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Flash comment

EU recovery fund: White smoke at last

White smoke at last emerged from Brussels after the marathon EU summit yielded a compromise on the '*Next Generation EU'* package. After tough negotiations, EU leaders agreed on a deal in the form of a EUR 750bn recovery fund (over 2021-2024) and EUR1074.3bn EU budget (over 2021-2027). Below we summarise the key things to note from the agreement.

- **Recovery fund** comprises of EUR390bn in grants plus EUR360bn in loans (52/48% split). This constitutes a watered down version in terms of the grant share of the earlier proposal in May, but in light of the stiff opposition of the frugal countries, the still sizable grant share should be seen as a positive, in our view.
  - The money will be raised via the Commission issuing bonds with 3-30Y maturity on the financial markets on behalf of the EU (see *here*). It will lend the proceeds to EU countries under the Recovery and Resilience Facility to finance their reform and resilience plans. Of the grants under the Recovery and Resilience Facility 70% will be committed in 2021 and 2022 and 30% in 2023.
  - The package includes an emergency brake that would allow any country to raise concerns that reform promises are not lived up to, which could lead to Brussels temporarily halting transfers. It is also planned that a weighted majority of EU governments can block payments to a country over rule-of-law violations.
  - With a deal now in place the final distribution among member states becomes key for markets. Some countries have criticised the original allocation key based on backward-looking measures of population, GDP per capita and unemployment. Currently it is planned that for 2023 allocations, the unemployment criterion will be replaced by the drop in GDP in 2020 and 2021. However, according to Bloomberg, Italy is likely to receive grants worth EUR82bn, which is actually in line with the initial proposal from May.
  - As long as the recovery fund remains a temporary instrument, it is set to lead to higher EU budget contributions. To ease this burden, EU leaders agreed to a new EU plastic levy to be introduced in 2021 and a new digital levy and carbon adjustment measure are also under discussion for 2022. Revenues generated from these EU taxes will be used for early repayment of the new borrowing.
- **MFF 2021-27 (*EU budget*).** Significant rebates for the frugal countries and Germany totalling EUR52.8bn have resulted in a smaller EU budget than originally proposed by the Commission in May (EUR1.1tr). The EU budget will complement the recovery fund, but its funds will be less tilted towards short-term economic revival and more towards 'future-proofing' the EU economy, especially regarding the Green transition and digitalisation efforts.

Other reading

- *FI Strategy: EU as an issuer - the recovery fund, 26 June*
- *Next Generation EU: A landmark for European history?, 27 May*

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- **Next steps.** We expect the ratification process to conclude during Q3 20, with the first recovery fund issuance to commence in January 2021 and last until 2024 (see also *FI Strategy: EU as an issuer – the recovery fund, 26 June*). Some countries such as Italy have urged that the recovery money should already be flowing in H2 20. However, we remain sceptical, not least because access to funds still requires the submission and acceptance of countries' reform and resilience plans first. Hence, we expect most of the fiscal boost from the recovery fund to materialize in H1 21, supporting particularly public investments at a time when national fiscal initiatives might otherwise be scaled back. In that light we do not see the EU recovery fund as something that will give renewed impetus to the euro area recovery in the short term, but more as an important element of 'bridge-financing' to smooth and ensure an ongoing recovery also in 2021.

Overall, we think the recovery fund deal is an important part of the *euro area's road to recovery (14 May)*, despite it being a watered down version of the original proposal. While not solving the issue of high debt levels, it will help reduce the risk of an asymmetric recovery.

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