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Economy

European stimulus plan on the launch pad. Take-off scheduled for 2021

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EU leaders have finally reached an agreement regarding the budget framework for 2021-2027 and the associated € 750bn 'stimulus plan'. This outcome would have been unthinkable a short while ago. Clearly, this marks progress. Relative to the initial proposal, compromises have been made lift the opposition from the self-proclaimed frugal states. The rebate on their contribution to the EU budget has been increased. The share of grants in the stimulus plan is reduced from 66% to 52%. From inception to agreement, two months were needed. The plan's rollout is scheduled for a start of 2021, with a ramp-up in 2022-2023.

It's been a hard day's night (… more precisely, four nights)

The EU does not have a fiscal stabilisation mechanism. When a shock occurs, each country is supposed to act to support its economy. This gives rise to two problems. First, there is no coordination amongst states. Second, the response from some states can by hampered by various constraints, institutional (Stability Pact) or financial (debt ratio). All too often, we then come to hope that monetary policy will be able to overcome the shortcomings of fiscal policy. In practice, the result is that the European policy-mix is unbalanced and therefore sub-optimal.[1]

As the coronavirus crisis is likely to exacerbate both problems, a common budgetary response to support recovery is a necessity. This is acknowledged, but its practical implications are complex. The meeting between heads of state and government lasted five days and four nights before an agreement was reached on the EU budget and the 'stimulus plan'[2]. In the present note, we review the major questions shaping this debate.

➤ **Why the stimulus?** – This question may seem absurd *today* given what we know about the economic shock, but this was not the case several months ago. At the summit on **26 March**, some European leaders saw no point at all in setting up a stimulus fund to help the countries most affected by the pandemic (often those with the least fiscal leeway). Moreover, many saw this idea as nothing more than a ruse to mutualize existing debts. The idea of coronabonds was rejected by the German Chancellor and was described as a mere "slogan" by the European Commission president.

Within a few weeks, GDP has fallen in proportions that are, in some instances, ten times greater than what is observed in a typical recession over several quarters. In its 7 July forecast, the Commission predicts an 8.3% contraction in GDP in 2020 at EU level. Assuming that the pandemic remains under control, the recovery that has just begun would continue and the rebound would be +5.8% in 2021. **If this is the case, the level of activity in 2021 would be 6% lower than it would have been in the absence of the pandemic. Such a widening of the output gap requires the mobilisation of as many resources as possible to support the economy. This point is now beyond debate**. It is no exaggeration to assume that everyone would have something to gain from this. For example, the German economy, which is so sensitive to foreign demand, has an interest in the EU not only not disintegrating (one Brexit is enough), but also in returning to growth as quickly and durably as possible. Note that the German government, which was often rather reticent on these issues, has become one of those pushing hardest to set up a European stimulus mechanism as rapidly as possible[3].

➤ **How to do it?** – It goes without saying that the EU had not during the last expansion built up the reserves necessary to quickly address the shock caused by the pandemic. **One way or another, the stimulus implies additional public debt. The question is who should take on the debt, who should pay it back, and under what terms**. After

[1] *See our* Eco Note *of 28 May 2020:* "A one-legged Europe no more?"
[2] See: https://www.consilium.europa.eu//media/45109/210720-euco-final-conclusions-en.pdf
[3] *See our* Eco Note *of 16 July 2019:* "10 questions on Germany"

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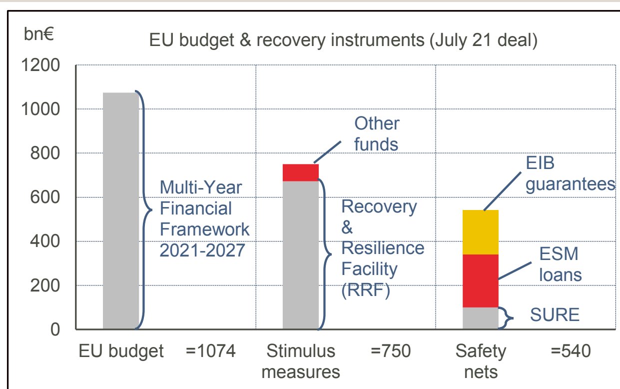
the financial crisis of 2008, several countries in the Eurozone benefited from aid programmes in the form of loans at preferential rates, which was welcomed at that point as these countries saw the capital markets were closing. In view of the action on the part of the ECB to ensure that spreads between countries do not widen too much, this option is no longer that useful. Sharing national debt is not realistic either for political and legal reasons. No state can be held liable for the debt of its neighbour (article 125 of the TFEU).

To get out of this impasse, the European Commission had the idea of combining two distinct issues, namely negotiating the new multi-annual EU fiscal framework for the period 2021-2027 and setting up a stimulus plan[4]. The stimulus plan is thus set to be an integral part of the new framework. To do this, it is expected that the EU will issue debt and will allocate the resources obtained to the recovery instrument. This approach offers the advantage of being legal (article 122 of the TFEU) and of having already been followed in 2010 at the time of the inception of the EFSM, the provisional forerunner of the ESM. **All told, to get out of an intractable problem (financing the recovery), the Commission grafted it onto a problem that is in itself complex, namely the multi-annual budget negotiation (see appendix). The appeal of this combined approach is that it should allow common debt to be raised that is not allocated to the member states, at least for the portion distributed in the form of grants**. The rest is all about compromises on the size of the instruments and their terms of use.

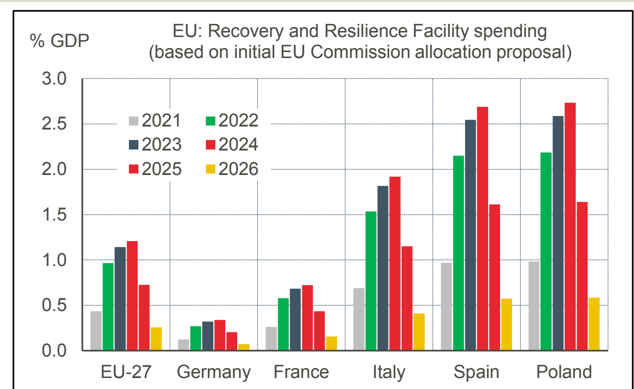
➤ **How much for the stimulus plan?** – Before it is an economic policy, the "stimulus" is a communication tool. It is often presented as a miracle cure, even if it means leaving to one side the operational aspects (implementation, efficacy, conditions). In this phase, the biggest possible figure is what is wanted, where possible expressed in trillions. In this way, it is possible to maximise the confidence factor. In a time of crisis, this is no small consideration. **Adding to the European budget all the associated measures, the figure comes to € 2,364bn, split into three blocks** (chart lhs):

- **the multi-annual financing framework (MFF) of the EU for € 1,074bn**;
- **various measures designed to encourage stimulus investment for € 750bn,** some of them pre-existing, others being new, of which the main one is the Recovery & Resilience Facility (RRF for € 673bn);
- **various schemes acting as a safety net for € 540bn**: loans backed by the EIB, pandemic credit lines from the ESM, financing of expenditure for short-time working by the Commission (SURE programme).

EU: the budget and the recovery instruments



EU: spending scheduled from the recovery fund



Sources: EU, EC, ODDO BHF Securities

In reality, it makes little sense to add the sums together. The various tools do not address the same end purpose, while some may never actually be mobilised. As such, to date, no country is particularly keen to request a special pandemic credit line from the ESM, the cost of which is unlikely to differ much from financing in the markets.

For the budgetary stimulus itself (what the EC calls "Next Generation EU- NGEU), the sum of € 750bn clearly does not correspond to an immediate spending budget. There is, within this amount, one portion designed to be distributed in the form of loans and another in the form of grants. The Commission's initial proposal was for € 500bn, or two-thirds of the total, to be allocated as grants. All the major countries, with Germany leading the way, and most other countries were favourable to this plan. Opposition came from the Netherlands and Austria, and to a lesser extent Sweden, Denmark and Finland, countries that style themselves "frugal"!

[4] *See Herszenhorn & al. (2020), "The coronavirus recovery plan that Von der Leyen built",* Politico, *16 July.*

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During the budget negotiations, the total amount of the "stimulus plan" was held at € 750bn but the share of grants was reduced. In the final agreement, the grants amount to € 390bn, down 22% relative to the initial proposal. A number of mechanisms adjacent to the RRF, intended to support investment, research and innovation, therefore had to be trimmed. The split per country still has to be ratified. The Commission's initial proposal was mainly favourable to Poland, Italy and Spain (chart rhs, page 2).

➢ **What governance?** – It is perfectly legitimate to supervise the way the funds granted to countries are used. Usually, this is the Commission's job, but in this case the so-called frugal countries wanted the decisions to be taken unanimously by the Council. In other words, they wanted a right of veto in case the funds were not used in line with the common objectives (digitisation, greening) and in the absence of structural reforms. This was bound to revive memories of the "troika" (IMF, European Commission, ECB) in the bailouts implemented between 2010 and 2015, with the difference that a troika, as the name suggests, allows a plurality of views[5]. Needless to say, this proposal was unacceptable. It served merely to increase the leverage of the so-called frugal countries in the negotiations.

Here again, during the budget discussions, the heads of state and government endeavoured to hammer out a compromise. On one hand, the rebates on the so-called frugal countries' contributions to the EU budget were increased. On the other hand, approval of the stimulus plans will be decided according to a qualified majority vote[6], and when the grants are disbursed each country will be able to activate an emergency brake if it believes that the funds are not properly used. In practice, this would consist of alerting the Council, which would then have three months to examine the problem "exhaustively".

As if this were not complicated enough, another governance issue was taken into account: respect for the rule of law. This should be a given in European democracies but the issue is often raised regarding Poland and Hungary. European negotiations are frequently reduced to opposition between the north and the south (virtuous countries vs lax countries) but, in reality, the bulk of European transfers are from west to east. This is therefore not a trivial point. At this stage, the other countries were so keen to reach a deal that they did not overly emphasise the problem, but the question could certainly receive greater scrutiny in the debates in the European Parliament.

➢ **What timetable for implementation?** – The EU stimulus plan is designed to support the recovery, and is not meant to be an immediate response to the shock that European economies have just endured. For that, action has been taken at the national level, in particular through short-time working schemes. The time horizon is not the next five months but the next five years. Assuming that the budget/stimulus plan agreement is ratified by the various parliaments, the grants and loans would be made available over a period from 2021 to 2023. **For the RRF, 70% of the grants are likely to be made in 2021 and 2022, and 30% in 2023. The associated payments are likely to be spread out over a longer period, up to the end of 2026, with a ramp-up mainly visible from 2022 to 2024**.

➢ **How is the money to be used?** – Each government is supposed to draw up a national stimulus plan setting out in detail the measures to be financed for a period of four years. It will have to be submitted to the Commission for examination between October 2020 and April 2021. The RRF is expected to encourage reforms and investments to revive growth potential. What is more, the agreement between European leaders stipulates that an overall climate target of 30% will apply to the total amount of expenditure from the multiannual financial framework (MFF) and the stimulus plan (NGEU), with the objective of EU carbon neutrality by 2050. These are fairly vague as guidelines go. In any case, the investment programmes will be up to each government (subject to control by the other countries). There is no obligation for governments to coordinate their plans. This is a critical point as we know that numerous infrastructure needs, in transport for example, involve decisions that go beyond national boundaries.

➢ **When and how to pay it back?** - A capacity to borrow assumes a capacity to pay back. The net debt to finance the stimulus plan must have been issued before 2026. **The reimbursement period is supposed to begin in 2028 and be completed by 2058. With such a distant deadline, we understand that European leaders remain relatively vague on the terms and conditions. It is assumed that in the meantime EU countries will have been able to raise new resources (see appendix), but, of**

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[5] *We remember the very strong differences between the IMF and the Commission in the implementation of the various Greek bailouts.*
[6] *The European Commission's initial proposal was a reverse qualified majority system, i.e. it would have taken a majority of countries to block payment of the grants.*

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course, there is no information regarding the measures envisaged. A **carbon tax**, in whatever form, would chime with ecological transition objectives but we know that popular acceptance of this type of tax is not guaranteed (cf. the "yellow vest" protests in France). A **border tax** would have the advantage of generating a contribution from the less environmentally virtuous countries, but this carries the risk of increasing tension on international trade, quite apart from any retaliation against the EU. The same can be said of a **digital tax**, which Europe is looking to impose on foreign/US technological giants.

Appendix: the financing of the stimulus plan

Under normal conditions, the European Union does not call on the markets to finance its spending, since its budget is supposed to be balanced. Every year it covers its spending via three sources of revenue. First, its own resources primarily made up of customs duty. Second, a small share of VAT receipts. Lastly, a direct contribution from the states calculated on their respective GDP; the amount is variable to adjust revenues to spending. In any event, the EU cannot call on revenues as long as its total resources remain below the ceiling of own resources which has already been set at 1.20% of European GDP.

Legally, there is nothing to stop the EU from borrowing on the markets, but two conditions must be satisfied, on the one hand this debt must be used to fund well-identified spending and, on the other, the EU must have sufficient revenue capacity to reimburse the debt[a]. To finance the stimulus, the Commission plans to invoke article 122 of the Treaty on the functioning of the EU, which stipulates: *"Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. The President of the Council shall inform the European Parliament of the decision taken".* No-one would deny the exceptional nature of the current situation.

With regards to revenue capacity, the Commission proposes increasing, for this specific use, the ceiling of own resources by 0.6 points of GDP. This figure includes a margin of security since if the aim is to reimburse the debt between 2028 and 2058 with an annual ceiling of 7.5% on the principal, this would imply a reimbursement of € 56bn per annum, i.e. 0.4 points of current GDP. In reality, the annual cost of the debt will be lower. If the reimbursement is evenly spread over the 30 years, thus factoring in growth, it would stand at closer to 0.1 points per annum.

When the Commission begins to pay back the loans (2028 according to the current hypothesis), it could increase the direct contribution from the states or find new dedicated own resources. Amongst the options that have been evoked, there is an extension to the carbon market for the maritime and air transport sectors (around € 10bn per annum), a border carbon tax (between € 5bn and € 14bn per annum), a tax on companies that garner the most benefit from the single market (around € 10bn per annum), and a tax on digital companies (€ 1.3bn per annum). Together, these amounts should be enough to pay down the debt generated by the stimulus plan. If the states refuse to grant new resources to the Commission, they will be forced to increase their direct contributions. The net cost by country is extremely difficult to calculate. As things stand, the agreement on the stimulus plan retains the system of rebates (or lump sum corrections), which we all agree is highly complex[b]. After the UK's departure from the EU, the main country to benefit from this system is the Netherlands (for the equivalent of 0.13% of its GDP, a figure that is almost doubled following the agreement of 21 July). Then come Sweden, Germany, Austria and Denmark. Excluding Germany, we find that the so-called "frugal" countries are the most reserved vis-a-vis the stimulus plan. This is obviously purely coincidental.

[a] See European Commission (2020), Q&A: Next Generation EU - Legal Construction, 9 June
[b] See Darcas (2019), Who pays for the EU budget rebates and why?, Bruegel blogpost, 9 December

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