FIGHTING INFLATION AND ADDRESSING LOW GROWTH

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Fiscal policy and long-term growth: challenges in a new normal

Ample fiscal support at the national and European levels and accommodative monetary policy helped the euro area overcome the recession stemming from the Covid-19 crisis. Still, the pandemic severely impacted supply chains, generating substantive inflationary pressures. The war in Ukraine, a tragedy itself, also exacerbated these pressures and knocked economic growth back down.

Energy-related support measures have helped shield citizens from excessive energy prices. But these measures also have been adding to fiscal stimulus as the European Central Bank (ECB) has been tightening monetary policy to meet its price stability objective.

The euro area now faces a difficult trilemma: containing inflation, improving public finances, and generating sustainable higher growth.

Tackling inflation is imperative. Persistent high inflation would prolong uncertainty, undermine business confidence, and thereby hamper investment and growth. The sooner inflation and inflation expectations stabilise in line with the ECB's objective, the better it is for investment and long-term growth.

Beyond the temporary fiscal windfall from higher revenues, lasting high inflation also poses significant risks to fiscal policy. This is particularly true when inflation is driven by an external supply shock. To avoid fuelling inflation further, governments will need to carefully calibrate how they support the economy. A better alignment between fiscal policy and monetary policy is needed.

Fiscal consolidation is required to support monetary policy in its quest to curb inflation. Thus, in the short-term, energy-related support measures need to be phased out. The Eurogroup statement on the euro area fiscal stance for 2024 reflects that commitment.

But fiscal consolidation is also necessary to enhance resilience. Reducing economic vulnerabilities, not only to domestic but also to external shocks, has become crucial, as these shocks could become more severe in the future. While a coordinated approach at the EU level is crucial, it also requires solidarity across Member States to enhance the ability to overcome common shocks. Creating fiscal space is vital for the longer-term challenges to increase potential growth, face population ageing, and make our economies greener and more digital.

Next Generation EU (NGEU) plays an important role in addressing these challenges: it has an element of risk sharing, sets incentives for broader structural reforms, provides inter-regional transfers to the areas where financing is most badly needed, and supports investments in digital and green transitions.

However, NGEU is a temporary instrument that will phase out in 2026.

Against this backdrop, reducing public debt over the medium-term is essential. The increase in public debt was needed during the pandemic to help citizens and businesses. Such additional flexibility to respond to the crisis was possible because of the activation of the general escape clause that is embedded in the Stability and Growth Pact. However, this clause will be deactivated at the end of this year.

Hence, coming to an agreement on the Economic Governance Reform, i.e. the reformed Stability and Growth Pact, sooner rather than later is key. The reformed framework should be transparent, credible, and ensure equal treatment across Member States. The framework should also put more emphasis on sustainable growth, which requires making enough room for productive investment. To boost potential growth, securing high quality investments will be essential.

On average, potential growth in the euro area has been close to one percentage point lower than in the US since 2000. Around 40% of this difference is explained by a lower investment ratio in Europe and 30% is due to lower technological progress. The remaining 30% are explained by a less dynamic growth of the labour force. This means that we not only need to invest more, but also invest better.

The role of the public sector as a catalyst for private investment should become more prominent. This means attracting private investors, both domestic and foreign, to invest in innovation to boost potential growth. And here reforms, rather than investments, are the key factor.

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Working on establishing a genuine European capital markets union (CMU) would be also helpful in supporting investment. It would facilitate more market-based financing and complement bank lending. An integrated market for capital would be conducive to a better allocation of capital and attract international investors as well. A deep, liquid capital market is key to the equity financing of innovation the EU needs. CMU would also make the euro area more resilient by complementing public risk sharing with private risk sharing.

So far, progress has remained disappointing. Let us hope that the Euro Summit's recent decision to enhance CMU will provide new and decisive momentum.

MARIO NAVA

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The Technical Support Instrument: reviving sustainable growth through support to reforms

Since its emergence from the last sovereign crisis, the European Union has set a clear vision for the future of its financial system and wider economy. Avoiding the mistakes of the past, the complete transformation of the economy, rooted in the green and digital transitions, has proven to be a persistent feature of European policymaking throughout subsequent years. Surely, this clarity of purpose has contributed to the resilience of the euro area at the outset of the COVID pandemic, with the financial sector acting as part of the solution. The response of financial markets to the Commission issuance of bonds confirms the right path taken by the EU in response to the recent crisis and in particular the right choice to tackle recovery and resilience at the same time. This resilience broadly persists today, in the current challenging environment.

Nonetheless, despite this resilience, the sudden onset of Russia's war against Ukraine exposed the depth of significant vulnerabilities, such as persistently low growth levels and declining productivity that ought to be tackled with appropriate reforms and investments.

Governments face pressure to consolidate their debts while at the same time to create the fiscal space for better investments in the green and digital transitions. This is a key challenge facing the Union. To respond to such challenges, Member States needs to prioritise structural reforms to boost the supply side of the economy, leading to higher productivity and sustainable growth, while being buoyed by the right fiscal and macroeconomic policies. NGEU, and more specifically, the Recovery and Resilience Facility (RRF), is at the forefront of orienting Member States' policies.

The performance-based nature of the RRF requires that Member States put in place reforms and investments, as well as reach corresponding milestones, in order to access funding. The RRF's combination of reforms and investments has proven a now widely accepted axiom: investments alone are not enough to trigger sustainable growth. Member States must undertake the necessary reforms that will underpin well-functioning, resilient institutions – in particular, the efficiency of their public administrations. Capital markets, recognising the credibility of this approach, routinely oversubscribe to the bond issuance, including green bonds, that underpins the NGEU and RRF.

With its "flagships", the Technical Support Instrument contributes to orient Member States's efforts.

By identifying key areas for reforms in line with EU priorities with its "flagships", the Technical Support Instrument contributes to orient Member States's efforts to improve the supply side of the economy. Flagships reforms are defined on a yearly basis by identifying the most pressing reforms needs at EU level and proposed to Member States as possible areas for support via the Technical Support Instrument (TSI). The high number of requests for support in the Flagships areas (more than 40% of all requests) confirms the convergence of Member States' reform objectives throughout the EU.

Overall, the TSI, and the SRSP its predecessor, has supported more than 1500 technical support projects in all 27 Member States since 2017. Digital transformation, sustainable growth and business environment, labour market, health, education, social services, revenue administration and public financial management or reforms relating to the financial sector are also covered by the TSI. Furthermore, the TSI is an agile and flexible instrument. For example, following Russia's invasion of Ukraine, DG REFORM supported 17 Member States to phase out their dependence on Russian fossil fuel imports, contributing to REPowerEU objectives and the long-term, sustainable development of Europe's energy systems. In the context of mounting public debt, DG REFORM has also responded to requests from Member States to strengthen their public finances.

Specifically, DG REFORM has supported 15 Member States to conduct high-quality spending reviews, which would allow them to identify and prioritise reforms and investments needed to reach debt consolidation. In addition, starting in late 2023, DG REFORM will further support Member States in the area through a flagship technical support project, facilitating knowledge exchanges and good practice sharing in spending reviews. Depending on the agreement reached by the co-legislators, this support could facilitate the implementation of a revised economic governance framework.

Over the last 3 years, the Commission has also stepped up its efforts to help Member States modernizing and making their public administration more efficient, conscious that the success of any reform and investments is strongly linked to the quality and efficiency of public administration.

Among other initiatives, it launched the first Public Administration Cooperation Exchange (PACE), an exchange of civil servants across Member States to foster exchange of expertise and good practices. In autumn, the Commission will propose a package of initiatives (so called "ComPAct") to further enhance the functioning and performance of public administrations in Europe.

REINHARD FELKE

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After the shocks: challenges for the European economy

Over the last three years, the European Union has grappled with not one, but two black swan events: the Covid-19 pandemic and Russia's full-scale invasion of Ukraine. The pandemic triggered the deepest recession in EU history, while last year's surge in energy prices caused inflation levels in the euro area to reach double-digits, amid concerns over possible gas shortages in winter and the competitiveness of Europe's industry.

Yet the European economy has managed to withstand these shocks better than many believed possible. It recovered more quickly than was the case during previous crises. GDP had returned to pre-pandemic levels already at the end of 2021. Last year, the economy recorded higher growth rates than both the United States and China. This year inflation remains above the ECB's target but has fallen considerably from its peak of 10.6% in October 2022. Unemployment rates are at historically low levels, while labour market participation and the employment rate have climbed to all-time highs.

This remarkable resilience of the European economy can be traced back to three distinct factors. The first is the strong and coordinated policy response at national and European level. During the pandemic, fiscal and monetary policy worked in tandem to shore up confidence and support businesses and households, helped by unprecedented decisions such as the activation of the 'General Escape Clause' of the Stability and Growth Pact and the launch of the SURE mechanism and NextGenerationEU, with its Recovery and Resilience Facility (RRF). The second key element are the reforms that many Member States have carried out in response to previous crises, whose positive effects are being felt years later when Europe's economy was again put to the test. Finally, the European corporate sector has shown an extraordinary adaptability, from diversifying input sourcing to embracing new working practices and greening their production methods.

These factors have helped the European economy ward off the risk of a deep recession in 2023. Nevertheless, growth is likely to remain subdued this year and to pick up only slightly in 2024, as tighter financing conditions weigh on demand and uncertainty around the global economic outlook remains high.

Looking ahead, Europe faces a number of structural challenges that will determine its long-term growth prospects. These include high investment needs for the green and digital transitions, and for economic security and defence; lingering trade tensions amid changing patterns of globalisation; population ageing, low productivity trends and high levels of debt.

Member States should maintain the momentum of reforms and investments.

In this context, one key policy challenge going forward will be to find the right balance and policy mix between the fiscal and monetary levers.

As our economies continue to wrestle with still high inflation, high public debt levels and higher interest rates, a more restrictive fiscal stance is warranted. This was also agreed by the Eurogroup, as reflected in its July statement on the euro area fiscal stance for 2024.

This shift will ensure greater consistency with the ECB's efforts to reduce inflation, while remaining mindful of the downside risks to the economy. Moving to a more restrictive fiscal policy will also avoid the need of even larger increases in interest rates, which in turn would affect investment and growth as well as the sustainability of public debts and macro-financial stability in the EU.

Ensuring a predictable conduct and close coordination of fiscal policy will be crucial. Reaching an agreement on a reformed framework of fiscal rules by the end of the year would be key in this respect.

Finally, the appropriate response to the structural challenges of the European economy is to continue to put in place growth-enhancing reforms and investments.

The implementation of the RRF is spurring a wave of ambitious reforms across Europe, encouraging Member States to make progress on many of the long-standing bottlenecks to growth identified in the country-specific recommendations.

The RRF has already helped to lift Europe's public investment-to-GDP ratio to its highest level in years, in a markedly welcome difference to the trend observed over much of the previous decade. REPowerEU is accelerating the clean energy transition and reducing Europe's dependency on Russian fossil fuels. With a bulk of RRF milestones and targets earmarked for this year and in 2024, and as Europe gets ready for the upcoming Winter season, continuing to deliver on this investment and reform agenda remains essential.

Still today, pilgrims making the *camino* to Santiago de Compostela can be heard greeting each other with the Latin words of encouragement *Ultreia et suseia* – onwards and upwards. As EU Finance Ministers gather in Santiago, it is in this spirit that work to build a more resilient and sustainable economy should continue.

TIBOR TÓTH
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Fighting inflation and addressing low growth in Europe

Lasting high inflation creates unfavourable environment for investments and economic growth: it disrupts the stability needed for investment decisions and long-term planning. Economic growth is often lower when inflation is high. Steeply rising prices restrain consumption because real wages cannot keep pace with the price level while businesses tend to be more cautious and reduce their investment activity.

Significant steps have been taken since the surge in the European inflation last year. The raise of interest rates and the cut back on money supply were the two main pillars of this policy. The communication of European Central Banks suggests that they are ready for further monetary policy tightening in order to approach inflation targets. However, these steps come with economic and growth trade-offs, so decision-makers will undoubtedly carefully weigh their application.

Most European countries are very determined to keep their finances under control and to maintain discipline regarding their fiscal deficit and continuous public debt reduction. There may have been several non-monetary or fiscal policy related reasons for the unusually high inflation rate, such as the increased demand following the course of the COVID-19 pandemic, significant supply chain disruptions, shortages of certain products and raw materials, and labour market challenges, particularly the emerging shortage of skilled labour. Alongside credible and prudent monetary policy, addressing these combined factors also requires handling the longer-term structural challenges facing the European economy like the climate change induced green and digital transition ahead of us. The European productivity and competitiveness should also be substantially improved on the global marketplace.

Challenges like the green transition and the response to the COVID crisis made us all concentrate more on the supply-side of the economy. In Hungary, the government have been engaged for years in industry policy to make sure that the transition to the green economy is orchestrated in a way which is economically and socially sustainable. Economic policy is incentivising the creation of new capacities in battery manufacturing and electro-mobility, investments in solar power production capacities to make sure that Hungary is ready for the economy of tomorrow.

The European productivity and competitiveness should be substantially improved.

The NGEU has been a one-off experiment in a challenging situation, an experimental response to counteract the economic damage of the pandemic. The lessons of the NGEU still needs to be drawn, but at this stage the least one can say that experience with the NGEU are so far mixed and controversial. It turned out to be an extremely bureaucratic tool putting heavy burden on national administrations, the implementation requirements of the national recovery plans remained rigid, furthermore substantial delays in transferring payments to every Member States did not ensure level playing field in this area. Today still 5 MS have got no access at all to those funds more than 2 years after the pandemic! How this can be called "recovery supporting" fund for them at the end of 2023? In addition against the background of the high interest rate environment it has become much more costly for the MS then originally foreseen. In that sense I do not see any reason for the EU to repeat of taking up loans and making the EU even more indebted for decades. As regards the economic governance reform, the basis for financing investments and reforms is rooted in sustainable economic growth. The review of the Stability and Growth Pact (SGP) is expected to result in a framework that places greater emphasis on the implementation and promotion of investments and reforms. However, it must be acknowledged that this in itself does not offer a solution for promoting desirable structural supply side-oriented reforms and investments. Achieving high quality investment performance and implementing growth-friendly reforms could still be accomplished within the existing fiscal rules. This requires crucial commitment and discipline from Member States and making appropriate choices regarding policy priorities.

The purpose of reviewing the Stability and Growth Pact (SGP) has to be the simplification of fiscal rules enhancement of the enforcement and the clarity of the regulatory framework. The economic governance framework is needed to strike a proper balance between the sustainability of public finances, fiscal discipline, and the financing of investments and reforms with a medium-term perspective. Fulfilling commitments and ensuring equal treatment among Member States are best guaranteed by a rule-based fiscal framework. It is crucial that future regulations include specific numerical provisions for debt reduction commitments.

Our efforts are directed towards establishing a future framework that better promotes national ownership, supports forward-looking public investments and reforms, and ensures sustainable and ratcheted reduction of the government debt ratio compared to the previous framework.

CARMINE DI NOIA

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Walking the tightrope between price stability and financial stability

Macroeconomically speaking, Europe is caught between a rock and a hard place. Inflation remains far above target, and even though headline figures have begun to fall as the energy price shock – fuelled by the war in Ukraine – has subsided, core inflation remains stubbornly high. Getting this situation under control is rightly a priority for central banks. However, this is taking place in an environment of unprecedented peacetime indebtedness for both sovereigns and corporates, as OECD work has highlighted. EU government debt is substantially higher today than it was in 2008. Non-financial corporate bond debt has increased by about three-quarters.

This borrowing spree has happened during the extended period of ultra-low interest rates following the 2008 financial crisis and was boosted further by fiscal and monetary expansion in the face of the COVID crisis. Thanks to near-zero interest rates and QE, this debt has not been a great burden so far – government interest expenditure as a share of GDP in the EU is still less than 60% of what it was in 2008. However, the main tool central banks have at their disposal to fight inflation – raising interest rates – serves to increase borrowing costs throughout the economy. In a high-debt environment, this creates a possible tension between ensuring price stability and financial stability, posing a significant challenge to central banks.

Monetary policy is a blunt instrument that impacts all parts of the system, and the higher the debt burden, the more sensitive the response. Changes in interest rates are like tectonic shifts in global markets. The fastest tightening on record, which we are currently going through, is therefore bound to have widespread effects on financial markets. We have already seen some of these risks unearthed around the world, with the recent banking turmoil as a salient example. In other areas, notably commercial real estate, risks have not fully materialised, but we know they are there. But the risks we should worry about most are those we are yet to discover; the structure of global markets has changed radically since 2008 with the expansion of new segments, notably within non-bank financial intermediation, and we still do not fully know how these are interconnected with the rest of the market, nor how they will fare under stress.

Significant economic uncertainty and volatility also make it difficult to estimate the connection and timing between monetary policy and (dis) inflation movements. In the face of this uncertainty, the logic has been that it is easier to undo a strict tightening than to get a wage-price spiral, for example, under control. However, in a fragile financial context, sharp increases in interest rates could have non-linear effects on financial markets, and thereby also on inflation.

The price of price stability should not be a rupturing of our mechanism for capital allocation.

A debt crisis is not a desirable way of getting inflation back to target. Even outside of an outright collapse, it is difficult to estimate the magnitude of the disinflationary effect of a sharp and widespread deleveraging, and a possible balance sheet recession. Triggering a sharp economic downturn may also call for fiscal stimulus, which would in turn confuse the messaging between monetary and fiscal policy.

None of this is to say that getting inflation back to target should not be a priority. On the contrary, doing so is a prerequisite for investment and sustainable economic growth – both much needed in Europe, which has been falling behind the US since 2008. But while it is imperative to get inflation down, the process must be orderly, because another prerequisite for investment and growth is well-functioning capital markets. The price of price stability should not be a rupturing of our mechanism for capital allocation. Against this challenging background, what should be done about the inflationary situation in Europe? Central banks should carefully monitor financial stability risks and their impact on inflation as part of their decision making, including the impact of quantitative tightening on market functioning. There should be recognition that we are uncertain about the lags with – and sometimes channels through – which monetary policy operates.

Importantly, sound prudential policies, including the corporate governance of financial institutions, can give monetary policy more freedom to focus on price levels, to ensure we can charter the path to low inflation while steering clear of financial instability.

This is a great challenge indeed, and as the BIS has noted in its annual economic report, one which stems from having leaned too much on what is supposed to be stabilisation mechanisms (monetary and fiscal policy) as engines of growth in recent years. It is an error to think that they can ever substitute for structural reform. But while reversing that model is crucial, it must be done with caution. Monetary policy cannot be an engine of growth, but if not carefully calibrated it can certainly be an engine of instability.

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In search of the right policy mix

Over the last three years, the ECB and European governments have deployed far-reaching measures to stem the effects of the pandemic and then the energy crisis. With the return of inflation and the economic slowdown taking shape on both sides of the Atlantic, the tensions between fiscal policy and monetary policy are becoming glaring: the policy mix can no longer mitigate both simultaneously.

These tensions are all the more acute as core inflation is struggling to slow down. The fall in energy prices since the start of the year is not enough to stem the pressure on service prices. Admittedly, the recent work presented in Sintra[1] shows that the fiscal policy implemented in Europe to limit the rise in energy prices helped to contain inflation last year and limit the shock to economic activity. But with falling energy prices, these measures should have been withdrawn much sooner. In the absence of fiscal consolidation, the ECB could be led to raise its key rates further. This "non-cooperative game" between fiscal and monetary policy results in an unbalanced policy mix which, by placing the burden of adjustment disproportionately on the central bank, poses a threat to macrofinancial stability.

Key interest rates are now above their neutral level. Has monetary policy overstepped? It is impossible to give a clear-cut answer. Recent work on neutral rates suggests that they have hardly changed over the last three years. The main factors that have caused real interest rates to fall over the last few decades are well known (ageing population, slowing productivity gains, growing demand for safe assets), and none of them seem set to reverse. However, it remains to be seen what impact the energy transition will have on the global balance between savings and investment: the huge investment needs alone could lead to a sustained rise in global real interest rates.

At the end of the day, as Obstfeld[2] so rightly notes: as unsatisfying as it may be, we largely remain in the situation described in the 1930s by John Williams (1931): *"The natural rate is an abstraction; like faith, it is seen by its works. One can only say that if the bank policy succeeds in stabilizing prices, the bank rate must have been brought in line with the natural rate, but if it does not, it must not have been."*

Why are inflationary pressures so persistent? Rising corporate margins and unit labour costs have played a key role. Inflationary pressures are the result of a combination of supply and demand factors. Goods inflation is falling, while services inflation remains high. To put it simple, it appears that goods inflation is driven by supply-side factors, while services inflation is increasingly driven by demand-side factors.

Fiscal consolidation should do more than monetary policy to reduce pressure on demand and inflation.

Policymakers must now consider the financial risks posed by rising interest rates. For the first time since WWII, very high levels of private and public debt coincide with high inflation. The highly accommodative monetary policy of the 2010s encouraged risk-taking on the financial markets and the accumulation of debt. The resulting risk of financial instability increases the challenges facing central banks.

The real reason for persistent inflation is fiscal policy, not monetary policy. If monetary policy is taking longer than expected to take effect, it is precisely because budgetary support has been "too generous". Governments no longer have much room for manoeuvre. They can no longer mobilise their policies to promote growth without fuelling inflation. The increase in public debt therefore requires a rebalancing of the policy mix. The emphasis should now be on fiscal consolidation. This would help to reduce the pressure on aggregate demand and inflation more effectively than continued monetary tightening. All the more so as rising interest rates will make fiscal consolidation more difficult.

And governments should not be afraid of the economic slowdown. Weaker growth is inevitable. Economic players overestimate the extent to which macroeconomic policies can be used to smooth the economic cycle. The nature of the economic cycle is changing. Globalisation can no longer be relied upon to contain inflation. On the contrary, geopolitical and climatic risks can materialise at any time. The policy mix will no longer be able to absorb as easily as in the past the new shocks we are likely to experience over the coming decade.

Budgetary consolidation (apart from the investment expenditure needed to increase supply and the energy transition) is a necessary condition for re-establishing a "cooperative game" between monetary policy and fiscal policy, for limiting macrofinancial risks and for being able to redeploy supportive policies effectively when the time comes.

1. *Gourinchas, Pierre-Olivier. "Unconventional Fiscal Policy in Times of High Inflation." ECB Forum on Central Banking, Sintra, 25-26 June 2023.*
2. *Obstfeld, Maurice. "Natural and Neutral Real Interest Rates: Past and Future." 10th Asian Monetary Policy Forum, Singapore, 25-26 May 2023.*