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COVER NOTE

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To:	Ms Thérèse BLANCHET, Secretary-General of the Council of the European Union
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Recommendation for a

COUNCIL RECOMMENDATION

on the economic policy of the euro area

{SWD(2022) 382 final}

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Recommendation for a

COUNCIL RECOMMENDATION

on the economic policy of the euro area

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 136(1) in conjunction with Article 121(2) thereof,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 5(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances[2], and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission,

Having regard to the conclusions of the European Council,

After consulting the Economic and Financial Committee,

After consulting the Economic Policy Committee,

Whereas:

(1) The euro area's post-COVID economic recovery has been interrupted by a series of external shocks. Thanks, in particular, to decisive economic policy response, both at national and EU level, and to the lifting of containment measures, the euro area posted solid GDP growth in 2021 and 2022, 5.3 % and 3.2 % respectively. Labour market also proved resilient, with the unemployment rate set to reach the record low rate of 6.8 % in 2022. However, the increase in global energy prices, heightened uncertainty and supply chain disruptions induced by Russia's war of aggression against Ukraine resulted in a clear deceleration in economic activity in the second half of 2022, and the energy crisis has led to a downward reassessment of forecasts for 2023. Overall, GDP growth in the euro area is set to decrease to only 0.3 % in 2023 before returning to a 1.5 % growth in 2024. The energy market and other commodities markets have been fuelling inflation, which over time has broadened into other items and reaches 8.5 % in 2022. Inflation is now expected to remain elevated in the coming months, staying at 6.1 % in 2023 before easing in 2024. Labour markets are expected to remain robust as demand for labour remains high. With a large share of businesses still reporting labour shortages, unemployment is set to increase only moderately next year, before abating again in 2024. Meanwhile, nominal wage growth is expected to increase in 2023 but to remain below inflation,

[1] OJ L 209, 2.8.1997, p. 1.

[2] OJ L 306, 23.11.2011, p. 25.

leading to a drop in purchasing power of households. In this context, the euro area's current account surplus has receded, in line with the strongly deteriorating energy balance and, going forward, the nominal depreciation of the euro against the US dollar and some other currencies since the second half of 2021 is likely to provide only a modest boost to competitiveness given the high energy costs.

(2) The deterioration in macroeconomic conditions and large price differentials across Member States challenge income and business cycle convergence in the euro area. While the COVID-19 pandemic led to deep, though largely transitory, divergences in macroeconomic performance, it had a limited and temporary impact on business cycle synchronisation. The energy crisis brings with it new heterogeneous macroeconomic impacts in the euro area. Due to cross-country discrepancies in energy mixes and in policies to mitigate the impact of the energy shock, large differences in headline and core inflation rates have emerged across the euro area. Higher energy prices and supply chain pressures have had an uneven impact on manufacturing and services across euro area Member States and may result in drifting relative competitiveness. While available indicators suggest that competitiveness gaps within the euro area have been limited so far, divergences in current account balances in the euro area have recently widened mainly on the back of deteriorating energy balances.

(3) Ensuring an appropriate policy response to a deteriorating economic outlook and high inflation is a requires monetary and fiscal policies to be appropriately calibrated and coherent. Monetary policy normalisation has to address high and divergent inflation while tackling possible risks of unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. In the current climate, a broad-based fiscal expansion to support demand would further fuel inflationary pressure, at a time when public debt is elevated in several euro area Member States. This calls for fiscal policies that are appropriately differentiated across Member States according to the economic and fiscal situation, as recommended by the Council in July 2022.[3] It also requires them to be prepared to adjust current spending to the evolving situation. At the same time, targeted and temporary fiscal measures are needed to support vulnerable people and companies, also with a view to maintaining jobs and human capital, while preserving price signals and providing incentives to reduce energy consumption. Close coordination of policy responses between Member States remains crucial. Labour market and social policies are also instrumental in addressing the social impacts of high inflation. Average wages are not keeping up with inflation in 2022. Going forward, wage developments need careful balancing to protect wage earners' purchasing power – with a focus on low-wage earners – while avoiding the risk that wages feed inflation and deepen emerging competitiveness differentials within the euro area and worldwide. Active involvement of social partners helps identify challenges, including on the specific challenges for the monetary union, improves policy solutions, and ensures broader ownership of the economic and social policy agenda. Supply-side policies can also contribute to lower inflation by accelerating the build-

[3] Council Recommendations of 12 July 2022 on the National Reform Programmes and delivering Council opinions on the 2022 Stability Programmes, OJ C 334, 1.9.2022.

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up of alternative energy supplies, enhancing competition, improving the allocation of resources, and supporting productivity growth. Risks to financial stability also require continued monitoring.

(4) The Recovery and Resilience Facility (RRF) and cohesion policy funds are key tools to strengthen the resilience of the euro area and support convergence. The implementation of the RRF in the euro area Member States is well on track, with over EUR 128 billion paid in pre-financing and following the fulfilment of milestones and targets. Since the outbreak of the pandemic, cohesion policy programmes disbursed over EUR 82 billion to euro area Member States. The RRF and cohesion policy funds contribute to the euro area policy priorities through several channels: both support economic activity through additional investment and, in the longer term, the planned investments and structural reforms are set to support the green and digital transition while stimulating higher growth in productivity and potential output. A large proportion of investments and reforms carried out as part of the RRF is relevant for the implementation of euro area policy priorities identified in previous euro area recommendations. Accordingly, continuing to implement planned reforms and investments based on the planned schedule is essential to maintain the reform momentum.

(5) To ensure a consistent economic policy response at the EU level, the Annual Sustainable Growth Survey (ASGS)[4] outlines the key policy priorities and guidelines for the year ahead. The ASGS is in line with the UN Sustainable Development Goals and is structured around the four dimensions of competitive sustainability: environmental sustainability, fairness, productivity, and macroeconomic stability. The Alert Mechanism Report[5] provides the Commission’s analysis of potential macroeconomic imbalances that may hinder the proper functioning of Member State economies, the Economic and Monetary Union and the Union as a whole.

(6) The rapid increase in inflation over the past year has prompted a rapid adjustment of the monetary policy stance worldwide. The European Central Bank (ECB) has started normalising monetary policy to ensure a timely return of inflation to the 2% medium-term target. It has also indicated that the normalisation of interest rates will continue, taking into account economic data developments. Supply constraints play a significant part in the recent inflation surge, and inflation differentials make the conduct of monetary policy more challenging. An even transmission of the policy stance across the euro area is a precondition for monetary policy to deliver on its mandate.

(7) The euro area fiscal stance, measured as the change in net primary expenditures relative to average potential growth, is projected to be expansionary in 2022 and broadly neutral in 2023, conditional on the planned roll-back of energy-related measures. In 2023, fiscal policy should avoid amplifying the inflationary effects of the ongoing supply shocks and, both at national level and for the euro area as a whole, a broad-based fiscal impulse to the economy is not warranted. The challenge is particularly acute for Member States experiencing high core inflation, also in light

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[4] Annual Sustainable Growth Survey 2023, COM (2022) 780.

[5] Alert Mechanism Report 2023, COM (2022) 781.

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of the serious economic and social difficulties inflicted by the erosion of wage earners' purchasing power, in particular for low wage earners. Moreover, fiscal policy should remain prudent and combine higher investment with controlling the growth in net primary current expenditure. In this context, the expected further increase in RRF absorption and in nationally-financed investments across Member States are consistent with the need to expand public investment for the green and digital transition and for energy security. At the same time, the fiscal policy agility would help to respond to high uncertainty and strong downside risks to the economic outlook, while not undermining incentives for the energy transition. The COVID-19 pandemic has left a legacy of record-high debt in the euro area, and public debt is expected to remain much higher than pre-pandemic levels in most euro area Member States. While short-term sustainability risks have largely decreased, medium- and longer-term risks remain elevated in several Member States, and interest rates rises will eventually feed into higher debt burden.

(8) In order to respond to the increase in energy prices, euro area Member States have taken measures estimated to represent 1 ¼ % of GDP in 2022 and up to 1 % in 2023, with the expected decrease contingent on developments in the price of energy and on the planned roll-back of the related measures. The measures taken so far mainly aim at mitigating price increases, and only 20 % are targeted income measures. There is a need to limit the fiscal cost of such support measures, while taking into account their distributional impact across income brackets, the impact on energy demand, possible distortions to the single market and negative spillovers across countries. To this end, it is important to agree on a common approach. A two-tier energy pricing model, whereby vulnerable consumers benefit from regulated prices up to a certain level of consumption, can be helpful here. Besides temporary energy measures, public investment can help bolster energy security and the green transition. Since the global financial crisis, the euro area has been suffering from low levels of both private and public investment. Policy steps taken in response to the COVID-19 crisis, with the exceptional support of NextGenerationEU, have helped maintain the level of public investment, with a positive impact on potential growth, especially in the Member States with the highest public debt burden. Further public investment, in particular through the implementation of the recovery and resilience plans, of cohesion policy programmes, and national energy and climate plans to be updated by Member States by June 2023, is critical for sustainable and cohesive growth and to achieve the green and digital transition.

(9) On 9 November 2022 the Commission published the Communication on orientations for a reform of the EU economic governance framework[6] to improve the effectiveness of economic surveillance and policy coordination in the Union. The Communication aims to define a simpler and integrated architecture for macro-fiscal surveillance to ensure debt sustainability and promote sustainable and inclusive growth. The key elements of the proposal aim at simplifying the framework, improving national ownership, and strengthening enforcement. The Communication proposes that fiscal trajectories are based on medium-term fiscal-structural plans

[6] Communication on orientations for a reform of the EU economic governance framework, COM(2022) 583 final

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proposed by Member States, within a transparent common EU framework. These plans would bring together fiscal, reform and investment commitments supporting debt sustainability and sustainable growth and reflecting EU and national priorities. Reform and investment commitments, which would be adopted by the Council, would allow for a longer fiscal adjustment period. While maintaining the Treaty reference values (3% of GDP for the deficit and 60% of GDP for the debt), the framework would rely on a more risk-based surveillance focused on debt sustainability. As regards the Macroeconomic Imbalance Procedure (MIP), the communication proposes a more forward-looking framework to be able to identify emerging risks as they develop. The assessment of whether imbalances exist would remain based on the three criteria of gravity, evolution and the policy response. However, the criteria of evolution and the policy response by the Member State concerned would be given more weight in the assessment

(10) The euro area labour market has shown remarkable resilience thanks to policy support during the COVID-19 crisis. In the first quarter of 2022, total hours worked surpassed pre-pandemic levels, and employment continued to grow throughout the first half of 2022 to historically high levels in the second quarter of 2022 pushing the unemployment rate to 6.8 %, its lowest level since the creation of the euro. Still, scope for improvement remains with regard to the labour market integration of women, young people, persons with disabilities, and vulnerable groups. Going forward, the expected slowdown in economic activity is set to weigh on employment prospects, with unemployment rate slightly increasing in 2023 and 2024. There is little evidence that the COVID-19 crisis led to a structural deterioration of job matching issues. However, there are significant labour market differences across Member States and sectors. Since 2019, job creation has been the strongest in information technology and professional services while transportation, accommodation and food have recorded job losses. Demographic change is likely to also play a role in the tightening of euro area labour markets.. Adequate and effective investment in quality education and training at all ages will be key to mitigating current and future skills shortages. Wage growth somewhat increased during 2022, leading to an aggregate increase in unit labour costs. However, it remained moderate overall and is projected to stay well below inflation. Real compensation by employee is projected to contract by 2.8% in 2022 and by a further 0.9 % in 2023 before recouping part of the loss in 2024. Anchored inflation expectations play a key role in mitigating risks that rapid rises in wage claims push inflation further up.

(11) Structural reforms, including those carried out as part the European Green Deal or supported by the RRF and REPowerEU plan, are key to strengthen the Single Market and the resilience of the euro area economies. Further improving the business environment, including by reducing barriers to investment and the reallocation of capital, modernising public administrations, removing restrictive regulatory frameworks, and speeding up of granting permits, can increase productivity and growth. Reforms, together with investment, are instrumental to accomplishing the green and digital transition, in particular for improving energy efficiency, supporting decarbonisation, increasing the supply and deployment of renewable energy and clean energy technologies, as well as supporting upskilling and reskilling. The rapid and persistent rise in energy prices has put the business models of energy-intensive industries and small and medium enterprises under pressure, with an impact on jobs and human capital. Efficient insolvency regimes can support the transition and make it easier to reallocate resources. Insolvency regimes across the euro area still differ

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greatly and increasing their effectiveness and harmonisation would support economic adjustment and the single market for capital.

(12) So far, the banking sector has shown overall resilience in 2022. While the euro area banking sector as a whole is well capitalised and has seen an improvement in profitability since 2021, a sharp deterioration in the macroeconomic outlook, together with increasing interest rates, may translate into weaker asset quality. In a context of tighter access to credit, timely monitoring of risks, proactive engagement with debtors and active management of non-performing loans is important to maintain banks' ability to finance the economy. The resilience of credit institutions may be hampered by structural factors, including overcapacity and competition from new financial service providers. Other risks may also emerge on the financial markets. In particular, higher risk premiums and tightening liquidity conditions may lead to a fall in asset prices. Due to margin calls, this may cause further pressures beyond the liquidity stress already experienced by some energy companies. How the residential and commercial real estate markets react to the interest rate hikes also requires close monitoring, as rising mortgage rates and worsening debt-servicing capacity can exert downward pressure on house prices and lead to cyclical risks. Moreover, increased cyber risks call for greater attention, and the recently agreed Digital Operational Resilience Act will strengthen financial firms' resilience against risks related to information and communication technologies. In September 2022, the European Systemic Risk Board issued a warning asking private sector institutions, market participants and relevant authorities to continue to prepare for tail-risk scenarios.[7]

(13) In June 2022, the Eurogroup agreed that work on the future of the Banking Union should focus on strengthening the common framework for bank crisis management and the national deposit guarantee scheme to have a framework that is suited to all types of banks. The Eurogroup committed to reviewing the state of the Banking Union and identifying in a consensual manner further measures regarding the other outstanding elements to strengthen and complete the Banking Union. The Commission has announced that it intends to make a crisis management and deposit insurance (CMDI) legislative proposal in early 2023. Modifications to the CMDI framework can help make the euro area banking sector more resilient. The Commission has also announced that it will table in the first half of 2023 a legislative proposal that would establish the digital euro and regulate its core aspects, with a possible introduction of the digital euro by the ECB in 2026. A digital euro, which would be complementary to cash, could unlock several benefits for the euro area economy. It would support in particular the digitalisation of the economy and innovation in retail payments. While the international role of the euro has remained broadly stable in recent years, it could be strengthened. Developing a digital euro could, also against the background of the current geopolitical situation, increase the economic and financial autonomy of the euro area and the Union and improve global financial stability.

[7] Warning of the European Systemic Risk Board of 22 September 2022 on vulnerabilities in the Union financial system (ESRB/2022/7).

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RECOMMENDS:

Euro area Member States should take action, individually, including through the implementation of their recovery and resilience plans, and collectively within the Eurogroup, in 2023 –2024 to:

1. Continue to coordinate fiscal policies across Member States to support the timely return of inflation to the ECB's 2% medium-term target. Refrain from broad-based support to aggregate demand in 2023, while targeting fiscal measures to address the impact of high energy prices on vulnerable households and companies. Agree on a common approach and, in particular, replace broad-based price measures with a cost-efficient two-tier energy pricing that ensures incentives for energy savings. Define appropriately differentiated medium-term fiscal strategies to ensure debt sustainability and raise the growth potential in a sustainable manner, through gradual consolidation to achieve prudent medium-term fiscal positions, as well as through investments and reforms.

2. Sustain a high level of public investment needed to boost economic and social resilience and support the green and digital transition, including for greater energy efficiency and for the transition to renewable energy sources. Implement the cohesion policy programmes and recovery and resilience plans, ensuring the timely delivery of reforms and investment, and ensure that updates to the plans are targeted and do not reduce the overall ambition. Take further steps, including through REPowerEU plan, to accelerate the clean energy transition and increase Union's energy independence.

3. In accordance with national practices and respecting the role of social partners, support wage developments that mitigate the loss in purchasing power of wage earners, in particular for low-income workers, while reflecting medium-term productivity developments and limiting second-round effects on inflation. Develop and adapt, where needed, social support systems to help vulnerable households deal with the energy shock and the green and digital transition, addressing the increased risk of poverty. Further improve active labour market policies and take measures to address skills shortages. Ensure the effective involvement of social partners in policy-making and strengthen social dialogue.

4. Ensure that the support to companies, in particular small and medium-sized enterprises, that come under financial pressure because of the energy crisis is cost-effective, temporary, and targeted to viable firms. The support provided should maintain incentives for energy efficiency and preserve the level playing field and the integrity of the single market, including through the State aid Temporary Crisis Framework. Increase the efficiency of insolvency frameworks by ensuring that they deal effectively and in a timely manner with bankruptcy and corporate restructuring. Contribute to progress towards the Capital Markets Union.

5. Preserve macro-financial stability, maintain the credit channels to the economy and continue supporting financial integration. Monitor risks linked in particular to tensions in the energy sector, rising interest rates, non-performing assets, and developments in real estate markets. Continue to actively engage in the preparatory work on the introduction of a digital euro.

Further steps in deepening the Economic and Monetary Union (EMU) should take into account the lessons learnt from the design and implementation of the Union's comprehensive economic policy response to the COVID-19 crisis, including the RRF and the economic

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governance review. Progress in deepening the EMU should be continued in full respect of the Union’s single market and in an open and transparent manner towards non-euro area Member States.

Done at Strasbourg,

For the Council
The President

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