EU Recovery Fund: No Gamechanger but a Clear Positive
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After four days of intense negotiations, EU leaders have reached agreement on a €750 billion recovery fund to help repair the economic damage from COVID-19. It took several concessions to EU creditor countries to break the deadlock. As expected, total grants in the deal have been reduced to €390 billion from an original €500 billion proposal.

The watered-down grant element, together with some nominal control over how the money is spent and a kickback in the form of rebates on their EU budget contributions, provided fiscally conservative northern European governments with enough cover to support the deal.

Important Support for Weaker Sovereigns

The grant reduction does not diminish the significance of the recovery fund. Its total of €750 billion is about 6% of euro-area gross domestic product (GDP), and the gross allocations to Italy and Spain will likely be even bigger at 11%–12% of GDP, with the grant allocation likely around 4.5% and 5.5% of GDP, respectively. Allocations for some eastern European countries are likely to be as, or more, generous—especially the grant component.

So, the recovery fund will provide support for weaker euro-area sovereigns as they attempt to rebuild their economies. That's important, as they work to ensure that the policy errors which undermined Europe’s recovery from the global financial crisis are not repeated. Even allowing for the low expectations from a few months ago, there’s little doubt that Europe’s policy response to COVID-19 has been impressive and warrants cautious optimism on the cyclical outlook.

Seeing the Recovery Fund in Context

But it’s important to retain a sense of perspective and recognize what the recovery fund is and is not. It's best seen as a temporary, though significant, expansion in the EU’s multi-annual budget—which already allocates funds between net contributors and net beneficiaries. And it has come in response to a completely unprecedented economic shock. The new facility is described in exactly these terms in the official communiqué.

There is, though, a unique feature of the recovery fund. For the first time, it enables the EU to borrow in size and on its own account. (There’s also provision for modest EU tax-raising powers, though these haven’t yet been defined.) It’s possible that this initiative will one day be seen as the first tentative step towards fiscal union. But there’s no mutualization of past debts here, and this is not Europe’s “Hamilton moment.”

The numbers also need to be put in context. Grants worth 4 or 5% of GDP are not to be sniffed at, but public-sector debt/GDP ratios are now above 100% in several euro-area countries and cumulative budget deficits for the 2020–23 period are in some cases likely to exceed 20% of GDP. The recovery fund, combined with European Central Bank (ECB) bond purchases, should help peripheral countries plug substantial funding gaps over the next year or so. But it’s a drop in the ocean when it comes to the solvency of EU debtor nations. Fortunately, the ECB has this problem covered through its longstanding and extensive monetary support operations.

A Big Positive Relative to Expectations

The market has reacted positively to the recovery fund with the spread between Italian and German government bonds now back close to pre-COVID-19 levels (Display).
Although we’re skeptical that Monday’s agreement represents the giant step towards fiscal union that some commentators claim, more optimism on the cyclical outlook is entirely warranted in our view.

The fund may be too small to lift the burden of supporting weaker euro-area sovereigns from the ECB’s shoulders. But it does mean that monetary and fiscal policy are both pointing in the same direction in the euro area. And relative to expectations at the beginning of the crisis, that’s a big positive.

¹A reference to the assumption/mutualization of US state debt by the federal government in 1790 in partial exchange for federal tax raising powers

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