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# NextGenEU: What we know so far

## Implementation will be key for this ambitious programme

Hundreds of billions of euros are due to be spent in the EU over the next few years under the NextGenEU initiative. In some countries, accompanying economic reform programmes are also ambitious. Growth, corporate earnings and risk assets in the region could all benefit. However, it is vital that funds are spent properly. In addition, even with all this extra spending, the EU's green targets may still be elusive.

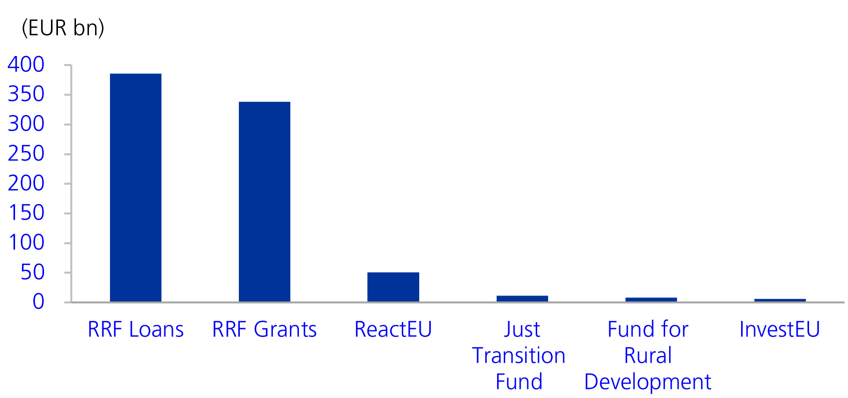
Source: iStock

The total amount to be disbursed over the next few years under the Next Generation EU (NGEU) initiative could in theory be up to EUR 806.9bn to be spent with a focus on promoting the transformation of the European economy in the direction of environmental sustainability and also to accelerate digitalisation.

However, the full spending envelope is unlikely to be used based on the plans recently submitted by the various EU countries. Many member states are reluctant to apply for the loan part of the programme, even those countries where the loans would be cheaper than issuing more debt at a national level.

Indeed, currently only Italy is planning to apply for its full allotment of grants and loans. In addition, implementation risks in Italy and elsewhere in the EU are high given the large amounts that are already due to be disbursed over a relatively short period of time.

NGEU Support Packages (current prices)




Source: The EU's 2021-2027 long-term budget & NextGenerationEU Facts and Figures, European Commission, April 2021

We think that rather than a temporary initiative lasting until 2026, the NGEU should become a permanent part of the institutional infrastructure of the EU. This would reduce implementation risks and increase the likelihood that the EU achieves its ambitious green targets.

Nevertheless, from a standard economic perspective, the NGEU is already a very positive development that should boost growth and risk assets in the region and make the Eurozone more resilient to shocks. We explore these issues in more detail below.

### What is the NGEU?

The NGEU is an ambitious set of EU funded recovery packages and fiscal support measures designed to help EU member states hit by the COVID-19 pandemic. Agreed by the EU leaders on July 21, 2020 at a European Council meeting, the programme was designed to disburse up to EUR 806.9 bn in current prices (EUR 750bn in 2018 prices, around 5.5% of EU GDP) in loans and grants by 2026, with spending expected to be front-loaded in the early years of the programme. (Current prices are used below unless specified otherwise.)

The largest component of the NGEU is the Recovery and Resilience Facility (RRF), designed with a total size of EUR 723.8bn, of which EUR 338bn is in the form of grants and the remaining EUR 385.8bn is in the form of low-interest loans.

Another large component of the NGEU is the EUR 50bn REACT-EU, which is designed to provide immediate economic support for less-prosperous EU countries to deal with the COVID-19 pandemic and to provide a bridge to the longer-term RRF.

Other grant elements of the NGEU include: EUR 10.9bn Just Transition Fund to help states likely to struggle the most with the green transition; EUR 8.1bn Fund for Rural Development; and EUR 6.1bn Invest EU that provides credit guarantees for investment projects.

In addition, in 2020 the EU also set up the EUR 100bn SURE programme providing loans to EU states mainly to help finance short-term working schemes. (SURE stands for "Support to mitigate Unemployment Risks in an Emergency".)

While all these schemes and acronyms can be confusing, the key point is that at an EU level a lot of funds are now available in the form of grants or cheap loans to support countries during the COVID-19 pandemic and over the longer term to transform their economies.

### Seven-year EU budget provides further support

Finally, the EU budget for 2021-2027, the so-called multi-annual financial framework (MFF), was also agreed last year, representing around EUR 1.2trillion of regular spending. One-third of this spending is also due to go on supporting the green transition of the EU economy.

### A Green Marshall Plan

The NGEU and other initiatives can be thought of as a second Marshall Plan for Europe focused on green transition and digitalisation. (The original 1948 Marshall Plan, named after US Secretary of State, General George Marshall, was a US initiative that provided large amounts of foreign aid to Europe following the Second World War to help rebuild and re-industrialise the war-torn continent.)

The NGEU is not designed just as a short-term fiscal stimulus package aimed at putting extra money into households' pockets, as much of the fiscal stimulus in the US was. Instead, it is better to think of it as close to previous EU structural funds that have been used to finance infrastructure developments and economic transformation across Europe, but much larger in size and focused on the environment and digitalisation.

### Where is all the money coming from?

The seven-year MFF budget will be financed as usual by regular contributions from the EU member states, complemented by some existing EU-wide taxes.

However, German Chancellor Angela Merkel indicated last year that, for the first time, Germany would support the EU being allowed to borrow significant amounts of money, rather than relying simply on annual contributions from member countries to finance its spending.

It was agreed that the EU would be allowed to borrow in large amounts on the international capital markets by issuing long-term bonds to finance the SURE and NGEU initiatives. The EU was also granted some further revenue raising powers with the ability to raise extra EU wide green taxes on plastics and carbon for example.

The bonds to finance SURE began being issued in 2020 and the first tranche of bonds to finance the NGEU were issued on June 16 this year. The EU sold EUR 20bn of 10-year NGEU bonds at a yield 0.086%, a yield spread over 10-year German government bonds of around 32 basis points at the time. The transaction saw strong institutional investor demand and was largest amount the EU has raised in a single transaction.

Within the next few years, the EU is likely to issue EUR 800-EUR 900bn in bonds, potentially creating an EU-wide supranational bond market and benchmark yield curve. However, this market will still be smaller than the total current government bond debt outstanding of for example Spain at around EUR 1.3trillion and Germany at EUR 1.5trillion, and much lower than current government bond debt of France or Italy which each have around EUR 2.3trillion outstanding. Around a third of the NGEU bonds issued will be green bonds.

### The Eurozone is more resilient by sharing fiscal risks

The issuance of debt at an EU level in large quantities is effectively a partial mutualisation of member countries' government debts, something that we have long regarded as necessary to make the Eurozone more resilient economically.

Sharing fiscal risks and burdens across countries should help insulate Eurozone sovereign bond markets from speculative attacks or a loss of confidence in any one government's ability to repay its debt. It should therefore make a repeat of the Eurozone debt crisis less likely.

In addition, the NGEU provides a mechanism for a fiscal transfer from Northern Europe to Southern and Eastern Europe. In economic theory, the ability to make fiscal transfers has long been recognised as a necessary condition to make a region a so called 'optimal currency area' - a region where it makes economic sense to have just one currency. This is another reason why we think the EU should consider making the NGEU a permanent rather than a temporary initiative.

### Risks

However, it is vitally important that funds are correctly spent and that the mutualisation of debt at an EU and Eurozone level is fully taken onboard by governments and that there is no back-tracking on this concept.

Given the large sums involved and the ambitious timeline, there is a danger of wasteful spending as well as simply not having enough projects ready. Careful monitoring will therefore be needed. Failure to spend the funds properly is a risk because it could then discredit the whole EU and Eurozone integration project. The stakes are therefore high.

### Structural reform is the quid pro quo for grants and loans

Encouragingly, the RRF component of the NGEU comes with conditionalities regarding structural reforms. Countries must lay out and then engage in a series of structural reforms to continue to be eligible for grants and loans under the RRF. This creates a strong incentive for EU countries to engage in much-needed structural reforms, although it also raises some more implementation risks as well.

### Next steps

In terms of next steps, most EU member states have now submitted to the European Commission (EC) their so-called National Recovery and Resilience Plans (NRRP) detailing how they intend to spend the RRF funds and reform their economies. Some plans have recently been approved and more approvals are expected over the next few weeks. Initial disbursement of funds is likely early in H2.

Italy and Spain have the largest spending plans, around EUR 200bn and EUR 70bn respectively. We summarise below the plans of the big four EU economies, Germany, France, Italy and Spain.

### Italy: Large spending & ambitious reforms

Under its new prime minister and former ECB President, Mario Draghi, Italy has presented the most ambitious spending and reform proposals. The Italian EUR 200bn NGEU spending plan represents around 11% of GDP.

The plan has six major lines of action. Green transition and digitalisation are the main ones, with EUR 70bn and EUR 50bn earmarked respectively. The other four lines of action are investment in healthcare, education, labour market training and social inclusion.

Green elements of the programme will include investing in renewable energy production, especially hydrogen, improving energy efficiency in the existing real estate stock and making waste disposal more environmentally friendly.

The infrastructure spending proposal includes plans to substantially modernise and extend the train network, especially in the South and to reduce travel times between major cities making regions more closely connected economically.

The plan also includes an ambitious set of structural reforms. These include reforming and stream-lining the civil service and judicial system, simplification and improvement of public procurement and planning permission, and improving competition in markets.

### Spain is targeting green mobility and digitalisation

Spain has applied for EUR 69.5bn in grants from the RRF (5.6%of GDP), but has not yet specified to what extent it will apply for loans. A decision on potential loan utilisation (EUR 70bn) has been postponed to 2023 and only if needed. Spain plans to invest proportionally more in the digital economy relative to Italy. It will also target green mobility leveraging its position as a car producer.

Spain has committed to start pre-funding its NRRP projects this year to speed up support to the economy. Indeed, the spending timeline in Spain is more front-loaded than in other countries, with the focus on projects primarily in the period 2021-2023.

The Spanish plan is structured around four pillars: green transformation; digital transformation; social and territorial cohesion; and gender equality. It includes supporting the transition to electric vehicles (EVs), improving energy efficiency in buildings, developing clean power, enhancing digital skills and connectivity, and support for the industrial sector, SMEs and for social housing.

In addition to the spending and investment, the Spanish government has said that it will target economic reforms in three main areas: the labour market to reduce temporary employment and structural unemployment; the pension system by seeking to raise the retirement age and contributions; and the tax system by raising the overall tax take in order to improve debt sustainability.

### France: Half of spending on climate transition

For France, the EU RRF grant of around EUR 40bn (1.6% of GDP) is only a subset of a national EUR 100bn (4% of GDP) "France Relance" fiscal package that it launched in 2020. France is not currently planning to apply for the loan facility part of the RRF, though this reflects the lower cost of finance that it can access by issuing debt itself.

Around half of the spending will be on climate transition such as green energy and technologies, railway investment and the energy efficient renovation of public buildings. A quarter of spending is due to go into digital transition such as financing research and development in AI and cybersecurity as well as financing the digitisation of the public and private sectors.

Accompanying planned structural reforms include measures to ensure debt sustainability, such as by implementing multi-year public expenditure rules and better impact assessments. The government has also said it still plans to go ahead with pension reform, which was started in 2019 but halted due to the COVID-19 pandemic.

### Germany: Focus on helping auto sector

Germany also plans to access only its entitlement of EUR 26bn (0.8% of GDP) of grants from the RRF and does not intend to apply for any loans. The allocation calculation for grants favours the weaker economies at the expense of the stronger ones, and so is an indirect way of creating a fiscal transfer within the EU. Spending in Germany will focus on supporting the green transition of the manufacturing sector. Around half of the spending could benefit the manufacturing sector, and especially the automotive sector.

The largest individual spending items are continued subsidies for the purchase of EVs, subsidies for renovations to buildings to make them more environmentally friendly, investments in the digitisation of the public administration, and the modernisation and digitalisation of hospitals. Planned reforms attached to the German NRRP are limited and are mainly focused on reducing barriers to investment, such as improving the transport infrastructure planning processes.

### Boost to growth: cyclical and structural

We estimate that Spain and Italy could see around a one percentage point boost to growth over the next few years as a direct impact of the extra spending. For Germany and France, the direct boost to growth will be much smaller, but still positive. However, they will also benefit indirectly from the stronger growth in their major export markets.

While the direct NGEU spending on investment will help, the impact on growth in the long-term will also depend upon the success in implementing planned structural reforms. If fully implemented the boost to trend or long-term growth, while difficult to quantify exactly, could be important, especially in countries where structural reform has been much needed, such as Italy.

Implementing reforms will require an extended political commitment in each country. Nevertheless, even partial implementation of reforms in the case of Italy, for example, would have a lot of benefits.

### Investment implications

The NGEU should boost overall growth and company earnings and therefore equity markets in Europe. It should also help reduce the risk premia attached to Eurozone assets because of concerns about the resilience and continuity of the single currency. The countries with the largest spending planned relative to the size of their economies, such as Italy and Spain, could see the biggest boost to growth and thus to corporate earnings. However, European companies from other countries could also benefit due to stronger demand for their exports.

In terms of sectors, the obvious beneficiary will be the green and renewable energy sector. In addition, the national plans include significant spending on construction to upgrade existing real estate stock and make it more environmentally friendly. This should therefore help the construction sector and in particular companies with expertise in green renovation of buildings.

Plans to upgrade transport infrastructure, especially railways, should help companies in these sectors. The strong emphasis on digitalisation should also help the IT sector, with many contracts in this space likely to be awarded as well. Finally, the automotive sector in Europe should get a boost from government subsidies to smooth the transition towards green mobility.

### Green targets may still be elusive

The EU has committed at least 30% of both the NGEU and its seven-year MFF budget to supporting its green targets of a reduction in EU greenhouse gas emissions of at least 55% relative to 1990 levels by 2030, and by 2050 making the EU climate neutral, i.e. an economy with net-zero greenhouse gas emissions.

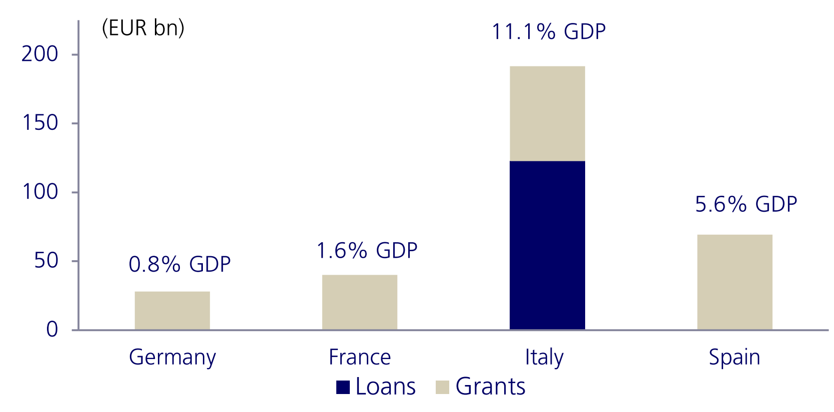
Together, the planned green investment flows from the NGEU and EU budget are sizable, worth more than half a trillion euros over 2021-30. However, this may not be enough to meet its 2030 and 2050 climate targets. While highly uncertain, the OECD estimates that around USD 90trillion are needed at a global level to limit global warming by 2050. Therefore, the EU is likely to require many trillions of euros. Hence the importance of, at a minimum, using the existing NGEU loans available fully and making the NGEU a permanent rather than temporary initiative.

### Conclusions

The NGEU is an important step forward that should help boost growth and asset prices in Europe whilst also facilitating the transition towards a green economy. It is encouraging to see quick progress in the submission and approval of national spending plans.

In term of equity markets, sectors such as renewables, construction, infrastructure, and IT should benefit the most. However, careful monitoring will be needed as implementation risks are high. The EU should also consider making the NGEU a permanent initiative and even more funds may be needed to achieve long-term climate goals.

## Big Four NGEU Spending Plans




Source: European Commission, National Recovery & Resilience Plans, Zurich Insurance Own Estimates, June 2021

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Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001631 (01/16) TCL