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European Recovery Fund: Sceptics Q&A*

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We see the Recovery Fund as a gamechanger for Europe and the euro. But many investors are not yet convinced. We set out some of the pushback we have gotten, and explain why we still think the scepticism is overdone.

We have argued that the EU Recovery Fund is a potential game changer for the periphery, and thus for the overall stability of the euro area. But that is not to say that the Recovery Fund will necessarily deliver as intended; financial and economic stability is always a work in progress. In this note, we share some of the

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[1] We acknowledge the contribution of Camille White to this report.

more sceptical questions and reactions we have heard from investors, as well as possible responses. Notable doubts include:

- *How is a temporary facility without debt mutualization a 'Hamiltonian moment'?*
- *Isn't the facility too small by post-covid standards of action elsewhere, notably the United States, thus undermining its effectiveness?*
- *Won't cumbersome governance arrangements and the prominence given to long-term projects slow disbursements and hence recovery?*
- *Will the Recovery Fund really provide additional stimulus or simply replace national spending?*
- *Have prospects for a permanent fiscal instrument at the union level been compromised by the establishment of a temporary pandemic facility?*

Recovery fund Q&A

Not everyone is convinced that the fund is a game changer for the periphery countries and for European stability more generally. In this note, we comment on some of the more sceptical reactions we have heard from investors.

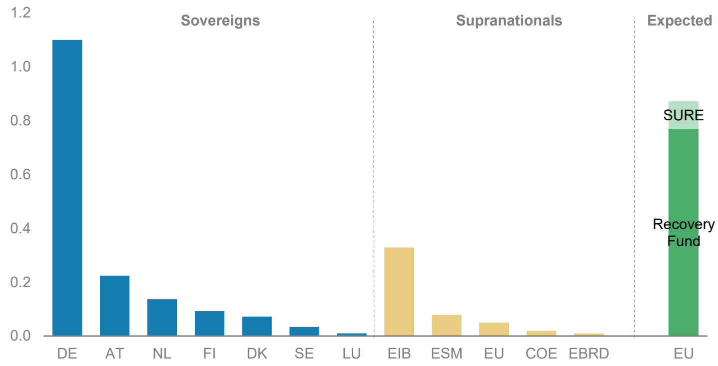
How is this a 'Hamiltonian moment'? Without debt mutualization, there is no resolution of the Italian debt problem and hence no fundamental answer to concerns about euro stability.

It is true that the Recovery Fund does not mutualize past debt and, for now, proposes only modest forms of common EU taxation to service debt. Worse, the Recovery Fund is in principle a one-time response to a once-in-a-lifetime shock, limited in scope, purpose, and duration – i.e., not a permanent instrument of common fiscal policy. As such, comparisons to Alexander Hamilton's 1790 reforms to assume state debts and establish a US federal budget and debt market seem hyperbolic.

But all reforms since the inception of the EU have taken place incrementally. The Recovery Fund is a very large step in the direction of establishing a union level fiscal policy, and even if it does not achieve Hamiltonian perfection, it is of signal importance. Four observations in this regard:

- **Common bond issuance in scale**. The EU is now on the verge of creating a very large liquid market for EU debt. Through deficit financing, the Recovery Fund, and the various other new EU-wide initiatives (such as the €100bn SURE employment support scheme), the EU will create almost €1 trillion of AAA-rated long-term euro assets. This provides euro investors a safe liquid instrument and establishes a Euro-wide yield curve through 2058. Once this market for a euro safe asset is established, it is difficult to see it scrapped by design.

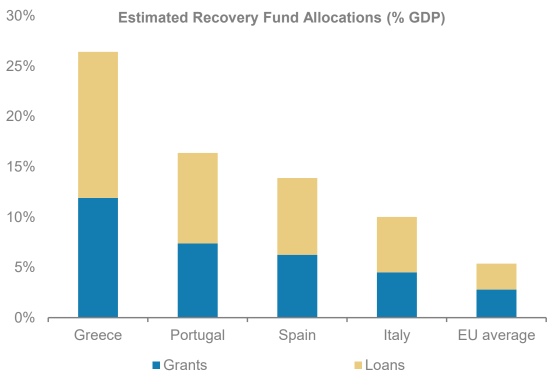
Highly rated sovereign bonds in Europe



Note: Includes outstanding issuance by European sovereigns and supranationals that are rated AAA by at least one agency, or AA+ by at least two agencies. Agencies considered are S&P, Fitch and Moody's. Source: Bloomberg, Morgan Stanley Research

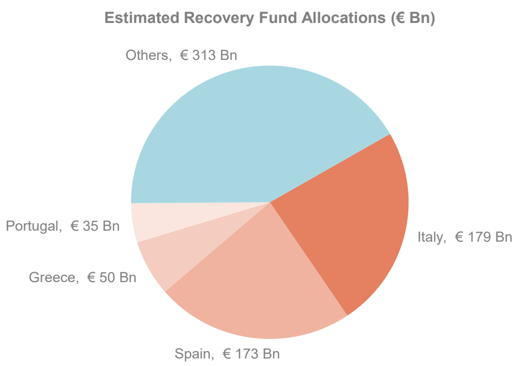
- Grants. For the first time, the EU will provide grants – not just loans – in large amounts in response to an adverse shock, with the bulk going to the euro periphery countries. This is precisely in recognition of the debt sustainability challenges faced by countries such as Italy. A common shock has hit the EU but it has affected the higher debt southern European periphery countries more adversely because of their weaker economic starting conditions and their larger exposure to the sectors affected by the pandemic (tourism, travel, hospitality). This has led to higher than average increases in debt in these countries, potentially constraining the scale of fiscal response. Grants restore at least some of the needed room for fiscal action without jeopardising debt sustainability.

Periphery allocations as share of GDP



Source: European Commission, Morgan Stanley Research

Periphery allocations as share of total funds



Source: European Commission, Morgan Stanley Research

- **Common Taxation**. For the first time, the taboo of a common EU tax has been broken. When approving the Recovery Fund, the EU Council agreed on a modest (€6bn per year) plastic tax. This will be adequate for any interest payments on the bonds in the short-run without having to resort to the EU budget, let alone member state budgets. The EU Council also agreed to look at other green and digital taxes for implementation from 2022 onwards. The political momentum behind this is strong in order to avoid interest or principal payment contributions from the member state budgets.

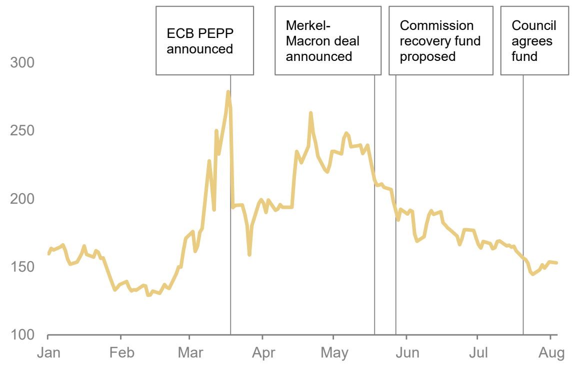
- **The precedent of centralised counter-cyclical fiscal policy**. The EU will be deploying large scale central spending and easing the burden of the ECB. True, the ERF is conceived as a one-off increase in the EU budget. That was the price of achieving unanimity of the EU Leaders to act. So, it is fair to say that this mechanism is unlikely to be deployed if an economic shock is idiosyncratic or small. But the problem in the euro area is not small shocks, for which there are numerous financing facilities, including the European Stability Mechanism (ESM). The Recovery Fund will surely set a compelling precedent for larger shocks with euro area-wide consequences, and therefore substantially reduces the tail risks of a euro break up.

By the standards of covid-responses elsewhere, notably the United States, €750 billion is not exactly an awe-inspiring figure, is it?

The Recovery Fund effectively targets the hardest hit countries in Europe's southern periphery – Greece, Italy, Spain, and Portugal. Relative to the size of those economies, the amounts being made available in grants and low-interest/long-term loans are substantial. Fiscal stimulus ranging from over 2% to around 7% of GDP per year for four years is assuredly a big deal for the growth and sustainability prospects of those countries.

Markets certainly have taken note of the Recovery Fund. Ever since the word got out of the core political compromise underlying it – the Merkel-Macron proposal in mid-May – risk spreads on periphery debt have fallen back substantially; Italy's spread has fallen by over 100 bps since that time, and is now below the level at end-2019.

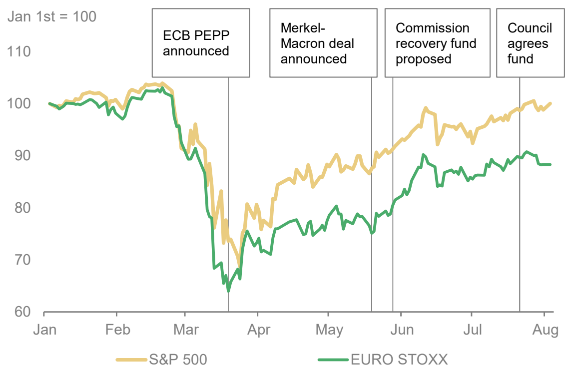
Italy 10Y yield spread vs Germany



Source: Bloomberg, Morgan Stanley Research

That said, the sceptics might still ask why all this has not translated into broader strength in euro assets? Fair enough. Although the euro has appreciated, the performance of Eurostoxx pretty much tracks the S&P500. However, as the Nobel-prize winning economist Robert Shiller has argued, it may take time for the market to absorb new information and for a new narrative to take hold, especially in the context of a pandemic.

European and US stock market performance YTD



Source: Bloomberg, Morgan Stanley Research

Isn't the governance framework problematic? The Frugal Four have imposed approval rules that could slow Recovery Fund disbursements and hence recovery.

The EU Council did introduce political oversight and review of countries' spending plans, which is understandable given the unprecedented scale of cross-border transfers. But formal rules were also put in place to avoid undue delays. Two points:

- First, to avoid deadlock, the EU Council has explicitly agreed to forgo decision making by consensus and rely instead on qualified majority voting. Thus, when the Commission approves and submits countries' spending plans to the EU Council, endorsements will be done by qualified majority, not the usual unanimity. Similarly, any sanctions proposed by the Commission for breaches of "the rule of law" can be decided by qualified majority. This is a major change in modus operandi of the EU to speed up decision making.

- Second, although any EU leader can hold up a disbursement if they have concerns about spending, their ability to do so is circumscribed: the Commission can proceed with the qualified majority decision after three months if there is no unanimous resolution to the contrary.

Isn't the effectiveness of the Recovery Fund undercut to the extent that it goes to long-term projects, which take time to get off the ground and cannot respond to changing circumstances?

The Recovery Fund will only start operating in 2021, and while 70 percent of the funds are expected to be committed during 2021-22, actual disbursements will be made later, likely peaking during 2022-23. So, it is certainly correct to say that the main impact of the Recovery Fund will not be felt for some time. On the other hand:

- The kind of supply shock confronting the periphery countries is likely to last a long time. The Recovery Fund will come on stream as the stimulus from national budgets tapers off and as the ECB's PEPP programme is wound down. The Recovery Fund will be critical to sustaining demand at a time when recovery is at risk of petering out in the periphery.

- It may be true that investment is a less flexible instrument than current spending, and especially so when the long-term implications of the pandemic shock are unclear. But green investment, an agreed priority for the Recovery Fund, seems more urgent than ever. And such spending should have positive employment, demand, and network effects.

- The timing of disbursements, per se, is arguably a secondary consideration. What matters from a macroeconomic perspective is that spending is planned and known in advance, along with approval-in-principle by the European Commission. Short-term delays in cash disbursements from the Recovery Fund can easily be made up in debt markets, allowing spending to proceed on track.

That said, we do agree that more thought needs to go into Recovery Fund spending. As we have argued elsewhere, in the time horizon of the Recovery Fund (2022-24), it would make more sense to target spending to unconstrained sectors (e.g., green and digital, where supply can readily respond to demand) than to constrained sectors (e.g., tourism and transportation, where public spending is unlikely to provoke strong supply and demand responses).

Is the Recovery Fund really additional spending? Are we not just changing the financing source of spending that member states would have undertaken anyway?

In targeting the hardest hit economies, the Recovery Fund also happens to be targeting the most fiscally constrained ones – Greece, Italy, Portugal and Spain. For sure the grants element of the Recovery Fund is additional spending because it does not add to national governments' debt and does not have to be paid back. However, there is no way of proving a counterfactual.

The reality is that there are no fiscal adjustment paths agreed or even specified by either the Commission or any member state with and without the Recovery Fund to assess the additionality argument. The Stability and Growth Pact (SGP) has been rightly suspended to allow governments to respond to the crisis as needed. The SGP will be reinstated at some stage but not necessarily in its pre-crisis form. Indeed, a review of SGP was already under way before the crisis hit.

Ultimately, the growth path out of the crisis will be a more important determinant of debt sustainability than any fiscal adjustment path. In that sense, the Recovery Fund, with its focus on spending in the hardest hit countries for the next few years, can provide additional spending and a transition to the post crisis SGP.

Is the Recovery Fund a pyrrhic victory for the proponents of a union-level fiscal instrument? After all, a permanent increase in the EU budget was sacrificed for a one-off pandemic fund.

This is a sophisticated political economy critique. But whether it is a priori correct is not obvious. Without taking too pointed a stand, we would note the following:

- While economists would probably prefer to have scaled up the existing EU budget and make it more of an annual budget that responds to economic conditions, this pre-supposes that Europe is ready for such an arrangement politically. Clearly, it is not – and foisting it on a divided polity may just deliver chronic impasses and annual "fiscal cliffs". With the pandemic recovery fund, at least, the EU has a decent chance of getting the stimulus needed in the periphery countries hardest hit by the crisis.

- Although economists tend to frown on the idea of earmarked funds such as the Recovery Fund, this is partly because they do not always appreciate the political economy value of earmarking. If earmarking fuel taxes to highways or green technology increases political support for taxes and needed spending, then that surely is better than the alternative of foregoing such spending. In the case of the Recovery Fund, we see two benefits of earmarking: a) it likely increases total stimulus in the more debt-constrained peripheral economies, b) it likely ensures the stimulus has a large growth impact, with higher investment and less spent on low-quality tax cuts or increases in current spending.

- If the experiment in common fiscal policy succeeds, it sets up the basis for garnering the political support needed for a standing facility to respond to large macroeconomic shocks. By the very narrowness of its scope, it could clearly demonstrate the benefits of a common fiscal response. ■

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