EU retains ample spare funding capacity to support member states and Ukraine

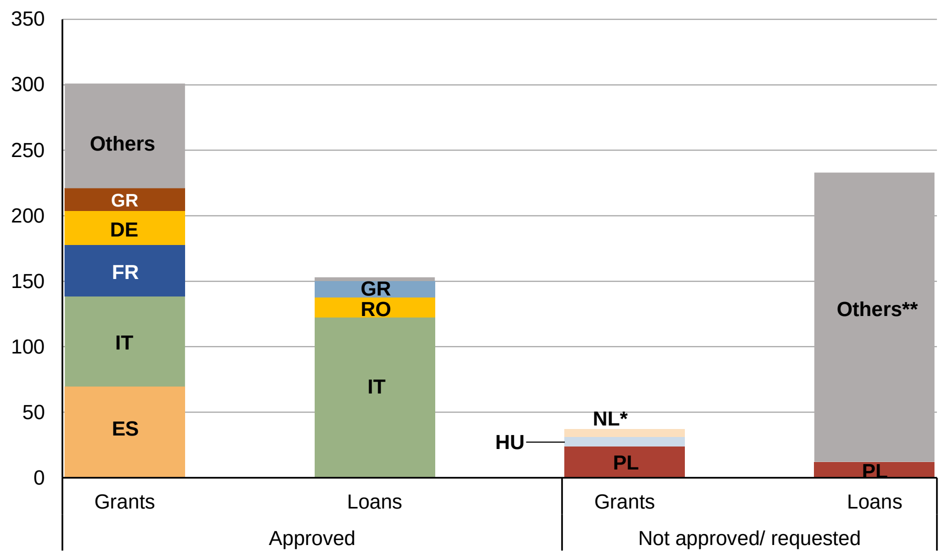
The European Union still has significant financial resources at its disposal to support Ukraine and protect member states from the impact of the war despite the Next Generation EU (NGEU) funds already committed to support post-pandemic growth and investment.

The EU (AAA/Stable) is providing substantial fiscal support to European countries in response to the Covid-19 pandemic with the EUR 800bn Next Generation EU (NGEU) programme, of which almost 90% will be disbursed via the Recovery and Resilience Facility (RRF). The programme, though not directly linked to the war, will support European sovereigns through 2022-24 period when most grants will be disbursed, just as member states are facing the economic consequences of reducing their reliance on Russian fossil fuels.

The EU has also granted EUR 1.2bn in Emergency Macro-Financial Assistance (MFA) to Ukraine (CCC/Under review for developing outcome) though the amount is modest compared with the government's estimated funding gap of around EUR 15bn for the next three months. The EU has the means to increase direct financial support to Ukraine and other non-EU countries experiencing the adverse knock-on economic effects of the war.

Figure 1. RRF grant and loan requests and approvals

EUR bn



*The Netherlands have yet to provide their recovery plan following a change in government. **The maximum amount that is left from the original EUR 386bn envelope following the approval of six loan requests, mostly Italy's.

Source: European Commission, Scope Ratings.

In this Q&A, we take stock of i) the EU member states' recovery plans, ii) the extent to which the EU funds support countries in 2022-24, iii) how much the EU could provide Ukraine with additional funds, and iv) how a sizeable programme for Ukraine could impact the EU's credit profile.

We conclude that i) about EUR 233bn of loans can be requested until August 2023, ii) EU funds are partially offsetting the adverse economic impact of the war in Ukraine on large euro area countries, boosting GDP levels by between 0.3-1.6pp, iii) the EU could provide Ukraine with at least EUR 10-12bn in direct financial assistance through a new financial package, and iv) the EU's AAA credit rating has ample buffers to absorb such a request.

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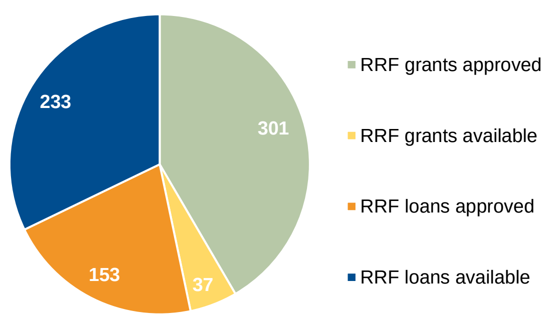
Where does the implementation of RRF disbursements stand?

Most RRF grants and 40% of loans have been requested

Disbursement of RRF funds to member states depends on the approval of countries' recovery and resilience plans and the successful implementation of agreed milestones. So far, EUR 301bn in grants out of a maximum EUR 338bn and EUR 154bn in loans out of a maximum EUR 386bn have been requested and approved (Figures 1 and 2). Most grants have been requested by and approved for Spain (EUR 69.5bn), Italy (EUR 68.9bn), France (EUR 39.4bn) and Germany (EUR 25.6bn). Italy, with an approved amount of EUR 122.6bn of RRF loans, has requested the bulk of repayable support.

Figure 2. RRF grants and loans

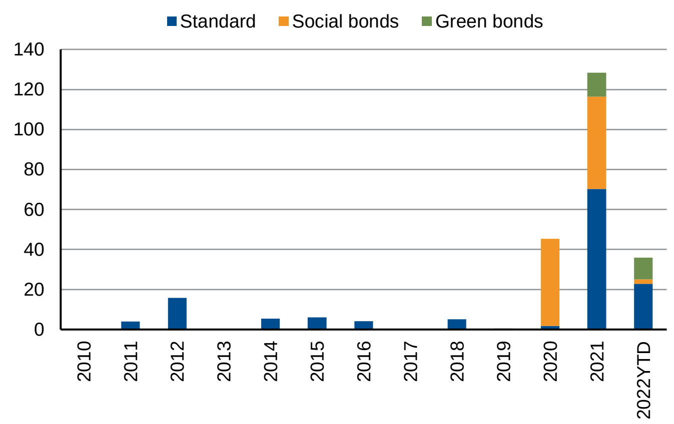
EUR bn, latest available figures



Source: European Commission, Scope Ratings.

Figure 3. EU annual debt issuance

EUR bn, excluding EU bills



Source: Bloomberg Finance, European Commission, Scope Ratings.

EC approves 24 plans, Poland's and Hungary's face hurdles

To start disbursements – involving a 13% pre-financing tranche of grants and loans –, the European Council needs to approve a country's recovery plan and pre-financing request. Out of 27 member states, 24 plans have been approved to date, and most member states have received their pre-financing tranche. The Netherlands (AAA/Stable) has yet to provide its recovery and resilience plan following a change in government, while the plans submitted by Poland (A+/Negative) and Hungary (BBB+/Stable) face implementation hurdles given the governments' disputes with Brussels over the rule of law, which have led the Commission to trigger the conditionality principle in the case of Hungary.

After the pre-financing phase, further disbursements can be applied for twice a year, and hinge on the fulfilment of the agreed milestones. As of today, the first tranches of RRF grants and loans have been approved for Italy (BBB+/Stable), Spain (A-/Stable), Greece (BB+/Stable) and France (AA/Stable) and a total of EUR 66bn of grants and EUR 33bn in loans have been disbursed.

NGEU to make the EU the largest supranational issuer

Disbursements will be financed by raising EUR 100-150bn on average a year between mid-2021 and 2026 on the capital markets using a revamped funding strategy. The EU's borrowing takes the form of long-term bonds, including up to EUR 250bn of green bonds, as well as EU bills. According to the EU's semi-annual funding plan, EUR 50bn of long-term bonds will be issued between January and June 2022, of which EUR 31bn have been raised so far, including EUR 11bn of green bonds, via syndications (EUR 21bn) and auctions (EUR 10bn). In 2021, EUR 71bn have been issued for NGEU, including EUR 12bn of green bonds (**Figure 3**).

How does the RRF support EU sovereigns during the war?

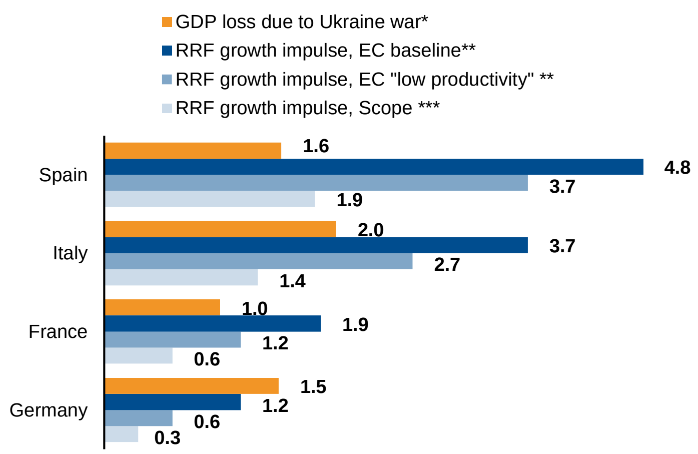
RRF will enhance the growth of Europe's largest economies even in a conservative scenario

The implementation of recovery and resilience plans is expected to enhance economic activity in 2022/23 for Europe's largest economies, although estimates of their economic impact vary significantly, as highlighted by Darvas 2021 (**Figure 4**). However, even in a conservative scenario, we still estimate that the growth impulse of the RRF will make a material contribution to growth in 2022/23 and therefore mitigate to some extent the severity of the economic shock triggered by the war.

For example, the adverse impact of the war on Spain, estimated at around 1.6pp, is more than offset by the boost from RRF funds, even under our conservative estimates. While the war's malign economic effects are not fully offset for the other large euro area economies, the contribution of the RRF funds remains significant.

Figure 4. Real GDP loss until 2023 versus RRF growth impulse

Cumulative until end-2023, pps of real GDP



* GDP loss is calculated as the difference in the level of real GDP by the end of 2023 as projected in the IMF World Economic Outlook in January 2022 versus April 2022.

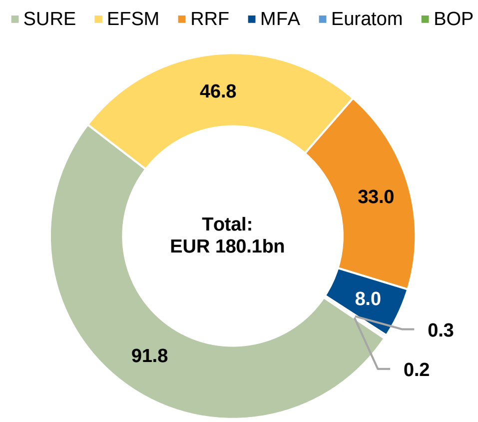
** The RRF baseline and "low productivity" growth impulse is taken from the respective European Commission Staff Working Documents.

*** Scope's alternative scenario impulse equals 0.5 times the effect in the respective Commission's "low productivity" scenario.

Source: IMF, European Commission, Scope Ratings.

Figure 5. The EU's loan portfolio by programme

EUR bn, latest available figures



Source: European Commission, Scope Ratings.

RRF climate spending to support energy resilience agenda

Further, since at least 37% of spending is earmarked for climate spending, we believe an effective implementation of the plans will help member states in strengthening their energy resilience via reducing fossil fuel dependency, including from Russia: between 41% and 50% of milestones and targets set by the four biggest European countries refer to the green transition.

This will lead to significant disbursements aimed at funding green investments. For example, EUR 60.5bn in Italy (3.3% of GDP) are earmarked for energy efficiency investments, which should support the country in reducing its relatively high reliance on Russian fossil fuels.

Finally, member states can still request their portion of loans until 31 August 2023, provided extra financial needs can be justified by additional reforms and investments included in the recovery and resilience plan. These funds could then be disbursed during the 2024-26 period.

Has the EU capacity to support non-member European countries?

MFA is the EU's main tool to provide financial support to Ukraine…

The EU's main tool to expand its financial assistance for Ukraine is another MFA programme. MFA support typically takes the form of long-term loans at favourable rates, in addition to grants. The loans are back-to-back instruments, disbursed once necessary funds are raised on the capital markets and matched in maturity and financing conditions.

The potential size of additional MFA support to Ukraine is governed by Regulation (EU) 2021/947 establishing the Neighbourhood, Development and International Cooperation Instrument – Global Europe. As MFA loans are guaranteed by the External Action Guarantee Fund (EAGF), with a targeted provisioning level of 9%, the regulation effectively caps the amount to be disbursed as MFA loans.

In total, operations signed to be guaranteed by the EAGF for 2021-2027 shall not exceed EUR 53.5bn, which would correspond to EUR 4.82bn in provisioning from the EU budget. Total assets of the fund were around EUR 3.65bn at the end of 2020, implying a total envelope for the guarantees of around EUR 35bn at the end of 2020.

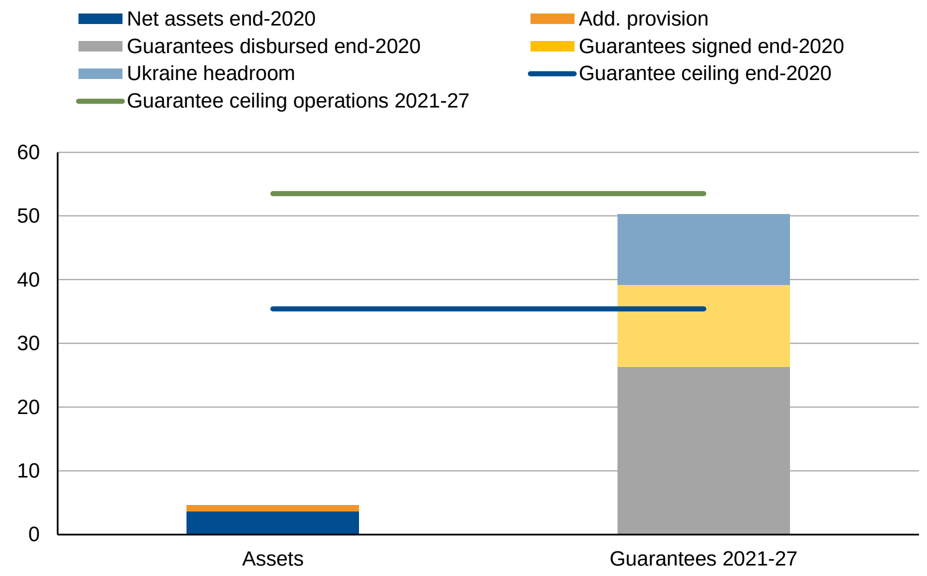
Of this amount, at end-2020, about EUR 26.3bn were consumed via operations that have already been disbursed under the EIB's external lending mandate (EUR 20.3bn), the EFSD programme (EUR 34m), Euratom loans (EUR 200m) and MFA loans (EUR 5.8bn). However, signed operations guaranteed by the fund amounted to EUR 39.2bn.

… but extra MFA support would require extra provisioning.

Therefore, any substantial MFA support to Ukraine would entail either a reduction in the EIB's non-EU related activities, which is unlikely, or additional provisioning needs for the EU budget, as current assets of the EAGF are already used for existing guarantees. We estimate that EUR 1bn of additional provisions of the EAGF would thus allow the EU to provide Ukraine with EUR 10-12bn in direct financial support. This would increase the guaranteed operations by the EAGF to around EUR 50bn, and thus remain within the established maximum ceiling of EUR 53.5bn.

Figure 6. External Action Guarantee Fund

Net assets at end-2020 and ceilings, EUR bn



Source: European Commission, Scope Ratings.

If the EU implemented a sizeable MFA programme for Ukraine, how would this impact its credit profile?

Potential implementation of a sizeable MFA programme would not impact the EU's credit profile

Credit implications of a large MFA programme to Ukraine would be commensurate with the EU's AAA-rating level. A programme for Ukraine would, however, affect the EU's loan portfolio and asset quality before taking credit enhancements into consideration. However, given the EU's proven preferred creditor status and history of zero non-performing loans, this would not impact our final assessment of the EU's portfolio quality, which we assess at the highest level. We would thus expect the EU's direct financial assistance to Ukraine to be treated preferentially in line with all its sovereign loans.

Second, the redemption of bonds issued for MFA would impact the EU's repayment profile and result in higher future repayment needs. However, given substantial liquidity buffers and repayment protections, including the expectation that Ukraine would repay its loans on time as well as the possibility to reprofile loans in case of need, this would be in line with our baseline scenario underpinning our rating view.

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