



1. Macroeconomic and financial developments and policies in the EU in 2021

Author



Sotiria
Theodoropoulou

Topics

Uneven pandemic economic impacts and recoveries	28
Inequalities in living standards and quality of life	29
Downwards convergence in GDP per capita during the pandemic	30
Variable and declining labour productivity growth in the EU27	32
Investment developments in the EU27	33
Positive developments in income inequality and at-risk-of-poverty rate	34
National crisis responses lead to higher budget deficits	35
Financing the recovery	37
The EU economic governance review relaunched	38
Surging inflation in the euro area considered transitory	39
The ECB response to the pandemic and its new monetary policy strategy	40
Looking ahead: rebuilding after the crisis	42



If the pandemic has shown anything, however, it is that a bigger role for the state is the only way to address large shocks and challenges, and that if a certain policy objective is considered worthwhile, financial ‘limits’ suddenly become less rigid

Sotiria Theodoropoulou

Introduction

Just 12 years after the global financial crisis, the Covid-19 pandemic has resulted in the biggest economic recession since World War II, with governments shutting down large parts of economies and societies to limit social contact and protect public health from the deadly effects of the virus. Governments and central banks in Europe and other advanced countries deployed extraordinary support measures to try to shield economies and financial markets from the effects of the shock. From the end of 2020, national and regional authorities around the world began granting emergency authorisation for the first vaccines against Covid-19 to be administered to the population. Universal vaccination campaigns thus got under way at the beginning of 2021, instilling a sense of optimism that the pandemic might be finally coming to an end.

Despite the fact that the vaccines proved to be effective in fending off severe disease, the combination of a new, far more contagious variant of the virus, the so-called 'Delta', and the failure in some parts of the world to vaccinate sufficiently high proportions of the population have been leading to new record numbers of cases and mounting pressure on healthcare systems. These recent developments have been a stark warning that the pandemic is unlikely to be tamed as long as the distribution of vaccine doses between richer and poorer countries, but also within countries, remains as uneven as it is now. Economic precarity and level of educational attainment have, moreover, been shown to correlate quite strongly with vaccination rates.

This chapter looks into economic developments and the ongoing policy debates in the EU in 2020 and 2021. It highlights inequalities between and within Member States in living standards and general quality of life. It also shows that despite the size of the shock, income inequality actually slightly improved in the vast majority of Member States in 2020, an indication that the unprecedented public support programmes that were deployed by governments and the ECB seem to have been effective at cushioning the effects of the shock. The chapter then concludes by looking more closely at the fiscal and monetary policy reactions at the national and EU level, the ongoing debates on their reform, and the questions they raise for the future.

Uneven pandemic economic impacts and recoveries

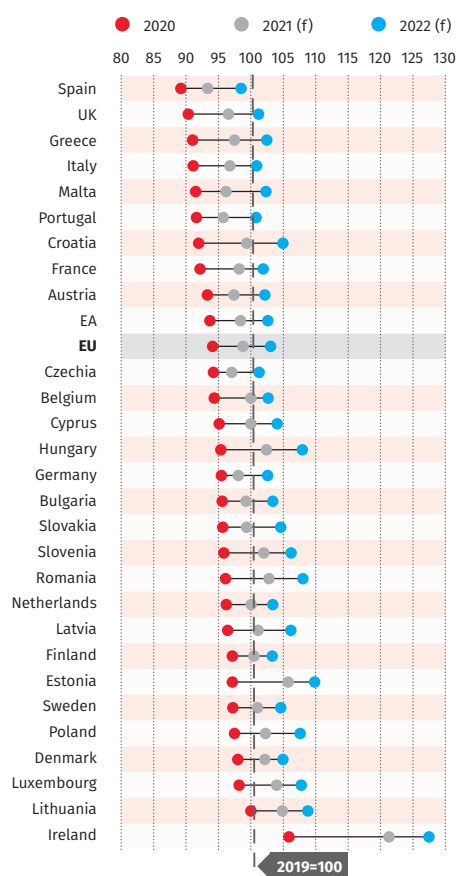


While all Member States and the UK are expected to have returned to positive real GDP growth rates in 2021, real output is expected to recover to or above its 2019 levels in only several Member States

According to AMECO data (OVGD series), compared to other advanced economies, such as the US, Canada, Australia, New Zealand, South Korea, Japan, Switzerland, and the UK, the EU experienced the third sharpest recession in 2020, with real GDP contracting by 5.9% (6.4% for the euro area), outperforming only the UK, where it was 9.7%. In Canada, real GDP contracted by 5.4%, in Japan by 4.8%, in the US by 3.4%, in Australia and in Switzerland by 2.4%, in New Zealand by 1.1%, and in South Korea by 0.8%. Real GDP is expected to recover to above its 2019 levels in 2022 in all these countries except Japan, where it is forecasted to have not yet recovered to this level even by 2021, as is also the case for the EU, the euro area and the UK.

The EU Member States have been affected to varying degrees by the shock of the pandemic. As Figure 1.1 illustrates, at one end of the spectrum, countries with big tourism sectors, such as Spain, Greece, Italy, Malta, Portugal, Croatia, France and Austria, registered the biggest real output losses: between 11% and 6.7% in 2020. While these Member States are currently projected to return to real GDP growth in 2021, they will not have returned to their 2019 levels. Several Member States, including Czechia, Belgium, Cyprus, Hungary, Germany, Bulgaria, Slovakia, Slovenia, Romania, the Netherlands, Latvia, Finland, Estonia, Sweden and Poland had real GDP losses, ranging from 5.8% (Czechia) to 2.5% (Poland). Denmark and Luxembourg had milder recessions of around 2% in 2020. On the other hand, real output did not decrease in Lithuania and even grew in Ireland.

Figure 1.1 **Change in real GDP (index: 2019=100%), EU, euro area, Member States and the UK, 2020, 2021 (f) and 2022 (f)**



Note: axis does not start at 0.
Source: own calculations using AMECO database OVG D series.

While all Member States and the UK are expected to have returned to positive real GDP growth rates in 2021, real output is expected to recover to or above its 2019 levels in only several Member States, most notably Cyprus, Hungary, Belgium, Slovenia, Romania, Latvia, the Netherlands, Latvia, Finland, Estonia, Poland, Denmark and Luxembourg. At the moment of writing, the European Commission's autumn 2021 forecasts suggest that the only country in which real GDP is not expected to have recovered to its 2019 levels, even by 2022, is Spain. However, significant uncertainty remains regarding these projections, as there is currently a surge in the number of cases in many EU Member States which may force governments to reimpose restrictions in social and economic activities to protect national healthcare systems, causing further disruptions in economic activity.



Inequalities in living standards and quality of life

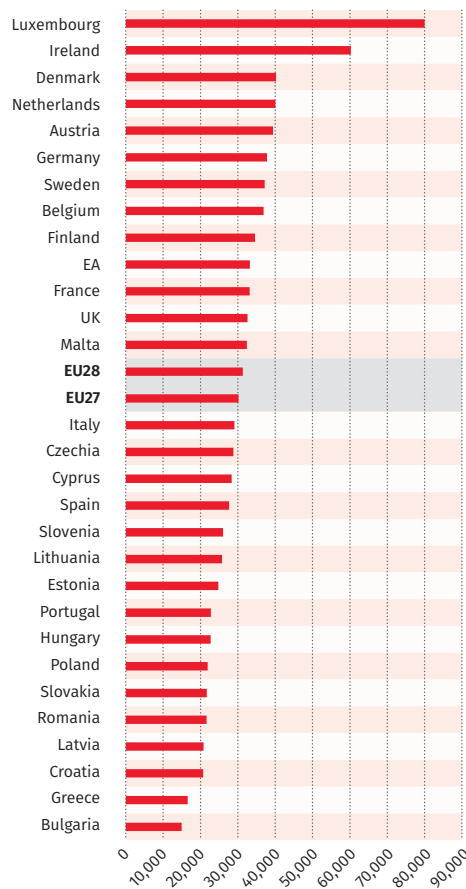
In 2019, the GDP per capita of the richest Member State (Luxembourg) was almost five times higher than that of the poorest (Bulgaria), whereas the EU27 average GDP per capita was almost twice as high as that of Bulgaria

Even prior to the uneven impact of the pandemic revealing itself, there had been inequalities across Member States. Figure 1.2 shows the GDP per capita of EU Member States, the EU27 (as of 2020) and the euro area in euro PPS terms, which allows the comparison of the purchasing power across different Member States. In 2019, the GDP per capita of the richest Member State (Luxembourg) was almost five times higher than that of the poorest (Bulgaria), whereas the EU27 average GDP per capita was almost twice as high as that of Bulgaria.

Going beyond GDP, one indicator of quality of life (or rather lack of it) is the self-reported unmet need for medical examination. Figure 1.3 shows the share of respondents aged 16 and above in the EU reporting that they had unmet

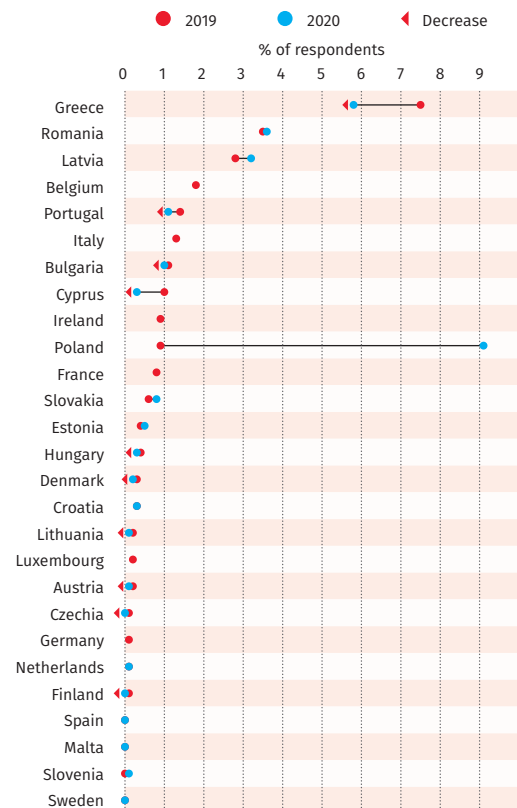
medical examination needs because it was 'too expensive' in 2019 and 2020. We see that in 2019, there were significant disparities among Member States: 7.5% of respondents in Greece reported unmet health examination needs because it was too expensive, while in most Member States, especially from the EU15, that share was virtually zero. Nevertheless, the group of countries where there were respondents that could not afford to meet their health examination needs was large enough to include Bulgaria, Belgium, Portugal, Cyprus, Ireland, Poland, Slovakia, Italy and France. These are rather striking figures considering that most of these countries are among the world's richest, with long-established and well-provisioned welfare states.

Figure 1.2 GDP per capita (PPS), EU Member States and the UK, 2019



Source: Eurostat nama_10_pc series.

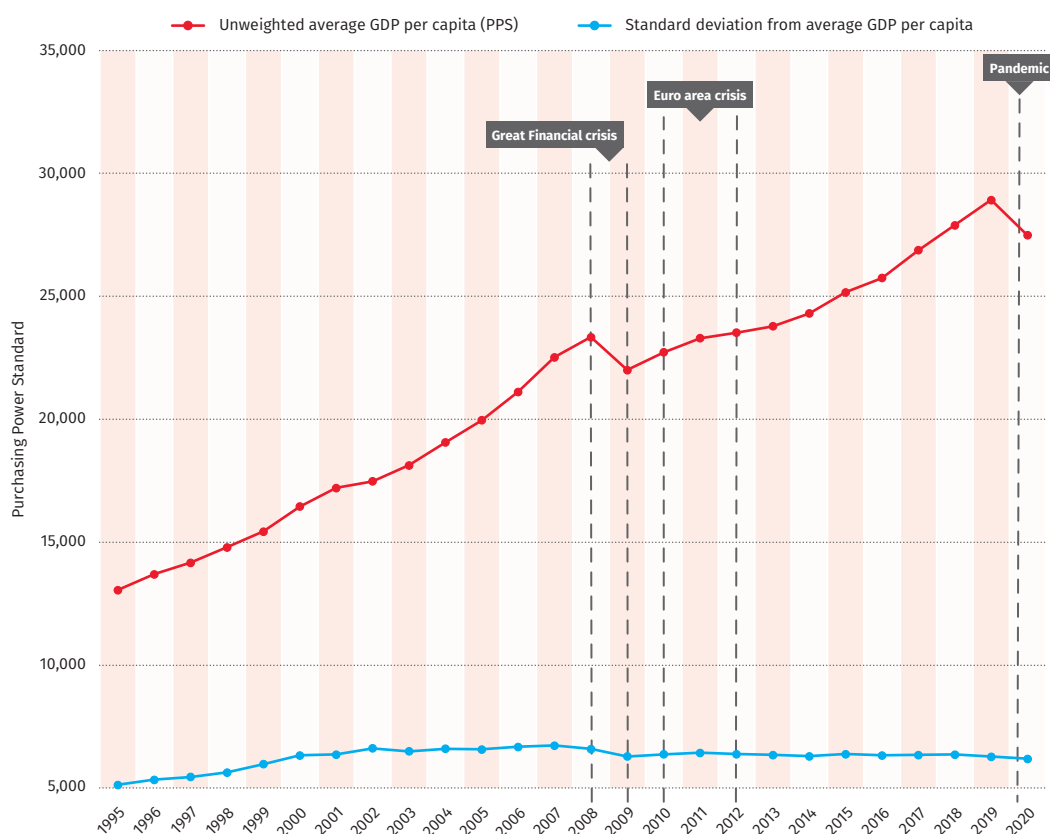
Figure 1.3 Self-reported unmet needs for medical examination (% of respondents, aged 16 and over), EU Member States, 2019 and 2020



Note: No 2020 data available for IE, FR, IT; 2020 data omitted for BE, DE, LU due to structural break in the series; 2020 data for PL and LV provisional. Eurostat hlth_silc_14 series.

Downwards convergence in GDP per capita during the pandemic

Figure 1.4 Unconditional convergence to average GDP per capita (PPS), EU Member States



Source: Own calculations based on Eurostat data tnama_10_pc series.

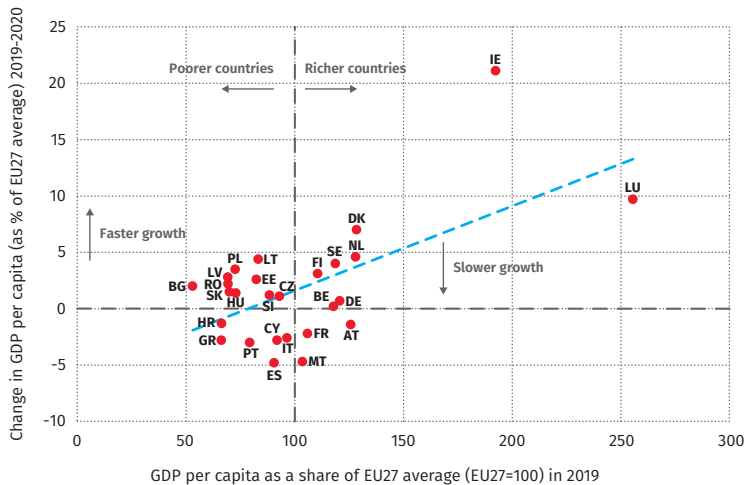
“
The impact of the pandemic seems to have been associated with downwards convergence in output-per-capita developments in the EU27

Such disparities between Member States on these various indicators are also the outcome of historical factors. Joining the EU held the promise of upwards convergence in living conditions, of which GDP per capita is the most comprehensive, albeit very imperfect, indicator. As Figure 1.4 illustrates, upwards convergence – whereby the average EU GDP increases while the GDPs of individual Member States all come closer to this average – has been occurring in fits and starts. A necessary condition for this upwards convergence to happen is that lower-income countries grow faster than higher-income ones, and the evidence shows that this has indeed

been the case in the EU since 1995. However, this process was more vigorous in 1996-2007 than it was in 2008-2019 (Theodoropoulou et al. 2019), reflecting the fact that the ‘catching-up’ had to some extent already taken place by the second period, but also reflecting the w-shaped recessions in the EU and in particular the euro area.

The impact of the pandemic seems to have been associated with downwards convergence in output-per-capita developments in the EU27: the (unweighted) average GDP per capita (in PPS terms) declined in 2020 (hence the ‘downwards’),

Figure 1.5 **Catching-up process (sigma convergence) in GDP per capita (EU27=100) 2020-2021, EU Member States**



Source: Own calculations using Eurostat data nama_10_pc series.

while the (unweighted) average divergence of Member States' GDP per capita from that average GDP per capita decreased slightly (hence the 'divergence'). This is not surprising, as some of the Member States most economically ill-affected by the pandemic were in the southern periphery of the EU, where there is a heavy reliance on tourism and services sectors which both involve social contact. Figure 1.5 suggests that on average, higher-income Member States grew faster than lower-income Member States over 2020-2021.

Box 1 Definitions and typology of convergence

There are different ways of defining and measuring convergence, which depend on underlying assumptions about what drives it. Here we focus on two:

- Unconditional convergence (also known as 'beta-convergence'): this is the convergence of a variable of interest (for example, GDP per capita or wage share) to the same average.
- Sigma convergence: this is the process whereby Member States with lower GDP per capita experience relatively higher growth rates than Member States with higher GDP per capita. Sigma convergence is a necessary condition for unconditional convergence: in other words, for unconditional convergence to happen, poorer Member States have to 'catch up' (by growing faster) than richer Member States.

When convergence takes place, however, it does not necessarily follow that it is upwards. It is possible that, for example, the average GDP per capita falls and Member States converge to that declining average. While this means that disparities are being reduced, it also implies that living standards (as illustrated by GDP) are generally declining. It is also possible that the average GDP per capita may increase but, on average, Member States do not converge to it.

For these reasons, we adopt the terminology of Eurofound (2018 updated 2021), defining upwards convergence as a process whereby the average of the indicator of interest increases *and* disparity in the performances of Member States on that indicator is reduced. We use 'unweighted' averages (that is, averages calculated without taking into account the different sizes of Member States) and the standard deviation (a measure of dispersion) of Member States around this average to characterise whether upwards/downwards convergence/divergence has been taking place.

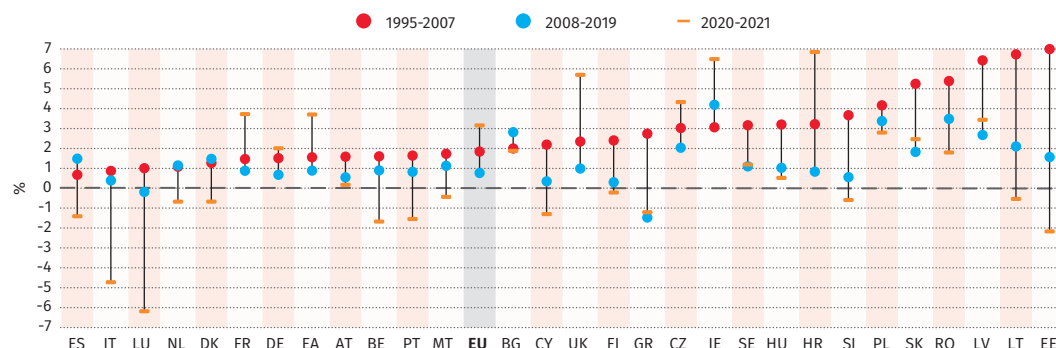
Variable and declining labour productivity growth in the EU27

Labour productivity growth is the material basis for sustainable increases in wages. While aggregate income growth does not necessarily lead to lower inequality nor is it necessarily compatible with respecting planetary boundaries (e.g. Wilkinson and Pickett 2009), it does in principle make redistribution politically easier. As Figure 1.6 shows, the average annual hourly productivity growth rates were, as expected, generally higher in the central and eastern European Member States than in the EU15 Member States in 1995-2007, as these countries were developing as 'new' market economies.

It turned negative in Greece over this time period and in several Member States during

the pandemic (2020-2021), most notably in Italy and Luxembourg, where it has dropped to -4.7% and -6.2% respectively, as well as Spain, Belgium, Portugal, Malta, Cyprus, Greece, Slovenia, Lithuania and Estonia. These figures are disconcerting with regards to the income convergence of Member States, as the vast majority of the above countries are either among the lower-income ones in the EU or those most affected by the previous recession of the early 2010s. In several other Member States, such as France, Germany, the UK, Czechia, Ireland and Croatia, real hourly labour productivity growth is expected to grow even faster than it did in 1995-2007.

Figure 1.6 Average annual growth rate (%) of hourly labour productivity, EU Member States, 1995-2007, 2008-2019, 2020-2021 (f)



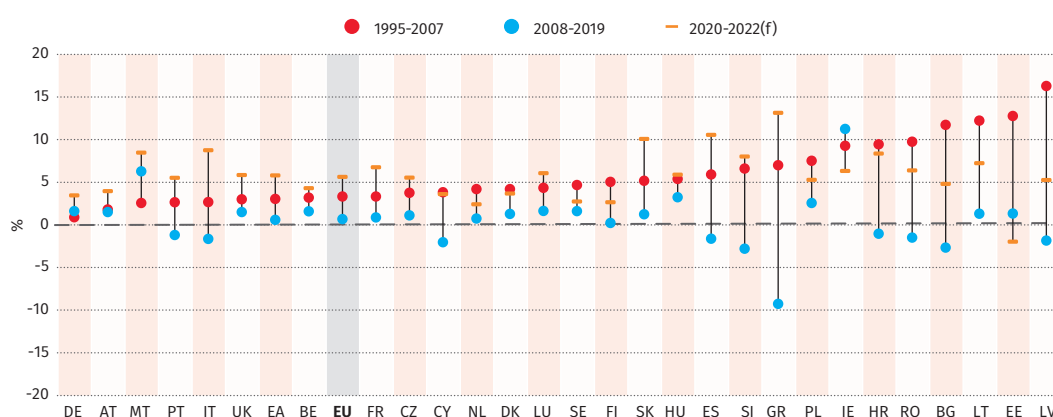
Source: Own calculations using AMECO database RVGDE and NLHA series.

Investment developments in the EU27

Investment is necessary not only for accelerating labour productivity growth but also for engineering the transition to a decarbonised socioeconomic model that the EU aims for by 2050. Figures 1.7 and 1.8 show the average annual growth in real gross fixed capital formation (investment) for the whole economy and the average annual growth in investment for the general government in current prices for 1995-2007, 2008-2019 and 2020-2022/2023

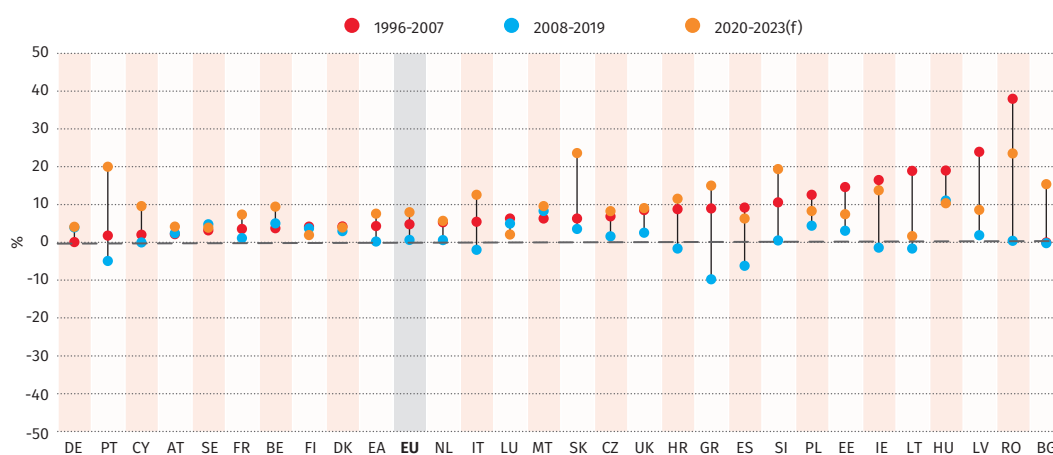
(f). The downward trend in 2008-2019 compared to 1995-2007 is evident here as well, both for real investment in the whole economy and for nominal public investment. Average annual growth rates in investment are expected to increase both for the whole economy and the government sector in 2020-2022/2023, as the EU's recovery instruments enter into force (see further below).

Figure 1.7 Average annual growth rate (%) real gross capital formation (investment), EU Member States, 1995-2007, 2008-2019, 2020-2021 (f)



Source: Own calculations using AMECO database, OITG series.

Figure 1.8 Average annual growth rate (%) gross fixed capital formation (investment, current prices) general government, EU Member States and the UK, 1996-2007, 2008-2019, 2020-2023 (f)

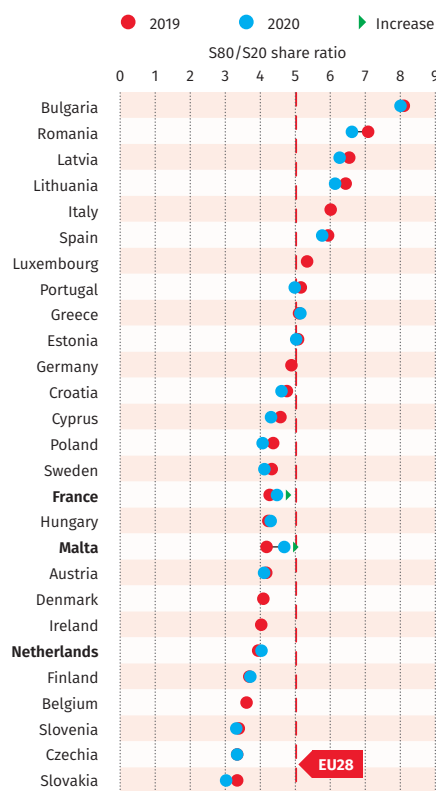


Source: Own calculations using AMECO database, UIGG series.

Positive developments in income inequality and at-risk-of-poverty rate

There is quite a large variation among Member States in the extent of their income inequality. The recession of the early 2010s had a significant impact on income inequality, especially in the most affected Member States. Figure 1.9 shows the income quintile ratio, that is, the ratio of the share of income commanded by the top 20% of the income distribution to the share of income commanded by the bottom 20% of the income distribution in 2019 and 2020. We see that in 2019 that ratio was over just over 8 in Bulgaria whereas it was just 3.34 in Slovakia. Member States with high income inequality thus measured also included Romania, Latvia and Lithuania but also Italy and Spain, all of which had a quintile share ratio of 6 and above. When we look at the same ratio for 2020, when the pandemic broke out, we see that it increased in very few countries, most noticeably France and Malta. In all other countries, it either increased or remained virtually unchanged.

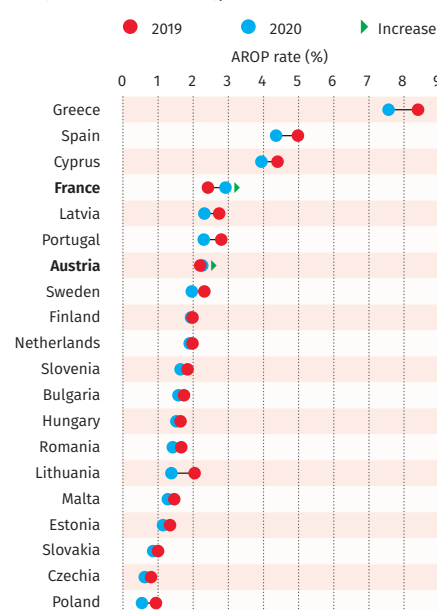
Figure 1.9 **Income quintile share ratio S80/S20 for disposable income, EU Member States 2019 and 2020**



Note: 2020 values are omitted for DE, DK, BE and LU due to structural breaks in the series; in IT and IE due to non-availability. Source: Eurostat ilc_di11 series.

Turning to income inequality at the bottom end of the income distribution, and the share of people at risk of poverty in 2019 and 2020, we see again in Figure 1.10 that in 2019, there were wide disparities across Member States, with 42% of people at risk of poverty in Greece, while it was only 4.7% in Poland. Spain and Cyprus also had high at-risk-of-poverty rates of between 20% and 25%, whereas it was around 5% in Czechia and Slovakia. In 2020, this indicator either improved or remained unchanged in all countries for which there are data (except France, where it increased) and this was despite the depth of the economic shock and its impact on employment, unemployment and earnings described in Chapters 2 and 3 of this year's *Benchmarking Working Europe*. This is an indication that the support programmes that Member States deployed from the beginning of the pandemic have actually worked in cushioning incomes from the impact of the crisis. Interestingly, the yearly shifts in these indicators between 2010 and 2012 – when EU Member States began a coordinated and premature fiscal consolidation and when the euro area got caught in its own crisis – suggested a widening of income inequality and increase in poverty.

Figure 1.10 **At-risk-of-poverty rate: share of persons with equivalised income lower than 60% of the median income (anchored at 2008), EU Member States 2019-2020**



Note: DK, DE, BE and LU are omitted due to structural breaks in the data; IE and IT had no available data for 2020. AROP = at-risk-of-poverty. Source: EU-SILC ilc_li22b.

National crisis responses lead to higher budget deficits



For 2021, the average EU27 budget deficit is projected to reach 7.5% of GDP (8% for the euro area), reflecting the continued impact of public support measures on public budgets

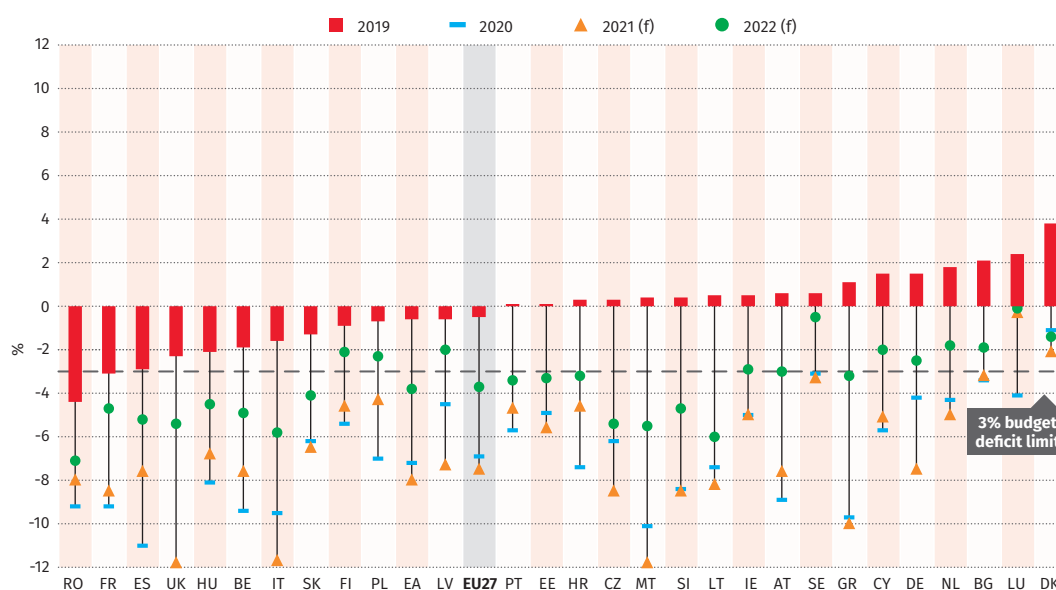
The economic crisis triggered by the pandemic has continued to weigh heavily on Member States' public finances. At the same time that the recession reduced tax revenues, governments had to deploy massive financial support programmes for households, firms and the healthcare sector. The European Commission estimated that the total fiscal response by Member States – calculated as the cumulative changes in primary budget balances (meaning budget balances including interest payments and the operation of automatic stabilisers, such as unemployment benefits and income taxes) compared to 2019 and including a conservative estimate of the impact of Recovery and Resilience Facility grants (including the function of automatic stabilisers) – for the period 2020-2022 is expected to reach 19% of GDP (European Commission 2021: 8).

Figure 1.11 shows the evolution of general government primary budget deficits in 2020, 2021 and 2022 (the latter two forecasts) by comparison to 2019. On average, the general government primary budget deficit as a share of GDP in the EU27 was 6.9% (7.2% in the euro area) in 2020, while in the UK it was 12.3% of GDP. Even though

in 2019, it was only Romania and France that had budget deficits greater than 3% (and France only barely, at 3.1%), and 16 Member States had budget surpluses, all Member States' budget balances went into the red in 2020, although with quite a wide variation: Spain and Malta had deficits of over 10% of GDP, while Greece, Italy, Belgium, Romania and France all had deficits above 9%; at the other end of the spectrum Denmark and Sweden deficits reached just 1.1% and 3.3%, whereas countries like Bulgaria, Germany, the Netherlands, Luxembourg, Latvia, Estonia, Ireland, and Finland had budget deficits of between 3.2 and 5.4%. Portugal, Cyprus, Czechia and Slovakia had deficits hovering around 6% in 2020. For 2021, the average EU27 budget deficit is projected to reach 7.5% of GDP (8% for the euro area), reflecting the continued impact of public support measures on public budgets, as despite the recovery in output, the primary deficits are even somewhat higher than in 2020.

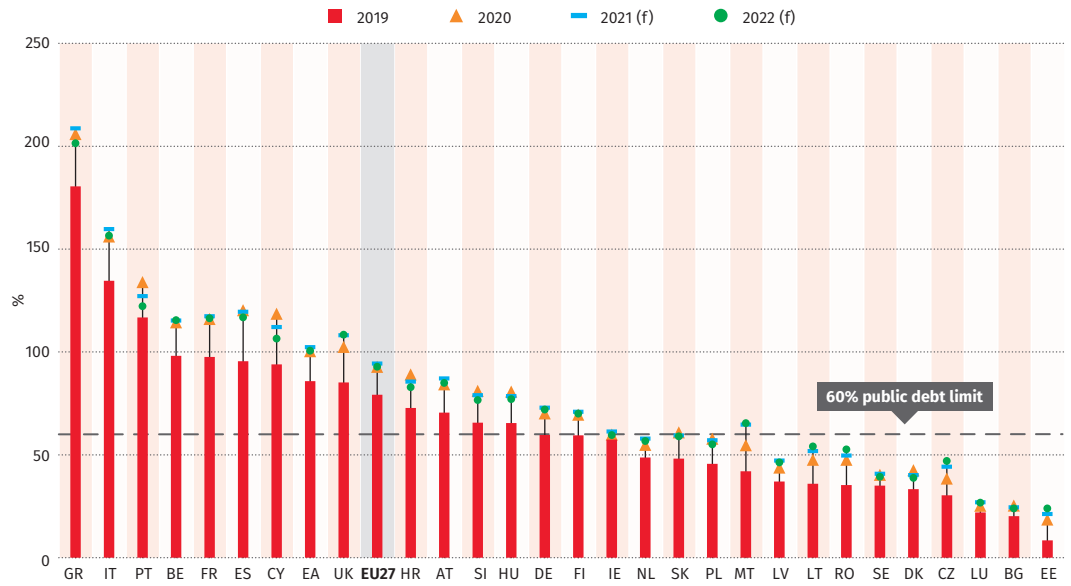
Figure 1.12 shows the evolution of public debt as a share of GDP in EU Member States and the UK in 2019 and 2020, as well as its currently forecasted value for 2021. In 2020, the average debt/GDP ratio reached 100% in the euro area

Figure 1.11 General government budget primary deficits (% of GDP) EU Member states and the UK, 2019-2022 (f)



Source: Ameco database ULBGE series.

Figure 1.12 **Public Debt (% of GDP), EU Member States and the UK, 2019-2021 (f)**



Source: Ameco database, UDGG series.

and 92% in the EU. By far the biggest cumulative increases between 2019 and 2021 have taken place in countries with already high public debt/GDP ratios, such as Greece, Italy and Spain, but also Belgium, France, Malta and Cyprus, where the debt/GDP ratio increased by between 17 and 28 percentage points. These were also countries where budget deficits as a share of GDP expanded the most. This could eventually be a disconcerting development insofar as public debt/GDP ratios had already increased disproportionately compared to the EU average in several of these Member States during the 2010s.

A number of actions have been taken at the EU level since the beginning of the crisis to ensure that Member States did not face the usual constraints in allowing their budget deficits to expand and their public debt to grow as a share of GDP. The activation of the general escape clause of the Stability and Growth Pact in spring 2020 was one of them and it remained in force in 2021. The escape clause is expected to be deactivated in 2023, and an important question is whether Member States will have to return to the previous status quo in terms of fiscal rules, which means that several of them would come under pressure to start reducing their public debt too.

Financing the recovery



A question that arises, however, is how to avoid a sharp adjustment in public investment spending once the Recovery and Resilience Facility has expired

Besides the activation of the escape clause (and the ECB policies, on which more below), several other initiatives were undertaken at the EU level to support Member State governments in deploying their support programmes. Most notable in this regard were the loans to Member States under the SURE scheme, the temporary loosening of the EU framework of state aid rules, and the two Coronavirus Response Investment Initiative packages. The centrepiece of the EU response was of course the agreement on the Multi-annual Financial Framework 2021-2027 and the Next Generation EU pillar, with its innovative Recovery and Resilience Facility, which provided for the first time a sizeable fiscal capacity for the EU (for an overview of EU responses to the crisis, see Alcidi and Corti 2022).

Member States will be supported by the Next Generation EU pillar until 2026 in continuing their public spending, and in particular by its Recovery and Resilience Facility. Starting in late April 2021, and following months of intense discussions with the European Commission Services, Member States started submitting their final National Recovery and Resilience Plans (NRRPs) of investment and reforms for formal approval to start receiving funding.

At the time of writing, the great majority of plans submitted have already received a positive

recommendation by the European Commission. All Member States who submitted NRRPs have asked for 100% of the available grants under the RRF, except for Latvia, who only requested 93%. Cyprus, Greece, Italy, Poland, Portugal, Romania, and Slovenia are the only Member States who have also requested loans and of those, only Greece, Italy and Romania have requested that 100% of funds be made available as loans. All Member States who submitted NRRPs, except Ireland and Sweden, have requested the pre-financing of up to 13% of the funds they are entitled to.

The RRF is expected to reinvigorate private and public investment spending in Member States (see Figures 1.7 and 1.8 above) in the coming years until at least 2026, as far as public investment is concerned. A question that arises, however, is how to avoid a sharp adjustment in public investment spending once the RRF has expired. One option would be to turn it into a permanent fiscal capacity. Another option would be to change the fiscal rules. And yet another would be to have some reassurance that the ECB would continue supporting euro area government bonds by buying them in the secondary markets to promote well-defined EU policy objectives such as greater social cohesion and equality, as well as decarbonisation.

The EU economic governance review relaunched



The EU taxonomy, if done in a way that avoids ‘green-’ and/or ‘social-washing’, could be blended into the economic governance reform by helping to redefine the sustainability of public debt for Member States

In October 2021, the European Commission relaunched the EU economic governance review which was first initiated in February 2020 but then put on hold, by publishing a Communication entitled ‘The EU economy after COVID-19: implications for economic governance’ (European Commission 2021). As its title suggests, the Communication assessed the implications of the changed circumstances but also of the economic governance policy responses following the Covid-19 crisis in order to reframe the public debate on the review. Several interesting points were raised in both this more recent Communication and the previous one (European Commission 2020), suggesting a discernible shift in the ideas informing the Commission proposals from the narratives seen in the aftermath of the Great Recession, when budget deficits and public debt/GDP ratios had also increased following the coordinated stimulus in Europe.

First, while the Communication reiterates the centrality of the need to reduce high and divergent public debt ratios in a sustainable and growth-friendly manner, it also urges caution against doing this too soon and unrealistically fast, lest it entail high and counter-productive economic and social costs for Member States. Secondly, the Communication underlines the crucial role of coordinated discretionary fiscal policy in responding to large economic shocks and limiting their social consequences and any scarring. Interestingly, the Commission highlights at this point, and rightly so, the useful complementarity between fiscal policies and the policies of the ECB, without raising any questions about any explicitly agreed principles guiding this complementarity, given that fiscal policies are decided and run by elected governments

whereas the monetary policy of the ECB is not (on which more below). Thirdly, the need to have fiscal rules that preserve public investment even when fiscal consolidation is practiced was acknowledged, especially given the challenges facing Europe. Fourthly, the need for symmetric adjustments of current account deficits was acknowledged. And fifthly, the reliance on unobservable measures to shape fiscal policy recommendations has been recognised as counter-productive.

The official debate on the economic governance review is only just beginning and, besides ideas, it will also depend on political developments in Member States, most notably Germany. If the pandemic has shown anything, however, it is that a bigger role for the state is the only way to address large shocks and challenges, and that if a certain policy objective is considered worthwhile, financial ‘limits’ suddenly become less rigid.

Besides the economic governance review, the EU has been engaged in defining the so-called EU taxonomy of environmentally and socially sustainable activities. This taxonomy should allow assets to be labelled as ‘green’ or ‘social’ if they finance activities that fulfil certain standards of environmental and social sustainability. Not surprisingly, the debate on what should be classified as such activities is heated. However, this taxonomy, if done in a way that avoids ‘green-’ and/or ‘social-washing’, could be blended into the economic governance reform by helping to redefine the sustainability of public debt for Member States who borrow to pursue environmental or social sustainability goals, of which lower inequality could be one.

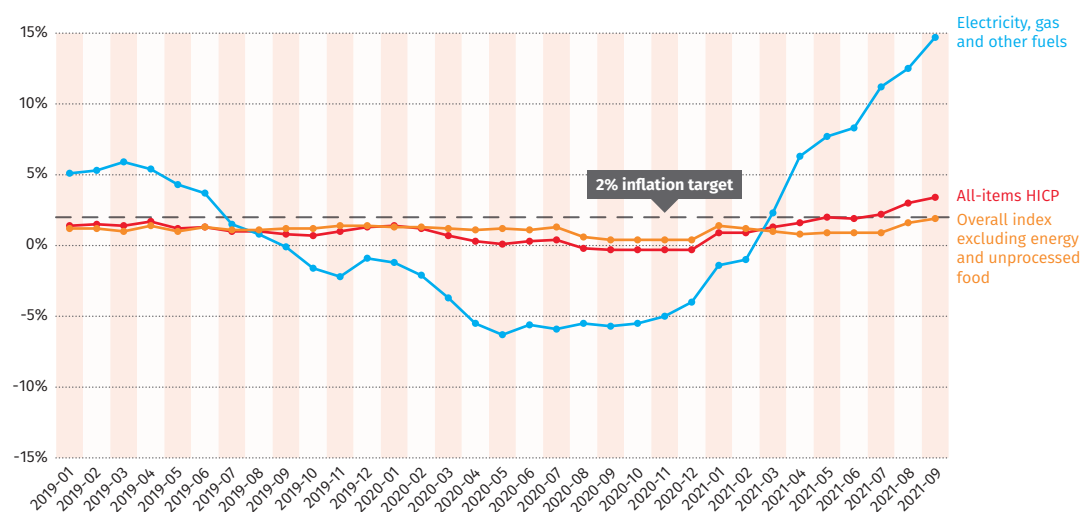
Surging inflation in the euro area considered transitory

Following years of hovering well below 2%, the euro area headline inflation (the Harmonised Index of Consumer Prices, HICP), exceeded the 2% target of the ECB in summer 2021 and reached 3.4% in September. Core inflation (the HICP excluding the (often volatile) prices of energy and unprocessed food) remained subdued and only picked up in August and September to reach 1.9%, the highest rate since 2012. As Figure 1.13 illustrates, the development of headline inflation was at least partly driven by energy prices, whose inflation rate started increasing in spring 2021 to reach 14.7% in September, marking the beginning of an energy crisis in Europe. This spike in energy prices has been the result of a combination of factors, including rundown stocks the previous winter and geopolitical issues between the EU and Russia, but also the fact that, in the context of the energy transition, fossil fuel energy production has begun being phased out before it has been ensured that the demand can be covered by cleaner forms of energy.

Other developments on the supply side of the economy have also been driving the current inflation spike. Ongoing disruptions in global

supply chains due to the pandemic and the ensuing shortages of production components, combined with brisk demand growth as economies have reopened in earnest, have also been putting upwards pressure on inflation. Moreover, labour shortages have been recorded in some sectors, particularly those involving a lot of social contact, as due to safety considerations, former employees have either been hesitating to return to fill in vacancies (especially for low wages and precarious working conditions) or have moved on to other safer sectors, putting upwards pressures on nominal wages. These developments have cast a shadow over the recovery prospects, opening up questions of whether they are really transitory and whether a tightening of the ECB's and other major central banks' monetary policy would and should be imminent. At the moment of writing, the ECB's governing council is considering the current increases in inflation as transitory and, following its revised monetary policy strategy (ECB 2021a), according to which it would tolerate temporarily higher inflation than the target of 2%, it is not envisaging a tightening of its monetary policy.

Figure 1.13 Inflation rate in the euro area, Harmonised Index of Consumer Prices (HICP), electricity, gas, and other fuels price index, overall HICP index excluding energy and unprocessed food (monthly annualised rate %), euro area, 2019M1-2021M9



Source: Eurostat, prc_hicp_manr series.

The ECB response to the pandemic and its new monetary policy strategy

The ECB continued unabated the interventions it had launched at the beginning of the pandemic, most notably keeping its policy interest rates constant and continuing its Pandemic Emergency Purchases Programme (PEPP) and the targeted longer-term refinancing operations (TLTROs) throughout 2021. The PEPP, whose financial envelope goes up to EUR 1.85 trillion, and in the context of which the ECB has bought most of the debt that euro area governments have issued since the pandemic began, is expected to continue at least until the end of March 2022, whereas the ECB has indicated that net asset purchases will continue until the crisis is over. These interventions have kept the costs of borrowing low for governments despite the aforementioned large increases in budget deficits and debt/GDP ratios, but also for businesses and citizens.

On 8 July 2021, the Governing Council of the European Central Bank announced its new monetary policy strategy, the first since 2003 (ECB 2021b). The process had already begun in January 2020 and had included public consultations with stakeholders and citizens. The review brought three important changes. First, there has been a reinterpretation of the Bank's price stability mandate: whereas the ECB previously considered price stability as 'an inflation rate below but close to 2%', it will now be 'aiming for a 2% inflation over the medium term', implying that the ECB will be willing to tolerate inflation rates moderately above 2% for a transitory period. In practice, this means that the ECB will not hasten to tighten its monetary policy if inflation surpasses 2%, especially if this overshooting has been preceded by periods of lower-than-target inflation, which usually indicate that an economy and employment is slowing down. This is an important departure from the ECB's previous asymmetric preferences in favour of inflation at the expense of output and employment stabilisation. Insofar as this is likely to support the fight against cyclical unemployment, it will also help to prevent, other things being equal, widening inequalities that unemployment can lead to. The second important shift was the inclusion in the Harmonized Index of Consumer Prices of

owner-occupied house prices, in which there have been persistent increases in recent years. That would render the HICP more accurate for guiding monetary policy.

The ECB climate change action plan

The third important change in the monetary policy strategy is that it now includes an 'ambitious climate change action plan', to be implemented and further reviewed by 2024. The action plan is meant to underline the ECB's commitment to align more systematically its monetary policy with environmental sustainability considerations.

The ECB has committed to accelerating the development of its modelling approaches to better incorporate the risks from climate change and the transition towards a more sustainable economy in its macroeconomic forecasts, its assessments of financial stability and of the transmission of monetary policy. Concurrently, the ECB has pledged to experiment with the development of new statistics indicators to monitor green financial instruments, the carbon footprint of financial institutions, and their exposure to climate-related physical risks. In this field, the ECB will align itself with progress in EU policies and initiatives in disclosure and reporting on environmental sustainability. These steps would allow it to better adapt monetary policy decisions to the risks from climate change.

Furthermore, the ECB action plan has set out steps to take more actively into account the environmental sustainability of activities financed by assets serving as collateral for its credit operations and/or purchased in the context of the ECB's corporate asset-purchasing schemes. Disclosure requirements for private sector assets will be introduced as an eligibility condition for both collateral and asset purchases, in line with EU policies and initiatives in the field. The ECB will take into account climate change risks when reviewing the valuation of assets purchased and used as collateral. It will



This is an important departure from the ECB's previous asymmetric preferences in favour of inflation at the expense of output and employment stabilisation



The involvement of the ECB in sovereign debt markets, effectively monetarily financing public debt, calls for an explicit framing of the terms and conditions in coordination with fiscal authorities in Europe

do that by assessing the disclosures of rating agencies and assessing how they incorporate climate change risks in providing their ratings of assets, by developing some internal rating standards and by introducing requirements into the Eurosystem Credit Assessment Framework to address climate change risk, if necessary. The Eurosystem's balance sheet will also be stress-tested to gauge the risks related to climate change.

The ECB will 'assess potential biases' in the market allocation from its collateral framework and asset purchase programmes, especially the corporate sector purchase programme, assess the pros and cons of alternative allocations and potentially propose alternative benchmarks in response to questions on whether these programmes are truly in line with the market neutrality and market efficiency principles of its monetary policy operations. The ECB has recently faced criticism that these operations have been inadvertently financing economic activities that enhance rather than mitigate activities detrimental to the climate. To that end, it will also enhance its due diligence and disclosures related to the corporate sector purchase programme (CSPP) (Dafermos et al. 2020, 2021).

Although the action plan takes steps in the right direction which might have even been unthinkable a few years ago, it has also been criticised for being too timid given the urgency of taking action to meet the EU environmental sustainability objectives and omitting aspects thereof beyond climate change.

More specifically, the emphasis of the action plan is on assessing the risks from climate change on finance and consequently on the way the ECB conducts its policies, but not on the risks that financial activity (including the ECB's policies, especially asset purchases) enhances climate threats, something known as 'double materiality'. This is an important omission given the extent to which the ECB has been engaging in these activities in recent years and evidence that its activities are not 'market neutral' (ibid.).

In a similar vein, the action plan seems to be oblivious to aspects of environmental sustainability other than climate change, such as biodiversity, despite emerging evidence that its

activities have an important impact there. It has also been criticised for not going a step further from the EU taxonomy in defining 'dirty assets' (that is, those subsidising climate-detrimental activities) but simply sticking to subsidising 'green' ones (Kedward et al. 2021).

The fact that there is already a date for reviewing the ECB strategy 2024 gives hope that the actions may be stepped up. However, what gives pause for thought are the apparent countervailing forces against taking sufficiently decisive action on greening monetary policy and finance.

The politics of monetary policy

The aforementioned changes in the ECB's monetary policy strategy for tackling the new challenges that the Bank has been facing in the last decade are all welcome. While it is true that, since 2012, the ECB has found increasingly creative and, given the circumstances, effective ways to support the euro (cf. Bibow 2020), financial stability and the policies of the EU more broadly, the fact that it has done so on its own, led by unelected officials raises questions about the democratic legitimacy of its decisions. Its policy actions, most notably the asset purchases at the scale seen in recent years and the interpretation of the price stability mandate, have important distributional consequences that range from what type of economic activities or governments receive affordable financing to how far higher inflation linked to higher energy prices will be tolerated during the energy transition before monetary policies are tightened and brought to bear upon output and employment. The different economic policy objectives that the ECB has aimed to support involve trade-offs, which should not be left to it alone to decide about (van 't Klooster 2021). Moreover, the involvement of the ECB in sovereign debt markets, effectively monetarily financing public debt, calls for an explicit framing of the terms and conditions in coordination with fiscal authorities in Europe (Gabor 2021). This, however, would call into question one of the cornerstones of the ECB, namely its independence from fiscal authorities, in order to avoid the so-called dominance of fiscal over monetary policy, which in the past has been associated with high inflation.

Looking ahead: rebuilding after the crisis



The scale of the response to the crisis in terms of both fiscal and monetary policies has shown that there are few limits to how far policymakers can go if they consider it necessary: if there is a will, there is a way

Europe seems to be moving slowly but surely towards adapting to the realities of an endemic coronavirus, but it must also make a greater effort to address the catastrophic increases in average global temperatures towards which current policies seem to be leading (Carbon Brief 2021). Moreover, Europe will have to go through these transitions in a way that simultaneously tackles pre-existing inequalities while mitigating those related to or emerging from climate change and the environmental transition (see also Chapter 4). A bigger role for public spending will be key for developing the new technologies and infrastructure that will be necessary for the indispensable energy transition, for supporting communities, workers and ordinary citizens in shifting to jobs, energy sources and life habits that are consistent with net-zero targets, and for climate change adaptation both in Europe and in the Global South.

A key question is whether Member States will be able to sustain that scale of spending. The main economic policy frameworks in the EU have been in a state of flux, struggling to address shortcomings that were already evident even prior to the pandemic. Given the externalities involved in climate change mitigation and adaptation, but also in moving towards greater

equality, there is a strong case for public investment taking the lead to ensure that the necessary actions will be taken on time. Even prior to the pandemic, persistently low interest rates were prompting leading academics to argue that public debt sustainability should not be a concern for governments, which should borrow cheaply to invest (Blanchard 2019).

The scale of the response to the crisis in terms of both fiscal and monetary policies has shown that there are few limits to how far policymakers can go if they consider it necessary (Tooze 2021): if there is a will, there is a way. Not only have public budget deficits and public debts been allowed to balloon as governments have borrowed to deploy their support programmes, but central banks around the world have also been effectively monetising public debt to keep borrowing costs low for governments, even if this is not explicitly stated. This, however, raises questions about the assignment of functions among monetary, fiscal and wage policies, and touches upon pivotal issues such as the dominance of fiscal over monetary policy and central bank independence. In this regard, the next few years will be critical, and certainly interesting.

References

- Alcidi C. and Corti F. (2022) The EU response to Covid-19: breaking old taboos? in Vanhercke B. and Spasova S. (eds.) Social policy in the European Union: state of play 2021, Brussels, ETUI. [forthcoming]
- Bibow J. (2020) Pushing the limits: the European Central Bank's role in restoring sustainable growth, Working Paper 2020.01, Brussels, ETUI.
- Blanchard O.J. (2019) Public debt and low interest rates, *American Economic Review*, 109 (4), 1197-1229. <https://doi.org/10.1257/aer.109.4.1197>
- Carbon Brief (2021) Analysis: Do COP26 promises keep global warming below 2C?, Analysis, Carbon Brief, 10 November 2021. <https://www.carbonbrief.org/analysis-do-cop26-promises-keep-global-warming-below-2c>
- Dafermos Y., Gabor D., Nikolaidi M., Pawloff A. and van Lerven F. (2020) Decarbonising is easy: beyond market neutrality in the ECB's Corporate QE, London, New Economics Foundation. <https://greenpeace.at/assets/uploads/publications/GreenpeaceNEFReportECB.pdf>
- Dafermos Y., Gabor D., Nikolaidi M., Pawloff A. and van Lerven F. (2021) Greening the Eurosystem collateral framework how to decarbonise ECB's monetary policy, London, New Economics Foundation. <https://greenpeace.at/assets/uploads/pdf/Greening-the-Eurosystem-collateral-framework-Report.pdf>
- ECB (2021a) Interview with Philip R. Lane, Member of the Executive Board of the ECB, conducted by Lluís Pellicer on 3rd November 2021, European Central Bank, 8 November 2021. <https://www.ecb.europa.eu/press/inter/date/2021/html/ecb.in211108~c270ad5bc6.en.html>
- ECB (2021b) The ECB's monetary policy strategy statement, European Central Bank. https://www.ecb.europa.eu/home/search/review/pdf/ecb.strategyreview_monpol_strategy_statement.en.pdf
- Eurofound (2018) Upward convergence in the EU: concepts, measurements and indicators, Luxembourg, Publications Office of the European Union. [updated 2021]
- European Commission (2020) Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee Regions. Economic governance review. Report on the application of Regulations (EU) No 1173/2011, 1174/2011, 1175/2011, 1176/2011, 1177/2011, 472/2013 and 473/2013 and on the suitability of Council Directive 2011/85/EU. COM(2020) 55 final, 5 February 2020.
- European Commission (2021) Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee Regions. The EU economy after Covid-19: implications for economic governance. COM(2021) 662 final, 19 October 2021.
- Gabor D. (2021) Revolution without revolutionaries: interrogating the return of monetary financing, Berlin, Bürgerbewegung Finanzwende and Heinrich Boell Stiftung.
- Kedward K., Buller A. and Ryan-Collins J. (2021) Quantitative easing and nature loss: exploring nature-related financial risks and impacts in the European Central Bank's corporate bond portfolio, Policy Report 2021/02, London, UCL Institute for Innovation and Public Purpose. https://www.ucl.ac.uk/bartlett/public-purpose/sites/bartlett_public_purpose/files/quantitative_easing_and_nature_loss_23_july.pdf
- Theodoropoulou S., Picek O. and Galgoczi B. (2019) Macroeconomic policies and developments in Europe: tackling the growth, inequality and climate change challenges, in ETUI and ETUC, Benchmarking Working Europe 2019, Brussels, ETUI, 1-24.
- Tooze A. (2021) Shutdown: how Covid shook the World's economy, New York, Viking.
- van 't Klooster J. (2021) The ECB's conundrum and 21st century monetary policy: how European monetary policy can be green, social and democratic, Berlin, Bürgerbewegung Finanzwende and Heinrich Boell Foundation.
- Wilkinson R. and Pickett K. (2009) The spirit level. Why equality is better for everyone, London, Penguin Books.
- All links were checked on 30 November 2021.