A deal regarding the EU recovery fund

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IN A WORD:

The EU leaders were able to agree on a deal regarding the EU recovery fund. The global size remains the same compared to the initial proposal but the split between grants and loans has been modified. The deal also includes a condition regarding rule-of-law violations. Leaders also agreed on a EUR 1tn EU budget over the next seven years.

The nature of the deal regarding the EU recovery fund

After difficult and lengthy negotiations, EU leaders were able to agree this morning. The global size remains the same compared to the initial proposal but the split between grants and loans is modified. The key topics were (1) the size of the fund and the split grants/loans, (2) the conditionality and governance and (3) the distribution.

The size of the fund and the split grants/loans: The global size of the fund will be EUR 750bn. Grants will amount to EUR 390bn and loans, EUR 360bn. This is broadly in line with our expectations.

The initial EU Commission proposal was for a headline amount of EUR 500bn in grants, including around EUR 70bn in guarantees and a number of smaller pockets of money (humanitarian aid). These items have borne the brunt of cuts to find a compromise, while the core of the fund, the Recovery and Resilience Facility, has remained intact.

The conditionality and governance: The terms of the agreement are quite complex Member states will submit national plans, detailing their post COVID-19 recovery strategies. The EU

finance ministers must then approve these by qualified majority voting. The European Commission then has to decide when and how much each country would get from the fund based on pre-**defined criteria. If a member state considers that there are "serious deviations" from a country's commitments, the payment may be delayed. In such situation, the matter** may be escalated to the EU leaders. The maximum period is specified to be three months.

This arrangement creates the potential for tensions and uncertainty each time there is a disbursement in the future. The arrangement however stops well short of an actual veto, and the delay is limited. These are thus positive aspects of the deal. This should also smooth the operation of the fund and have less political repercussions.

The deal also includes a condition regarding rule-of-law violations. In this case, a weighted majority of EU governments could block payments to a particular country.

The distribution: **The fund's allocation key for the years 2021 and 2022 will be established according to the Commission's proposal. For 2023, the 2015**-19 unemployment criterion is replaced with the cumulative loss in real GDP observed over the period 2020-21 to take into account the consequences of the pandemic. Regarding grants, 70% will be committed in 2021-22 and the remainder by the end of 2023.

Market reactions

A deal of this type was largely expected. The euro has strengthened over the past few days in anticipation of such a deal and has not reacted since the announcement (the value of one euro is fluctuating at around 1.145 dollar). We see more upside later this year after a period of consolidation. Peripheral bond spreads have also been lower in recent days. There is potential for more tightening. European equity markets were rising on Tuesday July 21st. However, the general positive mood on equity markets has also been supported by the positive news flow regarding vaccine trials and the expected additional economic stimulus under discussion in the US. The markets remain however vulnerable to negative news regarding US-China **tensions. We stick to our "buy on weakness" strategy for equity markets.**

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