Box 3. Next Generation EU: prospects for a swift economic recovery

The public health crisis that broke out in early 2020 has seen unexpectedly non-linear developments. More than a year after the World Health Organisation declared a pandemic, the SARS-CoV-2 virus, whose genome has undergone numerous mutations, leading to the emergence of new variants with different rates of contagion, continues to spread. Although the development of several vaccines and the launch of vaccination campaigns are expected the have beneficial effects, the pandemic has already left a significant mark on economic activity.

Nevertheless, national and international authorities have responded promptly to the new circumstances. In addition to the initiatives for managing the public health crisis, the aim was to limit its economic impact. For instance, on the domestic front, Member States have adopted job-retention schemes, as well as measures to support liquidity[1]. At international level, the European Commission, together with other institutions, have introduced a broad and diversified package of measures, acting on several fronts to stop the spread of the SARS-CoV-2 virus and to tackle the socio-economic impact of the pandemic[2].

Among the relevant economic measures taken at EU level, the Next Generation EU (NGEU) programme stands out. It is a temporary instrument, whose specific mechanisms will be implemented over the 2021-2026 period. The NGEU is intended to help mitigate the economic and social damage brought by the pandemic, with a total budget of EUR 750 billion, consisting of grants and loans (extended on favourable terms). The NGEU instrument was designed on three pillars (Chart A), and most of the funding will be used to support public investment and structural reforms.

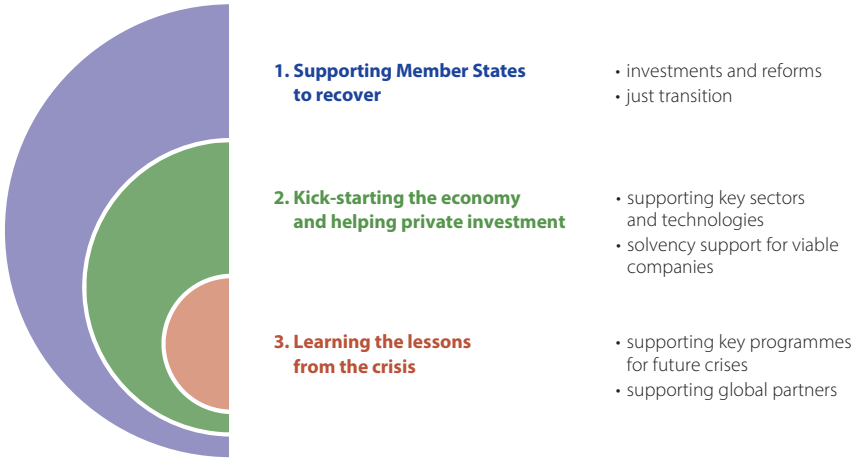


Chart A
Pillars of Next Generation EU

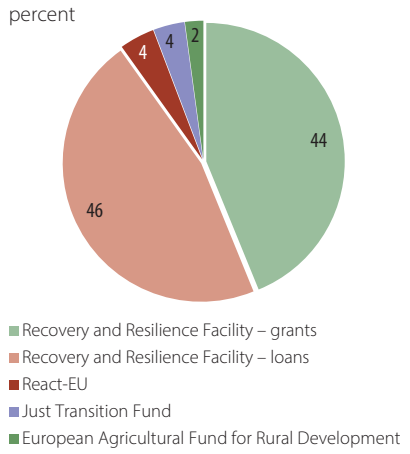
Source: European Commission

1 A tracker of the policies taken by various countries worldwide, including Romania, is available at: https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19

2 More information on the European Commission's response to the pandemic by area of action is available at: https://ec.europa.eu/info/live-work-travel-eu/coronavirus-response/overview-commissions-response_en

Romania's allocations under the NGEU amount to around EUR 32.4 billion[3], of which EUR 17.4 billion in grants and EUR 15 billion in loans under favourable terms. A nearly 90 percent share (Chart B) of these amounts is associated with the Recovery and Resilience Facility (RRF) – the centrepiece of the NGEU. The RRF is a programme intended to support investment and reform in Member States with an aim to mitigate the social and economic impact of the COVID-19 pandemic, to increase the resilience of EU economies and facilitate their green transition.

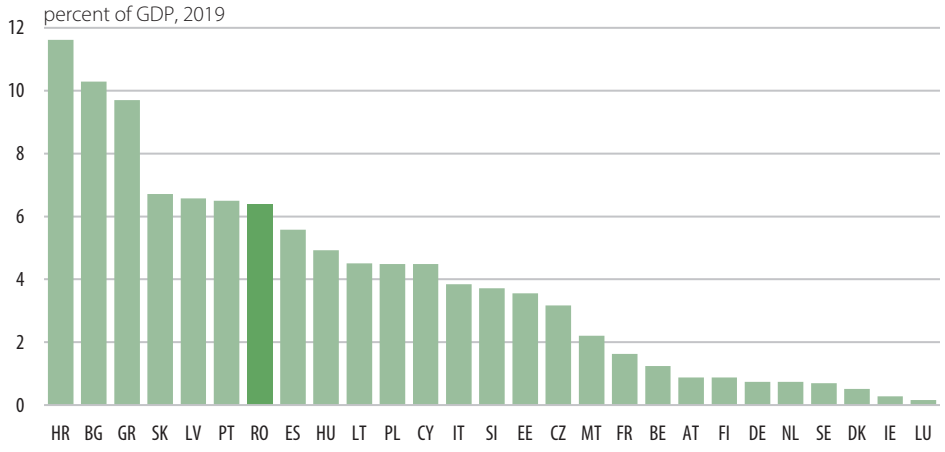
Chart B
Romania's allocations under the NGEU



Source: European Commission, NBR calculations

Romania is eligible to receive additional funding under the Multiannual Financial Framework 2021-2027 through the REACT-EU programme, an initiative that continues and extends the pandemic crisis response and repair measures. The REACT-EU resources should be used primarily for investments in health and to provide support to SMEs (especially in the sectors most affected by the pandemic)[4]. Moreover, due to the increased funding for rural development, projects supporting communities in these areas may receive financing. Another NGEU component, alongside the allocations under the standard multiannual financial framework, is the Just Transition Fund, a programme aimed at supporting the regions most affected by the transition towards climate neutrality and at preventing an increase in regional disparities.

Chart C
Grants allocated under the Recovery and Resilience Facility



Source: European Commission

Out of the various funds that make up the NGEU, the Recovery and Resilience Facility (RRF) is the key instrument for the recovery of the economies, due to the volume of allocations in the form of grants and loans. In the case of grants, 70 percent of the allocations for each Member State were calculated based on: (i) the population of the Member State concerned, (ii) the inverse of the

3 According to data from the National Recovery and Resilience Plan (the May 2021 version), corroborated with those available at: https://ec.europa.eu/info/strategy/recovery-plan-europe_en

4 Further details on the REACT-EU facility are available in the Regulation of the European Parliament and of the Council of 23 December 2020: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020R2221&from=EN

GDP per capita, and (iii) the average unemployment rate during the period 2015-2019 compared to the EU average. For the remaining 30 percent of the allocations, the observed loss in real GDP during the pandemic crisis was considered. In light of these indicators, Romania is among the countries with the highest allocations at EU level (Chart C).

The decision to allocate RRF resources is adopted by the EU Council based on the national recovery and resilience plans submitted to the European Commission by each Member State. The plan clearly defines a detailed set of measures as a balanced response to the economic and social situation of the Member State concerned, also in the light of country-specific recommendations identified by the European Commission and adopted by the EU Council in the context of the European Semester. In addition, other requirements concern the amounts allocated to investments and reforms that support the green transition (at least 37 percent of budget allocations) and the digital transition (at least 20 percent of budget allocations). The first instalments of funding from the EU under the RRF shall be disbursed to Member States as early as 2021, in the form of pre-financing payments accounting for 13 percent of the total allocation.

Other specific characteristics of these resources refer to existing constraints on the uptake and the release of RRF funds. To ensure that the financial support is frontloaded at the beginning of the period, 70 percent of the amount available should be legally committed by 31 December 2022 and the remaining 30 percent by end-2023. The release of funds under the Facility is contingent on the satisfactory fulfilment of the relevant milestones and targets by the Member States set out in the recovery and resilience plans. Payments shall be made by 31 December 2026. From this perspective, unlike in a standard multiannual financial framework, the amounts cannot be phased[5]. This particularity of the RRF increases the need for a speedy launch of investment projects, being preferable to avoid implementing them (especially the complex ones) towards the end of the RRF's lifetime in order to reduce the risk of delays leading to the suspension of payments. As regards the repayable component of the RRF, loans are to be repaid starting in 2028.

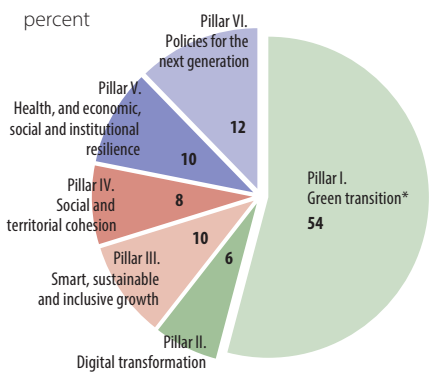
In Romania's case, a first draft of the National Recovery and Resilience Plan (NRRP) was prepared in November 2020. In 2021, further public consultations took place, leading to the Plan's update. At end-May, Romania submitted the official NRRP to the European Commission. The plan is structured around 15 components comprising reforms and investments that cover all six pillars of the RRF[6] (Chart D). The NRRP was designed based on the total allocation earmarked for Romania, i.e. EUR 29.2 billion. Among the priority areas for funding from the RRF funds, infrastructure (road, rail), energy, and health and education stand out. Regarding the next steps, the Commission will assess the NRRP based on the criteria set out in the Regulation and translate their contents into legally binding acts. The Council

5 Funding shall be suspended for projects not completed by 2026, and no payment shall be made after that year.

6 For details on each pillar's scope of action, see Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, available in electronic format at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0241&from=EN

shall subsequently adopt the Commission proposal for a Council Implementing Decision.

Chart D
Proposed budget by RRF pillar



*) includes infrastructure projects (accounting for 48 percent of Pillar I)

Source: National Recovery and Resilience Plan (May 2021), NBR calculations

The NGEU instrument (in particular, the RRF funds) paves the way for boosting economic recovery. Romania may receive large contributions for the implementation of investment projects and reforms in various areas. Some scenarios have assessed the macroeconomic impact of the use of NGEU grants. The results are shown as differences relative to a baseline scenario excluding these funding sources. In the case of loans, the scenarios envisage substituting expenditure financed from national funds and possibly implementing projects that exceed those in the baseline scenario only towards the end of the forecast horizon, as the volume of grants diminishes.

With regard to the amount of non-repayable external funds used in investment and reform projects, the technical assumptions underlying the scenarios rested on the multi-year cumulative absorption rate for the previous Multiannual Financial Framework (2014-2020 MFF). The reference to a multi-year cumulative absorption rate reveals the distinctive nature of these funds and the possibility of a faster implementation of investment projects precisely to enable economic recovery. In addition, given the specific constraints of the RRF (the centrepiece of NGEU) related to the uptake and release of funds, the use of grants may be relatively swift-paced ever since the early years of the new multiannual financial year.

Nevertheless, inherent uncertainties shape the profile of annual repayments. Despite an expected strong monitoring of the project implementation status, regarding also the targets committed to by the relevant authorities, potential hindrances may arise, especially in the case of early stage projects. For these reasons, two scenarios were examined[7]: (i) an optimistic one, which assumes the implementation of projects funded by NGEU grants accounting for 5.1 percent of the 2019 GDP in the period 2021-2023[8], anticipating a 100 percent absorption rate at end-2026, and (ii) a moderate one, which assumes the implementation of projects financed by NGEU grants totalling 3.2 percent of the 2019 GDP, and a partial absorption of 70 percent at end-2026.

In order to quantify the macroeconomic impact, use was made of the NBR's model for analysis and medium-term forecasting and of a number of expert assumptions[9]. Empirical evidence also point to the presence of stimulative effects within the

7 Scenarios constructed in the absence of information on the implementation timeline for investment projects and milestones and targets committed to by the relevant authorities.

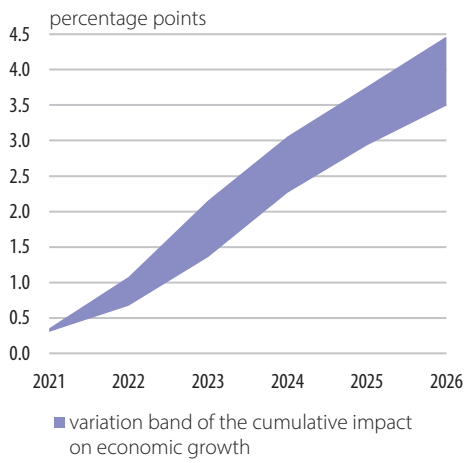
8 This period was chosen as a reference, considering the EU provisions on the full commitment of the RRF amounts by end-2023, payments being made by 31 December 2026.

9 For details on the multipliers prevailing in the case of European grants, see Box 1 "Assessment of the impact of the EU structural and cohesion funds on economic growth" in the 2018 *Annual Report*.

economy. Moreover, 70 percent of NGEU grants were assumed to be capital transfers (the investment component).

The implementation of investment projects and reforms via EU funds is expected to have a beneficial effect on the economy. Under the conditions described in the two scenarios, the cumulative impact on economic growth in 2021-2023 is assessed to range between 1.4-2.2 percentage points, including stimulative effects, exerting a possibly persistent favourable influence on the economy.

Chart E
Cumulative impact of NGEU funds on the real GDP



Source: NBR assessments

Over the medium term (2021-2026), the cumulative impact of the uptake of NGEU grants can reach up to more than 4 percentage points compared to the scenario where funding under this instrument is excluded (Chart E), a value well above the estimates for the euro area[10]. Added to these are the effects coming from loans, insofar as they are channelled towards investment projects, other than those quantified in the baseline scenario. However, in the case of the public sector, the need for strong and prolonged fiscal consolidation may lead to a replacement of domestically funded projects with those funded from RRF resources (given the potential for low-cost financing).

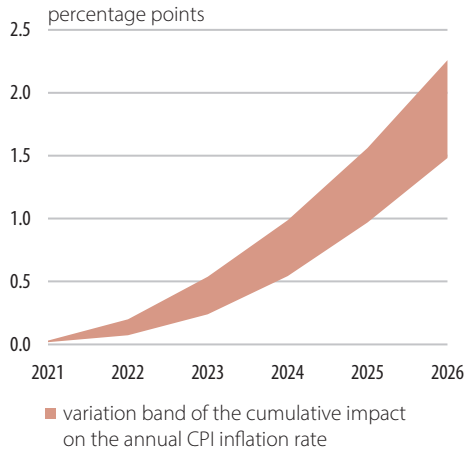
The stimulative effects may be even more pronounced in the event of implementing highly complex projects and ensuring their streamlined financing. Against this background, the multipliers taken into account to determine the macroeconomic effects of the absorption of NGEU may be higher, likely exerting wider-ranging effects than those described in the two scenarios. At the same time, an increased effort to absorb EU funds (at a faster pace than assumed in the scenarios) would also generate a greater impact on economic growth.

The breakdown of GDP shows that although gross capital formation is expected to see the strongest effects, also enhancing the growth potential of the economy, the commitment of major investment projects would lead to an increase in consumption as well. Compared to the scenario that excludes NGEU funds, the output gap is anticipated to be wider.

The higher investment volume in the economy can potentially create new jobs, mainly in the short run. Moreover, projects for infrastructure, competitiveness or human capital skills development would generate favourable productivity shocks on economic agents, offsetting to some extent the negative effects associated with the shortage of skilled/specialised workforce. In this context, a positive impact on the labour market may also come from productivity growth.

[10] Valenta *et al.* (2021) assessed the cumulative impact on the euro area of the recovery instrument at around 1.5 percent of GDP in 2021-2025. The significant difference from the potential impact on the Romanian economy owes, on the one hand, to the large amounts allocated to Romania, and on the other hand, to synergies to exploit large investment allocations, which are highly efficient in terms of their effects on output.

Chart F
Cumulative impact of NGEU funds on the annual CPI inflation rate



Source: NBR assessments

As regards the annual CPI inflation rate, the inflationary shock is assessed to be relatively low (Chart F), the upward inflationary pressures stemming from aggregate demand. Under these conditions, core inflation is expected to be revised against a baseline scenario. However, it would be only partly affected by investment stimuli, given that many of these funds will boost the growth potential of the economy, reflecting to a small extent in a net surplus of aggregate demand relative to aggregate supply. Acting in the opposite direction is the step-up in foreign capital inflows, automatically affecting domestic currency developments. Under the assumptions for the two alternative scenarios, the cumulative net impact on the annual CPI inflation rate in 2021-2023 is projected to fluctuate between 0.2 and 0.5 percentage points.

At the same time, the budget deficit may witness slight corrections, amid a more favourable macroeconomic framework compared to the baseline scenario. As for grants, their use may lead to a decrease in the government debt-to-GDP ratio, given their favourable effects on GDP[11]. This would create an additional fiscal space, which may serve to provide new stimuli, in addition to those financed by EU funds. Turning to loans, their efficiency may diminish insofar as they contribute to the increase in government debt. By contrast, if these loans are taken out by the general government and are used to replace the current expenditure, the positive effects of low-cost financing, specific to the RRF, will prevail.

Looking at the current account deficit, the impact of NGEU funds is assessed to be relatively small. Despite the rise in current transfers, which has contributed to the improvement in the secondary income balance and, implicitly, to the lower current account deficit, the implementation of investment projects is expected to increase imports, amid the limited capacity of the local intermediate goods production, as mirrored also by the significant share of these goods in international trade[12]. While the external imbalance may worsen, its financing from stable, non-debt-creating sources is expected to pick up with the potentially large inflows of capital transfers.

In conclusion, the pandemic crisis has had a significant impact on economic activity. At the same time, the need to manage it and to limit its adverse socio-economic effects has led to the implementation of comprehensive stimulus packages that may target specific priority areas of EU economies.
The NGEU instrument is an opportunity for faster economic recovery. The swift implementation of investment projects and reforms may lay the foundations for a modern economy that is highly resilient to adverse shocks. From this perspective, the uptake of non-repayable external funds should be a priority in the coming years.

[11] However, the EC recommends that public investment funded by RRF grants should come on top of existing levels of public investment. The EC press-release is available at: https://ec.europa.eu/commission/presscorner/detail/en/ip_21_884

[12] According to the latest NIS data, the share of intermediate goods in total goods imports is around 60 percent.

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