The EU Recovery Fund: An Unprecedented Step, But No Panacea

Public debt sustainability remains a key challenge.

September 2020

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KEY INSIGHTS

- The European Union's EUR 750 billion recovery fund is a historic move that could pave the way for fiscal integration for the bloc.
- The macroeconomic reforms linked to the fund will not, however, be enough to generate long-term growth or solve the debt problems of poorer members.
- The only way for southern European nations to grow out of their debt burdens is through stronger long-term growth.

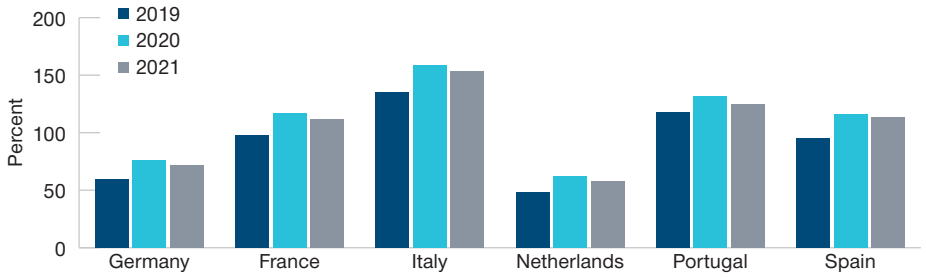
The European Union's (EU's) EUR 750 billion coronavirus recovery plan is a bold and historic move that will facilitate fiscal transfers from richer to poorer members—a possible first step toward fiscal integration for the bloc. It is not, however, a magic formula for conjuring up long-term growth or making the debt burdens of cash-strapped southern European countries disappear—those are challenges that will require longer-term solutions.

When the EU's 27 leaders signed off on the Next Generation EU (NGEU) fund to help countries recover from the coronavirus recession, they agreed to something that would have been unimaginable prior to the pandemic. The agreement gives Brussels the power to borrow huge sums from capital markets and hand it out as budgetary support to member countries. Significantly, EUR 390 billion of the EUR 750 billion will be distributed as grants and will therefore not add to governments' debt burdens—enabling the EU to target the money at the countries that need it most. While the grants will be made available to the countries most affected by the pandemic, the liability for the repayment of the EUR 750 billion NGEU will be shared by all member states. This will be the first time that some member states benefit more than others from commonly borrowed funds.

The grants are not "free money," however. They will be linked to national recovery plans, which will be assessed by the European Commission based on criteria including the growth potential, job creation, and economic and social resilience of the member state. Payments of grants will be conditional on recipient countries hitting key targets and can be temporarily held back if any government in the bloc believes those targets are not being met, although the final decision will be left up to the European Commission.

Debt Sustainability Remains a Major Challenge

Six EU countries' debt as a percentage of gross domestic product



As of August 17, 2020.
Source: European Commission AMECO Database.
2020 and 2021 figures are projections. Actual outcomes may differ materially from projections.

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This Time It's Different

The fact that such a groundbreaking agreement was reached after only one round of serious negotiations came as a surprise to EU observers—typically, the EU can only agree on significant change after tortuous discussions spanning several summits. Why was it different this time? There are several reasons. First, EU leaders have learned from the past that delayed decisions can lead to costlier solutions. Second, Germany currently holds the EU presidency and Chancellor Angela Merkel possesses strong powers of persuasion. Third, negotiations over the NGEU occurred concurrently with discussions about the next EU budget, making it possible for financial concessions to be made that meant every country could claim a political win.

Finally, this was the one of the first major EU summits to be held without UK participation. The UK's absence has shifted political power from northern to southern European countries, making it more difficult for the "Frugal Four"—Sweden, the Netherlands, Austria, and Denmark—to impose tight spending constraints on EU policies. It remains to be seen whether this latter factor becomes a permanent feature.

From a budgetary and political perspective, the NGEU fund makes sense. The symmetry of the coronavirus shock across countries with uneven fiscal positions, but which are members of a currency union, meant that a coordinated policy response was always the best solution. A strong, synchronized fiscal response will help to support the eurozone economy and limit the size of future fiscal deficits through a stronger overall tax take. Moreover, assuming that the more fiscally conservative northern European countries would have to bail out members with future unsustainable deficits, there is clear logic in helping heavily indebted southern European countries before they reach that tipping point.

No Magic Solution

The NGEU fund will not automatically solve the EU's biggest structural challenges, however.

While grants from the recovery fund are linked to macroeconomic reforms in principle, it is unclear if these reforms will be sufficiently ambitious enough to help recipient countries generate higher long-term growth potential. Indeed, rather than helping countries recover, the strict implementation of ambitious reforms could actually make the situation worse in the short run.

Ideally, monies would be released today against a credible promise of reform in five years from now. But any such promise would lack credibility because it is difficult for a government today

to dictate the actions of a future one. Successful macroeconomic reform is an issue for southern European economies because the only way to sustainably reduce the large public debt burden these countries face is by growing out of it.

It also remains unclear whether the NGEU fund is large enough to support the recovery in case of a second wave of the coronavirus. Many of the measures agreed to within the EU fund framework are seen by EU leaders as exceptional one-off support to the most affected countries. However, the pandemic is not over yet, and second spikes are already in evidence in some countries. Although we believe that national lockdowns are unlikely to occur again, they cannot be ruled out completely. In such a scenario, the money available through the NGEU fund would likely be a drop in the ocean relative to what would be required to support the bloc's economy. What's more, because some funds have already been provided, it is unlikely that the EU will agree to another step as bold as the NGEU fund. Policy complacency could set in.

Public Debt Sustainability Remains a Key Challenge

Overall, the agreement of the EU recovery fund, with some states benefiting more through grants than they will eventually pay back, creates a precedent for fiscal transfers to help mitigate economic shocks. This is therefore a first and important step toward fiscal union. However, the only sustainable way for southern European countries to grow out of a large public debt burden is through higher long-term growth. While the recovery plans that grants will be linked to have not yet been submitted, it is unlikely that macroeconomic reforms will be ambitious enough to help raise long-run growth. Medium-term public debt sustainability will therefore remain a key challenge for these countries.

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ID0003550 (09/2020)
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