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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN
CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE,
THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT
BANK**

Annual Sustainable Growth Survey 2023

1. Introduction

The swift, coordinated and united economic policy response to the pandemic has paid off: the post-COVID recovery of the EU economy has been the fastest since the post-war boom with real GDP expanding by 5.4% in 2021. In spite of the economic shock caused by Russia's war of aggression against Ukraine, GDP growth in the EU remained robust in the first half of 2022 and stayed positive in the third quarter, beating expectations. Labour markets have proved particularly resilient, having benefitted from short-time work schemes also supported by the EU's SURE mechanism as well as the reforms and policies of the last decade. Unemployment has reached a record low and employment a record high.

However, the EU economy is now at a turning point. High energy price pressures, erosion of households' purchasing power, a weaker external environment and tighter financing conditions are expected to tip the EU into a contraction this winter. Having outpaced wage growth, inflation is quickly eroding households' purchasing power, with a negative impact on consumption. Cost increases, supply chain disruptions and tighter financing conditions are weighing on investment. As strong inflationary pressures continue to dent demand in many emerging and advanced economies, the external environment is unlikely to provide support for EU growth. On an annual basis, real GDP growth in the EU is set to slow from 3.3% in 2022 to only 0.3% in 2023, picking up to 1.6% in 2024. Inflation is expected to remain very high: it is set to peak at 10.7% in the fourth quarter of 2022. As inflationary pressures broaden to core goods and services, inflation is expected to ease only gradually to 7.0% in 2023 and 3% in 2024. Labour markets are likely to remain robust as demand for labour remains high, although it has started to decline. Unemployment is expected to rise only slightly over the forecast horizon, remaining at around 6½%, close to its record lows. The public debt-to-GDP ratio in the EU, which increased markedly during the pandemic, is projected to decline marginally to 84.1% of GDP in 2024. The economic outlook remains surrounded by an exceptional degree of uncertainty, with risks tilted to the downside. The largest threat comes from adverse developments on the gas market and the risk of crippling shortages, especially in the winter of 2023/2024. Model simulations show high macroeconomic costs in case these risks were to materialise¹. Beyond gas, the EU remains directly and indirectly exposed to renewed shocks to commodity markets reverberating from geopolitical tensions.

Given this mix of challenges, economic and social policies must remain coordinated and agile, while staying on course with our long-term objectives. The EU stands in full solidarity with Ukraine in response to Russia's aggression. The immediate policy priorities requiring coordinated action at EU and national level include securing an adequate and affordable energy supply, safeguarding economic and financial stability, and protecting vulnerable households and companies, while preserving the sustainability of public finances and the integrity of the single market, which is the foundation of growth and prosperity in the EU. At the same time, more rapid action is needed to boost potential growth and quality job creation, deliver on the green and digital transitions, strengthen resilience and increase our defence capabilities in a changing

¹ European Economic Forecast (Autumn 2022), European Economy – Institutional Paper, 187 (November).

global context. The continued implementation of the European Pillar of Social Rights is also essential to deliver on the 2030 EU headline targets on employment, skills and poverty reduction. The implementation of the Union of Equality strategies² is also crucial to achieve stronger social and economic resilience.

The policy response to the energy crisis requires a combination of national and EU efforts, drawing on both NextGenerationEU and the Multiannual Financial Framework. The effectiveness of the EU response in building back better will depend on being combined with effective policies at national and regional level. The Recovery and Resilience Facility (RRF), the heart of NextGenerationEU, will provide a continuous stream of investment in European businesses, infrastructure and skills until 2026, at the same time supporting an ambitious reform agenda. So far, payments disbursed under the Facility are worth over EUR 137 billion. Furthermore, REPowerEU will provide additional resources to increase the resilience of EU energy systems and address energy poverty through targeted investments and reforms. This goes hand in hand with the implementation of cohesion policy programmes, which disbursed since the outbreak of the pandemic over EUR 160 billion to increase resilience and boost social and regional convergence, and with the national energy and climate plans³ to be updated by Member States by June 2023.

The European Semester and the RRF continue to provide a robust framework for effective policy coordination in view of the current challenges. The immediate priorities for EU economic and social policy action are consistent with the existing priorities under the European Semester: promoting environmental sustainability, productivity, fairness, and macroeconomic stability. The RRF, integrated in the European Semester of economic and employment policy coordination, remains key for supporting the reform and investment agendas in the years ahead. Together with cohesion policy, InvestEU and other funding programmes such as Horizon Europe or Digital Europe, it is accelerating the twin green and digital transition, boosting social and territorial cohesion and thereby strengthening Member States' resilience. This includes the forthcoming introduction of dedicated REPowerEU chapters into the recovery and resilience plans to tackle immediate energy-related priorities, in addition to actions supported by cohesion policy and other national or EU funds.

This year's Annual Sustainable Growth Survey outlines an economic policy agenda to mitigate the negative impacts of energy shocks in the short term and to keep up efforts to support sustainable and inclusive growth and increase resilience in the medium term, while maintaining flexibility to tackle new challenges. The approach is structured, like in previous years, around the four dimensions of competitive sustainability and in line with the UN Sustainable Development Goals, which are an integral part of the European Semester. For euro

² The Gender Equality Strategy 2020-2025, the EU Anti-racism Action Plan 2020-2025, the EU Roma strategic framework for equality, inclusion and participation for 2020-2030, the LGBTIQ Equality Strategy, the Strategy for the Rights of Persons with Disabilities 2021-2030 and the EU Strategy on combating antisemitism.

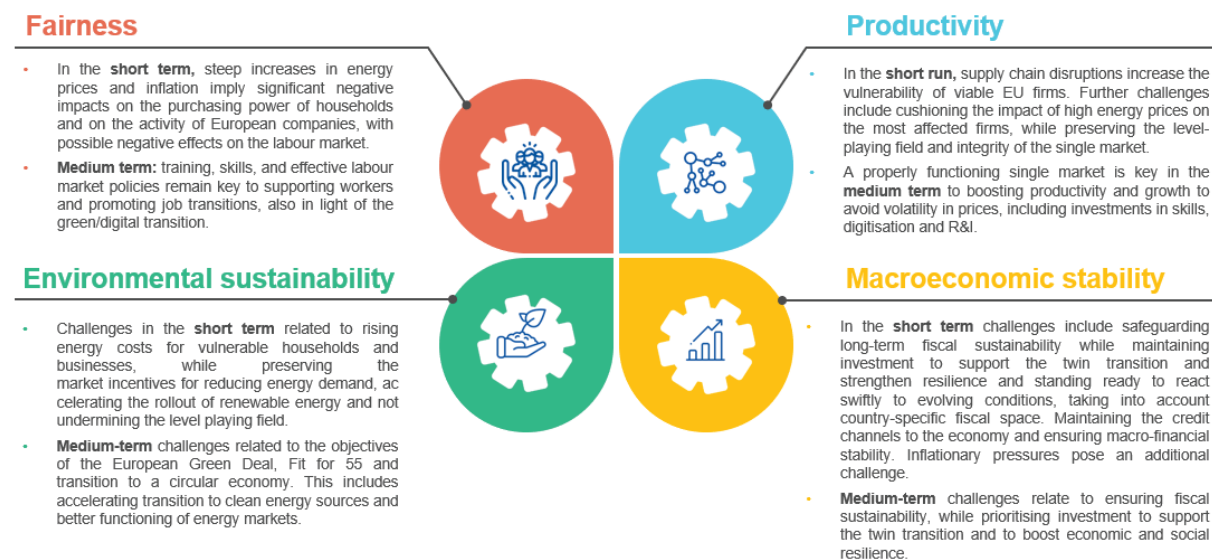
³ Pursuant to Article 14 of Regulation (EU) 2018/1999, Member States will submit draft updated NECPs by June 2023, taking into consideration the 2022 and 2023 country-specific country recommendations (COM/2022/8263). National energy and climate plans will help in delivering the REPowerEU objectives by providing a framework for planning and encouraging the reduction of use of fossil fuels.

area Member States, the policy priorities are translated into a recommendation for a Council recommendation on the economic policy of the euro area⁴. The communication also outlines the main characteristics of the 2023 European Semester cycle and explains the main changes compared to previous cycles, taking into account REPowerEU priorities and the need to adapt to evolving circumstances.

2. The four dimensions of competitive sustainability: stable anchors for the fundamental transitions in challenging geopolitical times

The four dimensions of competitive sustainability are stable anchors for the coordination framework of EU economic and employment policies in the face of structural changes, while also providing relevant steer to tackle the short-term challenges in the current turbulent times. The EU must continue to pursue competitive sustainability and social and economic resilience hand in hand. In the immediate future, support measures are required to cushion the impact of Russia’s aggression against Ukraine on Europeans and EU firms, in particular small and medium-sized enterprises (SMEs). These measures need to be well-targeted to vulnerable households and particularly exposed businesses. In addition, public and private investment, coupled with reforms, are fundamental to delivering more secure and affordable energy supplies, making our economies and societies more resilient and exploiting opportunities from the green and digital transitions. This includes achieving the binding targets of the European Climate Law. Implementing this deep transformation of the EU economy in a manner that is efficient and effective, as well as fair, inclusive and democratic, requires coordinated action by the Member States.

Graph 1: The four dimensions of competitive sustainability – addressing short- and medium-term challenges



⁴ COM(2022) 782.

2.1 Environmental sustainability

The current energy crisis has underlined the need for reliable and clean energy sources and well-functioning EU energy markets, also putting further emphasis on the EU's climate objectives. The Commission has proposed several exceptional policy initiatives aimed at addressing the immediate consequences of the current energy crisis on households and businesses, while delivering sufficient clean, secure and affordable energy and access to critical raw materials. A crucial part of this policy response is the REPowerEU plan, with the objective to end the EU's dependence on Russian fossil fuels and to speed up the clean energy transition. REPowerEU focuses on three pillars: diversification of energy supplies, energy savings and efficiency, and accelerated roll-out of renewable energy. It operates in full consistency with the European Green Deal and builds on the Fit for 55 objectives by proposing to increase the ambition on energy efficiency and renewables. Following the REPowerEU Communication⁵, the Commission and Member States have set up the EU Energy Platform to strengthen security of supply at affordable prices. Based on Commission proposals, the Council swiftly adopted the Regulation on gas storage and emergency interventions including a new legislative instrument and a European gas demand reduction plan to reduce gas demand in the EU by 15% by next spring. On 6 October 2022, it was followed by a Council agreement on emergency measures to reduce energy prices (see below). On 18 October, the Commission put forward a proposal on a joint gas purchasing mechanism, a complementary benchmark on liquefied natural gas (LNG) supplies, a market correction mechanism and applicable arrangements for solidarity agreements.

In the short term, the EU must balance energy supply and demand and tackle rising energy costs, while preserving incentives for the green transition. Following Commission proposals, the Council adopted new rules on coordinated demand reduction measures for gas on 5 August 2022 and it adopted the emergency intervention on 6 October 2022 to address high energy prices by reducing peak and overall electricity demand. The measures also include a temporary revenue cap on inframarginal electricity producers, namely technologies with lower costs, and a temporary solidarity contribution on excess profits generated from activities in the oil, gas, coal and refinery sectors that are not covered by the inframarginal revenue cap. The revenues from the solidarity contribution would be redirected, amongst others, to energy consumers, in particular vulnerable households, hard-hit companies, and critical ecosystems such as energy-intensive industries while maintaining investment incentives for the green transition. As policy measures to mitigate the economic and social impact of high energy prices in one Member State also affect others, they should be coordinated at EU level to ensure their effectiveness and include investments in cross-border projects. To safeguard the single market, take advantage of possible synergies and prevent fragmentation, common EU-solutions should be pursued. The support is meant to address the current crisis conditions and should therefore remain temporary,

⁵ COM(2022) 108 final.

but in line with the medium-term objective of phasing out fossil fuel and other environmentally harmful subsidies.

Today's energy crisis also shows the need to make rapid progress on the green transition, including by scaling up and speeding up of the rollout of renewables. This entails a paradigm shift in the way we produce, trade, secure and use energy, in line with EU's medium and long-term objectives. Since 2015, the energy union has been guided by the aims of energy security, energy affordability, and clean energy, which is also the way out of the crisis today. The required systemic transitions aim to deliver on our climate and environmental objectives and at the same time create opportunities for our economy and long-term competitiveness. Reducing the fossil fuel dependence from Russia and accelerating the EU energy transition away from fossil fuels requires an estimated EUR 210 billion of additional investments by the end of 2027⁶. This comes on top of the annual investment needs identified for the Fit for 55 package. These investments will benefit EU industries developing transformational technologies and innovations and boost the capacity for decarbonised, home-grown and affordable energy, notably when combined with measures to simplify and speed up permit procedures and remove other administrative barriers that slow the deployment of renewable energy sources. In turn, they will spur job creation and opportunities for job-to-job transitions based on the up- and reskilling of the workforce, while increasing the EU's open strategic autonomy. Besides strengthening energy efficiency measures and accelerating the rollout of renewables, REPowerEU also increases the ambition on renewable hydrogen as a key component of the plan to substitute natural gas, coal and oil in hard-to-decarbonise industries and transport⁷. REPowerEU sets a target of 10 million tonnes of domestic renewable hydrogen production and 10 million tonnes of renewable hydrogen imports by 2030. To help boost renewable hydrogen production, the Commission announced the creation of a European hydrogen bank. Structural reforms could also leverage these investments, for example by aligning taxation systems with environmental objectives and applying the polluter pays principle or by streamlining procedures.

As climate change and environmental degradation are an existential challenge and dependence on fossil fuels puts our societies in jeopardy, the European Green Deal remains our compass. This year, Europe has faced severe heat waves and extreme droughts resulting in more severe forest fires. This clearly shows the impact climate change has on our lives and livelihoods. Since December 2019, the European Green Deal supports decarbonisation, the shift to a circular economy, the protection of biodiversity and ecosystems and a just transition. In particular, the Fit for 55 package will drive a deep transformation of the EU economy, including energy, transport and industry in line with the EU's goals enshrined in the European Climate Law to reduce emissions by at least 55% by 2030 and to become the first climate-neutral continent by 2050. Member States should translate these higher ambitions into greater action in their updated national energy and climate plans due in draft and in final form by June 2023 and 2024, respectively. Further to decarbonisation, Member States are called to enhance their

⁶ Figures based on SWD(2022) 230 final. Member States should also make sure to use at least 50% of revenues from the auctioning of allowances under the EU Emissions Trading System for climate and energy-related purposes.

⁷ Other forms of fossil-free hydrogen, notably nuclear-based, also play a role in substituting natural gas.

resilience to climate change. Strategies on biodiversity, the circular economy, zero pollution, sustainable agriculture and food, sustainable mobility and adaptation to climate change are core policies of the European Green Deal, now being implemented.

In complementarity with other EU funds, such as cohesion policy and InvestEU, the RRF will be an essential delivery tool for implementing REPowerEU at national level, while supporting the objectives of the European Green Deal. Member States will contribute to the joint EU response to the current challenges by strengthening existing recovery and resilience plans in line with the REPowerEU objectives, with dedicated REPowerEU chapters. These chapters should focus on relevant reforms and investments, in order to boost the deployment of renewable energy and other clean technologies and the necessary infrastructure in the energy sector, as well as increase energy efficiency to reduce energy consumption. REPowerEU measures will benefit from synergies with green transition measures already supported by the RRF in its current form as well as by cohesion policy funds⁸ and the InvestEU programmes⁹, for example in reducing air pollution, promoting the circular economy and resource efficiency or restoring and protecting biodiversity, and should be accompanied by further efforts to boost skills for the twin transitions¹⁰.

2.2 Productivity

Strengthening EU competitiveness and its long-term potential for sustainable growth remain key for economic prosperity and social welfare. Record inflation, including record-high energy prices and supply constraints, is posing a challenge to many EU firms, in particular energy-intensive ones and SMEs. It is forcing some businesses into temporary production curtailment or to close permanently. Non-ferrous metals (aluminium and zinc), ferro-alloys, fertilisers, steel and glass are the sectors facing the biggest challenges¹¹. Whereas capacity is shrinking in the EU, new capacity increases are happening outside the EU, resulting in a risk of permanent losses in production capacity and of market shares for European companies, and usually with a much higher carbon footprint. For sectors competing globally, closures in Europe mean increasing import dependencies. In the short term, cushioning the impact of high energy prices on the most affected viable firms cannot be at the expense of the level-playing field and integrity of the single market. In September 2022, the Commission presented a Single Market

⁸ Cohesion policy support to the European Green Deal will be reinforced in the 2021-2027 programmes. Cohesion policy has contributed EUR 85 billion to climate and environment action under the 2014-2020 multiannual framework. The approval of the 2021-2027 cohesion policy programmes will make a further EUR 100 billion available for the green transition, including some EUR 40 billion for investment in renewable energy, energy efficiency and energy networks.

⁹ In line with the European Green Deal objectives, at least 30% of the InvestEU Programme will support investment funding that contributes to EU's climate objectives. Furthermore, 60% of the investments supported under the "Sustainable Infrastructure Window" of the InvestEU Fund will contribute to EU's climate and environmental objectives.

¹⁰ The Commission is supporting Member States through the Technical Support Instrument in identifying reforms and investments to phase out fossil fuel imports from Russia.

¹¹ In November 2022, the Commission presented its Communication "Ensuring availability and affordability of fertilisers" that outlines measure to maintain a sustainable European fertilisers' production, optimise use and reduce dependency on mineral fertilisers.

Emergency Instrument¹² to preserve the functioning of the single market and of EU supply chains in times of crisis. The instrument also aims to ensure the free movement and availability of essential goods and services, including for EU's SMEs. For durable progress on productivity and competitiveness, reforms and investments are needed to decarbonise industrial processes, address labour force shortages and skill mismatches, reduce administrative and regulatory burdens, improve insolvency frameworks and tackle systematic late payments.

Robust supply chains should ensure the EU's security of supply and, at the same time, ensure global competitiveness. Temporary or persistent bottlenecks in supply chains bear negative consequences across the EU's economy and its industrial sectors. In particular, the EU's commitment to the twin transitions will increase the needs for specific goods (for example certain raw materials) and technologies (for example batteries), exacerbating supply and price pressures. Member States have a key role to play in curbing strategic dependencies by promoting the sustainable exploitation of available resources in the EU, maximising the potential of the circular economy, supporting the EU's trade agenda to secure and increase a diversified and sustainable supply of raw materials from non-EU countries, and addressing supply chain disruptions. In this context, the economic diversity of EU regions can be a source of competitiveness and resilience for the Union. The EU has the ambition to become the main hub for innovative and cutting-edge green and transformational technologies, making use of the openness of our economy. The upcoming Critical Raw Materials Act will also contribute to addressing Europe's strategic dependencies. The EU's trade agenda contributes to the resilience of raw materials supply chains by ensuring rules-based open trade and investment in raw materials and by removing distortions to international trade, through bilateral trade and investment agreements and work in the World Trade Organisation¹³.

A proper functioning single market, where fair and effective competition is ensured, is key to boosting productivity and growth. The functioning of the single market should not be taken for granted, and concrete efforts are needed to deepen it, in particular for services. There are still restrictive regulatory practices that have a negative impact on the functioning of markets. Restrictions on exports and the circumvention of EU public procurement rules have a negative impact on the functioning of markets. With high inflation weighing heavily on consumers' purchasing power, restrictive regulatory frameworks in retail services should be addressed. Growth and productivity are best supported by competitive and efficient markets that avoid volatility in prices as well as structural reforms that remove bottlenecks in the business environment at national and regional level. Good governance and respect for the rule of law, in particular independent, quality and efficient justice systems¹⁴, functioning and effective tax systems, as well as effective insolvency and robust anti-corruption and anti-fraud frameworks are key determinants of an economy that works for people. In this context, the proposal for a single

¹² COM(2022) 459 final.

¹³ EU's most recent trade agreements (UK, Chile, Mexico, New Zealand) include specific commitments on energy and raw materials.

¹⁴ In addition to the European Semester, the Commission's Rule of Law Report also covers in one of its pillars the functioning of justice systems.

set of tax rules for doing business in Europe - BEFIT¹⁵ and the continued modernisation and digitalisation of tax administrations should help reduce compliance costs, minimise aggressive tax planning and tax avoidance opportunities, while supporting EU jobs and investment in the single market. An appropriate tax mix and effective revenue collection are instrumental in adapting for the future by ensuring fair, efficient and environmentally sustainable competition, facilitating the green and digital transitions and responding to the fiscal impact of population ageing. Connectivity across the single market should be further increased with greater investments in the transport, energy and digital infrastructure.

Investments and reforms for the digital transition remain essential to strengthen the EU's economic base, promote business creation and entrepreneurship among SMEs, and enable the swift implementation of the European Green Deal. Digital technologies enable businesses to gain competitive advantage, improve their services and products and expand their markets, and have the potential to support the green transition. While large firms are more likely to adopt new digital technologies, the digitalisation level of SMEs remains uneven across Member States and economic sectors. While some SMEs are frontrunners in the digital transformation, many more traditional SMEs lack the financial resources and/or skills to reap the benefits of digitalisation. More progress is needed on digitalisation to act as an enabler for SMEs to increase the efficiency of their production processes and their ability to innovate via the development and adoption of advanced technologies.

Increased productivity requires a workforce with the relevant skills and the modernisation of education and training, offering equal opportunities for all. The future competitiveness of the EU depends to a large degree on the skillset of Europeans. The development of high-end skills in higher education institutions, together with reskilling and upskilling strategies mitigate skill shortages in the labour market and address the changing needs during the green and digital transition as the economy becomes more technologically driven¹⁶. This is why the Commission has proposed to make 2023 the European Year of Skills and has launched a structured dialogue on digital education and skills. The Digital Economy and Society Index shows that 4 in 10 adults in the EU lack basic digital skills. Despite accounting for the majority of tertiary graduates, women are under-represented in tech-related professions and studies, with only 2 out of 5 scientists and engineers and less than 20% ICT specialists being women¹⁷. Investments and inclusive policies to support of both science, technology, engineering and mathematics (STEM) studies and (basic) digital skills are therefore essential to accelerate the development and adoption of advanced digital technologies and support the uptake and diffusion of innovation across our economies and shape the digital and green transition. Tackling the digital skills gap and promoting projects and strategies to improve digital skills at all levels in the EU is of paramount importance to increase productivity across economic sectors and firms, especially in

¹⁵ Business in Europe: Framework for Income Taxation.

¹⁶ Access to skills has become a key challenge for SMEs, which have difficulties competing with large companies. Among other actions, the EU is using the European Pact for Skills, a flagship of the European Skills agenda, to boost upskilling and reskilling including in SMEs, through the Large Scale Skills partnerships, and by taking advantage of 2023 as the European Year of Skills.

¹⁷ COM(2022) 526 final.

SMEs and to contribute to a broad and effective use of digital tools and services (e.g. in public administration).

Investing in research and innovation capacity is investing in Europe's future. Future income and sustainable prosperity in the EU will crucially depend on higher productivity, skills and innovation. The RRF, InvestEU, the recently launched renewed European Research Area, New European Innovation Agenda and EU missions will also help to address the gap in research and innovation investments and activity compared to the EU's main competitors by mobilising fresh funding for R&I and improving the conditions for financing, innovation skills and better coordinated R&I policies in Europe. Research and innovation are vital to accelerate the green and digital transition, as well as to support other key objectives such as improving people's health, developing open strategic autonomy and making our economies more competitive. Particularly in the current context, we need to accelerate innovation and investment in transformational technologies – wind, solar, hydrogen, heat pumps and smart electricity networks – and their deployment.

2.3 Fairness

In 2021 and in the first half of 2022, economic growth supported strong performance in EU labour markets, with a significant increase in employment rates. The EU employment rate grew throughout 2021 and reached a record 74.8% in Q2-2022. At the same time, despite a recent drop in youth unemployment, the rate of young people not in education, employment or training remains high (11.7% in Q2-2022). The risk of poverty or social exclusion remained stable throughout the pandemic, even if around 1 in 5 people were still at risk of poverty or social exclusion in 2020 and in 2021. This successful rebound of the labour market and broad stability in social indicators reflect the positive impact of the measures taken during the pandemic by Member States. It includes support from the EU¹⁸, the stabilising effect of welfare systems, as well as successful structural reforms implemented over the past decade.

However, steep rises in energy prices and inflation imply significant negative impacts on the purchasing power of households and on the activity of European companies, also creating risks of deterioration of the labour market. The higher energy prices are leading to higher cost of doing business and consequently to a reduction in working hours and a higher risk of job losses and in various sectors, compounded by falling demand. The impact on jobs will be shaped by the sectoral composition of economies, their sources of value generation and their dependency on energy-intensive value chains. As a result, the employment effects are expected to significantly differ by sector, by gender and by region.

Households continue to be severely affected by high energy prices, increasing the risk of energy poverty and calling for targeted and coordinated measures. For low-income households, food and energy represent higher shares of their consumption baskets, which makes them particularly exposed to the current price hikes. Member States have already taken

¹⁸ In particular, the Support to mitigate Unemployment Risks in an Emergency (SURE) instrument.

substantial measures to alleviate the impact of high energy prices on households. However, as explained in the next section, more than 70% of supporting measures in 2022 have not been targeted. While price pressures are spreading beyond energy, and resources remain limited, it is increasingly important that support measures are targeted to vulnerable households and that they retain incentives to reduce energy consumption and promote energy efficiency. Better targeting allows those measures to be effective in preventing energy poverty and poverty in general from rising, while not adding to inflation and limiting the budgetary impact. Moreover, measures that target disadvantaged groups perform better in terms of macroeconomic stabilisation. As part of REPowerEU, the Commission is proposing with SAFE (Supporting Affordable Energy) a more flexible use of the cohesion policy funds allocations for 2014-2020 to help Member States and regions support vulnerable households and companies and to preserve jobs¹⁹.

Strong social dialogue can help in ensuring that wage setting mitigates purchasing power losses, in particular for low earners, while limiting the risk of second round effects on inflation and preserving employment and competitiveness. While nominal wages picked up in 2021 and accelerated in 2022, high inflation resulted in falling real wages. Wage growth in 2021 was mainly driven by the increase in hours worked and the strong economic rebound that followed the COVID-19 crisis. In 2022, high inflation and labour shortages started triggering an acceleration in nominal wages. However, wage growth remained below inflation. Effective collective bargaining is key to achieving overall wage developments that are in line with changing macroeconomic conditions, while at the same time avoiding the risk of a de-anchoring of inflation expectations. Updating minimum wages (in line with the Directive on adequate minimum wages) plays a key role to protect the purchasing power of low wages. The above-mentioned targeted and temporary support measures can also play an important role, where profitability levels in some companies and sectors are under stress. Wage adjustments are further influenced by the sectors' specificities and the level of flexibility of the economy, while in the medium term, purchasing power is protected by wage improvements in line with increases in productivity and potential growth.

Effective labour market policies remain key to supporting workers and promoting job transitions, especially as labour and skills shortages continue to be prevalent in the EU. Labour shortages are affecting certain sectors in particular such as health care, education, hospitality and tourism, construction, ICT, and sectors linked to the green transition. Lay-offs that took place as a result of the COVID-19 pandemic created additional shortages especially in sectors where flexible contracts are used most, as not all workers returned once demand started to recover. As a temporary surge in production costs poses risks to jobs, short-time work schemes help preserve employment and firm-specific human capital. They should be designed in a way that supports restructuring processes by easing job transitions, including via upskilling and reskilling.

¹⁹ In addition, Member States can continue to draw from EU funds such as the Fund for European Aid to the Most Deprived (FEAD), which supports EU countries' actions to provide food and/or basic material assistance to the most deprived, reaching over 15 million people with food aid.

Active labour market policies, training and up- and reskilling measures provide support to employment and social inclusion. They can also play a central role in delivering on the twin transition²⁰. The digitalisation of the economy, which accelerated rapidly during the pandemic, has generated a greater demand for digital skills at all levels. Similarly, ending the EU's dependence on fossil fuels and achieving climate neutrality also requires measures to be refocused on upskilling and reskilling people in different industrial sectors and supporting job transitions²¹. Despite good progress in most Member States, long-standing challenges in relation to the employment of young people, women and disadvantaged groups, such as persons with disabilities, Roma and people with a migrant background – including displaced people from Ukraine²² – should be addressed with specific and tailored policy actions at national and regional level, and making full and effective use of available EU funding.

Adapting education and training systems is key to developing the skills needed in our economies, but teacher shortages may hamper efforts. Member States face increasing teacher shortages at all education levels, including in early childhood education and care, and particularly in subjects most relevant for the twin transition. Increasing the attractiveness of the teaching profession, particularly in subjects and regions most affected by teacher shortages, is key to equipping more young people and lifelong learners with the skills most in demand now and in the future on the changing labour markets. Similarly, improving equity in education, including in early childhood, will be essential after a pandemic that increased the impact of the socio-economic background on the learning outcomes of disadvantaged children and young people, including those with migrant or minority ethnic background. Investing in quality, accessible and affordable early childhood education and care is also key to facilitate women's labour market participation.

The pandemic has highlighted the importance of resilient and sustainable healthcare and long-term care systems that can rapidly respond to health emergencies, while preserving the quality and accessibility of care for other health conditions. While progress was made during the pandemic, several Member States need to make further progress on the resilience, quality and accessibility of their healthcare and long-term care systems, including the challenge of shortages in the health workforce. The pandemic revealed the need for increased vigilance and investment in all Member States to ensure that they are adequately prepared to deal with future health crises²³ and are also able to preserve the quality of care for all other illnesses and conditions. Accelerating the European Green Deal can further benefit health systems (for

²⁰ See the Commission Recommendation for Effective Active Support to Employment.

²¹ The national skills targets put forward by Member States in response to the EU headline target will help guide the up- and re-skilling efforts in the Member States, in line with their reform plans and also with the support of EU funding. The upcoming exercise on updating national energy and climate plans, planned for 2023-24, will further help reflect relevant employment, skills and social aspects in climate and energy policies.

²² Member States have provided assistance and safety to displaced persons, mostly women and children, fleeing Ukraine. This also resulted from the triggering in March 2022 – for the first time – of the Temporary Protection Directive, granting displaced persons from Ukraine the right to live and work in the EU until 2024.

²³ This includes ensuring and investing in surge capacity, adequate stocks of supplies (and manufacturing capacity), the availability and effectiveness of contact tracing systems, testing and laboratory capacity, qualitative and accessible health datasets and health data sharing including through early warning and surveillance systems.

example, via the zero pollution action plan as part of the European Green Deal) as one in eight premature deaths in the EU is linked to environmental pollution.

Preserving and improving the adequacy and sustainability of social safety nets remains a priority in the current economic situation. In some Member States, low levels of adequacy may result in benefits that are not keeping pace with increases in costs of living for the vulnerable households. At the same time, income support schemes should be well targeted and include appropriate incentives and support for the beneficiaries that are able to work to reintegrate into the labour market²⁴. Ensuring social protection coverage for non-standard workers and the self-employed remains crucial. Similarly, in the context of an adverse demographic trend and changing labour markets, ensuring the adequacy and financial sustainability of pension systems remains particularly important²⁵. The same goes for providing access to affordable, quality and sustainable long-term care.

Regional disparities and demographic change compound the challenges linked to the green and digital transition. The EU's working age population is declining, which contributes to existing labour shortages and hampers the growth potential and competitiveness of businesses. In many regions, in particular in rural areas, the impact of population ageing is magnified by outward migration. This adds to the challenge of ensuring the availability of a skilled workforce to build economies well-equipped for the green and digital transition. Moreover, the pronounced and persistent innovation divide in Europe hinders the ability of many lagging regions to reach higher levels of prosperity. The capacity of national and EU policies to rebalance growth across the EU and within Member States will be key to ensuring a fair recovery that will help citizens, no matter where they live in the EU, to participate in and benefit from the single market.

The 2030 EU headline targets on employment, skills and poverty reduction will play their part in boosting social upward convergence in the EU. Member States presented their national targets for 2030 and it is now important that appropriate policy action follows the declared ambitions. Progress towards the EU and national targets will be monitored as from this European Semester cycle, starting with the Commission proposal for the 2023 Joint Employment Report²⁶.

The RRF, together with cohesion policy funds and the Just Transition Mechanism, supports fair and inclusive growth in the EU. The recovery and resilience plans implemented by Member States include a wide range of reforms and investments that will have lasting effects. They will contribute to higher participation in the labour market, productivity gains through education, reskilling and upskilling measures, as well as social inclusion, intergenerational fairness, territorial cohesion and resilience²⁷. Cohesion policy programmes continue to enable

²⁴ The Commission proposal for a Council Recommendation on minimum incomes schemes addresses the various challenges identified in the design of national minimum income schemes, in line with the active inclusion approach.

²⁵ See the 2021 Ageing Report: Economic and Budgetary Projections for the EU Member States (2019-2070).

²⁶ COM(2022) 783.

²⁷ Fast responses to emerging challenges are clearly demonstrated by the additional flexibilities brought by the Cohesion's Actions for Refugees in Europe (CARE and FAST-CARE) packages to ongoing cohesion policy programmes. The rapid resources from the REACT-EU instrument will also contribute to greater resilience in national and regional economies. This

regions to grow, in particular by concentrating on regional enablers and drivers for economic development as well as investing in human capital.

2.4 Macroeconomic stability

Deteriorating economic conditions have increased vulnerabilities and risks associated with pre-existing imbalances, and new imbalances may emerge. The Alert Mechanism Report provides the Commission's analysis of the evolution of imbalances and emerging risks²⁸. Despite the strong slowdown in activity underway, nominal GDP growth is forecast to help reduce debt ratios in both 2022 and 2023, reducing the magnitude of some stock imbalances, while strong house price increases should moderate. However, the weakening of economic activity and the tightening in financing conditions increase the risks associated with high debt levels. In parallel, the divergence in inflation rates and increases in labour costs raise the possibility of cost competitiveness losses emerging, that may be costly to unwind, particularly if accompanied by structural transformations to production. As part of the in-depth review process, the Commission will closely monitor developments and risks related to common trends, within a common framework to provide context to the country-specific analysis, focusing on housing market developments, competitiveness dynamics and external sustainability and balances. In-depth reviews (IDRs) will be prepared for the ten Member States previously identified as experiencing imbalances or excessive imbalances, to assess whether those imbalances are aggravating, under correction, or corrected, to update existing assessments and to assess possible remaining policy needs. In addition, IDRs will be undertaken for seven Member States with particular risks of newly emerging imbalances. The IDRs will be informed by in-depth thematic assessment notes, which will form the background for the analysis²⁹.

Ensuring macro-financial stability and maintaining the credit channels to the economy are key for resilience in challenging economic circumstances. The position of the banks is solid thanks to policy actions in the last few years. Non-performing loans, albeit declining, should continue to be addressed. This includes monitoring asset quality, timely and pro-active engagement with distressed debtors (in particular viable ones), further improving the efficiency of insolvency frameworks and the further development of secondary markets for non-performing loans, notably through a timely transposition of the Directive on credit servicers and credit purchasers by the end of 2023³⁰. At the same time, banks need to maintain prudent provisioning policies and capital buffers that are consistent with the prevailing level of risk. The European Systemic Risk Board issued a warning on 22 September 2022, where it called for heightened awareness of the risks to financial stability stemming from a sharp fall in asset prices. Rising mortgage rates and the deterioration in debt servicing capacity due to a decline in real household

instrument supports Member States and regions in strengthening their capacities to plan and implement reforms, often in support of the recovery and resilience plans.

²⁸ COM(2022) 781.

²⁹ The ten Member States previously identified are Cyprus, France, Germany, Greece, Italy, the Netherlands, Portugal, Romania, Spain, and Sweden. Additional IDRs will be for Czechia, Estonia, Hungary, Latvia, Lithuania, Luxembourg and Slovakia.

³⁰ Directive 2021/2167 of the European Parliament and of the Council of 24 November 2021 on credit servicers and credit purchasers, *OJ L 438*, 8.12.2021, p. 1–37.

income could exert downward pressure on house prices. In turn, this could trigger the materialisation of accumulated cyclical risks in real estate markets. In addition, the probability of large-scale cyber incidents affecting the financial system has increased. Euro area Member States need to continue to work on completing the banking union, in line with the way forward outlined by the Eurogroup³¹, and on strengthening the international role of the euro. Well-functioning financial sector and markets, in particular through a deeper capital market union, are crucial to fund the very large investments needed for the green and digital transitions.

The recent shocks emphasise the importance of strong coordination of sound fiscal policies and of building fiscal buffers during good times to be used during downturns. The prevailing economic conditions have underscored the importance of sound budgetary processes that allow fiscal policies to be agile when faced with rapidly changing circumstances and to set priorities that ensure a high quality of public finances, with due attention to investment. During the pandemic, temporary fiscal support was needed to enable companies to retain their productive capacity and protect jobs and incomes at a time when large parts of the economy had to close down for short periods. The energy shock and high inflation currently affect economic activity and growth potential. While the nature of the crises as well as the policy responses differ, close coordination of policy responses between Member States, as well as coherence between fiscal and monetary policy, remain crucial.

In 2022, the fiscal stance has been expansionary, with Member States taking swift but largely untargeted actions to cushion the economic and social impact of the exceptional increase in energy prices. These measures are currently expected to amount to 1.2% of GDP for the EU as a whole in 2022. While the measures have been implemented in a timely manner, more than 70% of them, such as lower VAT rates or excise duties, or changes to levies and subsidies on energy products, were not focused on vulnerable households and exposed firms and two thirds of them did not provide incentives to reduce energy demand. It is increasingly important for measures to focus on vulnerable households and exposed businesses and to remain temporary. The expansionary fiscal stance has also been supported by additional financing of investment, both nationally and via RRF and other EU funds. Further investment is required to accelerate the twin transitions, increase energy efficiency and to speed up the rollout of renewable energy sources.

As a broad-based fiscal impulse to the economy would not be appropriate in 2023, a careful, coordinated approach is necessary for designing measures in response to energy price developments. An overall neutral fiscal stance in 2023 for the EU and the euro area as a whole, taking into account the impact of targeted energy measures, appears appropriate in the current economic context. It would complement the efforts of monetary policy to reduce inflation and keep inflation expectations well anchored. The energy support measures are currently estimated at almost 1% of GDP in 2023 for the EU as a whole, covering mostly the first half of the year in many Member States. Finalising the budgets for 2023 provides an opportunity to improve the design of the support measures and the quality and composition of public finances,

³¹ See Eurogroup statement on the future of the Banking Union of 16 June 2022.

with a view to targeting fiscal measures to address the impact of high energy prices on vulnerable households and companies. A two-tier model for energy pricing, where consumers benefit from regulated prices up to a certain level of consumption, can be instrumental there. Moreover, fiscal policies should remain prudent in particular in high-debt Member States, while protecting public investment. These considerations are reflected in the policy guidance for 2023 included in the Commission recommendation for a Council recommendation on the economic policy of the euro area³².

In the medium term, fiscal policies should ensure fiscal sustainability and prioritise investment to support the twin transition and social and economic resilience. Fiscal policies should aim at achieving prudent medium-term fiscal positions and ensuring fiscal sustainability through gradual consolidation and investment and reforms enhancing sustainable growth. Accelerating reforms that make taxation systems and revenue collection more growth-friendly and improve the long-term efficiency of public spending would strengthen potential growth, competitiveness and debt sustainability, in turn also supporting the crisis response capacity of fiscal policy. At the same time, there is a greater need to push forward structural transformation and investments, including to mitigate and adapt to climate change and the intensity of climate-related disasters, with clear impacts on national budgets. Member States are encouraged to develop tools to assess the climate implications of budgetary planning and long-term sustainability, alongside with policies and tools that help prevent, reduce and prepare for climate-related impacts in a fair way. Finally, demographic challenges call for further policy action, including through reforms that ensure the adequacy and sustainability of pension systems.

The general escape clause in the Stability and Growth Pact will continue to apply in 2023, and be deactivated as of 2024. The Commission's assessment of the euro area Member States' draft budgetary plans³³ indicates that the growth of nationally financed current expenditure in some Member States is projected to be high, leading to an expansionary fiscal stance in some Member States. Limiting the growth of current expenditure, taking into account temporary and targeted support to households and firms vulnerable to energy price hikes and to people fleeing Ukraine, is important not to add to inflationary pressures and is particularly relevant for high-debt countries. This should be combined with higher investments in serving green, digital and energy security objectives for a more resilient economy. Member States are invited to take action individually, including through the implementation of their recovery and resilience plans, and collectively, to use and coordinate national fiscal policies in the most growth-friendly manner.

The Commission does not propose to open new excessive deficit procedures. As announced in May 2022, it has reassessed the relevance of proposing to open new excessive deficit procedures³⁴. This assessment took into account updated outturn data for 2021, the implementation of fiscal policy by the Member States in the course of 2022 and the government

³² COM(2022) 782.

³³ COM(2022) 900.

³⁴ Romania has been subject to an Excessive Deficit Procedure since spring 2020. The procedure has been held in abeyance since autumn 2021. The Commission will re-examine compliance with the requirements set out in the Council recommendation next spring.

budgetary plans for 2023, as reflected in the Commission's 2022 Autumn Economic Forecast. The updated information largely confirms previous findings³⁵. Taking into account the current exceptional uncertainty, including for designing a detailed path for fiscal policy, the Commission considers that a decision to place additional Member States under the excessive deficit procedure should not be taken at this stage. In spring 2023, the Commission will again assess the relevance of opening excessive deficit procedures based on the outturn data for 2022 and plans for 2023, taking into account in particular compliance with the fiscal recommendations addressed to the Member States by the Council.

3. Features of the 2023 European Semester

The 2023 European Semester and the implementation of recovery and resilience plans will continue to frame EU policy coordination. The combination of the challenges mentioned above underlines the need to continue closely coordinating economic and social policies. The aim is to overcome the immediate economic challenges, and continue to support fair, inclusive, resilient and sustainable growth, while seizing the opportunities from the twin transition. As in 2022, the streamlined country reports will provide a holistic overview of the economic and social developments and challenges that Member States face, taking the regional dynamics into account, as well as of their resilience³⁶. They will include an assessment of progress on the implementation of the European Pillar of Social Rights via the Social Scoreboard, and on achieving the 2030 EU headline and national targets on employment, skills and poverty reduction. Country reports identify challenges that are only partially addressed or not addressed by the recovery and resilience plans, taking a close look at the progress on implementing the plan, and any emerging challenges. Country-specific recommendations (CSRs) continue to focus on a limited set of key challenges identified in the country reports, and where relevant the in-depth reviews, for which policy action will be required. The country reports, the in-depth reviews and the proposals for CSRs will be presented together in the 2023 European Semester Spring package.

On 9 November 2022, the Commission provided orientations on possible changes to the EU's economic governance framework³⁷. It is seeking to improve the effectiveness of economic surveillance and policy coordination in the EU by defining a simpler and integrated architecture for macro-fiscal surveillance to ensure debt sustainability and promote sustainable and inclusive growth. The reformed framework should help build the green, digital and resilient economy of the future, while ensuring the sustainability of our public finances. It should pursue an integrated approach whereby surveillance tools complement each other, in the context of the European Semester. Swift agreement on revising the EU fiscal rules and other elements of the economic governance framework is a pressing priority. A consensus on the reform of the

³⁵ See the Commission report under Article 126(3) Treaty on the Functioning of the European Union of 23 May 2022, COM(2022) 630 final.

³⁶ The resilience analysis also takes into account the input from the Commission's Resilience Dashboards:

https://ec.europa.eu/info/strategy/strategic-planning/strategic-foresight/2020-strategic-foresight-report/resilience-dashboards_en.

³⁷ COM(2022) 583 final.

economic governance framework should be reached ahead of the Member States' annual budgetary processes for 2024.

The Sustainable Development Goals (SDGs) will continue to be integrated into the European Semester. The 2023 country reports will assess the progress and challenges for each Member State on SDG implementation. The reports will include a detailed annex for each country which, based also on Eurostat monitoring, will link SDG implementation with the four dimensions of competitive sustainability. In parallel, the Commission will put forward the first EU-level voluntary review³⁸ of SDG implementation at the 2023 United Nations High-level Political Forum on Sustainable Development. Parallel to the integration of the SDG monitoring as part of the European Semester, the EU voluntary review will serve to reaffirm the EU's commitment to the 2030 Agenda for Sustainable Development in a whole-of-government approach, linking the internal and external dimensions. It will increase the visibility and consistency of the work undertaken by the EU on SDG implementation, and support the importance of these shared goals at a global level, at a time when multilateralism is under pressure and there is increasing focus on promoting sustainable and inclusive wellbeing.

The Commission is committed to an inclusive process and the timely involvement of social partners and other relevant stakeholders during the European Semester cycle. A sustainable recovery and the twin transition can only succeed if we act together, in close cooperation with all relevant stakeholders. The active involvement of stakeholders, through dedicated regular meetings, is important throughout all the stages of the European Semester and the RRF implementation process. The Commission calls on all Member States to engage actively with social partners, local and regional authorities and other stakeholders, in particular representatives of civil society organisations, through regular exchanges. They should draw on the successful application of the partnership principle in cohesion policy programming and implementation. This helps to jointly identify challenges, improve policy solutions, and ensures broader ownership of the economic and social policy agenda. The Commission will make use of the existing forums under the European Semester to inform and involve social partners also on RRF implementation. In 2023, the Commission will present a communication to strengthen social dialogue in the EU, as well as a proposal for a Council recommendation on the role of social dialogue at national level.

The Commission fully recognises the democratic accountability of the EU's economic governance and will continue the strengthened inter-institutional dialogue with both the European Parliament and the Council. It is committed to continue the close dialogue with the European Parliament on key social, economic and labour market developments, also as part of the European Semester and will engage with the European Parliament on each key stage of the European Semester cycle.

³⁸ Voluntary reviews aim to make it easier to share experiences, including successes, challenges and lessons learnt, with a view to accelerating the implementation of the 2030 Agenda for Sustainable Development. The reviews also seek to strengthen policies and government institutions and to mobilise multi-stakeholder support and partnerships for the implementation of the SDGs.

4. Conclusion

While the swift and coordinated policy action during the COVID-19 pandemic is paying off, the fallout of Russia's invasion of Ukraine confronts the EU economy and society with multiple new economic, social and geopolitical challenges that require policy action at EU and national level. Historically high energy prices, high inflation rates, supply shortages, increased debt levels and rising borrowing costs are affecting the economic activity of businesses and the cost of living of EU households, in particular vulnerable ones. Economic, social and fiscal policies face complex policy choices to cushion the economic fallout of this challenging environment and limit supply-driven inflation, while staying on course with our medium-to long term objectives to increase social and economic resilience and support the twin transition.

Our growth strategy, based on the four dimensions of competitive sustainability, provides the compass for our coordinated economic and social policy action, both in the short term and medium term. EU and national policy responses need to be well calibrated and coordinated to strengthen economic, social and territorial cohesion, improve energy security and affordability while accelerating the clean energy transition, foster competitive sustainability, increase productivity, and preserve macroeconomic stability and the single market.

To protect the achievements of EU integration and to make the EU's economies more future-proof, the European Semester will help identify the relevant policy challenges, specify policy priorities, provide policy guidance and ensure policy surveillance and monitoring. The European Semester will be at the core of the transformative process in the coming years. Together with the RRF, it will continue to ensure an effective reform momentum in each Member State until 2026 in combination with the reform and investment strategies enabled by other EU programmes such as the cohesion policy funds, InvestEU and the national energy and climate plans that aim to keep our economy on track to reaching our climate goals and the National Digital Decade Roadmaps that aim to contribute to a successful digital transformation by 2030. The European Semester will also continue to monitor the implementation of recovery and resilience plans and provide the analytical underpinning for identifying new economic, employment and social policy challenges not already addressed in the plans, putting forward relevant CSRs. Both processes will therefore remain interlinked, reaping the synergies to avoid overlaps and duplication, including in relation to reporting requirements.