Poland and Hungary have much to lose from ECJ decision

The European Court of Justice last week dismissed complaints from Hungary and Poland against a tool that ties EU funding to the rule of law. Poland and Hungary have too much to lose from a prolonged legal conflict so we see the odds in favour of a deal. Without an agreement before year-end, both countries stand to lose 70% of their grants from the Recovery Fund

What is the Rule of Law Conditionality Regulation and how far could it reach?

In December 2020, the Council of the European Union and the European Parliament adopted a new regulation creating a general mechanism on Rule of Law Conditionality. This new legislation aims to sanction rule of law violations linked to EU funds, in order to ensure effective protection of the EU budget and the interests of its beneficiaries.

According to the political resolution of the European Council, the mechanism can only start with the 2021-2027 budget cycle, thus it won't affect the payments for the period of 2014-2020.

Although the mechanism has been in place since the start of 2021, the European Commission said it would wait for the European Court of Justice's ruling on the two appeals by Poland and Hungary before activating the procedure. A delay on the effective start of the mechanism was agreed in late 2020 as a concession for an agreement on changes to the EU treaties, creating the Recovery Fund. In March 2021, Hungary and Poland submitted legal complaints to the ECJ against the conditionality mechanism, which makes the receipt of financing from the EU budget subject to member states' respect for the rule of law.

What is the ECJ's ruling and why does it matter so much economically?

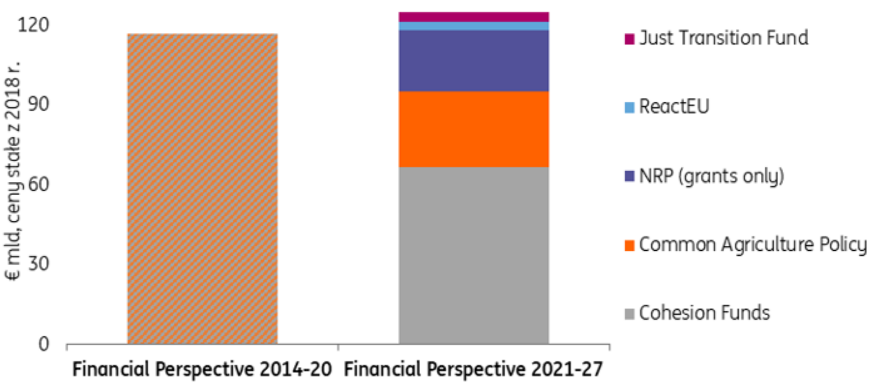
On 16 February 2022, the ECJ dismissed the actions brought by Hungary and Poland in their entirety. The verdict was in line with the opinion of the ECJ spokesman in early December 2021.

The verdict was a significant event in the prolonged legal conflict between Poland and Hungary and the EU over the rule of law and associated with the EC decision to block funds from Poland's and Hungary's National Recovery Plan. For Poland, the RRF consists of €24bn in grants and €12bn in preferential loans while for Hungary, the RRF brings access to €5.9bn in grants and €10bn in preferential loans, though Hungary has laid claim only to the grants for now.

In order to get access to these funds, Poland needs to implement legal amendments to the structure of the supreme court and reach a compromise with the EU, while the main topic for Hungary is the public procurement process.

In the context of the ECJ verdict, we see two important points: First, Poland and Hungary have until the end of December this year to reach an agreement with the EU institutions otherwise they may lose 70% of allocated NRP grants, which is about €17bn for Poland and roughly €4.1bn for Hungary. This is because, according to the official regulation on the Recovery and Resilience Facility, the EC makes 70% of the grants available for allocation until 31 December 2022. This deadline is associated with the initial objective of the Recovery Plan, which assumed accelerated EU payments from the new facility in order to support the recovery of EU economies after the Covid-19 pandemic.

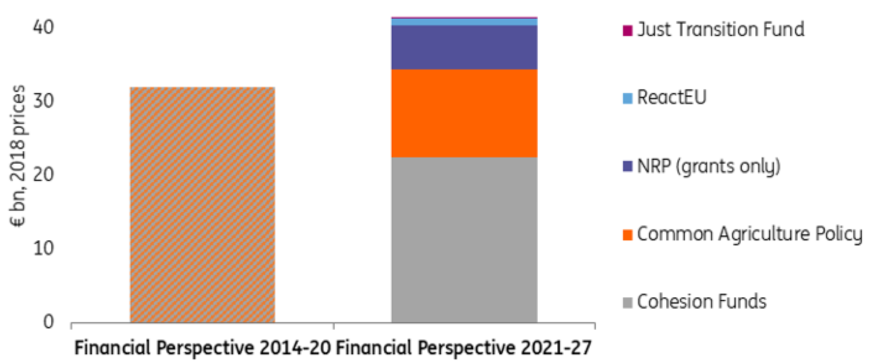
Projected inflows of EU funds to Poland in the EU's budget 2014-20 and 2021-21, in 2018 € billions



Source: ING estimates based on national and EU documents

Second, a failure to compromise with EU institutions would have negative implications in the future because this would put at risk payments of cohesion funds worth about €76bn for Poland and €24.3bn for Hungary in the next EU budget 2021-27. If applied, the conditionality mechanism would refer not only to the NRP, but also to the new EU budget. Poland and Hungary still need to sign a formal Partnership Agreement on this with the EU. Direct payments to farmers would not necessarily be at risk because they are governed at the EU level rather than the national level.

Projected inflows of EU funds to Hungary in the EU's budget 2014-20 and 2021-21, in 2018 € billions



Source: ING estimates based on national and EU documents

Will the EC implement the conditionality mechanism?

With the ECJ's decision, the Commission will be able to start the procedure though it has not yet taken any official steps to do so. The Commission's refusal to give the green light to the NRP suggests that combining the rule of law conditionality with the NRP is the Commission's preferred way forward. Back in November 2021, the Commission sent informal letters to Hungary and Poland asking for information on matters which could fall within the scope of the rule of law regulation.

The Commission asked the Hungarian authorities about real estate developments around Lake Balaton, state land auctions, the outsourcing of universities to foundations and the planned sale of shares in Budapest Airport. The EC also raised concerns about the conduct of public procurement, the activities of the prosecution and the independence of the judiciary. The major issue with Poland is the independence of the judiciary, specifically, the functioning of the disciplinary chamber in the supreme court.

However, given the current geopolitical situation in Eastern Europe, and an upcoming general election in Hungary on 3 April, we think that the EC will not start a formal procedure anytime soon.

It would take three to five months to reach the first really important milestone in the rule of law mechanism, which presents a window of opportunity for a possible compromise. In the pessimistic case, if all dialogue ceases, the EU Committee could submit a proposal to the Council of the European Union to withdraw the rights to transfer EU funds. The Council would then decide by qualified majority within one month of receiving the proposal. In exceptional cases, this deadline may be extended by a maximum of two months, giving one last chance for a compromise.

What are the financial and economic implications?

An agreement between Poland and Hungary with the EU institutions is necessary to unlock the NRP this year and prevent delays or even a suspension of cohesion funds.

In Poland, any steps towards reaching a compromise would reduce the premium in Polish assets which is priced in due to the risk of a prolonged conflict. This factor adds uncertainty and is preventing the zloty from appreciating (although the premium in PLN demanded by investors to compensate for the risk of a possible freeze in EU funds has recently fallen, and the main factor preventing the PLN from appreciating is Russia's actions against Ukraine). In the current environment, the main argument in favour of a stronger zloty is aggressive monetary tightening. The latest verbal interventions by the National Bank of Poland, which supported expectations of continued interest rate hikes and reinforced the central bank's preference for a stronger zloty, would be a more forceful driver if there were less uncertainty on access to EU funds.

The suspension of NRP or cohesion funds from the 2021-27 budget not only has an impact on the exchange rate but also on the economy, undermining the green and digital transformations. According to our estimates, Poland's GDP growth may slow by about 0.5 percentage points in 2022 and even 1ppt per year in 2023-25 under the pessimistic scenario.

In Hungary, the situation is a bit more delicate with a general election looming on 3 April. We expect the next Hungarian government to come up with a compromise. This is because, in six months' time, both monetary and fiscal policy will become restrictive, fighting against inflation and curtailing GDP growth. In this respect, matching the original debt and deficit target could become more challenging. Considering the possible market turmoil caused by the Federal Reserve's tightening cycle, as well as expectations that the ECB might start preparations for its own hawkish shift, refinancing debt for Hungary will become even more expensive.

Also, the importance of EU funds for the Hungarian budget is very significant due to the so-called pre-financing process. The Hungarian government has been pre-financing EU projects 100% from the budget, which creates a shortfall and debt accumulation. If the EU cuts the transfers, this means that Hungary is not only unable to spend the money, it must recover the money that was pre-financed.

Summary

Against this backdrop, access to EU funds for both Poland and Hungary is very important from a fiscal, real economy and financial market point of view. In the short term, we may hear opposing comments and a lot of posturing, but we assume that rational arguments will prevail and the odds for both a Polish and Hungarian compromise with the EU are more than 50%.

We think that access to the NRP will be unlocked in the second half of 2022, before the deadline of 31 December (in the case of Poland potentially even earlier than the second half of the year). Financial markets seem to be assigning a higher probability to our optimistic scenario. In our view, the recent rise in geopolitical tensions has increased the likelihood of a compromise by both the member states and EU authorities. It is still possible that the conditionality mechanism is reactivated in due course, should the threat to the rule of law resurface in 2023 or beyond.

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