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The economic impact of Europe’s audacious recovery plan

The EU's Recovery and Resilience Fund is no game-changer for economic growth, but it's no paper tiger either. It will nudge the recovery in the right direction, especially for those countries which are particularly vulnerable

European Commission President Ursula von der Leyen

Numbers at a glance

The agreement between EU leaders on a recovery fund can be considered a new milestone in terms of European solidarity and opens the door towards more integration. The most notable part of the agreement is that the EU will borrow from capital markets for subsidies to countries for the first time. Now that this is sinking in, the question is whether the impact of the fund will be largely symbolic or whether it actually will have a significant economic impact? So I've been crunching the numbers.

- The size of the Next Generation EU recovery effort is significant at €750bn.
- It will make the EU the third-largest borrower after Germany, France and Italy by 2021
- It is split between 390bn euro in grants and 360bn euro in loans.

Out of that, the specific tool meant to boost economic recovery is the Recovery and Resilience

Fund (RRF).

- This gets 312.5bn euro in grants and 360bn euro in loans.
- Of the grants, 70% will be disbursed in 2021 and 2022 and the last 30% will only be available in 2023.
- They are conditional on progress made regarding a recovery and resilience plan, to be submitted to the European Commission.

? Who gets what?

For the first two years and 70% of the RRF grants, the allocation key has already been determined. This depends on:

- The population of the country in 2019,
- GDP per capita in 2019 and unemployment between 2015 and 2019.

That means that 70% of the grants are disbursed based on economic performance going into the crisis, not during the crisis itself. The 30% disbursed in 2023 replaces the unemployment component by GDP growth during the coronavirus crisis in the calculation, making it more dependent on the Covid-19 impact itself.

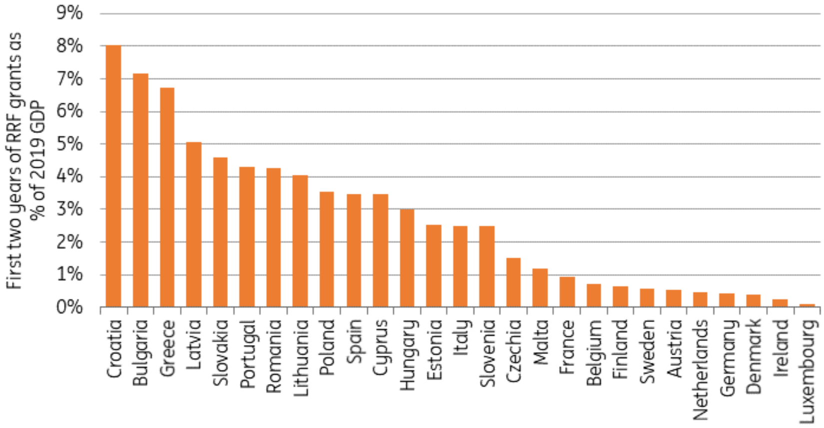
So here's what I'm looking at. I'll focus on the maximum grants for 2021 and 2022 by country, as those are already set and because they are most relevant for the recovery in terms of timing. Regarding loans, the eligibility is not yet determined and the take-up on them will be doubtful, meaning I'll stick to grants here.

Central-eastern and southern European economies stand to gain the most

The chart below shows that there are large differences between countries in terms of potential stimulus for their economies. Mind you, this is stimulus as a share of 2019 GDP and given that GDP will likely still be below 2019 levels in 2021 and 2022, the impact will still be somewhat higher depending on the severity of the crisis of course.

Overall, central-eastern and southern European economies stand to gain the most from the fund. Croatia, Bulgaria and Greece lead the pack with stimulus potentially north of 6% over two years. Of the larger economies, Spain and Poland get around 3.5% of GDP, Italy around 2.5% and France, Germany and Netherlands under 1% of GDP over those two years.

Maximum grants differ significantly between countries

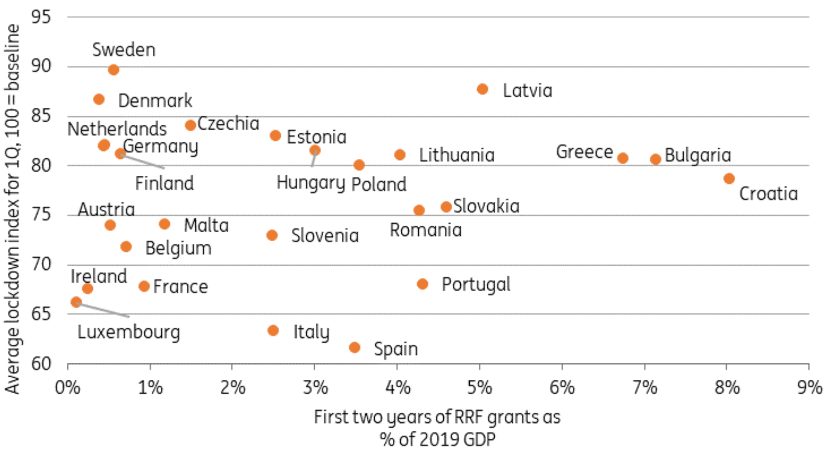


Source: ING Research, Google COVID-19 Community Mobility Reports

? Do the more vulnerable countries stand to benefit most?

As the purpose of the recovery fund is to provide relief for the hardest-hit economies, the question is whether the predetermined method actually benefits the countries most affected by the coronavirus crisis. One way of assessing this is by looking at the depth and length of the lockdowns in different countries, as this has proven to be a key determinant of the economic crisis. The chart below shows there is little relationship between the severity of the lockdown and the maximum grants for the first two years.

Grants are not strongly related to the severity of the lockdown



Source: ING Research, Google COVID-19 Community Mobility Reports

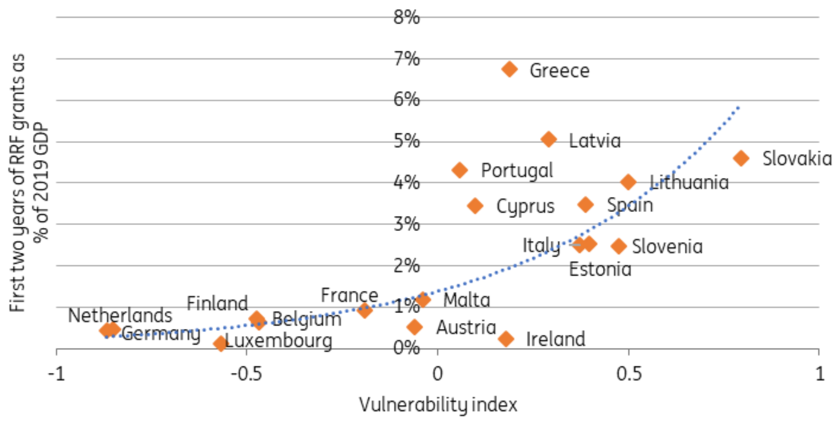
Note: index of activity since Feb 15 for retail & recreation, groceries & pharmacies and workplaces using Google Covid19 Community Mobility Reports with data through June 23. 100=baseline of activity between Jan 3 and Feb 9

It's all in the bounce

The question is of course not necessarily just how deep the recession is now, but also how quickly an economy can bounce back from it. That is something that we have focused on looking at just eurozone countries in a previous note. For that, we created a vulnerability index that captures the likelihood of an economy experiencing a prolonged slump due to the Covid-19 crisis. As you can see below, the relationship between the maximum grants as a % of GDP and the vulnerability index is a lot stronger, which shows that the money could well end up where it is most needed on average.

Countries that stand to gain more than the vulnerability index would suggest are Greece and Portugal for example, countries which are slightly more vulnerable than the eurozone average to a weak recovery but receive among the highest RRF payouts. Ireland has a similar risk to a weak recovery but receives a smaller share of GDP from the RRF than even the Netherlands and Germany.

Countries more vulnerable to a longer economic slump stand to gain more from the RRF grants



Source: ING Research, Google COVID-19 Community Mobility Reports

Note: vulnerability index comprises an average of normalised indicators: automatic stabilisers, emergency fiscal spending as a percentage of GDP, percentage employment of small enterprises (under 10 employees), average of the three financial conditions factors mentioned in the text, liquid household assets as a percentage of GDP, sectoral composition and the average for our lockdown index.

? Will it have a meaningful impact on the recovery?

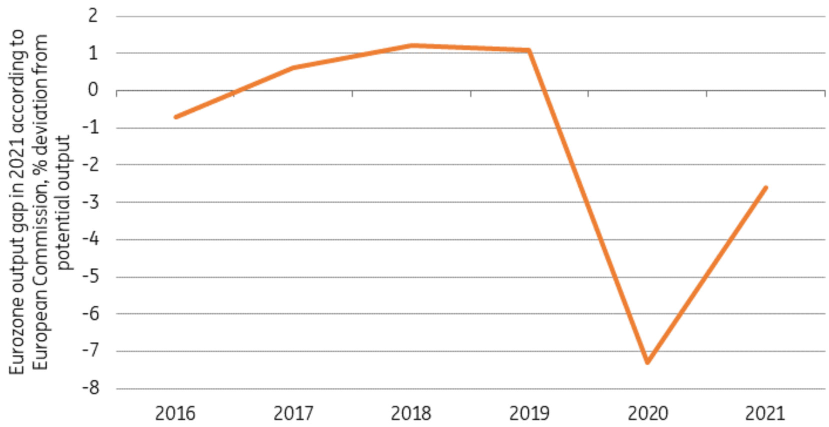
The big question is whether the fund will really make a difference or largely serve an important role through symbolism as the first mechanism through which the EU borrowed in the markets for subsidies to member states? This depends on the timing and the size. As mentioned above, the size is significant for a few of the CEE and southern eurozone economies, but definitely not all. But also for those countries which get more than 1% of 2019 GDP, the amount of stimulus provided through the RRF is significantly smaller than what national governments are providing in terms of fiscal injections. According to Bruegel estimates of the immediate fiscal impulse, only Greece would receive more from the RRF than from national fiscal injections, while most other economies receive far less than what they already commit to themselves.

The timing of the fund is not ideal for it to have a maximum positive impact

The timing of the fund is not ideal for it to have a maximum positive impact on the economic recovery, and that's also important. Most national stimulus measures are aimed at stimulating the economy now, but as the RRF only starts to disburse in 2021, it does not help stability in the depth of the crisis itself. It does boost the economy in the recovery phase, but the positive effects through multipliers would likely be stronger the sooner the money is sent out. It is important to note that the European Fiscal Board has already warned against too tight budgetary stances in 2021 though, so the RRF grants are also useful to counter effects on unwinding stimulus. All of this is conditional of a second wave not causing new lockdowns and lengthening the period of economic fallout.

Output gaps suggest that stimulus in 2021 is still useful, but not as effective as in 2020

Source: European Commission Spring Forecast, ING Research



Source: European Commission Spring Forecast, ING Research

Significant output gaps to remain

Looking at expectations of output gaps by the European Commission in late April, we see they expect significant gaps still to exist in 2021. The output gap means that the economy performs below potential, making fiscal stimulus meaningful. Those output gaps are expected to be far larger in 2020 though, -7.3% in 2020 versus -2.6% in 2021. This shows that any stimulus is expected to be more helpful now than next year. No estimates exist for 2022 and 2023, but the gap would only become smaller if not closed in those years if the recovery continues as the EC expects it to.

All in all, despite the EU recovery fund being a truly historic milestone in terms of solidarity and integration, the RRF is unlikely to be a real game-changer for the economic recovery for most economies. Don't underestimate the impact either though; it is definitely helpful in the recovery phase, but smaller in size than most national fiscal emergency spending plans and quite late in terms of disbursement to make it a real turning point as far as the growth picture is concerned.

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