03 June 2020

RESEARCH NOTE

From the EU, with Love

The EC Proposal for EU Recovery Funding

The European Commission (EC) raised the stakes on the €500 billion Franco-German proposal and put forward a **€750 billion** investment plan, dubbed Next Generation EU, to support recovery from the pandemic. Through this action, the EC is transforming the need to repair the EU into an opportunity to propel it into the future. The plan, if approved by EU member states, is also a massive step forward for European integration.

Some will certainly welcome the coherence of the spending, embedding new funds into pre-existing strategies, but others will surely dislike the centralisation. These will interpret the project as a further step toward the emergence of a federal EU government. The proposal will be debated vigorously before a Eurogroup meeting of Finance Ministers on June 11. The final version of the plan will end up in the hands of national parliaments for a vote and requires unanimous approval.

The discussion will be spirited but it is unclear how much dissension there really is. The four known opponents (Austria, Denmark, Sweden and The Netherlands) are grandstanding to their electorate but intrinsically side with Germany. Chancellor Angela Merkel is behind the project and will lead the negotiations as Germany takes the presidency of the EU on July 1. The process needs to be completed by the fall for spending to start in 2021.

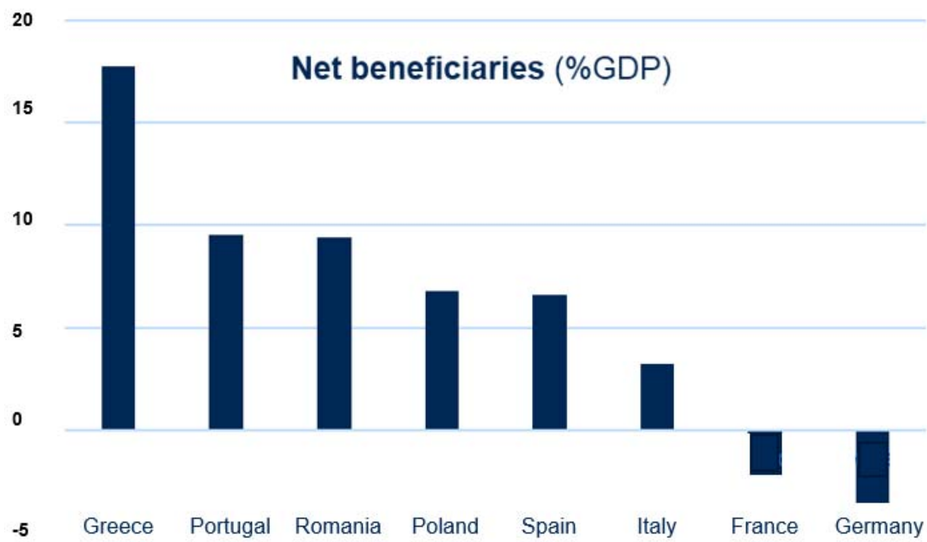
This new set of measures would complete the **€540 billion** of already-approved new programmes (the €100 billion SURE unemployment insurance, the €240 billion ESM credit lines, and the €200 billion EIB lending for corporates), for a total of €1.3 trillion in pandemic measures. The precise country allocation key is not set, nor are the details of what spending is done through grants or loans—there are just proposals and estimates. The funds will be managed together with the 2021–27 EU budget that, in parallel, the EC is putting forward for **€1.1 trillion**, creating a headline spending figure that reaches €2.4 trillion (12.5% of EU GDP).

The agenda for spending is impressive and revolves around four axes:

- **Offset the economic scars of the pandemic**: a new ReactEU initiative (€55 billion) and Recovery and Resilience Facility (€560 billion) will support the recovery in the most impacted regions and build economic convergence among all member states.
- **Strengthen the European health sector**: the goal is to ensure health security, including through the European Centre for Disease Control (€9.4 billion), build resilience against future crises through RescEU (€2 billion), and fund health research (with the Horizon Europe fund).
- **Support solvent companies in affected sectors**: €31 billion will be used to leverage €300 billion of private funds to develop European champions through a strategic investment facility. Another €15 billion will be leveraged into €150 billion to raise the resilience of strategic sectors and key value chains.
- **Deploy green and digital transitions**: the Just Transition Fund will continue to invest in carbon neutrality (endowed with €40 billion more) and a new Horizon Europe Fund will be endowed with €94.4 billion to finance innovative projects, including for the digital transition.

It is so complicated to extricate who does what spending, between the EC budget and the new investment plan, that it is possible the EC is trying to kill two birds with one stone. The discussion on the new spending plan now has to go hand-in-hand with the approval of its large budget. The end result is a significant injection of already-budgeted money and fresh money into the recovery of Europe.

The crucial point, in terms of receipts less budget contribution, is that those countries that need the most help will get it (see chart below). Spain would save all its contribution to the EU budget (€82 billion) and get some more. Italy would save its €96 billion contribution and get €57 billion more. The numbers are massive. Italian spreads have rallied 60bps since the Franco-German proposal.



Source: European Commission

Since the time for upheaval is now, some of the financing may come from EU-wide taxation. Disbursements are to be made from 2021–24 and, for the time being, contributions to the EC budget and bond issuance will cover immediate needs. Bonds will be issued with maturities ranging five and 30 years. To reduce debt servicing down the road, the EC is suggesting to create tax revenue by allocating receipts from the emission trading system and the carbon border adjustment mechanism. It also suggests raising an EU digital tax and taxing global firms that derive a large part of their profits inside the Single Market.

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Agnès Belaisch is a Managing Director and Chief European Strategist of the Barings Investment Institute. She joined the firm in 2019 and works on a variety of topics ranging from macroeconomic analysis to responsible finance. She has been in the industry since 1996. She spent 10 years at the IMF in Washington, DC, advising governments in Latin America, Europe and Asia. Agnès also worked as an emerging markets fixed income fund manager and strategist in London. When the European debt crisis hit, she helped set up the European Stability Mechanism, the euro-area bailout fund that provided financial support to Ireland, Greece, Spain, Portugal and Cyprus. She has spent time at the London School of Economics working on the design of impact investments. Agnès holds a Ph.D. in Economics from New York University.

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*As of March 31, 2020

20-1201060