A Hamiltonian moment for Europe? Demystifying Next Generation EU and the EU's recovery funds

The Next Generation EU (NGEU) programme represents a crucial first step towards fiscal mutuality against common shocks in the EU, changing the way the Union finances itself. This is why the LSE European Institute recently hosted a panel event aimed at bringing together experts to explore the design and implementation of the NGEU programme, weighing the positives against the negatives. In this article, **Renato Giacon** *and* **Corrado Macchiarelli** *draw together some insights from the panel discussion.*

The Next Generation EU programme is changing the way the EU finances itself. Never before has the European Commission borrowed at such a large scale on financial markets. Meanwhile, six EU member states (Cyprus, Greece, Italy, Portugal, Romania, and Slovenia) have decided to make the leap of faith and have included a formal request for concessional loans in their adopted Recovery and Resilience Plans with the aim of overcoming not only their large funding needs post Covid-19 but also a decade of low investment expenditure.

These developments raise a number of key questions, notably how the Next Generation EU programme and the EU's recovery fund (the Recovery and Resilience Facility – RRF) should be designed and implemented to better focus on effective, efficient, equitable and sustainable ways of spending EU and national money for bankable projects; successfully mobilise private sector funding from institutional investors, international financial institutions, and commercial banks; and deliver the promised medium to long-term benefits in terms of economic convergence, complexity and higher growth patterns that EU countries can derive from it.

The national Recovery and Resilience Plans – that each EU member state is asked to compile and stick to – are embedded in the European Semester, the EU's framework for economic policy coordination, with grants and loan payments to EU member states released only upon the successful implementation of performance-based milestones. These are defined both in terms of investments and reforms, with the additional request to achieve ambitious green and digital targets. Such enhanced policy steering at the EU level must balance different national agendas driven by often competing political economy needs. The mechanism represents strong external market discipline both in the funding and the investment framework, which finds a precedent only in the experience of some EU countries such as Greece under the Enhanced Surveillance Framework post-2010.

The European Bank for Reconstruction and Development

Some light was shed on these topics at a recent LSE event by Ines Rocha of the European Bank for Reconstruction and Development (EBRD). Drawing on operational insights provided by the active role of the EBRD in the implementation of the NGEU programme and the deployment of the Recovery Funds, she made the point that large grants-funded projects under the Recovery and Resilience Facility are usually included *ex-ante* in countries' Recovery and Resilience Plans, while smaller projects that are part of broader investment programmes might be selected through public tenders or similar procedures. Private sector projects to be financed via Recovery and Resilience Facility loans mainly depend on the international financial institutions, national promotional banks and commercial banks' pipelines, creating an important private sector-led investment stream in the implementation of the programme.

Furthermore, EU countries – which have requested EBRD engagement in the delivery of their Recovery and Resilience Plans – have recognised that the EBRD is strategically aligned in its own priorities and country strategies with the national Recovery Plans. The EBRD can assist the countries in delivering policy objectives and leverage the EU recovery grants and loans by attracting other private co-financiers to facilitate successful programme delivery.

The most typical sectors of EBRD intervention include the areas of: *green growth* (such as financing renewable energy, electricity storage projects, hydrogen production, green cities, clean mobility, and improving the energy efficiency of buildings); *accelerating the digital transformation* (5G, gigabit networks and fibre optic networks, broadband projects, digital upskilling and reskilling programmes, support for the digitalisation of businesses with a particular focus on SMEs, start-ups and greater cloud usage); and *financing research and development*, as well as innovation projects outside the digital sector such as in the field of climate innovation (i.e. fertilisers and cement sectors).

The most concrete EBRD engagement under the recovery funds so far has been in Greece through the Corporate Loan Facility. The programme will combine up to €500 million of Recovery and Resilience Facility concessional loans managed by the EBRD, up to €500 million of EBRD commercial own-resources financing, and financing from private investors and commercial banks. The EBRD signed an Operational Agreement with the Greek Ministry of Finance in November 2021. From the point of view of project structuring, the Greek Recovery and Resilience Facility is unique insofar as it promotes financial discipline by private sector final beneficiaries which have to pay back the loans, encourages proper risk assessment by market players in the absence of Greek state guarantees, and leverages Recovery and Resilience Facility funds through co-financing with private sector funding sources.

Gaps and opportunities

At the same event, LSE's Anthony Bartzokas singled out the NGEU programme as a new important tool to support investment recovery in the EU, funded through the Commission's borrowing on the capital markets. Furthermore, there are early positive signals from markets with NGEU-related announcements already demonstrating a significant spread-compressing effect on euro area sovereign borrowing costs. In addition, the investment stimulus provided by the EU recovery funds includes fine-tuning opportunities in response to concerns about European resilience, especially at a time of elevated geopolitical risk and green transition uncertainties such as the current one.

Bartzokas highlighted a few possible implementation gaps in the EU Recovery Funds linked to the focus on thematic clusters with limited microeconomics considerations, the need for detailed cost justifications during project cycles, and overlaps vs. complementarities with the European Structural and Investment Funds, and EU cohesion policy. Particularly, the experience of European Structural and Investment Funds and other existing EU funding programmes has already driven the evolution of investment decisions of different policy institutions at different governance levels (i.e. the European Commission, the EU member states, international financial institutions and private sector's financiers). Bartzokas advocates a similar learning process in the governance processes of the Recovery and Resilience Facility.

Finally, he underlined some legacy issues identified from the EU Cohesion Policy experience in the academic literature, including the lack of timely implementation, limited project upstreaming capacity, and a funding substitution effect for the national budgetary component, as important priority areas for the monitoring function of the Recovery and Resilience Facility in the implementation phase.

Learning from previous mistakes

Previous EU funds have not always delivered on initial expectations. Vedrana Jelusic Kasic, a member of the Management Board of Croatia's second largest commercial bank and a former regional Director at the EBRD, underlined this at the event, noting that previous funds had often suffered from cumbersome reporting requirements; a lack of coordination between EU co-funded programmes and national programmes; a lack of bankable projects; poor absorption capacity from Managing Authorities; and the fact that European funds have often given priority to basic infrastructure projects, instead of also trying to prioritise the advancement and reconstruction of the productive environment and the support of investments.

However, she indicated the experience with EU funds in the previous EU budget has helped the design of the new Recovery and Resilience Facility, which has a few in-built advantages that need to be translated from design to implementation. The release of funds is performance-based with a clear set of reforms and investment milestones that create concrete incentives for member states to deliver on their Recovery and Resilience Facility commitments.

Secondly, the funds focus on two clear strategic priorities, the green and digital agenda, which are aligned with the key implementing partners' agendas and should avoid "spreading the funds too thin" on the ground. Finally, the Recovery and Resilience Facility leaves autonomy to the member states to set their own country specific reform and investment priorities, while letting implementing partners set up their financial structures at the operational and implementation level.

Geography matters

A final insight from Frank Neffke, who also spoke at the event, is that geography still matters, especially for trade and the flow of foreign direct investment. He highlighted that "path breaking growth" often requires the ability to attract high-skilled workers, as well as the ability of generate return migration: low-skilled workers that move from advanced to less advanced economies. Foreign direct investment could help generate the required investment in skills where foreign firms could help kickstart new tech hubs. In that sense, the mix of policy reforms and higher investment volumes through the Recovery and Resilience Facility should be able to increase economic complexity.

He also emphasised that a sustained and sustainable economic recovery should include priorities such as a transition to a green economy that leverages the capabilities that currently exist and are used already in economies; investments in skills and skill ecosystems; an exploration of local economies' "adjacent possibles"; aiming for higher complexity; and a focus on connectivity and digitisation, return migration, and smart inward foreign direct investment.

A Hamiltonian moment for Europe?

To conclude, there are a number of points worth emphasising about the status and design of Next Generation EU and the EU's recovery funds. First, this new EU initiative brings together three relevant and interrelated dimensions of consensus building (fiscal, rule of law, and policy priorities around green and digital). Second, it is innovative insofar as it is strictly tied to an ongoing monitoring and conditionality mechanism of tranches of EU funds being disbursed upon the achievement of clear milestones.

Third, it is timely as it opens the way to other future large scale European Commission borrowing plans, including as part of a response to current EU energy and defence investment needs following Russia's invasion of Ukraine. Fourth, it highlights the agency and ownership of national authorities in the design and implementation of their national plans but also their reliance on international financial institutions such as the EBRD for co-financing with their own balance sheet, mobilising private financing, managing technical assistance and helping with unlocking policy reforms.

Fifth, it will help EU member states (like Greece) to achieve higher economic complexity, facilitate further integration in European supply chains, invest in skills and ecosystems, and to explore the appropriate green capabilities and attract foreign direct investment.

Sixth, it shows how policy makers in Southern European countries such as Greece, Spain, Italy and Portugal have reflected on lessons learned from the previous euro area sovereign debt crisis, taking reforms and investment milestones seriously and moving ahead of the EU pack in the implementation of their Recovery and Resilience Plans and further disbursements of Recovery and Resilience Facility tranches.

These countries have been the first cohort of EU member states whose plans have been approved by the EU Council. Spain, France, Italy and Greece have all also received the European Commission's positive preliminary assessments of their second payment requests based on the achievement of several milestones which cover reforms and investments in various areas (energy efficiency, electric mobility, waste management, labour market, taxation, business environment, pensions, healthcare, public transport, and many others).

Finally, and as a counterpoint, special attention ought to be paid to some Central and Eastern European countries where investment needs are high but there are still some delays in the implementation of the plans and the flow of new funds into their economies. Given past problems of scarce absorption capacity and bankable projects, the role of international financial institutions such as the EBRD as well as the European Investment Bank and national promotional banks has become increasingly linked to the success of this new pan-European funding and policy initiative, at a scale unheard of in the history of the EU.

This article is based on a panel discussion hosted by the LSE's European Institute on 9 March 2022. A recording of the event is available here.

Note: This article gives the views of the authors, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: European Council

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