CIO Memo

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EU recovery fund – a deal, finally

Key take aways

- The EU summit has reached a deal on the EUR750bn recovery fund, of which EUR390bn will be grants.
- European equity markets are up, in a globally-supportive environment. EURUSD is unchanged.
- The length and complexity of these negotiations suggest how difficult further integration may be.

1. What happened?

At one of their longest EU Council meetings on record EU leaders have agreed on an EU recovery fund (called "Next Generation EU") as well as on the Multiannual Financial Framework for 2021-2027. This agreed EU budget for the next seven years of EUR1.074 tn is in line with the proposal of EU Council President Charles Michel, and is up from EUR1 tn in the previous seven year period. The tricky point during the negotiations was the recovery fund and the split between grants and loans in particular. The original proposal by German Chancellor Merkel and French President Macron called for a EUR750bn fund to be split between EUR500bn in grants and EUR250bn in loans from the EU to its members, depending on the economic impact of the current crisis. During the negotiations the amount of grants was cut to EUR390bn and the amount of loans increased to EUR360bn (all in 2018 prices). While there will be new revenue streams for the increased EU budget (starting with a plastic waste levy next year in part to compensate for the missing British contribution), the fund will be financed via EU borrowing on the capital markets.

In an important new development, the European Commission will now be entitled to borrow funds on behalf of the European Union, but will stop net borrowing at the end of 2026 by the latest with planned repayments out until 2058. This is a major evolution in EU history and is one reason (along with the amount to be distributed via grants vs. loans) why negotiations were so difficult. Milestones and targets have to be defined in national recovery plans scrutinized by the EU Commission and approved by the EU Council in order to get financial support. There is also a mechanism for blocking payments to members seen as failing to respect the rule of law. "Next Generation EU" includes various other subcomponents of which the Recovery and Resilience Facility (RRF), worth EUR672.5bn, is the most important one. Some 70% of the RRF grants are to be committed in 2021 and 2022 with the remaining 30% to be distributed by the end of 2023.

2. How did markets react?

In a globally supportive market environment, European equity markets traded higher on the news of a deal this morning with the EuroStoxx 50 up 1.5% at the time of writing. EURUSD traded unchanged at 1.145. Spreads of European peripheral countries barely moved.

3. What does it mean for investors?

The agreement still requires national as well as EU parliament approval. The agreement on both the recovery fund and the Multiannual Financial Framework includes various elements, for example budget rebates, that should satisfy the interests of the various countries. The agreement process is expected to be finished in October. Capital markets have not only priced in an economic recovery but also continuous monetary and fiscal support. As the ECB will continue to provide ample liquidity, the fiscal package agreed by the European Union, although having a reduced grants component, should be seen as positive by capital markets. Also the loans provided may allow some countries to refinance themselves at lower rates than they could manage on their own. The package still marks a significant change through the shift from loans to transfers.

From a longer-term perspective, it must be acknowledged that this recovery package is a one-off exercise with a very long repayment duration. The length and complexity of the negotiations reflected the fact that this package is really an exception to the rule. But they also hint as to how difficult further ambitious steps towards a fiscal union could be.

Without the British, the dynamics of EU negotiations seems also to have changed a bit with smaller countries being more vocal in defining their positions and revealing the weaker bargaining power of the German-French duo. These may not be the last long nights in Brussels, but at least the EU has proved that is able to find a compromise and to provide a joint fiscal response.

The agreement points a way forward as to how the EU members may want to collaborate in the future. National efforts will remain important for the recovery in the various member states as well. Monetary and fiscal support are now provided, but the key element for a sustained recovery will remain a containment of the virus (e.g. via a vaccine). Investors should therefore accept that the road to recovery is unlikely to be a straight one.

Glossary

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Commission (EC) is the executive body of the European Union (EU) representing the interests of the European Union as a whole. It consists of 28 Commissioners (one from each EU Member State).

The European Council includes EU members' government leaders, the European Council President and the President of the European Commission. It defines the EU's overall political direction.

The European Stability Mechanism (ESM) is intended to provide financial assistance programs to Eurozone members experiencing financial difficulty.

The European Union Stability and Growth Pact defines and monitors limits for EU members' deficits and debt.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The EUR is the currency code for the euro, the currency of the Eurozone.

The EuroStoxx 50 Index tracks the performance of blue-chip stocks in the Eurozone and includes the super-sector leaders in terms of market capitalization.

The USD is the currency code for the U.S. Dollar.

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