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Macroeconomic Comment

EU-Reconstructin Fund – Opportunity for Reforms, but also Potential Fissure

July 10, 2021, Peter von Elten

A year ago, the 27 EU countries agreed on a **€ 750 billion reconstruction fund** to overcome the Corona-related economic crisis. This program marks a turning point in the history of the EU, as it involves the communitization of debt and liability, with the EU acting as debtor in its own name. Some countries had previously resisted any kind of so-called Eurobonds, even though in fact joint liability has long been established via the ECB's various programs amounting to several trillion. The markets assume joint liability, as the EU's AAA rating makes clear.

Poland was the last of the 27 EU member states to ratify the reconstruction fund in June. The total amount is divided as follows:

- € 360.0 billion loans
- € 312.5 billion grants
- € 77.5 billion grants from existing EU programs, such as structural and investment aid, climate protection etc.

In absolute terms, by far the largest beneficiaries are Italy (€ 191.7 billion) and Spain (€ 154.3 billion). The idea of solidarity becomes particularly clear when the amounts are placed in relation to the gross national product. Here, Greece leads with 17%, while Germany receives the smallest share at 0.8%. Germany is also making the largest solidarity contribution with a repayment obligation that is over € 50 billion larger than what Germany will receive from the program. The first disbursements are due to be made this month.

The reconstruction fund is also referred to as the **NextGenerationEU-Plan**, because the use of its money is intended to point to the future. The slogans "Make it Green, Digital, Healthy, Strong, Equal" describe the EU's requirements. More than 50% of the money is to be spent on research and innovation, climate change, the "Digital Europe" program, precaution and health programs. All 27 countries must submit plans to the EU that meet these requirements.

€ 150 billion is to be disbursed annually in two installments to the states according to the defined distribution key. The EU will borrow the money on its own behalf and benefit from its AAA rating. This year € 100 billion is to be borrowed, the following year € 213 billion and in 2023 another € 200 billion. The program is to be fully financed by the end of 2026. The money is to be repaid over

30 years from 2028 and generated from additional taxes such as a CO2 border adjustment tax, a digital levy, the EU emissions trading system and additional EU budget contributions.

The first sums have not yet been disbursed, and a discussion is already being fueled by countries like Italy and France, contrary to previous agreement, to make joint borrowing a permanent mechanism. Somehow concealed, it is argued that such joint debt should only serve investments in the future. However, Germany and other Nordic countries are (still?) resisting the communitization of debt and liability as a permanent mechanism.

European Sovereign Debt / Debt Brakes

The pandemic has opened the floodgates wide and long-term for significantly higher government debt in Europe. The EU has suspended the so-called Maastricht criteria for debt limitation for several years. National debt brakes have also been undermined by the pandemic. At both levels, new debt limits will only be feasible if they allow much greater leeway. Countries like Italy are even demanding that the bond purchases made by the ECB during the pandemic should be depreciated. An important incentive for the 27 EU countries to give their unanimous approval to the reconstruction fund, as constitutionally required, was the borrowing of money by the EU, which allows them to circumvent an allocation to the national debt ratio.

The enormous funds are tempting some countries to adopt a “new” industrial policy, as German finance minister has announced. In the fight against the pandemic, the EU countries have been given a decisive role, as the restrictions on economic activities imposed by them made clear. The state apparatus has been expanded in many countries during the pandemic. This state influence will also be perpetuated by the reconstruction fund. Various requirements in terms of climate protection are already endangering the competitiveness of European companies in some sectors.

Conclusion

Over the next five years, Europe should benefit from the EU reconstruction plan by additional growth of approx. 1% of the European GDP per year. Moreover, by lifting the debt brake, at least temporarily, the nation states have also given themselves greater leeway in terms of debt. The ECB is likely to continue its policy of financial repression with the help of artificially low interest rates and massive liquidity injections, thus enabling better sustainability of the further increase in debt. The European economy is receiving additional support from the global recovery and

should develop positively in the upcoming years as long as the current boost to inflation, which is largely seen as temporary, does not force the ECB to tighten policy. However, the continuation of expansionary fiscal and monetary policies will further increase the formation of huges bubbles in the years to come.

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Mr. von Elten has decades of experience in the banking industry. Since 2008 he has been a member of the advisory board of BSZ AG, which took over IFP AG in 2014 and thus became Belvoir Capital AG. He enjoyed an international career at JP Morgan for close to 30 years. He returned to Switzerland as General Manager of Schroder & Co Bank AG from 1995 to 2003. Furthermore, Mr. von Elten's passion is art; he is a co-founder of the gallery Elten & Elten.

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