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Some fresh hope for the EU Recovery Fund

The Franco-German proposal for €500 billion of EU fiscal spending funded by borrowing on markets is a potential game changer, but a lot needs to happen still before the fund sees the light of day

The German Chancellor and French President, July 2017

Source: Shutterstock

If nothing else, European leaders are making good progress at video conferencing. The press conference by Merkel and Macron this afternoon was a relatively smooth operation between Berlin and Paris, but to lead with that alone would be much too cynical. The French-German proposal presented is an important step towards an EU Recovery Fund.

The proposal's main dish from an economic perspective is a €500 billion Recovery Fund. The fund is meant to be temporary, funded by the EU through borrowing on the markets and will be part of the next EU multiannual budget (MFF). The funding is set to be frontloaded to provide enough support early. There will be a binding repayment plan spread over multiple EU budgets. The fund will provide direct fiscal stimulus through grants and funds will go to the industries and regions of the EU that have been most hit by the crisis. This comes on top of the already announced package designed by the Eurogroup of €540 billion. We have argued before that while this is a symmetric crisis, we are likely to see an asymmetric recovery, which is why a fund specific to the recovery phase is in focus among politicians at the moment.

Proponents of burden sharing will like the idea but dislike the size (too small) of the fund and will worry about the timing of release as the MFF is only set to start in 2021. Opponents of burden sharing will not like the common debt issuance, the fact that the stimulus is through grants, not loans and will worry about a precedent despite the fund's temporary nature.

Therefore, there's still quite a ways to go before the recovery fund potentially sees the light of day. The ball is currently in the court of the European Commission, which is working on a proposal for the fund. That proposal is due on 27 May. We can expect this to weigh heavily on the Commission's preparations. But some countries are expected to disapprove of the proposal and it needs a unanimous decision from the member states. It's therefore best to take this proposal as a starting point, not an end to the discussions.

Spreads between Italian and German 10-year yields have come down significantly since the announcement. But in the end this is Europe, so there's no reason to cheer until we've had some all-nighters, amendments to proposals and compromises. Still, the proposal does bring the Recovery Fund a step closer and in times when an asymmetric recovery seems likely and the possible role of the ECB in a recovery phase is uncertain, it's understandable that the French-German proposal is received positively on the markets.

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