



COVID-19

Interlinking Europe's recovery plan and the next EU budget

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Authors

Kevin Körner
+49 69 910-31718
kevin.koerner@db.com

Barbara Böttcher
+49 69 910-31787
barbara.boettcher@db.com

Editor

Barbara Böttcher

Deutsche Bank AG
Deutsche Bank Research
Frankfurt am Main
Germany
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

www.dbresearch.com

DB Research Management
Stefan Schneider

The press statement of European Council President Michel after yesterday's video conference of EU leaders remained vague on the EU's joint fiscal response to the COVID-19 crisis.

EU leaders endorsed their earlier agreement on the EUR 540 bn package of safety nets and also agreed "to work towards establishing a recovery fund", asking the Commission to rapidly prepare a proposal of what this requires. The analysis should include a clarification of how the fund would be linked to the EU's next multi-year budget, which leaders still need to agree on. The next formal meeting of EU leaders in the Council will be on June 18/19 and this might be the date where at least a principal agreement could be announced, but much more work and negotiations will be needed until then.

The Commission aims to publish its updated proposal for the next EU budget on May 6. This will include more details on how the budget could be frontloaded with a view to the COVID-19 crisis and how a recovery fund fits into the budget. A leaked Commission paper hints at a EUR 2 trillion recovery plan, including a new EUR 200 bn "Recovery and Resilience Facility, frontloading and repurposing of EUR 50 bn from Cohesion spending, and a EUR 320 bn "Recovery Instrument" through which the Commission could tap financial markets on behalf of the EU.

The EU budget seems likely to play a key role in the EU's recovery plans. Already before the crisis, negotiations about the EU's Multiannual Financial Framework (MFF) for 2021-2027 were highly contested and earlier attempts to foster agreement between members were unsuccessful. If the next EU budget should contain a recovery fund that matches the ambitions outlined in circulated proposals, a substantial increase of the EUR ~1 trillion seven-year budget would be needed and the current upper limit of the EU's own resources set at 1.2% of GNI would need to be (temporarily) lifted. Interlinking the EU's recovery plan with the budget might add another layer of complexity but could also serve as a spur for rapid agreements on both matters.



COVID-19: Interlinking Europe's recovery plan and the next EU budget

Tight timeline for the EU's recovery plan

No details yet after leaders' video conference. As expected, the press statement of European Council President Michel after yesterday's video conference of EU leaders remained vague on the EU's joint fiscal response to the COVID-19 crisis. Already before the video conference, it was clear that no joint statement of leaders would be issued after the meeting, illustrating that bridging the fault lines between members on a fiscal recovery package will need further time.

Working towards a recovery fund. In their video conference, EU leaders endorsed their earlier agreement on the EUR 540 bn package of safety nets (ESM pandemic crisis support, EIB credit guarantees and the labour market support tool SURE) that should become operational on June 1 (Europe Blog, April 10). They also agreed "to work towards establishing a recovery fund" and asked the Commission to rapidly prepare proposals of what this requires. The analysis should include a clarification of how the fund would be linked to the EU's next multi-year budget, which leaders still need to agree on. According to Michel, the envisaged recovery fund should "be of sufficient magnitude, targeted towards the sectors and geographical parts of Europe most affected".¹ Most notably, the highly contentious issue of "joint bonds" was not mentioned at all, suggesting that respective proposals might be off the table (Europe Blog, April 23).

Next to look out for is the Commission's updated proposal for the next EU budget aimed to be published on May 6. This will include more details on how the budget could be frontloaded with a view to the COVID-19 crisis and how a recovery fund fits into the budget. With a view to market expectations and economic confidence, a timely agreement at least on the broad framework of the recovery package is essential, and leaders are certainly aware of it. But equally important for them is domestic public perception of what will be agreed upon, and there the expectations of voters across the EU vary widely, with a notable divergence between Southern and Northern members. So a face-saving compromise that allows all leaders to bring home the eventual agreement as a victory (that still makes economic sense) is required. This is a formidable task, particularly given the time constraints.

(Broad) agreement in June seems feasible. The next formal meeting of EU leaders in the Council will be on June 18/19 and this might be the date where at least a principle agreement could be announced. But much more work and negotiations will be needed until then, also including the clarification of technical details and potential legal obstacles related to considered measures. Next to the Eurogroup and EcoFin meetings of eurozone/EU finance ministers of May 18/19 and June 11/12, further out-of-schedule conferences of leaders and their ministers should give more clarification of what to expect. With the need to find consensus between leaders on some of the farthest-reaching EU decisions of the last decades, the format of virtual meeting owing to the pandemic is certainly far from ideal. A personal meeting of leaders, if allowed under the circumstances and under respective health precautions, might be required at some point in order to reach a rapid breakthrough in negotiations.

Document hinting on EUR 2 trillion Commission plan circulated. The tight timeline gives the Commission less than two weeks to finalise its updated proposal for the next EU budget and the EU's recovery plan. One can expect to find elements of the diverging plans that circulate in Brussels and EU capitals to feed into the Commission's own recommendations. According to Reuters, an internal Commission note ahead of the leaders' call on Thursday showed that the

¹ European Council, April 23.



COVID-19: Interlinking Europe's recovery plan and the next EU budget

Commission considers an overall package of EUR 2 trillion to address the fallout from the crisis.² This would include the EU's next multi-year budget from 2021-2027 as well as a new "Recovery Instrument". The Reuters report quotes the preliminary proposal, including a new EUR 200 bn "Recovery and Resilience Facility", and a frontloading and repurposing of EUR 50 bn from Cohesion spending. It also describes the Commission's plans to use its own capacities to borrow EUR 320 bn via financial markets, providing about half of this amount in loans to governments and contributing the rest of it to the EU budget in order to be repaid by EU governments over the long term, starting after 2027 or through new EU owned resources (such as taxes) to finance the budget.

Differences in EU views on crisis response need to be bridged. Various proposals for the EU's fiscal response have been circulated over the last few days, most prominently a EUR 1.5 trillion Spanish plan for a recovery fund which should be backed by perpetual debt in order to finance grants rather than loans to EU members. Before the meeting, the Italian PM Conte repeated calls for the mutual issuance shared debt in the form of "Corona bonds" to address the fallout of the crisis – a no-go for frugal Northern European members such as the Netherlands. Reacting highly positively after the conference, Conte shifted his emphasis to grants from the recovery fund. In Germany, while being in the camp of countries that vehemently reject joint debt issuance, Chancellor Merkel showed herself open to a substantially higher EU budget and (temporary) debt instruments issued by the Commission and guaranteed through the budget in order to fight the fallout from the crisis. From Germany's perspective, the Commission should investigate which policy fields would be affected and where additional funding would be needed. A French proposal instead sought to anchor the EU's response in a newly created instrument or vehicle (such as the ESM that was created in the midst of the 2011/12 euro crisis, based on "solidarity clause" of article 122 of the EU treaty) rather than basing it on existing ones such as the EU budget.

EU budget likely to take center stage in recovery plan

Key role for the 2021-2027 MFF. What has crystallized so far is that the EU budget seems likely to play a key role in the EU's response as indicated by the press release following yesterday's video conference and the Eurogroup meeting in early April, even though details remain unclear. But as often is the case, the devil might be precisely in the details. Not only the size and financing of the EU's fiscal package, but also whether members receive support through loans or grants (or a combination of both as in the leaked Commission proposal), which criteria determine members' eligibility for support and what level of discretion they would have in the use of funds, prepare a contested ground for negotiations between 27 members with vastly different economic and fiscal backgrounds. And what can and cannot be done not only depends on members' ability and willingness to compromise but also on what can be done without a time-intensive and cumbersome change of the EU's treaties and the EU budget rules.

EU budget a hot button issue between members. The EU's next seven-year budget might be an obvious choice. But by itself, already before the crisis, the budget has been highly contested. Negotiations about the next MFF, which will run from 2021 to 2027 have been unfruitful for more than a year and a half and were made more complicated by the UK's exit from the EU that has left a sizeable gap in the EUR ~1 trillion budget. "Frugal" members mainly from Northern Europe insisted on keeping their contributions to the budget at 1% of Gross National

² Reuters, April 23.



COVID-19: Interlinking Europe's recovery plan and the next EU budget

Income (GNI), while others – including “friends of Cohesion” of Southern and Eastern European members as well as the Commission – insisted on increasing the budget in order to account for the UK shortfall, preserve current expenditures, and to finance new political priorities such as climate change and digitalisation. A compromise proposal made by Council President Michel (and earlier the Finnish EU presidency) could not find agreement earlier this year (Focus Europe, February 24).

Budget compromise under German EU presidency required. Already before the world and Europe were hit by the coronavirus crisis, painful EU budget negotiations were expected to stretch well into the second half of the year when Germany will take over the Union's rotating presidency. But the virus and the urgency to respond to its fallout with an unprecedented fiscal package has changed everything. The role of the presidency to mediate between members has traditionally already been a crucial one at times when the next budget was to be negotiated. But now, given the vital role the budget might play in the EU's recovery, it is even more important. For Germany, being the EU's largest economy and contributor to the budget, this means finding a balance between securing its own interests regarding the budget and the interests of the EU as a whole. In recent days, Merkel showed her readiness for a substantially larger German financial engagement, suggesting that Germany should be up to this task.

All leaders and EU Parliament need to agree. Unanimous agreement on the budget among all members, including its overall size, distribution of contributions and receipts from the budget, is a prerequisite. This is an extraordinary challenge, given the various budgetary issues that members disagreed on already before the crisis (for more details, see Focus Europe, February 24). It would also need to be agreed to what extent the budget, which historically has been distributed relatively equally over a seven year period could be frontloaded in order to make a bulk of the total funding already available in 2021, as planned by the Commission. Also the European Parliament will have to approve the next budget, but as its members already called for a “massive recovery package and coronavirus solidarity fund” and in the past for a larger EU budget, this should not be a real hurdle.³

Integrating the recovery fund into the MFF

The recovery fund could be integrated into the budget in various ways, or a combination of those. In the discussion about the fiscal response, the distinction between loans and grants to members has taken center stage. The EU budget is largely financed through contributions based on each members' GNI/VAT, whereas receipts from the budget are distributed based on various criteria, including the members' differences in economic development. For the countries (mainly in Eastern but also Southern Europe) that receive a positive net balance from the budget, this is a form of grants or transfers, even though many national projects funded through the EU budget need to be co-financed on the national level. While proposals such as the one in the Spanish “non-paper” circulated earlier this week focused on grants, the leaked Commission note seems to suggest that the EU's recovery plan might be based on a combination of both grants and loans.

Budget increase seems inevitable. If the next EU budget should contain a recovery fund that matches the ambitions outlined in circulated proposals, a substantial increase of the budget would be needed and the current upper limit of the EU's own resources (i.e. overall contributions to the EU from members and EU levies and duties) set at 1.2% of GNI would need to be lifted. On Thursday, Commission

³ European Parliament, April 17.



COVID-19: Interlinking Europe's recovery plan and the next EU budget

President von der Leyen stated publicly that linking the crisis response to the EU budget was the only way to deal with the fallout of the pandemic and that an increase of the Own Resources ceiling to around 2% of GNI for two or three years would be necessary.⁴ It would be a positive sign also to the markets if the gap between actual EU spending and the maximum ceiling the Union has at its disposal would be enlarged providing the Commission with additional budget headroom. EU members that rejected an increase of the budget before the crisis would have to be convinced that the substantial increases of the next budget are strictly limited to the 2021-2027 MFF to respond to the pandemic and will not translate into a permanent massive expansion of the budget.

Convergence and cohesion between members needs to be warranted. But sizing up the budget is not the only issue. One of the EU budgets' primary purposes is convergence and cohesion within the EU, meaning that a substantial share of the budget finances development of the EU's newer members, where GDP per capita and prosperity is substantially lower than in the rest of the Union. If one would just change the allocation criteria, e.g. for Cohesion policy, these countries would receive relatively less from the budget, which can be expected to be very hard to sell to the Council.

New "Recovery and Resilience Facility" could build on eurozone budget plans. One way to avoid this would be to add an additional spending line in the budget, such as the proposed "Recovery and Resilience Facility" with the declared purpose of steering the recovery from the COVID-19 pandemic. For this spending line, allocation between members could be based on criteria such as those suggested by the Spanish proposal for a recovery fund, i.e. raise in unemployment, share of population that has been affected or the severity of recession. It might well be linked to the "Budgetary Instrument for Convergence and Competitiveness" (BICC or "eurozone budget") that leaders agreed on in principle last year. The compromise on this new budget line plans to finance fiscal packages for structural reforms in the EMU and strengthen the resilience against economic shocks through grants. The size of its funding was left open to be determined together with the overall 2021- 2027 EU budget, but it was originally planned as a small budgetary item (Commission proposal: EUR 25 bn). Based on the leaked Commission note, the proposed recovery facility could be increased by a factor of 8 to EUR 200 bn. This could secure French support for a recovery plan that focuses on the EU budget, as the French President Macron has been among the strongest promoters of a sizeable eurozone budget all along.

If proposals to include a new Recovery and Resilience Facility in the next budget would be agreed upon by members, it can be expected that distribution and eligibility criteria would be different from the original BICC plans (with a stronger focus on severity of economic shocks). Still, Northern members can be expected to pull their weight to preserve the "economic resilience" and competitiveness aspect of the originally planned facility.

Alternative: Budget payment relief for affected countries. Alternatively, if one wants to avoid creating new spending areas, one could follow proposals to temporarily reduce or suspend budget contributions by heavily affected members. The EU budget is financed mainly through payments by its members, whereas their relative contributions are determined through the relative size of their economies. Accordingly, the net receipts and contributions of each EU member vary substantially. One way of increasing the net receipts of heavily affected countries would be to reduce (or even temporarily suspend) their contributions to the budget. As an example, Spain currently receives from the EU budget an annual average of EUR 2 bn in net terms while Italy contributes an annual average of EUR 3.8 bn.

⁴ New York Times/Reuters, April 23.



COVID-19: Interlinking Europe's recovery plan and the next EU budget

These figures derive from the two countries' contributions and gross expenditures from the budget. Based on the current budget, if one would suspend both countries' contributions, their net receipts would just be the gross expenditures on both countries, i.e. EUR 11.8 bn for Spain and EUR 11 bn for Italy. But a suspension or reduction of some members' contributions affected mostly by the crisis might not find a unanimous vote in the Council, in particular with a view to members with an overall much lower level of prosperity. Maybe for that reason and given the complex calculation for member states' contributions (rebate) this option (so far) did not find its way into the official political debate.

Linking EU budget and recovery plan - a formidable challenge but maybe an opportunity, too

Another layer of complexity. Negotiations about the EU's multi-year budget have always been a contentious issue between members. Before the start of the COVID-19 pandemic, opinions among leaders regarding the 2021-2027 MFF seemed to be more divided than ever. Adding another dimension to budget talks by integrating the EU's recovery plans will create a new layer of complexity and certainly will not make the process of finding an agreement easier. However, the deep economic implications of the coronavirus crisis have made it clear that unprecedented measures and a concerted response on the EU level are vital. Already before the crisis, it has also become clear that a reform of the EU's budget and an increase of its size might be inevitable in order to meet the changing global environment and the mounting challenges in particular stemming from climate change and digital transformation.

Joint momentum for budget and recovery plans. Contrary to first thoughts, interlinking the crisis response and the pending budget agreement might actually give the required impetus to find the urgently needed rapid agreement on both matters. For this to be case, however, leaders across Europe will have to prove over the next few weeks their capability and willingness to put joint European interests before narrow national interests. This applies both to countries likely to bear most of the (explicit or implicit) fiscal costs of joint action as well as the ones dependent on European solidarity. In the long term, an in-depth discussion and decision will be required regarding the general relation of government financing, risk-sharing, control and national fiscal sovereignty in the E(M)U.

Kevin Körner (+49 69 910-31718, kevin.koerner@db.com)

Barbara Böttcher (+49 69 910-31787, barbara.boettcher@db.com)

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