



EUR 750 bn EU Recovery Fund: Deal!

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A EUR 1.82 trillion financial package. EU leaders finally reached what looked impossible at times: agreement on a EUR 1.074 trillion next seven-year EU budget as well as a EUR 750 bn European recovery fund, consisting of EUR 390 bn in grants and EUR 360 bn in loans. In order to engineer consensus, Council President Michel repeatedly adjusted (downsized) his original proposal to meet the demands of frugal members. The EUR 390 bn grants facility agreed is a significant cut compared to the EUR 500 bn called for by France and Germany, but the share of grants in the Recovery and Resilience Facility (RRF) was slightly increased to EUR 312.5 bn.

The Council meeting that lasted from Friday to Tuesday was the first in-person conference between EU-leaders since the outbreak of the Corona pandemic and took place under heightened health precautions. In the end, leaders of 27 EU members managed to find a joint response to the unprecedented economic challenges posed by the COVID19-crisis.

Leaders in the Council managed a remarkable reduction of complexity, aligning the heterogeneous interests of 27 member states in a unanimous and, eventually, rather swift agreement on their joint finances and crisis response over the next seven years.

Concessions were necessary, including on rebates and to some extent on the rule of law. Another disappointment: Final agreement on the MFF has shown that once again protection of the status quo has prevailed over the need to focus on the future. This makes the deal more short-termist, less focussed on the long term and suboptimal when it comes to the union's long-term competitiveness. It also needs to be shown how the commitment of 30% of funds for climate action works in practice.

From a financial market point of view, there are two key positives: First, precedent. The Recovery Fund is the EU's first common counter-cyclical instrument; there is no austerity requirement; the Recovery Fund is an opportunity to support a large-scale climate change package. Second, optimal design. From a macroeconomic perspective, the optimal Recovery Fund would be (1) large enough for the scale of the COVID crisis, (2) targeted at the most growth-enhancing investment opportunities (in the hardest hit countries and sectors), and (3) complemented by structural reforms. The agreement is a reasonable attempt to satisfy all three.



A EUR 1.82 trillion financial package

Tuesday morning at 5:20 am, EU leaders finally reached what looked impossible at times: agreement on a EUR 1.074 trillion next seven-year EU budget as well as a EUR 750 bn European recovery fund, consisting of EUR 390 bn in grants and EUR 360 bn in loans. This brings the total package that leaders agreed on to EUR 1.82 trillion. In order to engineer consensus, Council President Michel went a long way in repeatedly adjusting (downsizing) his original proposal in order to meet the demands of frugal members. The EUR 390 bn grants facility agreed is a significant cut compared to the EUR 500 bn called for by France and Germany even though the share of grants in the Recovery and Resilience Facility (RRF) was slightly increased to EUR 312.5 bn.¹

“Deal!”

After a historical meeting that went into a fifth day—the second longest in the EU’s history—European Council President Michel announced the eagerly awaited agreement with one word on Twitter: “Deal!” There had been emotional debates and strong disagreements between leaders on various aspects of the proposed recovery package, including its size, distribution between grants and loans, governance, rule of law and question of rebates. The meeting was the first in-person conference between EU-leaders since the outbreak of the Corona pandemic and took place under heightened health precautions. In the end, leaders of 27 EU members managed to find a joint response to the unprecedented economic challenges posed by the COVID19-crisis. French President Macron said that during the meeting, there “were extremely tense moments”.²

In the end, everybody’s happy (to different degrees)

While the meeting lasted for almost five days, President Macron emphasized that EU27 leader managed to agree on the recovery plan within just two months. Council President Michel enthusiastically said in his press statement that “We have demonstrated that the magic of the European project works”.³ Commission President Von der Leyen emphasized that “Europe’s recovery will be green” but regretted that there are reductions to some spending proposals such as healthcare. Overall the public response of EU heads of state after the Tuesday agreement was positive, even though leaders managed to push through their agendas and key demands to varying degrees. The almost five-day negotiations have shown that the Franco-German alliance was necessary but not sufficient to broker this deal, in particular with view to tough negotiations on side of the frugal four (Netherlands, Austria, Denmark and Sweden). German Chancellor Merkel described herself as “very happy” and “relieved” that an agreement was achieved after very long negotiations. Referring to the urgency to tackle the fallout of the pandemic, she had said that an “extraordinary situation demands extraordinary efforts”. The deal was welcomed both by representatives of the frugal states (Austrian Chancellor Kurz: “good result”) and “friends of cohesion” (Italian PM Conte: “historic”, Polish PM Morawiecki: “happy”). It also received praise from ECB President Christine

¹ European Council 21.07.2020). Special Meeting of the European Council - Conclusion.

² AP News (21.07.2020).

³ Politico (21.07.2020).



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Lagarde who said that “the EU steps up and comes together to help the people of Europe.”⁴

Our main takeaways

In a press conference on Tuesday morning, President Michel presented the hard won results.

EU27 leaders agreed on:

- **EUR 750 bn recovery fund.** The total size of the recovery package proposed by the Commission and Council President Michel was maintained, despite fierce initial resistance of frugal members (Netherlands, Austria, Denmark and Sweden). In the compromise agreement, EUR 390 bn of these are provided in form of grants, down from the EUR 500 bn in the Commission’s and Michel’s original proposals. EUR 360 bn will be available in the form of loans. The bulk of the EUR 390 bn in grants will go to the specially-weighted Recovery and Resilience Facility (RRF) – EUR 312.5 bn (up by EUR 2.5 bn compared to the original proposal). 70% of the grants in the RRF will be provided in 2021 and 2022, the remaining 30% will be fully committed by the end of 2023. The maximum loan volume for each country is capped at 6.8% of its GNI.
- **Almost all for the RRF.** Originally, EUR190 bn was earmarked to prop up the MFF (‘EU Budget’) across all programs. But in order to maintain (and even slightly expand) the amount of grants provided to members through the RRF, this amount was slashed to EUR 77.5 bn. ReactEU, the initiative to bolster and frontload Cohesion was cut by EUR 2.5 bn to EUR 47.5 bn. The contribution of the recovery package to Horizon Europe was slashed by EUR 8.5 bn to EUR 5 bn; InvestEU was cut down heavily from originally EUR 30.3 bn to EUR 5.6 bn; the contribution to rural development was cut in half to EUR 7.5 bn. The contribution to the Just Transition Fund (JTF) was scaled down to EUR 10 bn from originally EUR 30 bn. An originally planned health programme and contributions to neighbourhood/international cooperation were abolished.
- **EUR 1074 bn Multiannual Financial Framework (MFF).** For the overall size of the MFF, leaders followed Michel’s proposal. Together with the recovery fund, this brings the total budget and recovery package to EUR 1.82 trillion.
- **Readjustment of budget lines.** Within the MFF, spending among budget lines were partly readjusted. In the final agreement, over seven years cohesion, resilience and values was slightly reduced but remains the largest post at EUR 377.7 bn, followed by a slight increase in spending on natural resources and environment to EUR 356.4 bn. EUR 132.8 bn goes to the single market, innovation and digital. Migration and border management as well as Security and Defence were kept unchanged from the earlier proposal at EUR 22.7 bn and EUR 13.2 bn, respectively. To Neighbourhood and the World, leaders agreed to allocate EUR 98.4 bn, while EUR 73.1 bn will be spent on public administration.
- **Governance rules.** Governance of the recovery fund was one of the most controversial items at the Council meetings, with Dutch PM Rutte calling for unanimous rather than qualified majority approval of members’ recovery and resilience plans in the Council. On Tuesday morning, qualified majority was agreed on, supplemented by a revised procedure in which members can

⁴ Politico (21.07.2020).



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delay approval of payments from the fund by putting the matter on the next Council's agenda.

- **Maintaining rebates, increasing of collection share in traditional own resources.** Originally, the Commission hoped to abolish all rebates post-Brexit. This was postponed in the Commission and Council President's proposals in order to get the frugal states on board. At the summit, Michel eventually offered an increase of rebates that was further scaled up in the night to Tuesday to almost EUR 6 bn for five members (Germany, Netherlands, Sweden, Austria, and Denmark – although Germany's rebate remains unchanged). As an additional concession, the share of traditional own resources (mainly custom duties) kept by member states as collection costs will be increased to 25% from currently 15%.
- **Rule of law.** The proposal of linking EU funding to the observance of rule of law was heavily criticized by Poland and Hungary, both of which are currently under Article 7 procedures for alleged breaches of the Union's rule of law. Hungary entered the negotiations presenting any rule of law conditions as a deal breaker. In the final agreement, the references to the rule of law were reduced substantially. The agreement now contains a statement that the Council "underlines the importance of the respect of the rule of law" and that a "regime of conditionality" will be introduced, including measures in case of breaches that the Council will adopt by qualified majority. The Council will come back on this issue "rapidly".
- **New own resources.** On new own resources to provide the EU with more direct revenues and support the early repayment of borrowing for the recovery package already before the end of the 2021-2027 MFF, leaders followed the proposals of Council President Michel. A plastic tax will be introduced already on January 1, 2021. A carbon border mechanism and digital tax will be introduced until January 2023. The Commission will prepare a proposal for a revised and possibly extended emission trading scheme. Other new own resources, such as a financial transaction tax, may be worked on during the next MFF. The full adoption of Michel's proposal on new own resources came somewhat as a surprise, as members in the past showed themselves rather reluctant to provide the EU with more direct funding. It might well be a concessions to the European Parliament that also needs to approve the package and repeatedly called for an expansion of the EU's direct funds.
- **Climate target.** The Commission's and President Michel's target to spend 30% of the MFF and recovery package on climate action was maintained. However, access to the Just Transition Fund will not only be granted to countries that commit to national targets to reach climate neutrality by 2050 but also members that only commit to an overall EU climate neutrality target.

Charles Michel: "Europe is united, Europe is present"

The decision on the next EU budget and recovery package was one of the hardest embattled in the recent history of the EU. Facing an unprecedented crisis, deep faultiness between EU members on various aspects of EU politics, policies and finances became visible more than ever. During the meetings, it repeatedly looked as if these could not be bridged. Already from that perspective, the agreement itself can be seen as a strong sign that despite all differences, cooperation and coordination in the EU in the face of crisis is still possible and still supported by its members.



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Various concessions had to be made to achieve this agreement, including on rebates and to some extent on the rule of law. The latter is an issue that might haunt the EU for the years to come, with burning questions regarding its fundamental setup as a union of democratic and rule of law based countries. Another disappointment: Final agreement on the MFF has shown that once again protection of the status quo (in particular cohesion and agriculture) has prevailed over the need to focus on the future (in particular innovation and digital). This makes the deal more short-termist, less focussed on the long term and suboptimal when it comes to the union's long-term competitiveness. It also still needs to be shown how the commitment of 30% of funds for climate action can be implemented and enforced in practice.

But altogether, leaders in the Council managed a remarkable reduction of complexity, aligning the heterogeneous interests of 27 members in a unanimous and, eventually, rather swift agreement on their joint finances and crisis response over the next seven years.

Next steps

Agreement in the Council was the first major hurdle to put the next EU budget and recovery fund into place in order to make urgently needed funds available from early 2021. But it was nowhere near the last. Following unanimous agreement in the Council, the consent (absolute majority) of the European Parliament is required to pass the new MFF and Recovery Fund. The next regular EP plenary after the summer recess takes place on September 14-17. However, the Council needs to enter negotiations with the European Parliament, and discussion might last well into autumn. The timeline in the Commission's original proposal conservatively assumes EP consent by the end of the year.

Approval by the EP should not be taken for granted. EP President Sassoli repeatedly called for an ambitious budget and recovery fund. Sassoli threatened that the EP would veto the budget if the EP's requirements were not met (the EP e.g. called for a larger MFF, abolishment of rebates, clear link to the rule of law and wants to play a role in the governance of the recovery fund). Whether the agreed package will be sufficient remains to be seen. With view to rule of law provisions, EPP leader Weber said yesterday that this would be "the benchmark" for the approval of the EPP as the largest fraction in the EP. On the other hand, several of the EP's demands, including an explicit timeline for the introduction of new own resources have been met. This should reduce the risk that, apart from a delay and lengthy negotiations between Council and EP, that the EP could actually fail to approve the package.

In addition, all 27 member states need to ratify the decision to temporarily increase the limit of the EU's own resources by 0.6% of members' GNI. This is required to allow the Commission to borrow from markets and thus finance disposal of grants from the recovery fund starting in 2021. In some member states, this might require parliamentary approval.

From a financial market point of view, there are two key positives

First, precedent. There is a danger of "missing the forest for the trees". The details are important, but the precedents being set with the Recovery Fund are important too: the Recovery Fund is the EU's first common counter-cyclical instrument; there is no austerity requirement in the Recovery Fund; the EU is using the Recovery Fund as an opportunity to do things that otherwise would have been extremely difficult, such as supporting a large-scale climate change package.



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Second, optimal design. From a macroeconomic perspective, the optimal Recovery Fund would be (1) large enough to be commensurate with the scale of the COVID crisis, (2) targeted at the most growth-enhancing investment opportunities, especially in the hardest hit countries and sectors, and (3) complemented by structural reforms which the Fund could incentivise. The agreement is a reasonable attempt to satisfy all three.

- **The Recovery Fund is not small.** EUR 750 bn is equivalent to about 5.5% of EU GDP (2019). Although spread over several years, these are common resources on top of national resources. For comparison, the post-Lehman Recovery Plan contained just 0.3% of GDP of common resources (mostly EIB).
- **The Recovery Fund is targeted.** The governance frameworks means that the resources will be funnelled into projects consistent with the Fund's and the EU's objectives. This gives the Recovery Fund a distinct narrative: recovery, resilience and transformation. This narrative sets it apart from most national fiscal responses to date (largely temporary income replacement) and the ESM/SURE/EIB package ('emergency' measures).
- **There will be reforms.** To access the resources of the Recovery and Resilience Facility, member states will need to develop a national recovery plan that embeds the EU's Country Specific Recommendations (that is, reform proposals).

The market is also likely to react positively to the distribution of grants between the various facilities. Although the total volume of grants declined to EUR 390 bn from the original proposal of EUR 500 bn, the volumes of grants in the RRF (Recovery and Resilience Facility) increased slightly from EUR 310 bn to EUR 312.5 bn. The additional grant resources to go to the MFF (EU Budget) were cut sharply in order to protect the RRF resources. By substantially weighting the grants towards the RRF, the EU is maximising the targeting of the grants towards the hardest hit member states as defined by the special allocation key. To the extent that the allocation key determines a spread benefit for the likes of Italy and Spain, the final deal preserved the volume of benefits despite the lower grants total.

There is a question about the demand for loans, but the design allows for a proportionately higher use of the Recovery Fund loan facility than the ESM pandemic loan tool. The loans component in the Recovery Fund increased to EUR 360 bn in the final deal compared to EUR 250 bn in the original proposals. On the negative side, all countries are attracted to the prospect of grants whereas only a subset will be attracted to loans as in several cases member states would find it cheaper to issue sovereign debt than to borrow from an EU facility like the Recovery Fund. Despite creating a new EUR 240 bn ESM pandemic loan facility with no economic conditionality, there have been no applications. That might be because member states were reluctant to apply before they knew their allocation of grants under the Recovery Fund. Alternatively, in some cases it might be because member states are concerned about adding additional liabilities to already elevated levels of debt.

On the positive side, EU loans have underestimated benefits for even the indebted member states. These loans are likely to be highly concessional, that is, have a lower interest rate than sovereign debt and have a maturity as long as 40 years. This means there will be benefits for Gross Financing Needs (see an analysis for Italy here). Moreover, similar to the EUR 240 bn ESM pandemic loan tool, the EU is unlikely to have created a EUR 360 bn loan facility unless it thought that the indebted hard-hit member states could not sustain the additional liabilities. An optimistic interpretation is that the EU would not be making this offer of more loans unless it was willing to ensure that the higher level of debt would be sustainable.



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There is a design feature that could help maximise the drawdown of the Recovery Fund loan facility. The ESM maintained that only about one-third of its EUR 240 bn pandemic loans might be used—there is only a subset of euro area members whose funding cost is higher than the ESM's. The one-third aggregate usage is limited by the 2% of GDP cap on individual member states' access to the tool. With the Recovery Fund loan facility, EU members will be permitted to borrow up to 6.8% of Gross National Income, equivalent to about EUR 120 bn for Italy, EUR 85 bn for Spain etc. As long as member states are willing to take more debt—as we argued above, there are benefits to Gross Financing Needs—this detail could mean that two-thirds of the Recovery Fund loan facility is accessible.

There are three aspects of the Recovery Fund that could weaken the market's perception of the instrument.

First, net increase in resources. EUR 750 bn is a significant number in and of itself but what matters is the net increase in resources. Pre-COVID, Commission President von der Leyen was planning a very significant expansion of EU resources to finance the European Green Deal. Importantly, the overall target to earmark 30% of all expenditures in the MFF and recovery package on climate action was maintained. But what matters for economic growth expectations is the net increase in resources between what was expected pre-COVID and what has been agreed post-COVID. It is not obvious there has been a net increase.

Second, appropriate reforms. Reforms are important for maximising the recovery, resilience and transformational hopes of the Recovery Fund. Using the off-the-shelf Country Specific Recommendations might be efficient, but is not necessarily effective. They are not designed for the specifics of the COVID shock or with the themes of the Recovery Fund in mind (green and tech).

Third, a temporary instrument. The recovery fund has been agreed on as a temporary instrument to address the unprecedented COVID-19 crisis. This was a crucial point for the frugal members and necessary to respect the Treaty and rein in the risk of moral hazard. But as was illustrated in particular in the euro crisis, the absence of a genuine counter-cyclical fiscal capacity is a key shortcoming of the single currency when it comes to crisis response and mitigation. At some point, euro members will have to face the question of whether a permanent, euro area-specific instrument will be created – including the implied loss of fiscal sovereignty of the members that this would necessarily bring.

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