Box 5

NEXT GENERATION EU: MAIN CHARACTERISTICS AND IMPACT OF ITS ANNOUNCEMENT ON FINANCIAL CONDITIONS

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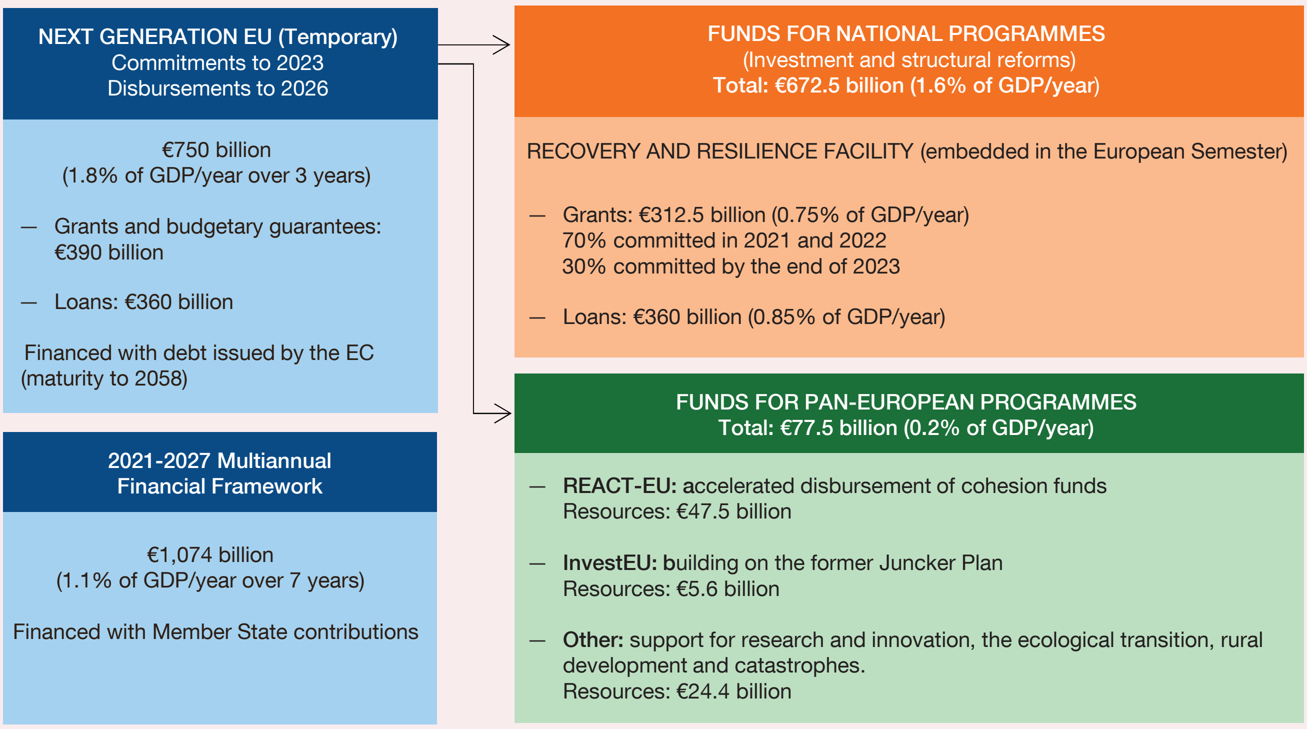
At its meeting of 17-21 July, the European Council agreed to create Next Generation EU, a temporary recovery fund additional to the multiannual budget of the European Union (EU) for 2021 2027. Unlike the multiannual budget, which is funded through contributions by Member States and some common taxes, the new fund will be financed through debt issuance on capital markets by the European Commission (EC). Up to €750 billion will be issuable between 2021 and 2026. The funds will be used to tackle the consequences of the COVID-19 crisis and to accelerate the digital and green transitions of the European economy (see Figure 1). It is envisaged that the fund will grant direct transfers to the Member States (42% of the total), finance pan-European programmes (around 10% of the total) and, if necessary, grant bilateral loans to countries (the remaining 48%). Debt issued by the EC under the framework of this fund will be repaid from 2028 and up to 2058. To this end, the possibility of providing the Commission with a number of new own resources is envisaged (in particular, through digital and environmental taxes).

To access these resources, Member States will be required to design "recovery and resilience plans" that will be evaluated by the EC. These plans must be in compliance with the specific recommendations drawn up by the EC for each country in the context of the European Semester.[1] Also, investments included in these plans must follow the general EU budget criteria. Thus, in aggregate terms, 30% of the funds are to be allocated to environmental sustainability enhancement projects.

In accordance with the draft agreement available, the legal expenditure commitments relating to the projects included in Next Generation EU are to be made by 31 December 2023 and related payments will be made by 31 December 2026.[2] Specifically, 70% of direct transfers to Member States must be committed in 2021-2022, with an

Figure 1
MAIN CHARACTERISTICS OF THE EU'S RECOVERY PLAN



SOURCES: European Council and devised by authors.

1 See P. García-Perea, A. Millaruelo, V. Mora-Bajén and M. Sánchez Carretero (2020), "The 2020 European Semester and the specific recommendations for Spain", Economic Notes, 3/2020, Banco de España.

2 The EC estimates that most transfers will be made between 2022 and 2025 (see COM (2020) 408 final).

allocation key between countries that depends on the unemployment rate recorded between 2015 and 2019, population and per capita income. The remaining 30% must be committed by end-2023. The allocation key will be amended to incorporate more directly the uneven impact of the health crisis. Thus, the unemployment rate will be replaced by a variable that will weigh, in equal proportion, the fall in GDP in 2020 and the cumulative loss in GDP in 2020-2021.

This instrument, which expands supra-national debt and incorporates a fiscal risk-sharing element, is a very important step in European integration. According to the historical experience available, the steps taken to press ahead institutionally both in the EU and in the euro area tend to bring about positive effects on the financial markets and, in particular, on the sovereign risk premia,[3] which tend to decline as these agreements are perceived as a guarantee of continuity and further strengthening of the European project. Also, in the long term, a more extensive supra-national debt market could promote greater banking and capital markets integration at European level, as there is a common and secure reference for all countries.

To quantify the impact of the various announcements linked to the new recovery fund on the euro area's financial markets, we present an event-study exercise, focusing on the stock and sovereign debt markets. This methodology consists of calculating the variation experienced by certain financial indicators within narrow time windows around the time a specific event is announced or takes place. Thus, the intention is to isolate the impact of the event from other possible factors that might also influence the financial indicators, such as economic or, in the current setting, epidemiological news. Specifically, the three most important milestones linked to the discussions leading up to the agreement to set up the recovery fund are considered for this exercise, namely: i) The Franco-German proposal of 18 May, ii) the EC proposal of 27 May, and iii) the announcement of the European Council agreement on 21 July. For these three events, time windows of a few hours around the moment when each announcement was made are set and intraday

Chart 1
CHANGE IN STOCK MARKET INDICES AND IMPLIED VOLATILITY (a)

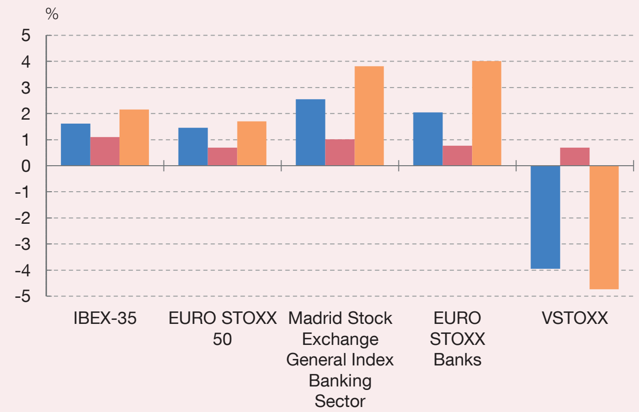
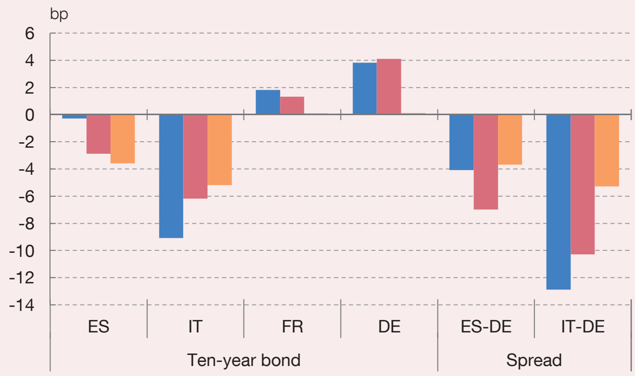


Chart 2
CHANGE IN YIELD ON SOVEREIGN DEBT (a)



FRANCO-GERMAN PROPOSAL (18 MAY) EC PROPOSAL (27 MAY) EUROPEAN COUNCIL FINAL AGREEMENT (21 JULY)

SOURCE: Thomson Reuters Eikon.

a For the 18 May event, the window's starting time was set 30 minutes prior to the meeting between the French and German leaders at 15:30, which was followed by a press conference at which they announced their joint proposal. The close of the bond markets (19:00) on the same day was set as the end of window. The window for the 27 May event, lasting 4 hours, starts at 11:00, a few minutes before some details of the European Commission's proposal were published by a media outlet. The 21 July agreement was announced in the early hours of the morning. Therefore, the window used runs from the close of the markets on 20 July to 12:00 the following day.

3 See I. Kataryniuk, V. Mora-Bajén and J.J. Pérez. (2020), "EU deepening and sovereign debt spreads: how relevant is the "political space"?", Working Paper, Banco de España, forthcoming.

data are used to calculate the variation in the financial indicators within such windows.[4]

Charts 1 and 2 contain the results of this exercise. According to Chart 1, the three announcements had a positive impact on the European stock markets, somewhat higher on the Spanish index (IBEX-35) than on the European index (EURO STOXX 50). The increases were higher for the respective bank sub-indices than for the general indices. The European Council's final agreement prompted the highest stock market appreciations, as regards both bank sub-indices (3.8% and 4% in the Spanish banks index and in EURO STOXX Banks, respectively) and in the general indices (2.2% and 1.7% in the IBEX-35 and EURO STOXX 50 indices, respectively) followed closely by the Franco-German proposal. The effect of the EC proposal was more limited. Also, stock market volatility in the euro area, measured with the VSTOXX index, declined substantially as a result of both the final agreement and the Franco-German proposal (down 4.8% and 4%, respectively), while it hardly changed with the EC proposal.

The three events also had a significant impact on the sovereign debt markets (see Chart 2). In the case of Spain, the ten-year sovereign bond yield and its spread over the German ten-year Bund yield decreased appreciably following the European Council's final agreement (with declines of nearly 4 basis points (bp) in the two variables) and the EC proposal (3 bp and 7 bp, respectively). The Franco-German proposal reduced the spread by 4 bp but had a negligible effect on the yield. In the case of Italy, the Franco-German proposal was the event with the greatest impact on the ten-year bond yield and on its spread over the German bond (down 9 bp and 13 bp, respectively), followed by the EC proposal (with falls of 6 bp and 10 bp, respectively); the effect of the European Council's final agreement was somewhat more limited (a decline of 5 bp in both variables). The yields on German and French bonds increased slightly in response to the EC proposal (by 1 bp and 4 bp, respectively) and to the Franco-German proposal (by almost 4 bp and 2 bp, respectively),[5] while the effect of the final agreement on the two indicators was negligible.

In short, based on the analysis conducted in this box, the most relevant milestones leading to the European Council agreement of 21 July for the creation of the recovery fund Next Generation EU have had a positive effect on the euro area stock markets and have led to an easing of the financing conditions of the Italian and Spanish Treasuries. This positive reaction of the financial markets suggests that investors interpreted that the creation of a fund with such characteristics would boost growth in the euro area and strengthen the common European project.

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4 See the footnote to Charts 1 and 2 for further information on the time windows chosen. The difficulty in establishing the exact moment when the information was sufficiently disseminated in the financial markets suggests the need to use several-hour windows, so as to capture market reaction to the event. However, this implies that market performance might also be affected by other contemporaneous events.

5 The increase in the yield on the French and, mainly German, sovereign bonds could be due to investors' higher appetite for risk a result of the announcements, in line with the stock market price appreciations.