The EU Recovery Plan: economic rationale and insights for Belgium

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ABSTRACT

Economists regard COVID-19 as a global and exogenous shock. In response, the EU set up a recovery plan consisting of grants and favourable loans to Member States over 2021-2026. The pandemic affected countries dependent on tourism more than the other countries. The recovery plan therefore involves an aspect of solidarity by providing grants and by taking into account both the initial vulnerability and the economic damage caused by COVID-19 in the Recovery and Resilience Facility allocation criteria for the grants. Thanks to these criteria, Italy and Spain are the main beneficiaries in terms of grants. Together with loans, this will boost their economic activity over the medium term more than in Germany, France and Belgium.

In exchange for EU grants and loans, all countries must submit Recovery and Resilience Plans describing the investments and reforms that they intend to carry out with a view to strengthening their economies. Belgium was expected to receive only € 5.9 billion worth of grants. This amount might even be substantially lower once the effective GDP losses for 2020 and 2020-2021 are known in spring 2022. Nevertheless, as a small open economy, Belgian GDP might benefit more from the Recovery and Resilience Plans implemented in Germany, France, Italy and Spain than from its own plan.

Early in the COVID-19 crisis, European Union authorities and the Member States' governments have set up a common policy response in the form of an EU-wide recovery plan, Next Generation EU (NGEU), amounting to €806 billion (€750 billion in 2018 prices). This plan is designed to speed up the recovery from the crisis and reinforce the resilience of the European economies.

Around 90 % of the NGEU Recovery Plan goes to the Recovery and Resilience Facility (RRF). In exchange for EU grants and favourable loans, Member States must submit National Recovery and Resilience Plans to the European Commission (EC) detailing investment projects and reforms.

In two articles, we will discuss several insights for the whole EU and euro area as well as for Belgium based on two articles published in the Economic Review of the National Bank of Belgium during the second semester of 2021 (Bisciari *et al*., 2021a and b). In this article, we explain the economic rationale behind the Recovery plan and the RRF, the main characteristics of this Facility and its expected economic impact. In a second article, to be published in the next edition of the *Revue Bancaire et Financière*, we will compare the National Recovery and Resilience Plans (NRRPs) of the four main euro area economies (Germany, France, Italy and Spain) with that of Belgium.

This article is organised as follows. The first section looks at the rationale for the NGEU Recovery Plan. The main features of the RRF are presented in section 2. Therein, we also discuss the amounts of RRF grants that can be expected for each Member State, both at the time the NRRPs were drafted and now. In section 3, we highlight the main insights from simulations of the economic impact of the NGEU.

1. Economic rationale of the NGEU Recovery Plan

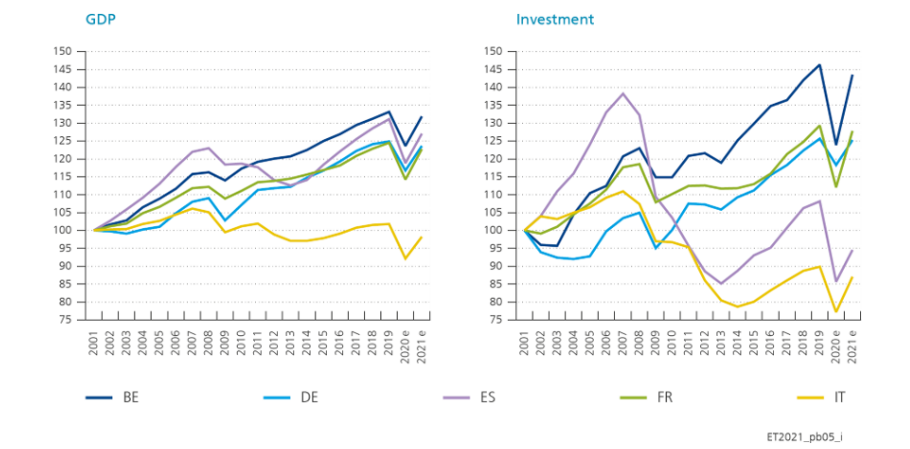
The COVID-19 virus came into Europe via Italy and then Spain before spreading to most of other Northern and Western European countries with the Central and Eastern European countries being largely spared in the spring of 2020. At that time, all EU countries were expected to face a severe recession as most Member States implemented lockdowns and restrictions to trade (closing shops and even closing borders in an initial phase) challenging the smooth functioning of the Single Market and destabilising supply chains.

While acknowledging extremely high uncertainty surrounding the estimates, the EC projected in Spring 2020 the EU economy to contract by 7.5 % in 2020 before partially rebounding in 2021. This major economic shock, unprecedented since World War II, was common to all Member States, requiring a common economic policy response. The NGEU Recovery Plan is a more structural response of the EU institutions to the COVID-19 crisis, besides immediate short-term response within the flexibility of the EU budget and new funding streams of three safety nets (SURE, EIB and ESM), the strong relaxation of monetary and prudential policies, the activation of both an easing of state aide rules and the general escape clause under the Stability and Growth Pact on the fiscal side, the latter having opened the door to an expansive fiscal policy by the Member States.

Italy and Spain were hit harder by the first wave of the epidemic than other countries. The asymmetric effects of this shock were all the greater because it hit the (contact-intensive) services sector hardest, and most notably tourism and the hospitality sector both of which are crucial for the economies of the Mediterranean rim. The shock was also perceived as exogenous and thus not prone to any moral hazard argument. In that, it was very different from the financial crises where imbalances had accumulated endogenously.

Besides, the COVID-19 shock has affected mainly vulnerable countries. Among them, Italy and Spain had suffered badly from the sovereign debt crisis in the euro area between 2011 and 2014. At the time, GDP had fallen sharply in real terms and, even by 2019, the Italian economy was still far below the level of activity that it had seen before the 2008 financial crisis (chart 1).

Chart 1 - In May 2020, COVID-19 was expected to exacerbate the differences in GDP and in investment among the main euro area economies
(index 2001 = 100)



Source: EC, May 2020 economic forecasts.

Even before the financial crisis, Italy had already faced sluggish growth. Apart from the small contribution made by investment, it was also a case of low total factor productivity, most notably less innovation potential, brain drain and misallocation. Added to that were other factors of imbalance that the EC and Ecofin had felt to be excessive in the Macroeconomic Imbalance Procedure: very high government debt, inefficient public authorities and a fragile banking sector (table 1).

Unlike Italy, after the property bubble burst, Spain had returned to stronger and sustainable growth since 2014 but it was building up even more macroeconomic imbalances. The EC had pointed up its vulnerability related to the high debt, both external and internal and both private and public, in a context of high unemployment. Ecofin (2021) also noted the high proportion of workers on fixed-term contracts, structurally low productivity growth and shortfalls in terms of investment.

Germany, France and Belgium had approached the pandemic in less unfavourable conditions than Italy and Spain. In Belgium, the government sector has a relatively high debt and the EC acknowledged that France had macroeconomic imbalances, “in particular relating to high government debt, weak competitiveness and low productivity growth” (Ecofin, 2021). Germany, however, was confronted with a rather different macroeconomic imbalance, namely the fact that it had posted very high surpluses on its current account in a context of under-investment. Albeit to varying degrees, a lack of investment was a fairly widespread concern within the euro area.

Italy and Spain's more pronounced weaknesses gave rise to specific recommendations from the Ecofin Council in July 2019 and 2020 for these countries, covering a wider field and a firmer attitude towards them than in the cases of Germany, France and Belgium.

Table 1 - Structural challenges identified by the European Commission

Structural challenges	DE	FR	IT	ES	BE
Labour market					
High unemployment rate			youth	x	x
High share of workers on temporary contracts				x	
Low participation/activity rates	vulnerable groups		women		x
Macroeconomic imbalances	x	x	excessive	x	
High current account surplus	x				
High external debt				x	
High private debt				x	
High public debt		x	x	x	x
Banking sector fragilities			x		
Lack of competitiveness		x			
Other structural vulnerabilities					
Low productivity growth		x	x	x	
Shortfalls in investment	x			x	
Inefficiencies in public administration			x		
High tax burden on labour					x
Business environment					x

Source: Ecofin (2021), own compilation.

Owing to the lopsided effects of the COVID-19 shock which hit the initially more vulnerable countries disproportionally hard, the acute economic crisis generated by the pandemic risked rekindling the tendency towards divergence between the main economies of the euro area that had been observed during the sovereign debt crisis. For instance, in its spring economic forecasts in May 2020, the EC said it was expecting the Italian economy to bounce back less strongly than other countries' economies. Moreover, at one point in March 2020, financial market participants were varying their sovereign bond purchase and sale habits between Germany, on the one hand, and Italy and Spain, on the other hand, which risked limiting the latter two countries' fiscal space.

The crisis that was triggered by the exogenous shock of the pandemic therefore provided the motivation for the European-level implementation of a coordinated recovery plan that involved an aspect of solidarity through grants and by taking into account both the initial vulnerability and the economic damage caused by COVID-19 in the Recovery and Resilience Facility allocation criteria. Involving both grants and loans, this Facility constitutes the main instrument of the Next Generation EU recovery plan on which the Heads of State and Government agreed in Brussels on 21 July 2020.

2. The Recovery and Resilience Facility

In exchange for EU grants and favourable high-rated loans (AAA), the Member States had to commit to investing the money largely in the green and digital transitions, as well as to adopting reforms intended to reduce their vulnerability and strengthen their resilience. To this end, all countries had to submit investment and reform plans (by 30 April 2021 as a target date and mid 2022 as an absolute deadline) as well as a precise implementation schedule. These are the National Recovery and Resilience Plans. The NRRPs contain the targets and milestones of reforms and investments until 2026.

By the end of 2021, all EU Member States but the Netherlands – where a government has only been formed in December 2021 - had submitted their NRRPs, the four main euro area economies and Belgium being among the 13 Member States having met the 30 April deadline with at most a one-day delay.

The EC assesses the NRRPs and prepares a Council Implementing Decision which then must be approved by the Council within a month. Among the *ex-ante* assessment criteria for the plans, investment and reforms have to tackle all, or at the very least, a significant sub-set of challenges identified in the specific recommendations addressed by the Ecofin Council to EU countries in the 2019 and 2020 cycles of the European Semester; at least 37 % of all expenditure has to contribute to the climate transition (although the plans also have to target other dimensions of the green transition like biodiversity) and no measure included in the plans may harm the environmental objectives in any significant manner; at least 20 % of all expenditure must go into the digital transition; it has to have a lasting effect on economies; investment and reforms need to make up a coherent set of actions. By 16 December 2021, the Council has approved implementation decisions for 22 NRRPs and the EC has not yet approved the assessments for Poland, Hungary, Bulgaria and Sweden.
In the second half of 2021, most Member States have also received a pre-financing of 13 % of the grants. This happened in August for the first countries among which Belgium. In a next step, Spain followed by France, Italy and Greece were the first to conclude operational agreements with the EC. After a positive preliminary assessment, the EC has paid a first instalment of €10 billion to Spain as the relevant milestones and targets had been satisfactory fulfilled.

The maximum volume of the loans for each Member State cannot exceed 6.8 % of its 2019 Gross National Income. Among the five countries considered in our articles, Italy is the only one to have applied directly for loans and it has asked for the maximum amount of loans allowed, i.e. €122.6 billion. Spain may apply for loans later for a potential amount of around €70 billion, probably for the 2024-2026 period.

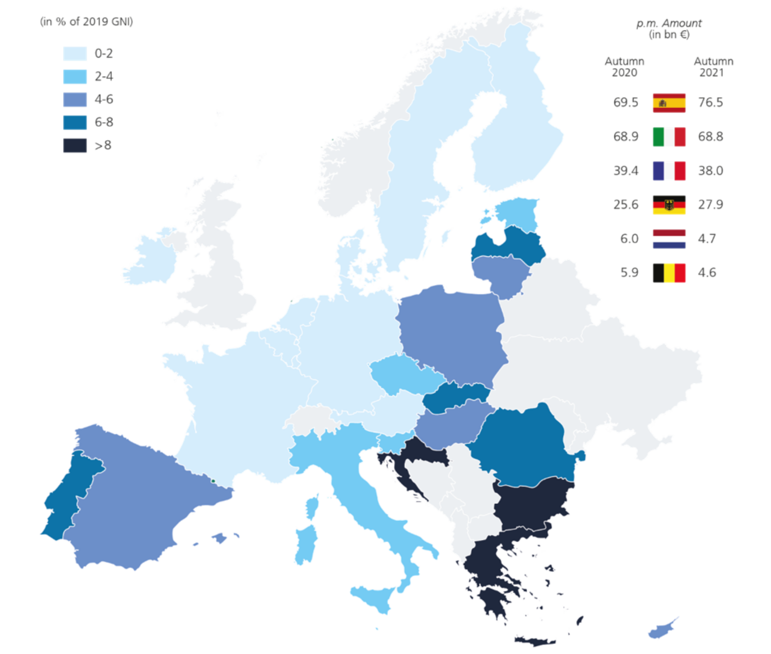
Most of the grants (70 %) will be committed in the years 2021 and 2022 and the allocation key between Member States includes the population to reflect the size of the countries and two indicators of their vulnerabilities: the inverse of GDP per capita and average unemployment rate over 2015-2019. In the allocation key for 2023, the latter criterion is replaced, in equal proportion, by the loss in real GDP observed over 2020 and by the cumulative loss in real GDP observed over the period 2020-2021 and final allocations will be calculated by 30 June 2022.

The RRF Regulation provisionally estimated the grants based on the Commission's autumn 2020 forecast and these amounts have served as a reference for the Member States to draw up their NRRPs.

As a result, Central and Eastern Member States as well as Southern Member States are expected to receive a larger share of grants expressed in percentage of their 2019 GNI than Northern and Western Member States, notably Belgium and its neighbouring countries (chart 2).

On top of the loans, Italy is expected to receive €68.9 billion worth of grants and thus no less than €191.5 billion of RRF funding. Spain will receive the highest absolute amount of RRF grants: €69.5 billion and, being the smallest of the four big euro area economies, it will also receive the highest share of RRF grants in relation to GDP. While being a smaller economy than Germany, France will get €39.4 billion worth of RRF grants, whereas Germany will be entitled to €25.6 billion. As for Belgium, the expected €5.9 billion (1.2 % of GDP over the period 2021-2026) has been retained as the budget for the NRRP.

Chart 2 - Central and Eastern European and Southern European countries are expected to receive higher RRF grants in relation to their Gross National Income



Source: EC, autumn 2020 and autumn 2021 forecasts.

The amounts of the RRF grants may however differ significantly from those provisionally set in the autumn of 2020 (Box 1). Since then, as the GDP estimates for 2020 and 2020-2021 worsened relatively more in some countries than in others, we expect, on the basis of the latest economic forecasts published by the EC (autumn 2021 forecasts), a substantial upwards revision for the amounts to be granted to Spain (around €7 billion) and to a lesser extent to Germany (around €2.3 billion). Conversely, due to relatively better economic development than expected in the autumn of 2020, the amounts to be granted to France, the Netherlands and Belgium could be reduced by €1.3-1.4 billion.

Based on the timing of the instalments in EC documents in June/July 2021, the time profile for the grants to be received is hump-shaped and frontloaded across the five countries considered. As expenditure is expected to have started and/or take place before the payment request, the time profile of spending may be even more frontloaded than that for the grants.

Box 1. The coronavirus economic damage criterion and underlying uncertainty

Originally, the Commission proposal in May 2020 foresaw only population, the (inverse of) GDP per capita and the pre-pandemic unemployment rate in the allocation key formula for the RRF grants. To various commentators - notably Codogno (2020) and Darvas (2020) - but also several Member States among which Belgium, it came as a surprise that the economic damage from coronavirus was not a criterion to allocate the grants for a Recovery Plan created to help alleviating the costs of this atypical crisis generated only by an exogenous shock, i.e. a pandemic.

Table - Introducing in the RRF grants allocation key a criterion related to the economic loss resulting from COVID-19 has benefited some countries (at the expense of others), but the final result is still uncertain (shares in %)

	Allocation key for the 70 %	**Allocation key for the 30 %**		
	Fixed	p.m. Summer 2020	**Autumn 2020**	Autumn 2021
DE	7.0	8.0	9.0	11.2
FR	10.4	15.7	14.5	13.2
IT	20.5	22.2	20.3	19.9
ES	20.0	16.8	22.2	28.7
PL	8.5	4.3	3.5	2.4
BG + RO	6.3	6.2	5.5	3.1
NL	1.7	2.1	2.0	0.7
DK + SE	1.8	1.4	0.6	0.5
Baltics + FI	2.6	2.0	1.1	0.5
BE	**1.6**	**1.9**	**2.2**	**0.9**
EL	5.7	3.8	4.1	4.4
CZ	1.5	3.6	3.4	3.9
PT	4.1	4.3	4.0	5.4
HU	2.0	2.1	2.5	1.2
AT	1.0	1.0	1.2	1.5
Others	3.0	2.4	2.4	1.5
SK	2.0	1.6	1.6	0.9
IE	0.4	0.5	0.1	0.0
EU27	**100.0**	**100.0**	**100.0**	**100.0**

Source: EC, own calculations.
(Group of) EU Member States are ranked in declining order of population.

Ahead of the July 2020 European Council, the creation of a 30 % tranche for a second allocation in 2023 had been acted and the criterion of economic damage from the COVID-19 crisis had replaced the backward-looking pre-coronavirus unemployment rate.

When comparing the (fixed) allocation key for the 70 % of the RRF grants (including the unemployment rate before the pandemic) and the allocation key for the remaining 30 % as possibly estimated at the time of the European Council on the basis of the summer 2020 forecasts published by the Commission in early July, France, Germany, Italy, the Netherlands and Belgium were among the countries to gain from this change in the allocation key. In contrast, a country like Spain, despite being badly hit by COVID-19, was expected to record a substantial loss in grants in the second tranche because its structurally very high unemployment rate was no longer accounted for. Some Eastern European Member States like Poland that were less badly affected by the first wave of the pandemic were expected to lose out substantially too.

The relative deterioration of the economy in several countries due to the second wave of coronavirus that hit Europe after the summer of 2020 led the EC to revise its forecasts in autumn 2020 and to raise its prospects of RRF grants for these Member States. This was especially so for Spain but also Germany and Belgium that found themselves at the epicentre of a new wave of infections in October. Accordingly, the share of countries first hit by the pandemic like Italy or France receded somewhat.

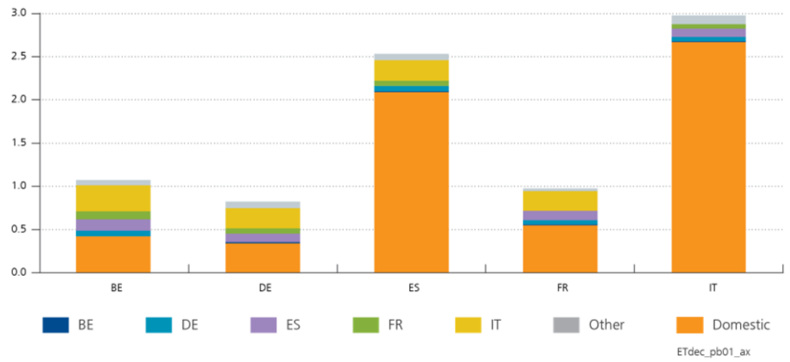
The allocation key has already moved considerably. National accounts for the year 2020 have already been approved and published by Eurostat in April and October with a base effect for the loss computed for both years 2020-2021. And, for the year 2021, we can consider the latest autumn 2021 EC forecasts. According to these figures, all EU countries around the Baltic Sea (but Germany) as well as some Eastern EU countries (Romania, Hungary and Slovenia), the Netherlands and Luxembourg are now expected to get back to their 2019 GDP level in 2021 so they will not benefit from part of the GDP loss criterion (that related to the GDP loss over 2020 and 2021 taken together). This explains the drop in their allocation compared to the provisional allocation made on the basis of the autumn 2020 forecasts. In Ireland, GDP even grew in 2020, so it will not be entitled to receive anything from the 30 % part of the RRF grant.

On the contrary, as the relative economic outlook for Germany and Spain has deteriorated, their allocation key is expected to increase somewhat with respect to the grants pre-allocated on the basis of the autumn 2020 forecast. As their economic outlook has brightened more than the EU average, the shares of France, Italy and Belgium have shrunk. If the autumn 2021 forecasts turn out to be right by June 2022, Belgium stands to lose €1.35 billion of its €5.9 billion RRF grant.

3. Expected economic impact of NGEU

The NGEU expenditures are expected to boost the EU's real GDP by 1.5 percentage points relative to a baseline scenario without this EU Recovery Plan according to simulations performed by the EC (Pfeiffer *et al.*, 2021). This peak impact is found in the last year of the implementation period considered, i.e. 2024 if the NGEU is assumed to be implemented quickly at a linear pace over only four years.

Chart 3 - The National Recovery and Resilience Plans of the four big euro area countries may contribute more to the Belgian GDP than its own NRRP
(contribution in percentage points to the deviation of real GDP after four years from a no-NGEU baseline, implementation over 2021-2024)



Sources: Pfeiffer *et al.* (2021), own calculations.

These simulations do neither take into account the reforms to be implemented by the Member States nor the positive interactions to be expected between reforms and investment. Nevertheless, they include the impact of cross-border spillovers, i.e. the impact that each NRRP has not only on the domestic economy but also on the other EU Member States' economies through trade and, for non-euro area countries, exchange rate channels. The EU-wide GDP effects are estimated to be around one-third larger when explicitly accounting for spillover effects.

These spillover effects are particularly important for small open economies like Belgium. Indeed, the NRRPs of the four main euro area countries may contribute more to the Belgian GDP than its own NRRP (chart 3). These spillover effects are also more important when they come from big countries, and especially from the big Member States that will receive a higher share of grants and loans from the NGEU recovery plan. Most of the spillover effects in the big countries are indeed found to emanate from the other big countries.

Thanks to the spillover effects, real GDP could be boosted in the medium term more in Belgium than in France even if France is expected to receive a higher share of grants in percentage of GDP than Belgium. Due to the much higher amounts of grants and loans to be expected, Italy and Spain are also expected to benefit from a bigger impact on real GDP than the other three countries considered.

Conclusion

The crisis that was triggered by the exogenous shock of the pandemic provided the motivation for the European-level implementation of a coordinated recovery plan that involved an aspect of solidarity through grants and by taking into account both the initial vulnerability and the economic damage caused by COVID-19 in the Recovery and Resilience Facility (RRF) allocation criteria for the grants. Due to these criteria, Italy and Spain will be the main beneficiaries both in terms of grants (and loans) but also in expected impact on economic activity.

In exchange for EU grants and loans, all countries have submitted National Recovery and Resilience Plans (NRRPs) describing the investment and reforms that they intend to carry out with a view to strengthening their economies both in the short term and in the medium and long run.

Belgium was expected to receive only € 5.9 billion of RRF grants and not to request any loan. Once the effective GDP losses for 2020 and 2020-2021 will be known in the Spring of 2022, this amount of grants might even be substantially lower. Nevertheless, as a small open economy, Belgian GDP might benefit more from the NRRPs implemented in Germany, France, Italy and Spain than from its own NRRP. The NRRPs of these countries will be the subject of a second article to be published in the next edition of the *Revue Bancaire et Financière*.

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