The Commission’s recovery plan for Europe – bold and challenging

Commission President von der Leyen presented the long anticipated Commission proposal for a EUR 750 bn European Recovery Instrument together with an upsized EU budget for the next seven years. The plan goes beyond the Franco-German proposal that surprised markets last week. It can be expected to cause heated debates in the European Council and meet fierce resistance from frugal EU members.

A EUR 750 bn European recovery instrument

The proposal that Commission President von der Leyen presented today to the European Parliament foresees a EUR 750bn temporary European Recovery Instrument (or “Next Generation EU”): EUR 500 bn in the form of grants, EUR 250 bn as loans. This comes on top of a “reinforced” EU budget of EUR 1,100 bn over the next seven years that roughly matches the (pre-COVID-19) proposal of Council President Michel from February.

The Recovery Instrument would finance a crisis response between 2021 and 2024, including the “centrepiece of the recovery” plan, a EUR 560 bn Recovery and Resilience Facility. The facility aims to support member states in funding their recovery and resilience plans and consists of EUR 310 bn in grants and EUR 250 bn in loans.

The Commission would borrow from markets on behalf of the EU while the bonds would be repaid jointly from 2028 to 2058. In order to allow the Commission to tap markets, the proposal foresees a temporary increase of the EU’s own resources ceiling (i.e. the maximum amount of resources that member states can be called upon to finance the budget) from currently 1.2% of GNI to 2% and permanently to 1.4%.

Repayment from 2028-2058 would be orchestrated through future EU budgets (i.e. a combination of increased national contributions and/or smaller programs) and new own resources. For these, the Commission proposes as possible candidates an extension of the Emission Trading System (EUR 10 bn p.a.), a carbon border tax (EUR 5-14 bn p.a.), own resources based on operations of large enterprises (around EUR 10 bn p.a.) and a digital tax (up to EUR 1.3 bn p.a.).
Almost doubling previous plans for the next MFF to EUR 1850 bn

The Recovery and Resilience Facility will be supplemented by frontloaded funding from cohesion policy (REACT-EU, EUR 55 bn from 2020-2022), a reinforced Just Transition Mechanism (EUR 40 bn) and additional funding for rural development (EUR 15 bn). Companies will be supported through a new Solvency Support Instrument based on a EU budget guarantee to the EIB (EUR 31 bn), a strengthening of InvestEU (EUR 15.3 bn) and an additional Strategic Investment Facility (EUR 15 bn). Support to the health sector will be provided through new health programmes, a reinforcement of Horizon Europe and the EU’s civil protection mechanism rescEU. The Commission also proposed to revise the current budget framework in order to allow for an increase of spending of EUR 11.5 bn still in 2020.

Together with the SURE/ESM pandemic crisis support/EIB Guarantee Fund package worth EUR 540 bn approved by EU leaders on April 23, the Commission’s proposal announced today amounts to a total “targeted and front-loaded” crisis response package on the EU level of EUR 1290 bn. In its communication to the European Parliament[1], the Commission provides “conservative estimates” of EUR 3.1 trillion in total leverage from the next MFF, including the Recovery Instrument. Including the funds from the Recovery Instrument, the next MFF would be almost doubled compared to previous proposals at EUR 1850 bn (2018 prices).

Loans versus grants – the debate over the recovery fund is just getting started

The proposal goes even beyond the Franco-German initiative that surprised markets last week with a EUR 500 bn Recovery Fund in the form of grants – last week’s initiative showing that German opposition to increased bond issuance of the Commission on behalf of the EU had diminished.[2] Already the Franco-German proposal led to a counter-proposal of the so-called frugal four (Netherlands, Austria, Denmark and Sweden). Last weekend, they repeated their insistence on limiting national contributions to the EU budget, linking the Recovery Instrument to structural reforms and repeating their general opposition to any measures that could lead to debt mutualization. Several aspects of the Commission proposal, with its ramped-up size of the EU budget and larger borrowing capacity for the Commission will certainly meet resistance. While the frugal four called to use EU borrowing only for the issuance of loans (“loans for loans”), the Commission tried to find a compromise with the Franco-German vision of just grants. But the precise ratio of grants to loans (2:1 in the Commission proposal) will certainly be hotly debated between members.
Conditionality and use of funds will remain another hot button issue
The Commission’s proposal emphasizes that the Recovery Instrument should support investment and reforms in member states and dedicates 80% of its funding to these purposes. But it remains ambiguous whether access to funds from this facility will be conditional on a (binding) commitment to reforms. From a market perspective, conditionality would be a negative, as any form of austerity measures required to qualify for additional funding might raise fears of a deepening of the recession. Member states will be in charge of designing their own national recovery plans. However, in order to bolster the resilience of EU members to future crises, structural reforms over the medium-term will be unavoidable to restore competitiveness and fiscal sustainability. Otherwise, the dependence on the fiscally most vulnerable members on EU support will deepen with each crisis episode, as experienced already in the 2011/12 euro crisis. This will remain a key issue for the frugal countries — and not only them — in the debates during the upcoming week.

Another issue will be the extent to which the budget proposal can be aligned with the Commission’s strategic priorities, in particular the transition to a green economy (carbon-neutrality by 2050) and catch up in the digital race with the US and China. It is less than clear whether the frontloading of the budget and focus on recovery can easily be streamlined with these long-term targets that require substantial economic restructuring. New own resources proposed by the Commission mainly focus on green transition (emission trading, carbon border tax) and digital transformation (taxes on large companies, digital tax). But if these resources will be mainly used for the repayment of the Recovery Facility, consistency between crisis recovery and long-term priorities can only be achieved by strongly linking the recovery funds to the long-term objectives in the first place.

Need for speed but the hard part has just begun
With the Commission’s proposal on the table, it is now up to the member states to make up their minds. But this is much easier said than done, given that a unanimous decision on the next EU budget and the Recovery Plan is needed. Already before COVID-19, EU leaders were deadlocked in their views on the next EU budget. Hopes are that the Council might find agreement on the next MFF at its June 18-19 meeting but with strongly diverging proposals circulated over recent days and the nature of what is at stake, expectations that 27 members will agree on such an extensive package should be kept low. It seems likely that negotiations will extend (well) into H2, when Germany takes over the rotating EU Presidency. The Commission hopes that the Council will reach an agreement already in July. By December, the revised MFF for 2021-2027 needs to be adopted by the European Parliament while the increase of the own resources ceiling (required for the Commission to borrow from markets) needs to be ratified by all members depending on their individual constitutional settings.
Resistance in the North
While Germany and France managed to co-align their positions, the opposition of the frugal four to key aspects of the proposal will be very difficult to overcome. One way to find a compromise with them might be through the issue of rebates. Major net-contributors have insisted on maintaining the system of rebates in the next budget, through which their contributions – which they consider too high – were reduced in the past. The Commission wants to scrap the rebates after Brexit, but keeping them at least for the next seven years might bolster the frugals’ willingness to accept other aspects of the proposal. And indeed, the Commission’s proposal concedes that a quick exit from the rebates would “disproportionately increase” the contributions of some members and calls for a longer “phasing out”. When it comes to accepting the dominance of grants in the Recovery Fund, the way to the frugals’ hearts may still be through commitments to reforms and access guidelines strongly linked to the EU’s climate, digital and growth agenda. Austrian Chancellor Kurz, speaking on behalf of the frugal four, called the proposal a “starting point for negotiations” and praised the “clear time limit” for payments from the recovery fund, suggesting that they might take a constructive stance in the upcoming discussions.[3]

Sceptics in the East
But wealthy members mainly in the North are not the only ones that need to be convinced. The main beneficiaries of the previous EU budgets were the EU’s newest – and mostly poorest – members in Central and Eastern Europe. They fear that with a reprioritization of spending within the budget lines (in particular cohesion), they might subsidize the recovery of much wealthier Southern European countries to their own disadvantage. Their agreement to such a proposal is unlikely to come without some major concessions. One aspect might be a watering down of proposals to link payments from the budget to the observance of the rule of law – which is a particularly sensitive issue for Poland and Hungary, both of which are currently under an EU Article 7 procedure due to alleged breaches of EU treaties regarding the rule of law. Hungary has become heavily criticized in Brussels and other EU capitals since the outbreak of COVID-19 over emergency laws that gave the government the power to rule by decree with no fixed cut-off date (it was now announced that the state of emergency will end on June 20).

Hopes in the South
The initial reactions by Southern European leaders has been positive, including the Italian PM Conte who said it was a “great signal” and Spanish PM Sanchez admitted that it met “many of Spain’s demands”. French President Macron declared the recovery plan as “unprecedented” and called on EU members to move quickly to “adopt an ambitious agreement”. [4]
Further hurdles down the road
Finding consensus among leaders in the Council will be the most formidable task over the next weeks, but even if they manage to agree, the next budget and recovery plan are not a done deal. The next hurdle will be the European Parliament, even if this hurdle is considerably lower than in the Council. Nevertheless, the budget requires the support of a majority of MEPs. In the increasingly fragmented EP, the risk is not that the budget might overstretch MEP’s appetite for EU funding but that they might consider the proposal insufficiently ambitious. In a previous vote, the EP demanded a “recovery and transformation fund” of EUR 2 trillion financed through bonds and mostly disbursed through grants.[5] Whether the Commission’s total MFF proposal totaling EUR 1.85 trillion will be sufficient (and a potentially adjusted compromise in the Council) is not a given.

Even if a consensus proposal is found by the Council and passes parliament, the next MFF is not just settled yet. In order to increase the EU’s ceiling of own resources required for the Commission to borrow from markets to 2% of GNI, constitutional requirements require votes in the national parliaments of several member states.

A bold move into unknown diplomatic territory
The Commission today presented a courageous proposal to address the fallout of the coronavirus crisis and prepare the EU for the challenges of the next decade. Knowing that it would be a formidable task to find consensus between 27 members with strongly diverging views and interests, many aspects have been left vague and open for the upcoming negotiations. That the EU needs to move boldly to address this crisis is understood by all parties involved. How (long-term) costs and risks should be shared between members and partners is an entirely different question.

Given the scope of and depth of the current crisis, rapid agreement on the joint response is essential, even though it is less than clear if it can be found before July. It is possible that an agreement could take longer. It could even be delayed into the autumn. This is a problem for two reasons. First, if the German Federal Constitutional Court finds against the PSPP on 5 August and the Recovery Fund has not been agreed, the market will lack conviction in Europe’s capacity for a fiscal counterbalance at a time when monetary policy becomes constrained (our baseline is that the GCC will not constrain the PSPP). Second, the longer it takes to agree and implement the Recovery Fund, the deeper and more persistent will the economic shock from COVID-19 be and the greater the risk of second round systemic shocks from business failures, unemployment, stressed balance sheets, etc. These would seriously test the resilience of the euro area and the EU.

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