EU RECOVERY FUNDING IN CEE: AN HISTORIC RESPONSE TO AN UNPRECEDENTED CHALLENGE

Opportunities & risks for international investors as CEE markets look to recover from the COVID-19 crisis

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Issues & Sectors	Green Economy, Digitalization, Health
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The European Union has started rolling out its major economic stimulus package as it looks to drive the post-pandemic recovery of its member states across the next decade. The Next Generation EU (NGEU) facility will provide €750 billion to EU economies in grants and loans and represents an historic opportunity for member states to inject momentum and direction into key policy initiatives over the coming period. This particularly holds for the green energy and digital sectors as the EU has placed climate change and digitalization firmly at the heart of its post-pandemic economic path.

Central and Eastern European EU member countries are all looking to benefit from the EU's recovery funding facility, however three crucial CEE markets – Bulgaria, Hungary and Poland – are yet to receive approval from Brussels to access the funds. This comes at a time when Budapest and Warsaw are embroiled in crucial political debates with the EU that will define whether the two countries will receive EU recovery support.

In this memo, Kesarev provides an introduction into the EU's post-pandemic economic recovery strategy, the situation of recovery funding in key CEE markets and a look at the opportunities and implications for investors provided by the NGEU.

This memo will cover:

AN HISTORIC RESPONSE TO AN UNPRECEDENTED CRISIS

The COVID-19 outbreak in Europe brought unprecedented challenges for all countries of the continent, quickly becoming a major public health emergency and expanding into an economic crisis of unseen proportions. With the notable exception of Sweden at the time, all EU governments responded with strict movement restrictions and implemented nationwide lockdowns to curb the spread of the virus. The crisis has pushed the global economy into recession and led to a major economic downturn in most countries of the European bloc.

Given the nature of the EU, its member states used different, national-level responses to mitigate the economic and social impacts of the pandemic, ranging from tax cuts and tax breaks through temporary allowances for several social groups, such as expanded unemployment benefits, to sector-specific support measures. The initial response from the European Union itself – namely its top executive body, the European Commission – was limited to public health measures: coordinating external border conditions, securing a smaller amount of medical equipment, as well as managing a common European vaccine procurement and distribution process.

The first EU-wide economic response to the COVID-19 pandemic came during its first wave in April 2020, when EU finance ministers approved a €540 billion-worth rescue package to provide a safety net for member states. Aside from other measures, the program offered loans for workers and businesses through the European Stability Mechanism, a bailout fund set up during the Eurozone debt crisis, and the European Investment Bank to help European SMEs, while support for financing extraordinary spending on unemployment benefits was also granted through the so-called SURE program of the European Commission.

The EU then started to look beyond the immediate anti-crisis measures, with Germany and France taking the lead on the foundation of a major European Commission proposal. Last May, the Commission moved to present the Next Generation EU (NGEU) instrument, a multiannual recovery funding program worth €750 billion to be distributed among the EU's member states in form of loans and grants for public and private investments. Initially, all EU heads of state and government endorsed the recovery package last July, however this was followed by months of negotiations to agree on the Multiannual Financial Framework (MFF), the EU's regular budget for 2021-2027 worth close to €1.1 trillion. A month after its planned adoption date, EU leaders finally greenlighted the NGEU process last December, as well as the 2021-2027 MFF, allowing the European bloc to provide an unprecedented €1.8 trillion-worth combination of internal and external financing under the next budgetary period.

Also known as the Recovery and Resilience Facility (RRF), the EU recovery funding package signalled an historic first for the EU, marking the first time when member states have signed up for joint loans through the European Commission, which itself was authorised to raise debt and distribute money among its members. This is a landmark step in an alliance of sovereign states, particularly following the sovereign debt crisis in the aftermath of the 2008-2009 economic downturn. On the political side, this has also seen the EU's executive body become a more influential organization within the EU structure.

The NGEU instrument represents a key innovation in the crisis management history of the European Union. In a sharp contrast to the aftermath of the 2008-2009 crisis, the facility aimed at supporting the post-pandemic recovery does not impose conditions for austerity measures. Instead, it focused on making funding conditional to policy reforms in several areas.

The NGEU is structured around six pillars that represent the priority areas of recovery spending:

- ensuring a green economic transition,
- enhancing digital transformation,
- supporting smart, sustainable and inclusive growth,
- improving social and territorial cohesion,
- building health, economic, social and institutional resilience and
- creating policies for the next generation.

The instrument was designed to support the implementation of key EU policies and mechanisms, including the European Green Deal, a decades-long EU strategy to make the continent climate neutral by 2050 and to assist the European Single Market through digital transformation. Accordingly, EU countries allocated an astonishing 40% of their spending for climate goals and more than 26% on digital spending – arguably the two most important priority areas of public and private investments under the NGEU for the next budgetary cycle.

THE RECOVERY FUNDING OF CEE ECONOMIES

As part of the previously agreed conditions to access the funds, every EU member state had to submit its National Recovery and Resilience Plans (NRRP), a governmental plan on how to spend the recovery money efficiently and transparently, to the European Commission. Member states, which were granted approval by the EU's executive body, were able to receive the first tranche of the funding from September.

While Southern European countries are expected to be the biggest beneficiaries of the recovery spending package, the NGEU instrument provides significant opportunities for public and private investments in the Central and Eastern European economies. Of the 11 Central and Eastern European member states of the EU, eight NRRPs have been approved by the EU Commission, with a number having already received the first tranche of funding. At the time of writing, approval of the Hungarian and Polish plans has been halted due to concerns surrounding the rule of law, transparency and democratic values, while Bulgaria's recovery plan was submitted in October and is currently still under review.

Concerning the eight approved NRRPs, commitments to ensure a green economic transition appear to make up one of the most significant elements, particularly in the Baltic countries. Approved by the Commission in October, Estonia's national recovery plan devotes spending 42% of the NGEU funds on climate, facilitating green transition for businesses and green finances for SMEs. Handed €1.8 billion in grants, Latvia's green contributions make up 37% of the country's recovery plan, while Lithuania – the largest Baltic recipient with €2.2 billion – will focus on creating wind farms and other green energy resources. Other CEE markets also made impressive commitments on climate change: Slovakia plans to spend 43% on climate change, with a focus on the green transition of its buildings, while the Czech Republic will allocate 42% to support the country's green transition, including energy efficiency in residential buildings.

Similarly important are the planned allocations to support digital transition across the region. Romania, one of the region's largest markets, recently received the first tranche of the NGEU funding (worth €1.8 billion). Besides spending a planned 41% of the funds on green issues, 21% of its total allocation – worth close to €30 billion – will be spent on the digital transition, with a heavy focus on further digitalizing the country's public services. Several other markets in the region plan to allocate considerable funds for improving e-governance, including Slovenia, which plans to spend €305 million on private investments and reforms to support the business environment.

NGEU FUNDING PER CEE COUNTRY

Country	Funding in grants (€ billion)	Funding in loans (€ billion)	Status
Bulgaria	6.5	-	awaiting approval
Croatia	6.3	-	approved
Czech Republic	7	-	approved
Estonia	0.97	-	approved
Hungary	7.2	-	awaiting approval
Latvia	1.8	-	approved
Lithuania	2.2	-	approved
Poland	24	12.1	awaiting approval
Romania	14.2	14.9	approved
Slovakia	6.3	-	approved
Slovenia	1.8	0.7	approved

KEY CEE MARKETS AWAIT APPROVAL

While the European Commission has distributed the first tranche of the recovery funding to several EU governments over the past few months, Hungary, Poland and Bulgaria are yet to receive the greenlight from the EU's top executive.

Leading up to the negotiations about the NGEU and the MFF last year, there had been a growing political demand from both the EU institutions and a large number of member states to introduce a conditionality mechanism to the MFF that would link EU money to upholding the rule of law in each member state. At the centre of these debates were Poland and Hungary, whose governments have been repeatedly criticized by the EU over alleged democratic backsliding. As EU leaders looked set to implement the so-called rule-of-law conditionality last November, Hungary and Poland vetoed not only the MFF but also the NGEU deal. The deadlock was eventually broken a month later by a political compromise, according to which EU leaders introduced the conditionality mechanism but the European Commission will refrain from using it until the European Court of Justice (ECJ) rules on its legality and compatibility with EU law. While the rule-of-law mechanism was designed to be implemented for the MFF, the European Commission has rejected the Polish and Hungarian recovery plans, also due to concerns over the rule of law and transparency.

POLAND

The current standoff concerning Poland is part of a long-running dispute between Brussels and Warsaw over the latter's controversial judicial reforms, as well as a recently emerged debate over the primacy of Polish national vs. EU law.

In an October ruling, the Polish Constitutional Tribunal (PCT) declared[1] certain elements of the EU's founding treaties incompatible with Polish law, while another PCT ruling in November found that parts of the European Convention on Human Rights are also incompatible with the Polish constitution. Also in October, the European Court of Justice imposed a record-breaking, €1 million daily fine for Poland for not suspending a controversial judicial disciplinary body. Shortly afterwards, the ECJ ruled that the Polish Government violated EU law when granting special rights to its Justice Minister in the nomination and removal of judges to higher criminal courts. It is unclear when the two sides could reach a potential agreement that could unblock the recovery funding for Poland.

HUNGARY

The European Commission rejected Hungary's national recovery plan due to concerns over the functioning of the country's justice system, however unlike in Poland the rejection came after the EU's top executive voiced concerns over corruption around the allocation of the NGEU funds. Most recently, the European Commission expected the Hungarian Government to carry out justice reform and investigate corruption cases brought up by the European Anti-Fraud Office (OLAF). The Commission's refusal to approve the Hungarian NRRP came as the Hungarian Government introduced controversial legislation on the LGBT+ community that banned sexual minorities from being featured in school education materials. While the Commission argues that its chief concerns about the Hungarian NRRP are the rule of law and corruption, the Hungarian Government claims that Brussels is halting EU funds to force the Government to repeal this legislation. As Hungary is heading towards much-awaited parliamentary elections next April, when the Government will likely hold a referendum on the controversial law, as well, the standoff surrounding the NGEU funding is likely to go into 2022.

Although not directly related to the NGEU, both Poland and Hungary await a crucial ECJ verdict that could greenlight the Commission in using the rule-of-law mechanism, potentially leading to procedures against both Governments. Following the political compromise that made the EU-level agreement about the NGEU and the MFF possible last December, Hungary and Poland challenged the legality of the conditionality mechanism in the EU's highest court this spring. In early December, the Advocate General of the ECJ advised that the mechanism is indeed compatible with EU law. While this does not amount to a court verdict, most ECJ rulings follow the legal opinion advised by the Advocate General, meaning that the EU court is highly likely to rule against the Polish-Hungarian complaint early next year. In letters to the Polish and Hungarian governments, the European Commission has signalled that it stands ready to use the mechanism once the ECJ approves it. Should that happen, political tensions between the two sides will accelerate, potentially postponing a compromise on the NGEU funds and their disbursement.

BULGARIA

Bulgaria's late submission of its national recovery plan is the result of a seven-month long political crisis[2] that has shaped political uncertainty in the country throughout the year. Neither the country's much-anticipated parliamentary elections in April nor the snap parliamentary vote held in July failed to produce a ruling majority and a stable government, just as the country was due to submit its own NRRP. With a hung parliament, the task was delegated to the country's Caretaker Government led by current acting PM Stefan Yanev. Following months of preparations, the Caretaker Government submitted the Bulgarian NRRP in October, with the country's incoming government expected to utilize €6.5 billion to strengthen the post-pandemic recovery. With the incoming government of a new, four-party coalition led by the anti-corruption We Continue the Change party, the European Commission is likely to endorse the Bulgarian plan, however, given delayed submission, this will only happen in 2022.

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[1] Please see here for our overview on recent Polish economic reforms and the standoff between Warsaw and Brussels

[2] For an overview of the backdrop to the Bulgarian political scene in 2021, please see our earlier memo here

LOOKING AHEAD

The implementation of the NGEU presents an historic opportunity for the European bloc to support its post-pandemic recovery. Combined with the funds from the EU's budget for 2021-2027, the €1.8 trillion-worth funding could provide major stimulus for Central and Eastern Europe's economic growth, with the European Commission's projected focus on green economic and digital transition indicating a sustainable growth path. The latter will present numerous opportunities for current and potential investors.

While most EU-member states in Central and Eastern Europe look to benefit from this ambitious funding facility, crucial CEE markets are yet to receive an approval from the European Commission to start spending the recovery money, including Bulgaria, Hungary and Poland, the largest market in the region. The Commission is likely to endorse the Bulgarian recovery plan, however its standoff with Poland and Hungary over rule-of-law and transparency concerns will likely go into 2022. Hungary's case will be further complicated as the country heads towards parliamentary elections next April.

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If you would like to schedule a discussion of this paper, please contact:
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