal sustainability concerns in the market in our view, especially if paired with renewed political uncertainty. As we have also discussed in *Research Global - Public debt levels post COVID-19: much ado about nothing?*, 30 September 2020, France is one of the countries whose public finances are most vulnerable to a rise in interest rates.

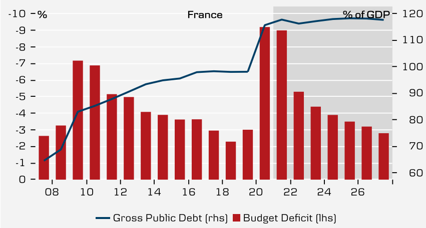
- **Conclusion:** The package represents a good mix of reforms and investments that aim to tackle known structural issues (public administration, unemployment insurance, pensions) and future-proof the French economy via investments in new technologies and the green transition. Whether implementation on the ground is as successful as on paper remains yet to be seen and opposition to unpopular structural reforms (as seen with the stalled pension reform) could yet again create stumbling blocks. However, time will be of essence for President Macron in reaping the benefits of the economic revival plan, as his re-election chances in 2022 will crucially depend on it. Political uncertainty therefore remains a key risk to the realization of the ambitious economic relaunch strategy, as a slackening of the reform and investment effort under a potential Marine Le Pen presidency could endanger disbursements of funds from Brussels.

### 50% of French recovery plan funds focus on green transition



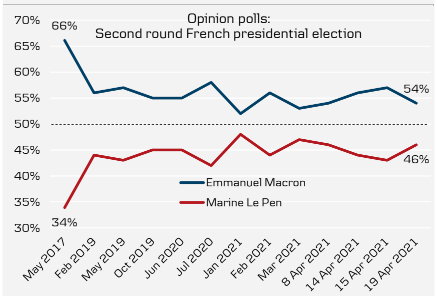

Source: French Economy Ministry, Danske Bank

### French debt ratio is stabilizing at a high level, raising concerns




Source: Macrobond Financial, European Commission, French Finance Ministry, Danske Bank

### Opinion polls highlight risk of Marine Le Pen winning French presidency in 2022




Source: Ifop, Elabe, Ipsos, Harris Interactive, Danske Bank

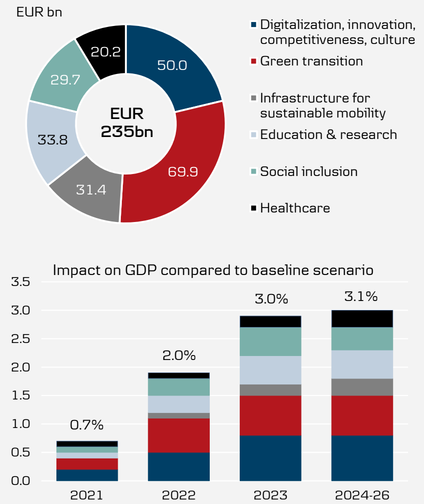
## Italy: Untying the Gordian knot

- **Recovery plan:** Italy's EUR 235bn *recovery and resilience plan* (14% of GDP spread over six years) focuses on three areas to restart growth and improve the competitiveness of the economy: digitisation and innovation, ecological transition and social inclusion. Initiatives under the digitisation and innovation stream (21% of total resources) target structural reforms of the legal system and public administration, support digitalisation efforts of SMEs and expand broadband and fibre networks. The green transition stream receives the largest allocation of resources (30%) and includes investments to improve the energy efficiency of buildings, increasing the share of energy produced by renewables and strengthening infrastructure and cycle tracks. A large part of the spending will also be directed towards modernizing and expanding Italy's rail system and providing the structurally weaker South with high-speed trains (ca. 40% of overall resources are targeted towards Southern Italy). But also investments in education (including nurseries and kindergartens) and improving the employment situation of young people and women are planned under the social inclusion stream. All in all, the government expects the plan to boost GDP by 3.1% and employment by 3.2% by the end of 2026. The structural reforms of the legal system and public administration are estimated to boost long-term GDP by some 3.3% percentage points.

  **Financing:** Italy's recovery plan aims to mobilize EUR 235bn in funds, of which EUR 204.5bn stem from NGEU resources (EUR 191.5bn from the *Recovery and Resilience Facility* of which EUR 68.9bn constitute grants and EUR 122.6bn loans, and EUR 13bn from *React EU*). A further EUR 30.6bn stem from the Italian 2021-2026 budget planning. The latest *budget projections* from the Italian Economy and Finance Ministry foresee a public deficit of -11.8% of GDP in 2021 (after -9.5% in 2020), that is gradually declining to -3.4% by 2024. The debt ratio is estimated to peak at 159.8% of GDP in 2021 - the highest since the creation of the Italian republic following WWII and compared with 135% of GDP before the COVID-19 crisis - and decline back to 152.7% by 2024.

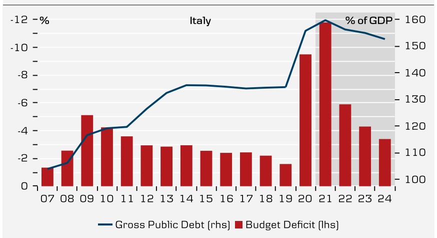
- **Conclusion:** Italy's recovery plan ticks all the right boxes and constitutes an ambitious overhaul of the economy in our view. Especially untying the two Gordian knots of an inefficient public administration and opaque legal system will play a key role in whether EU funds can be absorbed and utilized effectively on the ground. Historically, Italy's experiences on this front have been more mixed (see Bruegel blogs *here* and *here*), leaving public investment multipliers low. The political backdrop for structural reforms is uniquely benign, with Mario Draghi's national unity government enjoying broad support in parliament and thanks to his strong European credentials, markets so far have remained complacent despite the planned debt and deficit expansions. Still, in the long-run Italian debt woes could come back to haunt, especially if the reform pay-offs materialize only slowly and new elections in 2023 leave the risk of a return of political instability. Afterall, the expected debt decline and ultimate sustainability of Italy's public finances will crucially depend on whether the envisioned reforms can also raise Italy's potential growth, which remains the Achilles heel of the economy.

**Italy's recovery plan presents an ambitious overhaul of the economy**



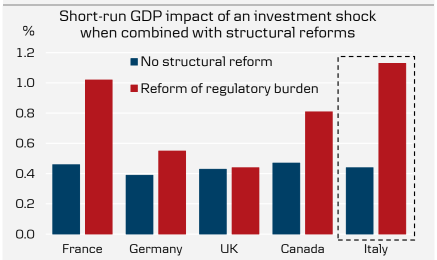

Source: *Italian Economy and Finance Ministry*, Danske Bank

**Italian debt and deficit to peak in 2021**




Source: Macrobond Financial, European Commission, *Italian Economy and Finance Ministry*, Danske Bank

**Structural reforms play crucial role for high fiscal multipliers**

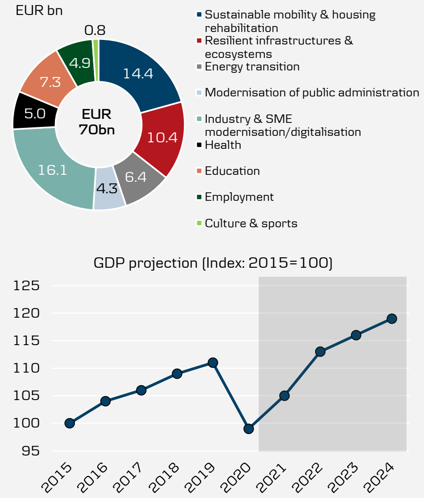



Source: *OECD*

## Spain: A green industrial revolution

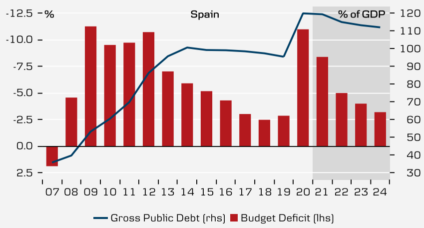
- **Recovery plan:** Spain's EUR 140bn *recovery and resilience plan* (12.5% of 2020 GDP spread over six years) relies on NGEU grants and loans in equal terms. 40% of resources target the green transition and 30% constitute investments in digitalisation. EUR 13.2bn will go towards the transition to electric vehicles, while the second largest investment will be focused on housing rehabilitation and urban regeneration worth EUR 6.8bn. A further EUR 4.3bn will go towards modernising the public administration. Another focus of the plan is to decrease Spain's overreliance on services and especially tourism, that has turned out to be a risky strategy under the corona crisis. Hence, an additional EUR 8bn will go towards the digitalisation of SMEs and the country's 5G road map, while some measures also aim to boost the domestic pharmaceutical sector. The plan is accompanied by over 100 proposed reforms (in the tax system and public administration among others). The Spanish government estimates that the plan will add two percentage points to GDP on average per year and create more than 800,000 jobs.
- **Financing:** In addition to the EUR 70bn of NGEU grants that Spain plans to tap between 2021-2023, the government intends to take out an equivalent amount of NGEU loans from 2024-2026. For the 2021 budget, EUR 27bn of EU funds have already been earmarked. Despite a large share of the money to rebuild the Spanish economy stemming from EU resources, the latest *budget projections* of the Spanish government foresee a budget deficit of -8.4% in 2021 (after -11.0% in 2020) and a continued budget deficit exceeding 3% all the way until 2024. That means that the envisioned decline in the debt to GDP ratio will progress only gradually, reaching 112% in 2024.
- **Conclusion:** Spain's recovery plan is among the best when it comes to the green transition towards climate neutrality according to the *Green recovery Tracker*. The clear focus on diversifying the Spanish economy away from (low productivity) services and towards creating an industry hub in key technologies of the future holds the potential of raising growth in the long-term in our view. Proposed reforms of the pension systems and labour market will also play a key role in that respect and have long been pointed out by Brussels as crucial areas for improving the sustainability of public finances. Another positive aspect of the plan constitutes a strong monitoring system to ensure the smooth flow of EU money in line with set milestones. However, while gross public investment is envisioned to reach ca. 4% of GDP by 2022, this still remains below the levels observed prior to the Financial Crisis in 2008/09. Furthermore, to realize the projected growth effects, the plan also heavily relies in the mobilisation of private investment in addition to public resources.

### Reviving Spain's industry fortunes



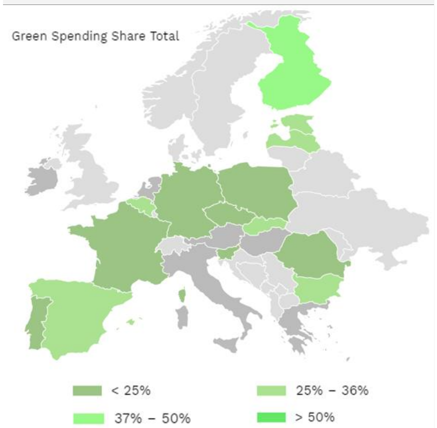

Source: *Spanish Government*, Danske Bank

### Spain's fiscal situation remains vulnerable




Source: Macrobond Financial, European Commission, *Spanish Finance Ministry*, Danske Bank

### Spain has one of the 'greenest' EU recovery plans




Source: *Green recovery Tracker*

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