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The Recovery and Resilience Facility – an innovative instrument to support a sustainable recovery[1]

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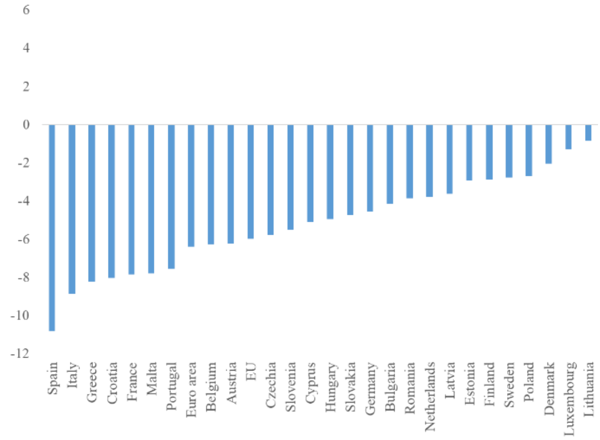
The EU revealed a high degree of union and solidarity in its response to the Covid crisis by adopting the legislative package "Next Generation EU", with at its core the Recovery and Resilience Facility. The package is estimated to be able to lift by up to 1.5% GDP at the Union level. The Recovery and Resilience Facility is a truly new and unique European policy instrument. It is a performance-based instrument; it combines investments and reforms; it supports the digital and green transitions while at the same time focusing on challenges of macroeconomic relevance; and it is financed by large European Commission borrowing backed by the Union budget. After the submission of the Recovery and Resilience Plans by the Member States, the focus is now on effective implementation of reforms to remove investment bottlenecks and reduce the risk of slow absorption of the available funds.

The COVID pandemic: an unprecedented crisis with a deep and asymmetric impact

10 years after the Great Financial Crisis and the subsequent euro-crisis, the COVID 19 pandemic hit across the globe. Lives were lost; Europe was mourning. The lockdown measures to contain the virus had a huge impact on economic activity; economies came to a standstill in the second quarter of 2020. For that year, GDP declined by more than 10% in Spain, by almost 9% in Italy and by 6% on average in the EU (Figure 1).

[1] This article builds on the analysis performed by several staff at DG ECFIN, European Commission.
[2] Views expressed in this article are solely those of the author and do not necessarily represent the official views of the European Commission.

Figure 1: Real GDP growth in EU Member States



Source: European Commission (Ameco; 8 Sep 2021)

Figure 2: Spread on 10 year government bonds vis-a-vis Germany

Source: Macrobond

Policy action at EU level: crisis repair, containment and fostering recovery

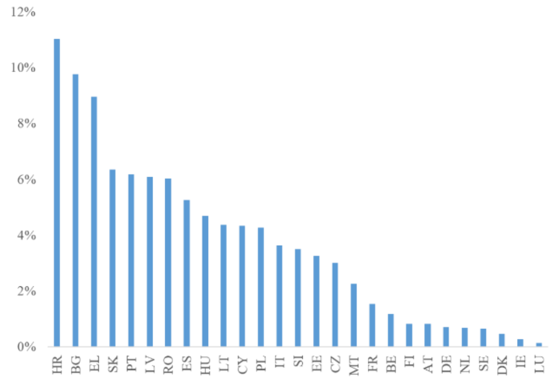
Immediate actions were launched at the national and EU levels to provide support to the European economy. While the ECB provided large scale liquidity, the Commission relaxed its staid-aid rules and activated the General Escape Clause, alleviating fiscal governance rules to allow for immediate budget support. This gave a fast and substantial impulse to the European economies. Furthermore, the Coronavirus Response Investment Initiative (CRII) and React-EU led to a fast deployment of available EU funds, while the recently developed SURE instrument provided loans to Member States at attractive conditions supporting short-time work schemes and similar measures to safeguard employment. Arguably, this shielded the labour market from the crisis, and protected jobs. Unemployment in the EU 27 increased, but by much less compared to what could have been expected on the basis of the fall in domestic production.

It was however soon felt that, beyond short-term crisis repair actions, there was a need for an additional bold intervention at EU level to foster investment and reforms. While initially considered as a symmetric shock, it became soon clear that the COVID crisis risked affecting disproportionately Member States who had pre-existing vulnerabilities, such as a high rate of unemployment, and leading to hysteresis. Without decisive action at EU level, the COVID crisis could have further exacerbated economic divergences.

In May 2020, about two months after the outbreak of the COVID crisis in Europe, the Commission proposed the legislative package for “Next Generation EU”. At its core is the Recovery and Resilience Facility (RRF) that provides support for productivity enhancing investments and reforms and to accelerate the green and digital transition, thereby ensuring a sustainable recovery and fostering cohesion and convergence. In total, Next Generation EU amounts to EUR 750 billion EUR (in 2018 prices) over the years 2021-2027, with the RRF accounting for the lions’ share (almost 90%; EUR 312.5 billion for grants and EUR 360 billion for loans).

To ensure its effectiveness, the RRF was designed to target funds particularly to the countries that needed it the most. The amount of support Member States are entitled to depend, amongst others, on the inverse GDP per capita and the 2015 – 2019 unemployment rate. Furthermore, for 30% of the total envelope, the impact of the crisis was taken into account via the real GDP growth in 2020 and, in equal proportion, the cumulative loss in real GDP over 2020 and 2021. As a result, economies with low GDP per capita, with a high rate of unemployment and a deep negative impact of the crisis are entitled to a relatively larger amount of grants, while economies with higher GDP per capita, lower unemployment rate and with a more robust growth outlook are entitled to comparatively less (Figures 3 and 4).

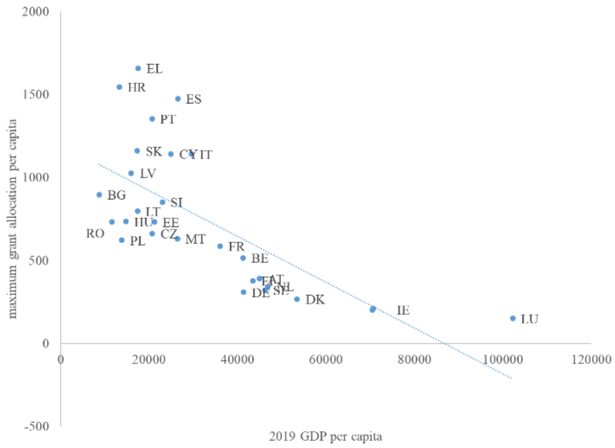
Figure 3: RRF grant support (% of pre-crisis GDP)



RRF non-repayable support as per RRF Regulation Annex IV, indicatively based on the Commission 2020 Autumn Forecast

Source: European Commission

Figure 4: RRF grants per capita and GDP per capita



Source: European Commission, Eurostat

The coordinated set of policy actions at the national and European level managed to truly calm financial markets. The agreement on the Next Generation EU and the RRF revealed the high degree of commitment to European cohesion and solidarity and was a clear demonstration of the collective resolve to do what it takes to protect our economies and recover from the crisis, thereby ensuring trust in the future of the Union. The economic recovery in the second half of 2020, and productive policy developments in the Member States leading to the Council approval of 18 Recovery and Resilience Plans (RRPs) by early September this year have further improved investors' confidence (Figure 2).

RRF: an instrument with innovative features

Several innovative features make the RRF a truly new and unique European policy instrument.
First, the RRF is a performance-based instrument. In contrast to conventional EU instruments, which provide funds against the invoices paid by Member States, companies or individuals, the RRF provides financing via grants and loans upon the achievement of results, i.e. the completion of specific agreed milestones and targets that constitute key steps in the implementation of the agreed investments and reforms.

The focus on results makes the instrument efficient. It lowers administrative costs, as there is no certification of expenditures envisaged. At the same time, disbursements depend on the achievements of specific and detailed pre-agreed milestones and targets. This means that countries need to achieve tangible results in order to receive the support.

A second key feature of the RRF is the combination of reforms and investments. Many EU instruments have focused so far on providing funding to investments[3]. While investment is key to foster growth, for these investments to bear fruits, framework conditions need to improve in parallel to make sure that investments pay off. In their RRPs, Member States were required to put forward coherent sets of reforms and investments aimed at addressing the key priorities of the RRF. Reforms such as those reducing regulatory barriers, justice reforms, public administration reforms, insolvency reforms, and more generally reforms aimed at improving the business environment are in that regard key and have largely been incorporated in the RRPs.

A third feature of the RRF is its focus on the country-specific recommendations (CSRs) and on the green and digital transitions. This double focus ensures that the plans will contribute to a sustainable recovery. First, the CSRs correspond to reforms that have been identified by the Commission and by the Council as part of the European Semester process as the key challenges to be tackled by each country. They are hence country-specific and validated collectively through the process of multilateral surveillance. The RRF regulation requires that each RRP addresses all or a significant subset of the country-specific recommendations that were adopted in 2019 and 2020[4]. This therefore ensures that the RRPs focus on the right reforms. Second, as addressing the challenges resulting from the green and digital transitions are essential to ensure a sustainable growth, the RRF Regulation requires significant *quantitative* investment in both climate and digital investments and reforms (i.e at least 37% and 20% of the estimated cost of the plans respectively), but also a significant *qualitative* contribution to the green and digital transitions. Furthermore, every individual measure will need to respect the 'do no significant harm principle' in relation to the environmental objectives as defined in the EU Taxonomy[5] and acquis.

Finally, the financing method of the RRF is also novel. To finance NextGenerationEU, the European Commission will, on behalf of the EU, borrow on the capital markets, and, thanks to the EU's high credit rating, pass the advantageous credit conditions to the EU Member States. This novel financing method has allowed the Commission to put forward a very large new instrument without burdening the EU budget excessively. These features make the RRF a very powerful tool to create a real tangible policy impulse to sustainable growth.

[3] The European Structural and Investment Funds also put some emphasis on reforms as a precondition for investment via the "ex-ante conditionalities" first and the "enabling conditions" later, which were part of the Common Provision Regulation for the funds since 2013.
A second European programme to support reforms is the Structural Reform Support Programme (now Technical Support Instrument). It offers technical support to the Member States who wish to implement structural reforms. Its scope is therefore different than the RRF, and works as a complement to it.
[4] Country specific recommendations (CSRs) are the reforms that are collectively identified as the most important measures for each Member State via the cycle of European policy coordination (European Semester)
[5] Objectives set out by Regulation (EU) 2020/852, Article 9: climate change mitigation; climate change adaptation; the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; the protection and restoration of biodiversity and ecosystems.

Box 1: How is the RRF financed?

To finance NextGenerationEU, the European Commission, on behalf of the EU, will borrow on the capital markets. Thanks to the EU's high credit rating, the Commission will be able to borrow on advantageous conditions. The Commission will then pass the benefit on to the EU Member States directly when providing them loans or to the Union budget in the form of low interest rate payments on borrowings to finance recovery spending.

To back the borrowing and raise funds under favourable market conditions, the EU will use the EU budget and its headroom. The headroom is the difference between the Own Resources ceiling of the long-term budget and the actual spending. To ensure sufficient headroom, the EU increased the Own Resources ceiling on a temporary and exceptional basis by 0.6 percentage points of the EU's Gross National Income (GNI). The headroom will serve as a guarantee that the EU will be able to make repayments under any circumstances.

The borrowing will be concentrated between mid-2021 and 2026. All borrowing by the European Commission will be repaid by 2058. Loans will be repaid via repayments by the borrowing Member States. Grants will be repaid through the EU budget. To help repay the borrowing, the Council, the European Parliament and the European Commission, in the context of the inter-institutional agreement of December 2020, agreed to introduce new own resources. The Commission intends to make proposals for new own resources in the second part of the year.

The Commission is then expected to borrow on average roughly up to EUR 150 billion per year between mid-2021 and 2026, which will make the EU one of the largest issuers in euro. Given the volumes, frequency and complexity of the borrowing operations, the Commission is following the best practices used by sovereign issuers, implementing a diversified funding strategy. By using diverse funding instruments and funding techniques, the Commission expands the investor base for EU securities, facilitate the smooth repayment of borrowed amounts, and will be able to deliver all funds as required on the most advantageous terms for EU citizens.

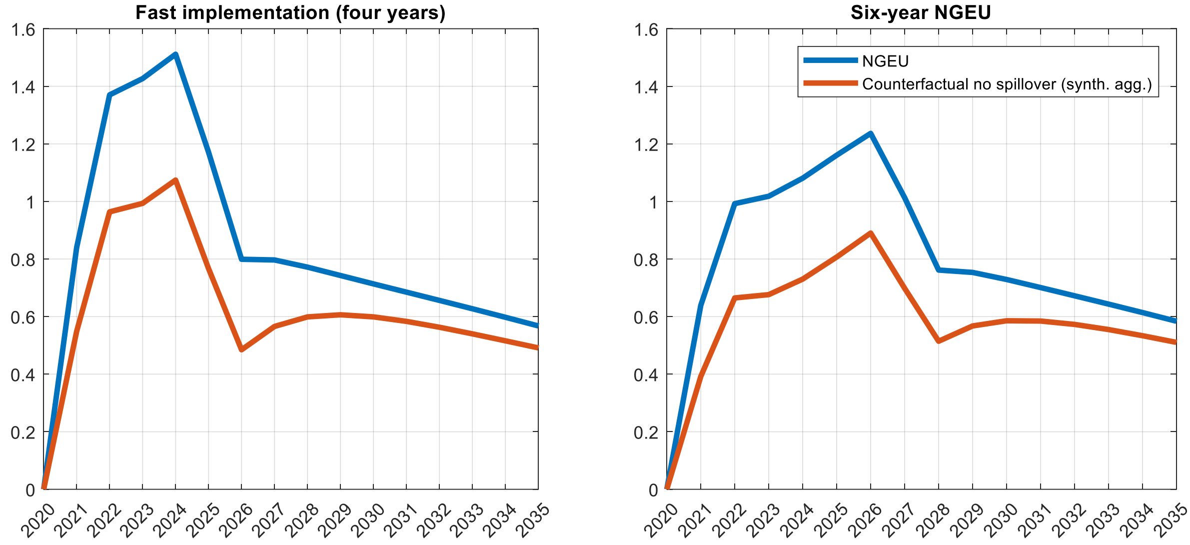
Coordinated action at EU level: the benefit of acting together

The Commission has run simulations with the Commission's QUEST model to quantify the impact of NGEU investments[6], also including spillovers effects[7]. Real GDP in the EU-27 is estimated to be up to 1.5% higher under the assumption of fast implementation over 4 years compared to a no-policy change baseline, i.e. without the NGEU/RRF. Furthermore, the simulations find that the macroeconomic spillovers are significant and explain about a third of the growth impact.

[6] This takes into account the whole NGEU, of which the RRF makes out some 90%.

[7] The model used features all 27 EU Member States and the rest of the world. It combines a dynamic model for fiscal policy analysis with detailed cross-border trade linkages. The model also incorporates core elements of NGEU: grant allocations, loan take-up by Member States as of July 2021, favourable loan conditions and new debt issued by the EU with stylised but explicit repayment assumptions. To remain conservative, grants are assumed to be fully additional, while only 50% of the loans are assumed to be so.

Figure 5: Main simulation results: The role of spillover for EU-27 growth



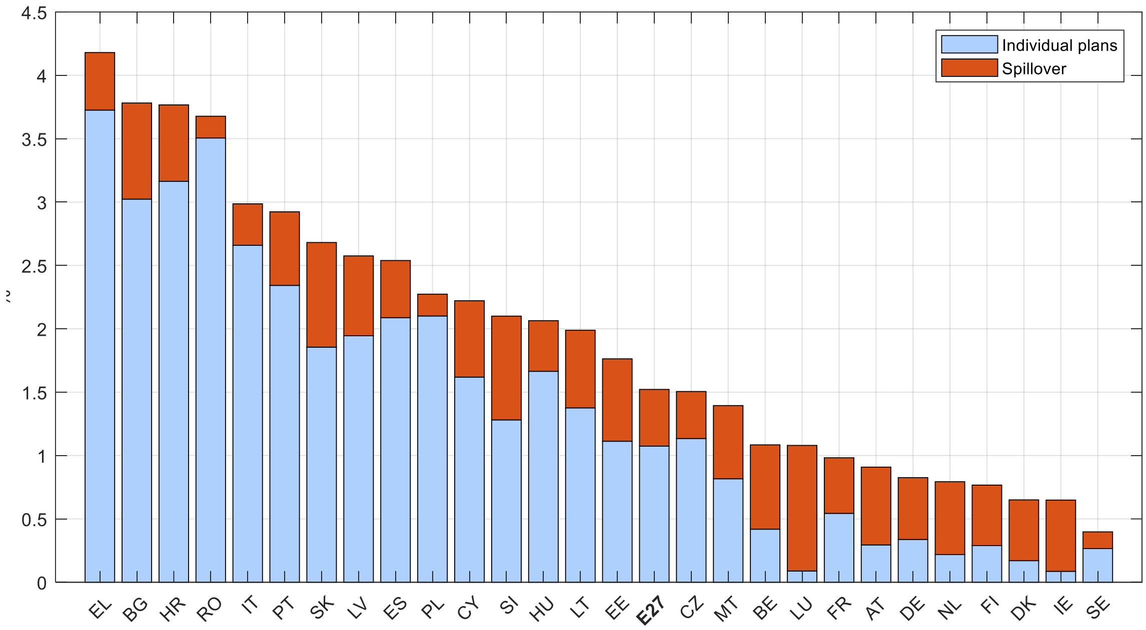
Source: Pfeiffer, P, J Varga and J in ’t Veld (2021)

Note: This graph reports the level of real GDP in percent deviation from a no-policy change (no-NGEU) baseline. Blue lines show simulation results from a simultaneous investment stimulus (NGEU). Orange lines display a synthetic EU-wide GDP (weighted average) obtained by aggregating stand-alone 27 simulations with unilateral stimulus in each country. All values are yearly averages of the quarterly series.

The estimated positive effects hold also under alternative assumptions. The sensitivity analysis also considers alternative assumptions on the spending profile, monetary policy accommodation and productivity. The first two assumptions affect the short-term impact but yield identical long-term output effects. Specifically, the peak effect is lower in a scenario where spending occurs over 6 years, while assuming a normal monetary policy response with central banks raising interest rates would lower the short run multiplier compared to the zero lower bound assumption. Although the model assumes a productivity effect in line with the literature, a lower efficiency of public capital would reduce the long-run output effects, even if the impact would still be very substantial. This however underlines the importance of the focus on high-quality investment.

In line with the allocation key, the strongest growth effects appear in economies with below-average GDP, and those hit hardest by the crisis. The simulated output gains in 2024 reach more than 4% in Greece, around 3¾% in Bulgaria, Croatia and Romania, and around 3% in Italy and Portugal.

Figure 6: GDP effects of NGEU across MS (% deviation from no-NGEU baseline)



Source: Pfeiffer, P, J Varga and J in 't Veld (2021)

Note: This graph reports the level of real GDP in 2024 expressed in percent deviation from a no-policy change baseline in a fast profile (even allocation across 2021 until 2024 for all Member States). Blue bars show simulation results from a simultaneous investment stimulus (NGEU). Spillover (orange) is defined as the difference of the coordinated simultaneous NGEU stimulus in all MS and the standalone simulations of the national plans.

Spillovers effects from the RRF are particularly significant for small open economies. For countries such as Greece, Romania, and Italy, the role of spillovers is smaller (red bars in Figure 6) because their trade partners receive smaller allocations and their economies tend to be less integrated into value chains and trade networks. But for other countries, the spillovers can account for a large share of their overall effects. Beyond the direct impact of their own national envelopes, countries will also benefit considerably from the effects of NGEU investments in other Member States, mainly through trade flows and exchange rate movements. The direct bilateral trade linkages are amplified by third-country effects. For example, Germany benefits not only from the direct spillover from higher Italian demand but also from the increased economic activity of Italy's other trading partners, which themselves require imports from Germany to grow. Spillovers are central for open economies with smaller grant allocations. In these cases, the positive effects coming from other Member States' plans account for the bulk of the GDP impact. In some cases, such as Luxemburg and Ireland, positive spillovers explain almost all of the total impact in the simulations.

Overall, the stylised simulations show large macroeconomic effects of NGEU, even though the effects of reforms are not reflected. The simulations follow a prudent approach and have not factored in the potential effects of the reforms foreseen in the respective plans on productivity, private investment and labour supply. Research suggests that structural reforms can have very significant positive and lasting effects on potential growth, thereby further enhancing economic resilience. In this regard, a model-based benchmarking exercise shows that undertaking reforms that would result in halving the gap vis-à-vis best performers in terms of structural indicators could raise GDP substantially in Member States, on average by 11% in 20 years' time. Gains would be higher in those Member States furthest away from best performance, up to 17-18% for Italy and Greece[8]. This illustrates that the overall benefits from NGEU including reforms could be even larger than the gains from investment shown here.

What do the RRPs look like?

The 18 RRPs that have been adopted by the Council up to July 2021 aimed at addressing a very large share of the country-specific recommendations. The relevant CSRs concern both 2019 CSRs which are of a more structural nature and the 2020 CSRs, which are much more focused on the immediate response to the crisis. When taking the 2019 and 2020 CSRs together, all 18 RRPs address all or a significant subset of challenges identified in the relevant CSRs. Examples of reforms can be found across several policy areas. For public finances and taxation, the RRPs include reforms to make more systematic use of spending reviews to improve the composition and efficiency of public finances (Belgium, France, Italy) and the introduction of environmental tax reforms (Austria, Denmark) or the rationalisation of tax systems and improvement of tax collection (Italy, Cyprus, Lithuania, Slovakia), including by beefing up the fight against aggressive tax planning (Cyprus, Malta). With respect to labour market and employment policies, noteworthy reforms include the reorganisation and strengthening of public employment services (France, Austria), the rationalisation of employment contracts (Spain) and the reform of unemployment benefits to strengthen incentives to work (France, Slovenia). These reforms are supported by substantial investments in education, training and skills development which are included in the vast majority of the plans. In the area of public administration and business environment, a number of RRPs include measures to reduce red tape and to modernise the functioning of the public sector, including in some cases, that of state-owned enterprises (Germany, Cyprus, Italy, Latvia, Lithuania, Portugal), whereas others comprise reforms of public procurement practices to stimulate private investment (Italy) and/or measures to tackle anti-money laundering and corruption (Estonia, Greece, Latvia, Finland, Sweden).

All the adopted RRPs also meet the quantitative climate and digital targets.[9] Measures supporting sustainable mobility and energy efficiency count for almost 60% of all climate-related measures among the RRPs for which the Commission adopted assessments (Figure 8). For digitalisation, the largest share goes to digitalisation of public services and the digitalisation of businesses (Figure 9). Other typical investments concern the deployment of cross-border 5G corridors, or investments in digital skills.

[8] See Varga J and J in 't Veld (2014). The Potential Growth Impact of Structural Reforms in the EU: A Benchmarking Exercise, *European Economy Economic Papers*, No. 541.

[9] For some Member States, like Austria, the coverage of digital and climate targets is relatively ambitious compared to the available allocation. This is because the total estimated costs of the plan is far larger than the allocation, implying that the climate and digital expenditures weighed by the relevant estimated costs are also relatively important compared to the final allocation of the plan.

Figure 7: Climate expenditure (% of total allocation)

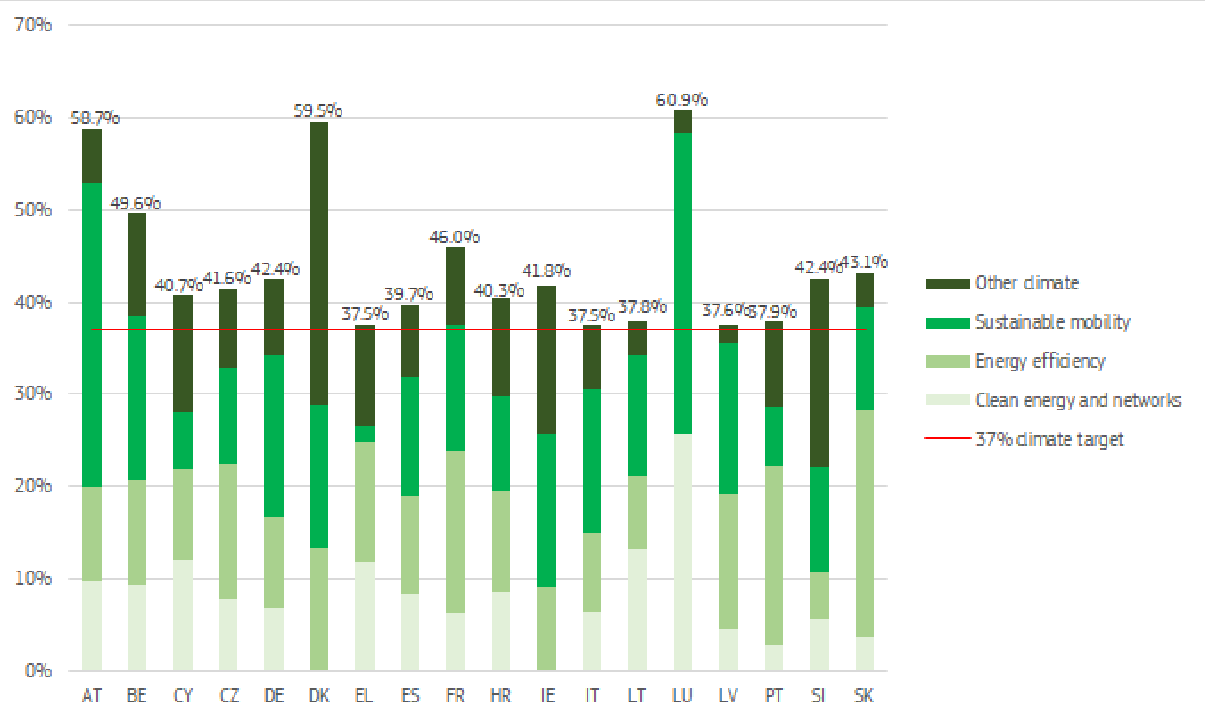
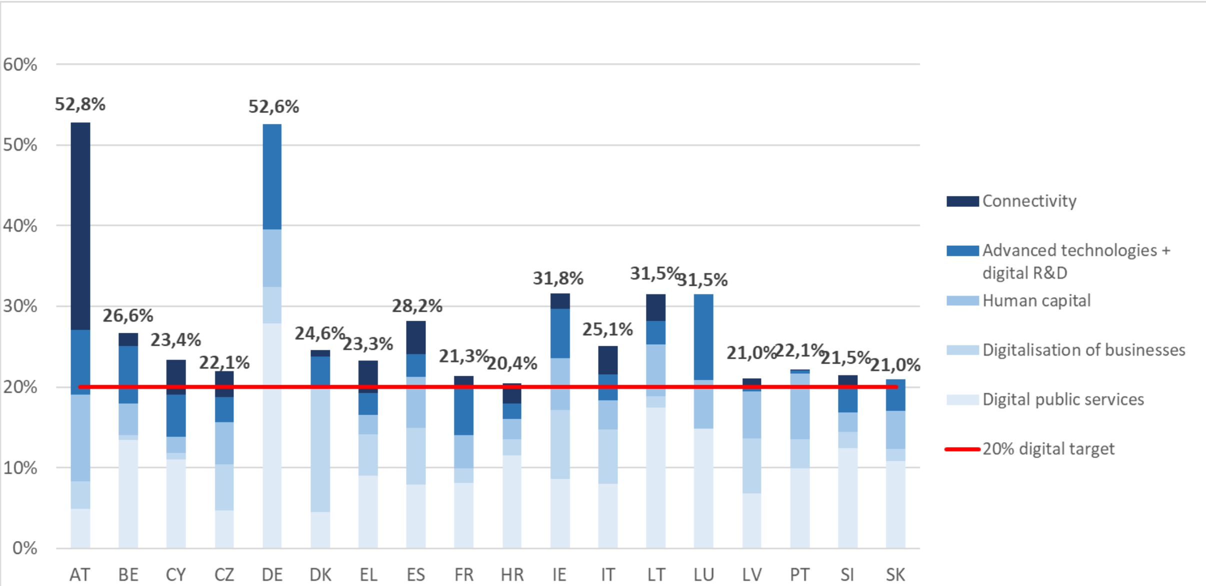


Figure 8: Digital expenditure (% of total allocation)



Social coverage

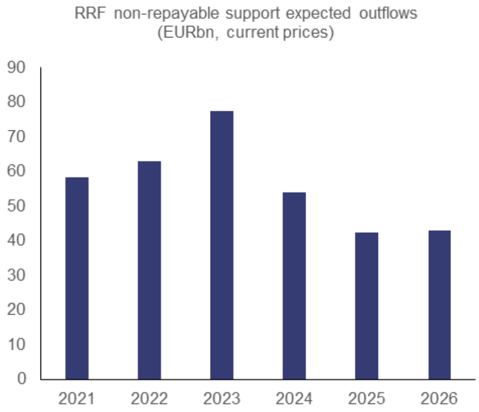
The plans have also a strong social dimension. The COVID-19 pandemic has accentuated social disparities and hit disproportionally the most vulnerable. The RRPs approved so far include a significant share of measures focusing on education, healthcare and long term care, labour market, including measures specifically targeting vulnerable groups, as well as measures to strengthen social protection and social services (Figure 10).

Lastly, the RRF has a particular focus on equal opportunities and gender equality. Reforms and investments in the adopted RRPs notably include measures to make the social protection system for people with disabilities more adequate and fair, improve inclusiveness of the education system, increase participation of women in the labour market and their full-time employment, improve childcare services and their affordability, reduce gender pay gap and increase wage transparency.

Next steps and challenges going forward

We are now entering the critical implementation phase of the RRF. After one year of intense collaboration with the European Commission, Member States have developed RRPs that have the potential to provide real impetus to the European economy, to both the supply side as well as the demand side of our economies. The next key step now is to ensure that the investments and reforms in the RRPs are delivered. The RRPs are very ambitious and stretch over a time horizon of four to six years. Only once the agreed milestones and targets are truly achieved, will a disbursement follow. It is crucial that the momentum is kept over these years, which also requires support by the political leaders emerging from the next rounds of the political cycle. A key element to ensure the success of the RRF is to reduce absorption risks. Member States should implement upfront in particular those reforms that address investment bottlenecks. All this will be challenging but it is needed to ensure that these ambitious plans boost the recovery, build resilience and launch the green and digital transformation of our economies.

Figure 9: RRF payments 2021-2026 (non-repayable support)



Source: European Commission

For many Member States the pre-financing has been paid. The majority of first payment requests are only expected by the end of the year 2021, as it takes time to meet milestones and targets. Payment requests will then continue on a bi-annual basis for most Member States.