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The why, how and if of the European recovery fund

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On 21 July 2020, barely five months after the COVID-19 pandemic made its first victims in the European Union, its leaders agreed to do something that EU countries had never done before, even during its worst previous crisis, the 2008-14 financial and sovereign debt crisis. They set up a €750 billion facility to help EU countries recover from the COVID-19 crisis. This short contribution seeks to answer three questions: Why did EU countries take this unprecedented step during the COVID-19 crisis? How does the recovery fund function and how is the money allocated among the 27 EU countries? Will the recovery fund be successful and if so, will it become a permanent EU instrument to fight future crises?

Why this time is different?

The Economic and Monetary Union (EMU) that was conceived in Maastricht in 1992 and gave birth to the euro in 1999 was not a 'genuine EMU'. It was a monetary union, with a centralized central bank, the European Central Bank (ECB), and monetary policy, but it lacked a centralized fiscal authority and fiscal policy, a centralized banking or financial authority with tools to prevent and resolve financial crises, and even a centralized economic authority since all the instruments of economic policy remained in the hands of national authorities.

The only centralized fiscal instrument foreseen by the Maastricht treaty was a fiscal rule demanding that Member States limit their government deficit to 3% of GDP (gross domestic product). The rule was hardened in 1997, with the Stability and Growth Pact that committed Member States to achieve medium-term budget positions of "close to balance or in surplus", which transformed the 3% limit into a hard ceiling that can only be breached in a recession.

There is broad consensus that the Maastricht architecture failed (1) to prevent the build-up of huge imbalances during the first decade of EMU, between 1999 and 2008, and (2) to swiftly resolve the ensuing financial-cum-sovereign debt crisis. There is less consensus, however, as to whether these failures were due to problems with the fiscal rules, especially the SGP, or to the incompleteness of EMU's architecture, although many agree that both bear a responsibility. See, for instance, Benassy-Quéré et al., 2018.

Regardless of whether stricter (and more intelligent) adherence to the EU fiscal rules could have prevented the Greek sovereign debt crisis, which started to unfold in 2010, there is little doubt that the incompleteness of EMU's architecture was responsible for the poor handling of the crisis and its spreading to other euro area countries that fell like dominoes one after the other, calling into question the very survival of the euro area itself.

The lack in the euro area of adequate fiscal instruments and capacity to define and implement an appropriate area-wide fiscal stance resulted in austerity measures in crisis countries and insufficient fiscal support in other member countries that led to a double dip recession in 2012.

Fortunately, the year 2012 was also when three important decisions to improve the EMU's architecture were adopted: the creation of the European Stability Mechanism; the decision to create a Banking Union; and Mario Draghi's declaration that "the ECB is ready to do whatever it takes to preserve the euro" followed soon after by the establishment of the Outright Monetary Transactions (OMT) program by the ECB Governing Council.

Although these decisions were crucial to gradually end the euro area sovereign debt crisis, they clearly fell short of the vision of the Van Rompuy (2012) Report "Towards a Genuine Economic and Monetary Union", further elaborated in the subsequent Four Presidents and Five Presidents reports, which called for the establishment of four unions to complement the monetary union: an economic union, a financial union, a fiscal union, and a political union.

Given its mixed track record during the sovereign debt crisis and the far from finished march towards a genuine EMU, Europe's policy reaction to the economic fallout from COVID-19 crisis in spring 2020 was by no means a foregone conclusion. In the event, however, Europe rose to the challenge rapidly and forcefully.

National fiscal authorities were given ample space to implement sizeable fiscal expansions thanks to the temporary (until end 2022) suspension of the SGP rules and the equally temporary ECB asset purchase programme of private and public securities, the Pandemic Emergency Purchase Programme (PEPP) initially capped at €750 billion, a figure later expanded to €1,850 billion.

In addition, and for the first time, national fiscal measures were complemented by direct EU level support programmes, the €100 billion support to short time work schemes (SURE) and the €750 billion Next Generation EU (NGEU), with at its core the Recovery and Resilience Facility (RRF). Both SURE and NGEU/RRF are entirely financed by bonds issued by the European Union, hence providing an important element of (COVID-19) debt mutualisation that complements the mutualisation provided (to euro area countries) by the ECB thorough the PEPP programme.

The idea of issuing EU debt to help Member States stabilize their economies during the crisis had been floated by people like Tommaso Padoa-Schioppa, one of the founding fathers of the euro, already back in 2010, at the start of the euro area sovereign debt crisis, but it never received any official hearing leave alone backing. So, why was an idea that had been considered as outlandish in 2010 become feasible in 2020? Asking this question largely amounts to asking why Germany, which was opposed to any debt mutualisation during the sovereign debt crisis, agreed to such mutualisation during the COVID-19 crisis.

Three main factors seem to be involved. The first is the nature of the crisis. The sovereign debt crisis hit only some countries, those in the periphery of the euro area, while its core members, including Germany, were relatively little affected and viewed the predicament of the peripheral countries as the result of their own poor policy choices. By contrast, the COVID-19 crisis negatively affected all EU countries and was ascribed mainly to exogenous factors rather than to national policy choices. This made it to see the COVID-19 crisis though the lens of an "EU-wide problem needing an EU solution" than had been the case with the sovereign debt crisis.

The second factor is economic. All EU governments have learned from their collective mistakes during the sovereign debt crisis, when the imposition of austerity measures and the lack of fiscal coordination led to the double-dip recession in 2012. Creating sufficient fiscal space, including for weaker euro area southern members that entered the COVID-19 with high debt levels, was therefore viewed as important in 2020 to avoid a prolonged recession. And it was not just important for the southern euro area members but also for the other euro (and non-euro) area members because the recession was worldwide, which meant that even export-driven economies like Germany could not hope to escape the recession by relying on markets outside Europe as they did during the sovereign debt crisis. Preserving internal EU demand was therefore crucial for all EU members.

The third factor is geopolitics. In her 2020 State of the Union speech, President von der Leyen stated that the EU lives in a fragile world. This view was shared by all EU national governments, not least in Germany, a country whose economic strategy relies on exports to the EU and global markets. With the increased fragility of world politics, certainly under the then Trump Administration, but also elsewhere in the world, Germany had come to realize that global markets, although essential to its economic strategy, are potentially more volatile than the EU market and certainly that it has less leverage on the political and economic stability outside than inside the EU, and therefore that it better invests in the cohesion of the European Union if it wants to ensure the prosperity of its citizens. This attitude contrasts sharply with Germany's attitude during the financial and sovereign debt crisis ten years ago when the dominant feeling in this country was that the EU market had become secondary in importance to its economic interests compared to the global markets that are much larger and faster growing than the EU market. In a fragile world, the EU market, and therefore cohesion among EU countries – both political and economic cohesion – was viewed as vital and worth a recovery plan financed by EU debt.

How does the RRF function?

The core of the NGEU scheme, the €672.5 billion Recovery and Resilience Facility is divided into two components: loans to EU countries of up to €360 billion and grants to EU countries of up to €312.5 billion. In principle, all EU countries can borrow up to 6.8% of their 2018 gross national income (GNI), but in fact only a few have decided to use this facility. On the other hand, all EU countries have decided to request their share of RRF grants, which is calculated based on three criteria: their share of EU population in 2018; their level of per capita GNI in 2018; and their cyclical situation measured according to their unemployment rate during 2015-19 for 70% of the grants and their loss in real GDP in 2020 and 2021 for the remaining 30%.

According to data compiled by Darvas et al. (2021), by end September 2021, 25 of the 27 EU Member States had made requests for RRF grants totalling €331 billion and only seven had made requests for RRF loans totalling €166 billion. The two countries with the largest grant requests, which have already been approved by the European Commission, are Italy and Spain, each amounting to €69 billion. The country that requested the biggest loan is Italy, with €123 billion also already approved by the Commission; Spain has not made any such request so far. Italy is therefore by far the largest user of the RRF, accounting for roughly 40% of the nearly €500 billion requested by the 25 Member States.

To be eligible for RRF money, EU countries had to submit their recovery and resilience plans to the European Commission. Each plan had to include a coherent package of reforms and public investment projects to be implemented by end 2026 that address challenges identified in the European Semester, particularly the country-specific recommendations of 2019 and 2020 adopted by the Council. The aim is not only to help EU countries to recover from the COVID-19 recession by making public investments, especially in green and digital technologies, but also to help them become more resilient by making appropriate reforms, including to improve the quality of governance, a factor that seems to have impacted significantly on differences between EU countries in terms of the GDP losses during the COVID-19 recession in 2020.

According to Sapir (2020), although all EU countries suffered an economic shock in 2020, some were hurt much more than others. In its July 2020 economic forecasts, the European Commission anticipated that some southern EU countries were anticipated to suffer GDP losses of more than 12 percent in 2020, while some northern countries were expected to suffer losses of 'only' around 7 percent of GDP. It seemed right, therefore, that in July 2020 EU leaders decided that the RRF should help southern EU proportionally more than northern countries, and that eastern countries would also be relatively well treated owing to their relatively low per capita incomes.

Using a fairly simple econometric model, Sapir (2020) found that three factors account for most of the differences in the size of the GDP shock felt by EU countries: the strictness of lockdown measures, the structure of the economy (and in particular the share of tourism in GDP) and the quality of governance. When comparing some of the southern countries, including Italy and Spain, with some of the northern countries, the study found that the quality of governance explains between roughly 30 percent and 50 percent of the difference in the size of the economic shock. The study concluded by calling on the European Commission, which was still designing the RRF at the time of its publication, to take on board this finding and insist that southern EU countries, where the quality of governance is generally rather low and which are the main beneficiaries of the RRF, use the money to make necessary reforms to improve the quality of their governance. This call seems to have been heard, at least partly.

Will the RRF be successful and become permanent?

Next Generation EU and its flagship programme, the RRF, were conceived and agreed upon by EU Member States as temporary mechanisms to deal with an exceptional situation, the COVID-19 crisis. Some hope, however, that the RRF mechanism will become permanent and constitute the centralized fiscal facility that was missing from the Maastricht architecture and that could be deployed in the event of another EU/euro area crisis. See, for instance, Buti and Messori (2021).

Nobody can say at this stage whether this hope will materialize. Surely, this will depend in part on the economic and political circumstances when the next crisis occurs. But above all, it will depend on whether the RRF will be deemed as a success and that judgement will rest above all on whether the Italian economic recovery plan, by far the largest of any national programme, succeeds. As Pisani-Ferry (2021) cogently argued, if it does, "it will change the European conversation, so that neighbourly solidarity and fiscal risk-taking are seen as good investments. If it fails, the EU's recovery plan will be remembered as a waste of money and fiscal conservatism will regain the upper hand."

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