Q&A: NEXT GENERATION EU

THE EU'S RECOVERY FUND PRESENTS CHALLENGES AS WELL AS OPPORTUNITIES

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SUMMARY

- In July 2020, EU leaders took an unprecedented decision to launch a recovery fund worth €750bn, labelled Next Generation EU (NGEU).
- To finance NGEU, the European Commission, will borrow an average of €150 bn per year between mid-2021 and 2026 on capital markets. All borrowing is set to be repaid by 2058.
- The core element of NGEU is the 'Recovery and Resilience Facility' (RFF).
- To be eligible for the RFF, EU member states must present proposals for 'investment and reform initiatives' to be implemented before 2026. Each state must devote at least 37% of the funds they receive to climate-related objectives and a further 20% to digital initiatives.
- Italy and Spain will be the two largest beneficiaries of NGEU grants in absolute terms, while eastern and peripheral countries in general will be the main beneficiaries relative to GDP.
- Take-up of NGEU funds will probably be limited until 2022. The overall economic impact will depend as much on governments ability to use the money efficiently and productively as on how rapidly it is deployed.
- NGEU could help countries, particularly in southern Europe, to boost their potential growth and make debt more sustainable.
- The main differences between the US and Europe depend not so much on the size of policy packages as on the political commitment and mindset. Europe lacks commitment to continuous fiscal expansion beyond the pandemic.

CHART 1: NGEU BREAKDOWN – LOANS VERSUS GRANTS

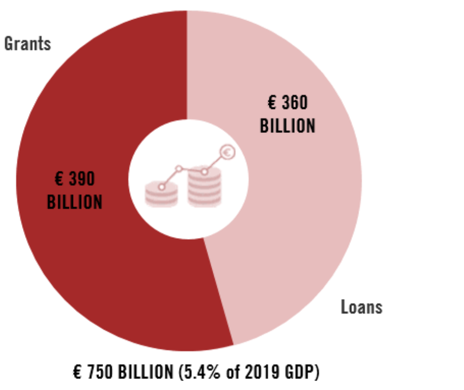

CHART 2: NGEU BREAKDOWN - PROGRAMMES

Programmes	Funds (€ bn)	
Recovery and Resilience Facility	**672.5**	Lasting investment & reforms with focus on Green and digital
RRF (loans)	*360.0*	
RRF (grants)	*312.5*	
ReactEU	**47.5**	Short-term repair to labour, health care & SMEs in crisis sectors
Just Transition Fund	**10.0**	Green transition in most difficult countries
Rural Development	**7.5**	Green transition for agriculture
InvestEU	**5.6**	Private investment with EIB
Horizon Europe	**5.0**	Investment in R&D
RescEU	**1.9**	Civil protection & humanitarian
Total	**750**	
Grants	*390*	
Loans	*360*	

Source: European Commission, Pictet WM- AA&MR, 6 May 2021

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What is Next Generation EU?

In July 2020, EU leaders agreed on a recovery package worth €750 bn (5.4% of 2019 EU27 GDP), labelled Next Generation EU (NGEU). The NGEU is made up of grants (€390 bn) and loans (€360 bn). **The core element of NGEU is the 'Recovery and Resilience Facility'** (RFF) worth €672.5 bn, of which €312.5 bn is in the form of grants and €360 bn are in loans. The remaining funds are split between six other programmes.

How much debt will the EU issue each year?

To finance NGEU, the European Commission will borrow on the capital market on behalf of the EU. On average, the Commission will borrow **roughly €150 bn per year between mid-2021 and 2026**, making the EU one of the largest issuers in euro. First issuance should be this summer. The Commission will seek to raise 30% of the funds by issuing a 'NGEU green bond'.

How will the debt be repaid?

All borrowing will be repaid by 2058. The idea is to finance the NGEU through new own resources that the EU intends to raise. Potential sources of revenue include: (i) the expansion of the EU's emissions-trading scheme (ETS, where companies trade their carbon allowances) to the maritime and aviation sectors; (ii) a new carbon border-adjustment mechanism[1] and (iii) a new levy on digital companies. A EU tax on plastic was introduced in January 2021.

What is the timeline?

For NGEU to become operational and the Commission to raise the relevant amount of debt on capital markets, all EU members must ratify the 'Own Resources Decision (ORD)'. ORD establishes how the EU budget is financed.

To be able to access the Recovery and Resilience Facility (RFF), the core element of the NGEU, member state governments must prepare 'national recovery and resilience plans' that contain proposals for "investment and reform initiatives" to be implemented by 2026.

Member states have been encouraged to submit their plans **before 30 April** but have up until mid-2022 to do so. The **European Commission has up to two months to assess submissions**. The EU Council of Ministers has a further month to deliver its own verdict on states' spending and reform plans.

Once the EU Council has given its green light, **the EU will disburse 13% of the total support agreed upfront in order to help kick-start recovery**. Member states can request further disbursements up to twice a year if they reach agreed milestones and targets. **In other words, after the first instalment, NGEU payments will be linked to performance**.

[1] The carbon border adjustment mechanism entails a tax on any product imported from a country outside of the EU that does not have a system to price carbon, like the EU ETS

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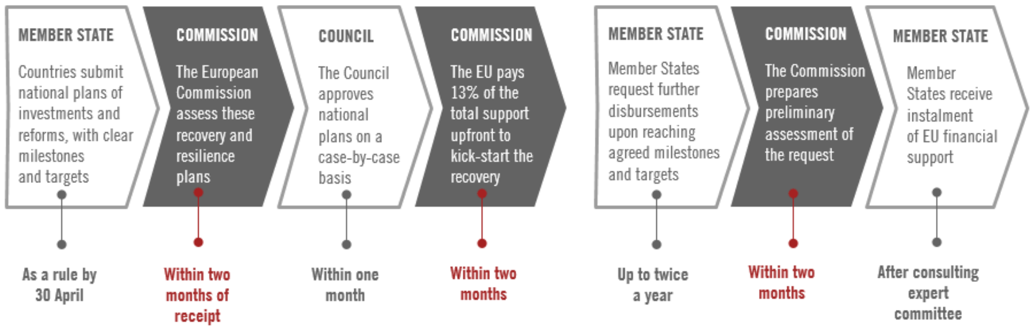
CHART 3: RECOVERY AND RESILIENCE FACILITY TIMELINE

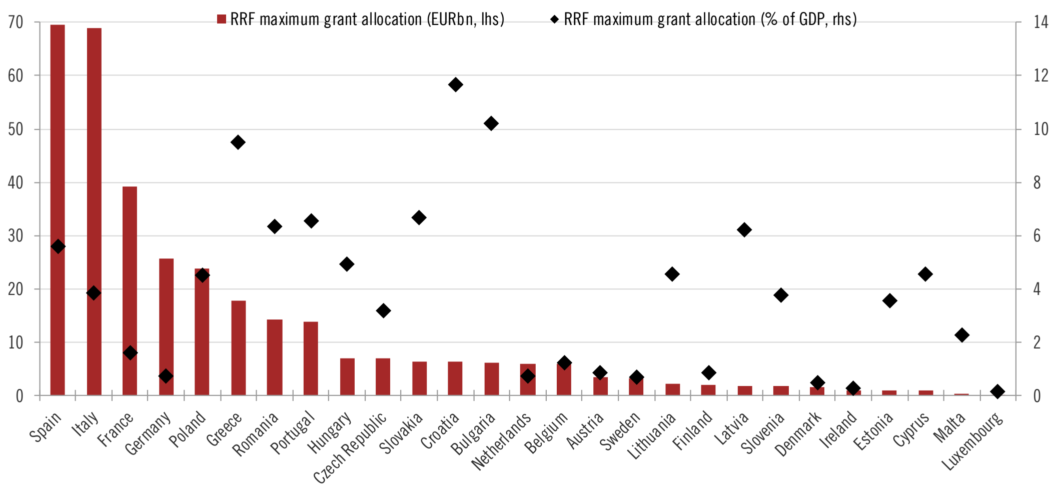


Source: European Commission, 6 May 2021

Which countries will benefit most?

The aim of the NGEU is to counteract the economic damage caused by covid-19 and increase climate and digital investments. Several broad criteria are used to allocate NGEU grants, 70% of which is set be committed in the years 2021 and 2022: (i) a country's unemployment rate in 2015-2019; (ii) inverse GDP per capita; and (iii) the country's share of the EU population. The remaining 30% will be fully committed by the end of 2023 based on another, slightly adapted set of criteria to give more consideration to the adverse economic impact of Covid-19: (i) **the drop in real GDP in 2020**; (ii) **the overall drop in real GDP 2020-2021**; (iii) inverse GDP per capita; and (iv) the country's share of the EU population.

CHART 4: RECOVERY AND RESILIENCE FACILITY – GRANTS ALLOCATION PER MEMBER STATE



Source: PWM - AA&MR, European Commission, 6 May 2021

Italy and Spain will be the two largest beneficiaries of the NGEU grants in absolute terms, while **eastern and peripheral countries in general will be the main beneficiaries relative to GDP** (see *chart 4*).

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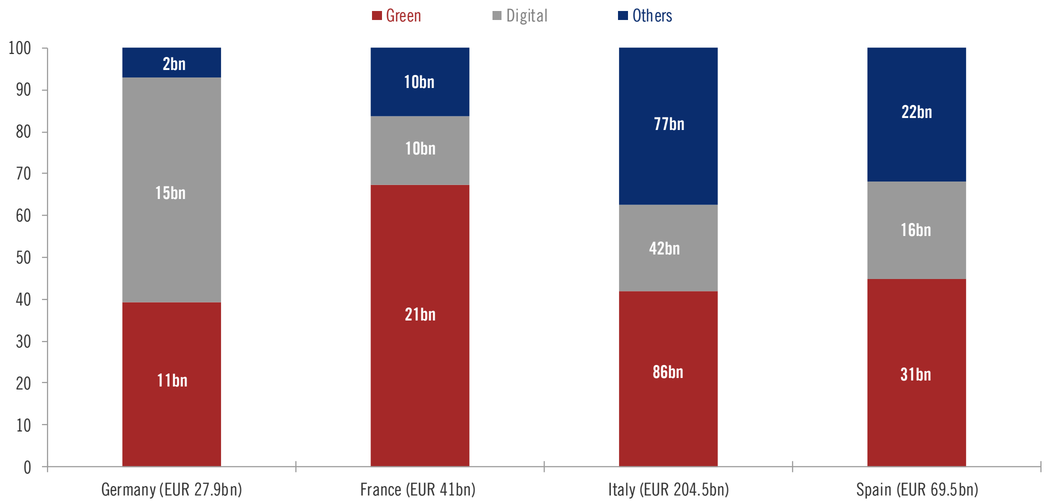
When it comes to loans, **each country can request an amount worth up to 6.8% of its 2019** Gross National Income (GNI). While grants do not add to recipients 'debt burden, loans do. Therefore, **only countries whose existing borrowing costs are higher will likely apply for NGEU loans**. And it is not even sure that such countries will apply for the maximum amount allowed.

How will countries spend NGEU funds?

Countries need to meet several criteria for their national recovery plans to be approved. **Each plan must devote at least 37% of outlays to climate-related projects and a further 20% to digital initiatives[2].** The reform proposals also need to follow the EU Commission's previously stated "country-specific recommendations" on spending and reforms.

CHART 5: OVERALL RESOURCE ALLOCATION IN NATIONAL PLANS



Source: Bruegel based on national plans submitted between 25-28 April

(Note: the numbers next to the country name indicate the total EUR amounts of the plans to be financed by NGEU. The amount of the Italy's plan is EUR235 bn, which also includes national funding amounting to EUR30.6bn)

National recovery plans are difficult to compare since some countries include not only RRF funds in their calculations but also funds from other components of the NGEU and extra spending from national resources. Furthermore, countries have structured the plans they present in different ways and have been providing varying levels of detail about resource allocation. A recent paper[3] published by Bruegel, a Brussels-based think-tank, took an initial look at the proposals drawn up by France, Germany, Italy and Spain. According to its analysis, Germany plans to spend more than half of NGEU funds on digitalisation, while the other three will spend a quarter or less. France plans to spend half of its share of NGEU money on green priorities, while the other three countries will spend around 40% (see *chart 5*)

[2] This includes investing in the deployment of 5G and Gigabit connectivity, developing digital skills through reforms of education systems and increasing the availability and efficiency of public services using new digital tools.
[3] Darvas, Z. and S. Tagliapietra (2021) 'Setting Europe's economic recovery in motion: a first look at national plans', Bruegel Blog, 29 April

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What will be the economic impact?

The take-up of NGEU money in 2021 will probably be limited and gradual, given capacity constraints across countries. Bureaucratic, legal and governance hurdles still need to be cleared. Thus, **the economic impact will be relatively muted in 2021. But NGEU should have a more significant effect on growth trajectories from 2022 to end-2026, when projects are expected to be completed.**

The overall economic impact of NGEU is difficult to estimate at this stage and will depend as much on governments' ability to spend money quickly, as their ability to use it efficiently and productively. Countries only have a short window to deploy NGEU monies and in the past some have been unable to fully absorb EU funds made available to them.

Country wise, **NGEU will be particularly important for countries in southern Europe hit hard by the pandemic.** The Italian government estimates that the investment plan it has devised to receive NGEU backing will have a significant impact on the main macroeconomic variables. In 2026, it expects Italy's GDP to be 3.6 percentage point higher than under its baseline scenario without NGEU funds (see press release here).

Will it make debt more sustainable?

Covid-19 has triggered aggressive fiscal expansion. To limit permanent unemployment and bankruptcies, authorities have moved swiftly to absorb the shock caused by the pandemic. This had led to significant increases in public debt and deficits. **The issue of debt sustainability is not top of the agenda at the moment, with the priority instead being to repair economies and to restore growth potential**. By maintaining favourable financing conditions, the European Central Bank (ECB) is playing a crucial role in creating fiscal space for countries. Put simply, as long as the growth rate is above the interest rate, a country can run a primary deficit while keeping its government debt ratio constant.

Over the medium term, a key parameter to gauge debt sustainability will be potential growth. **NGEU could indeed help countries in this regard and therefore make their debt more sustainable**. A lot will depend on the capacity of countries to spend the money they receive efficiently, particularly in peripheral countries.

Is the EU's policy response enough?

The scale of the US's fiscal response has raised questions about whether Europe is doing enough. Policy packages are difficult to compare, especially if we focus on headline numbers. All in all, however, we should not underestimate Europe's efforts. Giant fiscal stimulus in the US in some ways makes up for its lack of some of Europe's strong automatic stabilisers. Furthermore, apart from the NGEU, there have been several extensions to existing support measures throughout the pandemic.

The main differences between the US and Europe have to do with political commitment and mindset. Europe lacks commitment to continuous fiscal expansion beyond the pandemic. Furthermore, NGEU carries a lot of implementation risks. To close EU's output gap, a minimum condition will be to use the NGEU in full.

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