EUROPEAN UNION: AFTER AN AMBITIOUS PROPOSAL, PREPARING FOR DIFFICULT NEGOTIATIONS

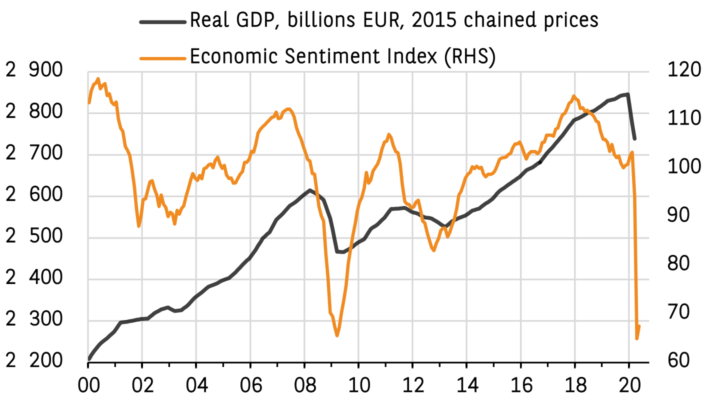
The European Commission is proposing a comprehensive plan to support growth and achieve the EU ambitions in terms of climate policy and digital strategy. Such an effort is necessary in order to avoid that the current crisis would increase the economic divergence between member states. Such a development would weaken the functioning of the Single Market and weigh on long-term growth. The Commission proposes a combination of grants and loans at favourable terms, funded by debt issued directly by the EU. Given the resistance of certain countries to grants, negotiations on the proposal will be tough.

Following the recent French-German proposal for a EUR 500 bn recovery fund and the frosty reaction of Austria, the Netherlands, Denmark and Sweden, all eyes were turned towards the European Commission. The proposal which was unveiled this week under the name "Next Generation EU", is thoughtful, comprehensive, ambitious and creative. The question remains however in which form it will go ahead.

It is thoughtful because of its analytical underpinning. The accompanying document[1] of the Commission staff explains very well why joint action, including transfers, is necessary at this juncture. The shock from the pandemic is symmetric because it affects all countries but its consequences are asymmetric as some countries are hit harder in terms of number of contaminations, requiring a stricter and longer lockdown, with a bigger hit to the economy. Differences can also arise from the sector structure, the importance of small companies, which tend to be financially less resilient, or the presence of underdeveloped capital markets. In addition, high public sector indebtedness reduces the policy leeway. The document states that this could *"lead to a permanent distortion of the level playing field of the Single Market and increased divergence of living standards. These two effects would be economically harmful, jeopardising competition, trade and investment across the Single Market and further aggravating Europe's long-term growth challenges."*

To avoid such a negative outcome, the Commission has proposed a plan which is comprehensive in terms of size and scope. At EUR 750 bn, corresponding to 5.25% of annual EU GDP, it is more than the EUR 500 bn of the Macron-Merkel plan. The money will be invested across three pillars: 1/ support to Member States with investments and reforms 2/ providing solvency support to companies and incentivising private investments to kickstart the economy 3/ health-related initiatives. The proposal is ambitious because of its focus on preparing for the future, i.e. the move towards climate neutrality and the digital transition: the right investments today not only support growth in the short run but also make the EU better equipped to cope with future challenges. The Commission proposal is creative in various ways. First of all, in its financing which is inspired by earlier proposals. The European Union will borrow up to EUR 750 bn in financial markets, the bulk of it between 2020 and 2024 and with a maturity stretching as far as 2058. The debt will be repaid from its budget and to this end, new resources will be made available, closely linked with EU priorities such as climate change, the circular economy and fair taxation. Secondly, there is a combination of grants and loans, respectively EUR 500 bn and EUR 250 bn. Grants are important because loans –even on very cheap terms- increase the size of public sector debt, which may cause an increase in bond yields. Grants avoid such an outcome. Thirdly, the access to financing is taking place on the initiative of the member states, i.e. on a voluntary basis. Although we can safely assume that the uptake for grants will be complete, it remains to be seen whether the same applies for the loans. Considering that the EU will borrow at very cheap conditions, one can suppose that many countries will be eager to tap this resource, all the more so considering that the conditions attached don't seem to be tough. Member States will have to submit national 'Recovery and Resilience plans' which are coherent with the long-term strategies of the EU and set milestones.

EUROZONE GDP AND ECONOMIC SENTIMENT



SOURCE: EUROSTAT, EUROPEAN COMMISSION, BNP PARIBAS

1. *Identifying Europe's recovery needs,* European Commission staff working document, SWD(2020) 98 final, Brussels, 27 May 2020

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They will be discussed with the Commission in the context of the annual cycle of policy coordination, the so-called European Semester, following which access to financing will be made available.

During their press conference on the proposal, Commission Executive Vice-President Dombrovskis and Economy Commissioner Gentiloni repeatedly insisted that this was not about conditionality as seen in the past.

The question remains in which form it will go ahead. The 27 countries all need to agree and discussions will be linked to those on the 'normal' EU budget -the multiannual financial framework (MFF) 2021-2027- on which there is no agreement yet. There will be ample room for debate, including on how the money should be allocated across countries and, of course, on the mix between grants and loans. It remains to be seen whether countries which hitherto have been strongly opposed to grants, will consider that the European Semester discussions with the Commission will impose enough discipline: is the threat that the next tranche of the grant would not be disbursed if a milestone is not reached sufficiently strong?

The European Commission hopes a political agreement will be reached at the level of the European Council by July. This would allow for making funding available swiftly for certain initiatives [2]. The rest would be conditioned by finalising an agreement on the MFF, i.e. before the end of this year. This implies that the boost to growth will be gradual: it is more about strengthening the recovery rather than kickstarting it. The impact should nevertheless be sizeable. The Commission staff estimates that EUR 750 bn extra investment would raise the level of EU GDP by around 1.75% in 2021 and 2022 and that two million jobs are expected to be created. It is clear what is economically at stake during the upcoming negotiations.

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2. T*he REACT-EU initiative (additional cohesion funding), the Solvency Support Instrument and the European Fund for Sustainable Development*. Source: European Commission, Questions and Answers on the MFF and Next Generation EU, 27 May 2020