

# 1. Economic developments and policies in Europe in the shadow of the geopolitical and green transitions



Sotiria  
Theodoropoulou

## Topics

Introduction	33
Output growth developments	35
The return of inflation	36
The unequal impacts of rising inflation	40
Developments in aggregate demand components	42
Public finance developments	43
The ECB response to inflation	47
Conclusions	49



The most recent surge in inflation has shifted the context in which macroeconomic policies have been operating to pursue their objectives

**Sotiria Theodoropoulou**

# Introduction

Following a robust recovery from the shock of the pandemic in output and employment, Europe is yet again facing more than one crisis: this time, energy and cost-of-living crises. Having already surged in 2021, driven by supply and some demand developments linked mostly to the pandemic, inflation shot up in all EU Member States in 2022 following the Russian invasion of Ukraine and the resulting global energy shock. Europe's significant dependence on imports of Russian fossil fuels made it particularly vulnerable to the shock. This dependence had been built on a doctrine that linked trade relations with peace, despite signs and warnings about the geopolitical threats and risks for democracy that the authoritarian Russian regime posed for Europe.

Given the still important role of fossil fuels in energy production, the war's impact on global food prices and the capacity of firms in several sectors to increase or protect their profit margins at the expense of less powerful firms and wage earners, inflation has spread to other commodities. However, wages have not followed suit, resulting in losses in the purchasing power of wage earners and triggering a cost-of-living crisis which is particularly affecting households at the lower end of income distribution, exacerbating energy poverty and ultimately creating risks of a recession.

The dramatic geopolitical developments in Ukraine have also cast China in a less favourable light as a trading partner and have reinforced the importance of resilience as an objective for the EU and its Member States, especially regarding supply chains for critical commodities. The likely national, but also company-level, responses to this consideration are expected to maintain inflationary pressures, as are climate change and the energy transition to mitigate its negative impacts, suggesting that the era of the 'great moderation' may be over.

These developments also significantly alter the parameters within which economic policies have to be conducted as well as their purpose, while important reforms, such as the reform of EU economic governance, the ECB's relatively recent monetary policy strategy, due to be reassessed by 2025, and a recently emerging new approach to industrial policy are still being debated. At the centre of this debate are the respective roles and suitability of the state and the markets in steering these transitions, when resilience is an important objective. The EU economy is expected to significantly slow down once again as a result of the energy shock (European Commission 2023). Although national governments and the EU have gone to significant lengths to mitigate both the rise and the impact of inflation on households and companies, their efforts are being pursued in the face of increasing public discontent over the higher cost of living. Larger spending plans on defence have been announced since the Russian invasion, coming on top of previous public declarations about prioritising the promotion of healthcare system resilience and increasing competition for public resources.

The pandemic response added several percentage points to public debt-to-GDP ratios in many countries without a sufficiently long interval of high growth that could have helped rebuild fiscal buffers, leaving the Member States with very uneven fiscal capacities to deal with the challenges. While Next Generation EU and the EU budget are currently providing vital funds to the Member States which need them the most to support recovery and the green transition and strengthen resilience, it is far from clear whether any talk of expanding or extending this type of fiscal facility after its expiry will gain traction.

No less importantly, central banks around the world have changed course since spring 2022, rolling back their large asset purchase programmes, sharply raising policy interest rates and issuing statements underlining their determination to pursue their price stability mandates. However, interest rate hikes are not conducive to expansionary fiscal policies:

they create vulnerabilities in financial markets for indebted governments. Their efficacy in mitigating the energy shock is questionable, to say the least, whereas their expected impact on aggregate demand and employment is likely to harm those in more precarious positions in the labour market the most, further exacerbating inequalities. Higher interest rates are also bound to hamper investment in alternative sources of energy, which for its part could, in the medium to longer run, ease the inflationary pressures from the energy shock.

This chapter looks at economic developments in greater detail to illustrate how these different

transitions play out, adding to the challenges that have been facing the EU since the global financial crisis. It focuses in particular on the pressures created by inflation and its drivers. It also examines fiscal and monetary policy responses to the energy price shock and the different transitions and explores whether these responses have been congruent. It is in this light that the recent European Commission proposals for EU economic governance reform are discussed. The final section presents the conclusions.



Real output in the EU had returned to its 2019 level by 2021, thanks not least to the economic support measures

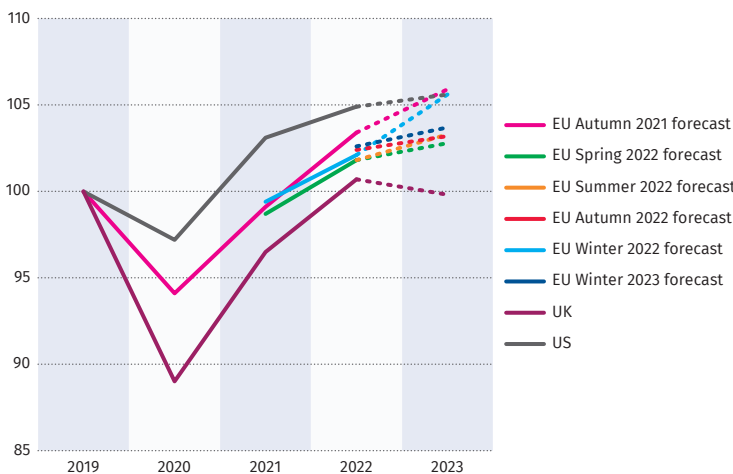
# Output growth developments

Real output in the EU and the US had returned to its 2019 level by 2021, thanks not least to the economic support measures from both fiscal and monetary policies in 2020 and 2021. Real output continued growing in Europe and the US in 2022, albeit at a lower rate than both the 2021 and previously predicted rates (European Commission 2021, 2022b). According to the European Commission's winter 2023 forecasts (European Commission 2023), real GDP in the EU grew by 3.5% in 2022 and is expected to grow by 0.8% in 2023, down by 0.4 percentage points compared to the winter forecast of 2022 for the same year (European Commission 2022e). Real output growth was also forecast to slow down in the UK and the US for 2022 compared to 2021 (European Commission 2022b). A further slowdown in real output growth, in the case of the EU even compared to previous forecasts, is expected in the EU as a whole, the UK and the US for 2023, particularly pronounced in the UK, where real GDP is projected to fall slightly below its 2019 level (see Figure 1.1).

The recovery in real GDP per head growth since 2021 has varied in EU Member States, as seen in Figure 1.2. While most of the worst affected Member States in 2020 (Spain, Italy, Greece, Portugal, France and Austria) and the EU and euro area on average had not reached their pre-pandemic real GDP per head levels by 2021, only Spain's and Czechia's real GDP per head

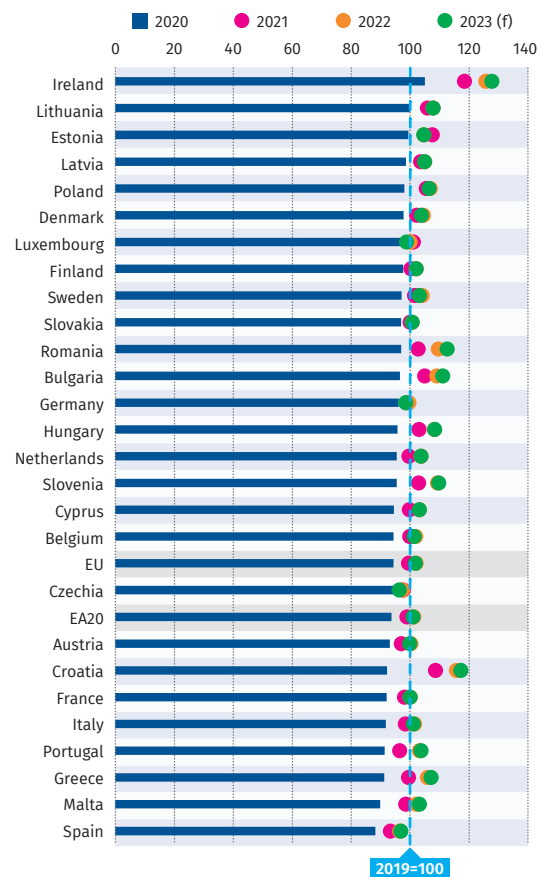
was still below their pre-pandemic level in 2022, with all other Member States and the EU and euro areas as a whole having more than fully recovered to pre-pandemic real output levels by 2022. However, real output per head growth rates are forecast to stall between 2022 and 2023 in most Member States, with a handful of exceptions (Ireland, Romania, Bulgaria, Greece and Malta), whose real GDP per head is expected to grow faster in 2023 than in 2022. The diversity of experiences and forecasts can be attributed to factors such as the relative weight of the tourism sector in an economy, the effectiveness of the economic support measures taken, the impact of disruptions in global supply chains since 2020 and the exposure of an economy to fossil fuel imports, particularly from Russia since the beginning of the war in Ukraine.

Figure 1.1 GDP (in constant prices), EU, UK, US, 2019=100, 2019-2022, 2023 (f)



Source: Own calculations using AMECO data (OVGD series) and European Commission Forecasts Autumn 2021-Winter 2023 (Autumn 2022 for the US and the UK).

Figure 1.2 GDP per head (in constant prices), 2019=100, EU27 Member States, 2020-2022, 2023 (f)



Source: Own calculations using AMECO data (RVGDP series).

# The return of inflation

In 2022, inflation resurged in earnest in Europe and elsewhere in the world following decades of the ‘great moderation’ and, in particular, the past decade, when, for the large part, euro area inflation stayed well below the 2% target of the ECB. In the euro area, the Harmonized Index of Consumer Prices (HICP) slowed down to 8.5 % in January 2023 relative to January 2022, having peaked at 10.6% (on a year-on-year basis) in October 2022 (Figure 1.3). Although inflation surged more sharply in the US than in Europe in 2021, it has been slowing down there since June 2022. Energy inflation was the fastest rising component of headline inflation in 2022, standing at 25.7% in December (ECB 2022). Energy inflation has also been the largest contributor to the increase in headline inflation in the euro area since early 2021. Figure 1.4 shows how, in the course of 2022, the contribution of other

groups of commodities, such as processed food, non-energy industrial goods and services, also increased as energy price increases started spreading to them.

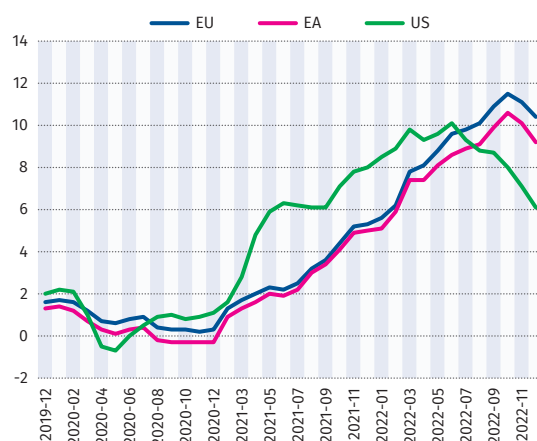
## Drivers of inflation and the cost-of-living crisis

### Geopolitical transition and its impact on supply chains

The sharp inflation acceleration from the beginning of 2022 was initially triggered by the war in Ukraine, the economic sanctions that the international community has been imposing on Russia and the impact that this geopolitical situation has had on fossil fuel energy and, to some extent, on food supply. Russia and Ukraine have also been major world exporters of cereals and of fertilisers, which support intensive agricultural production around the world.

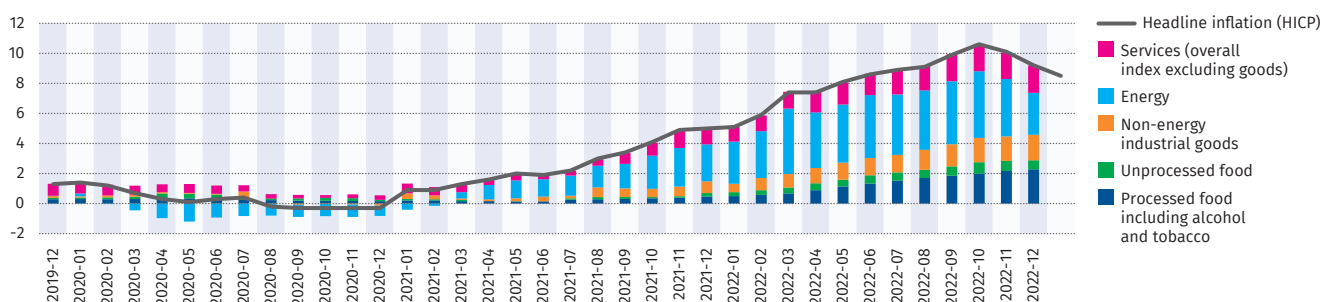
The conflict in Ukraine, however, is not the only underlying reason explaining the re-emergence of inflation. In Europe, inflation started increasing in early 2021. Major disruptions in global supply chains began during the period of Covid-19 lockdowns around the world: merchandise containers and cargo ships were stationed in different (unmatched) ports around the world, a situation that took time to resolve even as measures restricting economic activity were scaled down. Moreover, demand for some industrial goods increased, while it fell and robustly rose again for services, especially contact services, due to changes in consumption patterns, as populations were moving into and out of lockdown. These fluctuations in demand triggered changes in the planning of supply of

Figure 1.3 Inflation rate (Harmonized Index of Consumer Prices) (annualized monthly rate %), EU, EA and the US, 2019M12-2022M12



Source: Eurostat data (PCR\_HICP\_MANR series).

Figure 1.4 Contributions (in percentage points) to headline inflation (HICP) (% , year-on-year) of Euro area of various groups of inflation components 2019M12-2022-M12



Source: Eurostat (PRC\_HICP\_CRTB and PRC\_HICP\_MANR series).



Climate change and actions to mitigate it also have inflationary effects

manufactured goods, in particular intermediate goods, which, combined with the aforementioned disruption in logistics, eventually resulted in supply shortages in important commodities, such as semi-conductors, and led to price increases.

These difficulties, together with shortages of critical health material during the early days of the pandemic and the energy shock from the war in Ukraine, brought into sharp relief the downsides of just-in-time production management practices, which had prevailed as a means of reducing production and supply costs, and raised questions about how to strengthen the resilience of supply chains for critical commodities, by, among other things, reshoring their production or shifting it to partners that were more reliable and compatible with Europe's liberal democratic values. The process of rewiring supply chains to increase their resilience will take time and will also lead to persistently higher supply costs that will, in turn, exert pressure on the prices of commodities.

The return to greater normality in economic life following the periods of public health measures against Covid-19 in large parts of the world also led to higher global demand for energy in the second half of 2021, which, together with a longer than usual heating period in winter 2020-21, resulted in lower gas supply to and stocks in Europe. Adverse weather conditions also led to lower energy supply from renewable sources. Together with a higher carbon price under the EU's Emissions Trading System, these developments resulted in elevated wholesale energy prices as early as the autumn of 2021.

### **Climate change, the green transition and inflation**

Climate change and actions to mitigate it also have inflationary effects. Extreme weather events, especially droughts, can cause significant damage to crops, affecting the harvest and reducing the supply of food. Water shortages can lead to a fall in river levels and impede the transport of commodities and of materials (e.g. coal) that might relieve dependence on Russian fossil fuels. Higher carbon prices (to discourage its use) and insufficient investment in renewable energy are also likely to push up energy prices.

Firstly, therefore, extreme weather events (such as heavy rainfall or heatwaves) and the concomitant natural disasters (for example, floods, droughts or wildfires) that occur as a result of climate change that has already taken place may destroy harvests or agricultural land. This would lead to lower supply for some

foodstuffs which, given demand, would result in higher inflation for these commodities, contributing to what is known as 'climateflation' (Schnabel 2022).

A recent study carried out by ECB researchers looked more specifically at the effects of extremely high temperatures on inflation (Faccia et al. 2021), finding that 'climateflation' has a non-negligible impact on inflation even in the medium term, which is the time horizon (usually 1-5 years) over which central banks consider developments in inflation when deciding whether and how to adjust their monetary policy, especially in emerging (poorer) economies, although less so in advanced ones. Possible reasons for this difference between emerging and advanced economies are that, relatively speaking, food is a more important commodity in the 'basket of goods' used to calculate inflation in the emerging economies, and their resilience to natural hazards is lower. We therefore see that extremely high temperatures have an unequal impact on 'climateflation' (with all that it brings) between emerging and advanced economies. The ECB, however, has warned that the increased frequency of extremely high temperature episodes may start creating 'climateflation' even in advanced economies.

Secondly, the price of fossil fuels has been rising (which can be called 'fossilflation'), but for different reasons (Schnabel 2022). Despite grand declarations to the contrary, fossil fuels and natural gas still accounted for 85% of total energy use in the euro area in 2019, and 'fossilflation' therefore has a high impact on general (headline) inflation. There have been a number of reasons for 'fossilflation', from carbon pricing policies, aiming at reducing their consumption to mitigate climate change, to the rolling back of investment in extracting fossil fuels, which reduces their supply even though demand remains high. Finally, the fact that there can be only a few suppliers of fossil fuels, resulting in an 'oligopolistic' market, means that these companies can choose to increase the prices of fossil fuels and their profit margins by reducing supply.

Thirdly, the development of new green technologies (for example, wind-generated power) and products (such as electric cars) that would help curb carbon emissions and reliance on fossil fuels requires materials, such as minerals and metals, the supply of which (through mining) is unlikely to grow in line with the increase in demand for them in the next decade or so as countries around the world strive to meet their commitments to curbing carbon emissions. The limited supply of these



materials compared to the demand for them will lead to ‘greenflation’ (Schnabel 2022).

The above types of inflation and their sources suggest two insights. The fact that Europe has not yet weaned itself off its dependence on fossil fuels will cost it in terms of higher ‘climateflation’ and ‘fossilflation’. Speeding up that process of decarbonisation, on the other hand, by means of advancing innovative green technologies is likely to fuel ‘greenflation’ and, while it would curb ‘fossilflation’, we are nevertheless bound to live with extreme weather phenomena and the ‘climateflation’ they cause for decades to come. ‘Fossilflation’ and ‘greenflation’ suggest that, unless policy interventions are in place, households with lower incomes are likely to be stuck with energy supplied by fossil fuels, which will become ever more expensive, while more sustainable forms of energy may also remain unaffordable for them. This would perpetuate inequalities and energy poverty.

The above suggests that, although the war in Ukraine has dominated the headlines as the most potent shock recently driving inflation, a wider set of ongoing transitions is likely to continue triggering inflationary pressures.

### The cost-of-living crisis

While the aforementioned developments have been and will be creating pressures for higher prices during these transitions, inflation has also been fuelled by the pricing behaviour of firms with significant market power in their sectors. For high and rising (as opposed to stable) inflation to emerge, there has to be an unresolved ‘conflict’ between and among workers and firms over the distribution of output, in an economy where firms have some power to set prices and workers have some power to set wages, for example, through collective bargaining (Rowthorn 1977). Wage- and price-setting reflect the claims that each group of workers or firms makes over the distribution of output, and, for inflation to spiral, price and/or wage setters must have been trying to gain a higher share of output at the expense

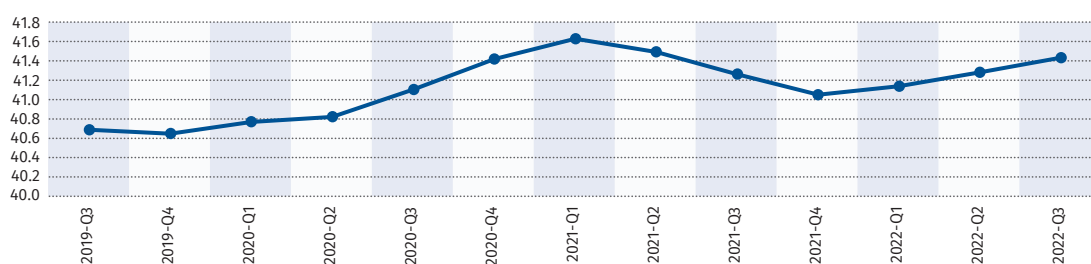
of other groups (e.g. firms in one sector raising their prices to make output gains at the expense of firms in other sectors and wage earners, other firms and/or wage earners responding with their own increases, and so on).

In open economies, where firms use imported inputs for production (such as natural gas and oil or semiconductors), part of the output produced domestically has to be paid to the foreign suppliers of those inputs. This then becomes a three-way contest over the distribution of the output ‘pie’ among domestic firms, workers and foreign suppliers. Rising costs of imported production inputs effectively shrink the pie that domestic wage and price setters have to share, which, unless there is a collectively negotiated process as to how output gains (and losses) should be distributed, intensifies the distributional conflict (cf. Matsaganis and Theodoropoulou 2022).

What seems to have turned this energy shock into a cost-of-living crisis has been the fact that, so far, it appears that only firms with significant market power have managed to expand their mark-ups and profit margins in order to make up for the impact of the energy supply shock, thus ‘broadening’ inflation from a couple of commodities (energy and food) to others at the expense of wage earners, whose purchasing power has diminished, as wages have generally not kept up with inflation. A recent analysis by the ECB corroborates this point (Lagarde 2022), as does the relative stability in profit share (see Figure 1.5).

As Figure 1.6 shows, nominal compensation per employee grew at rates close to inflation (consumer price index) in 2021, when inflationary pressures first emerged. For 2022, however, it is expected that, in all but a few EU Member States, nominal compensation per employee will not have kept up with the acceleration of inflation, pointing to a loss of purchasing power for wage-earners, which central banks have been warning against. What is more, Figure 1.7 shows that the wage share will have been declining

Figure 1.5 Profit share EU27 (% of GDP)



Source: own calculations using Eurostat data (NAMQ\_10\_GDP series, seasonally adjusted data).

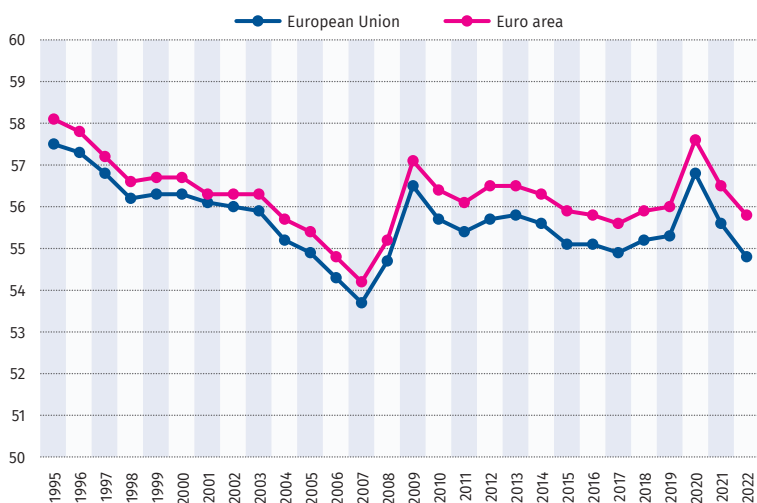


Figure 1.6 **Nominal compensation per employee vs. inflation (Consumer Price Index) (2020=100), EU Member States**



Source: own calculations using AMECO data (ZCPIH and HWCWD series).

Figure 1.7 **Adjusted wage share (%), EU and euro area, 1995-2022**



Source: AMECO (ALCD0 series).

for the period 2020-2022, suggesting that the compensation of employees will not even have kept up with labour productivity growth.

These developments have been even more remarkable as they have been taking place against the background of labour shortages in various sectors, reflecting a variety of factors from shifts in sectoral demand to inadequate working conditions at least in some sectors (see chapter 2). Labour shortages run the risk of fuelling inflationary pressures as they add to the supply-side constraints related to the aforementioned transitions. However, their likely causes (inadequate working conditions, including low pay, and any skills mismatches) would imply that policies aiming at lowering inflation by engineering a recession, such as the monetary policies which major central banks currently pursue, are unlikely to help resolve these shortages in a socially benign way: rather than helping to expand supply in sectors that are necessary for pursuing the green, digital and geopolitical transitions, these policies would instead steer demand to match lower supply, resulting in lower income and, very likely, higher inequalities.



The unequal impact of energy inflation has manifested itself not only among but also within Member States

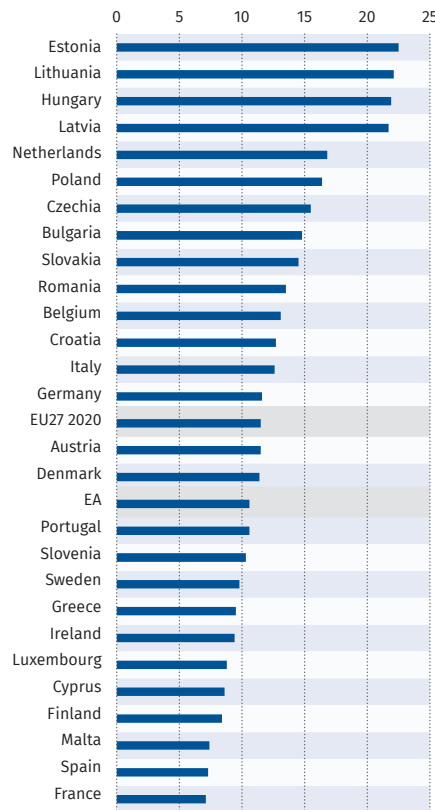
# The unequal impacts of rising inflation

There has been a wide disparity in headline inflation in the euro area (and the EU) average(s) across Member States (see Figure 1.8), reflecting different degrees of dependence on imported sources of energy, different energy market structures and different responses to inflation pressures. In October 2022, the three Baltic states and Hungary registered by far the highest inflation rates, between 21 and 22%, almost three times those of the three Member

States with the lowest inflation, namely France, Spain and Malta, where inflation hovered at just over 7%, and a little over twice the inflation of the euro area and the EU. Apart from the very unequal impact that inflation has been having in these economies, such wide disparities also raise concerns about the governability of the euro area, as the European Central Bank sets its monetary policy interest rates for the entire area. Such disparities imply that these interest rates are bound to have very different, if not inappropriate (in other words destabilising), effects on some of the euro area economies. This is because the (single) policy rate of the ECB results in very different real interest rates in Member States with different inflation rates. It is real interest rates that have an impact on investment decisions and, in turn, the real economy and employment.

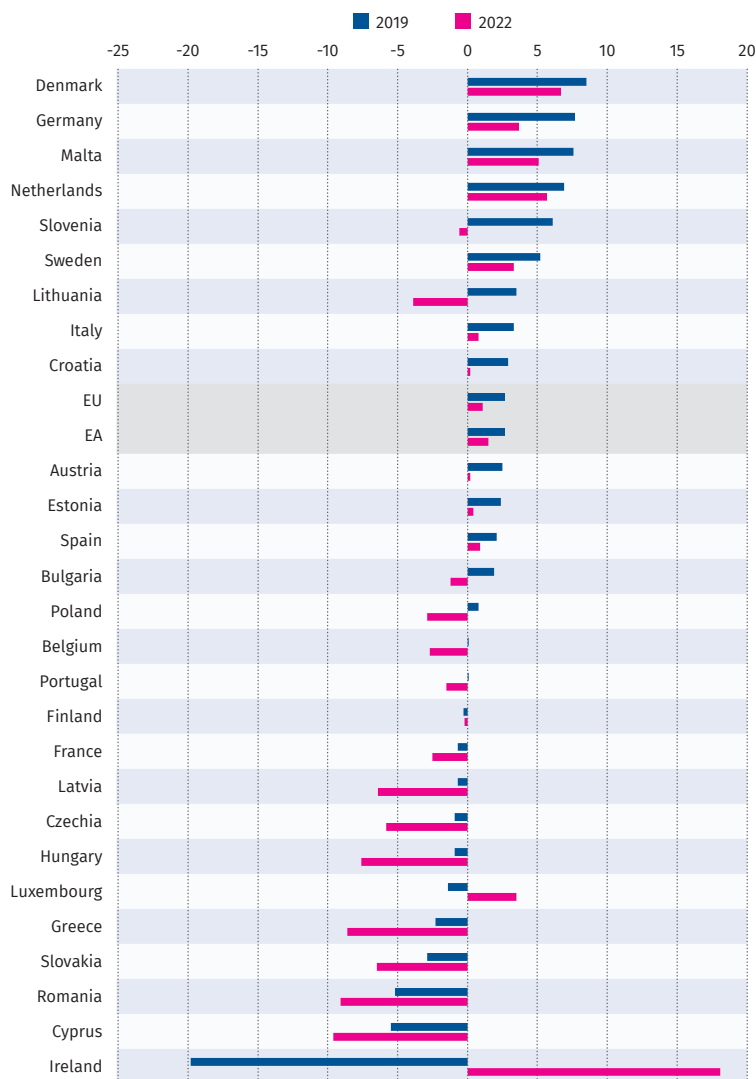
The unequal impact of energy inflation, however, has manifested itself not only among but also within Member States. Rising inflation is generally known to be regressive: it erodes the purchasing power of nominal (i.e. money) incomes, that is, the type of incomes that households at the lower end of the income distribution rely upon the most (wages, benefits, etc.), as they are less likely to have other assets. Moreover, in this particular case of inflation, low-income households spend a greater share of their budget on energy and food, the prices of which have increased faster than other items (Claeys et al. 2022).

Figure 1.8 Inflation rate (Harmonized Index of Consumer Prices, %, year-on-year), EU Member States, 2022M10



Source: Eurostat (PRC\_HICP\_MANR series).

Figure 1.9 **Current account balances (% of GDP), EU Member States, 2019, 2022**



Source: AMECO (UBCA data series).

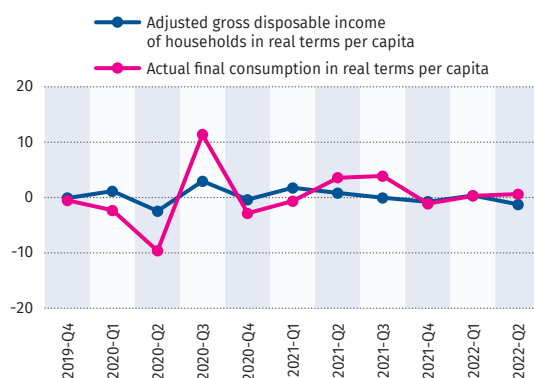
Furthermore, as seen in Figure 1.9, wide current account imbalances in different Member States, especially within the euro area, have re-emerged. While Member States with long-standing high current account surpluses, most notably Germany and the Netherlands, have seen them shrinking, large current account deficits have (re-)emerged in other Member States, such as Latvia, Czechia, Hungary, Greece, Slovakia, Romania and Cyprus. Current account deficits imply heightened vulnerability to developments in international financial markets, as countries that present these deficits effectively buy from the rest of the world more (goods and/or services) than they sell, and, therefore, in order to finance them, they need to borrow the equivalent of the deficit on the international financial markets. If the 'market sentiment' changes and financial actors start selling assets on a massive scale, as often happens when interest rates rise, countries with current account deficits run the risk of having to undergo painful adjustments in their real economies (e.g. fiscal austerity), because they can no longer borrow to finance them. These imbalances also signal persisting asymmetries in the institutional capacity of different Member States in dealing with inflationary pressures, which further adds to the inefficacy of the ECB's monetary policy to stabilise the euro area economies (demand and inflation).

# Developments in aggregate demand components

## Real private consumption

Unchecked high and rising inflation has deleterious effects on the economy. Its suppression of real money incomes, apart from the fact that it exacerbates income inequalities, also reduces disposable income and private consumption (see Figure 1.10). Private consumption is the largest component of aggregate demand, and therefore any fall is likely to result in a slowdown or even recession, job losses and higher unemployment (see also Chapter 2). Of course, lowering consumption is a way of reducing greenhouse emissions and ultimately mitigating climate change. Under current circumstances, however, the burden is falling more on those with the lowest carbon footprint, relying on money incomes at the low end of income distribution, rather than on those on higher incomes, who have a much higher carbon footprint.

Figure 1.10 **Adjusted gross real disposable income of households and actual real final consumption per capita (% change quarter-on-quarter), EU, 2020Q1-2022Q2**



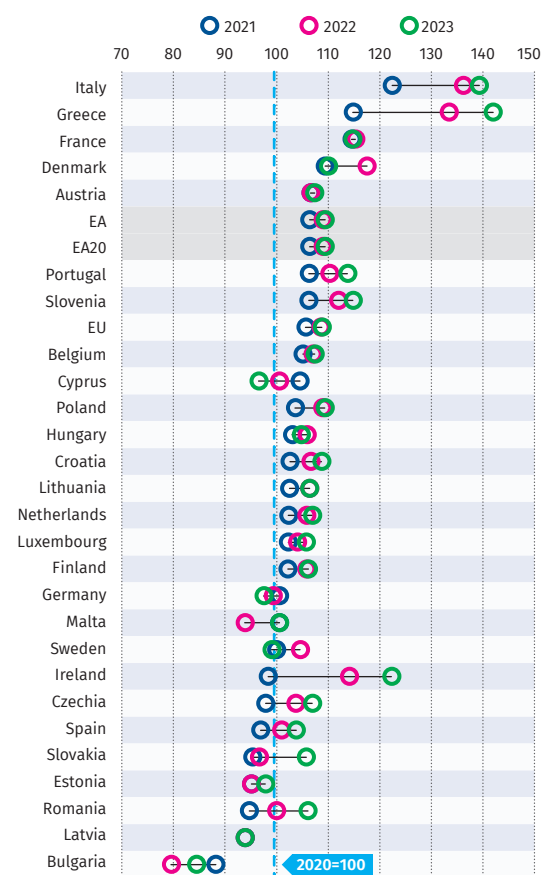
Source: Own calculations using Eurostat data (NASQ\_10\_KI series).

## Real investment

Real investment (gross fixed capital formation in constant prices) grew in most, but not all, countries in 2021 from its 2020 levels (with the exceptions of Ireland, Czechia, Spain, Slovakia, Estonia, Romania and Bulgaria). However, in many countries, real investment grew very little

from 2021 to 2022, and it is forecast to grow only slightly, if not to decrease, between 2022 and 2023. This slowdown in 2022 and 2023 is most likely the consequence of rising interest rates and of the uncertainty that high inflation and its geopolitical causes entail. There have been exceptions to this stagnating picture, most notably Italy and Greece, where investment growth took off in 2022, as Recovery and Resilience Facility (RRF) funds began to flow to the two countries that are among the highest beneficiaries of the Facility, with Greece having the highest ratio of RRF funds to GDP and Italy the highest per capita amount of RRF funds. Both countries, however, experienced several years in a row of negative net investment, that is, of falling capital stock, in the 2010s.

Figure 1.11 **Gross fixed capital formation (constant prices) 2020=100, 2021-2023 (f), EU Member States**



Source: Own calculations using AMECO data (OIGKO series).

# Public finance developments

Following two years of expansion, the fiscal policy stance in the EU and the euro area turned neutral (that is, neither tightening nor expanding), as the exceptional support measures started to be scaled down (Figure 1.12).

Government deficits started shrinking after 2021 (Figure 1.13). Nevertheless, almost half the Member States still had deficits greater than 3% in 2022, which, however, did not result in excessive deficit procedures being activated, as the general escape clause of the Stability and Growth Pact (SGP) was still in effect.

Faced with skyrocketing energy prices, EU Member States, supported and often coordinated by the European Commission, began taking measures to alleviate the pressure on households and companies. According to Bruegel data (Sgaravatti et al. 2022), between September 2021 and November 2022, EU governments had either allocated or earmarked 600 billion euros to alleviate the impact of higher energy prices on consumers, of which 264 billion euros was earmarked by Germany alone. Measures took various forms, from reductions in energy tax/VAT and retail price regulation, to transfers to vulnerable groups and retail price subsidies. Support for businesses was also on the menu, as was taxing windfall profits of energy companies. Figure 1.14 below summarises the estimated public funds allocated to these measures in the EU Member States.

One of the positive but unintended consequences of rising inflation is that it tends to reduce the public debt-to-GDP ratio, as it increases nominal GDP. Figure 1.15 shows that the gross public debt-to-GDP ratio either fell or remained

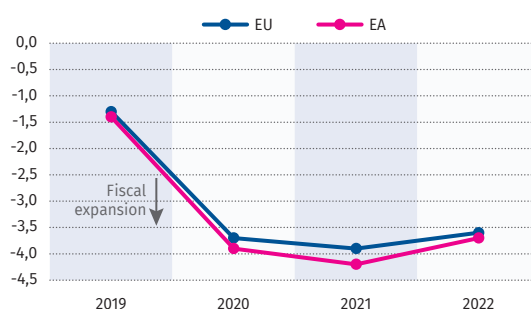
stable in 2022 compared to 2020 and 2021 in all EU Member States, despite the fact that many national governments chose once more to deploy fiscal measures to mitigate the impact of inflation on households and companies. Nevertheless, about half of the Member States have seen their public debt rise above the 60% of GDP limit stipulated by the Treaty, and six of them above 100%.

Given these high ratios, the benign effects of unexpected inflation on public debt should be balanced against the risk to financial market stability that rising interest rates (to fight inflation) create and the rolling back of asset purchase programmes of central banks, both of which effectively increase the cost of borrowing, including for governments. As history has shown, when governments face difficulties in borrowing on the financial markets at affordable interest rates, this can trigger financial crises, the detrimental effects of which reach the real economy and the livelihoods of ordinary people, causing lasting damage.



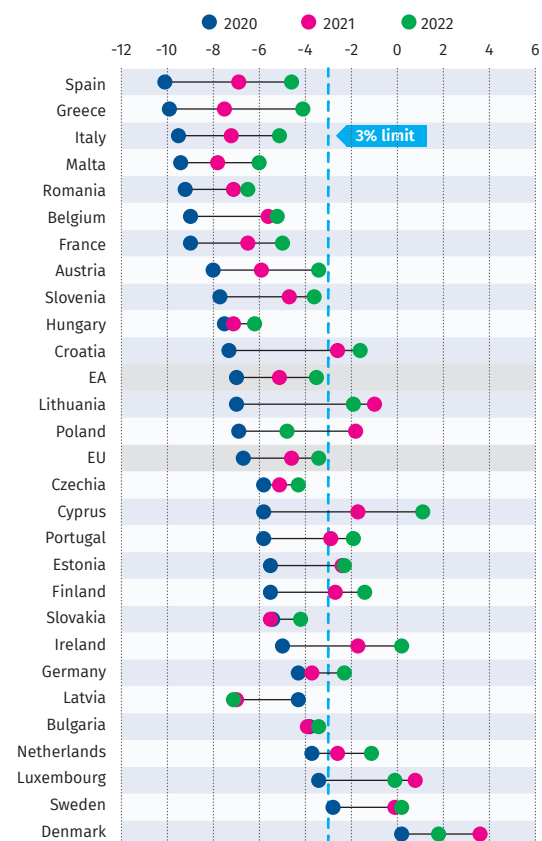
Faced with skyrocketing energy prices, EU Member States began taking measures to alleviate the pressure on households and companies

Figure 1.12 Fiscal policy stance (% of potential GDP), EU and euro area, 2019-2022



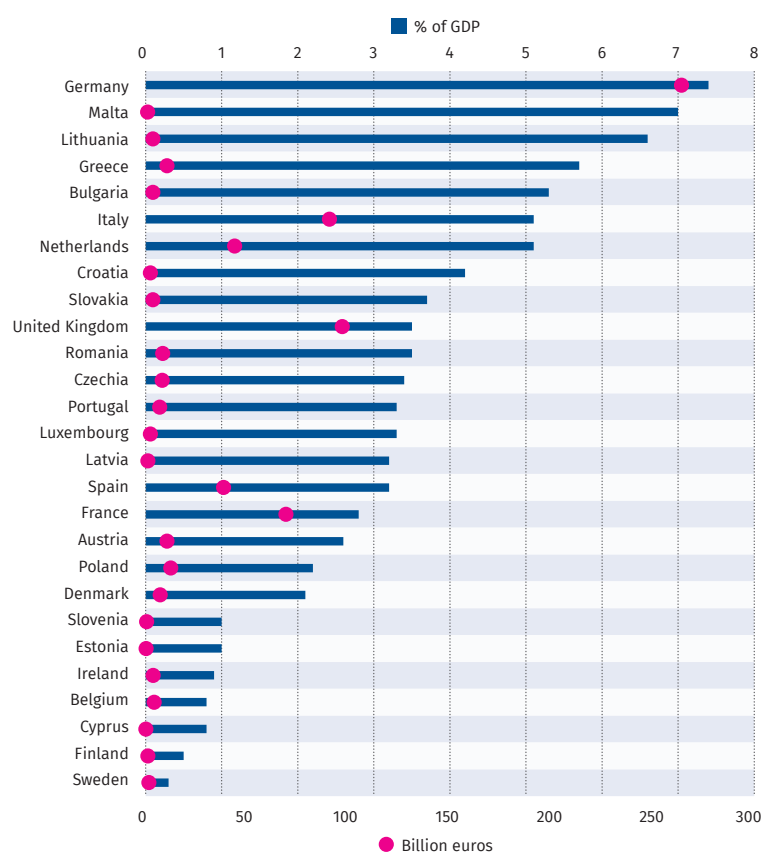
Source: AMECO (UBLGAP series).

Figure 1.13 Government budget deficit (% of GDP), EU Member States, 2020-2022



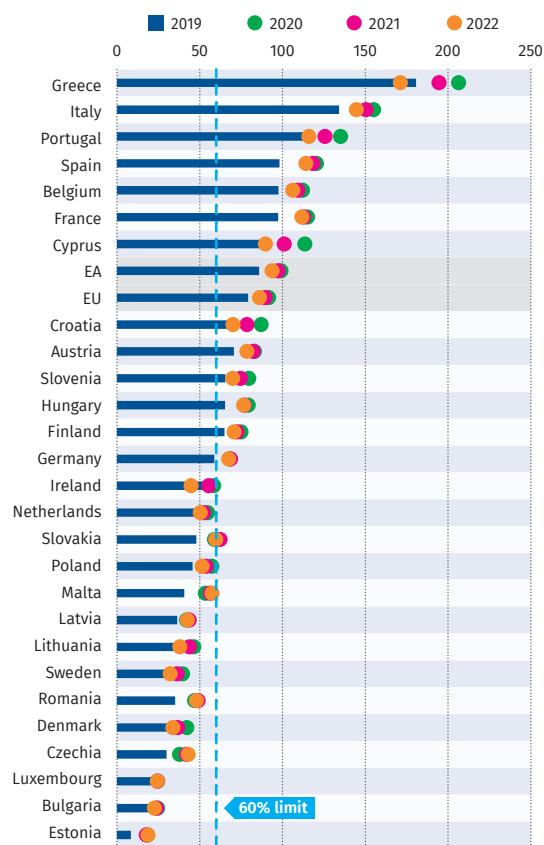
Source: AMECO (UBLG series).

Figure 1.14 Governments' funding (both allocated and earmarked) for mitigating the impact of high energy prices on households and firms (% of GDP and billion euros), EU Member States, September 2021–November 2022



Source: Sgaravatti, Tagliapietra and Zachmann (2021).

Figure 1.15 Public debt as a share of GDP (%), EU Member States, 2019–2022 (f)



Source: AMECO (UDGG series).

On the other hand, the activism of central banks, including the ECB, in stabilising financial markets through their asset purchasing programmes since the global financial crisis raises the question of how central banks would react if government bond spreads became critically high. Taking action to maintain financial stability was more aligned with pursuing price stability mandates while inflation was subdued, as in the euro area during the 2010s.

## The EU economic governance reform proposals

On 9 November 2022, the European Commission published a long-awaited Communication outlining its proposals on how to reform the EU economic governance framework (European Commission 2022a). The Communication takes further a process of assessment and public consultation which began in February 2020, but which had to be put on hold twice due to critical events: first, due to the Covid-19 pandemic in March 2020, and second, last year due to the war and the energy crisis that followed Russia's invasion of Ukraine. The debate on how to

reform the EU framework of economic policy coordination and surveillance in response to the global financial crisis and the euro area sovereign debt crisis has been evolving in parallel with the debate on whether and, if so, when and in what form a common fiscal capacity should be established in the euro area and possibly the EU (cf. Juncker et al. 2015).

Initially, the emphasis was on the capacity of Member States to stabilise their economies and preserve public investment and their production capacity in the face of shocks, especially long-lasting ones. The recovery from these crises also showed that fiscal policies which aim too hard to reduce budget deficits when output growth is low are ultimately detrimental to reducing public debt to sustainable levels, highlighting the fact that the fiscal rules as applied had, at least in some cases, been undermining the objective they had set out to achieve. During the same period, the question of whether fiscal policies should be given leeway to play a more important role in stabilising economies had also resurfaced, as policy interest rates, the main conventional tool of monetary policy, had fallen to zero in most advanced economies, restraining



the capacity of monetary policy to steer demand and stabilise the economy.

The launch of the European Green Deal in late 2019 (European Commission 2019), the EU growth strategy which followed that of Europe 2020, spelled out the vast magnitude of the investment flows required to meet its pledge of making Europe the first carbon-neutral continent by 2050 without leaving anyone behind, and set out the challenges facing European governments in financing both the green and digital transitions. The Covid-19 pandemic only magnified these challenges, as Member States had to deploy public funds unprecedented in the post-war era to support economies and healthcare systems during the emergency and recovery. During the pandemic, the EU and Member States generally rose to the occasion, thanks to the activation of the general escape clause of the Stability and Growth Pact and the mobilisation of instruments such as SURE and the NGEU, which have been financed by common EU debt. What the response to the pandemic also illustrated was that differences in ‘fiscal space’ among Member States can hinder effective responses and lead to negative spill overs across the EU, providing a strong case for fiscal capacity at EU level to deal with shared challenges.



Ultimately, it is not clear whether these proposals will allow for the public investment necessary to deal with the challenges lying ahead

The European Commission proposals for reforming EU economic governance consist of several building blocks. First, they suggest the adoption of a single observable indicator to guide governments and the European Commission in shaping and monitoring national fiscal policies that are compatible with public debt sustainability, namely nationally financed net primary public expenditure. This expenditure is nationally financed (i.e. excluding any EU funds), net of discretionary revenue measures (i.e. ad hoc taxes or one-off revenues), and excludes interest payments (over which governments have no control) and cyclical unemployment expenditure. The latter should increase the capacity of national fiscal policies to respond to the fluctuations of the business cycle by expanding when the economy slows down (and unemployment rises) and tightening when the economy grows fast (and unemployment falls). The 3% limit for budget deficits would also remain as a constraint.

Secondly, the Commission proposes using its debt sustainability analysis framework in order to determine the evolution of nationally financed net primary public expenditure over at least four years, which would be compatible with a sustainable evolution (path) of public debt-to-GDP ratio, which will still have to seek to abide by the 60% limit stipulated in the Treaty. The

requirements for adjustment, mostly in terms of time horizon, will vary depending on a Member State’s public debt-to-GDP ratio. This framework would make it possible to take into account risks and vulnerabilities and also investment and reform needs specific to each Member State, thus providing more flexibility and a more tailor-made approach (which, however, would be governed by the same principles for all Member States) than the currently applying rule, which dictates that Member States with a public debt-to-GDP ratio of over 60% should shape their fiscal stance so as to achieve a reduction of at least 1/20th per annum in the difference between the actual and the Treaty-mandated ratio (60%). Escape clauses for exceptional circumstances will also be provided for. The Commission argues that this gain in flexibility will have to be balanced with stronger ex post enforcement that remains to be defined, but which could include the effective use of financial sanctions, macroeconomic conditionality for structural and RRF funds, and enhanced reputational sanctions, with the Ministers of Finance of Member States having to undergo an excessive deficit procedure (if they violate the parameters of the agreed medium-term plan), being obliged to present their corrective measures to the European Parliament.

Thirdly, while the European Commission will propose a pathway for the evolution of public expenditure, it will be up to each Member State to present a medium-term fiscal and structural plan describing the fiscal, reform and investment commitments to set (or maintain) their public debt on a sustainable path by the end of the programme. These plans would translate the proposed path into annual budgets, while the proposed investments and reforms would need to be coordinated with the country-specific recommendations as well as the national energy and climate plans, the recovery and resilience plans and national Digital Decade roadmaps. Member States could also request that their fiscal plan (the minimum duration of which should be four years) could be extended by up to three years if they propose a series of investments and reforms which would lead to sustainable growth and thereby enhance debt sustainability. The draft fiscal plans would be subject to intense technical consultation between the Member State administration and Commission services before they are assessed and eventually approved by the Council.

Fourthly, the Macroeconomic Imbalances Procedure (MIP) would be subject to an enhanced dialogue between the European Commission and the national governments to



increase ownership and commitment and would be reformed to become more forward-looking and improve the capacity to prevent imbalances by focusing more on flow rather than stock variables in the related scoreboard.

These proposals will have to be debated and very likely revised before an agreement on the reform is reached in the Council. On the positive side, they take steps to address several of the diagnosed problems of the current fiscal surveillance framework, namely the fact that the current rules can lead to pro-cyclical fiscal policies<sup>1</sup> in the Member States, the insufficient differentiation (and therefore the inadequacy) of adjustment paths across Member States, the vulnerability of public investment to fiscal consolidation paths, the opaqueness of the rules and the lack of opportunity to develop ownership. It is also positive that greater coherence is sought between the MIP and the SGP and other policy challenges. These changes, if upheld, would grant Member States more leeway to use their fiscal policies and preserve public investment than they had before.

On the other hand, it is not clear how this framework would coordinate national fiscal policies to achieve an adequate aggregate fiscal stance for the euro area or why the MIP would become more effective in treating current account imbalances more symmetrically. Moreover, the proposal is vague on the criteria under which the proposed investments and reforms will be positively assessed to permit Member States a longer adjustment period. It is also not very clear how the assumptions that would be used for the debt sustainability analysis will avoid political assessments made without any democratic control.

Ultimately, however, it is also not clear whether they will allow for the amount of public investment necessary to deal with the challenges lying ahead (supporting the green transition, developing strategic autonomy and tackling inequalities). The emphasis often placed on 'improving the quality of public finances', that is, tilting spending towards public investment as opposed to public consumption (in other words, recurrent expenses such as benefits and salaries for the provision of public services), while sounding as though it offers possibilities, is also subject to limitations. Public investment can, in principle, create potential for growth which could help pay for the additional public spending to finance it, and, in this way, it makes financial sense. However, the green and digital transitions cannot come about as a result of investing in enabling citizens to participate in them by helping them acquire different and better skills *alone*. Some buffering against the consequences of these transitions is also necessary, through income support and/or the provision of quality public services (cf. Sabato and Theodoropoulou 2022).

Moreover, given that certain shortcomings remain, making it likely that there will be continued suboptimal stabilisation of national economies, it is still probable that there will simply not be sufficient, or sufficiently even, fiscal space across Member States to stimulate public investment in the different transitions. The solution to that, given that the perils of failing to navigate these transitions successfully are not likely to be limited to one Member State, should be the issuing of common EU public debt, that is to say the extension or establishment of further new fiscal capacity instruments, such as Next Generation EU.

---

1. Involving excessively restrictive fiscal policies when output is growing slowly and excessively loose policies when output is growing fast.

# The ECB response to inflation



Conventional monetary policy is likely to be less effective and to cause considerable collateral damage in terms of growth, jobs, incomes and financial stability

Faced with inflation well above their target, central banks around the world have begun reversing the lax policies they had pursued over the previous decade: asset purchases have been rolled back and increases in interest rates have been implemented, often in large steps, in the hope that higher interest rates will take the steam out of inflation pressures. Following a period of cautiousness and gradual rolling back of asset purchase programmes, the Governing Council of the ECB increased all three of its policy interest rates by 25 basis points in July 2022 for the first time since July 2011. The ECB followed up with 75 basis point increases in September and November 2022, while it slowed down the rate of increase to only 50 basis points in December 2022, when there were signs that the inflation rate was slowing down. Thus, the interest rate on the deposit facility currently stands at 2% (up from -0.50% in July), the main refinancing operations rate, through which the ECB provides liquidity to banks in normal times, stands at 2.50% (up from 0% in July), and the interest rate for the marginal lending facility, through which banks can borrow liquidity overnight through the Eurosystem, stands at 2.75% (up from 0.25% last July).

The policy reversal runs the risk of stifling the recovery from the pandemic without really addressing the roots of rising inflation, which in Europe are located on the supply side, as higher energy prices increase the costs of production. Moreover, the monetary policy reversal creates financial stability risks, especially for governments which saw their public debt-to-GDP ratios rising as a consequence of the unprecedented public financial support programmes rolled out during the pandemic, and which are currently constrained in providing financial support to mitigate the impact of inflation and speed up the transition to alternative, greener sources of energy.

Raising interest rates is a blunt instrument (it affects aggregate demand rather than addressing the causes of rising prices) and it is slow (it takes time for interest rates to work their way through the economy). Moreover, there is scant evidence that price-wage spirals are a real risk in Europe (Alvarez et al. 2022). As mentioned earlier, nominal compensation per employee has been lagging behind the consumer price

index. By engineering a recession, monetary policy is bound to cause higher unemployment than would otherwise have been the case, harming those in more precarious labour market situations and ultimately exacerbating inequality. Therefore, in terms of income, wage earners as a whole, including those without a job, stand to lose out.

Furthermore, many economists would argue that raising interest rates is not a solution to the problems currently fuelling inflation, which in Europe are firmly situated on the supply side of the economy: the war in Ukraine and the sanctions against Russia have raised the cost of energy; extreme weather conditions have pushed up food prices (and the cost of waterway transport of coal); and disruptions in global supply chains have affected commodity prices. Mitigating climate change and facilitating the energy transition will require substantial investments on the part of governments, businesses and households. In view of the current US Inflation Reduction Act and the incentives it creates for companies to locate their activities in the US, reshoring economic activities to achieve strategic autonomy is likely to be costly. These tasks are already daunting enough; higher interest rates are bound to make them more daunting still, both by raising the cost of the necessary investments, and by limiting the scope for compensating the losers in the energy transition.

The ECB approach is even more puzzling, given that, as part of its recent monetary policy strategy review, it has committed to take practical steps to support policies for climate change mitigation. For example, among other measures, in autumn 2022, it announced the details of a system it would put in place to reduce the Eurosystem's exposure to climate-related financial risk, following the Governing Council's July 2022 decision to tilt the Eurosystem's corporate bond purchases towards issuers with a better climate performance.

In addition, interest rate hikes also pose substantial risks to financial stability, especially after the accumulation of debt during the Covid-19 pandemic, as, when interest rates rise, the price of financial assets falls. This could cause problems in the balance sheets

of households, companies, governments and also financial institutions, which, given their neuralgic role in capitalist economies, would then need to be bailed out, adding further pressures on public budgets. The fact that central banks have been tightening their policies in an uncoordinated manner compounds the problem. In the euro area, debt servicing costs are set to rise asymmetrically, reducing the fiscal space available to governments, especially in the highly indebted countries which were worst affected by the euro crisis and the pandemic, such as Italy and Greece.

In view of all this, conventional monetary policy is likely to be less effective and to cause considerable collateral damage in terms of growth, jobs, incomes and financial stability, making it harder to justify its implementation.

More broadly, granting central banks independence and delegating to them monetary policy decisions to maintain price stability was a defensible, albeit far from distributionally neutral (as the economic orthodoxy of the time claimed), option in the economic and political conditions of the 1970s and 1980s. Now that anti-systemic parties are on the rise across Europe, national economies have not fully recovered from the effects of the pandemic (and of the Great Recession), price rises are mostly driven by energy and food imports, and our efforts to address climate change require massive investment, the option of allowing central banks to pursue their single-minded objective of bringing inflation down to 2% and governments to subordinate fiscal policy to that end may simply prove too costly (Matsaganis and Theodoropoulou 2022).



The transitions, green, digital, geopolitical and social, that Europe has to navigate are intertwined and generate challenges for macro-economic policies

# Conclusions

This chapter has provided an overview of how the transitions, green and digital, geopolitical and social, that Europe currently has to navigate are intertwined and generate challenges for macroeconomic policies, most notably the surge in inflation rate and the cost of living crisis, to the extent that these policies are crucial for financing these transitions and for creating favourable conditions for them by stabilising economies and promoting job creation.

Economic policies in Europe are also currently in a state of flux: a long-debated and much awaited reform of the framework of economic policy coordination and surveillance is currently under way. Moreover, in December, the President of the European Commission announced that she intended to push the governments of the EU Member States for the establishment of the 'European Sovereignty Fund', in order to finance the twin (green and digital) transition for which the European Commission has been putting forward industrial policy frameworks. This announcement is linked to concerns about the impact of the US Inflation Reduction Act and the financial incentives it offers in relation to global firms' location decisions. This announcement illustrates the fact that the common challenges facing the EU require a further pooling of financial resources among the Member States. On the other hand, the ECB introduced a new monetary policy strategy in 2021, adopting, among other initiatives, more explicit objectives to support the EU's climate objectives as part of a strategy that it is due to reassess and, if necessary, further revise by 2025.

The most recent surge in inflation has shifted the context in which macroeconomic policies have been operating to pursue their objectives, most notably as central banks around the world, including the ECB, have changed course and raised interest rates to fight inflation. Higher interest rates make the tasks of fiscal policies, whether national or EU, more challenging as

the cost of borrowing increases. The debate on whether inflation and what central banks regard as 'necessary' interest rate increases will prove to be relatively transitory is still open. While energy prices have already returned to pre-war levels in international markets, this chapter has shown that the transitions that the EU has to undergo suggest that inflation is likely to stay higher than in the era of 'great moderation'. At the same time, by raising interest rates, central banks may face a conflict between meeting their own objectives in terms of price stability and financial market stability.

This shift in context does not mean, however, that macroeconomic policies in Europe cannot support the green, digital and geopolitical transitions by facilitating a social transition towards reduced inequality. Reduced inequality would be crucial not only to make the fight against climate change more effective (Gough 2017) but also to create the political consensus for implementing policies that mitigate it. It would, however, take a decisive shift away from established theoretical frameworks, the seeds of which have already been sown. Establishing greater fiscal capacity at EU level and pushing the economic governance reform as far as possible would be one way forward, especially if coupled with an open debate and decision on what the interaction between the policies of the ECB and the fiscal policies of the EU should be (Gabor 2022). Moreover, the ECB has expanded the range of tools it used during the 2010s in ways that could still allow it both to fight high inflation if it must (under the current circumstances) and to support EU investment that would foster the energy transition and greater strategic autonomy by differentiating its policy interest rates through the targeted longer-term refinancing operation (TLTRO) schemes (van t'Klooster 2022). Considering the impacts of ECB policies on inequality more explicitly would also be a sensible way forward.

# References

- Alvarez J. et al. (2022) Wage-price spirals: what is the historical evidence?, IMF Working Paper 2022/221, International Monetary Fund. <https://www.imf.org/en/Publications/WP/Issues/2022/11/11/Wage-Price-Spirals-What-is-the-Historical-Evidence-525073>
- Claeys G., McCaffrey C. and Welslau L. (2022) Does inflation hit the poor hardest everywhere?, Bruegel Blog, 28 November 2022. <https://www.bruegel.org/blog-post/does-inflation-hit-poor-hardest-everywhere>
- European Central Bank (2023) Inflation dashboard, accessed on the 14 February 2023. [https://www.ecb.europa.eu/stats/macroeconomic\\_and\\_sectoral/hicp/html/index.en.html](https://www.ecb.europa.eu/stats/macroeconomic_and_sectoral/hicp/html/index.en.html)
- European Commission (2019) The European green deal, COM(2019) 640 final. [https://eur-lex.europa.eu/resource.html?uri=cellar:b828d165-1c22-11ea-8c1f-01aa75ed71a1.0002.02/DOC\\_1&format=PDF](https://eur-lex.europa.eu/resource.html?uri=cellar:b828d165-1c22-11ea-8c1f-01aa75ed71a1.0002.02/DOC_1&format=PDF)
- European Commission (2021) European economic forecast - Autumn 2021, Institutional Paper 160. [https://economy-finance.ec.europa.eu/system/files/2021-11/ip160\\_en\\_0.pdf](https://economy-finance.ec.europa.eu/system/files/2021-11/ip160_en_0.pdf)
- European Commission (2022a) Communication on orientations for a reform of the EU economic governance framework, COM(2022) 583 final. [https://economy-finance.ec.europa.eu/system/files/2022-11/com\\_2022\\_583\\_1\\_en.pdf](https://economy-finance.ec.europa.eu/system/files/2022-11/com_2022_583_1_en.pdf)
- European Commission (2022b) European economic forecast - Autumn 2022, Institutional Paper 187. [https://economy-finance.ec.europa.eu/system/files/2022-11/ip187\\_en\\_3.pdf](https://economy-finance.ec.europa.eu/system/files/2022-11/ip187_en_3.pdf)
- European Commission (2022c) European economic forecast - Spring 2022, Institutional Paper 173. [https://economy-finance.ec.europa.eu/system/files/2022-05/ip173\\_en.pdf](https://economy-finance.ec.europa.eu/system/files/2022-05/ip173_en.pdf)
- European Commission (2022d) European economic forecast - Summer 2022, Institutional Paper 183. [https://economy-finance.ec.europa.eu/system/files/2022-07/ip183\\_en.pdf](https://economy-finance.ec.europa.eu/system/files/2022-07/ip183_en.pdf)
- European Commission (2022e) European economic forecast - Winter 2022, Institutional Paper 169. [https://economy-finance.ec.europa.eu/system/files/2022-02/ip169\\_en.pdf](https://economy-finance.ec.europa.eu/system/files/2022-02/ip169_en.pdf)
- Faccia D., Parker M. and Stracca L. (2021) Feeling the heat: extreme temperatures and price stability, Working Paper 2626, European Central Bank. <https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2626-e86e2be2b4.en.pdf>
- Gabor D. (2022) Revolution without revolutionaries: interrogating the return of monetary financing. [https://transformative-responses.org/wp-content/uploads/2021/01/TR\\_Report\\_Gabor\\_FINAL.pdf](https://transformative-responses.org/wp-content/uploads/2021/01/TR_Report_Gabor_FINAL.pdf)
- Gough I. (2017) Heat, greed and human need: climate change, capitalism and sustainable wellbeing, Edward Elgar.
- Juncker J.-C. et al. (2015) Completing Europe's economic and monetary union. [https://commission.europa.eu/system/files/2016-03/5-presidents-report\\_en.pdf](https://commission.europa.eu/system/files/2016-03/5-presidents-report_en.pdf)
- Lagarde C. (2022) Monetary policy in a high inflation environment: commitment and clarity, Lecture organised by Eesti Pank and dedicated to Professor Ragnar Nurkse, Tallinn, 4 November 2022. [https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp221104\\_1-8be9a4f4c1.en.html](https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp221104_1-8be9a4f4c1.en.html)
- Matsaganis M. and Theodoropoulou S. (2022) The return of inflation: can we protect real incomes?, Policy Paper 117, Hellenic Foundation For European & Foreign Policy.
- Rowthorn R.E. (1977) Conflict, inflation and money, Cambridge Journal of Economics, 1 (3), 215–39. <https://doi.org/10.1093/oxfordjournals.cje.a035360>
- Sabato S. and Theodoropoulou S. (2022) The socio-ecological dimension of the EU's recovery: further traction for the European green deal?, in Vanhercke B., Sabato S. and Spasova S. (eds.) Social policy in the European Union: state of play 2022, ETUI.
- Schnabel I. (2022) A new age of energy inflation: climateflation, fossilflation and greenflation, Speech at a panel on "Monetary Policy and Climate Change" at The ECB and its Watchers XXII Conference, Frankfurt am Main, 17 March 2022. <https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230110-21c89bef1b.en.html>
- Sgaravatti G., Tagliapietra S. and Zachmann G. (2022) National fiscal policy responses to the energy crisis, Bruegel. <https://www.bruegel.org/dataset/national-energy-policy-responses-energy-crisis>
- van t'Klooster J. (2022) The European Central Bank's strategy, environmental policy and the new inflation: a case for interest rate differentiation, Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy, London School of Economics and Political Science.

All links were checked on 14.02.2023