EUROFI Regulatory Update

FEBRUARY 2024

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Comments on monetary policy

Communication to the Académie des Sciences Morales et Politiques[1] September 18, 2023

Note written by Jacques de Larosière

Introduction

I would like to thank our President, a man who throughout his career has been a resolute defender of monetary stability, for choosing me to give you my views on monetary policy as it has been conducted in recent years.

The subject is a technical one, but it is of the utmost interest to our societies. The literature shows that in peacetime, inflation was considered by the populations surveyed to be the greatest danger, even before unemployment[2].

This is understandable: "money is the standard by which all things are given their value", as Montesquieu taught. How can we imagine that this standard could itself change value at any time?

Traditionally, since their emergence at the end of the 17th century, central banks have been entrusted with the task of ensuring currency stability.

For most of the 19th century, the major countries decided to base their currencies on the physical value of gold, a rare commodity that was easy to value and had a fairly stable market. Holders of banknotes issued by central banks could convert them into metal at any time. All currencies that played a key role in international trade were defined by a weight of gold. Since they were defined in the same way, they were easy to exchange. To ensure the stability of the system, currencies did not change the weight of gold that defined them: exchange parities were therefore fixed: no devaluation for mercantile purposes.

This system – which had ensured great international monetary stability and helped finance the Industrial Revolution – collapsed with the outbreak of war in 1914. Military expenditure had become so gigantic that it was illusory to continue pledging the issue of currency in gold. We resigned ourselves to issuing as much money as the continuation of hostilities demanded. This meant the end of stability and the rise of inflation.

After the Great War, attempts were made to restore the gold standard, but to no avail. The habit of financing ever-increasing public spending with debt, and the desire to win export market share through competitive[3] devaluations, explain this failure. The world had entered a regime of floating exchange rates.

At the end of the Second World War, the United States was determined to recreate a new world monetary order. This order took the form – under the name of the "Bretton Woods system" – of a regime of fixed exchange rates. Each currency was defined in relation to the dollar, which became the anchor of the system. But the dollar itself was subject to gold convertibility: foreign central banks that felt they held too many dollars could exchange them for gold with the American authorities.

As long as the United States had a balanced balance of payments, the system worked pretty much as it should. Currencies, defined in dollars, were bound by a certain discipline. They were only authorized to devalue with the agreement of the International Monetary Fund, which could thus impose its "conditionality".

But the Vietnam War at the end of the 60s destroyed the Bretton Woods system. The United States had decided not to finance the war by raising additional taxes, but by borrowing. However, because of rising military spending, the United States – whose indebtedness was growing rapidly – did not possess enough gold to ensure the convertibility of the dollar.

1. This speech has been slightly modified to take account of the main statistical developments in the last quarter of 2023.

2. After the Great War, inflation had become, in Keynes's eyes, "one of the most significant events in the economic history of the modern world". Quoted in: "The Currency of politics" by Stefan Eich, Princeton 2022.

3. It was the "beggar thy neighbor policy" that exacerbated geopolitical tensions in the 1930s.

The international monetary system collapsed in August 1971 with President Nixon's decision to end dollar convertibility.

This was followed by a more or less administered floating exchange rate regime. This "non-system" still governs us today, with no discipline whatsoever.

It is in this international context, which alone allows us to understand the subject, that I shall attempt to describe and assess the monetary policy followed for almost twenty years.

1. Monetary policy in recent years has been characterized by continuous stimulation. In so doing, it has led to the weakening of the financial system

Since the financial crisis of 2007-2008 – itself the result of excessive indebtedness – the monetary policy of the major central banks – which have followed the Fed's lead – has been consistently stimulative. Money creation had been "firing on all cylinders" for over 15 years, the advocates of the new policy, acknowledge.

Monetary policy over the last twenty years can be characterized as follows:

1.1 Key interest rates have been maintained at 0 and even lower in real terms for twenty years

This is shown in Chart 1

It shows that, apart from the 2007-2008 crisis, real key rates have been kept in negative territory for over twenty years.

In concrete terms, this means that a European buyer of Treasury bonds has had to pay a subsidy to the borrowing state in order to be allowed to lend to it.

This anomaly was not confined to short rates. It had spread across the entire yield curve. By 2020, 40% of European public debt had a negative nominal interest rate.

This incongruity – unique in history – insofar as it involved taxing savers who wanted to finance the economy – seemed normal and even desirable to many, including central bankers.

However, the paradox was considerable: when it comes to financing an economy and its productive investment, is it normal to punish the saver, *i.e.* the provider of capital?

1.2 Growth in money supply has continually outstripped that of the real economy

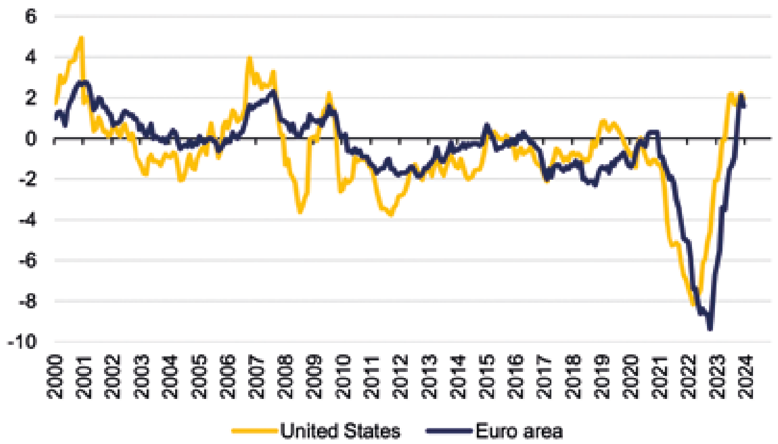
Chart 2 shows that growth in the most comprehensive monetary aggregate – M3 – has consistently exceeded that of the economy (GDP). This is true in both Europe and the USA.

Thus, between 2000 and 2019, M3 grew by 220% in the USA, compared with real GDP growth of 48.6% (the corresponding figures for the Eurozone are 172.5% and 28% respectively).

If we refer to "central bank money" (banknotes in circulation and reserves held by commercial banks with the Institut d'Emission), we see that for the majority of OECD countries, central bank money has risen from $2.5 trillion in 2006 to $25 trillion in 2022, a record increase of 900% in fifteen years.

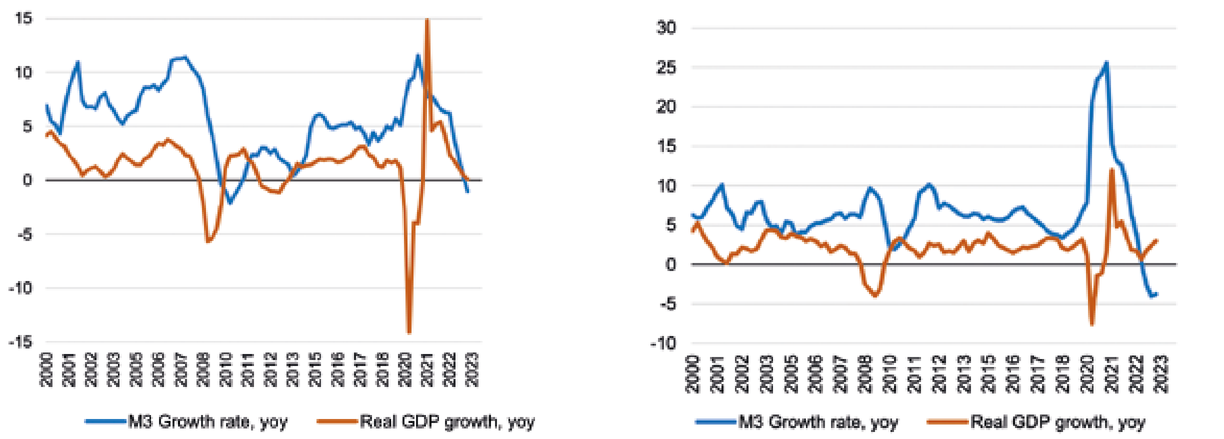
Admittedly, these figures must be interpreted with caution, as the relationship between money creation and inflation is complex and non-linear (the velocity of circulation, as well as the irregularity of economic agents' need for money, are difficult to model). But the continuity and scale of this "excess" of money should, at the very least, have prompted to question the wisdom of such a policy... Traditionally, growth in financing was proportional to growth in the economy. Over the past 20 years,

CHART 1.
Real Refinancing Rates in the US and Euro Area
Policy rate minus headline inflation rate, % points



Source: BIS
Notes: Latest data from December 2023

CHART 2.
Monetary expansion has continuously exceeded GDP growth.
M3 Growth Rate Against Real GDP growth rate, % annual change



Source : OECD
Last data from Q3-2023

this link has disappeared: financing now exceeds economic needs.

In 1568, the French economist Jean Bodin posed the quantitative equation for money, which was taken up much later by Milton Friedman and American economists. He demonstrated that if the creation of money exceeded the economy's financing needs for too long, inflation would eventually set in. This thesis has never been contradicted in the long run.

1.3 Monetary policy was conducted asymmetrically

Detailed examination shows that monetary policy was continually stimulative:

- very stimulative at the slightest sign of economic slowdown,
- without becoming truly restrictive in the event of overheating.

Yet we know that an anti-inflationary monetary policy must take account of the economic cycle, alternating phases of easing and tightening according to the economic situation.

1.4 Low-interest monetary policy has contributed to massive debt growth in advanced countries

Chart 3 from the Institute of International Finance (IIF) shows that global debt has literally exploded over the past 17 years. Between 2006 and 2022, global debt (financial + non-financial) doubled in value, rising from $150 trillion in 2006 to around $300 trillion by the end of 2022.

CHART 3.
Global debt has soared

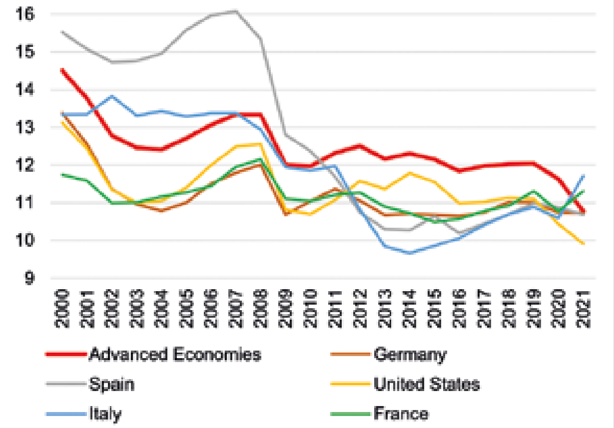
Source : Institute of International Finance
*Notes: as of Q4 2022; * the dotted line indicates the trend over the pre-Covid-19 period*

According to BIS figures – which, unlike the IIF, exclude debt issued by financial organizations – global debt has risen in real terms :

- in the USA, from 186.8% of GDP in 2000 to 255.6% in 2022 (*i.e.* +36%).
- in the Eurozone, from 198.1% in 2000 to 250.9% in 2022 (*i.e.* +26.6%).
- This explosion in debt concerns all economic agents:
  - Governments have seen their debt soar in real terms:
  USA: 48% of GDP in 2000 to 112% in 2022 (+130%)
  Euro: 69% of GDP in 2000 to 92% in 2022, *i.e.* +33%.
  - During the same period, private non-financial companies and households saw their debt rise, particularly in Europe:
  USA: from 135% to 152% of GDP (+12%)
  Euro: from 126 to 162% of GDP, *i.e.* +28%.

CHART 4.
Productive investment has declined

Non- Residential Investments in Advanced economies, % of GDP



Sources: OECD, IMF Staff Calculations
Notes: Advanced economies = Australia, Canada, France, Germany, Italy, Japan, Korea, Spain, United Kingdom, United States ; the series include government and corporate investment

the case. The debt indicator no longer even appears on the dashboard of our central bankers. And yet, the spectacular explosion in credit (100% between 2006 and 2022) should, at the very least, have triggered a reaction of concern... But it didn't.

Has productive investment at least benefited from low interest rates? Unfortunately, the answer is no.

Zero interest rates may have encouraged indebtedness, but not productive investment.

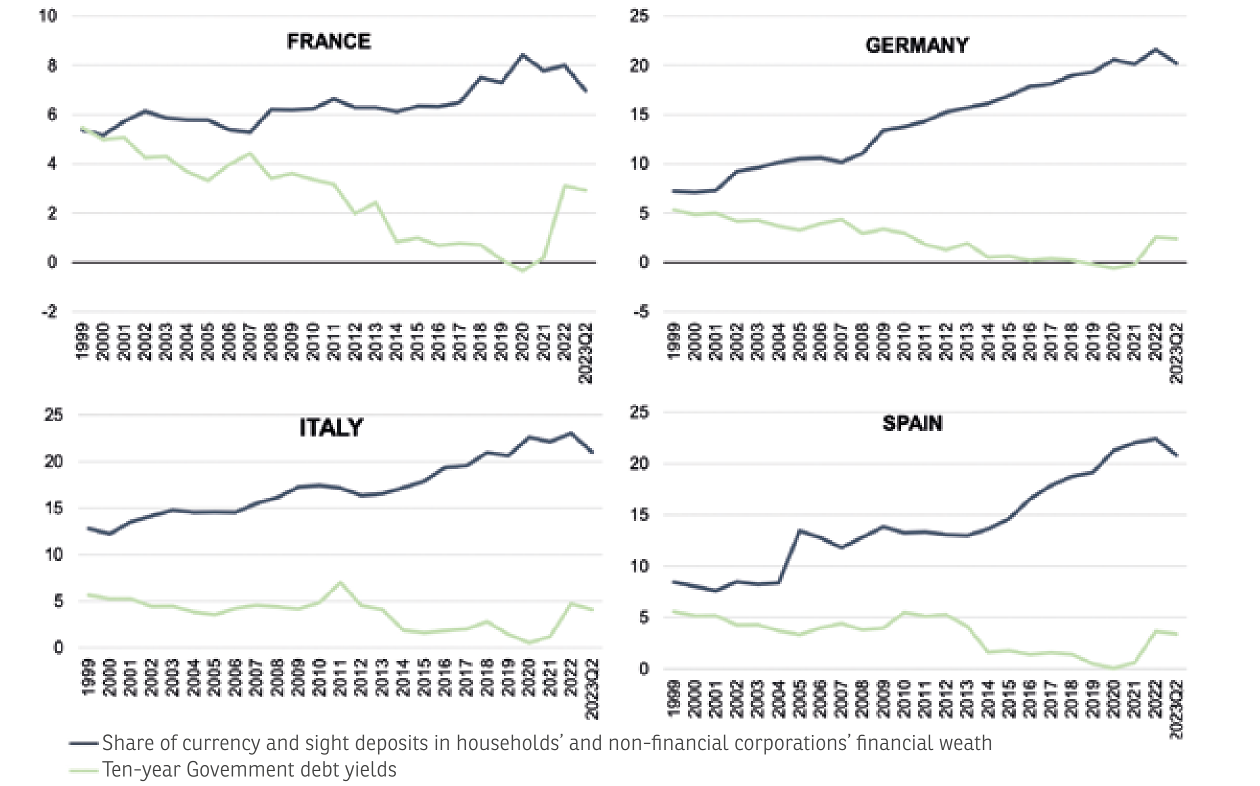
Chart 4 shows that, in the advanced countries, capital invested in productive (non-residential) assets declined by 2.5% of GDP over the twenty years of zero interest rates. This is unique for a global economy that is supposed to be growing.

Part of the explanation lies in monetary policy.

Keynes warned us that the “liquidity trap” is not conducive to long-term productive investment. Faced with the absence of a return on savings, economic agents rationally prefer to remain liquid, and not commit to risky long-term investments with no prospect of gain. Chart 5 below shows that, in fact, the purely liquid portion of European household savings has literally soared to the detriment of long-term productive investments.

CHART 5.
Savings are increasingly liquid

Evolution of the liquid assets of economic agents as proportion of financial wealth and interest rates and government bonds



Sources : Eurostat, Refinitiv Eikon, OEE (Observatoire de l’Epargne Européenne)

4. The IMF taught that the deterioration of a country’s current account balance depended on the evolution of “net domestic assets”, *i.e.* the variation in credit to the economy and the government.

CHART 6.
Volumes of Share buybacks have doubled in the US since 2011

Share buybacks by non-financial corporations (USD billions)

Sources: S&P Global Market Intelligence, via AGEFI

It had also become more attractive for a company to take on low-cost debt to buy back its shares than to invest for the long term. Hence the explosion in "share buy backs" (*see Chart 6*).

1.5 Central bank balance sheets have reached levels unseen in the past, at least in peacetime

Given that – as shown above – key interest rates have been kept at zero – or even in negative territory – for twenty years, central banks have faced an arithmetic challenge.

Since nominal interest rates could not fall much below zero (there is, in fact, a common-sense limit to the "repression" exerted on savings), central banks came up with the idea of compensating for the rigidity of the zero limit by transferring their stimulating action from the fall in rates – now blocked – to the growth of money creation. This was the way they imagined to restore "room" for manoeuvre to monetary policy. After 2008, this became known as "quantitative easing". To ensure that monetary policy was properly transmitted, the idea was to create virtually unlimited amounts of money. To turn the zero lower bound, central banks bought financial securities, mainly bonds, on the market. These purchases were financed by money creation. By buying back securities from market players, liquidity was increased. And it was thought that this liquidity would encourage banks to finance investment. So did productive investment at least benefit from these low rates? The answer is negative, as shown above (*see Graph 4*).

Buying (or selling) securities has always been part of the central banks' arsenal. It's one of the classic ways of influencing financial market liquidity and avoiding very short-term crises.

But that's not what this was about. It was about flooding the economy with money creation on the pretext that the inflation target ("just under 2%") had not been met.

Chart 7 (*see next page*) shows that securities purchased by the ECB have literally exploded:

- The ECB's balance sheet has grown from 1 trillion euros in 2006 to 8.2 trillion in 2022[5] (+720%).
- Cumulative purchases represented up to 70% of Eurozone GDP.

Chart 8 shows that, for the Fed, securities purchased and on its balance sheet rose from \$1 trillion in 2006 to \$8.9 trillion in mid-2022 (its peak): an increase of 910%.

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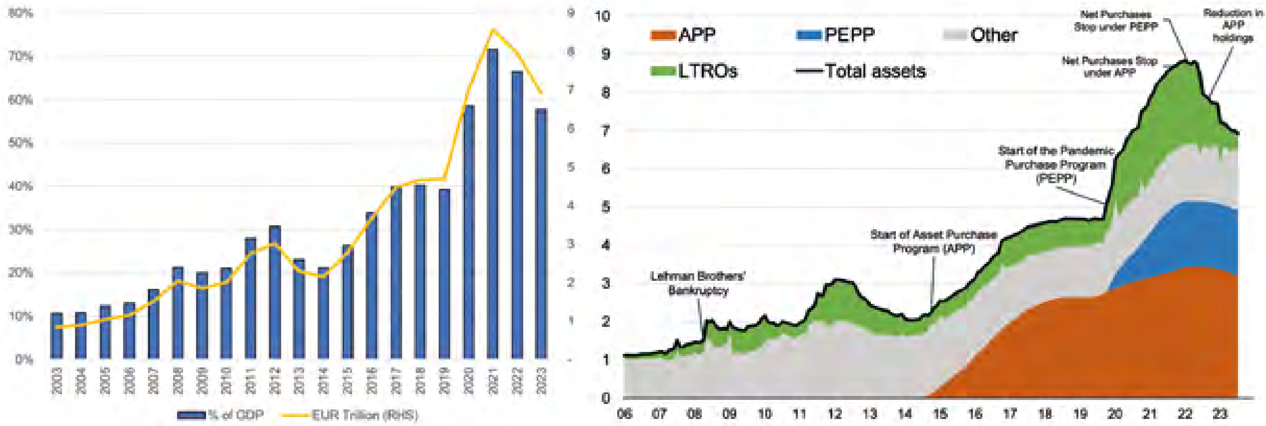
These are the facts: unbridled monetary stimulation that continued until 2022. What were the consequences?

I will summarize them as follows:

1. **The exponential growth of indebtedness has led to the vulnerability of the financial system**, increasing the probability of debtor defaults and, by the same token, fostering financial crises.
2. **"Short-termism" has invaded the financial system**
Since long-term financing of productive investments was virtually non-remunerative, investors were driven to hold on to their cash or to make short, speculative investments.
3. Central banks' purchases of abysmal quantities of securities on the market contributed to an **unprecedented financial** bubble: stocks, bonds and real estate saw their value soar far beyond "fundamentals".

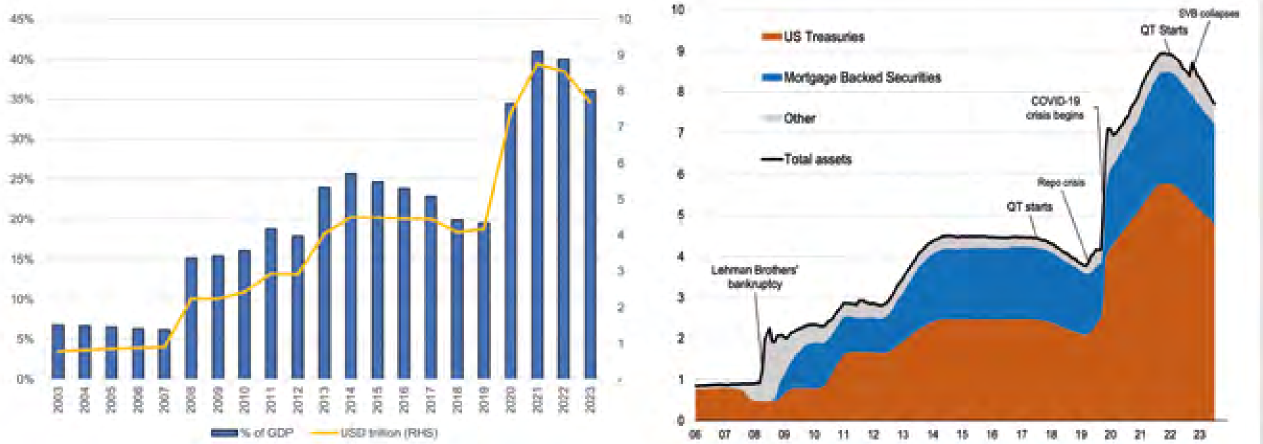
5. The increase in the balance sheet is also due to LTROs (long-term refinancing operations) (24% of the balance sheet in 2022). These facilities provided commercial banks with long-term loans at attractive rates.

CHART 7.
Eurosystem balance sheet soared (from 1 to 8 trillion euros)



Source : ECB
Last observation from 31 December 2023

CHART 8.
Similar development for the Federal Reserve



Source : Federal Reserve
Last data from 31 December 2023

But trees never grow taller than the sky, and sooner or later the markets turn around and the crisis begins.

4. Many companies benefited from very low interest rates, which enabled them to survive. But when rates rise with inflation, these "zombie" companies are threatened, as their subsidies disappear and the value of the securities they hold plummets. These companies account for an estimated 16% of all companies in advanced countries. This phenomenon would have contributed to reducing the productivity of the productive sector insofar as it had slowed the development of the most dynamic firms (*see Chart 9*).

5. **The extreme financialization** we have achieved (it should be noted that 75% of the rise in the global balance sheet over the last 20 years has been due to increases in speculative valuations, rather than increases in added value[6]) has privileged the 10% of the population most able to benefit from it.
   In a world where salaries are tending to stagnate, we can measure **the aggravation of social inequalities** resulting from such "two-speed finance" and its political consequences.

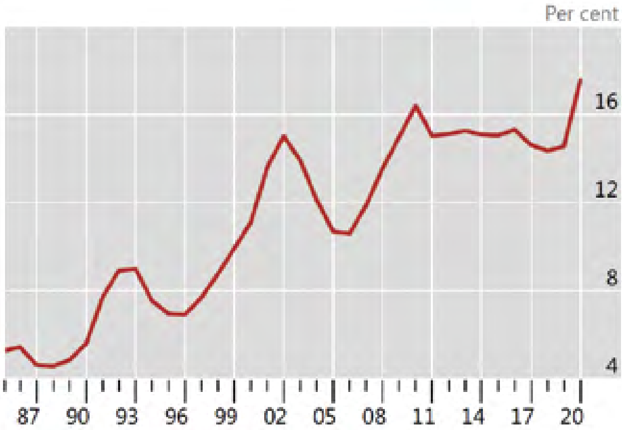
6. Finally, the fact that **interest rates have been very low** for a long time is **hardly an incentive for governments to undertake the necessary structural reforms**. It's so easy to borrow cheaply!

I would add that the policy of quantitative easing (QE) has led central banks to hold a very large share of public debt.

In total, as shown in Charts 10.a and 10.b, the Eurosystem held one-third of the Eurozone public debt in June 2023.

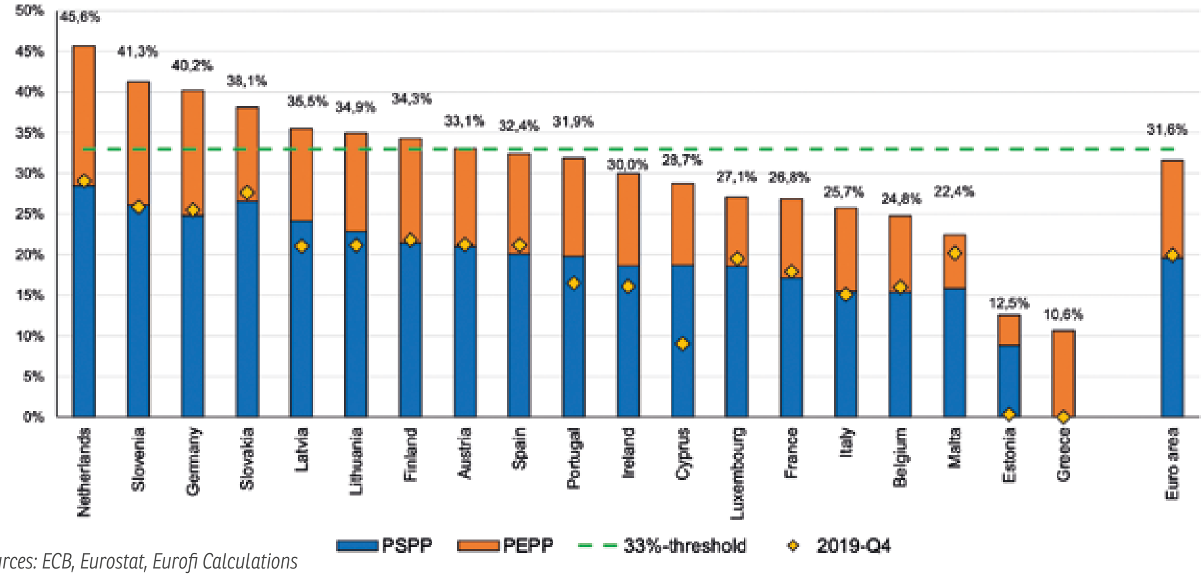
6. See my book: "Putting an end to the reign of financial illusion" Odile Jacob 2022.

CHART 9.
The share of zombie firms has risen from 4% to 16%
Share of zombie firms in listed Non-Financial Companies across advanced economies, %



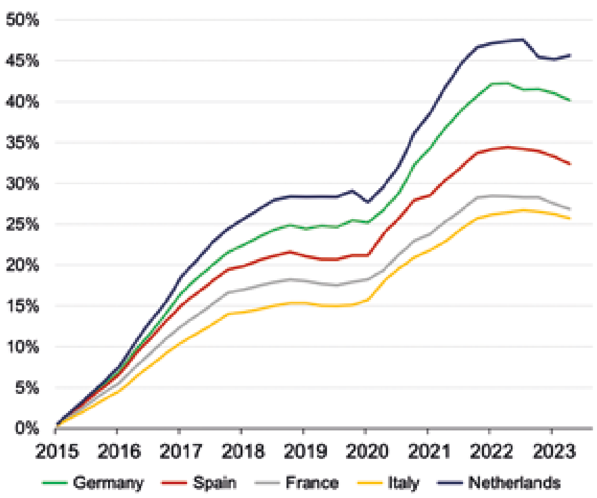
Sources: CGFS Working Group calculations, Datastream Worldscope
Notes: Across 14 advanced economies, zombie firms defined as firms with both an interest coverage ratio of less than 1 and a Tobin's q below the median firm in the sector over two years. To be declassified as a zombie firm, an ICR larger than one or a Tobin's q above the sector median over two years is required. Zombie share is the ratio of zombie firms to all firms

CHART 10.a
The Eurosystem holds a third of Euro area government debt
Share of Government Debt held by the Eurosystem as of June 2023, %



Sources: ECB, Eurostat, Eurofi Calculations

CHART 10.b
The Eurosystem holds a third of Euro area government debt
Share of public debt held by the Eurosystem



Sources : ECB, Eurostat, Eurofi Calculations
Last observation from 2023-Q2

2. Why and how did we get here?

There is no denying that monetary policy has had some positive results. The most undisputed is the reaction of central banks to financial crises. Their rapid intervention and firepower have twice prevented the collapse of the financial system.

But we must not forget that the crises (particularly that of 2008 and the euro in 2010) were largely provoked or encouraged by excessive indebtedness, which in turn was strongly reinforced by the actions of central banks.

Nevertheless, the asymmetrical nature of monetary policy, the fact that real key rates were held at zero for 20 years, the gigantic scale of quantitative easing, the lack of interest in the quantitative theory of money, the unprecedented level of indebtedness... are all deviations that are difficult to understand and justify.

CHART 11.
Long-term interest rates have been falling for one hundred and twenty years
Estimated natural interest rate (R*) for the United States and Eurozone, %

Source : "Measuring the Natural rate of Interest after Covid-19", by Kathryn Holston, Thomas Laubach, and John C. Williams, Federal Reserve Bank of New York Staff Reports, no. 1063, June 2023

In any case, central banks felt they had to act freely in an "unconventional" – but, in fact, extremely dangerous way. The fact remains that they had made a formal commitment to limit inflation to "just under 2%". This commitment was not kept. Inflation rose again in 2021 to over 10% after years of moderation. It still stands at 5%.

This fact needs to be explained if we are to learn from it. It must not be denied or treated lightly.

So let us try to understand the ancient origins of these trends.

Three facts seem important.

1. **The memory of the Great Depression of 1929** has left its mark on people's minds. In the eyes of Keynes and his followers, a deep economic crisis accompanied by an explosion in unemployment was incompatible with a tightening of monetary policy.
   In fact, the monetary policy followed in 1929 had only exacerbated the economic crisis. It was therefore necessary to completely rethink the data and our understanding of the problem. It was then that the New Deal, the stimulation of demand through budgetary spending and major public works were implemented by the Roosevelt Administration.
   The results were spectacular, and Keynesianism took hold in the monetary sphere too. Lowering interest rates to encourage investment became a recognized instrument of macroeconomic management.
   Since then, the fear of deflation (*i.e.* a fall in prices likely to lead to depression) has become a haunting feature of economic thinking (although at no time over the past 20 years have we slipped into deflation).
2. This belief in the virtues – and inevitability – of monetary stimulus **was reinforced by the theory of weakening secular growth** (Robert Gordon[7]). According to this theory, the world is engaged in a long-term process of very low economic growth for structural reasons. The fundamental reasons lie in the aging of the population and the correlative slowdown in technological innovation and productivity gains. As societies of older people consume and invest relatively little, while continuing to save, there is a "savings glut" in relation to the – declining – financing needs of the economy. This has two consequences:
   - The downward trend in "natural" interest rates resulting from these excess savings helps to explain the long-term downward trend in "real interest rates", which may well continue once inflation has dissipated.
   - Hence the need for monetary policy to adapt to this evolution.
   But we must also recognize that forecasting models for long-term interest rates are extremely uncertain. In particular, they depend on how major environmental investments are financed, and on future trends in public spending.
3. The third explanatory factor is linked to **the absence of a genuine international monetary system**.
   Since the collapse of the Bretton Woods system, relations between currencies – and exchange rate interventions – are random and no longer respond to a common macroeconomic discipline imposed and controlled by the system. As a result, players are primarily concerned with their exports, and adjust their exchange rates accordingly. Recourse to borrowing to "cure" their exchange rate has become normal. The resulting indebtedness goes a long way towards explaining the system's structural imbalances.

7. The Rise and Fall of American growth, *Princeton University Press* 2016.

3. How to get out of it?

3.1 The difficulty of getting out of a trap we have unconsciously created is often a sign of the inadequacy of the policy we are following

Clearly, today's traps are huge.

- By raising interest rates to combat inflation, central banks are making the right decision. But in doing so, they are causing a collapse in fixed-income assets with low yields. The debt crisis is then compounded by a market crisis. Californian banks were unable to withstand the shock: as customers watched the collapse of Silicon Valley Bank's balance sheet assets, they began to withdraw their deposits, and the bank, now bankrupt, was bailed out by the state, which guaranteed all deposits (thus recreating the "moral hazard" that had flourished in the wake of the 2008 crisis and is one of the evils of our time).

What had we learned?

- Raising interest rates in times of inflation is wise. But the governments that benefited from QE will now have to pay positive rates to service their debt.
- A "soft landing" for advanced economies is desirable, but not guaranteed. The risk of a hard landing has not been completely ruled out.

Will central banks allow rates to rise as much as necessary to beat inflation, or will they take account of the effects of rising spreads on highly indebted countries ("fiscal dominance")?

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Finally, the above analysis calls for an answer to the question "what to do?"

I'll outline the following points in this regard:

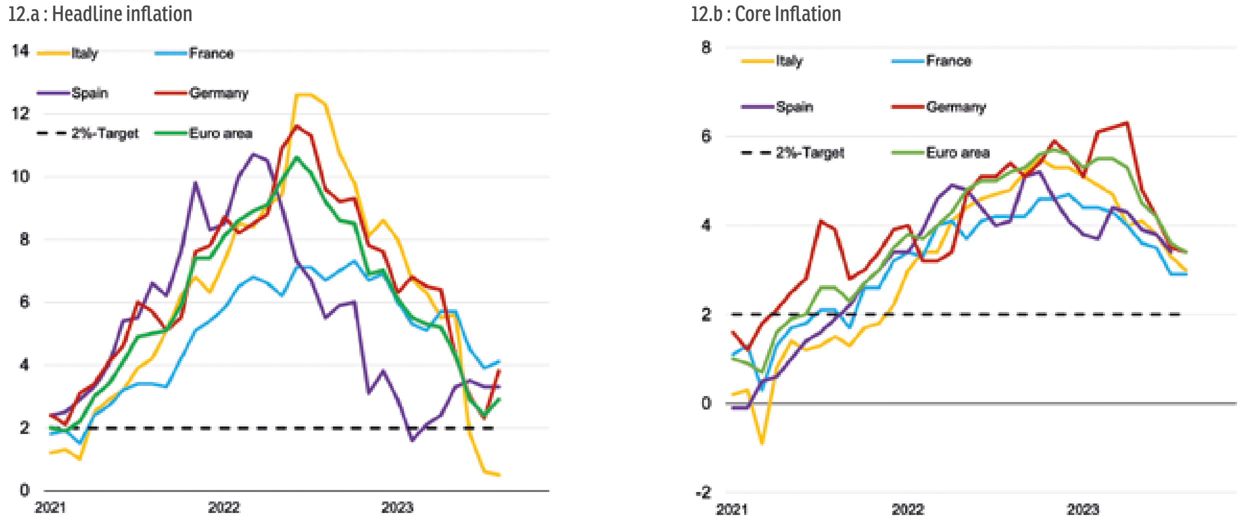
1. **It is vital to beat inflation**, the tax that hits the poorest.

As early as spring 2021, before the invasion of Ukraine (which dates back to February 2022), inflation had re-emerged, as shown in graph 12.

Central banks began by denying the seriousness of the phenomenon:

- It was due, we were told, exclusively to external factors (rising energy and food commodity prices, as well as the failure of international production chains).
- Inflation, for these reasons, was expected to be transitory, and would have disappeared by the end of 2022.
- Central bankers therefore saw no need to tighten monetary policy... which remained unchanged (ECB securities purchases continued despite rapidly rising inflation[8]).

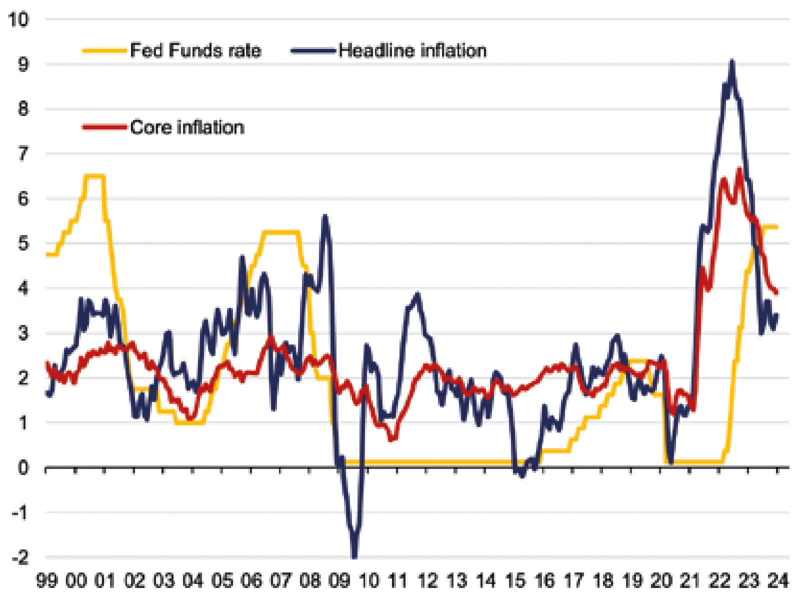
CHART 12.
Core inflation remains an issue in the Eurozone



Source : Eurostat
Last data from December 2023, except for Spanish core inflation which dates from November 2023

8. Instead of looking at the very sharp rise in inflation in monthly terms, central bankers took comfort in the fact that one-year statistics do not allow us to understand the very powerful dynamic recent rise in inflation in the first few months.

CHART 13.
US core inflation remains high
Fed funds rate versus headline inflation in the United States



Source : Federal Reserve
Last observation from December 2023

TABLE 1.
Evolution of real policy rates since 2019

		Nominal policy rate, %	YoY Headline inflation, % (i)	YoY Core inflation, % (ii)	Real policy rate (deflated by (i)), ppts	Real policy rate (deflated by (ii)), ppts
United States	déc-19	1,6	2,3	2,2	-0,7	-0,6
	janv-21	0,1	1,4	1,4	-1,3	-1,3
	janv-22	0,1	7,5	6,0	-7,4	-5,9
	janv-23	4,4	6,4	5,6	-2,0	-1,2
	déc-23	5,4	3,4	3,9	2,0	1,5
Euro area	déc-19	0,0	1,3	1,3	-1,3	-1,3
	janv-21	0,0	0,9	1,4	-0,9	-1,4
	janv-22	0,0	5,1	2,3	-5,1	-2,3
	janv-23	2,5	8,6	5,3	-6,1	-2,8
	déc-23	4,5	2,9	3,4	1,6	1,1

Sources : BIS, Eurostat, OECD
YoY = year-on-year ; ppts = percentage points

- In a system where the central model is based on inflation **expectations** (by definition uncertain) "anchored at 2%" over the long term, and not on the factual evolution of statistical data, there is a strong likelihood of not anticipating a resurgence in inflation. Inflation needs to be monitored as closely as possible, and not in terms of reassuringly uncertain expectations.

The following table gives an idea of how low key rates are in real terms.

Real policy interest rates were below 0 in the Eurozone until August 2023. In truth, the implicit message from central banks was still: "you can borrow at rates close to zero"[9].

In December 2023, real policy rates in the Euro area stood at 1,6%. This recent return to positive territory follows several years of negative real interest rate policy.

What have we learned?

2. **What can we make of the reduction in central bank balance sheets?**

They have begun to deflate, albeit very moderately

- Fed: balance sheet reduction has begun: but half of this reduction has been offset by the bailout of US banks which had not protected themselves against the risk of rising interest rates.
- As for the ECB, it is very timidly embarking on QT (quantitative tightening).

How far should we go, and at what pace, in deflating central bank balance sheets? This is not the place to discuss the issue in detail, but the importance of the problem should not be underestimated. The legacy of monetary stimulus continues to be present, and reflects the stock of assets held by central banks.

9. The weakness of spreads (sovereign & corporate), virtually unchanged since the start of the rate hike, shows that monetary policy may not be perceived as restrictive enough.

These amounts (in money stocks) are still gigantic and contribute to market liquidity.

Specialists believe that this problem must be tackled, and scenarios are currently being developed by the ECB.

But will central banks dare, despite their independence, to tackle the problem vigorously and face up to the risk of rising rates?

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By way of conclusion, I would like to make the following points:

1 Monetary policy should not be – as it has been for over 15 years – "the only game in town".

Yet there is too much of a tendency to systematically turn to monetary policy to deal with structural problems, and in particular the drifting budget deficits. These problems can only be solved by structural action, since the aim is to increase productive supply, not demand.

2 Monetary policy, in its quest for permanent stimulation, has too often sought to be "popular":

a. By creating money,

b. By keeping interest rates at zero,

c. By multiplying targets (green, social, crypto currencies...) when the role of the central bank should be to concentrate on one essential objective, that of currency stability.

3 **The way in which the 2% inflation target has been used has been highly questionable.** An inflation target should be conceived as a ceiling: "no more than 2% inflation per year".

But it was used as a target. How many times have I heard officials justify monetary stimulus at times when a more measured policy would obviously have been in order, by saying: "We haven't reached the 2%. We need to wait until this figure is respected before thinking about tightening".

But there is no point in getting carried away with money creation in order to reach the arbitrary figure of 2%. At the time, structural factors were keeping equilibrium inflation at around 1%, which was satisfactory; there was no reason to intensify money creation in order to push inflation up to the sacrosanct figure of 2%.

4 **All in all, monetary policy was guided by a doctrinaire view.** The aim was to force interest rates to 0, whereas it was essential to let the capital market find its equilibrium rates.

But meddling in the administrative setting of medium – and long-term interest rates means that central banks are entering the political arena of resource allocation. Creating price distortions in the market in order to "do the right thing" and "redistribute better" is the domain of politics, not the role of a central bank[10].

With QE, monetary policy has sunk into the depths of the budgetary problem. It is a dangerous position for a central bank – such as the ECB – to hold 33% of the public debt of the countries under its jurisdiction. The risk of "fiscal dominance" is there.

Finally, a dose of humility seems in order.

By taking care of everything, we end up believing that this is reasonable.

But an institution that respects itself and its public must :

a. Accept that it doesn't know everything and doesn't do everything systematically,

b. Be cautious about the temptation of "unconventional" imagination,

c. We must not confuse good governance (we have never seen so many learned and ineffective reports on monetary stability and guidance on interest rate policy) with good policy (which, although essential, has largely failed).

In short, we need to get monetary policy back on its feet, based on facts and experience, and defined with a degree of independence that is desirable but should never be a pretext for persevering in error.

In a world governed today by the financial cycle, it's time for central banks to take care of the stability of financial systems, avoid creating speculative bubbles, moderate indebtedness and stop focusing exclusively and at all costs on the objective of inflation, to the detriment of financial stability[11].

•

Finally, a word on the political aspect of the question.

With the emergence of inflation and the social dangers it entails, Hayek said in a lecture in 1975: "We must find a way to protect money from politics[12]".

10. "For a reason that has to do with the unrivalled strength of personal motivations, the market economy, based on the engine of competition, is more efficient than systems where, instead of setting the rules of the game, public authority claims to guide the player's hand. But the excessive inequality of income that the system generates, the existence of externalities and non-market values that are ignored by market mechanisms, the preservation of long-term interests that are difficult for players to calculate – all these are problems. And, assuming that these problems can be adequately controlled, competition must be allowed to work. (Marcel Boiteux, "Concurrence et service public", Sciences de la Société 42/1997, p.9-10).

11. See the remarkable article by William White, former advisor to the BIS : "Why the Monetary Policy framework in advanced countries needs fundamental reform" Institute for New Economics Thinking) August 2023.

12. Quoted in "The Currency of Politics" by Stefan Eich.

In its time, the gold standard had succeeded. Money was "depoliticized" by the introduction of an international discipline (convertibility into gold) which, in principle, eluded politicians.

The gold standard had led to adjustments and sacrifices that would otherwise have been dictated by political choices (or non-choices).

But Hayek was not listened to.

In the wake of the failure to deal with inflation in the 1970s, we came to advocate the statutory independence of central banks as a means of immunizing "monetary stability" from political temptations. But there are several reasons why the results of central bank independence have been disappointing.

Firstly, the "financialization" of the system, which led to the market becoming king, and the extraordinary freedom to borrow over the past 40 years, have weakened the international monetary discipline that should have been sought. This evolution (the multiplication of "false rights" according to Jacques Rueff) has led to a weakening of the system and the appearance of unprecedented financial bubbles, themselves harbingers of inflation.

Secondly, the way in which "inflation targeting" was applied, which consisted in raising the level of inflation through money creation on the pretext that a higher arbitrary figure had not been reached, when bubbles and the danger of inflation were just around the corner, was a manifest error.

When the ECB buys financial securities, it is, by definition, running a risk, which is that of the intrinsic value and duration (interest-rate risk) of these securities.

If the Central Bank has miscalculated its risk (by underestimating inflation or forcing rates to 0 while financial bubbles are inflating), it is preparing for a crisis.

In the ascending phase of QE, governments were happy with the fall in rates and the rise in Treasury securities. But as soon as inflation reappeared and rates had to be raised, governments began to worry: borrowing would cost them more, and they would have to make up the central banks' deficits (through recapitalization) and suffer the consequences of rising interest rates.

In reality, the concept of central bank independence had been largely emptied of its substance: the watchword was to create ever more money through purchases of public debt securities, without paying any attention to the resulting growing fiscal and financial dependence, which ended up devouring the very notion of financial stability.

EMU: myth or reality?

Note written by Jacques de Larosière and Didier Cahen

1. The Single Currency area has failed to deliver all the expected benefits because some Member States have not demonstrated the economic discipline imposed by a monetary union

The specificity of the euro currency is that it is not an overwhelming symbol of unity but rather a permanent source of issues to negotiate for the Member States of the Eurozone.

A national and sovereign currency usually constitutes a synthesis of the economy of a given country. It reflects the relation between the given country and the international system and is part of the necessary dialogue between the fiscal and monetary authorities. To put it bluntly, the currency is normally the catalyst of a country's unity.

For sure, the euro has been a success insofar as it has become the second most important currency globally after the American dollar. Indeed, in 1999, the euro became the single currency of a vast economic entity whose market of 350 million inhabitants is one of the largest in the world. Exchange rates have disappeared by design, and the share of the euro across various indicators of international currency holdings continued to average close to 20% in 2022[1] (*see Chart 1*).

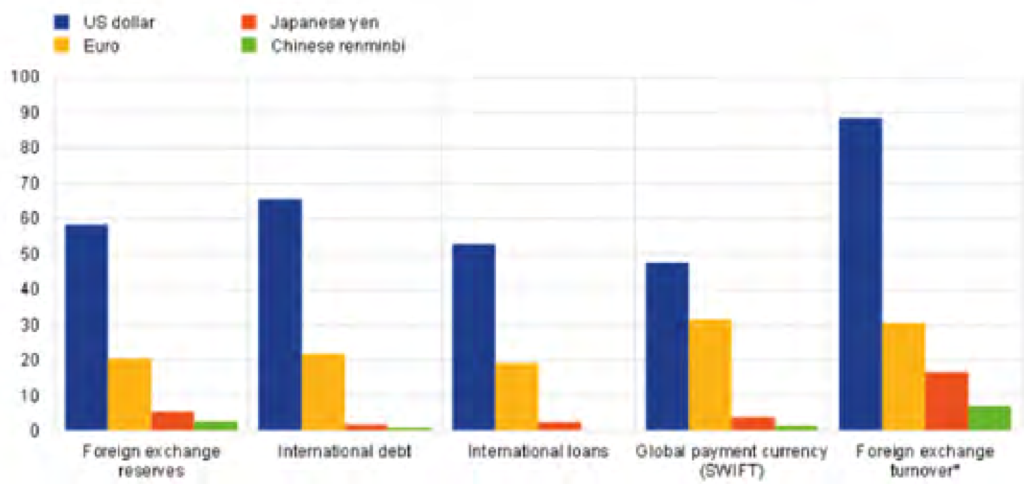
But this success cannot conceal the deep internal divisions within the monetary zone.

If one takes a close look at the euro, one can perceive that, unlike other currencies, it is far from being the reflection of a country's unity. The euro has gone through dramatic turmoil during the euro sovereign debt crisis and is regularly a source and a manifestation of some discord among Member States.

Why is that? There are several reasons:

- The first reason is that there are as many fiscal policies as there are members of the Eurozone,
- The second reason is that there are heterogeneous perceptions of the inflation that must be fought (North countries are less prone to inflation than South countries),
- The third one is that the key interest rate of the euro is the same for all members of the monetary zone. It is an average, which, by definition, is more tolerant for countries with

CHART 1.
Snapshot of the international monetary system



Source : BIS, IMF, Society for Worldwide Interbank Financial Telecommunication (SWIFT) and ECB calculations.
*Notes: The latest data for foreign exchange reserves, international debt and international loans are for the fourth quarter of 2022. SWIFT data are for December 2022. Foreign exchange turnover data are as at April 2022. *Since transactions in foreign exchange markets always involve two currencies, shares add up to 200%.*

1. ECB, The international role of the euro, June 2023.

higher inflation than for those that have a more stable outcome,

- The fourth one is that the Union has moved since the 60s from structural European policies (industrial, agricultural, energy competition…) towards a single market with no community preferences and strong national trends.

In short, the handling of the single currency is a matter of permanent discussions between the members of the boards of the ECB and the Eurogroup.

As Europe is not a single nation but a confederation of national states, we have to accept that the EU seeks compromises that optimize national objectives. But a monetary union can only function if a minimum of fiscal discipline is ensured by all States which has not been the case for 25 years.

It is common knowledge that the Eurozone is not an optimal currency zone[2]. Moreover, if external shocks (Covid-19 pandemic, energy crisis…) hit all the EU Member States, they do not hit all of them with the same intensity.

This conception illustrated by Mundell does not apply to the Eurozone insofar as the fiscal policies (and related national indebtedness) have been disjointedly steered in a certain number of countries. The solution which could have compensated the effects of this absence of convergence, *i.e.* collaboration between Member States, has never happened.

It is sometimes argued that the imported shocks suffered by the EU have become symmetric. There would no longer be shocks affecting South countries as opposed to shocks affecting North countries. Everybody would be on the same boat.

In reality, when one takes a closer look at facts, one notices that, if it is true that there are shocks affecting the Union as a whole (the Covid-19 pandemic, the energy crisis, the environmental crisis…), there are also behind them national shocks of significant importance and variability depending on the country.

The fact that the "supplement of shocks" suffered by some countries, particularly those with very expensive public spending, have a national origin, whereas the global shocks (*i.e.* those which affect the Union as a whole) have an external origin only adds add to the complexity of the issue.

2. The Eurozone is characterized by growing heterogeneities

All observations point to the same finding: the Eurozone is characterized by these internal economic and fiscal divergences and not by its unity. Here are some examples of the mentioned heterogeneities.

- **In terms of growth, the Eurozone has been lagging behind the US for decades.** Indeed, since 1995, the cumulated level of real GDP has risen by 94% in the US, compared to only 51% in the Eurozone[3] (*see Chart 2*).

CHART 2.
Real GDP, 1990-Q1 = 100

Source: LSEG Datastream, BEA, Eurostat, Natixis

One can also observe on Chart 2 that the growth gap between the US and the Eurozone has been intensifying since the Great Financial Crisis (GFC). This is partly due to productivity growth, which is stronger in the United States.

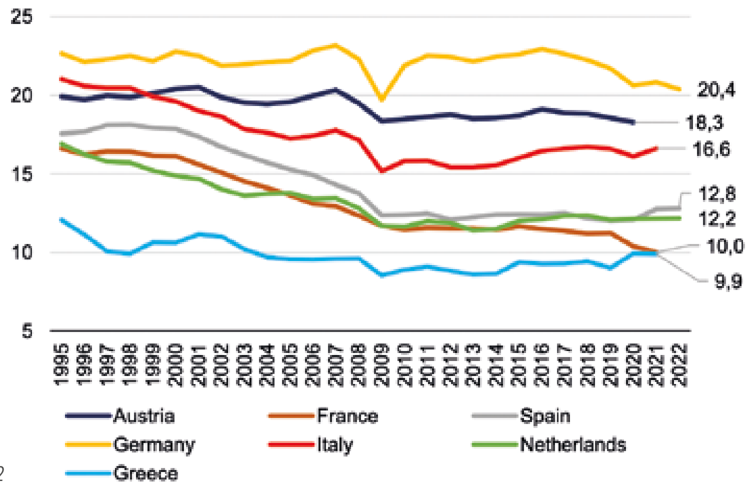
- **The euro has strengthened the more industrialized countries, to the detriment of those experiencing deeper industrial decline.**

The elimination of foreign exchange risks normally encourages productive specialization within a Monetary Union. This turned out to be true only for certain Member States of the Eurozone; the single currency has given an edge to exporting countries that specialized in tradable products for which they exhibit a strong competitiveness such as Germany and Austria over countries that have progressively experienced deindustrialization such as France and Spain.

Indeed, the economies of the best performing countries benefit from the fact that the external value of the euro represents an average for the

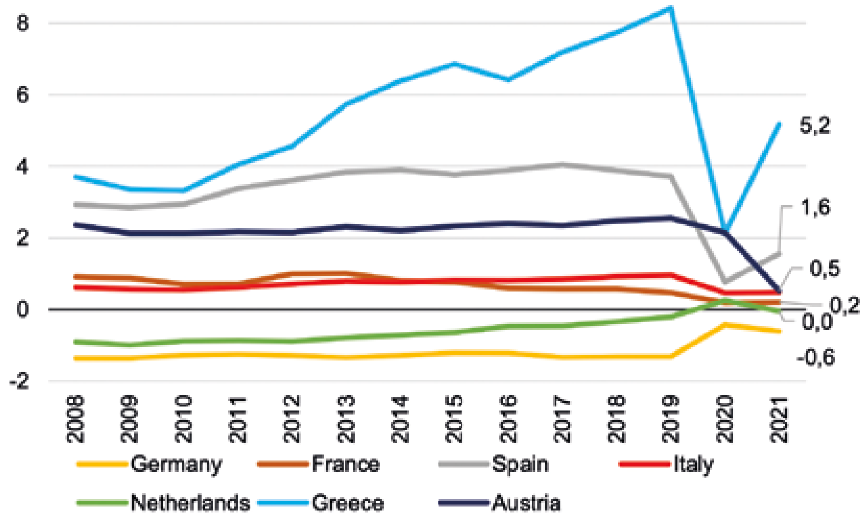
2. In 1961, R. Mundell developed a theory about optimal currency zone. The 4 often cited criteria for a successful union are: labor mobility across the region, openness with capital mobility and price and wage flexibility across the region, a risk sharing system, participant countries have similar business cycles.
3. P. Artus, "The growth gap between the United States and the Eurozone and its consequences", *Natixis Flash Economics*, 20 September 2023.

CHART 3.
Manufacturing,
% of total added value



Source: OECD
Last observation is from 2021, except for Spain, Germany and the Netherlands which dates from 2022

CHART 4.
Balance of payments
in travel, % of GDP



Source: Eurostat

entire economic area and appears undervalued in relation to their own economic performance, resulting in an additional competitive advantage. For example, it is estimated that Germany's exchange rate is 20% undervalued, in terms of real effective exchange rate relative to the Euro area.

Charts 3 and 4 below highlight the divergences between industries in EU member states.

- **The Eurozone macroeconomic divergence is especially conspicuous when looking at the TARGET 2 imbalances (*Chart 5*)**. Indeed, the net TARGET 2 liabilities of the Bank of Italy and the Bank of Spain are quite high, standing at respectively €555 bn and €395 bn as of September 2023 (which represents roughly 29% of GDP for the two countries).

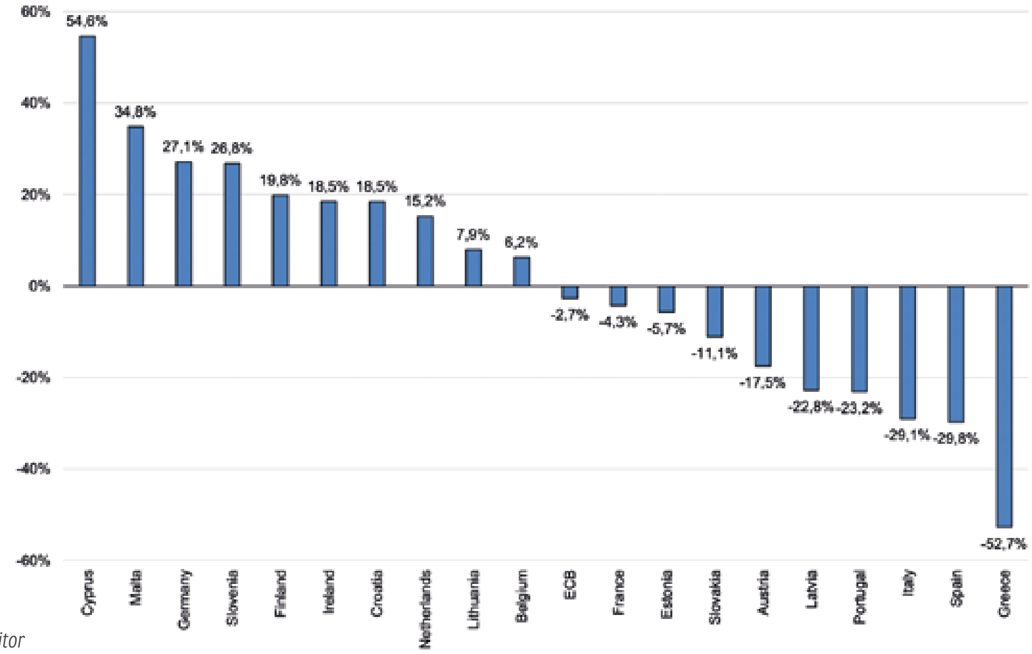
Conversely, the Bundesbank had a net TARGET 2 credit of around €1.048 bn in September 2023 (roughly 27% of Germany's GDP).

It has been forgotten that a monetary union does not erase current account imbalances which remain, by definition, national.

So even though we are in a monetary union and have a single currency, the monetary reality is different: the value of the euro minus inflation is highly volatile depending on the Member State.

- **The divergence in public debt levels across Member States is a major concern (*see Table 1*)**. Indeed, the public debt-to-GDP ratio has continued to grow steadily in significant countries of the Eurozone (*e.g.* France, Italy, Belgium, Spain) and is approaching – and even in certain cases exceeding – 120% of their GDP. On the contrary, countries such as the Netherlands, Germany or Austria have been able to maintain a ratio of public debt-to-GDP of about 60% or less in the recent years.
- **Disparities are also striking in terms of public deficit (*see Table 1*)**: in 2023, while Germany and the Netherlands have managed to have a public deficit below the 3% threshold (respectively -2.2% and -0.5%), France, Spain and Italy have exceeded the 3% threshold with respectively -4.8%, -4.1% and -5.3%.

CHART 5.
TARGET2 imbalances as of September 2023, % of GDP



Source: Euro Crisis monitor

TABLE 1.
Economic and Fiscal Fundamentals across key EU Member States

	Gross Public Debt, % of GDP					
	2000	2008	2014	2019	2022	2023
Germany	59,3	65,7	75,3	59,6	66,1	64,8
France	58,9	68,8	94,9	97,4	111,8	109,6
Italy	109,0	106,2	135,4	134,2	141,7	139,8
Spain	57,8	39,7	105,1	98,2	111,6	107,5
Netherlands	52,2	54,7	67,9	48,6	50,1	47,1
Portugal	54,2	75,7	132,9	116,6	112,4	103,4
Austria	66,1	68,7	84,1	70,6	78,4	76,3
Belgium	109,6	93,2	107,0	97,6	104,4	106,3
Greece	103,6	109,4	180,4	180,6	172,6	160,9

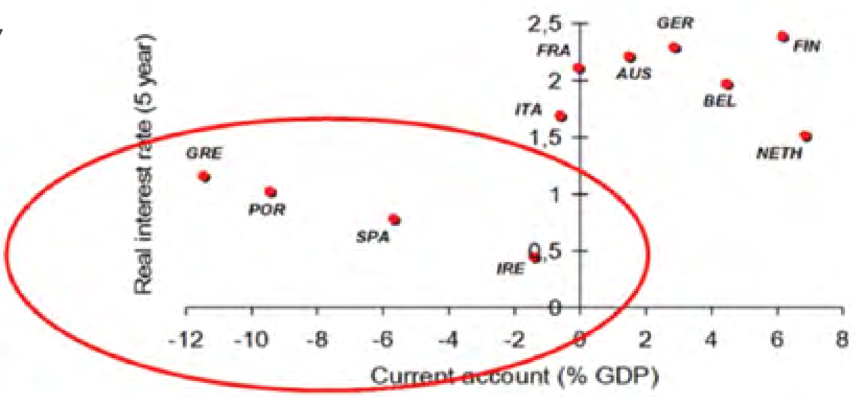
	Total Budget Balance, % of GDP					
	2000	2008	2014	2019	2022	2023
Germany	-1,6	-0,1	0,6	1,5	-2,5	-2,2
France	-1,3	-3,3	-3,9	-3,1	-4,8	-4,8
Italy	-2,4	-2,6	-3,0	-1,5	-8,0	-5,3
Spain	-1,2	-4,6	-6,1	-3,1	-4,7	-4,1
Netherlands	1,2	0,1	-2,2	1,8	-0,1	-0,5
Portugal	-3,2	-3,7	-7,3	0,1	-0,3	0,8
Austria	-2,4	-1,5	-2,7	0,6	-3,5	-2,5
Belgium	-0,1	-1,1	-3,1	-2,0	-3,5	-4,9
Greece	-4,1	-10,2	-3,7	0,9	-2,4	-2,3

	Total Government Expenditure, % of GDP					
	2000	2008	2014	2019	2022	2023
Germany	47,8	44,2	44,3	45,0	49,5	48,2
France	51,7	53,3	57,2	55,4	58,3	56,5
Italy	46,5	47,8	50,9	48,5	56,1	53,1
Spain	39,1	41,4	45,3	42,3	47,4	46,8
Netherlands	42,4	43,5	46,1	42,1	43,5	43,2
Portugal	42,7	45,3	51,7	42,4	44,1	42,5
Austria	51,0	49,9	52,4	48,7	53,2	51,4
Belgium	49,4	50,8	55,6	51,9	53,2	54,9
Greece	46,4	50,8	51,2	48,2	52,9	50,5

	Current Account Balance, % of GDP					
	2007	2011	2014	2019	2022	2023
Germany	6,9	6,2	7,2	8,2	4,2	5,9
France	-0,1	-0,9	-1,0	0,5	-2,0	-0,5
Italy	-1,4	-2,8	1,9	3,3	-1,5	0,8
Spain	-9,4	-2,7	1,7	2,1	0,6	1,9
Netherlands	6,9	8,6	8,5	6,9	9,3	9,2
Portugal	-9,6	-6,0	0,2	0,4	-1,2	1,6
Austria	3,8	1,6	2,5	2,4	-0,3	0,7
Belgium	1,9	-1,9	0,8	0,1	-1,0	0,2
Greece	-15,2	-8,8	-0,7	-1,5	-10,3	-6,7

Source : AMECO
Notes : all data are taken from the Autumn Forecast of the EU Commission (November 2023)

CHART 6.
Real interest rates and external balances, 1999-2007 average



Source : Eurostat, BNP Paribas

As M. Luis de Guindos said: "After four years without EU fiscal rules, governments may have got used to a little bit of a 'whatever it takes' approach with respect to fiscal policy,". "But that has to change. Having a tightening of monetary policy and, simultaneously, an expansionary fiscal policy would be a very bad policy mix."[4]

- **Current Account Balances are another indicator of the heterogeneities of the Euro area (*see Table 1*)**: in 2023, Germany and the Netherlands had Current Account Surpluses of respectively 5.9% and 9.2% of GDP whereas France and Greece had important structural deficits of respectively -0.5% and -6.7%.
- **Regarding inflation in Europe, there were two discernable zones during the 2000s (*see Chart 6*)**: one where inflation was rather high (Spain, Italy...) and one where inflation was rather low (Germany, the Netherlands...).

In other words, while the objective of maintaining an inflation rate similar to the one observed before the global financial crisis (*i.e.* close to 2%) was, on average, attained, it remains that the "peripheral" countries who had let their inflation soar, their budgetary deficits derail and their real estate markets explode, had, in a way, "taken advantage" of the low interest rates of the ECB (whose rates were obviously too low for them while they were more in line with the needs of the more stable core-countries of the Eurozone).

Consequently, the current account balance of countries with high inflation have deteriorated during the 2000s. Meanwhile, countries that had contained inflation had positive real interest rates and current account surpluses, encouraging them to be even more virtuous in their fight against inflation. The monetary system has thus pushed countries towards one extreme or the other depending on their economic discipline.

- **The reality of the European Single Market has not favored more economic coherence**

The single market is an essential objective, but it does not improve the homogeneity and economic performance of all member states in itself. It would only have positive results if all Member States advanced at an almost similar pace in terms of structural reforms.

Cross-border capital flows within the Eurozone have been limited since the euro sovereign debt crisis. Additionally, until 2008, European cross-border capital flows mainly fueled unproductive asset bubbles (in Spain, Ireland...).

- The ECB's interest rates have been structurally lower than the FED's ones for 15 years, which leads to capital flight from the Eurozone to finance the rest of the world, especially the United States.
- The accentuated economic divergences between Member States can scare investors away, as they have better remunerated and less risky opportunities elsewhere, especially in the United States.
- The EU banking market remains fragmented notably due to home-host issues and ring-fencing practices from host countries.
- The Capital Market Union (CMU) remains a dream[5].
- The absence of a European safe financial asset due to the absence of a common fiscal policy.

It is therefore important to promote integrated banking and financial markets where excess savings from North countries could finance necessary investments in South countries which would foster not only growth in Europe and the international role of the euro but also the European strategic autonomy in the financial area. But unfortunately, this does not work due to the increasing economic divergences between Member States.

To overcome the inherent contradiction of the heterogeneity of the monetary zone, there should have been at least one element of macro prudential surveillance: in the 2000s, simple, non-monetary regulatory measures such as loan to value, increasing down-payments by borrowers for loans would have been effective in preventing asset bubbles. We missed out on this macroprudential phase.

It is already difficult to manage a single monetary policy with strong economic divergences, and it's even more difficult if we don't use the simple measures known as macroprudential measures, which would have made it possible, in particular, to attenuate the problems of financial instability in the 2000s.

The current intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a current policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharking and weakens the Eurozone. The prerequisite to move towards a federal EU fiscal capacity is to achieve economic convergence in all parts of the Union in order to build sufficient trust amongst EU Member States.

4. Interview with *Financial Times*, 2 October 2023.
5. To achieve a genuine CMU, the EU needs to have adequate financial products – especially pension funds (essential to fund retirement pensions at the national level), sufficient interest rate remuneration, rules that foster equity financing and securitization, and European actors as well as consolidated infrastructures, which requires a harmonized legal framework regarding bankruptcy and securities.

Consequently, it is not easy to achieve global objectives (*e.g.*, green transition, digitalization, defense, social redistribution, migration...) including monetary stability while maintaining fiscal policies so diverging from one another.

3. The ultra-loose monetary policy in the Euro area (2008-2022) has disincentivized Member States to undertake structural reforms and has led to "fiscal dominance"

The delicate arrangement of the European construction, largely illusory, depended very much on the maintenance of a zero-interest rate policy from the ECB to make public deficits easily financeable. Which is what we did for 15 years! (apart from the crisis of 2009-2011) (*see Chart 7*).

Keeping interest rates at 0 during more than 15 years reduced the financial difficulties caused by the emergence of spreads and the public deficits but encouraged general indebtedness as well as the vulnerability of the financial system and have disincentivized Member States to undertake necessary structural reforms (especially in France and Italy).

The fact that the ECB has gone so far on the fiscal issue (the Eurosystem holds more than 30% of the outstanding public debt) sheds a rather dark light on the concept of independence of the central banks.

Monetary policy can erase spread differentials in the Euro area but can neither solve domestic structural problems nor relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita GDP countries (Spain, Italy, Portugal, Greece)[6].

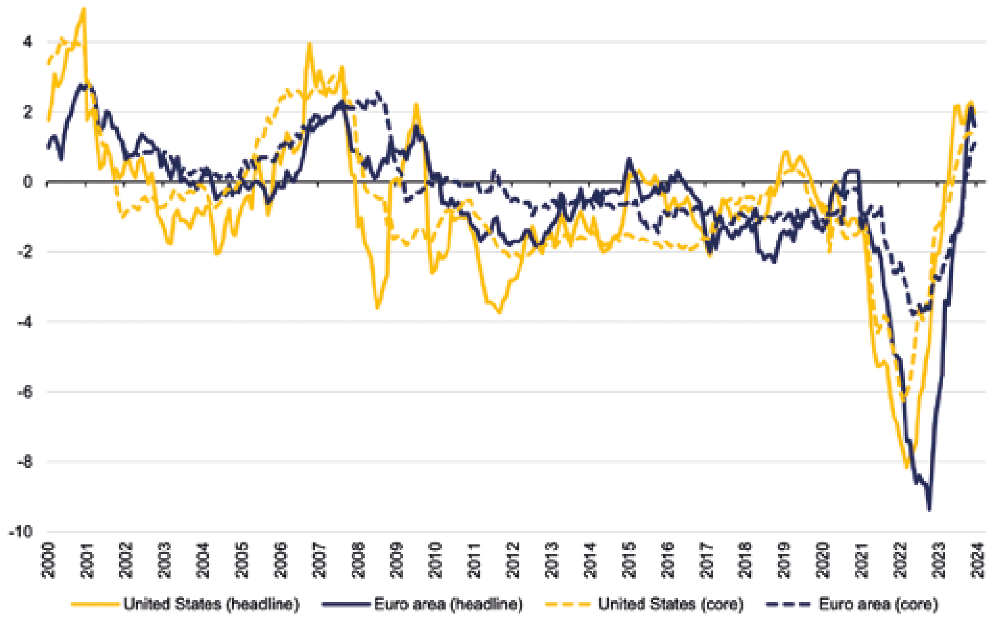
By setting medium and long-term interest rates in an administrative manner, central banks have crossed a crucial boundary: that of intervening in the allocation of resources and the distribution of wealth without letting the market define interest rate equilibria based on the supply and demand of capital. In fact, central banks have systematically favored debtors over creditors. Are we still in the realm of monetary policy or in a market economy?

Now, the debt servicing costs are rising along with the interest rates and are becoming heavy on highly indebted countries' budgets, leaving them with really little room for maneuver. Without efforts to comply with the fiscal discipline required by a monetary union, the sustainability of the debts of certain EU Member States could be questioned.

When the ECB massively buys financial securities, it is, by definition, running a risk, which is that of the intrinsic value (risk of default) and duration (interest-rate risk) of these securities.

If the Central Bank has miscalculated its risk (by underestimating inflation or forcing rates to 0 while financial bubbles are inflating), it is preparing for a crisis. This is exactly what is keeping.

CHART 7.
Real Interest rates in the United States and the Euro area, percentage points



Sources: Fed, ECB
Real policy rates are calculated as the difference between the nominal interest rates and year-on-year headline/core inflation of the corresponding period ; Last observation from December 2023

6. This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between the Eurozone countries, the insufficient number of investment projects and the absence of a European industrial policy.

In the ascending phase of QE, governments were happy with the fall in rates and the rise in the value of Treasury securities. But as soon as inflation reappeared and rates had to be raised, governments began to worry: borrowing would cost them more, and they would have to make up the central banks' deficits (through recapitalization) and suffer the consequences of rising interest rates.

- What goes around comes around. A political agenda that encourages fundamental economic divergence is one that turns its back on reality. And when one turns its back on reality, the spreads of interest rates on the markets tend to increase and the spreads for the least competitive countries to jump.

As long as it is not sufficiently understood, especially in highly indebted countries, that over-indebtedness is a source of under-competitiveness and higher spreads, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to make progress in the construction of an economic and financial Europe.

Indeed, the intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharking and weakens the Eurozone.

4. Necessary improvements are required to face challenges ahead of the EMU

Monetary policy must continue to be normalized to fight inflation

ECB should pursue the normalization of monetary policy to fight inflation which remains persistent and elevated.

TABLE 2.
Evolution of real key rates since inflation started

	Nominal key rates in 2021	Key rates in Dec. 2023 (a)	Underlying inflation, Dec. 2023 (b)	Real rate (a-b)
Fed	0%	5,5%	3,9%	1,6%
BCE	0%	4,5%	3,4%	1,1%

In recent months, real interest rates have turned positive in the Eurozone, which is necessary to keep inflation under control.

However, should the monetary policy consider the possible financial fragmentation that exists in the Eurozone?

The fear of the reappearance of spreads in Europe should not dominate the decision-making process of the monetary policy. Indeed, sooner or later, structural spreads – based on the past accumulation of fiscal and structural deficiencies – in Europe will appear on the markets.

The ECB is certainly concerned with moderating "excessive" market rate differentials between European countries. But central banks do not have an obligation to systematically erase all traces of interest rate differences in the appreciation of the markets. The elimination of all spreads would be difficult to reconcile with the Maastricht Treaty, as some member states – known for their fiscal discipline – place greater emphasis on the objective of monetary stability (believing that the ECB should not monetize public debt).

Monetary policy cannot solve structural issues. Member States are the ones which must adjust their economic and fiscal policies accordingly to address their domestic economic weaknesses.

It would make sense to decisively start a quantitative tightening monetary process in order to undo the excessive liquidity that has accumulated during the years of monetary accommodation.

The review of the Stability and Growth Pact (SGP) is not ambitious enough

Turning to fiscal policy, it is time to tighten belts. Public debt levels are at records and fiscal deficits remain way too large in large EU member States (France, Italy, Spain in particular). The fact that money has been thrown at the problems for years has worked against supply-side policy which are essential to raise potential growth, and which have been the orphans of this EMU story during the 25 past years.

Excessive deficits and debt work against economic growth. In the absence of an competitive production system stimulating demand does not translate into increased domestic production, but leads to a widening of our trade deficit if a country does not have an efficient production system. In this respect, the quality of public spending is becoming an absolute imperative: as much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spendings.

On 21 December 2023 the Ecofin Council achieved an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament on the preventive arm regulation.

The goal of simplification of the rules has regrettably not been achieved. What is even more worrying is that the Commission's proposal demands from the most indebted countries the smallest effort, which should perpetuate the decline of these economies.

The European agreement on the Stability and Growth Pact of December 2023[7] contains some positive elements:

- The case-by-case framework – which is a specific technical dialogue between the EU Commission and each Member State regarding their differentiated multi-year budget trajectory – has been introduced in the reformed Pact. It enables a differentiated approach towards each Member State to take account of the heterogeneity of fiscal positions, public debt and economic challenges across the EU.
- This dialogue will be based on a new indicator, the "net expenditure[8]", which should, in principle, serve as a basis for setting a fiscal path and carrying out annual fiscal surveillance for each Member State. The multi-annual trajectory for this indicator, prepared by each Member State, must also be adopted by the Ecofin Council, which could reinforce the self-discipline of Member States.
- The obligation to reduce the public debt-to-GDP ratio by a minimum average of one percentage point of GDP per year over a period of 4 to 7 years for countries where outstanding public debt exceeds 90% of GDP (preventive aspect of the Pact) has been introduced. This measure is reduced to 0.5% for countries whose debt is between 60% and 90%.

However, there are several areas of concern:

- Countries that are subject to an excessive deficit procedure (total public deficit over 3% of GDP) are exempt from the rule requiring them to reduce their public debt by an average of 1% a year until their deficit falls back below 3%. These countries will only be subject to the procedure once their public deficit has fallen back below the 3%. This is not the best way to encourage the worst performers to reduce their debt to GDP ratio! It's as if the worst performers in a class were exempt from extra effort and sanctions as long as their results remain mediocre.
  The quality of public spending and composition on public finances must be given more importance than its quantity[9]. A review of the composition of public finances must take corrective actions to ensure a path to primary surpluses and reduce unproductive public spending. Illusion over these countries 'capacity to stimulate demand should be ditched out. But if countries that are subject to an excessive deficit procedure are not required to reduce their public debt by an average of 1% a year, they will have no incentive to do so. This is an incentive to remain above a 3% deficit for as long as possible. When the level of public debt is at the limit of what can be tolerated, the trade-off in public spending is generally in favour of the most current and unproductive expenditure in order to cope with the next day, instead of giving priority to research, training and well-chosen public infrastructure investment.
- Adjustment implementation horizons seem very long: 4 to 7 years to reduce the public deficit below 3% and experts deem the Commission unlikely to force a government elected with different priorities in the middle of the seven-year cycle to implement policies agreed by its predecessor[10]. As mentioned by L. Garicano, "the framework is also vulnerable to manipulation through creative accounting and over-optimistic growth assessments".
- For the transitional period in 2025, 2026 and 2027, the Commission may exclude the expected rise in debt servicing costs from the calculation of the adjustment effort, despite the fact that this will be the largest item of budget expenditure in some countries.
  This measure raises questions insofar as it reduces the effectiveness of the mechanism and weakens efforts to consolidate the public finances of over-indebted Member States.
  This measure is all the more questionable given that, between 2014 and 2022, some Member States that benefited from very low interest charges due to zero or even negative interest rates have not begun to rebuild their primary budget surpluses.
- Reference is made to the structural deficit in both the corrective and preventive sections of this revised Pact. Its definition as a "cyclically adjusted deficit" risks weakening the agreement. Why take up this complicated reference, which has failed to reduce excessive deficits in the

7. At the time this note is written, the preventive arm of the proposal still has to be adopted by the European Parliament.
8. "Net expenditure" means "government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programs of the Union fully matched by revenue from Union funds, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures" (Chapter 1, article 2).
9. See J. de Larosière and D. Cahen, "Reforming the Stability and Growth Pact", , Eurofi Regulatory Update, April 2023.
10. L. Garicano, "The EU's new fiscal rules are not fit for purpose", *Financial Times*, 8 January 2024.

past, and not keep the simple notions of total public deficit (as a % of GDP) or primary budget surplus, which are essential ratios for putting the public debt trajectories of the most indebted countries back on a sustainable path?

- In any case, primary budget surpluses are necessary to reduce public debt, but not sufficient for a return to growth, as shown by the example of Italy in the years preceding Covid-19. These primary surpluses must be accompanied by the implementation of structural policies to return to growth (*see detailed recommendations related to these reforms issued by the OECD and the IMF – articles IV*).
- The Commission's powers to enforce these "new" rules have not been strengthened, even though it can initiate an excessive deficit procedure based solely on the criterion of public debt in relation to GDP.

What makes these new rules any more likely to be implemented than the previous ones? All the more so as the final discussions in the Council focused on minimum safeguards, which risk becoming maximum rules...

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The postponement of the of budgetary adjustment for countries subject to an excessive deficit procedure and the extremely long periods granted to over-indebted countries to bring their public debt back to below 60% of their GDP (around 50 years for France, 80 years for Italy) are based on two erroneous prejudices:

- The reduction in the public debt ratio is based on the expectation that medium – and long-term interest rates will return to very low levels in the coming years, which is likely to prevent budgetary efforts (*i.e.* cuts in public spending). The peak of the increase in the interest burden on the public debt of hyper-indebted countries is expected to be reached by 2027 and should subsequently fall as a result of the return to permanently low interest rates. This is the "easy money" paradigm: an accommodating monetary policy (permanently low interest rates) avoids budgetary efforts.
- Any budgetary adjustment is "by nature" recessionary because economic growth is based primarily on domestic demand.

These two assumptions should lead European countries with excessive debt to continue their economic decline. There are several explanations:

- Recent monetary history (2014-2021) puts the emphasis on the paradigm of easy money which leads to excessive debt that does not stimulate economic growth. Persistent low (or even negative) interest rates over this period have not led to an increase in productive investment but have on the contrary encouraged savers to keep their financial assets in liquid instruments (see Eurofi Scoreboards) and not to channel them in securities geared to long-term investments[11]. Furthermore, persistent low interest rates encourage indebtedness and the proliferation of asset bubbles, increase wealth inequalities and favor a misallocation of resources (*e.g.* development of zombie firms).
- Excessive deficits and debt jeopardize economic growth. They require an increasing tax pressure, which deteriorates further the competitiveness of companies in these countries. Stimulating demand does not translate into increased production but leads to a widening of trade deficit if a country does not have an efficient production system. On the contrary, what is needed to increase potential growth and achieve a better allocation of resources is:
  - To return to primary surpluses as soon as possible,
  - To rationalize of public spending – qualitative public spending must be an absolute priority – in countries where the public spending-to-GDP ratio exceeds the European average,
  - To steer supply side-oriented reforms that enhance productivity gains.

The Macroeconomic Imbalance Procedure (MIP) needs to be rigorously respected thanks to equal treatment and multilateral surveillance assured by an independent dedicated Commission.
Unfortunately, the review of EU economic governance rules does not address this issue.

The Macroeconomic Imbalance Procedure (2011) must be applied effectively, and evenly among all Member States. This means that the adjustments of the current account balances should not only concern countries running structural deficits, but also countries running structural surpluses.

It is not possible nor honest to expect South countries to be the only ones to indefinitely scale down their revenues to compensate for the growing surpluses of North countries.

11. Long-term investments do not produce returns consistent with the risks involved in such projects. So, savers act rationally and prefer to keep liquid banking accounts that are easily mobilizable. This is the "liquidity trap" feared by Keynes which is particularly severe in European countries that do not have the risk appetite for equity that characterizes US markets.

It is therefore high time to design and implement a **symmetric** adjustment mechanism where surpluses are addressed the same way deficits are. Unfortunately, the revision of the EU economic governance framework did not change the MIP.

The present complex situation where a monetary union is run without a credible mechanism dedicated to economic stability is not sustainable in the long term. Member States must use their fiscal and structural policies to strengthen the cooperation that the Union needs. In the present circumstances, the European Union with 27 members is not willing to force economic convergence on Member States in the name of a discipline that ultra-loose monetary policy discouraged.

To break this contradiction, it is essential that the European executive power, and more precisely the Commission, assume their responsibility regarding the respect of economic discipline.

This requires independence, skills, vision and courage from the leaders in charge of these economic topics within the Commission.

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It has to be acknowledged that institutional progress has been achieved to a certain extent. Such progress can be illustrated by the creation of the European Stability Mechanism (2011) and the design of Next Generation EU (2020).

These are positive decisions as they emphasize the need for structural adjustment. However, it cannot be ignored that the financing on the market of both these initiatives is accompanied by average interest rates that reflect the European economic heterogeneity.

When comparing NGEU (€800 bn) and the American IRA ($369 bn), one thing is striking: the American funds are easily and quickly accessible and work as an incentive to achieve the fixed objectives, whereas national and European bureaucracies make the process of spending NGEU funds cumbersome and relies heavily on prohibitive rules. As a result, only 30% has been spent halfway through the lifetime of the project. Additionally, some European companies have been attracted by the IRA and have thus shifted investment to the US, including Total Energies, MBW and Northvolt.

Several economists think that it is not possible to finance massive investment in the ecological transition if Eurozone fiscal policy brings fiscal deficits below 3% of GDP and if monetary policy keeps inflation below 2%. They propose to accept higher inflation, low interest rates and fiscal deficits in excess of 3%.

These are dangerous ideas for several reasons:

- The negative real interest rates do not favor productive investment as observed for 10 years but encourage liquid assets holdings as well as the proliferation of asset bubbles (*see Eurofi Monetary Scoreboards*) and increase wealth inequalities.
- Inflation reduces the purchase power of households and reduces consumption.
- Economic uncertainty linked to inflation hold productive investment back.
- Public deficits can only be accompanied by an increasing tax pressure, which will deteriorate further the competitiveness of companies.

Contrarily, we must fight persistently high inflation: it is necessary to refrain from administratively fixing long-term interest rates and to accept to let the market remunerate medium and long-term savings according to supply and demand, without which there can be no productive investment or productivity gains.

National budgets must be under control in all part in the Union: the future depends on a consolidation of present weak fiscal positions (primary surpluses) and shift towards qualify of expenditure and investment.

To do that, there is a need for a deep review of all the layers of national public spending – renewed because voted beforehand – and for the reduction of unproductive and socially not obvious spendings.

The idea of labelling a spending as "investment" and to add it on top of the 3% rule makes no sense. Indeed, given the little room for maneuver that countries have in terms of budget, it is paramount to substitute productive investment to spending that does not benefit the general interest. The experience has proven that the 3% rule has been perfectly applicable in countries like Germany, which is among those having the most productive investment and the least non-necessary public spending.

Furthermore, increasing public deficits is not a solution, as market rates would become even tighter, and the borrowing machine would be hindered. Ultimately, if we were to continue, at all costs, to pile up public debt, the risks of a market downturn would become very serious, just when we had exhausted our fiscal margins.

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If fiscal, inflationary and economic drift continues in the Eurozone, the "virtuous" countries will end up paying for it. This would be the definition of an uncooperative game, where most players try to evade their obligations by passing on the cost to those who respect them. We must therefore take the Union's destiny into our own hands and not let it drift. If this is to be the case, the logical outcome could well be a new and inevitable Eurozone crisis.

Addressing indebtedness in the European Union

Note written by Didier Cahen and Alicia Valroff

Executive summary

Even before the Covid-19 and the energy crises, global debt was at an all-peacetime record. According to the BIS, global debt has risen from 173% of GDP in 2001 to 240% in 2023. This unprecedented rise in debt over the past 20 years is the result of ultra-accommodative monetary policies and very low interest rates. Furthermore, in Europe, the fiscal rules of the Stability and Growth Pact have not been respected by some large Member States.

Excessive debt is a source of crisis. In the face of certain countries' over-indebtedness, it is necessary to gradually reduce the current excess of debt by questioning public budgets, giving priority to qualitative expenditure for the future and the undertaking of structural supply side-oriented reforms, which are the only way forward and that have been postponed for too long.

On 21 December 2023 the Ecofin Council achieved an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament. The goal of simplification of the rules has regrettably not been achieved. What is even more worrying is that the Commission's proposal demands from the most indebted countries the smallest effort, which should perpetuate the decline of these economies. Indeed, according to this Ecofin Council compromise, countries that are subject to an excessive deficit procedure (total public deficit over 3% of GDP) are exempt from the rule requiring them to reduce their public debt by an average of 1% a year until their deficit falls back below 3%. This is not the best way to encourage the worst performers to reduce their debt to GDP ratio! It is as if the worst performers in a class were exempt from extra effort and sanctions as long as their results remain mediocre.

If fiscal, inflationary and economic drift continues in the Eurozone, the "virtuous" countries will end up paying for it. This would be the definition of an uncooperative game, where most players try to evade their obligations by passing on the cost to those who respect them. We must therefore take the Union's destiny into our own hands and not let it drift. If this is to be the case, the logical outcome could well be a new and inevitable Eurozone crisis.

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Introduction

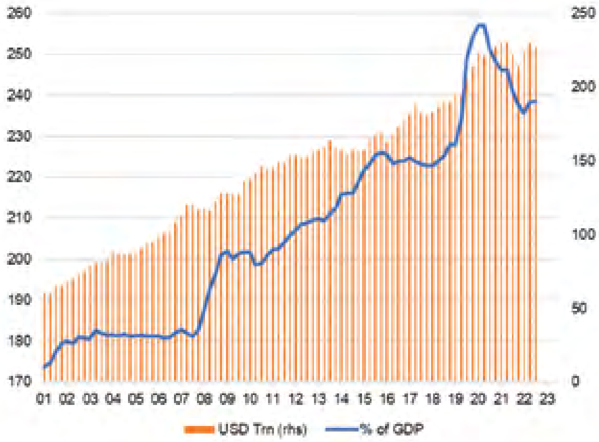
Excessive debt is a source of crisis. Examples abound, such as the European sovereign debt crisis (2011-2012) that would not have occurred if public debt in several EU countries had not been so high.

Even before the Covid-19 and the energy crises, global debt was at an all-peacetime record as evidenced by Chart 1. Indeed, the continuation of very low interest rates during the past two decades has pushed many advanced countries to implement active fiscal policies and economic agents to borrow more. Indeed, global public debt in advanced economies has grown by 30% between 2007 and 2019, according to the World Bank. In the Euro area, the aggregate government debt-to-GDP ratio in the same period rose from 65.9% to 85.9% – debt has grown by one third compared to the pre-crisis level.

The unprecedented rise in debt over the past 20 years is the result of ultra-accommodative monetary policies and very low interest rates. Furthermore, in Europe, the fiscal rules of the Stability and Growth Pact have not been respected by some large Member States.

The Maastricht Treaty specifies reference values – known as The Maastricht criteria – for the general government sector of the various EU Member States: government deficit should not exceed 3% of the GDP, and government debt should stay below 60% of the GDP. But in 1998, a political logic replaced the accounting reading of the debt situation. Indeed, Belgium and Italy – two founding countries of the European Union – qualified for entry into the Eurozone with public debt-to-GDP ratios of 117% and 115% respectively.

CHART 1.
Global debt as a % of GDP



Source: Bank for International Settlements (BIS)
Note: global debt gathers 45 advanced and emerging economies; last observations from Q2-2023

Since then, the European Union has accepted that debt could be inexorably rising in many Member States. In the Euro area, the divergence in public debt levels has become a major concern. While negative interest rates ensured the sustainability of European countries' public debts in the short term, the absence of structural reforms to gradually reduce these public debt-to-GDP ratios in the long run may lead to economic decline and call into question the future of the Eurozone.

Monetary policy and the resulting credit expansion in the 2000s played a major role in preparing the Great Financial Crisis of 2008. Since then, many advanced countries have continued to increase their recourse to public debt encouraged by lasting very low – and even negative – interest rates, and eventually to ask future taxpayers to bear a large part of the costs that the present generation refuses to assume.

In the face of certain countries' over-indebtedness, it is necessary to gradually reduce the current excess of debt by questioning public budgets, giving priority to qualitative expenditure for the future and the undertaking of structural reforms, which are the only way forward and that have been postponed for too long.

This paper focuses on public and private indebtedness issues in the European Union. The first part of this paper shows that European economies – be they part of the Euro area or not – are characterized by significant public and private debt divergences. The second aims at explaining how public and private debt levels got out of control in many European countries, especially large Member States. The third part outlines the different issues brought about by excessive public and private debt levels, while the last part explores the potential solutions that would enable highly indebted countries to recover healthy public and private finances.

1. The Euro area and the EU are characterized by significant public and private debt divergences

The first part of this note aims at depicting the state of public and private debts across EU Member States and identifying certain categories of countries according to their public and private debt levels. Indeed, great divergences can be observed between countries, be it in the levels of debt of governments and of private economic agents (households and Non-Financial Corporations (NFCs)).

1.1 Public debt-to-GDP ratios differ widely across Member States

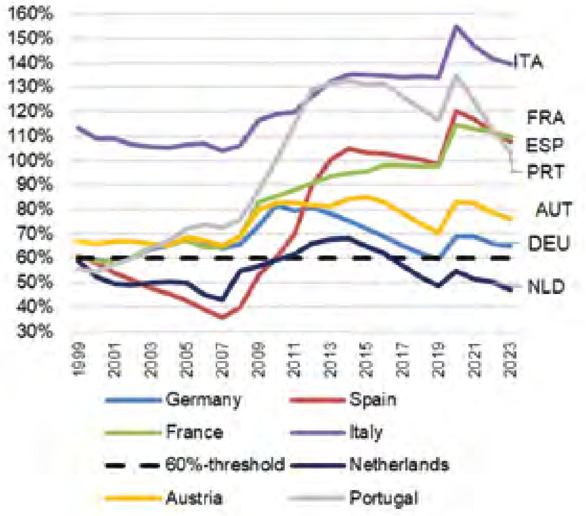
At the end of 2023, public debt has reached a very high level in a small set of mainly large European countries.

Despite the different reforms decided in the wake of the sovereign debt crisis (European Semester, Six pack, Two pack, Treaty of stability, coordination and governance in the Economic and Monetary Union), the public debt-to-GDP ratio has continued to grow steadily in significant countries of the Euro area (*e.g.* France, Italy, Belgium, Spain, Portugal) and is approaching – and even sometimes exceeding – 110% of GDP in certain Member States (*see Chart 2*)[1]. On the contrary, countries such as the Netherlands, Germany or Austria have been able to maintain a ratio of public debt-to-GDP of about 60% or less[2].

In 2023, 14 countries in the EU had a public debt-to-GDP ratio below 60% (Estonia, Bulgaria, Luxembourg, Sweden, Denmark, Lithuania, Latvia, Czech Republic, Ireland, Romania, the Netherlands, Poland, Malta, and Slovakia). However, two countries had a public debt exceeding 130% of their GDP: Greece (160.9%), Italy (139.8%). Portugal,

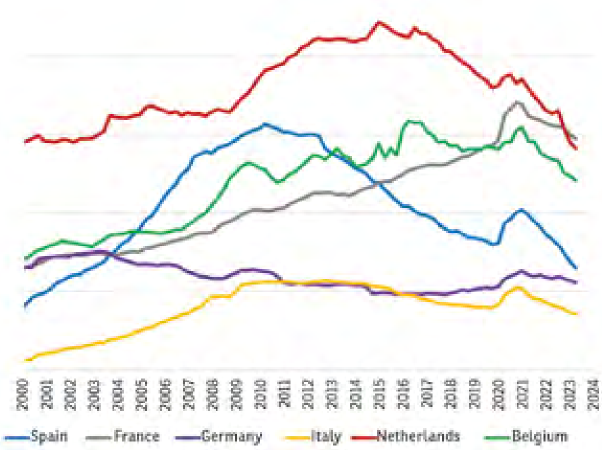
1. Between 2008 and 2022, gross public debt-to-GDP ratio increased by 38.2 pp in Italy, 42.5 pp in France, 20 pp in Spain and 11.6 pp in Belgium.
2. Gross public debt-to-GDP ratio increased by 1.7 pp between 2008 and 2022 in Germany, and by 3.9 pp in the Netherlands.

CHART 2.
Evolution of Gross Public Debt to GDP ratio in Major Eurozone Economies, %



Source: EU Commission; Data for 2023 are taken from EU Commission's Autumn Forecasts of November 2023

CHART 3.
Non-financial private debt, % of GDP



Source: BIS
Last observation from 2023-Q2

France, Spain, and Belgium also had high public debts, exceeding 100% of their GDP (respectively 103.4%, 109.6%, 107.5% and 106.3% of GDP), well above the average of the 27 countries (83.1%), while Germany and the Netherlands showed respectively 64.8% and 57.1%.

Chart 2 shows a surge in government debt in all countries – whatever their level of indebtedness – due to the Covid-19 crisis. However, debt has marginally decreased after its peak of 2020 because of high inflation and enhanced growth – that followed the end of lockdowns, but it remains nowadays at levels above to their pre-pandemic levels. Besides, the energy crisis has not widened the gap between Member States' public debt-to-GDP ratios, though the latter have stabilized at elevated levels in many EU countries[3].

1.2 Significant divergences among Member States are also observed in private debt levels

Private debt, *i.e.* the debt of households and non-financial corporations, has strongly diverged across EU Member States over the past years as evidenced by Chart 3[4].

In France, private debt has increased from 181.1% of GDP in 2013 to 226.1% in March 2023 according to the BIS.

By contrast, private debt fell significatively in Spain from 202% of GDP in 2013 to 140.9% in March 2023 following the deleveraging of companies and the deflation of the real estate bubble. It also decreased in Italy from 125% of GDP to 107.8% and increased slightly in Germany from 124.3% to 126.4% over the same period.

Although the level of French private debt remains lower than that of the Netherlands until Q4-2022 as share of GDP, it should be noted that the Netherlands' private debt decreased by 48.2 pp in 2023 compared to 2013 while it increased by 47.1 pp in France in the meantime. Since Q1-2023, the private debt of the French NFCs has exceeded the Dutch's one, after the latter fell by an additional 10 pp between Q4-2022 and Q2-2023.

1.3 Several categories of countries can be drawn from their levels of public and private debt

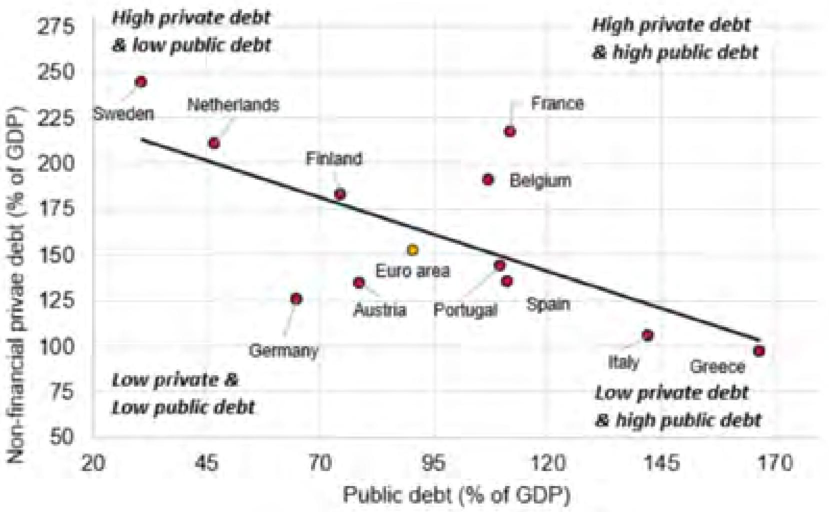
As underlined above, private and public debt levels vary across EU Member States, and debt profiles fall into four categories that are observable on Chart 4.

The first category gathers countries that have both low public and private debts, namely Germany and Austria below Eurozone average.

The second category encompasses countries that have high public but low private debts. This category includes Italy, Greece, Spain and Portugal, which are among the countries with the highest public debt-to-GDP ratios in the Euro area while their level of private debt is below the Euro area average.

3. See 2.1.4.
4. It must be acknowledged that private debt has often increased due to the indebtedness of non-financial corporations than of households since 2010; see Appendix 1.

CHART 4.
Private debt v. public debt across selected Euro area Member States, as of Q2-2023



Source: BIS

The third category encapsulates countries that have low public but high private debts. The Netherlands, Finland and other EU Member States that are not part of the Euro area like Sweden fall into this category. For instance, the level of Dutch public debt is one of the lowest in the Euro area – 48.4% of GDP in Q2-2023 – while that of the private sector ranks among the highest with 215% of GDP.

The fourth category is made of countries that have both high public and private debts. It includes France and Belgium which have respectively a public debt of 112.5% and 107.4% of GDP and a private debt of 226.1% and 193.9% of GDP, well above the average for both public and private debt in the Euro area (152.1% of GDP). This category is more exposed to challenges linked to the rise in interest rates; all economic agents – be they public or private – are more vulnerable to the macro-economic and monetary changes. The threats of a financial crisis are all more important in such countries, especially since potential growth is low.

2. How did we get there?

This second part of this note focuses on the two main explanations of the diverging debt levels illustrated above. First of all, a chronological study of debt trajectories over the last two decades outlines that some large EU Member States have let their public debt-to-GDP ratios slip in non-crisis times whereas others have demonstrated more discipline with respect to the fiscal criteria of the Stability and Growth Pact (SGP), and that in some cases private debt levels followed the same path as public debt ones. Second of all, excessive public debt in some EU Member States have been strongly enabled by the ECB's ultra-accommodative and asymmetric monetary policy since the EU sovereign debt crisis (2011-2012) and the lack of fiscal discipline.

2.1 A chronological observation shows that debt levels of over-indebted EU countries have risen in crisis-times (GFC, sovereign debt crisis, Covid-19…) as well as in non-crisis times

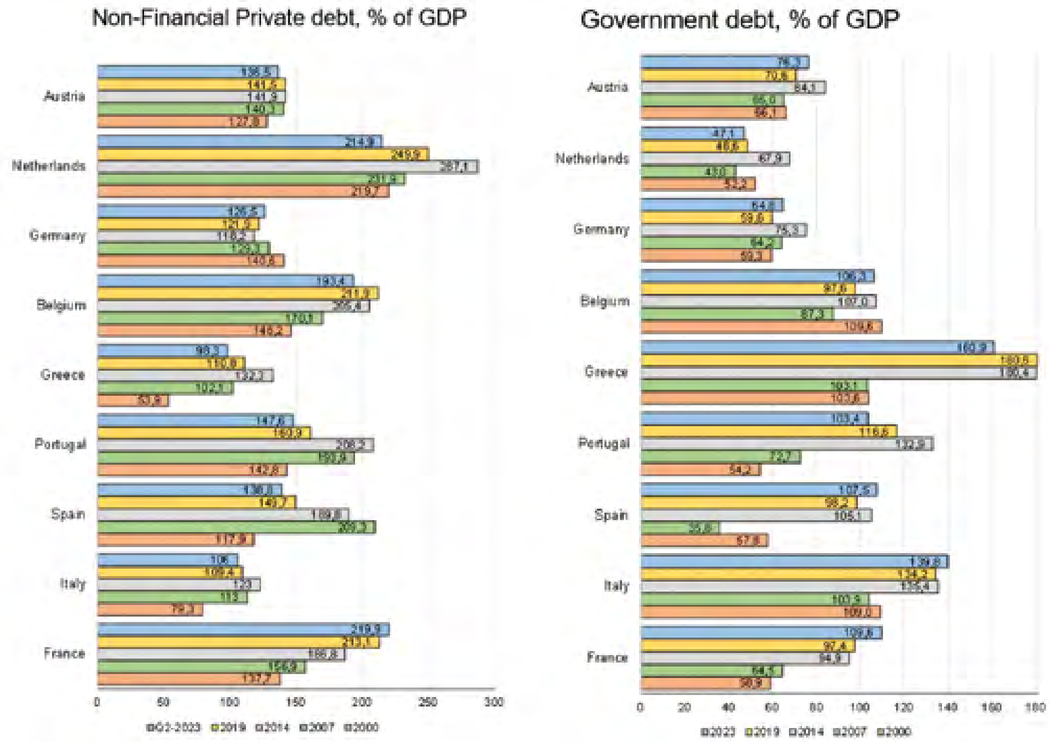
Chart 5 and the following sections aim at providing a chronological understanding of diverging debt trajectories in EU Member States. The first section focuses on the period 2000 and the EU sovereign debt crisis by showing that, despite the fact that most Eurozone countries met the Maastricht fiscal criteria until 2007, public debt levels soared in all parts of the EU in the wake of the Great Financial Crisis (GFC) and the EU sovereign debt crisis.

The second section studies the increase in Member States' fiscal heterogeneities between 2014 and 2019, while the third section shows that these fiscal heterogeneities have been exacerbated by the Covid-19 crisis. Section 4 shows that the divergences in terms of fiscal deficits and public debt have not been accentuated by the Russian war in Ukraine, but that public debt-to-GDP ratios have stabilized at high levels in 2022 and 2023. Eventually, the fifth section puts in perspective the private and public debt trends.

2.1.1 Even though most Eurozone countries complied the Maastricht fiscal criteria between 2000 and 2007, their public debt soared with the Great Financial Crisis and the EU sovereign debt crisis

Before the subprime crisis, with a few exceptions, fiscal deficits were relatively limited (*see Chart 6*). Thus, in the period preceding the crisis (2000-2007), the fiscal balance was, on average, positive in

CHART 5.
Government and private sector debt across selected Eurozone Member States since 2000, % of GDP

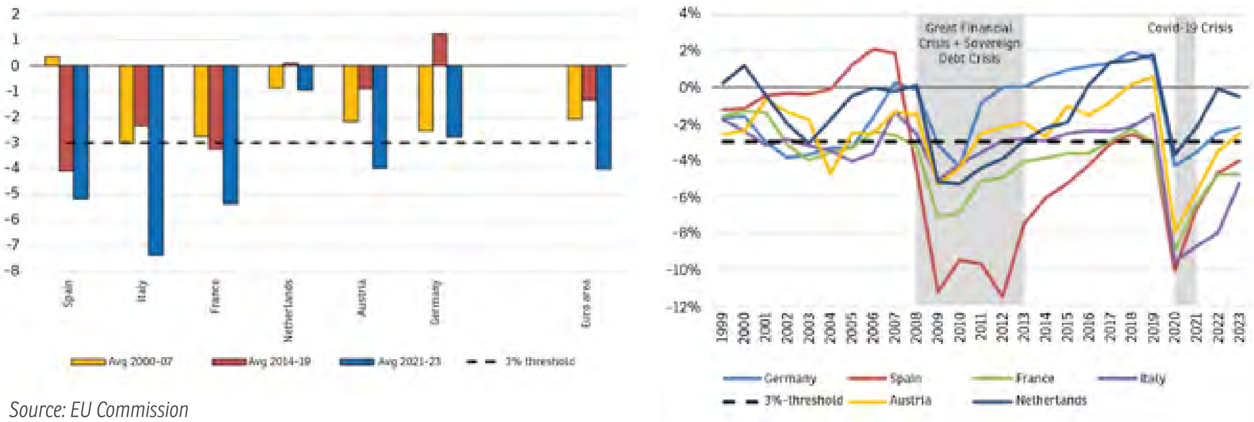


Source: BIS, EU Commission's Autumn Forecasts (November 2023)

CHART 6.
Total Budget Balance across the main EU Member States since 1999, % of GDP

6a. An average over selected non-crisis periods

6b. Since 1999



Source: EU Commission

Ireland (1.4% of GDP) and Spain (0.4%)[5]. It should be noted, however, that both countries' government revenues were kept artificially high by tax revenues generated by with a real estate boom. In contrast, fiscal balances were negative in Austria (-2.2%), Germany (-2.5%), France (-2.7%) and Italy (-3%), but only Greece (-6.4%) did exceed the Maastricht criterion of 3%.

When the crisis broke out in 2007, public debt-to-GDP ratios soared, especially in Southern Europe countries, as evidenced by Chart 5. For instance, Spain had a public debt of only 35.8% of its GDP; in 2013, its debt reached 100.5%. In Ireland and Greece, over the same time period, the debt-to-GDP ratio rose from respectively 23.9% and 103.1% to respectively 119.6% and 178.2%. Countries of Southern Europe have been particularly hit by the GFC because of "sudden stop" in capital flows: over the period 2000-2007, they benefited from massive foreign capital flows, which suddenly stopped in the aftermath of the collapse of Lehman Brothers.

As a consequence of the GFC, growth fell in every part of the world, leading public debt-to-GDP ratios to mechanically increase. Additionally, "the

5. Data for Ireland and Spain are from R. Baldwin & F. Giavazzi, "The Eurozone Crisis A Consensus View of the Causes and a Few Possible Solutions", CEPR Press (2016).

governments also supported the financial system by increasing deposit insurance ceilings, providing guarantees for bank liabilities, and recapitalizing banks being bailed out or wound down. In addition, they implemented fiscal measures to reduce the fall-out of the crisis on the rest of the economy. This resulted in a mix of 'automatic stabilizers' (decreasing tax receipts coupled with increased government welfare payments as the economy slows down) and targeted discretionary fiscal measures, such as tax relief and subsidies for part-time employment. These actions let to a dramatic escalation of public debt"[6]. For instance, the Spanish government debt has tripled from 35.8% of GDP in 2007 to 105.1% of GDP in 2014 (*see Chart 5*).

Such increases have cast doubt upon the ability of governments to sustain large debt burdens; higher debt-service costs combined with a plummeting GDP made many investors suspect that several Member States' debts might be unsustainable. Indeed, EGOV explains that "the [Sovereign debt] crisis occurred as a result of soaring public debt: it was triggered when the under-reporting of the Greek public debt and deficit was revealed in 2009. A domino effect followed owing to a massive loss of confidence on the part of financial markets in the creditworthiness of several other Member States. Ireland and Spain came under scrutiny owing to negative effects caused by the bursting of real estate bubbles and the increasing public debt used to bail out banks. Portugal owing to a large and increasing macroeconomic imbalances, and Cyprus following a profound banking crisis"[7].

2.1.2 Fiscal heterogeneities across EU Member States have increased between 2014 and 2019

In low-indebted Member States such as Germany, the Netherlands and Austria, enhanced growth and primary surpluses contributed to maintain healthy public finances.

In 2019, after several years of efforts to reduce their general government deficit and debt, the Netherlands and Germany brought back their public finance stance in line with EU fiscal rules. Indeed, between 2014 and 2019, they ensured an average public surplus of respectively 1.3% and 0.1% of their GDP per year. Such fiscal efforts resulted in a gradual reduction and a stabilization of their public debt, at respectively 59.6% and 48.6% of GDP in 2019, from 75.3% and 67.9% in 2013. Austria also made such efforts over that period, contributing to reducing its public debt burden to 70.6% of GDP in 2019, down from 84.1% in 2013 (*see Chart 5*).

In countries where debt exceeds 100% of GDP, public debt trajectories have been heterogeneous between 2014 and 2019.

Over the period running from 2014 to 2019, a period characterized by economic stability, some EU Member States still saw their public finances deteriorate, or at least did not see significant improvements. It is the case of France, Italy, Spain, Belgium, Portugal and Greece (*see Chart 5*).

First of all, some EU Member States such as France and Spain deviated permanently from the fiscal rules established by the Stability and Growth Pact. The French debt rose from 94.9% of GDP in 2014 to 97.4% of GDP in 2019, and this is due to the accumulation of yearly fiscal deficits. Indeed, the total deficit of France between 2014 and 2019 averaged 3.2% of GDP per year, exceeding the 3%-threshold decided by the Maastricht fiscal rules. Over the period 2014-2019, Spain also had yearly fiscal deficits exceeding 3% of GDP: namely Spain's deficits averaged 4.1% of GDP per year between 2014 and 2019, and were rarely below 3% except in 2018 (2.6% of GDP). Yet, its public debt has been reduced a little, from 105.1% of GDP in 2014 to 98.2% in 2019 mainly thanks to denominator effect (high nominal GDP growth), which mechanically reduced its public debt-to-GDP ratio.

Second of all, other EU Member States like Italy and Greece have been more rigorous and have accumulated primary surpluses. Nevertheless, their fiscal efforts have been insufficient to compensate low growth and high debt-servicing costs. Indeed, over the period 2014-2019, Italy and Greece had average primary surpluses of respectively 1.6% and 2.3% of GDP per year, but this was insufficient to compensate for (i) large debt-servicing costs amounting to respectively 3.9% and 3.4% of GDP and (ii) stagnant growth, which averaged respectively 0.9% and 0.7% per year. As a result, public debt in Italy was only reduced by 1.2 pp in 5 years, and the Greek public debt stabilized at about 180.5%.

Eventually, other heavily indebted countries such as Belgium and Portugal managed to reduce their public debts thanks to enhanced growth and primary surpluses. Indeed, over the period 2014-2019, Belgium and Portugal were among the countries that had the most dynamic real GDP growth, averaging respectively 1.8% and 2.3% per year – which is close or above the growth of Germany (1.8%) and France (1.5%). Moreover, the two countries both accumulated primary budget surpluses with respective average of 0.6% and 1.1% per year between 2014 and 2019. Additionally,

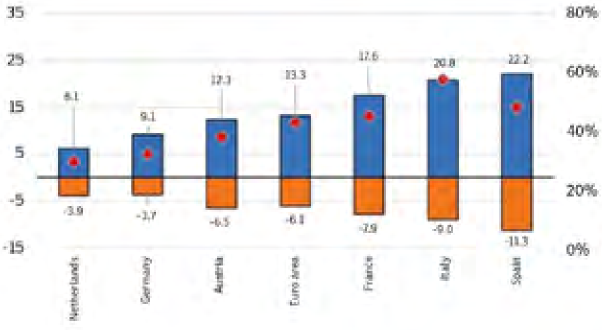
6. "A decade on from the crisis", EGOV, 2019.
7. Op. Cited think tank of the European Parliament.

Belgium benefitted from an relatively higher inflation of 1.6% – which was of the same magnitude as that of Germany (1.8%) and above that of France (0.8%) and Italy (0.9%). Consequently, the public debt of Belgium went from 107% in 2014 to 97.6% in 2019, while Portugal saw its debt decrease from 132.9% in 2014 to 116.6% in 2019.

2.1.3 The Covid-19 crisis has exacerbated the already existing fiscal heterogeneities

EU countries that have best managed their public finances after the GFC and the EU sovereign debt crisis are those that have suffered the least economically from the Covid-19 shock. By contrast, the most indebted countries on the eve of the Covid-19 crisis have been the most severely hit in terms of output shortfall in 2020.

CHART 7.
Real GDP growth, change in public debt ratio and denominator effect in 2020



Source: Eurostat

As observable in Chart 7, France, Italy and Spain have been the most severely hit in terms of output shortfall in the Euro area. In 2020, real GDP in Spain collapsed by 11.3%. It fell by 9% and 7.9% in Italy and France, respectively. With public finances already deteriorated on the eve of the crisis, these three countries registered the strongest increase of their public debt-to-GDP ratio between 2019 and 2020. Spain experienced the highest rise (+22.2 pp, against 13.3 pp of the Euro area). Italy and France followed, as their public debt grew by 20.8 pp and 17.6 pp respectively. These figures are twice as high as those experienced in the Netherlands (+6.1 pp) and Germany (+9.1 pp) between 2019 and 2020.

Accordingly, the Covid-19 has worsened the fiscal heterogeneities across Member States in terms of public debt-to-GDP. Five EU Member States saw their public debt exceeding 110% of GDP in 2021: Greece (194.9%), Italy (147.1%), Portugal (124.5%), Spain (116.8%) and France (112.9%). By contrast, eighteen countries kept their ratios below 75% of GDP in 2021. Among them are Germany, the Netherlands and Finland which had their public debt-to-GDP ratios hovering respectively at 69%, 51.7% and 72.5% of their 2021 GDP. Compared to 2019, the public debt-to-GDP ratios prudently increased by 3.1 pp in the Netherlands and 9.4 pp in Germany.

2.1.4 The war in Ukraine has not accentuated divergences in terms of fiscal deficits and public debt between Member States, but public debt-to-GDP ratios have stabilized at high levels in many EU countries in 2022 and 2023

Economies of the EU have been affected differently by the war in Ukraine as inflation pressures have intensified. But divergences in terms public debts have not increased across Member States, despite large levels of fiscal deficits maintained by several Member States in 2022 and 2023. One reason is that GDP growth has rebounded; another the is that inflation was high, mechanically leading the public debt-to-GDP ratio to decrease in the short run.

In such an economic context, for 2022, the ratio decreased marginally in France from 112.9% of GDP in 2021 to 111.8% in 2022. It fell by 5.2 pp in Spain (from 116.8% to 111.6%), and by 5.4 pp in Italy (from 147.1% to 141.7%) according to the EU Commission[8].

Though debt-to-GDP ratios have stabilized, important heterogeneities were observable in fiscal imbalances. In 2022, fifteen Member States have experienced a deficit higher than 3% of GDP. Spain experienced a fiscal deficit of 4.6% in 2022 while it exceeded 5% of GDP in France (-5%), Italy (-5.1%), and Belgium (-5.2%). By contrast, fiscal deficits in Germany (-2.5%) and the Netherlands (-2.7%) should remain below 3% of GDP.

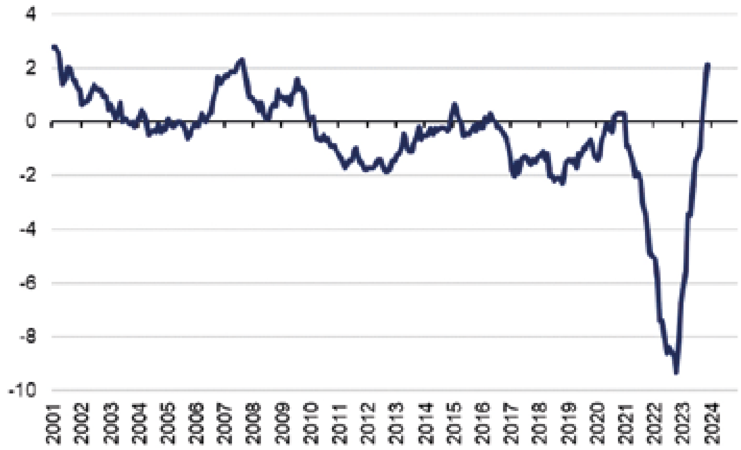
2.1.5 Did private debt trends follow the same path as public debt in EU Member States?

Several trends are observable regarding the trajectories of private debt levels in the EU over the period running from 2000 to 2023 (*see Chart 6*).

As observable on Chart 6, the "GIPS" (Greece, Italy, Portugal, Spain) saw their private debt increase significantly between 2000 and 2007; for instance, the Spanish private debt nearly doubled from 117.9% of GDP in 2000 to 209.3% in 2007. Excessive private debt levels – which was in certain cases, such as Spain, closely linked to real estate bubbles – has been a source of financial vulnerabilities which materialized during the GFC.

8. Spain and Italy experienced higher inflation and nominal growth in 2022 than France, given the measures to freeze energy prices in that country. The decline in public debt-to-GDP ratios in Spain is all the more significant as in France, where the primary deficit of 2.8% of GDP in 2022 was much higher than in Spain (-1.6%), for instance.

CHART 8.
Real refinancing rates in the Euro area (policy rate minus inflation rate), % points



Source: BIS

Between 2013 and 2023, private debt levels in the GIPS have been on a downward trend but stabilized in Q2-2023 at levels higher before the GFC (*see Chart 5*). For instance, the Spanish private debt decreased from 209.3% in 2007 to 189.8% in 2014 and 138.8% in Q2-2023 (compared to 117.9% in 2000), and the Portuguese private debt peaked to 208.2% in 2014 from 193.9% in 2007, and then decreased to 147.6% in Q2-2023 which is still higher than its 2000 level of 142.8%.

In Austria and Germany, private debt seemed to have followed the path of public debt by remaining low comparatively to other EU Member States. Chart 5 shows that German private debt stabilized around 125% of GDP between 2000 and 2023 and private debt in Austria remained around 140% over the same period.

However, private indebtedness has remained high in France, the Netherlands and Belgium. France and the Netherlands have private debt levels among the highest in the Eurozone, and even in the world. While private debts of France and the Netherlands in 2023 stood at similar levels (respectively 219.9% and 214.9% of GDP), the French one was up by nearly 40 pp from 166.8% in 2014 while the Dutch one was down by more than 70 pp from 287.1% in 2014. In that regard, one can say that both French and Dutch private debts have followed the trend of their public debts. And even though the Dutch trajectory is encouraging, Dutch private debt at Q2-2023 remains nearly 40 pp above the average private debt of advanced economies (161.5%)[9].

Eventually, Belgium has managed to slightly reduce its private debt from 211.9% of GDP in 2019 to 193.4% in 2023, after having continuously increased from 146.2% of GDP in 2000.

2.2 The ECB ultra-accommodative and asymmetric monetary policy since the European sovereign debt crisis (2011-2012) and the lack of fiscal discipline have led to excessive public debt in some EU Member States

The very accommodative monetary policy in the Euro area over the last 20 years explains to a large extent this public debt overhang

The monetary policy has created favorable conditions for Member States to accumulate debt for 2 main reasons. The first is that real interest rates have been most of the time negative between 2000 and 2023 (*see Chart 8*), maintaining favorable financial conditions for borrowing.

The second reason is the ECB's balance sheet policies, which has led it to purchase government securities massively, in particular since 2015. Initially decided in the context of the GFC and the EU sovereign debt crisis, these non-conventional policies were not removed once the crises ended.

One key illustration has been the launch of the Asset Purchase Program (APP): the ECB decided to embark in a massive asset purchase program. Launched in January 2015, it aimed at purchasing public and private securities at a monthly pace of €60 bn, as part of the APP.

What favored over indebtedness is that in the non-crisis period running from 2014 to late-2019, non-conventional policies have not been stopped, quite the opposite insofar as the ECB announced its Quantitative Easing policy (QE) in 2015. By pursuing non-conventional policies in a period of stability, the ECB contributed to the monetization of the debt and central banks have de facto become the agents of fiscal policies.

9. See Appendix 1.

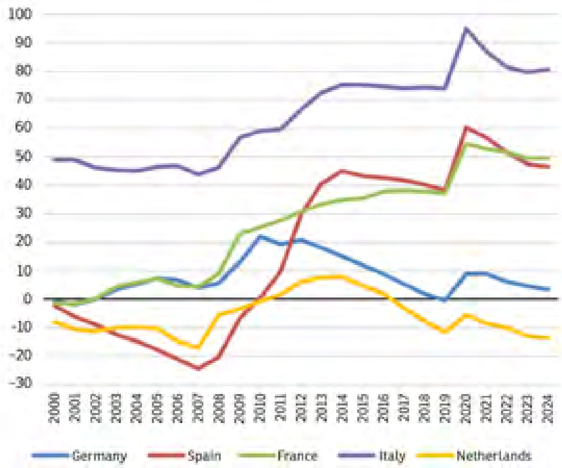
In the wake of the pandemic, this whole configuration has been exacerbated: the Governing Council decided in March 2020 to launch the Pandemic Emergency Purchase Program (PEPP) on top of the already existing APP, which had a total intended envelope of €1,850 tn. Thus, the Eurosystem had a leading role in public debt monetization during the Covid-19 crisis and until mid-2022, as its public securities purchases amounted to most of governments' borrowing requirements. Consequently, the Eurosystem absorbed 85.2% of new government issuances in 2020 and 147.5% of public debt issuances in 2021, meaning that not only did the Eurosystem absorbed the entire public debt issued in 2021, but it also repurchased part of the debt that matured in 2021[10].

The purchase of sovereign bonds since 2015 has led the Eurosystem to hold more than a third of the Euro area's public debt in 2023. 26.8% of the French public debt and 25.7% of the Italian debt were held by the Eurosystem in June 2023. The share of Dutch and German government debt still exceeded the 33% threshold, initially set under the APP but suspended under the PEPP.

The fiscal rules of the SGP have not been obeyed by many large European countries (France, Italy, Spain...) which has contributed to their over-indebtedness.

The outcome of the diverging debt trajectories since 2000 is that the deviation of levels of public debt to the 60%-threshold enshrined in the Stability and Growth Pact has significantly diverged between Euro area Member States. Indeed, Chart 9 shows that in 2000, Spain, France and Germany had similar public debt levels (around the 60%-threshold). In 2023, France and Spain have public debts' 50 pp above this threshold (*i.e.* their debts exceed 105% of GDP) while Germany's public debt only exceeds the threshold by 3 pp. Regarding Italy, its debt was already 40 pp above the 60%-threshold when it joined the Eurozone in 1999; in 2023, this gap has increased to 80 pp.

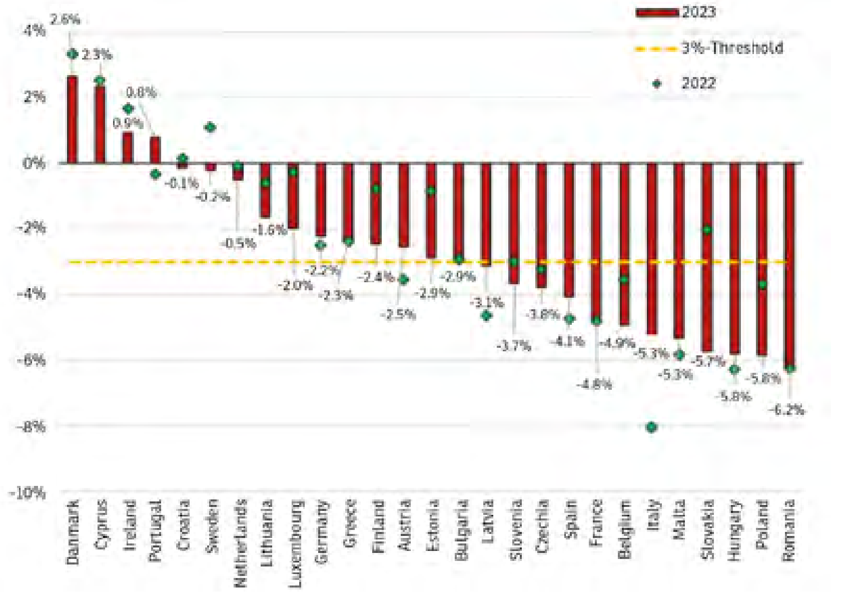
CHART 9.
Gross public debt-to-GDP ratio, deviation from the 60%-threshold across the major Eurozone (percentage points)



Source: EU Commission's Autumn Forecasts (November 2023)

The fiscal rule enshrined in the Stability and Growth Pact is the 3%fiscal threshold. Similarly, repeated failure to comply with this rule by Member States is obvious (see Chart 10). Out of the 27 Member States, only 4 showed primary surpluses in 2023, and 12 experienced deficits exceeding 3% of GDP, – among them Spain (-4.1%), France (-4.8%), Belgium (-4.9) and Italy (-5.3%).

CHART 10.
Total budget balance in 2023, % of GDP



Source: EU Commission's Autumn Forecasts (November 2023)

10. See 2.4 of Eurofi Monetary Scoreboard, September 2023.

Fiscal coordination is needed in a monetary union. The reason stems from the fact that the European Union is not a state and that negative externalities – stemming from questionable national fiscal policies – should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy, hence the need for fiscal coordination.

3. Why is excessive public and private debt a problem in Europe?

This part aims at highlighting several issues arising from excessive levels of debt, be it private or public. The first issue is related to debt sustainability which can be challenged in the context of rising interest rates and low growth. Second, high sovereign debt makes countries more vulnerable to shocks. Parallelly, excessive private debt levels pose a threat to financial stability in Europe. Furthermore, both public and private over-indebtedness is a barrier to productive investments. Additionally, over-indebted EU Member States risk losing their leadership in Europe and put the European construction in a deadlock. Eventually, high levels of public debt are costly for future taxpayers who will bear a burden they are not responsible for.

3.1 France, Italy, Belgium, and Spain are currently concerned with debt sustainability issues, especially in the context of high interest rates and low growth

3.1.1 The sustainability of public debt is linked to the confidence of creditors

The variation of the debt in a specific country is explained by its primary budget balance, the difference between r and g and its level of public debt for the precedent period[11] which determines the debt service costs[12]. As a result, creditors are attentive to:

- The potential growth and income available to the sovereign to meet its debt obligations,
- The average interest rate on the stock of debt issued by the government compared to the capacity to raise tax,
- The primary budget balance which will increase the debt in case of deficit or reduce it in case of surplus; the higher the debt, the greater the primary surplus required.

However, these determinants are influenced by several other factors including:

- The total amount of public debt and especially its maturity are crucial, especially when interest rates are rising,
- The share of debt that is held by non-residents as foreign ownership is a strong constraint for the borrowing state,
- The nature of the expenditure financed by the debt (infrastructure and social expenditure having different effect on long-term growth).

3.1.2 Over-indebted Member States are burdened by important debt servicing costs, which can challenge the sustainability of their debt

Debt servicing costs have followed a paradoxical trajectory in indebted countries between 2012 and 2021: while debt has risen, or stabilized at high levels, interest expenses on debt has fallen as a proportion of GDP, thanks to the ECB's ultra-accommodating monetary policy.

This is particularly visible in France:

- In the years preceding the GFC (2004-2008), the public debt ratio averaged 66.2% and the interest burden 2.7%.
- In the pre-Covid-19 years (2014-2018), the debt ratio continued to rise (97%) and the interest burden to fall (1.4%).
- By 2021, the debt ratio had jumped to 114.6%, while interest expense had further fallen to 1.3%.

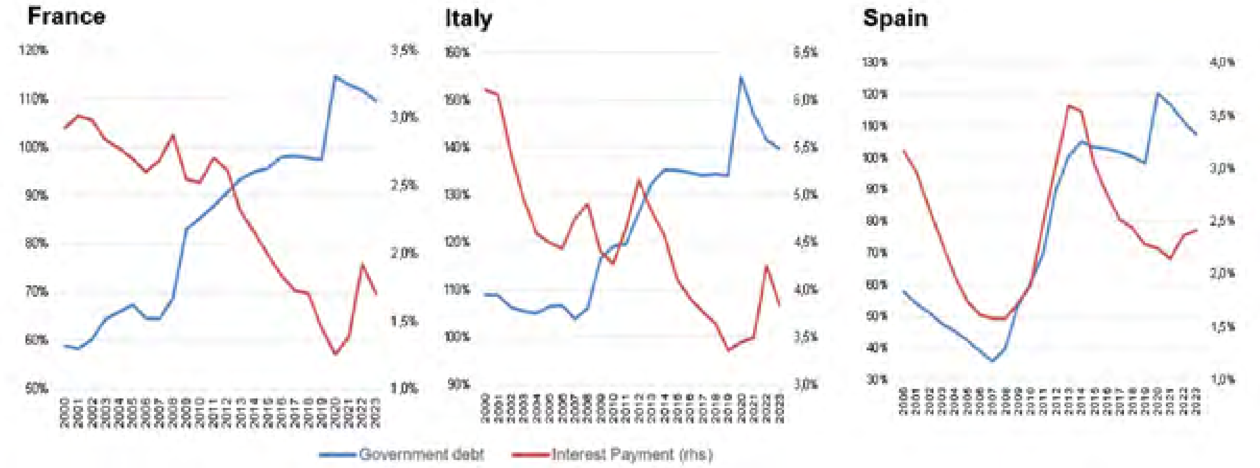
Underlying all this is a continued decline in the implicit rate on debt, from an average of 4.1% in 2004-2008 to 1.1% in 2020. According to BIS data, the real (inflation-adjusted) interest rate on 10-year government bonds has fallen from 5.9% on average 1984-1995 to -0.6% for the period 2013-2023, and to -3% for the years 2021-2023 alone (-2.4 in June 2023).
This also applies to other indebted countries, such as Italy and Spain (*see Chart 11*).

As explained by P. D'Arvisenet, "[this situation] is the consequence of the ultra-aggressive monetary policy (policy rate in negative territory – the ECB deposit rate had been gradually reduced to -0.5% between 2014 and mid-2022), quantitative easing with the APP and PEPP programs which leads one to question the nature of central banks' independence"[13].

Since 2022, debt servicing costs have been increasing alongside the increase in market

11. The precedent period (t-1) can be a year, a quarter, a month... depending on the chosen reference period (t).
12. See 4.1.
13. Op. Cited P. d'Arvisenet and see Eurofi Monetary Scoreboard.

CHART 11.
Government debt and interest payments, % of GDP across key indebted Member States



Source: EU Commission
Notes: data for 2023 are projections taken from the EU Commission's Autumn Forecasts (November 2023)

CHART 12.
Debt service costs according to different metrics across key EU Member States

Source: EU Commission
Notes: Data for 2023 & 2025 are projections taken from the EU Commission's Autumn Forecasts (November 2023)

interest rates and will be a cause for concern for the next few years in over-indebted countries.

In France, debt servicing costs rose from €35 bn in 2019 (1.4% of GDP) to €48 bn in 2023 (1.7% in 2023). French current interest burden is at its highest level since 2007, and it exceeded the defense budget in 2023 (€43.9 bn). Projected at €69.5 bn euros in 2025 by the EU Commission, debt servicing costs are set to become the government's biggest budget item, ahead of education (€63.6 bn).

Spain and Italy have also seen sharp increases in their debt servicing costs since 2022. In 2023, the Italian government allocated €79.1 bn to servicing its debt, compared with €60.4 bn in 2019. The cost should exceed €100 bn in 2025, according to the Commission's forecasts. In Spain, €34.1 bn were earmarked for interest payments in 2023, up on 2019 (€28.4 bn). The amount is expected to reach €40.2 bn in 2025 (*see Chart 12 and Table 1*).

3.2 High sovereign debt makes Member States more vulnerable to shocks

A high government debt burden makes the economy more vulnerable to macro-economic shocks and limits the room for counter-cyclical fiscal policy. For instance, a rise in long-term interest rates may reignite pressures on more vulnerable sovereigns, thereby triggering a sovereign re-pricing risk.

Additionally, a high government debt entails the need to sustain high primary surpluses over long periods, which may be difficult under fragile political or economic circumstances, as it is the case nowadays.

TABLE 1.
Debt service costs according to different metrics across key EU Member States

	Billion Euros			% of GDP			% of Government debt (t-1)		
	2019	2023	2025	2019	2023	2025	2019	2023	2025
France	35,3	48,1	69,5	1,4%	1,7%	2,3%	1,5%	1,6%	2,2%
Germany	27,4	34,1	41,5	0,8%	0,8%	0,9%	1,3%	1,3%	1,5%
Italy	60,4	79,1	101,6	3,4%	3,8%	4,6%	2,5%	2,9%	3,4%
Spain	28,4	35	40,2	2,3%	2,4%	2,5%	2,3%	2,3%	2,5%
Austria	5,6	5,8	7,6	1,4%	1,2%	1,4%	2,0%	1,7%	2,0%
Netherlands	6,2	7,7	8,6	0,8%	0,7%	0,8%	1,5%	1,6%	1,7%
Portugal	6,3	5,4	6,7	2,9%	2,0%	2,3%	2,5%	2,0%	2,4%
Belgium	9,5	10,9	14,2	2,0%	1,9%	2,2%	2,1%	1,9%	2,2%

Source: EU Commission
Notes: Data for 2023 & 2025 are projections taken from the EU Commission's Autumn Forecasts (November 2023)

3.3 Excessive private debt levels also pose a threat to financial stability in Europe

Non-financial private sectors are challenged by a rising debt-service costs, and higher funding costs spur corporate default.

As underlined by the ECB's financial stability review[14], "Steep increases in interest rates are particularly challenging for borrowers carrying high levels of debt contracted at variable rates or loans that fall due for refinancing in the near term". Indeed, the unanticipated surge in interest rates can challenge borrowers that must honor their commitments in the near future and a fortiori the financial stability of the Euro area as emphasized by the ECB's review: "Financial stability risks associated with high interest rates are emerging in the context of a challenging macro-financial outlook and geopolitical tensions".

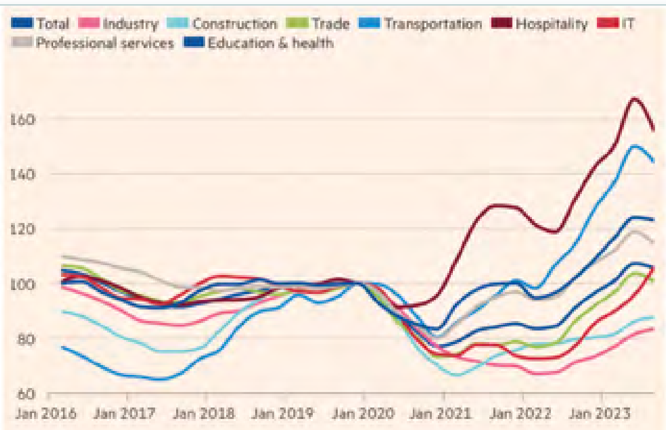
Manifestations of the financial stability risks in Europe have been illustrated by a recent article by V. Romei and Chart 13[15]. For instance, "Germany, the EU's largest economy, said bankruptcies rose 25 per cent from January to September 2023 compared with the year-ago period. Since June 2023, monthly "double-digit growth rates have been consistently observed compared to the previous year". Moreover, Eurostat estimates that "across the bloc, corporate insolvencies rose 13 per cent year on year in the nine months to September 2023 to reach their highest level in eight years".

Chart 13 also evidences that the labor-intensive hospitality, transportation and retail sectors have been hit the hardest.

Financial stability risks are also triggered by the excessive debt level of some households has emphasized by the ECB: "Euro area households, especially those with lower incomes and in countries with mainly floating-rate lending, are increasingly being challenged by higher interest rates. Resilient labor markets as well as government support measures and excess savings accumulated during the pandemic have so far mitigated Euro area household vulnerabilities.

However, real household incomes and consumption remain under pressure, especially in the lower income segments. At the same time, higher interest rates have begun to feed through to higher debt service costs, notably in countries where the share

CHART 13.
Declarations of bankruptcies in the EU, by activity, Q1-2015 to Q3-2023
Seasonally adjusted data; 2015=100



Source: Eurostat

14. "Financial Stability Review", ECB, November 2023.
15. V. Romei, "Bankruptcies soar as high rates and end of Covid-19 aid hit businesses hard", Financial Times, 18 December 2023.

of variable-rate lending has historically been very high. Going forward, households may see their debt servicing capacity erode if energy prices soar again, interest rates remain higher for longer and/or labor market conditions deteriorate significantly"[16].

V. Romei concluded its article affirming that currently, "bankruptcy numbers remain modest by historical standards in big economies, including the US, Germany and France". However, the risk posed by over-indebtedness *vis-à-vis* financial stability is still looming as "higher debt service costs are increasingly challenging indebted firms, households and sovereigns, with the real economy impact of tighter financial conditions yet to fully materialize", hence the necessity to take meaningful measures to reduce indebtedness in the EU.

3.4 Both public and private over-indebtedness is a barrier to productive investments

Theoretical and empirical literature suggests that high government debt burdens can ultimately impede long-term growth. Indeed, several studies found that beyond a threshold of 90-100%, public debt has an impact on growth performance. However, it is important to analyze the nature of the expenditure financed by this debt, as infrastructure and social expenditure do not have the same effects on long-term activity. In any case, over-indebtedness ends up impoverishing countries and lock them into a vicious circle.

In countries that have debt exceeding 90-100% of GDP and outstanding public spending ratios, it has become difficult to prioritize measures fostering productivity and public investment because they are hindered by public spending decided in the past and that have been automatically renewed for years[17].

Lasting loose monetary policies discourage productive investment and growth.
Net public investment in the Euro area during the 2011-19 period was the lowest of the advanced economies, except for Japan. Before the global financial crisis (2008), public investment levels were at around 4% of GDP in the Euro area. But, according to F. Panetta[18], after the sovereign debt crisis, public investment tumbled by more than one percentage point. When accounting for the depreciation of capital stock, net public investment fell from about 1% of GDP in 2010 to around 0% in 2013. It hovered around that level until 2019 and even turned negative between 2014 and 2017. Euro area governments invested around €500 billion less in the 2011-19 period compared to the 2000-09 pre-crisis period.

Negative or very low interest rates are supposed to encourage productive investment, which has been in decline for more than 10 years. However, the reality is quite different. It has been shown that negative interest rates discourage savers, particularly in Europe, from investing in long-term projects and encourage them to hold on to their liquid assets. A saver is not going to finance a risky investment if they are not entitled to receive any return!

If interest rates remain negative in real terms, it is to be feared that investment will not pick up again. How can savers be encouraged to invest in future projects that carry a certain amount of risk if they receive zero return, or even a tax, on the money they invest?

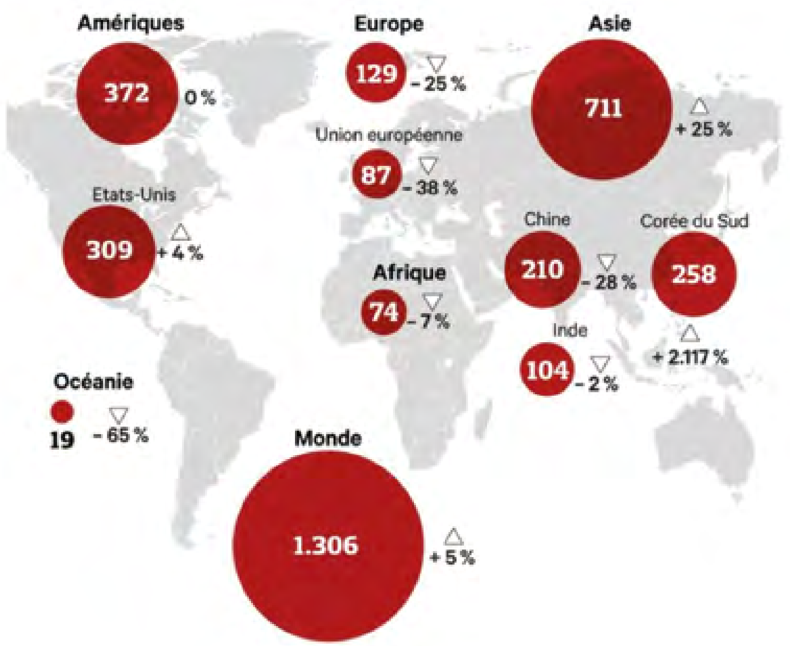
Excessive levels of private debt also burden productive investments.
A strong corporate sector is crucial for investment, innovation and eventually economic growth. Yet, high corporate debt has a negative impact on investment. Indeed, high corporate indebtedness implies higher interest expenses and thus less money available for investment. Firms with high debt also find it harder to obtain new funds from external sources due to their higher default risk. Moreover, the desire to repair weak balance sheets leads firms to reduce their debt burden, and thereby forgo investment opportunities.

In an ECB research document[19], the authors found "a strong interaction between firm indebtedness and investment amid activity shocks. Firms with higher leverage reduce investment significantly more than their peers with lower debt. Over the four years after a large economic contraction, the growth rate of tangible fixed capital of high-debt firms is some 15 percentage points below that of their counterparts with lower debt burden."

This is all the more concerning that the EU is counting on more capital expenditure to promote recovery from the pandemic, to kick-start the European economy and support the ecological and digital transitions, making Europe more resilient and better adapted to future challenges. Namely, the NextGenerationEU program was launched in July 2020 and dedicates a nearly €750 bn envelope to foster investment as well as growth and promote recovery and resilience in all EU Member States.

16. Op. Cited ECB.
17. Op. Cited J. de Larosière.
18. F. Panetta, "Investing in Europe's future: the case for a rethink", Milan, November 2022.
19. "Medium-term investment responses to activity shocks: the role of corporate debt", ECB Working Paper Series N°2751, November 2022.

CHART 14.
Distribution of investment by region
In $bn, between July 2022 and June 2023 compared with the period June 2021-June 2022:
△▽ evolution, in %



Source: Trendeo, Fives, McKinsey, extracted from Les Échos

Indeed, fostering a sustainable path to stronger growth is essential. This requires structural reforms and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries has led to the deterioration of the potential growth which cannot be improved by cyclical policies.

As observable on Chart 14, the EU is lagging in terms of investment, even more than 2 years into NGEU's lifetime. Investments in the US have increased by 4% over the period from July 2022 to June 2023 compared with the period June 2021-June 2022: this figure even reached -38% in the European Union (compared with the period June 2021-June 2022).

The results of the same research document[20] "question the capacity of the corporate sector to promote the recovery from the Covid-19 crisis via an increase in capital spending". Moreover, the war in Ukraine, the fight against climate change and the digital transition will also require large-scale corporate investments. Therefore, it is urgent that private debt also be under control to foster investment and, in the long-run, economic growth.

3.5 Over-indebted EU Member States risk losing their leadership in Europe and put the European construction in a deadlock

Over-indebted countries, such as France, are currently losing their credibility and leadership insofar as they are not living up to the commitments they took when signing the Maastricht Treaty, namely, to contain their public debt-to-GDP under 60% and their public deficit under 3% of GDP.

As a result, the EU currently faces a deadlock. Indeed, heterogeneous economic situations make it hard for EU Member States to define a common interest and a common vision for the future of the Union. Consequently, with diverging interests, no meaningful agreements are reached, and the EU is not moving forward. For instance, progress towards a genuine banking and Capital Markets Unions is hampered by the lack of trust among Member States that stems from these economic and fiscal divergences, and even the euro itself has become "a permanent source of issues to negotiate" and is "regularly a source and a manifestation of some discord among Member States"[21].

3.6 The current high levels of public debt are unfair to the future taxpayers who will have to bear a burden they are not responsible for

The high levels of public debt generated by important public deficits constitute a burden on posterity, especially if these deficits are used to finance public spending and not productive investment as it is the case in France where public spending reaching 57.9% of GDP in 2022. It is not legitimate to make future taxpayers bear the burden of debt-servicing costs and honoring commitments

20. Op. Cited ECB Working Paper Series N°2751.
21. J. de Larosière, "EMU: myth or reality?", Keynote Address – Towards EMU 2.0: Hindsight and Prospects, 4 October 2023.

that have been made to finance important unproductive expenditures. Indeed, future taxpayers will also have to incur these public spending, but they will also more than ever need room for maneuver in terms of public finances in order to make the necessary investments for the green and digital transitions, and this will be all the more difficult if they already have outstanding debts[22].

4. How can public debt in the EU be reduced?

As an accounting phenomenon, the mechanisms for reducing public debt are well known and can be assessed in order to find a realistic way to reduce public debt in the EU. The first solution would rely on inflation and monetary creation, but such a strategy is inefficient and even harmful in the long run. Another apparent solution would be to expect growth to continue to exceed interest rates; yet, uncertainty remains around the trajectory of these two variables.

Consequently, the only credible solution to reduce public debt is to achieve primary surpluses. The latter requires fiscal discipline, starting with rationalizing public expenditures and undertaking structural reforms. In that respect, the project of the Stability and Growth Pact reform introduced in December 2023 may not be sufficient to achieve a genuine debt reduction strategy in over-indebted EU Member States for the decade ahead.

4.1 As an accounting phenomenon, the mechanisms for reducing public debt are well known

The sustainability of public debt depends on its long-term trajectory which depends on fiscal policies – *i.e.* the accumulation of primary balances, and on the gap between the interest rate (r) and the activity growth rate (g).

The dynamic of public debt ratios depends on:

- The difference between the implicit interest rate (interest expenditure/debt) and the nominal GDP growth (real growth + inflation),
- The level of public debt as a percentage of GDP of the previous year,
- The primary budget balance, as a percentage of GDP.

This mechanism can be illustrated by the following equation:

$$b_t - b_{t-1} = b_{t-1}(r - g) + d_t \qquad (1)$$

with: b, the government debt to GDP ratio; r, the implicit interest rate (debt service cost/government debt at t-1); g, the nominal GDP growth; and d, the primary budget balance as % of GDP.

From equation (1), the stabilizing budget balance (-d*), *i.e.* the budget balance for which the debt/GDP ratio is constant between two periods, can be deducted. This balance is equal to the differential (r-g), multiplied by the debt-to-GDP ratio of the previous period. The following equation proves it:

$$b_t - b_{t-1} = 0 \longleftrightarrow d_t^* = b_{t-1} \times (r - g) \qquad (2)$$

The difference (r-g) is thus the determinant of the dynamic of public debt. As described by P. d'Arvisenet[23], several configurations are to be considered depending on whether r > g or r < g:

- If r > g

With a zero primary balance, the debt ratio will increase exponentially at the rate r-g. To put the debt ratio on a downward path, the primary balance must be positive and greater than the stabilizing primary balance (-d* explained above in equation (2)). Otherwise, the debt ratio will increase.

- If r < g

Fiscal adjustment is easier, and if the primary balance is zero, the debt ratio will fall steadily; it will also fall provided that there is no primary deficit greater than -d*.

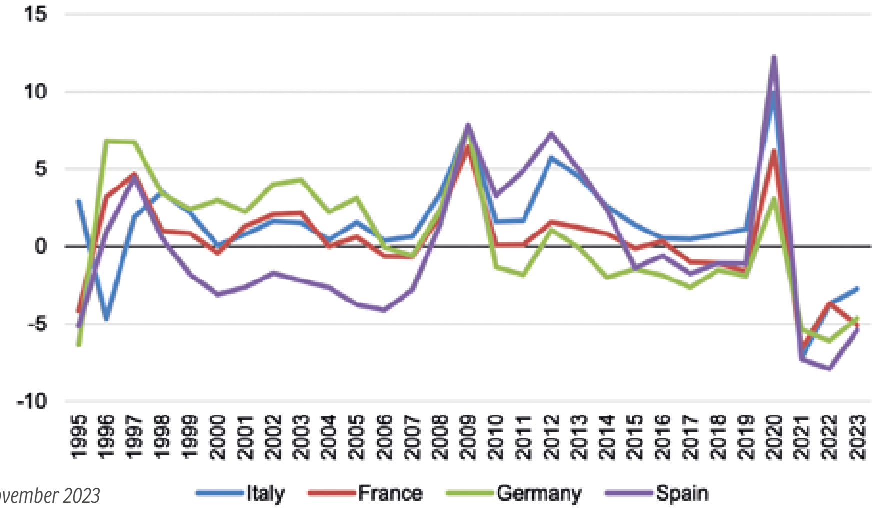
To understand this better, here is a numerical example to illustrate the dynamic of a public debt. Let's consider an implicit interest rate (r) of 4% and growth (g) of 2%. The primary budget surplus needed to stabilize a debt ratio of 50% is 1%, 2% for a debt of 100% and 3% for a debt of 150%. Conversely, if r = 2% and g = 4%, the debt ratio can be stabilized with a primary deficit of 1% for a debt ratio of 50%, 2% for a debt ratio of 100%, 3% for a debt ratio of 150%.

But beyond that, as stressed by J. de Larosière[24], debt problems cannot be only addressed by accounting tricks. Rising debt levels raise key issues to both economy and society.

History has shown that r < g is not sufficient to ensure public debt control in the absence of a primary surplus. The analysis of the conditions that have enabled debt ratios to be reduced in the past after a major crisis indicates that successful

22. M. Pébereau, "Mieux gérer nos finances publiques", Académie des Sciences Morales et Politiques, 25 September 2023.
23. P. d'Arvisenet, "Maitriser l'endettement, enjeu de souveraineté et de prospérité", working paper, October 2023.
24. J. de Larosière, Roundtable: "jusqu'où financer l'emprunt ?", Fondafip Think Tank, 24 November 2023.

CHART 15.
(r-g) difference across key EU Member States since 1995



Source: EU Commission (Autumn Forecasts of November 2023

reduction episodes have relied on a combination of negative (r – g) spreads and primary surpluses.

Since 2015, most of the Member States have benefited from a negative (r-g) difference.
A few elements about the dynamics of (r-g) in France, Italy, Spain and Germany in recent years are worth noting:

- Apart from Italy, r – the interest payment expressed as a % of total debt – was overall lower than nominal growth between 2014 and 2019 on average for France, Germany and Spain, whereas the relationship was positive between 1999 and 2007 on average for the first two countries (*see Chart 15*). Spain enjoyed a much higher nominal growth than the other members (7.7% v. 4.2% in France and 2.5% in Germany), during this period (1999-2007).
- Compared to Germany, France and Spain, Italy suffers from relatively low nominal growth for a relatively high debt burden, which is the source of a positive r-g over the entire 1999-2022 period. Already prevalent in 1999-2007, this dynamic worsened in 2014-2019, with the deterioration in nominal growth (4% on average between 1999 and 2007, and 1.8% between 2014 and 2019), which the fall in the interest payment was unable to offset (5% between 1999 and 2007 v. 3% between 2014 and 2019).
- After a sharp rise in 2020 following the collapse of nominal growth, (r-g) has become negative again since 2021 for the four member countries, to the point of reaching historically low levels since the creation of the Eurozone. This dynamic continued in 2022, given the exceptionally high nominal growth due to inflation, while interest charges barely increased.

Table 2 shows that between 2014 and 2019, (r-g) was weaker in Germany than in France because, compared to France, Germany supports a lower debt service cost (r) for a higher nominal growth (g). Germany benefited from lower debt service costs than France (1.7% of public debt on average in Germany v. 1.9% in France). Additionally, nominal GDP growth was significantly higher in Germany than in France (3.6% in Germany v. 2.4% in France on average). The latter resulted from a higher real GDP growth (+1.8% in Germany v. 1.5% in France) and a higher GDP deflator in Germany (1.8% in Germany v. 0.8% in France).

TABLE 2.
Implicit interest rate on public debt (r) and current GDP growth rate (g) across key EU Member States

	r - g, percentage points			
	Italy	France	Germany	Spain
Avg 1999-2022	1,6	0,4	0,4	-0,1
Avg 1999-2007	1,0	0,6	2,3	-2,8
Avg 2014-2019	1,1	-0,4	-1,9	-0,6
2021	-7,2	-6,6	-5,4	-7,3
2022	-3,7	-3,7	-6,1	-7,9
2023	-2,8	-5,1	-4,6	-5,4

Source: EU Commission (Autumn Forecasts of November 2023)
Notes: r = total interest payment over year t divided by the debt stock at the end of year t-1; g = nominal GDP growth rate at year t

The level of (r-g) was much more negative in Germany than in France in 2022 for quite similar reasons. In 2022, interest payment, calculated as the ratio between the amount of interest paid and the stock of public debt of the previous year, amounted to 1% in Germany, against 1.7% in France. Nominal GDP growth was 7% in Germany, compared to 5.5% in France. The GDP deflator (measure of domestic production price inflation), twice as high in Germany (+5.3%) as in France (+2.8%), contributed to explain this nominal growth difference between the two countries in 2022.

Comparatively to 2022, the level of (r-g) has been slightly reduced in 2023 in most EU Member States but remained well below the pre-pandemic level. This important difference between r and g reflects the particularly high level of nominal growth. The latter is enhanced by the deflator growth which exceeds the implicit interest rates. Thanks to the maturity of the debt, those are still moderate despite the rise in market interest rates. Contrary to its neighbors, France had in 2023 a wider differential (r-g) (-5.1 in 2023 v. -3.7 in 2022) because of the acceleration of the deflator compared to 2022 (+6.7% in 2023 v. +5.9% in 2022). These dynamics have remained favorable to the trajectory towards lower levels of debt in 2023.

4.2 Monetary phenomena such as inflation and monetary creation cannot solve the problems arising from excessive debt

4.2.1 Is inflation a solution to reduce public debt?

It is often said that inflation would be an effective way to reduce public debt ratios. It is theoretically easier to stabilize or reduce public debt when inflation is higher. Indeed, the higher the inflation, the higher the GDP in value terms, which tends to lower the debt-to-GDP ratio. However, the debt must not increase faster than GDP under the effect of the primary deficit and the interest burden.

Another argument often defended is that inflation boosts fiscal revenues in the short run (via taxes directly indexed to consumption, *e.g.* the tax on fossil fuels) while expenses are slower in adjusting. This difference improves the budgetary balance temporarily, thus reducing public debt.

But one should be careful with these arguments. After the WWII, inflation was high and helped to reduce public debt ratios. But now central banks have a clear inflation target which should lead them to raise their interest rates and reduce their balance sheets in the coming months.

For inflation to become a tool for reducing public debt ratios again, central banks would have to change their inflation targets, which would raise other structural problems: lasting high inflation slows down the economic activity. It makes the future more uncertain for economic agents and discourages them from investing and consuming, which could depress economic growth, and mechanically increase the debt to GDP ratio. Additionally, in the long run, the deterioration of the economic activity reduces fiscal revenues via the decrease of consumption while it increases the government expenditures. The latter can also increase because of public servants' wage revaluation and of pension revaluation in reaction to inflation. All these elements end up deteriorating the fiscal balance, which is detrimental for government debt trajectories.

Moreover, if it is higher than that of the main trading partners, inflation reduces the foreign competitiveness of domestic companies, further depressing growth. Lastly, inflation increases social risks and the development of extremism. It is a factor in increasing inequalities between households – it hits the poorest first – because the ability of economic agents to preserve or increase their purchasing power and their assets in periods of high inflation is not equally distributed.

Consequently, inflation is never a proper long-term solution to reduce public debt and could even turn out to be dangerous for the resilience and the prominence of Europe in international trade.

4.2.2 Monetizing debt is not a credible and sustainable solution

Between March 2020 and June 2022, central banks and notably the ECB have been carrying a primary role in public debt monetization, as they purchased a large share of new public debt issuances. In sight of the massive debt purchases, central banks have de facto become the agents of fiscal policies. This current "fiscal dominance" questions the independence of central banks and is a major disincentive for governments to engage in structural reforms.

Central banks purchases of public debt do not change a state's total indebtedness. It prevents interest rates from rising in the long term, but it cannot be permanent or it will become inflationary and create asset bubbles.

Prudent fiscal policy sustains credibility, not monetization

The idea that states can compensate for everything by exposing their balance sheets is unfortunately a fantasy. Indeed, it is not because budget deficits are monetized that they disappear. Despite the QE and its possible magnitude, the budget constraint remains. Analysts and rating agencies continue to examine ratios and make judgements about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of the quality of an issuer's "signature" and a key factor in the decision to buy securities by private investors, especially non-residents. Indeed, private investors are very sensitive to the rating and thus they still play a decisive role in the demand for public securities offered for issue.

Considering that these judgements voiced by the markets actually do not matter, because the central bank will always be there to buy, is doubly inaccurate: the central bank will not always be able to buy every bond, and the quality of a state's signature is an essential element of confidence that must be preserved at all costs for the country's future.

The ECB cannot absorb all public debt forever

If some national central banks are theoretically free to monetize the entirety of their state's public debt, the same cannot be said of the ECB, which is governed by an international treaty that prohibits the monetization of public debt. Similarly, the idea that central banks purchasing public securities could cancel their assets in order to reduce their state's debt to zero is, in the European case, legally impossible. The subsidy to the state that would be implied by the cancellation of public debts is not compatible with the Maastricht Treaty, which prohibits the monetary financing of Treasuries.

Money creation cannot indefinitely exempt our societies from having to face the question: "who will pay?". Do we seriously believe that unlimited issuance of sovereign securities will never come up against a fundamental questioning of the markets as to the solvency of States?

4.3 Uncertainty remains for the future path of a (r – g) difference in the context of rising interest rates and slow growth

Except for some countries like Italy, most EU Member States have benefited from a negative r-g differential over the past decade (2013-2021), *i.e.* a higher nominal growth rate (g) relative to the implicit interest rate (r). However, there is no guarantee that this trend will continue in the coming years. While lasting low interest rates largely caused the negative difference from 2013 to 2021, their recent increase in long-term interest rates since 2022 could reverse this trend. In 2023, nominal interest rates remained elevated compared to their 2019 levels, coinciding with a slowdown in global growth, particularly in Eurozone countries. Accordingly, the combination of higher interest rates and lower growth raises doubts about the future path of (r – g) in the years ahead. As described earlier, this differential depends on uncertain variables such as GDP growth and interest rate levels, making long-term predictions challenging.

Thus, uncertainty looms, especially regarding the future path of interest rates which are driven by inflation and monetary policy. Ongoing structural changes such as energy transition, population aging, and global trade fragmentation could sustainably keep inflation above pre-pandemic levels. In March 2023, Larry Summers expected long-term average inflation to be 2.5% in the US and "assign a very low likelihood to it being well below two"[25]. This could lead investors to demand higher compensation to protect their real asset returns.

Beyond influencing bondholders' attitude, the prospect of structurally higher inflation could induce less accommodative monetary policies than seen in the past decade. Since 2023, the ECB has begun reducing the stock of government bonds accumulated since 2015, exerting upward pressure on long-term interest rates. As Mahmood Pradhan and his co-authors note (2023[26]), the "trends suggest a new paradigm with more public debt being financed by the market, marking a shift from the pandemic period when central banks effectively financed the net issuance of government debt in most jurisdictions. At the end of this process, financial markets will hold a lot more government debt than they currently do. […] How quickly central banks can unload their holdings, and the impact this will have on market yields, will also depend on how much additional debt (net issuance) governments might issue."

4.4 The only credible solution to reduce public debt is to achieve primary surpluses

The Euro area should move gradually and cautiously towards monetary normalization, in order to avoid a cliff effect. The market – the supply and demand of capital – must be gradually reintroduced in the determination of medium and long-term interest rates as remuneration is a key driver for contributing to sustainable growth. This would be a step to a more productive post-pandemic period of higher growth and productive investment.

Conversely, in the absence of fiscal adjustments, investor mistrust may arise, forcing over-indebted states to pay higher risk premiums, thus hampering their ability to repay their debts.

4.4.1 Fiscal discipline is needed to recover primary surpluses

Generating primary surpluses is the only credible and certain path to debt reduction. To do so, countries have two main levers of action: one is increasing their revenue, usually in the form of tax increases, and the second is cutting public spending and/or conducting growth-enhancing reforms.

25. O. Blanchard & L. Summers, "Summers and Blanchard debate the future of interest rates", Virtual event, PIIE (March 2023).
26. M. Pradhan, L. Portelli & T. Perrier, "Central banks' endgame: a new policy paradigm", SUERF Policy Note, Issue No 328 (November 2023).

Over-indebted countries such as France, Italy and Belgium must thus urgently get back on track with fiscal discipline as healthy fiscal policies are required to navigate shocks and preserve sustainability. Given the already high level of tax burden in these countries[27], a further tax increase is hardly acceptable, hence the focus on rationalizing public spending.

In that respect, the IMF'S article IV offers country-specific guidelines on the reforms to steer in order to achieve fiscal consolidation, debt reduction and more productive investment. The IMF insists on the urge to introduce effective fiscal reforms in over-indebted countries to restore potential growth, reduce debt, and improve the ability to address shocks and the green transition.

For instance, one of France's main priorities to recover healthy public finances is to implement a "steady, expenditure-based consolidation until reaching a structural deficit of 0.4 percent of GDP in 2030" and "reduce the (fiscal) deficit"[28], as well as restore potential growth. France is thus expected to steer continual structural reforms, particularly in pensions, unemployment, and product and services markets that are essential for future fiscal health as well as better competitiveness and growth. To do so, France needs a credible package of reforms to rationalize public spending (*e.g.* pensions and unemployment benefits reforms) to narrow the gap with European and EA peers and to recover fiscal space to make the green/digital transition. Additionally, the IMF recommends that "to minimize drag, the consolidation (be) gradual and focus on current spending while protecting investment (particularly given large green/digital investment needs), underpinned by structural reforms".

In Italy, extensive fiscal policy support and rising interest costs have kept fiscal deficits very high in recent years. Yet, the IMF stated that "given the moderate risk of sovereign stress and the need to support disinflation and build fiscal buffers, a faster improvement in the primary balance is warranted and feasible"[29]. The IMF also deemed that "there is scope for further increase spending efficiency, including in the near term" and that "beyond the near term, a credible fiscal framework with well-defined measures, accompanied by growth enhancing reforms, is needed to anchor debt reduction".

The IMF also suggests that Belgium's top priority is advancing fiscal consolidation in order to preserve its social model, reduce debt, rebuild buffers and lower inflation. Indeed, Belgium is facing rising spending pressures from aging (0.3 ppt of GDP per year), defense needs, the green transition and other capex investment while "the limited fiscal space is constraining Belgium's ability to address future shocks while risks to the outlook abound. To avoid an abrupt adjustment should a risk or a combination of risks materialize, Belgium needs to rebuild the fiscal buffers that the pandemic and energy crisis eroded"[30]. Thus, fiscal consolidation is particularly challenging for Belgium, and the latter should primarily focus its fiscal adjustment on rationalizing public spending and increasing efficiency. Given its already high level of taxation, Belgium has very little room for mobilizing additional tax revenue and should instead implement efficiency-enhancing tax reforms.

4.4.2 A change in the nature of budgetary expenditure is required to address the financing challenges related to the climate transition: from unproductive to productive goals

A proactive fiscal policy to "substitute" for a dwindling monetary policy would be a great mistake. Fiscal or monetary stimulus will not necessarily enhance potential growth. Indeed, the huge monetary and fiscal stances of the last decades have not led to investment or higher growth. There is no automatic substitution effect: less monetary expansion is offset by more fiscal deficits.

Fiscal deficits – if they are increased above their huge present levels – will only be possible if monetary policy and interest rates remain accommodative. One of the most worrying consequences of accommodative and low rates for long policies has been precisely the marked reduction of global productive investment over the last 15 years: lasting low interest rates do not foster, by themselves, more productive investment. What they do – notably in the EU – is to encourage economic agents to keep their financial assets in liquid instruments or favor purely financial investment (e.g. share buybacks, M&A) rather than long-term productive investments.

What we need is more long-term investment to cope with the challenges of reduced labor and the green transition. This will not be achieved though more distribution through budgets or more money creation. It will only be possible if structural – supply-side oriented – reforms as well as a normal payoff of risky investments are made possible.

27. In 2023, current tax burden amounted to 46% of GDP in France. It reached 42.6% in Italy and 45.1% in Belgium. In the three countries, tax burden exceeded the Euro area average of 41%.
28. IMF Country Report No. 23/56 (Article IV), International Monetary Fund, January 2023.
29. IMF Country Report No. 23/273 (Article IV), International Monetary Fund, July 2023.
30. IMF Country Report No. 23/386 (Article IV), International Monetary Fund, December 2023.

This combination requires a reining in of excessive current public expenditure (*i.e.* fiscal normalization), alongside a qualitative shift towards reasonable public investment.

If we continue to live on the illusion that fiscal stimulus can "replace" monetary stimulus, we will have two negative results:

- Fiscal dominance because fiscal stimulus cannot co-exist with high rates,
- A financial crisis because excessive leverage always leads to it.

4.4.3 How credible is the reform of the Stability and Growth Pact agreed by the Ecofin Council in December 2023?

On 26 April 2023, the Commission presented a package of three legislative proposals: two regulations aiming to replace (preventive arm) or amend (corrective arm) the two pillars of the stability and growth pact first adopted in 1997, and an amended directive on requirements for budgetary frameworks of member states.

On 21 December 2023 the Ecofin Council achieved an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament on the preventive arm regulation.

In essence, the reviewed SGP would give 4 to 7 years to Member States that have fiscal deficits exceeding 3% of their GDP to return to fiscal deficits below 3% of GDP (corrective arm).

The rule to reduce public debt by an average of 1% a year for countries having a public debt to GDP over 90% (preventive arm) does not apply as long as its fiscal deficit exceeds 3% of the GDP. Additionally, for Member States displaying a public debt-to-GDP ratio between 60 and 90%, the reduction must be on average 0.5% a year.

The goal of simplification of the rules has regrettably not been achieved. What is even more worrying is that the Commission's proposal demands from the most indebted countries the smallest effort, which should perpetuate the decline of these economies. For instance, the debt trajectory of France until 2027 would remain almost unchanged by such an agreement[31].

The European agreement on the Stability and Growth Pact of December 2023[32] contains some positive elements:

- The case-by-case framework – which is a specific technical dialogue between the EU Commission and each Member State regarding their differentiated multi-year budget trajectory – has been introduced in the reformed Pact. It enables a differentiated approach towards each Member State to take account of the heterogeneity of fiscal positions, public debt and economic challenges across the EU.
- This dialogue will be based on a new indicator, the "net expenditure[33]", which should serve as a basis for setting a fiscal path and carrying out annual fiscal surveillance for each Member State. The multi-annual trajectory for this indicator, prepared by each Member State, must also be adopted by the Ecofin Council, which should reinforce the self-discipline of Member States.
- The obligation to reduce the public debt-to-GDP ratio by a minimum average of one percentage point of GDP per year over a period of 4 to 7 years for countries where outstanding public debt exceeds 90% of GDP (preventive aspect of the Pact) has been introduced. This measure is reduced to 0.5% for countries whose debt is between 60% and 90%.

However, there are several areas of concern:

- For the transitory period in 2025, 2026 and 2027, the Commission may exclude the expected rise in the debt service costs when calculating the adjustment effort, despite the fact that it will be the largest item of budget expenditure in some countries, such as France.
  This measure raises questions insofar as it reduces the effectiveness of the mechanism and weakens efforts to consolidate the public finances of over-indebted Member States.
  The credibility of the Pact in terms of restoring structural balances in a period of higher interest rates is questionable, given that between 2014 and 2019, Member States that benefited from very low interest charges due to zero or even negative interest rates did not begin to rebuild their primary budget surpluses.
- Countries that are subject to an excessive deficit procedure (total public deficit over 3% of GDP) are exempt from the rule requiring them to reduce their public debt by an average of 1% a year until their deficit falls back below 3%. This is not the best way to encourage the worst performers to reduce their debt to GDP ratio! It's as if the worst performers in a class were exempt from extra effort and sanctions as long as their results remain mediocre.

31. According to the draft budgetary plan submitted by the French Treasury to the EU Commission in November 2023, the French public debt as a percentage of GDP should reach 108.1% in 2027, compared with 109.7% in 2023, assuming a real GDP growth of 1.7% per year. For further details, see the table 7 of "Draft Budgetary Plan", French Treasury (November 2023).
32. At the time this note is written, the preventive arm of the proposal still has to be adopted by the European Parliament.
33. "Net expenditure" means "government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programs of the Union fully matched by revenue from Union funds, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures" (Chapter 1, article 2).

- Adjustment implementation horizons seem very long: 4 to 7 years to reduce the public deficit below 3% (the annual adjustment of the structural primary deficit must be 0.5%) and decades to return to the 60% public debt ratio. Such horizons also extend beyond typical political cycles, and experts deem the Commission unlikely to force a government elected with different priorities in the middle of the seven-year cycle to implement policies agreed by its predecessor[34]. As mentioned by L. Garicano, "the framework is also vulnerable to manipulation through creative accounting and over-optimistic growth assessments".
- Reference is made to the structural deficit in both the corrective and preventive sections of this revised Pact. Its definition as a "cyclically adjusted deficit" risks weakening the agreement. Why take up this complicated reference, which has failed to reduce excessive deficits in the past, and not keep the simple notions of total public deficit (as a % of GDP) or primary budget surplus, which are essential ratios for putting the public debt trajectories of the most indebted countries back on a sustainable footing?
- The Commission's powers to enforce these "new" rules have not been strengthened, even though it can initiate an excessive deficit procedure based solely on the criterion of public debt in relation to GDP.

What makes these new rules any more likely to be implemented than the previous ones? All the more so as the final discussions in the Council focused on minimum safeguards, which risk becoming maximum rules...

The postponement of the of budgetary adjustment for countries subject to an excessive deficit procedure and the extremely long periods granted to over-indebted countries to bring their public debt back to below 60% of their GDP (around 50 years for France, 80 years for Italy) are based on two erroneous prejudices:

- The reduction in the public debt ratio is based on a return to very low medium and long-term interest rates, which is likely to prevent budgetary efforts (*i.e.* cuts in public spending). The peak of the increase in the interest burden on the public debt of hyper-indebted countries is expected to be reached by 2027 and should subsequently fall as a result of the return to permanently low interest rates. This is the "easy money" paradigm: an accommodating monetary policy (permanently low interest rates) avoids budgetary efforts.
- Any budgetary adjustment is "by nature" recessionary because economic growth is based primarily on domestic demand.
  These two assumptions should lead European countries with excessive debt to continue their economic decline. There are several explanations:
- Recent monetary history (2014-2021) puts the emphasis on the paradigm of easy money which leads to excessive debt that does not stimulate economic growth. Persistent low (or even negative) interest rates over this period have not led to an increase in productive investment but has on the contrary encouraged savers to keep their financial assets in liquid instruments (see Eurofi Scoreboards) and not to channel them in securities geared to long-term investments[35]. Furthermore, persistent low interest rates encourage indebtedness and the proliferation of asset bubbles, increase wealth inequalities and favor a misallocation of resources (*e.g.* development of zombie firms).
- Excessive deficits and debt jeopardize economic growth. They require an increasing tax pressure, which deteriorates further the competitiveness of companies in these countries. Stimulating demand does not translate into increased production but leads to a widening of trade deficit if a country does not have an efficient production system. On the contrary, what is needed to increase potential growth and achieve a better allocation of resources is:
  - To return to primary surpluses as soon as possible,
  - To rationalize of public spending – qualitative public spending must be an absolute priority – in countries where the public spending-to-GDP ratio exceeds the European average,
  - To steer supply side-oriented reforms that enhance productivity gains.

In over-indebted countries, governments must take corrective actions to ensure a path to primary fiscal surpluses and reduce unproductive and inefficient public spending. Illusion over these countries' capacity to stimulate demand should be ditched out.

A review of the composition of public finances focusing on the nature of spending is therefore urgent and essential in highly indebted countries. To do so, there is a need for a deep review of all the

34. L. Garicano, "The EU's new fiscal rules are not fit for purpose", Financial Times, 8 January 2024.
35. Long-term investments do not produce returns consistent with the risks involved in such projects. So, savers act rationally and prefer to keep liquid banking accounts that are easily mobilizable. This is the "liquidity trap" feared by Keynes which is particularly severe in European countries that do not have the risk appetite for equity that characterizes US markets.

layers of national public spending – renewed because voted beforehand – and for the reduction of unproductive and socially not efficient spendings.

The climate and digital transition will indeed have a significant cost for the public finances of Member States. But this effort must be undertaken by redirecting current expenditure toward investment expenditure that are productive. One can lament that the current proposal for the reform of the SGP excludes this objective.

Only productivity-enhancing and supply side-oriented reforms can foster productivity and growth, and not negative real interest rates or Quantitative Easing (QE).

If the current drift in public debt were to continue, the fiscally "virtuous" countries will end up paying for it. This would be the definition of an uncooperative game, where most players try to evade their obligations by passing on the cost to those who respect them. We must therefore take the Union's destiny into our own hands and not let it drift. If this is to be the case, the logical outcome could well be a new and inevitable Eurozone crisis.

APPENDICES

APPENDIX 1.
Credit to Non-Financial Private Sector, Public Sector, Firms and Households, % of GDP

	General Government			Private Non-Financial Sector (a + b)			Non-Financial Corporations (a)			Households (b)		
	2000	2008	Q2-2023	2000	2008	Q2-2023	2000	2008	Q2-2023	2000	2008	Q2-2023
United States	48,6	66,1	110,4	135,2	168,7	150,2	64,3	72,6	76,5	70,8	96,1	73,7
United Kingdom	37,7	50,8	102,4	136	185,3	146,7	70,7	90	66	65,3	95,3	80,7
Japan	114,6	145,1	227,2	187,5	163,8	183,7	117,7	103,5	116,2	69,8	60,3	67,5
China	22,9	27,1	79,4	109,3	111,9	228	n.a	93,9	166	n.a	17,9	62
Euro area	69	69,6	90,4	126	156,7	152,2	76,5	96	97	49,6	60,8	55,2
France	58,8	68,8	111,8	137,7	164,2	217,3	104	115,6	152,6	34,2	48,6	64,7
Germany	59,3	65,8	64,7	140,6	129,9	125,3	69,4	70,1	71,8	71,2	59,8	53,5
Italy	108,8	106,2	142,3	79,3	116,5	105,1	56,6	77,5	65,6	22,6	39	39,5
Spain	57,8	39,7	111,3	117,9	214,2	134,9	72,5	131,6	85	45,4	82,6	49,9
Netherlands	52,2	54,7	46,9	219,7	234,7	211,1	130,1	123,2	121	89,6	111,5	90,1
Austria	66,1	68,7	78,6	127,8	142,5	134,2	83	90,5	88,3	45,3	52	45,9
Portugal	54,2	75,6	109,7	142,8	206,3	143,7	83,9	117,4	86,4	58,8	88,9	57,3
Belgium	109,6	93,2	107,1	146,2	192,1	190,6	105,4	142,2	130,9	40,8	49,9	59,7
Aggregate	n.a	55,5	85,9	n.a	130,7	155	n.a	76,8	97,7	n.a	53,9	57,3

Source: Bank for International Settlements
Note: 'Aggregate' gathers 45 advanced and emerging economies

Next Generation EU impacts

2

Is Next Generation EU a game changer? A Comparison with IRA and ways to respond

Note written by Didier Cahen, Alicia Valroff with Elias Krief

The Covid-19 crisis significantly hit economies worldwide. On 21 July 2020, the EU Council agreed upon a massive and unprecedented recovery plan – Next Generation EU – to kick-start the European economy and support the ecological and digital transitions, making Europe more resilient and better adapted to future challenges.

This program was designed out of the solidarity between Member States and the will to help the most severely hit by the pandemic conditional on structural reforms to improve their economic situations and resilience capacity.

The disruptions in global supply chains associated with the pandemic have also led countries to reflect on the state of their industrial fabric and capacities. Namely, the renewed interest in industrial policy worldwide is visible through the launch of the Inflation Reduction Act in the US, a massive subsidy program focused on the US market that aims at decarbonizing the American economy thanks to public and private investments in cleantech and clean energy.

NextGeneration EU was agreed in principle by the European Council on 21 July 2020 and officially entered into force on 19 February 2021. The goal is to make the EU greener, more digital, healthier, more equal and stronger. It consists of a massive subsidy plan focused on the EU Member States and financed by common debt and aiming at helping Member States recover economically and socially from the Covid-19 crisis as well as reinforce their efforts regarding the digital and green transitions. Strong requirements in terms of green and digital investments are included in NGEU. The announcement of the NGEU program also aimed at reassuring markets regarding the strength of the EU.

The goal of the first part of this paper is to assess the progress of NGEU almost 4 years after its launch, and to see if it has met the expected benefits, in a context where the EU economy remains less dynamic than its international counterparts (*e.g.* US, China...).

On 16 August 2022, the Inflation Reduction Act was passed by the Biden administration with the aim to address climate change in the US through a massive plan of subsidies and tax breaks. It is the third piece of legislation of a \$1.2 tn investment plan that aims at safeguarding the US's competitive edge. Some measures of the IRA, most notably the Local Content Requirements (LCRs), have come under severe criticism for undermining the free trade principles that are at the core of the World Trade Organization (WTO). Yet, one year on, the IRA has proved very efficient and attractive, with a massive movement of industries and capital relocating in the US.

The objective of the second part of this paper is to study the effectiveness of the IRA and how it potentially threatens the European Union.

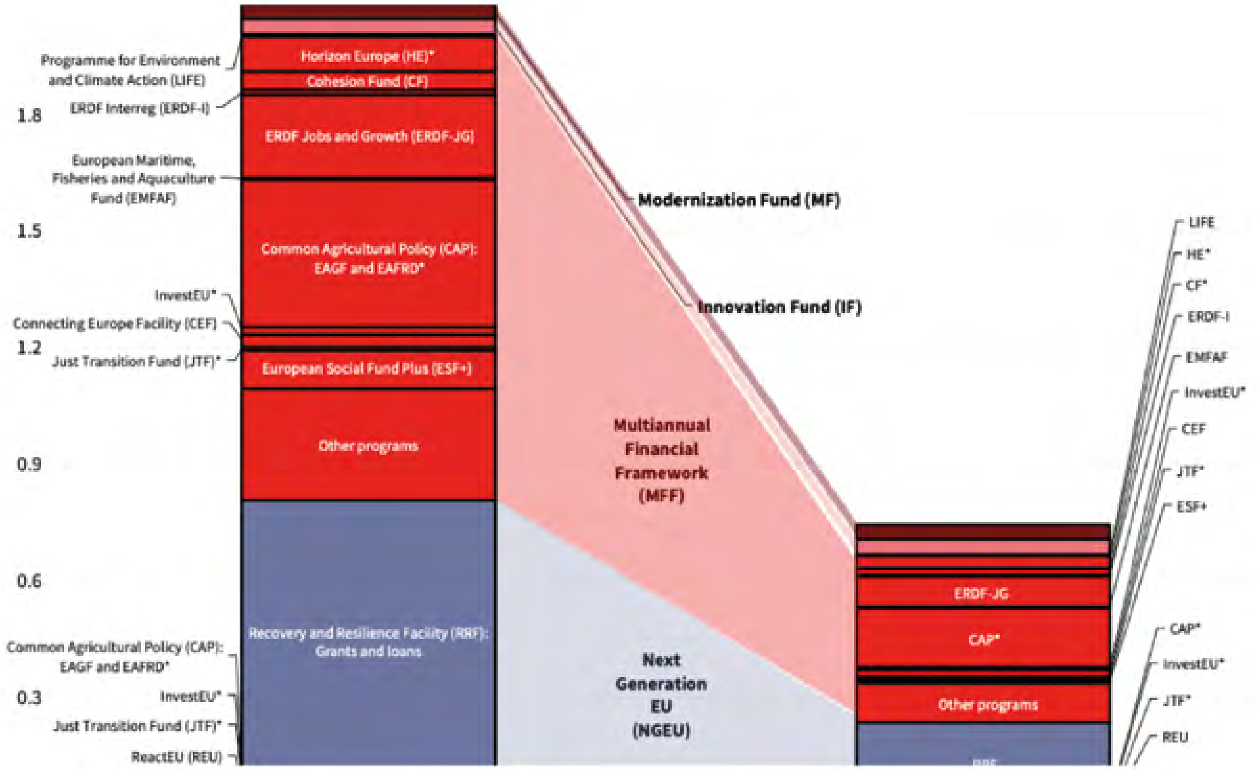
The third part of this paper shows that government support through the IRA in the US turns out to be more efficient than through NGEU in the EU. Even if NGEU has been designed following virtuous and ingenuous principles, its deployment seems suboptimal, and the benefits are slow to come.

1. NGEU is an unprecedented joint response to the Covid-19 crisis, making over €800 bn available to Member States to stimulate economic recovery by investing mainly bin the green and the digital transitions

In the wake of the economic challenges brought about by the Covid-19 crisis, the EU agreed on the Next Generation EU program on 21 July 2020 to provide financial support to its Member States, stimulate economic recovery and transform the EU into a more resilient, sustainable, and competitive region in the post-pandemic era. The program aims to address key challenges such as climate change, digitalization, social inequality, international competition, and economic disparities across EU countries

NGEU was preceded by three other program adopted in early 2020: (i) the temporary Support to mitigate Unemployment Risks in an Emergency (SURE), which empowered the European Commission to borrow up to €100 bn between 2020 and 2022 to

CHART 1.
EU Funding Programs as per the Multiannual Financial Framework (MFF) 2021-2027, the NGEU program and additional funds



Source : EU Commission

finance loans for Member States to fund expenditures necessary for preserving employment throughout the pandemic ; (ii) the European Investment Banks' Guarantee Fund of €25 bn addressing liquidity and funding needs of European businesses, predominantly SMEs. The Fund would enable the EIB to mobilise up to €200 billion in resources for viable firms affected by the crisis; and, (iii) the ESM's Pandemic Crisis Support (PCS), an ESM credit line of up to €240 billion (2% of Euro area GDP in 2019) to spend on direct and indirect health-related costs.

The Next Generation EU program has a financial volume of approximately **€750 billion** (at 2018 prices). Its centerpiece – the Recovery and Resilience Facility (RRF)[1] – consists of **€338 bn in grants and €385.8 bn in loans**[2] that are made available to Member States over the period 2021-2026. **The RRF is a performance-based instrument: all the funds must be requested during the lifetime of the program, *i.e.*,** before Q3 of 2026. NGEU is also linked to the 2021-2027 budget of the EU's Multiannual Financial Framework, and together they amount to more than €1,800 bn (12.4% of the EU's GDP of 2021).

As the funds are provided through the issuance of joint EU debt, NGEU underlines the European solidarity and support for the Member States most affected by the crisis. It also aims at targeting new priorities insofar as **at least 37% of RRF funds will be spent on fighting climate change** as part of a major investment plan combining EU and national public funds as well as public and private investments to support the EU on its path to climate neutrality by 2050.

Moreover, **20% of RRF funds** – Next Generation EU largest component (see below) – **will be invested in the EU's digital transformation** (cybersecurity, artificial intelligence, supercomputing...).

This part aims at thoroughly presenting the NextGeneration EU program by describing the several instruments it encompasses and the performance based approach according to which funds are granted to Member States. Then, the paper describes the state of play as of January 2024 and the slow progress of NGEU due to:

- insufficient absorption capacity of the Member States, the lack of qualifying profitable projects and skilled workforce in public administration,
- the REPowerEU initiative that led to amend the

1. See 1.2.
2. At current prices, which represented respectively €312.5 bn and €360 bn at 2018 prices.

RRF Regulation to add additional €20 bn for energy projects in the NRRPs,

- Russia's war against Ukraine that is leading to delays in implementation of the National Recovery and Resilience Plans (NRRPs),
- and some amendments linked to inflation and supply chain bottlenecks.

Eventually, the financing of NGEU will be under focus as it is the first time in the EU history that the Commission is allowed to issue such a substantial common debt.

1.1 NGEU is one of the tools at the EU's disposal to achieve its objectives of building strategic resilience, and bring the private sector onboard to push environmentally related investments

This paper is deliberately focused on NGEU as to provide a more precise overview, but NGEU is part of a larger movement of European decisions towards climate neutrality and strategic autonomy.

The first relevant decision on the matter was the launch of the European Green Deal (EGD) in December 2019, which mostly aimed at strengthening the EU regulatory framework with the Fit for 55 (FF55) energy and climate package[3]. Yet, EU financing dedicated to the EGD were initially limited and left most of the financial burden to the national level.

In 2020, the EU created the NGEU program which is linked to the Multiannual Financial Framework (MFF) and whose centerpiece is the Recovery and Resilience Facility (RRF)[4]. 37% of RRF spending is earmarked for climate action and 20% for the digital transition, and the overall budget of the EU also dedicates a significant amount – about €750 bn – to tackling climate change (*see Chart 1*).

In 2022, the energy crisis triggered by the war in Ukraine led to the REPowerEU plan which mainly strengthened the EU energy regulatory framework. The goal is to phase out Russian fossil fuels, to encourage energy sobriety and production of clean energy in Europe.

In 2023, the Green Deal Industrial Plan (GDIP) was launched to address tensions in cleantech supply chains and to create a more conducive environment to advance the EU's manufacturing capacity for net-zero technologies and products. Its objective is to put net-zero industry at the heart of future EU competitiveness and energy security. It is articulated around two new pieces of law: the Net Zero Industry Act (NZIA) and the Critical Raw Material Act (CRMA). The NZIA and CRMA introduce targets and regulatory framework and governance.

A recent rapport from the Jacques Delors Institute[5] deems that "the regulatory push remains shallow". Indeed, it explains that "the NZIA sparked little enthusiasm in the political and industrial ecosystem, due to the lack of concrete instruments to achieve the new target of 40% of European production in clean technologies, a figure that is, moreover, unsubstantiated. Apart from carbon capture, the law contains no quantified targets by sector, even though vulnerabilities and the need to deploy new industrial capacity vary greatly from one technology to another and depend on the stage in the value chain under consideration. Additionally, the list of net-zero technologies excludes some key sectors such as energy efficiency and near-zero materials".

To finance the GDIP, the Strategic Technologies for Europe Platform (STEP) has been created to recycle existing funds; the overall financing of GDIP remains modest. Although still a blueprint, the GDIP contributes to the design of an EU-wide industrial policy aligned to decarbonization goals.

Eventually, in September 2023, the European Chips Act came into force and aims at fostering semiconductor production in the EU, reducing external dependencies, and doubling the EU's global market share to 20% in 2030. The act is based on a three-pillar structure: the "Chips for Europe" initiative which aims at supporting research, development and innovation in the EU chips ecosystem and improve the transition "from lab to fab"; the second pillar focuses on improving supply security with a new framework to attract large-scale investments in production capacities; and the last pillar aims at setting up a co-ordination mechanism between Member States and the Commission to monitor market developments and anticipate crisis.

The act provides derogations to state aid rules for key facilities, reallocates €3.3 bn from existing EU funds complemented by €2.9 bn to relevant projects, and seeks to rationalize investment by Member States. The European Commission intends to mobilize €43 bn in public and private funds through the act, with €11 bn coming from the repurposing of existing funds[6].

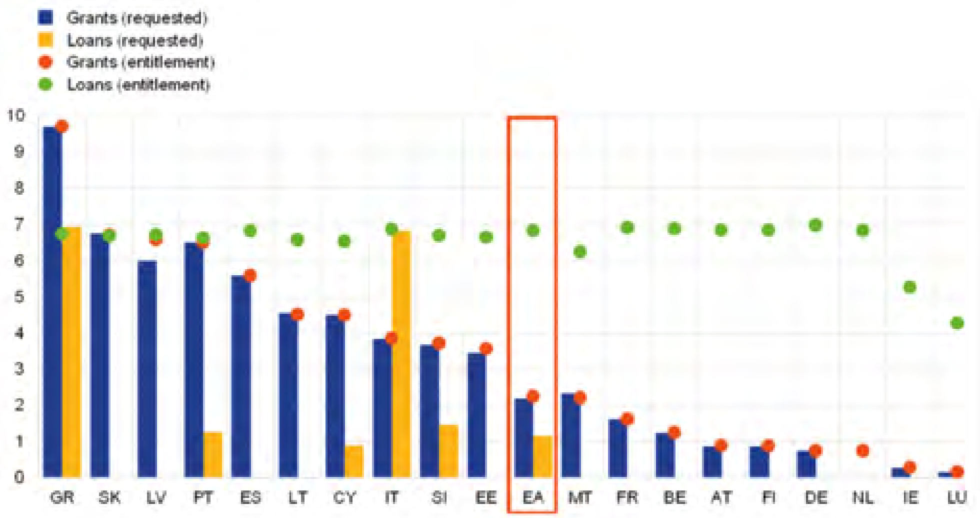
3. Under the European Climate Law, the EU committed to reduce its net greenhouse gas emissions by at least 55% in 2030 compared to 1990. The FF55 package is a set of 12 proposals to revise and update EU legislation and make all sectors of the EU's economy fit to meet this target. Source: the European Commission.
4. See 1.2.
5. "Energy Union 2.0. to deliver the European Green Deal: stronger governance, common financing and democratic tools", Jacques Delors Institute, November 2023.
6. Data and information are taken from "The return of industrial policies: policy considerations in the current context", OECD, 8 November 2023.

TABLE 1.
NGEU program, breakdown by instruments

Name of the instrument	Amount of the instrument	Purpose of the instrument
Recovery and Resilience Facility	€723.8 bn (€338 bn in grants + €385.8bn in loans)	Supporting the implementation of structural reforms, investing in green and digital transitions, and enhancing the resilience of national economies
React-EU	€47.5 bn	Supporting investments and reforms, focusing on mitigating social and economic of the Covid crisis, especially through employment
Just Transition Fund	€10 bn	Assisting regions that are heavily dependent on fossil fuels in addressing challenges associated with the green transition
Rural Development	€7.5 bn	Supporting the vibrancy and economic viability of rural areas through funding and actions that support rural development
InvestEU	€5.6 bn	Mobilizing private and public investment by providing guarantees and technical assistance to support sustainable infrastructure projects, R&D, and SMEs
Horizon Europe	€5 bn	Strengthening the impact of R&D in developing, supporting and implementing EU policies while tackling global challenges
RescEU	€1.9 bn	Protecting citizens from disasters and managing emerging risks
REPowerEU	€20 bn	Saving energy, producing clean energy, diversifying energy supply chains

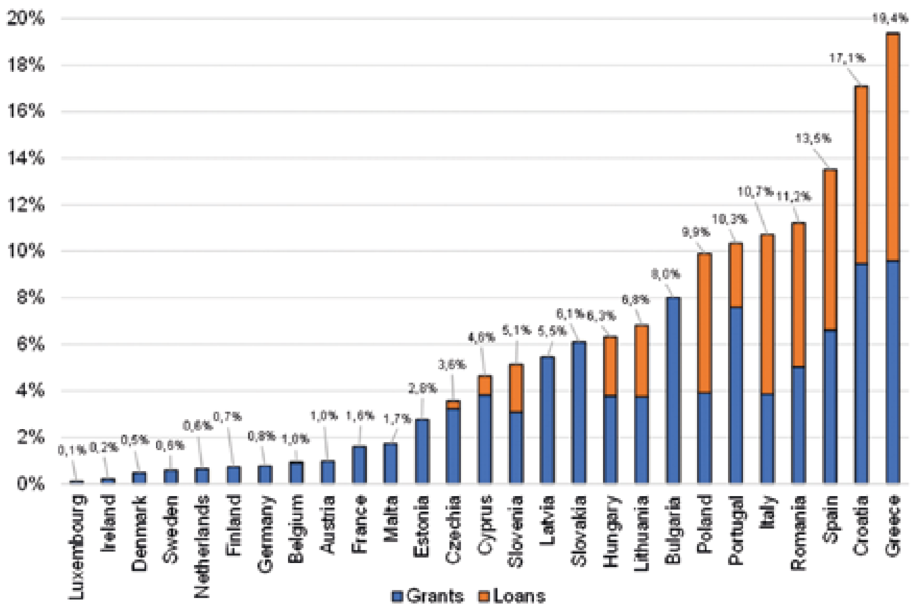
Sources: NGEU tracker, European Council
Notes : REPowerEU chapters must be included in Member States' NRRP but REPowerEU is not per se part of NGEU

CHART 2.
RRF entitlements and funding requested in Euro area countries (2021-26, percentage of GDP)



Source : ECB

CHART 3.
RRF funding (loans and grants) to be received by EU Member States, % of GDP



Source: EU Commission, NGEU tracker

All the decisions mentioned above combined with the role of institutions like the EIB in leveraging public and private funds and the recently voted Emission Trading System (ETS) reform are contributing to filling critical gaps in the EGD policy architecture, in terms of funding, regulation and governance.

1.2 NGEU encompasses several instruments to achieve its objectives: green and digital transitions, structural reforms to recover from the pandemic and economic resilience in all parts of the Union

REPowerEU was adopted on 4 October 2022 by the European Council to reinforce its strategic autonomy *vis-à-vis* Russian fossil energy; the revised Recovery and Resilience proposal offers Member States the possibility to add a REPowerEU chapter to their National Recovery and Resilience Plan, thus closely intertwining REPowerEU and NGEU, though REPowerEU is not part of NGEU. REPowerEU is based on three pillars: energy savings, renewable deployment and supply diversification.

As pointed out by the Jacques Delors Institute, "No individual Member State possesses the capacity to independently manage the accelerated phasing-out of Russian gas. This underscores the need for a collective, coordinated effort on a European scale". REPowerEU goes side by side with FF55 as "it first requires the full implementation of the FF55 proposals and higher targets for renewables and energy efficiency and lifting permitting barriers to renewable deployment. It aims at tripling the installed capacity of solar and wind by 2030. If fully and successfully implemented, REPowerEU could lead to a 57-58% emission reduction by 2030, overshooting the EU Climate Law objective of -55%"[7]

Eventually, no EU fresh funding is provided for this program: €225 bn of loans still available from the RRF have been redirected towards the achievement of REPowerEU.

1.2.1 With a dedicated envelope of €723.8 bn, the Recovery and Resilience Fund (RRF) is the centerpiece of Next Generation EU, with a focus on the green and digital transitions

The RRF is the centerpiece of the NGEU program and Member States are entitled to a certain amount of grants and loans. For 70% of the total of €338 bn available in grants, the allocation key takes into account the Member States' population, the inverse of its GDP per capita and its average unemployment rate over the period 2015-2019 compared to the EU average.

For the remaining 30%, instead of its unemployment rate, the observed loss in real GDP over 2020 and the observed cumulative loss in real GDP over the period 2020-2021 is considered.

Member States can also request a loan worth up to 6.8% of their 2019 Gross National Income (GNI).

1.2.2 Italy and Spain are the main recipients of the Recovery and Resilience Fund in volume

Chart 2 reflects the agreed allocation of RRF funds of 2023[8] as a percentage of each Member State GDP. One third of the fund (30.1%) is currently[9] estimated to be absorbed by Italy (€71.8 bn in grants and €122.6 bn in loans), or 10.9% of Italy's 2021 GDP. Spain has become the second largest recipient of the RRF's fund with 25.6% (€79.8 bn in grants and €83.2 bn in loans), or 13.5% of Spain's 2021 GDP.

The structure of the RRF was designed at a time when it was thought that interest rates were going to be "low for long". Since the start of 2022, interest rates have risen rapidly for all sovereign issuers including the EU, but it does not seem to have interfered with the Commission's issuance of bunds to fund the RRF and other EU programs. Through this period, EU bond issuance was met with steady investor demand, despite the backdrop of market volatility.

1.3 Recovery and Resilience Facility (RFF) funds are awarded to Member States following national plans and are conditional on the delivery of reforms and investments

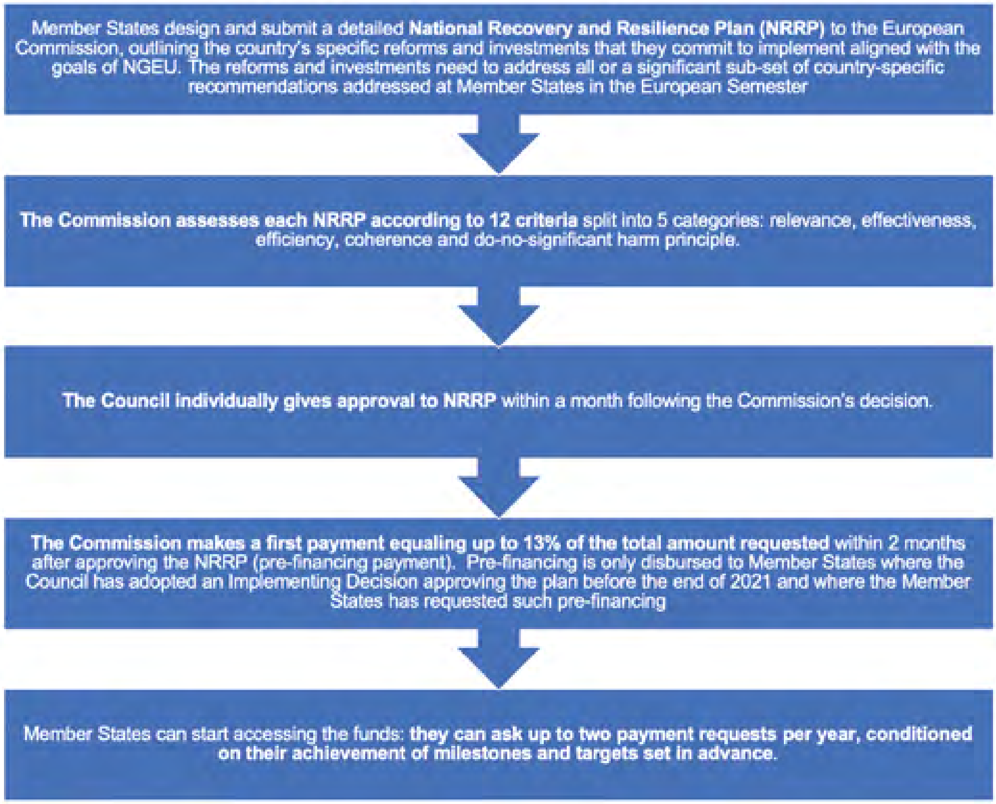
The Recovery and Resilience Facility is performance based. This means that the Commission only pays out the amounts to each country when they have achieved the agreed milestones and targets towards completing the reforms and investments included in their plan.

As there is little common policy regarding energy, the green transition, budgets and industries, NGEU has adopted a decentralized model that relies on Member States, which have obligations of results but not of means, in contrast with the US centralized approach of the IRA.

Thus, to access the loans and grants offered by the NGEU program, Member States are required to go through the following procedure:

7. Op. Cited Jacques Delors Institute.
8. Several Member States have requested amending their initial plan written in 2021.
9. Data of 30 September 2023.

CHART 4.
Procedure for receiving European funds



Source: Fondation Robert Schumann, European Commission

The EU is determined to get results from the NGEU program and has introduced clauses in the RRF Regulation to ensure that Member States are moving in the right direction. First, the disbursement of funds is conditional on achieving satisfactory progress on the roadmap submitted by Member States to the EU Commission. Additionally, as a preventive action, if the Commission discovers deficiencies, it can interrupt or suspend payments to Member States until the problems detected are resolved. The Commission can also take action after payments have been made by introducing financial corrections if it identifies failures at a later stage.

1.4 January 2024 state of play: NGEU is almost used at full capacity but faces deployment issues

Halfway through its lifetime, 30.5% of RRF funds have been disbursed. More precisely, 41.9% of the total RRF grants available and 20.5% of the total RRF loans available have been disbursed (*see Table 2*).

On 9 November 2023, V. Dombrovskis[10] affirmed that “the implementation of the [Recovery and Resilience] Facility is now at full speed. We expect, if everything goes according to plan, the amount of disbursements to exceed €200 billion by the end of the year”. Additionally, he warned that “we also need to deal with backlogs. Towards the last years of the RRF's timeline, we should avoid an accumulation of payment requests and funding needs”.

TABLE 2.
RRF funds available and disbursed as of mid-January 2024

	Total RRF	RRF Grants	RRF Loans
Available (EUR bn)	723,8	338	385,8
Disbursed (EUR bn	220,5	141,6	78,9
Percentage disbursed	30,5%	41,9%	20,5%

Source: EU Commission

1.4.1 The 27 national plans have been approved by the Commission and adopted by the EU Council

Table 3 highlights that the 27 Member States' NRRPs have been approved by the Commission and adopted by the EU Council.

As of January 2024, 27 Member States had submitted requests for amending their plans. These modifications are an opportunity to include a REPowerEU chapter in the plan – which has been done by 23 Member States – but also to address

10. V. Dombrovskis, “Statement at the European Parliament BUDG-ECON committee 12th Recovery and Resilience Dialogue”, October 2023.

TABLE 3.
State of play on implementation of RRF payment requests (as of December 2023)

	BE	BG	CZ	DK	DE	EE	IE	EL	ES	FR	HR	IT	CY	LV	LT	LU	HU	MT	NL	AT	PL	PT	RO	SL	SK	FI	SE
27 plans approved by the Commission and adopted by the Council																											
21 pre-financing disbursed (EUR 56.6 billion							*																				
25 Operational Arrangements signed																											
42 payment requests submitted to the Commission		2x	2x					4x	3x	2x	3x	4x										3x	2x	2x	3x		
28 payments disbursed (EUR 174.69 billion)								2x	3x		2x	3x										2x	2x		2x		

Source: EU Commission

administrative capacity issues with additional measures, to increase the absorption capacity of RRF and other EU funds, and to catch up on the disbursement schedule[11].

Several Member States have used the option to take out loans under the RRF; as part of modifying their plans, ten Member States have asked to increase the amount of loan support or requested loan support for the first time for an extra amount of €127.2 bn, bringing the amount of requested RRF loans to €292.6 bn.

As of December 2023, the Commission had endorsed 18 modified Recovery and Resilience Plans[12].

Overall, the Commission has so far received 55 payment requests and disbursed a total amount of €220.5 bn through 32 payments, of which €141.6 bn are grants and €78.9 bn are loans[13].

1.4.2 NGEU is a slow and complex process which faces Member States' limited capacity regarding the absorption capacity of European funds

Though it is an innovative initiative that relies on strong rational principles (*e.g. performance based approach*), NGEU remains so far too little used, compared to the initial planning and ambitions. its deployment is not optimal and NGEU procedures turn out to be slow, complex and very bureaucratic. This can be explained by several reasons.

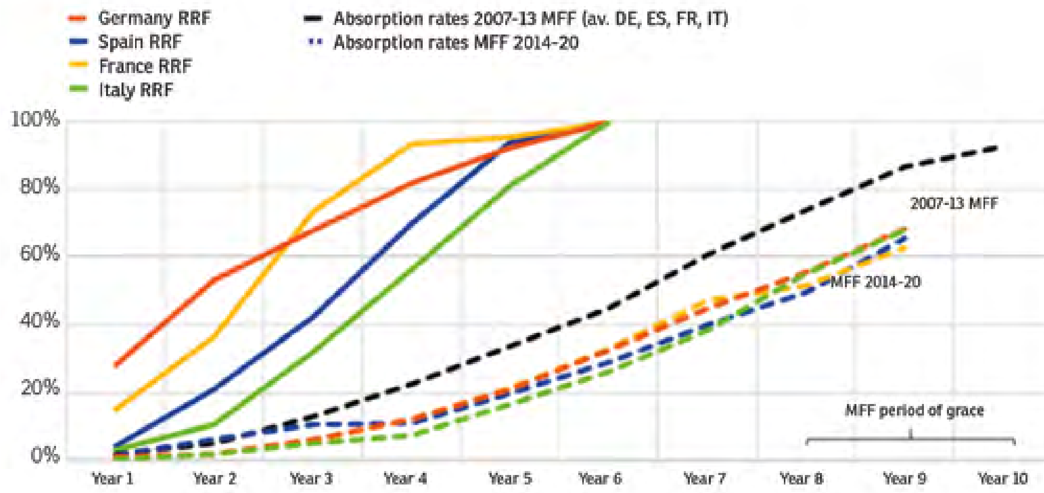
First, NGEU is a very bureaucratic tool, which stumbles upon the lack of skilled and efficient workforce in public administration – local, regional, national and even European in some cases. This is particularly visible in the difficulties of the Commission and Member States to keep up with the initial indicative disbursement calendar as seen above. Additionally, the complexity in the structure of the program – *e.g.*, encompassing seven different funds and being intertwined with separate plans like REPowerEU – only adds up to the existent difficulties.

A massive challenge lies ahead of the EU insofar as approximately two thirds of the RRF envelope will have to be disbursed during the second half of the facility's lifetime. In that respect, the capability of the Commission can be questioned as such an amount to disburse indicates a future heavy workload in terms of assessing the required preliminary conditions in due time. This is all the more important as, even during the first half of RRF's lifetime, some preliminary assessments were overdue; indeed, no preliminary assessments have been made publicly for the requests submitted by Greece on 17 May, Estonia on 30 June, and Croatia on 24 July[14].

Second, past experiences have suggested that Member States have limited absorption capacities, which are likely to hinder the speed of the disbursement of NGEU loans and grants. The challenge will be for Member States to have the capacity to absorb a significant amount of money in a short period of time.

11. Op. Cited V. Dombrovskis.
12. "Recovery and Resilience Dialogue with the European Commission", EGOV, 11 December 2023.
13. Source: Recovery and Resilience Scoreboard.
14. The European Commission must approve the NRRP within the two months following their submission.

CHART 5.
Projected cumulative absorption rates of RRF funding compared with realized absorption rates of past EU multiannual financial frameworks (x-axis: year of programme; y-axis: absorption as cumulated percentage of total envelope)



Source : Dorrucci and Freier (2023), based on European Commission data and estimates of the Working Group on Public Finance of the European System of Central Banks. For France cash pay-outs under RRF according to Coeuré report (2021).
Notes: The solid lines refer to the foreseen absorption of RRF funds in Germany (DE), France (FR), Italy (IT) and Spain (ES) over the RRF period (2021-26). The dotted lines refer to the actual absorption by these four countries of past EU resources made available under the EU's multiannual financial framework (MFF). The absorption rate is the amount paid to a Member State as a percentage of the total EU budget made available to that country. Year 1 is the first year of the respective programme, i.e., 2007 for the 2007-13 MFF, 2014 for the 2014-20 MFF, and 2021 for the RRF. Pre-financing under the RRF is included in Year 1. The absorption rate of the 2007-13 MFF (black dotted line) is shown as average of the four countries and includes the European Regional Development Fund (ERDF), the Cohesion Fund (CF) and the European Social Fund (ESF), while the 2014-20 MFF includes only the ERDF and the CF. Data under the 2014-20 MFF are provisional for the year 2021 (Year 8 in the chart)

In that respect, Chart 5 shows that, for the 2014-2020 multiannual financial frameworks, the largest Member States absorbed only 60 to 70% of funds that they were allocated after 9 years. Regarding NGEU, the same Member States are expected to absorb the entirety of the funds they were allocated over 5 and a half years.

Third, the lack of qualifying and profitable projects[15] to be financed by NGEU funds slows the process and consequently, little progress is visible. One explanation is the weak industrial fabric of the EU and the lack of skilled workforce, especially in strategic sectors[16]. As a result, some countries struggle to fulfill their milestones and targets, and the delays observed in the implementation of the NRRPs lead to question the efficiency of NGEU.

1.4.3 Spain seems to be on the right track

Spain seems to have a quite successful story with NGEU so far[17]. As of 18 October 2023, €37 bn were received so far in grants, representing 46.4% of the total initial grant amount for Spain. Loans were only included in the plan in the revision that took place in October 2023. So far, no payment in loans was made. Overall, the total payment received by Spain so far represents 22.7% of its plan, and Spain is ranking third in progress of its NRRP (with 29% of milestones and targets fulfilled), which is an indicator of the positive impact of NGEU in Spain.

CHART 6.
Spanish National Program: Breakdown of funding by lever policy

Source: EGOV (think tank of the European Parliament)

15. Prof. A. Bartzokas from the LSE Hellenic Observatory and the University of Athens identified several possible implementation gaps in the EU RRF, and among them were "lack of timely implementation [and] limited project upstreaming capacity". Source: Growth Lab, Harvard University.
16. See 3.4.
17. The European Parliament, "Spain's National Recovery and Resilience Plan", October 2023.

TABLE 4.
Spanish national program : Measures receiving the largest amount of funding

Ten largest projects — 39.4 % Share of total national RRF

Ten largest projects	€ billion
Instituto de Crédito Oficial (ICO) Green Line and Enterprises and Entrepreneurs Line (LP 5)	22.2
CHIP Financing Facility (LP 5)	10.8
Regional Resilience Fund (LP 5)	9.8
ICO Loan Facility for the Promotion of Social Housing (LP 1)	4.0
ICO Next Tech Fund (LP 5)	4.0
Rehabilitation programme for economic and social recovery in residential environments (LP 1)	3.0
National transmission network: European Corridors (LP 2)	3.0
Programme to boost industrial competitiveness and sustainability (LP 5)	2.5
Low-emission areas and transformation of urban and metropolitan transport (LP 1)	2.5
Development of innovative renewables, integrated into buildings and production processes (LP 3)	2.4

Source : EGOV (think tank of the European Parliament)

The Spanish NRRP was amended in October 2023 and increased its value by roughly 135% (from €69.5 bn to €163 bn: the grants went from €69.5 to €79.8 bn, and loans representing €83.2 bn were added). The Spanish NRRP also exceed the RRF's target of 37% of funds disbursed in the green transition and 20% in digitalization as it will respectively invest 39.9% and 25.9% of the funds it has been allocated.

Spain's amended plan includes 11 lever policies (LPs) observable on figure 1. Out of 253 measures planned, 111 are reforms and 142 are investments. Reforms aim at improving business demographics and climate, promote entrepreneurship and increase the size and efficiency of companies.

The main focus will be LP 5 which targets the modernization and digitalization of the Spanish industry and SMEs and for which 33 investments have been planned and €87.8 bn – or 54% of the Spain's NRRP – have been budgeted. Out of the 10 largest investment projects worth €64.2 bn or 39.4% share of Spain's RRF allocation, five are featured in LP 5 with endowed RRF resources of 49.3 bn, equaling roughly 30% of the available RRF allocation (*see Table 4*).

The Spanish NRRP also introduces strategic public-private partnerships (PERTEs) in LP5, which are the equivalent of the Important Projects of Common European Interest (IPCEIs) at EU level[18]. Table 5 shows the different areas in which Spain aims at developing public-private partnerships. As of December 2022, about 29% of the budget for these PERTEs projects had been awarded or opened to calls.

However, an industry representative explained to Eurofi that although the program is on course and the government is making progress on the milestones that were sought, according to data and their experience, SMEs are not receiving all the aid they need to boost their investments, to increase their productivity and gain competitiveness.

TABLE 5.
Execution status of the Spanish PERTE projects
(€ millions, as of 14/12/2023)

PERTE project	Public funds	Awarded and open calls
Microelectronics	12,250	–
Renewable energies, hydrogen and storage	10,475	4,957
Electric and connected vehicle	4,295	2,018
Decarbonisation	3,100	–
Digitalisation of the water cycle	2,790	425
Aerospace	2,126	1,844
Social and care economy	1,808	380
State-of-the-art health	1,650	912
Agrifood industry	1,450	1,063
New language economy	1,101	298
Circular economy	792	192
Marine sector	310	250
Total	**42,146**	**12,339**

Source: Caixabank research, Portal of the Recovery, Transformation and Resilience Plan

This is due to the fact that the calls for proposals are complex and usually have a very short deadline, so that small and medium-sized enterprises that do not have a specific department to follow these issues often give up access these calls for proposals. To remedy those flaws, they made some recommendations including:

- Improve coordination between the different levels of government to manage public funds,
- Simplify access to resources by, for instance, generating large calls for proposals with relevant budgets, establishing sufficiently reasonable deadlines, standardizing and simplifying the requirements for accessing measures,
- Reinforcing communication and dissemination,
- Introducing fiscal measures, such as adopting new instruments that have proved efficient in other countries and facilitated the financing of some actions...

18. See 3.4.3.

1.4.4 Italy is now keeping up with its ambitious plan

Italy is the main beneficiary of the RRF funds: the country is entitled to receive €191.5 bn of NGEU funds - €68.9 bn in grants and €122.6 bn in loans. Italy has known a rocky start and seems now to continue to have difficulties keeping up with its objectives and spend the money received accordingly.

The Italian NRRP is structured around six fields of intervention that will be targeted through a mix of reforms and investments. Across its six missions, Italy plans to exceed the RRF's expenditure targets by spending 37.5% of its RRF allocation on the green transition, and 25.1% on the digital transformation. All six missions are also required to address three horizontal priorities: youth, gender equality and territorial cohesion.

Italy's NRRP counts 60 reforms to be carried out in the scope of all 6 missions, with a focus on missions 1 ("Digitalization, innovation, competitiveness, culture and tourism"), 2 ("Green revolution and ecological transition") and 4 ("Education and research") (*see Chart 80*). In parallel, Italy has committed to 132 investment measures aiming at increasing the country's growth potential in the long term.

CHART 7.
Breakdown of funding by mission

Source: EGOV

Italy's initial NRRP was said to be above ambitious and has already been re-written by M. Draghi[19] who admitted in December 2021 that it was impossible to keep up with such a plan. In 2022, only 10 out of 27 goals were achieved, and only €12 bn were spent instead of the €40 bn planned. In March 2023, Brussels decided to temporarily freeze Italy's third instalment as it failed to deliver the expected milestones and targets, especially the accommodation for 7,500 university students. In that regard, the Financial Times[20] wrote that Italy "has struggled to keep pace with the demanding reform and investment timetable agreed with Brussels in 2021, particularly since Meloni's rightwing coalition took power last year".

The difficulties encountered by Italy show that money is not the only issue European Member States are facing. In that regard, H. Waiglein, the Director General of the Federal Ministry of Finance of Austria, stated for the *Eurofi Magazine*[21] that "money is less of an issue than the co-ordination of all markets to deliver goods and services needed for the green transition".

Italy submitted a revised version of its NRRP during the Summer 2023, and the Council adopted it on 19 September 2023. Now that necessary amendments to the plan have been made, Italy seems to be back on track: as of December 2023, the Commission had disbursed €101.8 bn to Italy out of €191.5 bn, and Italy has submitted a fourth payment request.

Nevertheless, to be able to spend funds received faster, Italy could allocate more money to tax credits as "private entities tend to be more nimble than public agencies bogged down in cumbersome bureaucracy", which is the strategy chosen by the US and it seems to have borne fruit so far (*see Part 2*).

1.5 NGEU is financed by common debt and national resources

Chart 8 highlights the key features of the EU debt issued to finance the NGEU program.

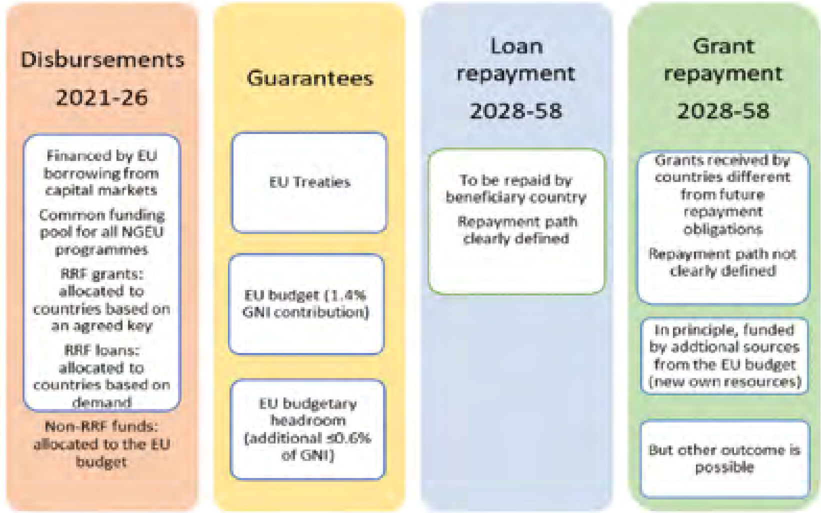
1.5.1 NGEU is by far the largest EU bond-financed program ever

The financing of NGEU relies primarily on common debt. Before the pandemic, the EU was thought to be legally barred from financing its expenditure through joint debt. A recent briefing from the European Parliament[22] highlighted the challenge that designing the RRF represented: "As the EU Treaties do not allow the EU budget to be financed by debt, the RRF had to be run outside the EU budget's framework. (...) The debt taken up for provisioning the RRF is a Commission debt contracted on behalf of the EU, not common debt of the Member States."

"For the RRF, the Commission was exceptionally as a one-off measure authorized to take up a considerable amount of debt. It is to be noted that

19. Mario Draghi was Italy's Prime Minister between 13 February 2021 and 22 October 2022 and took part in the development of Italy's NRRP.
20. "Will Italy squander its €200bn opportunity?", *Financial Times*, 30 August 2023.
21. H. Waiglein, "Green transition and fiscal sustainability", Views, The Eurofi Magazine, September 2023.
22. https://www.europarl.europa.eu/RegData/etudes/IDAN/2023/740087/IPOL_IDA(2023)740087_EN.pdf

CHART 8.
Key features of EU debt within the NGEU/RRF program



Source: ECB

under the RRF in order to satisfy the requirements of the no-bail out clause (article 125FEU) the Member States do not guarantee another Member States' debt".

To fund the NGEU program, the EU borrows on the capital markets, allowing low-rated countries to benefit from its high credit rating that helps obtain more favorable financial terms[23]. To protect this credit rating, the EU is using the EU budget headroom[24] as a guarantee (*see Chart 81, "Guarantees" box*). In order to protect the borrowing under NGEU, the EU headroom is 0.6 percentage points higher than the standard one for the period until 2058, as the debt will be gradually reimbursed over the period 2025-2058[25]. Indeed, the average maturity of EU securities is 11 years, and payback deadline are spread out between 2025 and 2058.

It is the first time in the EU history that such a substantial common borrowing and, to a certain extent, risk sharing mechanisms have become characteristics of a EU budgetary plan. To issue the common debt, the Commission resorts to multiple instruments: a combination of medium – and long-term debt issuance across different maturities via EU-Bonds (both regular and green bonds) and short-term via EU-Bills[26].

The borrowing strategy to finance NGEU relies on the safety and cost-effectiveness of the way money is raised. In this perspective, EGOV explained that "NGEU is making the EU one of the largest issuers of euro-denominated debt (on average €150 bn a year) and the world's biggest green-bond issuers, in line with the diversified funding strategy"[27]. Indeed, the EU plan to finance up to 30% of NGEU, *i.e.* €250 bn, by issuing green bonds. NGEU green bonds can solely fund eligible green measures.

However, as of July 2023, only €44.2 bn in green bonds have been issued, and about €21.4 bn have actually been allocated and given to states. The pool of planned eligible expenditure for NGEU green bonds, however, stands at €187 bn according to forecasts made by the Commission when assessing the NRRPs[28]. The Commission must also ensure that the use of funds complies with the EU Green Bond framework, and report to investors on the impact achieved.

1.5.2 Some uncertainty persists around the resources used to reimburse the common debt

The European Commission has committed to reimbursing the funds borrowed on the markets to finance NGEU in the long run, over the period 2025-2058.

The repayment path of the loan part of NGEU is clearly defined: loans will be repaid by the borrowing Member State. However, the repayment path of the grant part of NGEU has not yet clearly been defined as of January 2024. Two things are certain though: grants received by countries are different from their future repayment obligations, and, as a last resort, all grants will be repaid by the EU budget by 2058 at the latest (*see Chart 8, "Grant repayment" box*).

23. The EU's credit rating (AAA by Fitch and Moody's) is better than the rating of 22 out of the 27 EU Member States.
24. The headroom is the difference between the maximum amount of revenue that the EU can raise for the EU budget and the actual spending from the EU budget.
25. *I.e.*, Member States agreed to a temporary increase in the maximum amount of revenue the EU can call from Member States per year (adding an allocation of 0.6% to the basic own resources ceiling of 1.4% of EU Gross National Income) until all NGEU liabilities have ceased to exist. (source: EU Budget Policy Brief).
26. See "The EU as an issuer: the NextGenerationEU transformation", EU Budget Policy Brief, European Commission, July 2022.
27. EGOV, "Borrowing strategy to finance Next Generation EU", November 2022.
28. Data taken from "Degree of implementation of EU green bonds program linked to NGEU", J.-F. Pons, July 2023.

CHART 9.
Evolution of 10-year benchmark yields for the EU, France, Germany and Spain (in %)

Sources: EGOV, Bruegel, Bloomberg data

Several resources are considered to pay back the debt: the Carbon Border Adjustment Mechanism (CBAM[29]), the EU Emissions Trading System (EU ETS), and a digital levy. The EU also contemplates the possibility of new own resources such as a tax on financial transactions, or a new agreement on corporate taxes[30].

In the coming months, Member States must examine the Commission's proposals about the reimbursement of NGEU and will have to make a decision unanimously. The main question is who will incur the repayment costs of the NGEU[31].

Even though NGEU is a solidarity instrument, it has limits: no economically healthy country will accept to incur the risks to repay for weaker countries of the Union. The enhanced economic and fiscal heterogeneities of the Union are largely responsible for this.

1.5.3 Is EU common debt a fantasy?

The interest rate on European Union bonds is higher than that of its strongest Member States, and that despite its favorable credit rating.

An article by *The Economist*[32] highlights two important lessons that should be drawn from markets' reaction to EU debt and its interest rates: "one is that investors are indicating it is unlikely that there will be more such joint debt issuance in future (...), the second lesson is that markets think of the EU as something that differs from a top-notch sovereign issuer like Germany or America – the safest bets when it comes to lending money. Such governments have the power to raise taxes when they need to repay creditors. The EU, by contrast, needs to ask nicely for national capitals to send a cheque". Even if the EU budget provides strong guarantee, it does not have the sovereignty over its debt as other sovereign states do.

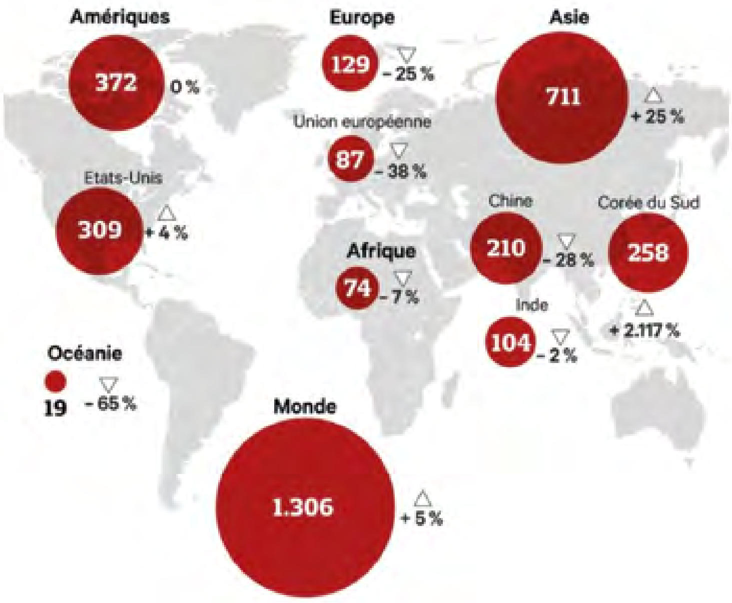
Some indicators can lead to wonder if the common debt issued under NGEU is indeed a first step towards a European safe asset. As explained by *the Banque de France*[33], "a genuine European safe asset would have several benefits for financial stability and European integration and would facilitate the financing of public policies by reducing borrowing costs". Yet, the current situation is different:

- After two years of issuance, and even though the EU has not faced particular problems to get funds, the EU debt turned out to be less attractive for investors than that of its main Member States[34],
- The fact that NGEU is a unique and temporary initiative implies that EU securities are not going to remain on markets forever, which can have a deterrent effect for investors looking for liquid and easily tradable assets,
- Though liquidity has improved with the introduction of the unified funding approach in January 2023, the current market of EU common debt remains narrow and not deep enough, and so, insufficiently liquid.

A recent study by Trendeo, Fives, McKinsey & Company and the institute for reindustrialization shows the distribution of investment by regions and highlights that despite its significant efforts, the EU struggles to convince investors to invest on its

29. CBAM would allow the EU to introduce the same carbon price for domestic and imported products.
30. "L'économie mondiale", CEPII, September 2023.
31. "Plan de relance : 10 points sur les progrès de NextGenerationEU", *Le Grand Continent*, October 2023.
32. "What markets are trying to tell Europe – and why it should listen", *The Economist*, October 2023.
33. "A European safe asset: new perspectives", *Banque de France Bulletin*, April 2021.
34. Op. Cited *Le Grand Continent.*

CHART 10.
Distribution of investment by region
In $bn, between July 2022 and June 2023 compared with the period June 2021- June 2022:
△▽ evolution, in %



Sources: Trendeo, extracted from Les Échos

territory (*see Chart 10*). According to this study, investments in the US have increased by 4% from July 2022 to June 2023 compared with the period June 2021-June 2022, amounting to $309 bn. This is undoubtedly mainly due to the Inflation Reduction Act (IRA).

Additionally, even if China recorded 28% less in investments over the same period, investments in Asia have grown by 25%, especially thanks to a $227 bn investment by Samsung in South Korea. By contrast, investments recorded by Europe between July 2022 and June 2023 stood at -25%; this figure even reached -38% in the European Union (compared with the period June 2021-June 2022), which questions the performance of the RRF and the effectiveness of Member States' public spendings.

Therefore, one can wonder to what extent NGEU is efficient, and what role the IRA plays in such a growth gap between both sides of the Atlantic. Indeed, differences on the efficiency and speed of implementation seem to exist between the IRA and NGEU, potentially threatening to further widen the gap between both regions.

In that regard, the Jacques Delors Institute argues that "at a time when the energy transition is gaining pace, the EU and the United States are actually facing similar challenges: increasing Chinese and international competition, vulnerable strategic value chains, labor shortages, lengthy permitting processes, public sensitivity to activities with a high environmental impact, and demands for a fair and equitable transition. The difference lies within the type of policy answer provided as a result of these challenges"[35].

2. Can the IRA widen the gap between the US and the EU?

On 16 August 2022, the Biden administration promulgated the Inflation Reduction Act (IRA), a **$369 bn subsidy package that aims at making the US the global leader in clean tech, notably by cutting CO2 emission by 40% by 2030**. Though it was announced nearly two years after the launch of NGEU, the IRA raises many questions and concerns on the European side.

This part aims at thoroughly describing the IRA and the goal of the Biden administration to make the US the leader in cleantech energy and to reduce its CO2 emissions by 40% by 2030. It also assesses the success of the IRA one year after it was voted, showing that companies from all around the world are attracted to the US, even if structural headwinds mitigate this deeply optimistic assessment.

2.1 The IRA is a protectionist-inspired subsidy package that aims at making the US the global leader in clean tech and CO2 emission cuts

2.1.1 The IRA gathers a variety of measures worth approximately $400 bn to reach its goals

- The IRA is a massive subsidy package that was signed into law by President Biden on 16 August 2023 and that clearly states the US ambition to:
- Become the global leader in the environmental transition by cutting its CO2 emission by 40% by 2032,

35. Op. Cited Jacques Delors Institute.

- Attract investments on the US territory to reinforce its industrial fabric,
- Enhance innovation in the US to stay at the edge of the digital transition,
- Reinforce its strategic autonomy by weakening China's position at the global level and avoid supply chains disruptions,
- Lowering prescription drug prices.

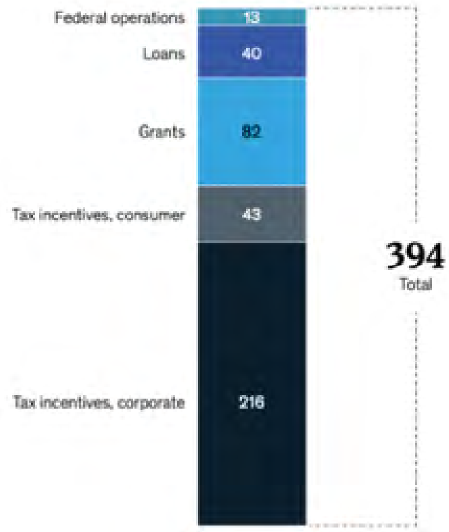
To do so, **the IRA commits $400 bn in tax credits, loans and subsidies over the next 10 years**. But estimations remain unprecise, and subsidies could tally to up to $1.2 tn over 10 years, depending on the take up as most measures are not capped. These funds focus on several aspects of the industrial policies: investing in domestic manufacturing capacity, encouraging procurement of critical supplies domestically or from free-trade partners, enhancing R&D and commercialization of leading-edge technologies such as carbon capture and storage and clean hydrogen, allocating money to environmental justice and demonstrating equity impacts.

A central element of the IRA – and the most criticized overseas – is the protectionist measures on which it relies. Indeed, to benefit from IRA funds, Local Content Requirements (LCRs) must be met, which establishes a disloyal competition between the US and its competitors.

One of many examples of LCRs is the fact that half of the subsidy for EVs depends on a minimum percentage of critical minerals being extracted and processed in the US or a country with which the US has a free trade agreement, and the other half on a threshold percentage of battery components being manufactured or assembled in North America. Additionally, the final assembly must take place in North America to qualify to the IRA tax credit.

In that regard, the EGOV[36] affirms that LCRs are the biggest issue with the IRA: "LCRs come in gross violation of the international trade architecture that is enshrined in the WTO statutes, of which the most-favored-nation principle is blatantly disregarded".

CHART 11.
Energy and climate change funding in the Inflation Reduction Act, $ bn



Source: McKinsey&Company
This exhibit reflects analysis of the appropriation figures contained in the Inflation Reduction Act, as well as those reported by the Congressionnal Budget Office and Joint Committee on Taxation. This analysis may differ from the other analysis due to differences in methodology.

Table 6 shows the sectors in which IRA tax incentives, grants and loans guarantees will be disbursed. A major part of it ($161 bn) will be directed on clean electricity in the form of tax credit while $40 bn will be spent on air pollution, transportation and infrastructure. Other expenditure items include individual incentives for clean energy ($37 bn), tax credit for clean energy production and for fuel and clean vehicles (respectively $37 bn and $36 bn).

TABLE 6.
Allocation of the IRA "Climate and Energy" package, $bn

Climate and energy	**391**
Tax credit for production and investment in clean electricity	161
Air pollution, harmful products, transportation and infrastructure	40
Individual incentives for clean energy	37
Tax credit for clean energy production	37
Tax credit for fuel and clean vehicles	36
Conservation, rural development, forests	35
Subsidies and grants from the Energy Ministry for the increasing efficiency and transmission of electrification	27
Other spending for climate and energy	18

Source: Extracted from the paper : Inflation Reduction Act – Comment l'Union Européenne peut-elle répondre ?", Policy brief n°40, CEPII, February 2023

36. "EU's response to the US inflation Reduction Act (IRA)", briefing by EGOV, September 2023.

It is unarguable that the IRA's primary goal is to provide incentives for private investments, which is a key difference compared to the European approach focusing on public investment: out of the $393.7 bn allocated to energy and climate funding, $216 bn will be received by corporations in the form of tax credits[37] (*see Chart 11*). Moreover, $43 bn in IRA tax credits aim to make EVs, rooftop solar panels and other clean technologies more affordable, and thus to reduce CO2 emissions. For instance, qualifying new EVs will be eligible for a tax credit of up to $7,500.

2.1.2 The IRA is the third piece of law passed since late 2021 that seeks to improve US economic competitiveness, innovation and industrial productivity

The IRA is part of a wider US plan to assert its leadership position on the economic stage and launch a new era of American industrial policy. Indeed, the IRA joins two other pieces of law that seek to improve economic competitiveness, industrial productivity and innovation in the US.

Firstly, the Bipartisan Infrastructure Law (BIL) voted in November 2021 is a piece of law aiming at rebuilding America's roads, bridges and rails, expanding access to clean drinking water, ensuring that every American has access to high-speed internet, tackling the climate crisis, advancing environmental justice and investing in social justice. Over 10 years, the act should allocate an estimated $1.2 tn in total funding, of which $550 bn will be spent on surface-transportation network ($284 bn) and society's core infrastructure ($266 bn) over the first five years.

Secondly, the CHIPS and Science Act passed in August 2022 aims at boosting US innovation and competitiveness, as well as enhance US national security regarding semiconductor manufacturing. Out of the $280 bn dedicated to this act, $200 bn will be for scientific R&D and commercialization. Additionally, about $53 bn will go to semiconductor manufacturers, R&D and workforce development and $24 bn worth of tax credits will enhance chip production. The remaining $3 bn will be spent on programs aimed at developing leading-edge technology and wireless supply chains. Overall, the goal is to keep the US the leader of the industries of tomorrow, including nanotechnology, clean energy and Artificial Intelligence (AI).

The BIL, the CHIPS and Science Act, and the IRA have partially overlapping priorities and together introduce $2 tn in new federal spending over the next ten years.

TABLE 7.
The three main pieces of legislation passed by the Biden administration, (in $bn and %)

	Over 10 years	On average per year	% of 2022 GDP
Inflation Reduction Act	391	39.1	0.2
Chips and Science Act	278	27.8	0.1
Bipartisan Infrastructure Law	1200	120	0.6
Total	**1869**	**186,9**	**0,9**

Source: CEPII[110]
Note: only the "climate and energy" part of the IRA was taken into account in this table, because public spending increase for healthcare is estimated to 0.05% of US 2022 GDP per year

Parallelly, President Biden has inaugurated on 29 November 2023 a Council on Supply Chain Resilience[38]. While measures have been taken to bring manufacturing to the US and strengthen supply chains since supply chain bottlenecks peaked during the pandemic, this Council should further work to keep supply chain secure, diversified, and resilient into the future. Both geopolitical and economic benefits are at stake: having secure supply chains *vis-à-vis* China is key in some fields such as medicine and semi-conductor, and avoiding supply chain disruptions such as those suffered during pandemic fostered will minimize inflationary trends.

2.1.3 Firms from all over the world are entitled to receive IRA funds under certain conditions

The IRA favors its territory and people. To fully benefit from full IRA tax credits, industrial manufacturers must meet prevailing wage and apprenticeship requirements; the goal is to build stronger talent pipelines and better-skilled workforce.

Moreover, many IRA-incentives are conditioned to scaling domestic-production or domestic-procurement requirements. Subsidies allocated through the IRA – which represents 0.17% of the US GDP over 10 years – incentivizes foreign companies to relocate their production sites on the American soil, as the allocation of funds is conditioned to certain Local Content Requirements (LCRs).

In that regard, the EVs are an epitome: as mentioned above, to fully benefit from the EV consumer credit of $7,500, the battery must have been at least assembled in North America, and a scaling percentage of critical minerals in the battery must have been recycled in North America or been extracted in a country that has a free-trade agreement with the US.

37. "The Inflation Reduction Act: Here's what's in it", McKinsey & Company, October 2022.
38. "La Maison-Blanche se transforme en tour de contrôle des chaînes d'approvisionnement", *Les Échos*, 28 November 2023.

Similarly, regarding the electricity production, the $15 tax credit per MWh is granted to companies that have a carbon-free process, but these $15 are conditioned to a LCR: companies must use steel, iron or other products that have been extracted in the US[39].

The conditionality on the sourcing site of materials and/or on the assembling site have been claimed to go against World Trade Organization (WTO) principles, and to be a disguised protectionist decision. An article from the FT[40] phrases the contrast in perspective between the US and the rest of the world, especially Europe: "what the US sees as a strategy to reverse deindustrialization in deprived areas, allies have interpreted as a thinly veiled exercise in protectionism because it encourages companies to shift plants and customers to buy American". IRA subsidies are thus distorting trade, but in the particularly tense current economic and geopolitical context, other countries cannot afford to pick a fight with the US and prefer to follow its path regarding industrialization.

2.1.4 The IRA is financed through new corporate taxes and revenues raised by new reforms

According to figured produced by the Congressional Budget Office (CBO) and the Joint Committee on Taxation, the estimated investments made amount to $369 bn in energy security and the fight against climate change, and $64 bn in the extension of the Affordable Care Act. The funds will be delivered through a mix of tax incentives, grants and loan guarantees. The same sources estimate the revenue raised by these investments to amount to $288 bn through the Prescription Drug Pricing Reform, $124 bn through IRS Tax enforcement, $14 bn through efforts to close the Carried Interest Tax loophole and $313 bn through the establishment of a 15% corporate alternative minimum tax rate for companies with higher than $1 bn of annual financial statement income[41].

The CBO also estimates that the law will reduce fiscal deficits by $237 bn over the next decade[42].

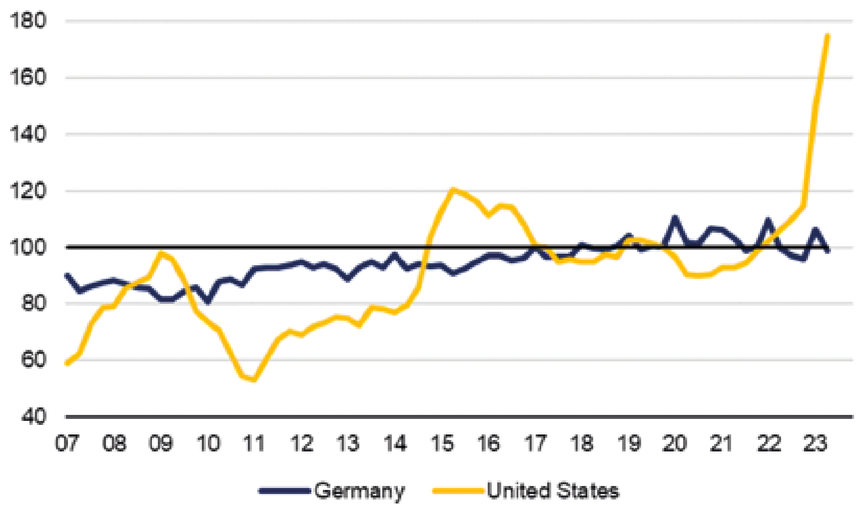
2.2 In one year, the IRA already proved very attractive for both US and foreign companies

As written by G. Moëc[43], "the Inflation Reduction Act (IRA) is one of the ingredients of the current resilience of the US economy – showing up for instance in the already visible rebound in manufacturing investments projects – in stark contrast with the increasingly dismal readings on the European economy".

Chart 85 shows the boom in private investment in non-residential structures on the US territory, while Germany – the industrial heart of the European Union – observes a declining trend: between late 2019 and mid 2023, the volume of private investment in progress has increased by 75% in the US while it remained almost unchanged in Germany.

This gap does not seem to affect only Germany insofar as the IMF World Economic Outlook forecast no economic growth in Italy and a decrease from 2.5% in 2023 to 1.7% in 2024 in Spain.

CHART 13.
Private real investment in non-residential structures, index 2019 = 100



Source: DeStatis, US Bureau of Economic Analysis
Note: last observation from 2023-Q2; data are seasonally adjusted and expressed in real term

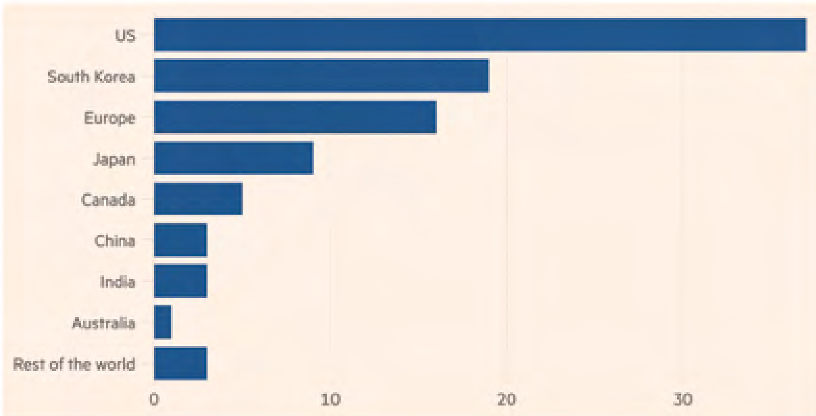
39. Op. Cited CEPII Policy Brief n°40.
40. "A global subsidy war? Keeping up with the Americans", *Financial Times*, 13 July 2023.
41. The IRA imposes a 15% corporate alternative minimum tax on certain corporations ("CAMT"), since Congress focused on the phenomenon of very large publicly traded corporations with significant earnings paying little or no tax, hence the decision to have the CAMT calculated based on book income rather than taxable income.
42. However, as the IRA is uncapped, this figure could be much lower (*See 2.3*).
43. G. Moëc, "In defense of Europe's net zero strategy", AXA Macrocast, 20 November 2023.

TABLE 8.
The past year's 10 biggest projects, by announced capital expenditure

Company	Investment ($bn)	Location	Company HQ
Intel	30	Chandler, AZ	US
Taiwan Semiconductor Manufacturing Company	28	Phoenix, AZ	Taiwan
IBM	20	Hudson Valley, NY	US
Micron	20	Clay, NY	US
Micron	15	Boise, ID	US
Texas Instruments	11	Lehi, UT	US
LG Energy Solution		Queen Creek, AZ	South Korea
Wolfspeed		Chatham County, NC	US
Hyundai and SK On		Bartow County, GA	South Korea
Honda and LG Energy Solution		Fayette County, OH	Japan and South Korea

Source: The Financial Times

CHART 14.
Number of cleantech projects by investor country since August 2022



Source: The Financial Times

Given the conditions to benefit from the IRA mentioned above, the latter seems to be undeniably successful at attracting investors from all around the world.

2.2.1 American firms are massively investing in the US

Out of the 10 biggest investment projects announced in the first year of the IRA, 6 have been made from American companies (*see Table 8*)[44].

The largest investment worth $30 bn is made by American firm Intel to expand a campus in Chandler, Arizona. Among other investments are a $20 bn investment implemented by IBM to expand the technology ecosystem in New York, and a $20 bn investment by Micron to build the US's largest semiconductor plan in Clay, New York. Micron also announced an additional $15 bn investment in Boise, Indiana. Other smaller investments are flourishing, as that of US manufacturer First Solar worth $1.1 bn to open its fifth factory in Iberia Parish, Louisiana.

But as shown by chart 86, "foreign investors want a stake in US cleantech supply chain"[45].

2.2.2 A number of foreign companies are shifting their investment plans to the US to benefit from the IRA

"The flurry of projects comes as US allies roll out their own policies to compete with IRA subsidies that they say have created an uneven playing field" experts of the FT wrote. Indeed, while countries are trying to enhance their industrial policies, they also refuse to be distanced by the US and to miss on significant opportunities to secure a stake in the US supply chain.

- **Asian companies are leading the capital influx to the US.**

South Korea makes the running with 20 projects announced in one year, with 3 of them being among the 10 biggest projects (*see Table 8*). Other important investments have been made by Singapore-based Maxeon Solar Technologies which announced a $1 bn solar cell and panel facility in Alburquerque,

44. "Inside the $220 bn American cleantech project boom", *Financial Times*, 16 August 2023.
45. "The impact of the Inflation Reduction Act, one year on", *Financial Times*, 17 August 2023.

CHART 15.
Contracted capacity, gigawatts

Source: The Financial Times

New Mexico, by Taiwan Semiconductor Manufacturing Company with a $28 bn investment in Phoenix, Arizona, or by Japanese company Toyota which decided an $8 bn investment in its battery manufacturing plant in North Carolina, where the state offered at least $900 mn in incentives.

- **Europe is the second largest foreign investors since the passage of the IRA and the Chips Act.**

On the European side, 19 investments over $100 mn in the US have been registered within the first year of the IRA. This is particularly detrimental to the EU strongest country – Germany – which has the most developed industrial fabric of the Union. For instance, Meyer Burger, a Swiss solar manufacturer, announced last month that it was putting its German expansion plan on hold to open a $400 mn factory in Colorado to receive tax credits from the IRA. Besides, Dutch-headquartered automotive constructor Stellantis announced in February 2023 a $155 bn investments to build new plants in Indiana.

An article from the Financial Times[46] also warns on the overall industrial situation of Germany: "even before the IRA came into force, there were signs that investment was flowing out of Germany. Other European firms are willing to invest on the other side of the Atlantic; it is namely the case of the Italian electricity producer Enel which plans to spend $1 bn in Oklahoma, or the Swedish battery manufacturer Northvolt which is attracted by a nearly $8 bn tax credits for its investments on the US territory[47].

According to a study by the Cologne-based German Economic Institute, the gap between outbound investments by German companies and business investment into the country in 2022 was the largest on record: **more than €135 bn of foreign direct investment flowed out of Germany and only €10.5 bn came in".**

2.3 Structural headwinds mitigate the success of the IRA

The deeply optimistic assessment of the IRA is counterbalanced by the fact that not all the investment projects announced end up materializing in the US. Indeed, major investments have been cancelled in the recent weeks, and this could potentially hinder the swift decarbonization of the US economy intended by the IRA.

An article from *the Financial Times*[48] listed several cancellations of projects in the green energy sector. Namely, the global leader in offshore wind energy Ørsted abandoned two projects aiming at delivering 2.2 gigawatts of power to New Jersey early November, Navigator CO2 cancelled its $3 bn project regarding carbon capture and storage in October, and Ford announced pushing back its $12 bn in Electric Vehicles investments.

46. "A global subsidy war? Keeping up with the Americans", *Financial Times*, 13 July 2023.
47. "Industries vertes: face à l'Europe, l'Amérique de Biden prend l'avantage", *Le Figaro*, 7 July 2023.
48. "Green energy investment headwinds threaten Joe Biden's climate targets", *Financial Times*, 4 November 2023.

Several reasons are accountable for these cancellations. Among them are "high interest rates, supply chain constraints and impediments to permitting new infrastructure. Certain projects have also stalled due to a lack of guidance on tax rules and strict domestic content provisions in the new law"[49].

Additionally, the clean energy sector remains expensive, and uncertainty about the future is making companies question their investments as evidenced by Chart 15: at least 2 projects have been fully cancelled, and more than 2/3 of Ørsted's massive project has been cancelled as well. Besides, 4 other projects representing about 6.5 gigawatts are expected to be renegotiated.

On the one hand, US offshore wind sector is currently at risk as "more than half of all US offshore wind contracts have been terminated this year or are at risk of being ended", which threatens the Biden administration's ambition to deploy 30 GW of offshore wind power by 2030. On the other hand, "large-scale wind and solar projects built on land have been hit by financing costs related to interest rates and a cumbersome process to connect far-flung generation to electric grid". Indeed, it took only three years in 2015 from the interconnection request to commercial operations for such projects, against five years in 2022, indicating that "the backlog is worsening as more projects are attracted due to the incentives in the IRA".

Regarding the strained profitability of projects, there are two main explanations. On the one hand, costs have exploded due to the rise in costs of steel, copper and other scarce metals that are necessary to build wind turbine. On the other hand, governments refuse to increase the price of electricity in order to protect the consumers. Other logistic issues such as the lack of port capacity to berth a boat transporting wind turbines have been brought to explain the termination of some contracts.

The offshore wind sector is not only floundering in the US. Indeed, a recent podcast by F. Lenglet[50] explained that there was a bubble asset on windmill project and that it has burst, leading a significant number of projects to be interrupted or cancelled and crippling the commitment of countries of Northern Europe to multiply by 10 their offshore wind production within the coming years.

Other headwinds are visible in the EV sector[51]. First, the transition to EV has become highly political and polarized: EVs represented between 14% and 25% of car sales in Democrat states such as California, Washington and Oregon while it represented less than 2% in Republican state like Oklahoma, Western Virginia and Mississippi. The conditions imposed by the IRA to be eligible to the $7,500 tax credit have also led carmakers to rethink their strategy. Indeed, the price of qualifying new EVs is capped at $55,000 and this drives prices down, implying profitability issues for manufacturers who are consequently forced to cancel or delay their investment projects.

Moreover, the protectionist-inspired conditions to get IRA funds could end up being a hurdle for companies to meet demand for critical minerals such as nickel by exclusively relying on domestic sources and free-trade partners.

Eventually, the IRA could also become the victim of its own success in the coming years. Firstly, with little constraints on tax credits, an increasing amount of companies are benefiting from them, which could significantly raise the bill of the IRA over 10 years, and could push federal debt higher. In that regard, the IMF forecast the US public deficit to remain above 5.5% of its GDP for the next ten years – with the IMF announcing a public deficit between 7.5% and 8.2% of GDP in 2023, and debt could go as high as 138% of GDP in 2028[52].

Furthermore, the US could face a lack of skilled workers and raw material constraints[53]. In that regard, the FT wrote that "more than 1mn US jobs for computer scientists and engineers risk going unfilled by the end of the decade (...) and the US faces a shortfall of 500,000 construction workers this year alone as it tries to meet demand fueled by the new factory announcements".

3. The EU seems to be distanced by the US in the race to clean energy, competitiveness, and industry

Even if NGEU, was launched two years prior to the voting of the IRA, and that the EU has afterwards launched other initiatives such as REPowerEU and the GDIP, the EU seems to fall behind the US in the race to clean energy, competitiveness and industry. This part shows that both external and inherent features of the EU can explain that the latter is lagging behind the US: the current global context is more favorable to the US than to the EU, and the American instruments seem also more efficient than in the EU.

49. "Green energy investment headwinds threaten Joe Biden's climate targets", *Financial Times*, 4 November 2023.
50. F. Lenglet, "Mauvais vent sur les éoliennes: la bulle spéculative explose !", RTL, 23 November 2023.
51. "L'Amérique se divise aussi sur la voiture électrique", *Le Figaro*, 17 November 2023.
52. "Pourquoi les États-Unis s'endettent à tour de bras", *Les Échos*, 28 November 2023.
53. "Inside the $220 bn American cleantech project boom", *Financial Times*, 16 August 2023.

The second half of this part focuses on recommendations for the EU to improve its competitiveness and its overall economic health to fully reap the benefits of NGEU.

3.1 Global context is more favorable to the US than to the EU

The EU has been through a sequence of crises over the past few years that have further exacerbated existing detrimental trends in various areas of the economy[54]. Listed below are the different elements of the global context which are undeniably hampering the reindustrialization of Europe and undermining the effects of the massive investments under NGEU.

- **The EU has suffered from importing energy at very high prices**

"European industry has long struggled with energy prices substantially higher than in the US and parts of Asia. Over the 10 years to 2020, European gas price were on average two to three times higher than the US, according to the International Energy Agency".

Besides, the major difference between the United States and the Euro area is that the former produces its energy, whereas the latter imports it. Therefore, contrary to EU countries, the US has not experienced any external shocks and benefits from an external surplus for energy; this is a very different situation from that of Europe, which saw its energy price explode.

Therefore, one of the motivations of REPowerEU – and to a lesser degree of NGEU – is to reduce Europe's dependency on fossil energy and thus re-establish a more favorable trade balance while reinforcing its open strategic autonomy.

- **The EU has few raw material resources**

Commodities on Europe's territory are scarce. Oil, natural gas and metals are at the basis of industrial production; the insufficient level of supply of such resources to respond to the demand forces the EU to import them. This has a double effect: 1) it leads to poor trade balances, and 2) it makes the EU dependent on the rest of the world for its consumption of raw materials, which hampers the objective of open strategic autonomy.

This is all the more problematic as the EGD, the FF55 and REPowerEU involve "an unprecedented increase in cleantech components and raw materials needs. The demand for batteries for electric storage and electric mobility could increase fourfold by 2030 and more than sevenfold by 2035. This implies a growth in demand for strategic materials such as lithium, graphite, cobalt, nickel or manganese"[55].

- **Europe's ageing population is not attractive for companies**

Demographics in the Eurozone are less dynamic than in the US[56], leading to a future decline in labor force that will reduce potential production, tax revenues, etc.

Additionally, Europe's ageing population does not make it very attractive to establish new industrial production capacity, especially as it gives rise to structural recruitment difficulties.

- **The workforce is cheaper, better-skilled, more productive in the US than in the EU**

Labor productivity increased by only 14% in the Eurozone between 1998 and Q3 2022 compared to 62% in the US. Reasons explaining this gap includes better education, higher spending on R&D and a larger volume of hours worked in the US. Additionally, though European workforce seem less performing that the American one, unit labor costs are rising much faster in the EU than in the US, further increasing the costs for companies in the EU.

- **High public debt and fiscal deficits in the EU hampers competitiveness and effectiveness of companies**

Unlike the United States, the Eurozone countries do not issue the world's currency. The overall economic and fiscal health of certain EU Member States are further hurdles to their reindustrialization and attractiveness. Indeed, as long as no structural reforms are steered, high public debt as well as important fiscal deficits are limiting the possibility of the most highly indebted countries to help reindustrialization through public funding[57]. In that respect, the RRF is trying to link the approval of recovery and resilience plans to the country-specific recommendations whereby Member States needed to include structural reforms in their plans to address long standing issues, among which fiscal sustainability.

54. See Eurofi Macroeconomic Scoreboard.
55. Op. Cited Jacques Delors Institute.
56. America's working age population – those between 25 and 64 – rose from 127 million in 1990 to 175 million in 2022, an increase of 38%. By contrast, in Western Europe, the working-age population rose by 9% during that period, from 94 million to 102 million. Source: *Eurofi Macroeconomic scoreboard*, September 2023.
57. See 3.3.

- **Germany, the manufacturing pillar of Europe, is being forced to review its growth model and has been in recession in 2023.**

Germany needs to review its industrial model which was built on low-cost energy imported from Russia and dependent on its exports particularly from China. The ability to increase fiscal deficits to support companies, the strong industrial culture, and the high skills of the population point to a temporary weakness in growth. But population ageing, stagnant productivity, the cost of the energy transition and competitiveness problems could lead to lasting weak growth.

All in all, European firms face costs explosion in terms of energy, skilled labor, tax law and environmental regulations, while simultaneously, the US and China fight to attract industrial activities and employment.

It has to be emphasized that the industrial decline of the EU started decades ago; as written in a recent article of the Financial Times[58], "one moment of truth for the EU was in the early 2000s, when the internet technology boom created dozens of major US conglomerates, but hardly any in Europe. In the decades since, EU companies have failed to come even close to the likes of Apple, Alphabet or Amazon, or challenge the scale of Chinese rivals such as Alibaba. Now EU policymakers are very concerned that the next technology revolution – in artificial intelligence and quantum computing – will similarly pass Europe by and further widen the gulf with the world's two economic superpowers".

3.2 The US employs instruments that are more efficient than the EU, and qualitative differences in the approaches are also observed

The IRA is very attractive for firms worldwide, and its success relies on various elements. First, the focus is on the market, firms and private investment. The US benefits from a genuine single market that enables companies to achieve economies of scale. The focus of NGEU is on EU Member States and public investment rather than the single market. Moreover, the IRA resort to massive tax credits, which cannot be implemented in the EU because tax policies remain national.

Besides, the US has a genuine industrial policy: the IRA includes Local Content Requirements (LCRs) that automatically favor the US over international competitors and attracts companies which want to benefit from IRA subventions. In that regard, the US has already favored its national economy for almost a century with the *Buy American Act* of 1933 which requires the US government and third parties to prefer US-made products in its purchases, with legal requirements changing according to sector, price and competition.

This is in profound contrast with the European approach regarding industrial policy: for decades, the EU has favored competition policy and free trade over having a genuine industrial policy with a community preference. This absence of EU industrial policy is reflected in the current struggles in the progress of NGEU.

Additionally, one of the main differences between the IRA and NGEU is that the former massively grants subsidies and tax credits to private companies and citizens, while the latter follows a bureaucratic intermediated procedure where the Commission distributes grants and loans to national public authorities which then award it to private sector agents.

This burdens the efficiency and the speed of the fund allocation and disbursement, even if it is true that the disbursement by the Commission is made upon evidence that milestones and targets – *e.g.* signature of contracts/grant awards – have been fulfilled and thus that Member States have supported private companies and citizens. While everything is centralized in Europe, IRA funds swiftly and efficiently flow through more than a dozen federal agencies, with 5 main agencies handling 96% of the funding.

Furthermore, available IRA funds are spent almost immediately while halfway through its lifetime, only one third of NGEU funds have been spend. Indeed, the Member States – which have never before benefited from so much money – seem to be struggling to absorb all the funds made available to them.

3.3 Highly indebted Member States need to review the composition of public spending and favor quality over quantity in order to have new margin to increase productive public investment

Eurofi's Macroeconomic Scoreboard shows that EU countries with the highest level of government expenditure as percentage of GDP are those with the least competitive firms and that excessive level of public debt does not fuel productivity growth and employment. In such a context, it has become urgent to achieve a credible and ambitious EU agreement on the review of the Stability and Growth Pact in order to achieve sufficient fiscal discipline in all parts of the EU.

In that regard, D. Cahen and J. de Larosière made some recommendations[59].

58. "EU's plan to regain its competitive edge", *Financial Times*, 5 November 2023.
59. D. Cahen & J. de Larosière, "Reforming the Stability and Growth Pact", *Eurofi Regulatory Update*, April 2023.

3.3.1 Public investments should not be excluded from a country's deficit and debt calculations

There are huge public spending needs, given new investments for the green and digital transitions, education, and healthcare. But a special treatment for growth-enhancing expenditure would not be helpful. It comes from the illusion that public financial means are not scarce. In reality, it is a matter of refocusing the priorities. Unproductive spending needs to be replaced by productive public spending.

It would be a grave mistake to push the extreme fiscal limits in the present situation. Investment-friendly rules – such as the golden rule to protect public investment implying a separate capital account – can lead to excessive borrowing and weaken the link between fiscal targets and debt dynamics, fostering potential risks to debt sustainability. In addition, as stated by an ESM paper[60], "creative accounting and the reclassification of unproductive expenditures as investments to circumvent rules could challenge monitoring and enforcement, alienate the targets from the numbers and reduce transparency".

Strong fiscal positions are needed to face the challenges of infrastructure investments and ecological policies. The last thing needed would be to deteriorate current imbalances budgets.

The future depends on:

- a consolidation of present weak fiscal positions,
- a shift toward quality of expenditure and investment.

With the amount of liquidity created in the past years, no more redistributive expenses are required. The latter must be reined in and adequate space for public investment must be allowed.

3.3.2 The quality of public spending and composition of public finances must prevail over quantity

Fiscal policy should ensure a composition of public finances that is both growth-friendly and sustainable. It has to be recognized that the shift towards more productive investment will require substantial political effort because presently public investment only accounts for some 4% of GDP while current expenditure represent almost all public expenditure.

In this perspective, putting in place early warning mechanisms to prevent unsustainable public finance trajectories would be required. Indeed, a country whose share of public expenditure reaches record levels in relation to the European average should be subject to special discipline.

The fact that money has been thrown at problems for years has worked against supply-side policy. In order to raise growth potential, it is necessary to deal not only with stimulating demand and reducing unemployment but also boosting productive investment and productivity gains, which have been the orphans of this story.

In an extreme case, stimulating demand does not translate into increased production, but leads to a widening of our trade deficit if countries do not have efficient production systems. In this respect, the quality of public spending has become an absolute imperative: as much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spending (including research) that can be financed by debt.

3.4 The EU needs to design and implement a genuine industrial policy

3.4.1 The EU needs appropriate competition rules to boost its industry

The recent paper of the European RoundTable[61] (ERT) reminds us that the EU's competition policy is an essential pillar of a comprehensive industrial strategy for the Union. The Commission should assertively deliver a competition policy that reinforces the role of open markets and incentivizes European firms to compete effectively, both across the internal market and on the global stage. Such a policy should also foster the emergence of European industrial and financial champions able to compete on the international stage: merger decisions should seek the benefits for the entire single market, not only the markets of individual Member States and should be assessed regarding global competition and trends.

An effective industrial policy could also rely on state aid for early stage innovations for the digital and green transitions as well as for key strategic sectors when market forces alone are insufficient. The EU must offer faster and more efficient procedures to entice European companies to invest at home rather than being lured away by attractive and unbureaucratic incentives in the US and elsewhere.

3.4.2 State aid rules must be carefully relaxed insofar as they could jeopardize the Single Market because Member States have diverging fiscal capacities

In the EU, tax policy remains the preserve of Member States so it has relaxed rules on state aid to deter companies from redirecting investment to

60. "EU fiscal rules: reform considerations", ESM Discussion Paper 17, October 2021.
61. "Securing Europe's place in a new world order", ERT Vision Paper. 2024-2029, 26 October 2023.

CHART 16.
Total state aid by EU27 countries (€bn)

Source: The Financial Times

the US[62]. Indeed, the Temporary Crisis and Transition Framework (TCTF) of March 2023 can be seen as a European response to the financing gap between the EU and the IRA.

In the wake of the Covid-19 and Russia's invasion of Ukraine, Brussels decided economic emergency measures and abandoned the single rule book: rules on the permissibility of state aid and national subsidies were lifted and EU oversight of its members' deficits and debts were suspended. But the FT reminds us that **"the EU's state aid rules were drawn up to protect poorer states with less fiscal firepower from the richer states that would otherwise be able to pump cash into their national champions and give them an unfair advantage.** That, say some officials from mainly southern and eastern countries, is exactly what has happened.

Governments in countries such as Germany and France, in the name of economic stability for the entire bloc, have given their own companies the financial clout to outcompete their EU rivals, trampling on the safeguards of the single market in the meantime"[63]. Indeed, France and Germany accounted for half of the €733 bn in state support that Europe approved between March 2022 and August 2023. **The state aid explosion showed by Chart 16 has thus given Member States, particularly richer ones, the incentive to keep the rules as they are, but this situation also brings about fundamental disequilibria insofar as fiscally sound Member States can afford to provide financial assistance to their economies, while fiscally weak countries cannot, which worsens the existing heterogeneities within the Union.** Therefore, without adequate safeguards and limits, a relaxation too loose risks fragmenting the Single Market.

EGOV (the think tank of the European Parliament) deems that in the continuity of the pandemic and the War in Ukraine, "the EU, to counter the IRA's negative effects on EU industry, decided upon additional support to industry to be made available through the relaxation of EU state aid rules. This is based on an extension of the more generous application of state aid rules in response to the Russian invasion of Ukraine, for which the Temporary Crisis Framework was created in March 2022. On 9 March 2023, its latest modification transformed it into the Temporary Crisis and Transition Framework (TCTF), which *de facto* also made it a response to the IRA. The framework uses the flexibility foreseen under state aid rules to support the economy. In 2022, the Commission declared specific categories of state aid compatible with the Treaty if they fulfil certain conditions"[64].

However, the Agefi warns that, as there is no European fiscal capacity, a generalized relaxation of the state aid rule risks jeopardizing the single market because Member States have diverging fiscal capacities[65]. In the same spirit, Belgian Prime Minister A. de Croo told the Financial Times[66] that "the EU's policy of relaxing state aid rules is the exact opposite of what is needed to regain competitiveness in response to high energy costs and generous US tax breaks" and that "the EU should instead deepen its single market and put in place bloc-wide incentives for industry".

3.4.3 IPCEIs should be continued and enhanced

Important Projects of Common European Interest (IPCEIs) are useful instruments that enable Member States and the EU to support certain industries without going against international competition rules. It relies on a bottom-up approach insofar as private companies are involved in the projects since their beginning, and Member States remain the drivers of the projects all along.

IPCEIs were created in 2014 and allow firms to receive state aid under the EU state aid rules in complement to private funding in order to promote innovation in strategic industrial sectors.

They have known an increasing success since 2018: at least one IPCEIs has been approved each year by the Commission since 2018, with significant

62. "Industrialists call for deeper political union in the EU on energy", *Financial Times*, 14 November 2023.
63. Op. Cited FT.
64. "EU's response to the US inflation Reduction Act (IRA)", briefing by the think tank of the European Parliament, September 2023.
65. "Les aides d'État restent sous contrôle étroit en Europe", Agefi, 30 August 2023.
66. "More state aid will not help Europe compete, warns Belgian PM", *Financial Times*, 5 December 2023.

CHART 17.
Approved IPCEIs

	First IPCEI on Microelectronics (2018)	First IPCEI on Batteries (2019)	IPCEI Fehmarn Belt fixed rail-road link (2020)	Second IPCEI on Batteries – EuBatIn (2021)	First hydrogen IPCEI - Hy2Tech (2022)	Second hydrogen IPCEI – Hy2Use (2022)	Second IPCEI on Microelectronics and Communi-cation Technologies (2023)	Total
Participating companies	29	17	1	42	35	29	56	209 180*
Participating projects	43	22	1	46	41	35	68	256
State aid approved (EUR billion)	1,9	3,2	9,4	2,9	5,4	5,2	8,1	36,1
Expected private investments (EUR billion)	6,5	5	NA**	9	8,8	7	13,7	50
Participating Member States								21 with UK included as a Member State, plus Norway participated in at least one IPCEI

*Excluding the companies that participated in more than one IPCEI **A study confirmed this projects creates a positive socio-economic return for the entire EU

Source: European Commission

amounts engaged: the approved state aid along with the expected private investments into research and development of the 7 IPCEIs so far add up to almost €80 bn. Moreover, the increase in the number of participating Member States and companies observable in Chart 17 shows a positive trend. IPCEIs are also supported as part of the NRRPs.

Six approved IPCEIs falls into three categories: microelectronics value chain, batteries value chain and hydrogen value chain. A seventh IPCEI has been approved to enhance the territorial integration of the EU.

Microelectronics value chain

So far, two IPCEIs in the microelectronics value chain have been launched. These IPCEIs comprise 100 projects in 14 Member States including up to €10 bn state aid which is expected to unlock more than €20.2 bn of additional private investment.

32 companies from 5 Member States take part in the first IPCEIs on Microelectronics that was approved on 18 December 2018. The project's overall objective is to enable research and develop innovative technologies and components that can be integrated in a large set of downstream applications such as energy efficient chips, power semiconductors, compound materials, advanced optical equipment and smart sensors.

The second IPCEIs in the field of microelectronics was approved on 8 June 2023, focuses on communication technologies, and involves 68 projects from 56 companies coming from 14 Member States. The project's overall objective is to enable digital and green transformation by creating innovative microelectronics and communication solutions and developing energy-efficient and resource-saving electronics systems and manufacturing methods.

Batteries value chain

So far, two IPCEIs in the ecosystem of batteries have been launched. These IPCEIs include 59 companies in 12 Member States including up to €6.1 bn state aid which is supposed to trigger more than €13.8 bn of additional private investment.

17 companies from 7 Member States have come together for the first IPCEI in the field of batteries approved by the Commission on 9 December 2019. The project focuses on research and development activities to deliver beyond state-of-the-art innovation across the batteries value chain, from mining and processing the raw materials, production of advanced chemical materials, the design of battery cells and modules and their integration into smart systems, to the recycling and repurposing of used batteries.

The second IPCEI on batteries is called European Battery Innovation (EuBatIn) and was approved on 26 January 2021. 42 companies from 12 Member States are participating in this project. The IPCEI EuBatIn will cover the entire battery value chain from extraction of raw materials to recycling and disposing the batteries with a strong focus on sustainability.

Hydrogen value chain

So far, two IPCEIs in the hydrogen value chain have been launched. The two IPCEIs include 59 companies in 16 Member States and Norway including up to 10.6 bn state aid which is expected to unlock more than €15.8 bn of additional private investment.

The first hydrogen IPCEI Hy2Tech was approved on 15 July 2022 and gathers 35 companies from 15 Member States. The project's objective is to contribute to the development of important technological breakthroughs in the hydrogen technology value chain.

The second hydrogen IPCEI Hy2Use was approved on 21 September 2022 and gathers 29 companies coming from 13 Member States.

Fehmarn Belt fixed rail-road link

A seventh IPCEI has been approved on 20 March 2020: the Fehmarn Belt fixed rail-road link, which is key in the cross-border integration of central and northern Europe. The Fehmarn Belt coast-to-coast infrastructure which will link Denmark and Germany and

IPCEIs are key strategic instruments with regards to the implementation of the EU Industrial Strategy. An IPCEI brings together knowledge, expertise, financial resources and economic actors throughout the union, as to overcome important market or systemic failures and societal challenges which could not otherwise be addressed.

Since IPCEIs are supported from national budgets, Member States are in the driving seat to form an IPCEI, identify the scope of the projects and select participating companies and projects. A centrally EU IPCEI fund does not exist, but IPCEIs require the approval of the European Commission under state aid law.

IPCEIs are a way forward towards a European industrial policy and enhance the competitiveness of the Union at a time where it most needs it. As P. Gentiloni told *Le Monde*[67], the EU "will not win the race to competitiveness only with regulations". IPCEIs are a promising way forward and could be extended to other strategic sectors such as health, solar panels and even a European cloud. But uncertainty remains around the financing of such initiatives: is more common debt the key? Only the reimbursement of NGEU will tell if a European fiscal union can emerge, or if it is doomed to remain a pipe dream.

3.4.4 The EU needs to accelerate the single market while re-establishing a community preference

With the Single Act of 1986, the EU has abandoned the community preference, and this limitless openness of trade has undoubtedly contributed to the weakening of industries in certain EU countries. However, experts such as French Nobel Prize of Economics M. Allais warned in the early 2000s about the threats of an unregulated economic globalization and the detrimental effects it would have on the various regions of the world, with a focus on European Union. He advocated in his work **the need to build a European community based on a democratic political structure as well as on a community preference and an appropriate protection of the community single market**. He also suggested that the European Treaties, especially the Article 10 of the Treaty of Rome, were revised as to introduce a reasonable level of protectionist that would always put the best interest of the European community first. His proposal was the following: "In order to safeguard the harmonious development of world trade, a reasonable community protection must be ensured regarding imports from countries whose exchange rate wage levels are incompatible with the abolition of all customs protection".

Furthermore, the potential of the single market has not yet been fully tapped. Indeed, the IMF estimates that further integration of the single market would enable the EU to gain up to 7 pp of GDP. In that respect, the ERT[68] made some recommendations to remove single market barriers: "the European Commission must spearhead an 'encompassing program' to shape a common market across all policy areas, including energy, digital, capital, environment and defense. It should proactively compel EU Member States to promptly remove unlawful or unreasonable barriers and burdens *via* mechanisms like the European Semester, guaranteeing the free circulation of goods, services, people, capital and data. There should also be a concerted effort to harmonize and simplify the implementation of EU Regulations, Directives and Delegated Acts, as fragmentation makes it difficult for businesses to compete fairly across the single market". A collaborative and genuine single market would be beneficial for the overall union and to secure Europe's place in the new world order.

The growing inequalities both at regional and global levels as well as the fierce competition that put pressure on workers and the environment are increasingly observable. Re-establishing a community preference in Europe would also reinforce the development of a European industrial policy, the multiplication of IPCEIs and the emergence of European industrial companies. It also seems to be an adequate response to the LCRs at the heart of the American IRA.

67. "L'Europe a un problème de compétitivité", *Le Monde*, 17 November 2023.
68. Op. Cited ERT Vision Paper 2024-2029.

To conclude, several salient points must be emphasized.

To date, **the main issue in the EU is not essentially one of financing, but of carrying out investments that could consequently give rise to a need for financing.**

With €370 bn of excess savings in 2023, Europe has significant financial resources to engage in the green and digital transitions but lacks adequate investment projects in spite of the different EU plans that have been launched over the past years. In other words, the additional financing needs assumed according to the Commission's calculations for additional investments in the climate transition (+€350 m/year) and digitalization (+€150 bn/year), have not materialized, as investments have remained stagnant.

With regard to the ecological transition, all public and private reports confirm that the EU is still a long way from the levels of investment required to meet commitments (FF55). Roughly speaking, to successfully achieve the transition, the investment efforts should be multiplied by 2 to 3. For this to work, a positive investment-financing feedback loop would have to be triggered. This is what the US has achieved with the IRA. What is puzzling is that they have attracted including European companies on their territory – all the more since energy prices are cheaper on their side of the Atlantic!

The multiplication of European investment plans over the past years underlines the EU's standardization effort. In addition, the RRF is a well-designed innovative performance-based instrument which combines reforms and investments, emphasizing the effort of the Commission to get results. Furthermore, the RRF offers one more advantage to Member States: expenditure financed by RRF grants does not add to national debt and deficits, and thus provides an important support to high-quality investments and reforms without subtracting from the available fiscal space.

Nonetheless, external factors tend to limit the speed and the impact of the program. **NGEU lacks European design.** Indeed, the solidarity and ambition demonstrated in NGEU are undermined by the Recovery and Resilience Plan being fragmented along national lines. 27 national plans have been submitted to the Commission with no enhanced cross-border dimension, even though Member States have similar needs regarding the digital and green transitions.

When qualitatively comparing NGEU and the American IRA, one thing is striking: the American funds are easily and quickly accessible and work as an incentive to achieve the fixed objectives, whereas national and European bureaucracies make the progress of spending NGEU funds cumbersome and relies heavily on prohibitive rules. In that respect, some experts also pointed out to the fact that the EU does not have the fiscal means of the US, and therefore needs to rely much more on the approach of ETS combined with a well-designed subsidy/industrial support.

The speed of deployment of the IRA and the whopping number of companies that have announced investments on the American soil indicates the success and the simplicity of the IRA one year on. By contrast, the deployment of NGEU is slower as it is impeded by the lack of skilled workforce and the burden of bureaucracy.

Moreover, NGEU does not reap the full benefits of the European single market. This is less attractive for investors than the vast and unified American single market which offers significant opportunities and economies of scale. As a result, 30.5% has been spent halfway through the lifetime of the project. Additionally, some European companies have been attracted by the IRA and have thus shifted investment to the US, including Total Energies, MBW and Northvolt.

In light of this situation, what should be done?

a. Rewarding risk taking and long-term investment.

Long-term investments incur a risk – especially linked to technological and regulatory updates, as well as uncertainty – and demands the immobilization of resources in the long run. The development of technologies necessary to the green transition thus requires investments in R&D, as explained by a recent study from McKinsey & Company[69]: "40 to 50 percent of the emissions reductions needed by 2050 are expected to come from technologies that are currently in the early market stage (for example, lithium-ion energy storage, onshore wind power, and passenger battery EVs)". But those investments involve a risk.

Therefore, risk-taking must be rewarded, otherwise private savings will remain liquid and will not be directed towards long-term productive investments in the EU. This has not been the case over the past 15 years as real interest rates have remained close to – and even under – zero.

b. Giving certainty to transition pathway in the EU.

EU Member States should give all economic agents clear and complete national transition scenarios (sectoral priorities, timetables, risk edging mecha-

69. "An affordable, reliable, competitive path to net zero", McKinsey & Company, 30 November 2023.

nisms) and guidelines so that citizens, companies and public authorities make coordinated progress.

c. Getting public finances back in order.

The sooner we get public finances back in order, the sooner states will regain the leeway they need to invest. In addition, over-indebted Member States must also revise the composition of public spending to accentuate the efforts in the fields at the heart of the transitions – *i.e.* R&D and carry out supply-side-oriented reforms to reinforce their production system and rekindle their industrial power.

d. Elaborating a genuine European industrial policy to face common challenges.

To avoid lagging behind the US and China, the EU needs to adopt a genuine industrial policy. To do so, the EU needs appropriate competition policy to boost its industry, foster the emergence of European industrial and financial champions and to accelerate the single market while re-establishing a community preference. The IMF estimates that further integration of the single market would enable the EU to gain up to 7pp of GDP.

e. Developing European projects financed by European companies.

What the EU needs now is to finance common European projects led by European companies.

As highlighted by P. Gentiloni[70], NGEU has been designed like a solidarity tool that enabled to give more funds to countries that suffered more from the pandemic. But today, Europe should finance common European projects, hence the necessity to implement a genuine industrial policy, especially in strategic sectors such as digital, energy, cleantech space...

The multiplication of IPCEIs and collaborative projects between Member States is undeniably a way forward, given that they align their objectives, they identify qualifying and profitable projects and that they find adequate funding. This would facilitate and foster the emergence of competitive European companies as they would benefit from economies of scale in the single market.

f. Balancing national and common interests in the EU

There is an urgent need to find the right balance between national and common interests in the EU economic, financial and industrial areas.

Recent events seem to show that industrial and economic nationalism is rising in Member States, which further thwarts the efforts towards more integration in the industrial field. For instance, Italy blocked in November 2023 the $1.8 bn acquisition by French jet engine maker Safran of the flight control business of Collins Aerospace called Microtecnica. Italy alleged that the deal "poses an exceptional threat to the essential interests of national defense and security"[71] because Microtecnica produces and delivers spare parts to the Eurofighter and Tornado jet fighter programs which are needed to comply with the operational requirements of Nato. "This is a very bad signal sent by Italy and Germany for the future of European defense collaboration" lamented Safran CEO O. Andriès.

This growing economic nationalism – fostered by rising nationalists parties in some EU Member States – hinders the progress of the EU towards open strategic autonomy and towards more integration in key sectors such as industry, finance and defense. Even if it is understandable that each Member State wants to keep their sovereignty, they cannot have it both ways. There is an urgent need to find the right balance between national and common interests.

Additionally, as explained in the paper, NGEU is undermined by its complex and bureaucratic procedure, the lack of skilled workforce in public administration, Member States' limited absorption capacity and uncertainty around the reimbursement terms of the common debt

70. Op. Cited *Le Monde*.
71. "Italy blocks Safran deal over national security concerns", *Financial Times*, 21 November 2023.

CMU state of play and next steps

3

Update on the progress made on CMU

Note written by Marc Truchet

1. Overall progress made on the Capital Markets Union action plans

The Capital Markets Union (CMU) initiative was launched in 2015 with the objective of developing and further integrating capital markets in the EU. Several goals were put forward by the European Commission including a further diversification of the financing of EU enterprises, support for the green and digital transitions, an improvement of long term investment opportunities for savers and an enhancement of resilience and private risk sharing across the EU.

More than 40 legislative and non-legislative actions have been proposed by the Commission since 2015 to implement the CMU, in three main action plans.

The measures of the two initial CMU action plans published in 2015 and 2017 are now in force. These action plans prolong and complete previous work initiated with the Financial Services Action Plan (FSAP) to develop a common framework for securities and derivatives markets, with measures covering a wide range of areas including: prospectuses and SME listings, securitisation, the cross-border distribution of investment funds, prudential calibrations of capital market activities for banks and insurance companies and supplementary pensions with the PEPP[1] framework. Measures were also proposed in the 2017 action plan to strengthen the powers of the European Supervisory Authorities (ESAs), develop the role of fintech in the capital markets and promote sustainable finance.

A third action plan was set out by the Commission in September 2020, comprising several new proposals such as the Retail Investment Strategy, the European Single Access Point (ESAP) to EU corporate information, a Listing Act and a targeted harmonization of corporate insolvency rules, as well as reviews of the main existing capital market legislations MiFIR, EMIR, CSDR, ELTIF and AIMFD/UCITS. These measures are aimed in particular at further increasing the engagement of retail investors and SMEs in the capital markets and also facilitating access to EU capital markets, notably with the implementation of the ESAP and consolidated tapes at EU level.

Most of the legislative proposals of the September 2020 CMU action plan have now been adopted at Level 1, except the EMIR 3 review and the Retail Investment Strategy (RIS). A deal was struck between the ECON Committee and the Council on the EMIR 3 proposal on February 7th that needs to be formally adopted by Parliament and Council. The RIS proposal is less advanced[2]. It is expected that a position can be agreed by the ECON Committee by the end of the current legislature and also that a general approach can be reached in Council by June 2024, but trilogues on the RIS will most likely start with the new Parliament and Commission.

Two initiatives that may contribute to the objectives of the CMU have also been proposed in the fiscal area: FASTER (Faster and Safer Relief of Excess Withholding Taxes), which aims to improve withholding tax processes and DEBRA (Debt-Equity Bias Reduction Allowance), which proposes mechanisms to rebalance the cost of debt and equity financing for non-financial corporations.

In parallel, efforts are being made to develop local capital markets[3], for example through the Technical

1. PEPP: Pan European Pension Product.
2. In October 2023, the ECON Committee rapporteur published her draft report on the RIS proposal in which she proposes to delete the partial ban on inducements and the development and use of benchmarks under the Value for Money (VfM) approach, as well as proposing a less stringent best interest test. Views across the political groups still differ substantially on these issues at the time this note is written (some groups would support a full inducement ban and maintaining VfM benchmarks). The vote in ECON is scheduled to take place in the second half of March 2024. In the Council, discussions on the proposal have progressed under the Spanish Presidency and negotiations are set to continue under the Belgian Presidency with the goal of reaching a general approach. Similar to the situation in the Parliament, the most challenging discussions revolve around the partial inducement ban and value for money provisions.
3. The actions proposed in 2017 to support the development of local capital market ecosystems included: the provision of technical support to Member States through the Technical Support Instrument (TSI) or previously the Structural Reforms Support Programme (SRSP) and the establishment of a CMU Working Group by the Vienna initiative to promote the diversification of investment finance in the region. The Commission proposed to establish a comprehensive EU strategy in 2018 on steps that could be taken at EU level to support local and regional capital market development across the EU.

Support Instrument (TSI), whereby the EU provides technical assistance to certain EU Member States for reforms that include the development of their capital markets. Actions are also being undertaken by certain member states, in some cases with the support of the Commission's TSI or in connection with the IFIs[4], to implement national strategies aiming to improve their market ecosystems. The EBRD for example has been playing an active role in facilitating the implementation of national strategies in Central Eastern European (CEE) countries and supporting the consolidation and inter-connection of domestic exchanges in the CEE region.

2. Impact of CMU on EU capital markets size and activity

Statistics and indicators show that the major efforts made since 2015 in the context of the CMU initiative to improve the EU capital markets framework have not yet translated into significant growth and integration of EU capital markets or in a stronger role of capital market instruments in the funding of firms or household savings[5]. This is understandable, since many actions are still in the process of being implemented, but shows that the CMU has not kickstarted strong progress at market level yet.

2.1 Short term impacts in terms of growth and integration of EU capital markets

European capital markets remain under-developed compared to other developed regions, in terms of size relative to GDP and did not grow significantly over the last few years. In addition there is a widening gap with the US and some APAC countries in terms of capital market activity. Although structural differences (e.g. in the pension systems, the way capital markets and banks have evolved historically, the structure of the economy…) mean that the US in particular cannot be considered as a direct benchmark for the EU, the comparisons below show that there is still a long way to go to bring European capital markets into line with the size of the European economy, particularly in the retail space and in terms of funding of firms.

At the end of 2021, EU securities markets were about half the size of those in the US in percentage of GDP and also smaller than those of major economies such as Japan, China and the UK. The total of EU27 debt securities and public equity markets represented 233% of GDP compared to 449% for the US, with the main difference coming from public equity markets which amounted to 81% of GDP in the EU compared to 227% in the US. In addition, while US public equity markets practically doubled in % of GDP between 2015 and 2021, the increase was only of 30% in the EU[6].

Some more recent figures[7] confirm the limited growth of EU capital markets over the last few years and their under-representation in relation to the size of the economy. Between 2006 and 2022, the EU's share of global capital market activity has decreased by more than 40% (10% down from 18%) while the APAC's share rose significantly (to 31%) and the US's share decreased but remained high (47%). In addition, the EU's share of global capital market activity (10%) remains significantly lower than its share of the global economy (19% of global GDP). The gap with the % of GDP is particularly high for IPOs and pension assets (9 and 10% share of global market activity in these areas) which are important determinants of future market growth.

European capital markets also remain fragmented, which limits their efficiency, liquidity and depth, with persistent home bias in the detention of equities and bonds and in the issuance of equity[8], although a growth of cross-border investment fund volumes has been observed. The level of development of capital markets is also quite variable across the EU, with strong markets in the Nordics, relatively well developed capital markets in some Western European countries such as France, the NL, Belgium and practically inexistent markets in many Southern and Central Eastern Europe (CEE) countries[9].

4. IFIs: International Financial Institutions such the EIB, the EIF or the EBRD.

5. According to the AFME CMU Key Performance Indicators published in November 2023, the competitiveness of EU capital markets has not improved either over the last few years and remains significantly lower than the US and the UK. This is true for all the key indicators of competitiveness measured by AFME (available pools of capital, access to finance of NFCs, level of market liquidity and the adoption of new trends such as sustainability and digitalisation) except for the role played by sustainable finance, where the EU is in a leading position. In the EU a higher proportion of ESG bond issuance as % of total bond issuance than other regions is observed (12.7% in H12023 compared to 7% in the UK and less than 1% in the US).

6. Source CEPS Time to re-energize the EU's capital markets November 2022. In the US public equity markets grew from 137% of GDP to 227% between 2015 and 2021, whereas in the EU27 they grew from 61% of GDP to 81% during the same period. Figures from 2020 also show that the EU-27 average stock market capitalisation amounted to 52% of GDP in EU-27 in 2020, compared to 116% in the UK and more than 190% in the US.- Source World Bank database. Capitalisation represented by the outstanding listed shares issued by domestic firms. Further detail can be found in a note on CMU drafted by Eurofi in April 2023 – Capital Markets Union: progress made and future steps.

7. New Financial – EU capital markets : a new call for action – September 2023.

8. The AFME CMU KPIs of November 2023 show that while the level of intra-EU integration is quite limited in terms of equity issuance and holding and debt holding, it is high for debt issuance.

9. In terms of % of GDP, Sweden (155%), Denmark (150%), the NL (136%), France (134%) and Belgium (110%) have significant market caps, but many Southern and CEE countries have % of market cap below 30% with an EU average of 55%- Source CEIC database (2022).

2.2 Evolutions in terms of access to capital of NFCs

When considering the access to capital of firms, EU non-financial companies (NFCs) remain very reliant on banks[10]. Bank lending still represents 76% of the corporate borrowing of EU NFCs, compared to 27% in the US, despite a slight increase of the share of corporate bonds over the last few years[11]. More broadly, the share of tradeable assets (debt securities and listed equity) in the overall funding structure of EU NFCs remains low in 2022 (26%) compared to the US (68%), the UK (42%) and Japan (48%)[12].

Statistics also show that the proportion of NFC funding derived from bond and equity issuance has decreased compared to the years preceding the pandemic (10.3% in H12023 compared to an average of 11.5% between 2016 and 2019) and compared to the peak of 2021 (14%). A fall has been observed notably in terms of IPO issuance volumes, although this is not specific to the EU. The proportion of equity financing compared to debt in the funding of NFCs remains stable with a slight decrease in 2022[13].

Equity market statistics moreover show that although equity underwriting increased in 2023 on European exchanges, this is due to secondary equity issuance, while IPOs have decreased by 50%. Equity trading also decreased on European trading venues in 2023[14].

2.3 Available pools of capital

The participation of EU households in the capital markets has not improved significantly either over the last few years, and the pools of capital available for investment in the capital markets are also significantly below the potential of the EU economy.

Figures from 2021 show that the proportion of financial assets held in currency and deposits by EU households remains much higher on average than in the US (30% compared to 12%) and nearly two-thirds of EU member states have a share of bank deposits above this average. In addition, the share of assets held by households in securities (equities and investment funds) is much lower in the EU (about 25%) than in the US (about 45%)[15].

Aggregate statistics on available pools of capital confirm this gap with other regions. First, the total size of financial assets in the EU[16] is about half the size of the US and lower than the UK in % of GDP (254% of GDP in the EU compared to 553% in the US and 339% in the UK in 2022). In addition, pools of capital are growing more slowly than in the US (total EU pools of capital increased by +15% since 2014 in the EU compared to +30% in the US). Moreover, the share represented by longer-term assets such as pension assets and securities did not grow significantly within EU household assets over this period[17].

The proportion of household financial market assets (*i.e.* excluding cash, deposits and unlisted equity) in the EU also remains much lower than in the UK and the US as a % of GDP (90% compared to 182% in the UK and 310% in the US) in H1 2023, with a decrease since 2018 (98%)[18].

10. This predominance of bank funding in EU can partly be explained by the greater importance of SMEs in Europe, which may prefer bank financing and non-listed equity financing due to the complexity and governance impacts of listing on a stock exchange.
11. New Financial - EU capital markets : a new call for action – September 2023. The share of corporate bonds compared to bank lending grew from 18% to 24% between 2012 and 2022.
12. Source: IMF background note on CMU for Eurogroup – June 2023. The KPIs published by the European Commission (Overview of CMU indicators – 2023 update – 16 August 2023) however measure a % of market funding closer to 50% in the EU that is stable, but this is calculated as the sum of corporate bonds and listed shares issued by NFCs relative to the sum of those two volumes and bank loans, whereas the IMF also takes into account unlisted equity (which is significant in the EU) and non-bank loans in the overall funding structure of NFCs.
13. Source AFME CMU KPIs November 2023.
14. See Equity primary markets and trading report 3 Q 2023 AFME.
15. Source: IMF background note on CMU for Eurogroup – June 2023. The proportion of household financial assets held in pension and insurance products is similar in total in the EU and the US, according to these statistics, but the split is different, with a much higher proportion invested in pension products in the US.
16. Including currency, deposits, insurance, pension assets and other financial assets.
17. Source: New Financial – EU capital markets : a new call for action – September 2023.
18. Source AFME CMU KPIs November 2023.

CMU future steps

Note written by Marc Truchet

1. The CMU has not triggered significant market growth or integration so far

1.1 EU capital markets have not significantly grown since 2015

Despite major efforts made with the Capital Markets Union (CMU) initiative to complete and improve the capital markets regulatory framework since 2015 and nearly 50 legislative and non-legislative measures set out through three successive action plans, no major progress can be observed in terms of size or level of integration of EU capital markets at this stage[1].

European securities and derivative markets remain under-developed compared to other major jurisdictions such as the US or the UK and also relatively to the share of the world GDP represented by the EU. The EU's share of global capital market activity amounted to 10% in 2022 compared to a share of world GDP of 19%. In addition, this share has significantly decreased over the last 15 years down from 18% in 2006, showing that the development of EU capital markets lags behind other regions such as the US and APAC. In the same way, no real progress has been observed in the funding of EU non-financial corporates, which remains mainly bank-based or in the participation of EU households in the capital markets[2].

EU capital markets also remain quite fragmented, limiting available liquidity pools, despite the efforts made by the EU institutions to complete and strengthen the EU single rule book for capital markets and to increase post-trade connectivity[3] and some consolidation movements at the trading level. Some positive evolutions have been observed in the market in the last few years such as a growth of cross-border investment fund volumes, but intra-EU cross-border activity is still limited or below its potential in many areas of the market such as equity issuance and holding, cross-border post-trading costs remain high and industry players still face divergent applications of certain EU rules, notably in the retail space[4].

The limited short-term development of EU capital markets is understandable, given that many CMU actions are still in the implementation phase. Additionally, the macroeconomic landscape of recent years with lower real interest rates compared to the US has hindered investment in the EU and market volatility stemming from geopolitical events has limited retail investment, despite an uptick during the pandemic. However, this lack of growth in the European capital market indicates that the CMU initiative has not yet triggered significant momentum in the market. Furthermore, the EU has missed opportunities to capitalize on major events such as Brexit and the post-pandemic growth recovery, which should have served as catalysts for stimulating the growth of its capital markets.

1.2 Factors limiting the impact of CMU measures

The disappointing short-term development of EU capital markets can be attributed to various factors. Recent articles in the latest Eurofi Magazine (February 2024) and recent papers on the CMU offer a range of explanations.

Some explanations relate to the complexity of the EU capital market landscape and to existing EU legislative processes and competencies.

One of the obstacles most frequently highlighted is the lack of robust political commitment behind the CMU, despite support expressed in many European Council and Euro Summit statements,

1. See Eurofi note of the February 2024 Regulatory Update 'Update on the progress made on CMU' for further detail on current market trends
2. Bank lending still represents 76% of the corporate borrowing of EU NFCs, compared to 27% in the US, despite a slight increase of the share of corporate bonds over the last few years. The proportion of financial assets held in currency and deposits by EU households remains much higher on average than in the US (30% compared to 12%) and nearly two-thirds of EU member states have a share of bank deposits above this average. See the Eurofi note of the February 2024 Regulatory Update for further detail and statistics – Update on the progress made on CMU.
3. Post-trade connectivity has improved with the implementation of TARGET2Securities and open access measures, but the EU still counts multiple post-trading infrastructures operating at domestic or multi-domestic level in stark contrast with the US. The wholesale banking landscape is also more fragmented than in the US or UK. A recent Amafi report shows that very few European banks have a global scale in terms of capital market activities and there is a multiplicity of banks with a more limited regional or local relevance due to limited consolidation in the EU banking sector – Amafi Which priorities for EU capital markets? – January 2024.
4. See ESMA Costs and Performance of EU Retail Investment Products 2023, AFME CMU KPIs November 2023 for example.

albeit in general terms. This is evidenced by instances where certain CMU measures proposed by the Commission have been diluted or carved-out at Council or Parliament level, for example concerning supervision or securities market rules. The overall slow pace of CMU measure adoption and ongoing competition among Member States to bolster their individual financial centres are further illustrations. This situation is to a large extent the result of the EU legislative process, which entails lengthy negotiations between co-legislators on compromises, while considering diverse industry and Member State positions. However, concerning the CMU, there is a prevailing frustration that the outcomes of this process so far appear to fall short of the initial ambitions to significantly develop and integrate capital markets at the European level.

Closely linked to the previous impediment is the difficulty of constructing a compelling narrative around CMU to mobilize Member States and industry. This difficulty is partly inherent to the complexity of the project itself, as the development of capital markets necessitates multiple technical and specialized actions that are challenging to encapsulate in a straightforward narrative. Moreover, no single legislative action or institutional change can bring the CMU forward in a credible way. While efforts have been made to link the CMU to economic objectives, such as the necessity of increasing investment to stimulate growth and innovation, the CMU is still lacking a convincing narrative based on a precise evaluation of expected macro- and micro-economic benefits[5].

CMU, as a policy framework mainly, is also constrained by the limits of EU policy-making. Several policy areas which are key for the further development and integration of EU capital markets are either outside the direct competences of the EU (*e.g.* pensions, education, taxation) or imply actions in areas beyond the scope of financial services regulation (*e.g.* corporate and securities laws). If it proves impossible to reform these areas, EU capital markets will not be able to compete on equal terms with the US or with other integrated jurisdictions and the CMU will always be sub-optimal. Another area where EU policy-makers do not have a fully free hand is market structure, since market infrastructures are private sector entities, except for the ECB run TARGET2 Securities. The dependence of the EU on third-country CCPs for some key segments of the derivative market that is being tackled by EMIR 3 is a further issue, from a systemic risk and also from a strategic autonomy perspective.

A further challenge arises from the heterogeneous nature of the EU capital market landscape, which requires objectives and actions to be adapted to different market situations and levels of maturity. While some Nordic and Western European countries boast well-developed capital markets, many Central and Eastern European (CEE) and Southern European Member States have limited capital market activity, relying heavily on bank financing instead. Additionally, some Member States have sizable domestic markets while others mainly serve as export hubs for their products to other EU countries.

Other factors contributing to the limited short-term development of EU capital markets relate more to the way the CMU initiative has been structured and managed so far.

There is a widespread perception that the current approach to the CMU has pursued too many objectives without clear focus or clarity. In addition to the primary objectives of developing and integrating capital markets, several ancillary goals such as private risk-sharing, supporting the green and digital transitions, and achieving open strategic autonomy have been introduced. While these objectives are relevant, their multiplication has blurred the overarching narrative of the CMU. In addition, the large number of actions, many of which involve reviews of existing regulations, and the importance given to 'low-hanging fruit' particularly in the two first action plans, have diverted efforts towards actions with more marginal effects. This has had a detrimental effect on the momentum of the project and has led to a loss of focus on priorities, ultimately resulting in what is perceived as 'CMU fatigue'.

This perception is reinforced by the fact that several actions outlined in the initial action plans have failed to bolster significant volumes in EU capital markets. Examples include the initial iterations of ELTIF, PEPP, STS securitization measures[6], and the initial wave of measures supporting SME listings, none of which have resulted in substantial additional investment or funding volumes. It is hoped that the actions of the September 2020 action plan, stemming from the recommendations of the CMU High Level Forum aimed at introducing 'game changers' for the CMU – such as the European Single Access Point (ESAP), the implementation of consolidated tapes, the Listing Act, and the Retail Investor Strategy proposal – will prove more effective in attracting issuers and investors to the EU market.

5. For example in terms of financing costs, funding capacity, investment return for investors, market resilience.
6. European Long-Term Investment Funds (ELTIF), Pan-European Personal Pension Product (PEPP), Simple, Transparent, and Standardized (STS) securitization.

2. The revival of the CMU debate with a new European political cycle approaching

2.1 A growing political recognition of the importance of CMU

The growing awareness of the high level of investments needed for Europe to remain competitive compared to Asia and the US and to fund future growth and innovation, as well as the post-Covid EU open strategic autonomy objectives, have revived the political debate around the CMU. There is now an increasing recognition at the political level (Council, Eurogroup...) of the essential need and urgency to build strong capital markets in Europe, leveraging the scale of the single market, to better connect EU household savings to productive investment and retain growing and innovative firms in the EU.

There is indeed a general consensus that public spending – constrained by high levels of public debt and limited potential for fiscal capacity enhancement – and bank financing – restricted by prudential requirements and unable to finance the most innovative projects – will not be sufficient to provide the high amounts of financing needed for supporting the green transition, boosting technological competitiveness and diversifying supply chains. It has indeed been estimated by the European Commission that the green transition alone will require additional investments of €620 billion every year on average until 2030 and a further €125 billion per year will be needed for the digital transition[7], amounts which are compounded by different geopolitical and demographic pressures[8]. In addition, the funding of innovation is currently insufficient in the EU and the gap with the US in terms of long term investment capacity is increasing with the Inflation Reduction Act (IRA). It is estimated that at present around 20% of EU tech firms are acquired by US firms because of the lack of adequate exit strategies in the EU and more than 50% of late stage financing ($50 Mio+) of EU companies comes from outside the Union. The limited short term economic growth prospects of the EU economy are a further challenge.

Private capital, including a greater share of the European household saving capacity, which is much higher than in the US (around 14% of disposable income is saved by European households compared to around 5% in the US) will therefore need to be put at use for funding these investments, which is one of the objectives of the CMU[9]. Firms also need to diversify their funding with a greater use of equity financing, to innovate and achieve more growth.

2.2 On-going initiatives at EU level on the future of the CMU

As a new European political cycle is approaching, several initiatives have been launched by the European institutions to make proposals for relaunching the CMU, showing a renewed political commitment behind the project.

In response to a call from EU leaders at the Euro Summit in March 2023 for stepping up collective efforts across the Union to take forward the CMU, the **Eurogroup** has committed to working on measures for deepening the CMU and enhancing the engagement at national level around the initiative. Following a stock taking exercise and assessments conducted during the second semester of 2023 with a large number of public and private sector stakeholders at EU and domestic levels, the Eurogroup President is preparing a set of political priorities on CMU due to be negotiated with the Members States and presented at the Euro Summit in March 2024.

The **German and French Finance Ministers** also laid out joint priorities to move forward on CMU[10] including: an improvement of public market access for SMEs with the EU Listing Act, measures to increase retail investor participation, a revitalisation of the securitisation market, an improvement of the European sustainable finance framework and a strengthening of the EU securities market infrastructure. Following this statement, the French Minister of Finance has tasked a committee of experts in January 2024 with making recommendations for enhancing the financing conditions of EU businesses that could contribute to the future stages of the CMU.

The **high-level report on the future of the single market that is being prepared by Enrico Letta** for the European Council for March 2024 is also expected to address the CMU and how to enhance the single market for capital, which is considered

7. Source: 2023 Strategic Foresight report.

8. Age-related expenditures could increase by 2 percentage points to 26% of GDP by 2070 – Source Amafi – Which priorities for EU capital markets – January 2024.

9. The high saving rate in the EU (calculated as gross saving divided by gross disposable income) compared to the US (around 14% in the EU in 2023 up from 12% before 2019 compared to about 4.5% in the US) shows the significant potential that exists for the increase of investment in financial assets in the EU. The lower rate of saving in the US may however be accentuated by the fact that a significant proportion of savings in the US are invested in mandatory retirement plans such as 401 (k) which represent up to 10 to 14% of disposable income, when considering employee and employer 401(k) contributions, part of which may not be taken into account in the evaluation of the gross savings of households. Sources Eurostat indicators 5 October 2023, Fidelity Q2 2023 retirement analysis. According to some estimates, there is an annual saving surplus in the EU27 of about € 330 Mio.

10. See op'ed published in the FT by Bruno Le Maire and Christian Lindner – We must close the EU capital markets gap – Financial Times 13 September 2023.

as the area where the single market has been least successful so far[11]. In the same way, the **report on EU competitiveness commissioned from Mario Draghi** by European Commission President Ursula von der Leyen aiming to make proposals to revitalise the EU's economy in the face of competition from China and the United States, could also include aspects relevant for the CMU.

3. Possible ways forward for the future stages of CMU

When reviewing the contributions to the February 2024 Eurofi Magazine, along with recent statements from prominent public sector figures and industry representatives regarding the future steps of the CMU and recent reports on CMU from market stakeholders, three main paths for advancing the CMU emerge. These proposals, which address both the substance of the actions required to deepen the CMU and the method of implementation, can be to a large extent combined and should serve as a basis for shaping the CMU strategy moving forward.

3.1 Focusing on a smaller number of transformational priorities

Many stakeholders recommend narrowing the focus of the CMU initiative to a smaller set of high-impact priorities, likely to drive more tangible progress in the growth and integration of EU capital markets. The suggested priorities encompass policy objectives, drivers for capital market development, and additional policy actions. However, the extensive and diverse list of proposals put forward by public authority and private sector representatives shows the need for further prioritisation, taking into account the potential impact of these actions on market growth and integration, as well as their feasibility.

Moreover, it has been suggested that the ability of the measures proposed and adopted to attract investment to the EU and support the funding of EU firms should be more systematically evaluated throughout the legislative process, with market impact or competitiveness pre-implementation tests (along with post-implementation monitoring), to ensure that the regulations adopted effectively foster an environment conducive to the development of EU capital markets[12].

Among the most commonly proposed priorities for the future steps of the CMU are:

- Developing larger pools of long-term savings within the EU, likely to be invested in the EU capital markets with actions to develop private pensions and retail engagement in the capital markets[13].
- Revitalizing the EU securitization market to develop the market for asset-backed securities, leveraging banks' risk assessment capabilities, while enhancing bank financing capacity [14].
- Further harmonizing corporate insolvency rules and withholding tax processes, beyond the targeted measures of the current action plan.
- Strengthening equity markets to diversify the funding for EU firms and offer savers greater long-term returns with measures such as the DEBRA proposal (Debt-Equity Bias Reduction Allowance)[15] and continued efforts to facilitate access of SMEs to capital markets building on the Listing Act.
- Enhancing supervision with increased EU-level supervision for cross-border and systemic activities and measures to enhance the agility of EU rule-making[16]:
- Improving the EU sustainable finance framework with manageable requirements to sustain and expand European leadership in the area of ESG, and placing greater emphasis on transition finance.
- Supporting the provision of adequate (tax) incentives on the investor and issuer sides, including DEBRA and the FASTER proposal to improve cross-border withholding tax procedures[17].

11. See remarks made by E. Letta during a meeting with the ECON Committee in October 2023.
12. At present an impact assessment of the legislative proposals made by the Commission is systematically performed, but the measures adopted following the trilogues are not systematically subject to additional impact assessment. A set of CMU KPIs is measured by the Commission on an annual basis but these do not relate to specific legislative measures.
13. Actions proposed include enhancing private pension products such as the PEPP, implementing tax incentives for investors, and bolstering efforts to increase retail participation building on the actions proposed in the Retail Investment Strategy (RIS).
14. This would involve a review of prudential calibrations – capital charges for the holding of securitized assets by banks in the CRR and insurance companies in Solvency II and a review of the treatment of ABS in the LCR (liquidity coverage ratio) – and a review of disclosure and due diligence requirements in particular.
15. DEBRA proposes mechanisms to rebalance the cost of debt and equity financing for non-financial corporations.
16. Many proposals are made by market stakeholders in this area including a mandatory or optional transfer of supervisory competences concerning cross-border activities or entities to the EU level, notably for the more systemic ones, an improvement of the supervisory coordination between the ESAs and the national competent authorities building on the RIS proposals, possible changes in the governance and decision-making processes of the ESAs to evolve towards a model closer to ECB, along with measures to enhance the agility of the EU legislative process, such as the use of no-action letters. Some commentators also suggest that more radical changes in terms of supervision, such as a transfer of all cross-border competencies to the ESAs would accelerate the achievement of a single rulebook.
17. DEBRA is an example but some stakeholders also propose measures to increase the consistency of tax incentive approaches at EU level. The limited progress of DEBRA so far however illustrates the challenge of making any changes in the area of tax rules beyond possibly unifying processes to avoid double-taxation, such as the FASTER proposal to improve withholding tax procedures.

Some stakeholders also suggest that future CMU priorities should encompass more than just regulatory and supervisory measures. They argue that addressing catalysts such as product innovation, market structure, issuer and investor incentives, market access and data availability is also crucial for growing the European capital market.

Some measures are proposed on the product side, for example to build new investment products with a European scale such as an EU equity fund covering all major EU 27 indices or an IPO fund that may attract investment from savers in all Member States.

Certain commentators have also highlighted the importance of taking steps to streamline the current capital market infrastructure and avoid fragmentation in new areas of development. Proposals include the establishment of new EU platforms in niche or emerging areas of the capital market, potentially through joint ventures involving existing exchanges, such as the development of common EU infrastructures for tokenized assets, laying the groundwork for a future digital CMU, and efforts to consolidate SME exchanges to enhance liquidity in these markets. Furthermore, actions at the regional level may be beneficial and pave the way for the development of interconnected regional ecosystems, as demonstrated by the cooperation in this area among the Baltic countries[18]. Suggestions also include encouraging more significant EU level capital market integrating moves at the trading or post-trading levels[19]. While such audacious moves at EU level hold promise for accelerating integration, their feasibility from both political and capitalist perspectives remains to be demonstrated.

The setting of ambitious targets in terms of digitalisation of trading and post-trading activities and investment product distribution is also proposed, which may include specific measures to support the implementation of DLT and AI in securities markets and an adoption of the FiDA open finance measures proposed by the Commission, as well as bolder standardisation such as a shortening of settlement cycles in order to lead to greater digitalisation [20].

3.2 An improved balance between a top-down and bottom-up approach to CMU

A second debate, which concerns both the content of the measures and the way they are implemented relates to whether future stages of the CMU should prioritize top-down or bottom-up approaches[21].

Recently, there have been several calls for emphasizing a top-down approach to the CMU and a greater focus on integration. Advocates argue that EU-level actions, such as implementing a unified rulebook and creating a single market for capital, are vital for providing financing to support innovation and address challenges related to the green and digital transitions, which are shared objectives among all EU Member States. Broader capital markets are indeed essential for innovative firms to have access to sufficient financing, necessitating greater harmonization and integration efforts. Additionally, integrated markets can lower financing costs for all firms and improve private risk-sharing across the EU.

In November 2023, the ECB President advocated for a 'Kantian shift' towards a more top-down CMU approach[22], emphasizing the need for a European SEC to enforce a unified rulebook and market infrastructure consolidation. Similarly, the IMF General Manager, in June 2023[23], urged greater emphasis on the 'Union' aspect of the CMU, proposing a single access point for disclosures and information, rule harmonization (including corporate insolvency), supervisory convergence, and the creation of interconnected clusters of expertise on the continent, rather than multiplying separate domestic financial centres. Additionally, a former ECB Executive Board member highlighted the necessity of a permanent European safe asset[24], as a common form of collateral and a risk-free benchmark necessary for pricing risky financial products[25].

A top-down approach also relates to the way CMU measures are adopted and implemented. The CMU High-Level Forum for example proposed in 2020 to seek an upfront commitment from the Commission, the Council and the Parliament on the main components of the CMU action plan, including a joint delivery timetable, monitored and enforced by all the EU institutions[26].

18. Actions supported by the EBRD have been conducted in the Baltic region to better align taxation, market regulation and green taxonomy which has facilitated integration and connectivity of market infrastructures, along with the establishment of a regional index. See Eurofi Views Magazine February 2024 O. Renaud-Basso.
19. This may involve major cross-border mergers in the stock market or clearing and settlement domains to create pan-European scale and create bigger pools of liquidity.
20. See David Wright's editorial Eurofi Views Magazine February 2024.
21. The top-down approach involves EU-level actions aimed at implementing a unified rulebook and a single market for capital and possibly fostering market consolidation, while the bottom-up approach focuses on developing existing domestic capital markets, potentially involving gradual harmonization efforts across these markets.
22. Speech by C. Lagarde at the European Banking Congress, 17 November 2023 'A Kantian shift for the Capital Markets Union'.
23. IMF Managing Director's remarks on strategic priorities for the European capital markets, 15 June 2023.
24. F. Panetta, ECB Blog, 'Europe needs to think bigger to build its capital markets' 30 August 2023.
25. A common form of collateral in the EU would also promote centralised clearing and cross-border collateralised trading, helping to attract foreign investors.
26. Final Report of the High Level Forum on the Capital Markets Union – June 2020 The report also proposed that Member States should subsequently commit to 'swiftly and faithfully' implement the agreed measures and pursue measures at national level in domains where there are no EU policies yet. However, these proposals have not been implemented so far.

However, CMU measures must also address the diverse needs of EU countries, particularly regarding SME financing and retail engagement, while promoting capital market development in countries where markets are underdeveloped. Bottom-up approaches are necessary to address these varied needs, but the aim should be to support progress towards common objectives and rules, albeit at a speed adapted to markets' maturity level, requiring coordinated EU-level efforts.

An improved and more explicit combination of top-down and bottom-up approaches is therefore likely needed for future stages of the CMU, taking advantage of the complementarity of these two approaches. Merely developing domestic markets and integrating them bottom-up with harmonization efforts, may fall short as separate domestic markets and national specificities would persist, hindering the creation of large, efficient capital markets in Europe. Hence, a top-down approach is necessary to achieve a single capital market over time – with features such as common European rules and procedures[27], consistent enforcement and supervision of rules across the EU and single access points to the EU market – combined with coordinated efforts to support progress of all Member States towards these objectives[28].

3.3 A more comprehensive approach, better involving Member States and all components of the ecosystem

A third aspect to consider in managing the CMU process that some stakeholders have emphasized, is the necessity for a comprehensive strategy that engages both Member States and the various sectors of the financial industry operating within the capital markets. Such a holistic approach must also encompass monetary policy considerations, as investor attraction to EU capital markets is influenced by interest rates and interest rate differentials with other regions, alongside broader macroeconomic conditions.

While EU-led regulatory actions are essential for building CMU, they may not be sufficient due to many capital market aspects lying beyond EU policy-making competencies. These include tax incentives for retail investment, financial education, pensions, corporate insolvency rules, which are all predominantly under Member State control. While the initiative led by the Eurogroup President and forthcoming reports from Enrico Letta and Mario Draghi may set the stage for an inclusive process involving Member States , it is uncertain whether they will address these areas under domestic competence, notably the most contentious ones, such as insolvency laws or tax.

The proposal from the French authorities to collaborate with like-minded Member States to explore coordinated actions or enhanced cooperation could offer a way forward for addressing some domestic competence areas. However, careful consideration is needed to prevent increased fragmentation within the EU as a result.

These actions should ideally pave the way for potential EU-level implementation, albeit at varying speeds, aligning with the coordinated bottom-up approach mentioned earlier.

Similarly, engaging all industry participants contributing to EU capital market development is crucial. This includes banks, and insurance companies that pay essential roles as gateways to the capital markets for investors and issuers, traders and market-makers in the secondary markets and institutional investors. Initiatives to ensure that prudential requirements do not excessively impede the capital market activities of these players and to better align requirements such as MiFID and IDD must be pursued. Establishing appropriate linkages between the Banking Union and CMU initiatives is also imperative, as a robust and more integrated EU banking sector is essential for the development of cross-border EU capital markets.

27. Including notably common capital market rules, common key corporate laws for the capital market, common tax procedures to avoid double taxation.
28. See contribution by J. Berrigan to the Eurofi February 2024 Views Magazine for example.

Pensions in the EU: challenges, EU competencies and on-going reforms

Note written by Marc Truchet

1. Existing pension systems in the EU

1.1. Structure of the EU pension systems

All pension systems in Europe include a public and a private part. They are usually organised in three pillars, although the functioning of these pillars differs across the EU. The terminology used to describe them also differs across Member States.

The first pillar (pillar I) consists of public statutory pensions, which are mandatory and aim to provide a basic level of income to all pensioners, including those who do not have a capacity to save for their retirement. The second pillar (pillar II) covers occupational pensions, which are sponsored by employers at an individual company, sector or industry-wide level and can be either mandatory, quasi-mandatory (with opt-out options) or voluntary. The third pillar (pillar III) are voluntary personal pensions that can be supported by tax incentives.

Public pension systems in the EU (pillar I) are generally financed on a pay-as-you-go (PAYG) basis, with the contributions to the pension system from the working age individuals paying for the benefits of current retirees, which means they are not pre-funded and have no disposable assets to invest[1]. Some pillar I PAYG schemes are however backed by a limited pre-funded reserve fund that may be used to alleviate demographic challenges. Some of them are also completed by smaller pre-funded mandatory components (as in Sweden) aiming to provide future pensioners with higher long term returns via equity and bond investments. Different mechanisms are used for determining pension benefits. Depending on the Member States, pillar I systems are based either on a defined-benefit (DB) scheme, a notional defined contribution (NDC) system or a points system or on a combination[2].

Pillar II systems are usually pre-funded and based on the principle of asset accumulation. They work on a DB or DC basis, or a hybrid of DB and DC, although a trend towards DC is generally observed, as in the Netherlands, where a pension reform was recently passed. The payment of pillar II pension benefits is usually triggered by the payment of pillar I retirement benefits. Pillar III systems work on a DC and individual basis in most cases.

1.2. Size of pension spendings and assets

The majority of pension spendings in Europe are channelled into public PAYG pensions. Eurostat statistics[3] show that the annual spending on mandatory old-age and survivor pensions (pillar I pensions and some mandatory pillar II schemes) amounted to 12.5% of GDP in the EU in 2020 on average, corresponding to approximately €1.7 Tio[4]. These expenditures however vary significantly across the EU, ranging from 17% of GDP in Greece and 16.5% in Italy to 4% in Ireland[5].

In addition to this, the annual expenditures on mandatory and voluntary private pensions represented less than 1% of GDP in most EU countries in 2019, except for the NL (5.3%), Sweden (2.9%) and Denmark (2.4%)[6].

1. Pre-funding refers to the practice of setting aside funds in advance to cover future pension obligations. Pre-funded schemes can also be described as asset-backed as opposed to PAYG schemes that do not hold assets except for a possible reserve fund. Pre-funding is typically done by employers or governments to ensure that there are enough funds available to pay pensions to retired employees or citizens. Pre-funding can also be performed by financial institutions managing supplementary pensions.
2. DB schemes provide a set level of pension at retirement depending on the length of service and the earnings over a number of years preceding retirement. With NDC schemes, the amount contributed by each individual to the system is added to a pot which is appreciated by a notional interest rate set by the government. At the end of the contribution period workers receive annuity based on the final financial value of their lifetime contributions, their life expectancy and expected return during the remainder of their lifetime in a similar way they would in defined contribution scheme. In a points system, contributions paid throughout a person's career are converted into points and the pension benefit depends on the number of points accumulated and the value of the point at the time of retirement. In a DB system the risk is in effect borne by the sponsor of the pension system, whereas in defined contribution (DC) and point systems the risk is borne by the pension holder
3. Source Eurostat Social protection statistics - pension expenditure and pension beneficiaries.
4. The total annual spending on pensions estimated by Eurostat amounts to 13.6% of GDP and €1.8 Tio, but includes disability pensions and some unemployment pensions, which have been taken out from this evaluation.
5. Other statistics from the OECD show that the annual public expenditures on old age and survivor benefits (pillar I mainly) ranged from 15.9% of GDP in Italy to 3.3% in Ireland in 2019. Source OECD Pensions at a glance 2023.
6. In these countries expenditures on public pensions amounted to 5% (NL), 7% (Sweden) and 8.1% (Denmark) in 2019 according to OECD statistics.

In comparison, in the US, Canada and UK, the proportion of private pensions is much higher. In the US, Canada and UK, annual spendings on private pensions amounted to approximately 5.6% of GDP. Spendings in these countries on public pensions are also lower than the EU average (5% of GDP in the UK and Canada, 7% of GDP in the US)[7].

As a result, the size of private pension assets in % of GDP, which comprise pillar II and III private pension assets and the reserve funds of public pillar I systems, is relatively limited in the EU on average, amounting to 29% of GDP in 2022[8], compared to 138% in the US, 153% in Canada, 131% in Australia and 85% in the UK.

The US also represents 68% of the total of assets earmarked for retirement at the global level ($35 Tio of a total of 51.3 Tio at global level), with 70% of US assets held in employer-sponsored plans such as 401(k) and 30% in individual IRAs[9], whereas the proportion of pension assets represented by the EU is below 9% ($4.6 Tio), which is below the EU share of global GDP (16%). In addition, 62% of EU pension assets are concentrated in 3 Members States (NL, Sweden and Denmark), which only account for 12% of EU GDP.

Pension assets are however growing in the EU. According to a New Financial report[10] based on OECD data, EU pillar II and III pre-funded pension assets have grown over the last 10 years from 23% to 29% of GDP.

2. Challenges facing EU pension systems

2.1 Demographic challenges facing pillar I PAYG systems

Demographics and particularly the ageing of the population are the main challenge that pillar I PAYG pension systems are facing, due to the potential impacts in terms of long-term sustainability of pensions and adequacy for providing sufficient protection for the elderly population.

The European population is ageing and the share of the active population is shrinking, which impacts PAYG systems. In 2022, 22.1% of the EU population was aged 65 and over and this share is expected to rise to about 30% by 2070 with improved life expectancy, leading to higher expenditures in terms of pensions[11], healthcare and long-term care. Although trends are similar across OECD countries, the proportion of people aged 65 and over is higher in Europe than in North America or Asia[12].

At the same time, the share of the 20-64 age group (working age population) is expected to fall from 59% to 51% of the total population by 2070. Birth rates are also declining, which may lead to a decline of the overall EU population in the long term. Projections from Eurostat predict a decline of 6% of the total European population between 2022 and 2100[13]. The old-age dependency ratio – *i.e.* people aged 65 and over relative to those aged 20 to 64 – is therefore projected to double in the EU between 2023 and 2080, meaning that there will be much fewer working-age people to pay for the state PAYG pensions of older people in the future. This will also put pressure on public health systems in the coming 20 to 30 years, leading to a potential increase of private health contributions, which will require additional savings to be built before retirement.

This demographic context, combined with labour market specificities (*e.g.* special regimes providing early retirement) and evolutions such as an increasing number of self-employed or part-time workers[14] put into question the future financial sustainability of pillar I PAYG pension systems across Europe, creating the risk of a pension gap. There are moreover potential issues in terms of pension adequacy. The European Commission is expecting that the average state pension as a percentage of the earnings at retirement will fall from 46.2% in 2019 to 37.5% in 2070[15]. There has also been little progress since 2016 to reduce the risk of poverty or social exclusion for older people in the EU, after almost a decade of improvement following the 2008 crisis. In 2021, 16.8% (15.2 million) of people aged 65 and above were still at risk of poverty or social exclusion in Europe,

7. Source OECD Pensions at a glance 2023. Figures are from 2019.
8. Source EU capital markets : a new call to action – New Financial – September 2023 based on OECD figures.
9. As of 31 December 2022, a total of $37.8 Tio was held in US retirement plans and accounts, of which $26.3 Tio was in employer-sponsored plans and $11.5 Tio was in Individual Retirement Accounts (IRAs). Source Congressional Research Service US retirement assets: data in brief September 2023.
10. EU capital markets : a new call to action – New Financial – September 2023.
11. Projections from the OECD estimate that the public expenditure on pensions is due to increase in the EU from 8.5% of GDP in 2020-23 to 13.9% of GDP in 2060 - Source OECD Pensions at a glance 2023.
12. Statistics show that the share of population aged 65 and over is higher in Europe (around 20%) than in North America (17%) and Asia (10%) and this gap is expected to persist in the coming 30 years. An acceleration of the ageing of the population has also been observed since the 90's. Life expectancy is also expected to continue to grow between 2023 and 2050 after a temporary setback caused by Covid-19. Source Allianz global pension report 2023 Reforming against the demographic clock.
13. Source: Understanding EU action on pensions – European Parliament Research Service – October 2023.
14. For example in 2021 nearly 10% of the EU's working population was over 60 and among those working over 65, 40% were self-employed and 59% worked part time.
15. Source The 2021 Ageing report.

according to the European AROPE index (At risk of poverty or social exclusion).

Statistics also show a persistent gender gap in pension protection, although some progress has been observed since 2010, with 44% of women not saving individually for retirement compared to 34% of men, a risk of poverty almost 35% higher for women in old age than for men and a 30% difference in the average pension received by women and by men[16].

2.2 Challenges facing pillar II and III pension schemes

A further challenge, particularly for private pensions, is a potential gap in long-term savings for retirement that is developing in the EU, with 39% of EU citizens surveyed by Insurance Europe in 2023 stating that they are not saving for retirement through a supplementary pension system[17]. According to Eurobarometer data from July 2023, only 23% of EU citizens participate in an occupational pension scheme and 19% own a personal pension product[18], which means that a majority of EU citizens fully depend on statutory pensions for their future retirement income. This has impacts in terms of confidence in pension systems, since only 45% of Europeans are financially confident in their retirement – 37% of women and 47% of men, which is another illustration of the gender gap[19]. Citizens with a supplementary pension also feel more financially confident in their retirement than those without one (53 compared to 37%).

Moreover the awareness of the need to save for retirement is not fully shared among the European population. The Insurance Europe 2023 survey shows that about 26% of those who do not save for retirement are not interested in doing so and 14% state that they do not have enough information.

40% of people surveyed by Insurance Europe also declare that their pension savings are negatively impacted by the current economic environment, leading to a reduction of contributions or delayed savings. The macro-economic environment indeed poses further challenges for pre-funded pillar II and III schemes. Low interest rates have decreased the assets held by pension schemes in nominal terms and more recently high inflation and economic uncertainties have diminished the saving capacity of individuals and the number of new enrolments. The recent rise of interest rates should provide some relief, with lower DB liabilities[20] and higher DC returns.

The macro-economic context can also indirectly affect pre-funded occupational pensions by impacting the workforce or the competitiveness of a given industrial sector or company.

3. EU competencies and on-going pension reforms

3.1 EU competencies on pensions

Pensions are a Member State competence, which means that the EU has no powers to legislate on the design of pension systems or take measures which may affect the fundamental principles or financial equilibrium of national social protection systems

However, the EU can legislate on matters that affect the functioning of the internal market relatively to pensions (free movement of persons, freedom to provide services, protection of consumers) and issues such as gender equality and workers' rights to secure equal pension benefits.

In addition, the European Commission provides Member States with input and non-binding guidance on how pension systems should be designed and implemented in the EU. Several initiatives have been conducted at EU level over the last few years to analyse pension sustainability and adequacy across the Union and the impact of demographic, labour market, digital and green transition trends.

The European Commission also works with Member States through the Economic Policy Committee (EPC) and Social Protection Committee (SPC) on the provision of country analysis and guidance. The Commission runs in cooperation with the EPC and SPC a monitoring cycle publishing reports every 3 years related to ageing (the Ageing report), pension adequacy notably in terms of risk of social exclusion in older age (the Pension Adequacy report) and the challenges facing long-term care systems in the EU (the report on long-term care).

16. Source: Insurance Europe 2023 Pan-European pension survey : key findings, EIOPA Technical advice for the review of the IORP II Directive (September 2023), Eurostat Closing the gender pension gap? (February 2021).
17. See Insurance Europe 2023 Pan-European pension survey.
18. According to figures from the Commission, only 27% of EU citizens between 25 and 59 years old had enrolled themselves in a private pension product in 2019 - Source: Capital Markets Union Pan-European Pension Product (PEPP) FAQ – 4 April 2019.
19. See Article written by P. Hielkema in Eurofi Views Magazine February 2024 Building on past initiatives to address growing pension gaps and EIOPA, Consumer Trends Report 2023, January 2024, EIOPA report probes consumer treatment and financial well-being amid the cost-of-living crisis - European Union (europa.eu).
20. The increase in interest rates has translated into higher discount rates used to calculate the liabilities of DB pension plans, leading to a reduction in the present value of these liabilities.

Retirement policy is moreover embedded in the European Semester economic coordination cycle, which reviews Member State budgets and policy-making. In addition it is part of the scope of issues monitored by the European Parliament, which has published several resolutions in this area, for example a roadmap towards a social Europe (2023) which calls on Member States to preserve pension system sustainability and ensure that their minimum pensions are high enough, or a resolution on employment and social aspects in the European semester (2021) calling on Member States to develop incentives to increase employment opportunities for older workers.

3.2 The current EU body of secondary law on pensions and on-going reviews

Currently, the EU body of secondary law on pensions covers several aspects related to pensions, namely the protection of rights in case of cross-border mobility, consumer protection, gender equality and the single market for occupational and supplementary pensions (pillar II and III schemes).

The **EU regulation on social security coordination**, which applies to pillar I pensions, ensures that people moving between EU countries do not lose out. It mandates that each individual is covered by the legislation of one country at a time (and therefore pays social contributions towards their future pension in only one country), and has the same rights and obligations as the nationals of that country (the principle of equal treatment or non-discrimination). In addition, when claiming pension benefits, the individual's previous periods of insurance, work or residence in other EU countries should be taken into account as necessary. If a person is entitled to a cash benefit from one country, he or she may generally receive it even when living in another EU country (portability of rights).

Concerning occupational and supplementary pensions (pillars II and III), additional rules have been adopted to protect the rights of mobile workers moving between EU countries and to implement minimum common standards[21].

The **IORP II directive** (institutions for occupational retirement provision) adopted in 2016, which is currently under review, aims to ensure the soundness and sustainability of pillar II pension schemes and increase IORP cross-border activity in the EU by setting minimum standards for the governance, risk management, transparency and risk provision of occupational pension schemes in the EU. The objective of the on-going review is inter alia to better take into account the continued shift from DB to DC schemes and the challenges of climate change, diversity and inclusion, improve the governance, prudential standards and information provision of IORPs, and also make sure that existing DB IORPs are properly regulated and supervised. Any decision regarding whether the review should result in a legislative proposal will need to be made by the next Commission.

The IORP sector has developed over time and represents nearly €3 Trillion of AuM in 2021 out of the €4.2 Tio of assets[22] earmarked for retirement in the EU, but the sector is highly concentrated with Dutch IORPs representing nearly 2/3 of this amount, followed by those located in Germany (10%), Sweden (7%) and Italy (6%). In addition the volume of cross-border IORPs is very limited (less than 1% of AuM). One of the main on-going trends is the move from DB to DC schemes, with the latter representing 43% of schemes in 2021[23].

In 2019, the EU also adopted a framework for a **pan-European personal pension product (PEPP)**, a voluntary EU personal pension scheme (pillar III) that offers EU citizens a new option to save for retirement. Complementary to existing national pension regimes and pillar II and III schemes, it allows citizens to continue saving in the same product even when they change residence in the EU. It is however subject to domestic tax rules and incentives. PEPP products should include a default investment option (the Basic PEPP) with costs capped at 1% of the accumulated capital per annum[24] offering a capital protection that can take the form either of a capital guarantee or of other risk mitigation techniques. Transparency on fees and costs is provided via disclosures in a standard Key Information Document (KID) supplied to savers before the purchase.

The PEPP Regulation has applied since March 2022. So far its take-up has been very limited with only one provider in the EU offering PEPPs. Some reasons put forward by product providers for this lack of success include the fee cap and the challenges of implementing capital protection and risk-mitigation techniques for the Basic PEPP

21. Council Directive 98/49/EC of 29 June 1998 on safeguarding the supplementary pension rights of employed and self-employed persons moving within the Community and Directive 2014/50/EU of 16 April 2014 on minimum requirements for enhancing worker mobility between Member States by improving the acquisition and preservation of supplementary pension rights.
22. Corresponding to the $4.6 Tio of assets mentioned higher up in the document.
23. Source: EIOPA Occupational pensions in Europe, Cross-border IORPs (November 2023).
24. The potential impact of management fees on savers' total return was the main reason for implementing a fee cap. The OECD highlighted in 2018 that an annual management fee of 1.5% of assets would lead to a reduction of nearly 30% in a person's pension pot at retirement compared to no charges. Source Eurofi Views Magazine September 2019 Olivier Gilvarry, Department of Finance, Ireland.

default option, and also the problems posed by the disparity of national tax incentives and national authorization obligations. The alleged insufficient added value of the PEPP compared to existing domestic pillar III products, beyond portability, is a further issue. The low interest rate environment was also considered by the private sector to be a disadvantage for the PEPP when it was launched. A review of the fee cap is due in 2024. A review of the PEPP Regulation is due in 2027.

3.3 On-going pension reforms at Member State level

To face up to demographic challenges, most European countries have been implementing retirement reforms that adjust the parameters of the PAYG pension system in order to safeguard their sustainability, while ensuring sufficient pension adequacy. Some EU countries have also added mandatory pre-funded components or reserve funds to alleviate the burden on PAYG schemes, but no EU country has shifted to a fully pre-funded system. The objective of these reforms is to mitigate possible fiscal implications from an unsustainable pension system, ensure the continued trust of citizens in the pension system and avoid the imposition of an excessive burden on future generations (with higher pension contributions and lower benefits).

The adjustment of normal retirement age[25] to the improvement of future life expectancy remains the linchpin of these reforms. Longer working lives and later retirement age are being promoted in most Member States by increasing the statutory retirement age, which triggers the payment of the pillar I pensions, and curbing early retirement[26]. These reforms include automatic adjustment mechanisms in some cases that adapt parameters such as pension ages, benefit or contribution rates when demographic indicators such as life expectancy change.

Labour market reforms that provide incentives to work longer have also been implemented by many Member States, with efforts to foster the employability of older workers (retraining, reskilling, improving working conditions), improve possibilities to combine pensions and employment and provide more flexible retirement pathways[27]. In parallel, the role of supplementary pensions (pillar III) has also been promoted in many Member States with specific product frameworks involving tax incentives and employer contributions to encourage workers to save on a voluntary basis for their retirement.

PAYG public pensions (pillar I) and occupational pensions (pillar II) are also expected to become less generous in future, for example with an increase of contribution periods to get a full pension for pillar I pensions and a progressive shift from DB to DC for pillar II schemes.

Increasing contributions of workers to the pension system is not the solution chosen in most cases, as it may lead to an increase of labour costs, decreasing economic competitiveness, and could trigger transfers of workers to the more informal market, particularly if the expected future pension payouts do not increase.

3.4 Actions proposed in the context of the Capital Markets Union (CMU)

Supporting people in their retirement is one of the actions of the September 2020 CMU action plan set out by the European Commission as part of the objective to increase the level of retail investor participation in capital markets.

Proposals were made by the Commission in three main areas: auto-enrolment, pension dashboards and pension tracking systems.

- Auto-enrolment

A study was published by the Commission in November 2021 on **auto-enrolment** (AE) mechanisms that enrol individuals automatically in a supplementary pension scheme, unless they opt-out. The objective is to stimulate participation in these schemes when it is not mandatory. A number of best practices were identified at the international level for the successful implementation of AE including: mandatory employer contributions to the AE scheme, the possibility for employees to contribute to pension schemes without having worked for their employer for a minimum period of time, the presence of a default fund with capped costs and a life-cycle investment strategy and a transparent presentation of charges and costs.

- Pension dashboards

The Commission proposed the development of **pension dashboards** in the September 2020 CMU action plan in order to facilitate the monitoring of pension adequacy in Member States by policy-makers and the tackling of possible shortcomings,

25. Age at which a person is eligible to full retirement benefits from all mandatory components.

26. The average normal retirement age is 64 for people retiring at present in OECD countries and it is due to increase to 66 for currently active people. A similar evolution is observed in the EU, with the current retirement age ranging from 62 to 67 across Member States and due to increase to a range of 64 to 70 in the future years. Source OECD Pensions at a glance 2023.

27. At OECD level such reforms have been successful with the employment rate of 55-64 year-olds reaching 64% in 2023, almost 8 percentage points higher than a decade ago (OECD Pensions at a glance 2023). In the EU, significant progress has been made in increasing older workers' participation rates (age group 55-74), whose participation rate grew from 31.6% in 2010 to 39.1% in 2018 (Joint EPC-SPC paper on pensions 2019). Additional efforts may however need to be made to increase labour productivity, as increasing strongly labour participation among the shrinking group in age of working may be challenging over the long term.

with more detailed information on occupational pension schemes in particular. A projection of public pension spendings of all Member States over the next 50 years and of replacement rates over the next 40 years is already conducted in the context of the Ageing report, but the coverage of pillar II and III pensions is only partial in these projections and assessments[28].

EIOPA delivered a technical advice to the Commission in December 2021 that advises a gradual approach to the development of these tools at European level, given the complexity of collecting the necessary data and ensuring its comparability with differing national pension, social security and tax systems. The advice is to develop a visual pension dashboard presenting a complete set of indicators drawn from the European Commission's triennial Ageing, Pension Adequacy and Fiscal Sustainability reports that may allow the enhanced analysis and comparison of occupational pension schemes across the EU. This approach would start in the short term with existing pension data, before newly collected data on private occupational and personal pensions is added to complete the dashboards with more detailed pension projection data.

- **Pension tracking systems**

The Commission also recommended the development of best practices for the setting-up of national **pension tracking systems** (PTS) which allow citizens to benefit from an overview of all their pension entitlements in one place in an accessible and understandable way. The objective is to help citizens understand what total income they can expect in retirement and evaluate whether it will be sufficient.

EIOPA provided the Commission with technical advice in December 2021 focusing on PTS best practices to help member states that do not have a PTS in place (20 member states at present) to set one up. EIOPA recommended the setting up of digital PTSs using a secure digital ID system that should be free of charge for users and providing information at least on projected future retirement income at the expected retirement date and data on accrued entitlements. A progressive implementation approach is proposed, given the variety of pension systems in the EU, with recommendations on the way the information should be presented for it to be simple and understandable and on how the governance of PTSs should be organized.

28. About a dozen member states provide projections for non-public pension schemes (pillar II and III) as a voluntary input to the Ageing report. In addition since 2012 the Commission and the member states also cooperate in making adequacy projections in the Pension adequacy report but data on pillar II and III pensions is limited at present.

How important are pensions for the CMU?

Note written by Marc Truchet

1. Pre-funded pension systems are a key driver for constituting pools of capital

Pension systems, beyond providing future revenue for workers during retirement, also play a significant role in the funding of the economy, particularly when they are pre-funded.

There is indeed strong evidence that pre-funded pension systems (pillar II and III asset-backed pension schemes and pre-funded components of the pillar I system[1]) are a strong determinant of the development of capital markets, which are essential for funding growth and innovation. This is due to a combination of supply side and demand side factors[2].

Pre-funded pension systems are indeed providers of significant sources of long-term capital that are mostly invested in the capital markets to achieve sufficient returns. Unlike pay-as-you-go (PAYG) systems used in particular for pillar I public statutory pensions, where contributions from the working age individuals pay for the benefits of current retirees, which means they do not have any disposable assets to invest (except for a limited reserve fund in some cases), pre-funded schemes work on an asset accumulation basis.

In addition, their long-term perspective reduces the sensitivity of savers to short-term volatility, which may facilitate the funding of more innovative and growing companies. In turn, larger and deeper capital markets supported by pension savings provide citizens with opportunities for higher long-term returns, encouraging more retail investment. Regular investments in the capital markets via the pension system also contribute to developing investor culture and experience among the population that may further contribute to retail engagement in the capital markets and also smooth out investors' investments, thereby reducing their investment risks.

Literature shows that pre-funded pension systems such as pension funds can also have a positive qualitative impact in terms of corporate governance, given their size and long-term perspective, and may also foster the modernisation and efficiency of capital markets. A further element is that asset pools supported by pre-funded pension systems, such as mandatory or quasi-mandatory (with opt-out options) pillar II occupational pensions, can accumulate capital quite rapidly, as shown by IORP (institutions for occupational retirement provision) statistics[3].

2. Market statistics show a connection between pension assets and capital market activity

Market statistics tend to confirm that a connection exists between the size of capital markets and the volume of pension assets.

For most countries there is indeed a correlation between the volume of pension assets in pre-funded pension systems as % of GDP (pillar II and III) and market capitalisation as % of GDP[4].

Practically all countries with high levels of pension assets have large market caps[5] and the countries with the largest market caps tend to be those with the highest volumes of pension assets[6]. There are however some exceptions such as Japan and France that have relatively high market caps with fairly

1. See Eurofi note from the February 2024 Regulatory Update for further detail on EU pension systems and EU competencies in this area – Pensions in the EU: challenges, EU competencies and on-going reforms.
2. Existing literature shows that supply factors, including the presence of strong asset-backed pension systems, as well as the legal system, market liquidity and shareholder protection, play a stronger role in the development of capital markets than the demand for capital market products, which may be obtained by measures aiming to develop retail investment. See: Pension funding and capital market development T. Niggermann and J. Rocholl August 2010.
3. The assets of EU IORP pillar II schemes grew by about 9% between 2020 and 2021 in the EU countries where IORP schemes were available and significant growth in the assets managed by IORPs has been observed in the last few years in the countries where they are offered.
4. These statistics may also illustrate a higher home bias of investments in countries with a higher level of pension assets, although a more detailed analysis would be needed, since pension funds tend to invest in a geographically diversified range of assets and that listed companies have diverse investors as well.
5. Except Iceland which is among the countries with the highest level of pension assets (200%) but only has limited market cap as % of GDP (63%).
6. Some studies also show that there is a negative relation between the size of the stock market and the proportion of GDP devoted to unfunded PAYG public pensions. See: Pension funding and capital market development T. Niggermann and J. Rocholl August 2010.

limited pension assets, which shows that other factors need considering such as the size and competitiveness of listed companies, the maturity of the stock market, the volume of issuances, the role of foreign investors, etc...

Countries with the highest levels of pension assets also tend to be those where households hold the highest proportion of financial assets as a % of GDP (*i.e.* financial assets invested in capital market instruments, excluding cash, deposits and unlisted equity)[7].

Country (% GDP)	Market cap	Pension assets	Household financial assets
US	190% (*)	138%	310%
Canada	135%	153%	
Australia	100%	131%	
UK	91%	85%	180%
Japan	126%	30%	
EU average	54% (*)	29%	90%
Sweden	155%	100%	165%
Denmark	150%	192%	187%
NL	136%	151%	174%
France	134%	11%	100%
Germany	45%	7%	100%
Italy	32%	11%	105%

In % of GDP. Figures are from 2022 except (*) from 2020
Sources: CEIC database for market cap, OECD Pension markets in focus 2023 for pension assets and AFME CMU key performance indicators November 2023 for household financial assets

In term of assets, bonds and equities represent more than 70% of the investments of pre-funded pension systems at the OECD level, with equities representing 30 to 40% of assets in most of the countries where pension assets as % of GDP are highest[8]. EU IORPs also invest on average 75% of their assets in bonds and equities (about 45% in corporate and government bonds and 30% in equities), when considering both the amounts invested directly and via investment funds, the rest being invested in money markets, real estate and alternative assets[9]. The split between equities and bonds depends on regulatory investment requirements in some cases and also the attitude towards risk of savers and the managers of the pension assets[10].

The Swedish pension system is often cited as an example in Europe where an adequate balance between PAYG and pre-funded mechanisms has contributed to the development of a vibrant equity ecosystem and to a strengthening of equity culture. PAYG is the main component of the pillar I pension system, but it is completed by a mandatory pre-funded premium pension system with a default option managed by the AP7 fund[11] that exclusively invests in equity until savers reach the age of 55 and then the proportion of equity is gradually reduced to reach 33% at the age of 75. This premium system is financed by a mandatory contribution rate of 2.5% of pensionable earnings, completing the 16% of annual pensionable income that finance the PAYG system[12].

3. Further leveraging the role of pension savings in the CMU

3.1 Actions proposed in the context of the September 2020 CMU action plan

This interplay between pension savings and capital markets is recognised in the Capital Markets Union (CMU) initiative. Supporting people in their retirement is indeed one of the actions of the September 2020 CMU action plan set out by the European Commission as part of the objective to increase the level of retail investor participation in capital markets.

Actions aiming at identifying best practices that may be developed at EU level have been launched by the Commission in three main areas: auto-enrolment (mechanisms that enrol individuals automatically in a supplementary pension scheme), pension dashboards (dashboards that facilitate the monitoring by policy-makers of pension adequacy) and pension tracking systems (online

7. The high saving rate in the EU (calculated as gross saving divided by gross disposable income) compared to the US (around 14% in the EU in 2023 up from 12% before 2019 compared to about 4.5% in the US) shows the significant potential that exists for the increase of investment in financial assets in the EU. The lower rate of saving in the US may be accentuated by the fact that a significant proportion of savings in the US are invested in mandatory retirement plans such as 401 (k) which represent up to 10 to 14% of disposable income, when considering employee and employer 401(k) contributions, part of which may not be taken into account in the evaluation of gross savings. Source Fidelity Q2 2023 retirement analysis, Eurostat indicators 5 October 2023.
8. Source: OECD Pension markets in focus 2023 for pension assets.
9. Source EIOPA How do IORPs invest 2023 (figures from Q4 2022).
10. Asset-backed pension systems also tend to diversify their investments geographically, particularly for equity investments, in order to maximize returns and reduce investment risks. The data on IORPs shows that while US markets represent about 45% of the equity investments of EU IORPs, they mostly invest in EU debt instruments. Source EIOPA How do IORPs invest 2023 (figures from Q4 2022).
11. Alternatively savers can choose to invest directly in a range of funds.
12. Most employees in Sweden are also covered by semi-mandatory occupational pension schemes based on collective agreements between the unions and employer confederations which invest in a diversified portfolio comprising equities, bonds and real estate. Different options are also available for pillar III including the investment savings account (ISK) that facilitates investments in financial instruments with simplified tax returns in particular. Source Regeringskansliet The Swedish pension system.

systems that allow citizens to benefit from a consolidated overview of their pension entitlements). A study on auto-enrolment best practices was published by the Commission in November 2021 and EIOPA provided technical advice at the end of 2021 on how pension dashboards and pension tracking systems may be implemented.

Other measures of the CMU action plan could also help to tackle the pension savings gap. These actions include the Retail Investment Strategy (RIS) proposal, which sets out measures in different areas to increase retail participation in the capital markets and is currently under review at Parliament and Council levels. The Commission proposal includes measures aiming to improve the value for money of investment products and enhance financial literacy and product disclosures, as well as reviews of MiFID and IDD to limit the use of inducements to cases where they are considered to enhance the quality of service, and extend these measures to insurance-based investment products with an alignment of MiFID and IDD in this area. The measures related to inducements and value-for-money are among the most debated ones in Parliament and Council, so the outcome of the approaches of the co-legislators is still uncertain at the time this note is written. A further issue to consider is that some personal pension products may not be covered by the RIS (*e.g.* products that do not come under MiFID and IDD rules) and that some types of private pension providers may fall outside the scope of EU regulation[13]. A review of the ELTIF framework has moreover been adopted, which should contribute to enhancing the attractiveness of ELTIF long term investment funds for retail investors in particular.

3.2 Future stages of the CMU

The future stages of the CMU and on-going initiatives, such as the work undertaken at the Eurogroup level to propose measures for deepening the CMU should provide fresh opportunities to further assess the role of pre-funded pension products in the development of capital markets and the actions needed to increase this role either at the EU level or at Member State level.

Addressing pension savings gaps requires a combination of supply side actions to improve the offering of private pension products across the EU and provide appropriate incentives and demand side actions such as those set out in the Retail Investment Strategy[14], to foster more long-term investment in pension-based capital market products.

While pensions are a Member State competence, which means that the EU has no powers to legislate on the design of pension systems or take measures which may affect the fundamental principles or financial equilibrium of national social protection systems, the EU can legislate on matters that affect the functioning of the internal market relatively to pensions. This includes aspects such as worker mobility across the EU, the freedom for private pension providers (pillar II and III) to supply products and services across the EU and consumer protection. Issues such as gender equality and workers' rights to secure equal pension benefits can also be addressed at the EU level.

The pan-European personal pension product (PEPP) framework, which was implemented in 2022 following the proposals of the 2017 CMU action plan was an attempt to provide a voluntary pillar III pension scheme at EU level. The objective was to address worker mobility issues across the EU and complete the current offer of private pensions, particularly in Member States where these schemes are in limited availability.

So far the take-up of PEPPs has been very limited with only one provider in the EU offering these products. Some reasons put forward by product providers for this lack of success include the fee cap and the challenges of implementing capital protection and risk-mitigation techniques for the Basic PEPP default option[15], and also the problems posed by the disparity of national tax incentives and national authorization obligations that PEPPs are subject to[16]. The alleged insufficient added value of the PEPP compared to existing domestic pillar III products, beyond portability, is a further issue. The low interest rate environment was also considered by the private sector to be a disadvantage for the PEPP when it was launched. A review of the fee cap of the Basic PEPP default option is due in 2024. A review of the PEPP Regulation due in 2027 should be an additional opportunity, albeit relatively distant, to identify the conditions for a successful relaunch of the PEPP[17].

13. See Article written by P. Hielkema in Eurofi Views Magazine February 2024 Building on past initiatives to address growing pension gaps.
14. The scope of the RIS may need to be adjusted to ensure that all pension products are captured by the legislation.
15. PEPP products should include a default investment option (the Basic PEPP) with costs capped at 1% of the accumulated capital per annum offering a capital protection that can take the form either of a capital guarantee or of other risk mitigation techniques.
16. See note of the Eurofi Regulatory Update of February 2024 for further detail on the PEPP 'Pensions in the EU: challenges and possible EU actions' and also on the IORP II regime for supplementary pensions.
17. Some commentators have suggested that one aspect to consider for example is the scope of the PEPP regulation, which could be broadened to include occupational pensions, for which there is potentially a greater demand than for pillar III supplementary pensions. See Article written by P. Hielkema in Eurofi Views Magazine February 2024 Building on past initiatives to address growing pension gaps.

Securitisations, Europe's categorical imperative

Note written by Ian Bell for Eurofi

Enlightenment philosophy explicitly intruding in financial markets policy discussions is hardly an everyday occurrence. But in November of last year, Christine Lagarde did just that in a speech where she called for a Kantian shift in Europe's approach to capital markets[1]. Those of us with an interest in securitisation could not fail to notice that, together with suggestions for a better regulatory and market infrastructure, the only market segment singled out to play a decisive role in the creation of a deep capital markets' union was securitisation. For those who see securitisation as, at best, a useful emergency capital management tool for banks in difficulty, this focus by as eminent a person as the president of the European Central Bank on the potential transformative role of this financing channel might appear strange. In this article, we will try to show why, on the contrary, it makes enormous sense.

The challenges

In finance, the challenges facing Europe are well known.

First, we must finance the enormous green and digital transformations of the continent. The Commission has estimated the necessary *additional yearly* funding at €620 bn for the former, €125bn for the latter.

Secondly, the world is becoming a more unforgiving place where large economic blocs appear to be turning their back on globalisation and cooperation. If Europe wishes to preserve its values and economic health, it will need to give itself the means to hold its own. These challenges extend well beyond the realm of finance. But it has at least two financial components.

One involves innovation. The tales are endless of European innovators unable to raise finance to move to stage two of their development. They fly to Silicon Valley and raise the necessary funds. But the cost is almost invariably relocation to the United States from which they sell their product back to Europe as an American corporation. An important and often overlooked point is that these European innovators do not raise this finance from US banks but from US funds. Banks in the US fund start-ups when they have already some success (stage 3). Innovation in the US is funded by the capital markets via private equity and joint-venture funds. The second involves the international footprint of European banks. There are no EU banks in either the top or second tiers of "global systemically important banks" as ranked by the FSB[2]. There are only two out of ten in the third tier. There are twice as many Chinese banks in that third tier as EU. The price to book ratio of almost every EU bank is below one and for many, way below one. Neither is this state of affairs an artifact of temporary stock exchange blues. It has been the case unbroken for over twelve years. For that whole time, the world equity investors have been telling European banks that they do not have the capacity to create value. If being a major player in international finance is a form of soft-power, Europe is failing that test.

Europe's advantages and the key to exploiting them

The good news is that Europe has the money. Europeans save and have done so for a long time.[3]

The bad news is that without a capital market, there are few places for this money to go. OECD figures show that US households hold only 13.4% of their financial assets in currency and deposits. Despite the creditable 13.5% of Danish households, no EU county achieves this level. France is at 31.3%, Italy at 31.8%, Germany at 42.8% and Greece at a staggering 58%.[4]

1. https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp231117~88389f194b.en.html
2. Technically, these are the second and third ranks since the first rank is always, as a matter of policy, left empty by the FSB.
3. EU savings rates for 4Q23 were 13%, compared to 3.9% in the US.
4. OECD Data - https://data.oecd.org/hha/household-financial-assets.htm#indicator-chart

Europe's problem is "plumbing". We have a large pool of savings. We have enormous demands. But of the large twin pipelines available in the United States to shift finance from where it to is where it needs to be, banks and capital markets, Europe lacks one – capital markets – and finds the other too small in size for the volumes it must carry.

The size constraint on banks is, of course, driven by capital constraints. This is unlikely to be resolved though by traditional capital raising. The below one price to book value and analyses of banks' implied cost of capital versus their actual return on equity indicate that issuing equity is going to be both challenging and very costly. Recent problems in the market for subordinated bank debt are not making this source of capital very attractive either.

To achieve its ambitions, Europe must increase the width of the banking channel and create a proper second channel with a real capital markets union.

Securitisation is, in our view, the only means to achieve these twin goals at speed. This is why this article bears its Kantian title of securitisation as a categorical imperative.

Note: There is, of course, another crucial limb to the capital markets union project in the form of the development of equity markets. This article only seeks to deal with fixed income but in no way seeks to downplay the importance of the other side of the capital market equation.

Securitisation and banks

Securitisation can provide banks with funding. But this is not of great interest. Between deposits and covered bonds, banks can raise funding. That does not mean that securitisation should not be used as a prudent form of diversification of funding, as we show below in our discussion of securitisation as a systemic stabiliser. But this is not its primary function *vis-à-vis* the banking system.

Securitisation primary purpose in Europe is as a safe form of capital management[5]. Through securitisation, banks can remove risk from their balance sheet. This, in turn, frees capital that is no longer required to "insure" the bank against the now removed risk. One sometimes hears the concern that securitisation allows banks to conduct lending without adequate capital. This though misunderstands how capital in the banking system operates. Capital is made up of assets available to meet unexpected losses. Traditional capital is made up of assets owned by the bank itself – equity or deeply subordinated loans. A bank can reduce capital requirements from securitisation either by a traditional true sale securitisation or by a synthetic securitisation (a form of credit insurance). In the former case, the assets leave the banking system altogether and are transferred to the securitisation investors. That does not mean there is no capital against those assets in the financial system as a whole. The holders of the junior tranches provides "capital" against those assets but do so from outside the banking system. In the case of a synthetic securitisation, the investor agrees to pay for losses on the securitised assets. This payment commitment is an asset from outside the banking system available to meet unexpected losses within the banking system. This means that traditional bank capital is replaced by the non-bank capital provided by that synthetic securitisation investor. Capital in the system has not been reduced but shifted from the banks' balance sheets to the non-banks' balance sheet.[6]

Banks can then use the freed-up capital to make additional loans. Securitisation widens the banking funding channel in Europe.

But it does more.

By allowing European banks to make additional loans on the same traditional capital base, securitisation will increase their return on equity since the returns on these new assets are additive to banks' existing returns on the same equity.[7]

Securitisation is also a generator of fee income – *i.e.* income that does not need to be backed by scarce capital. This is because, insofar as the assets securitised are still serviced by the bank – which they almost invariably are – the bank receives a fee for that servicing without this income stream incumbering its capital base. This additional fee income also increases banks' returns of equity.

Finally, securitisation is a generator of investment banking fee income. By generating tradable securities, it creates additional services that banks can charge for (arranging, underwriting, trading, derivative provision, fund management, etc.). Again, this is additional fee income that does not require capital (or a lot less capital) and so can boost the profitability of banks.

5. Securitisation can also underpin a non-bank financial institution ecosystem and add value in this way. This though is a matter for another paper.
6. In fact, because of the non-neutrality of the CRR capital requirements for securitisations, after a synthetic securitisation, the total amount of capital in the system is increased.
7. Although this is not the place to develop this, this effect results from the technical concept of "excess spread".

These additional features of securitisation explain, in part, the much better financial performance of US banks. By importing these to Europe, securitisation will, in the longer term, increase European banks' capacity to raise traditional capital. It will also allow them to hold their own place in the global financial markets.

Securitisation as systemic stabiliser

Securitisation can not only increase the volume bearing size of the European banking channel but can also, at the same time, strengthen its resilience. This is because securitisation is also an important systemic stabiliser.

In times of building stress in the banking system as occurs during economic recessions, when capital is eroded by losses, a deep and safe securitisation market allows banks to maintain healthy capital ratio's by sharing risk with non-bank investors.

During times of more acute stress when doubts are raised about the very solvency of banks, the securitisation market is a source of liquidity for troubled institutions when other source dry up. During the 2011/2012 sovereign crisis in Europe, some banks found that they could not issue bonds (either on a secured – *i.e.* covered bond – format or unsecured format). But they were able to issue securitisations since the risk of those bonds was not tied to the survival of the issuing bank.

Securitisation and capital markets

At its most basic, securitisation generates a capital market simply by creating investable capital market instruments. But this is not just a quantitative benefit – *i.e.* more investment instruments for EU savers. Securitisation is also ideal to kick-start the growth of a meaningful CMU because it creates the right kind of investment instruments. EU investors are risk averse. To be successful, a deep capital market needs to generate a large volume of safe investable instruments to meet those retail investor needs. Through tranching, securitisation allows the creation of large pools of safe, AAA, STS securitisations with stellar credit performance. These can be bought by conservative savers whilst the lower, riskier tranches can be bought by high(er) risk/high(er) reward funds[8]. If Europe wishes to mobilise all those savings currently in cash deposits, such safe instruments must be made available in substantial amounts.

Securitisation is not the only source of high credit quality instruments. Covered bonds also provide this type of investment. However, covered bonds are a bank product. They involve investors lending to banks and taking bank risk. In other words, rather than creating a second funding channel away from banks, they reinforce Europe's reliance on the banking sector. Rather than creating an independent second financing channel, they create only a capital market extension of the existing bank channel. And since covered bonds cannot recycle existing capital, they cannot by themselves widen that existing bank channel.

Securitisation and innovation

The ability of securitisation to generate large volumes of extremely safe investments is also key to the CMU's hope of funding innovation within Europe.

The rationale here is that Europe needs to create a retail investor ecosystem (primarily and, certainly at first, mediated by funds) that is attractive in terms of returns whilst still conservative in terms of overall credit risk. The way this is achieved in the United States is by investing in a blend of instruments. Typically, and depending on one's risk appetite, one would invest for example 85% of one's savings in conservative, safe but low yielding investments and 15% in riskier but high yielding bonds. The private equity, joint-venture type funds that finance innovation are clearly in the latter category. But to attract investors into that 15% sector, one needs to have the 85%. To build a capital market solely or primarily on risky investments will only lead to investors turning away from that market as it becomes seen, not entirely unfairly, as a high-risk casino for people willing to gamble their retirement savings.

By creating the safe but low yielding part of the capital markets in sufficient volume, securitisation can allow the riskier but high yielding part to flourish and finance European innovation *in Europe*.

Why securitisation?

Although securitisation can generate this growth in capital markets, other instruments such as corporate bonds, SME bonds and project bonds are also available. Why should we focus on this particular instrument in a priority manner? Why was this the only instrument specifically mentioned in Ms Lagarde's speech?

8. We are not suggesting that securitisations should be sold directly to retail investors. Securitisation remains a fairly complex instrument that requires professional due diligence. However, we would envisage retail investment in AAA senior STS tranches mediated by funds such as UCITS.

The answer, we believe, is that in an economic bloc where 80% of financings are generated by banks and have been for many decades, banks are where financial assets exist in large quantities. At the end of 2022, according to the ECB, EU headquartered banks held almost €31 trillion in assets. To build out in volume any other instrument will take time as new borrowings must be generated. Bank borrowings already exist ready to be turned into securities.

If we look at the needs of the European economy, including the green and digitisation transformations, these are not only large, but they are urgent. We cannot afford to build out a market able to mobilise savings over decades. In addition, none of the other candidates to kick-start the capital market union provide for increased flow of funds from both available channels via the positive effect on bank capital.

Why is there only a small EU securitisation market?

The European securitisation market in 2023 saw issuance of public securitisations of around €120 bn including the UK. This is much smaller than the volumes in other jurisdictions.

Although many reasons have been put forward for the small size of the market, none save one are very convincing. They are not convincing because almost all point to conditions that also exist in all the other jurisdictions from Canada to Japan where the securitisation market is broader and deeper than in the EU. The one that is convincing is that Europe has a uniquely penalising regulatory framework.

What must be done?

Although it is not possible to guarantee a flourishing securitisation market following an improvement of the regulatory framework, it is clear that without any change in that framework, the outcomes are exceedingly unlikely to be different from what they are now.

The good news though is that despite the need for a deep securitisation market to create globally competitive banking and capital markets, there is no need for "special treatment" or modifications to the prudential regulatory treatment of securitisation away from a prudent, fact-based approach to ensuring the safety of the financial system. To allow securitisation to grow, all that is required is to finalise the reforms already brought into being in Europe. The current punitive regime was imposed as a first step and in acknowledgement of the agency risks potentially embedded in securitisation and how these, coming from the US, had devastated the financial world in 2007/2008. A second step, enshrined in the STS Regulation, was the removal of the most egregious agency risks for all securitisations through "skin in the game" retention and a ban on re-securitisations and the creation, in STS, of a new standard from which all such risks were effectively excluded. Although some modifications were made to CRR and Solvency 2 at the time, the missing third step is to see through to their logical conclusion the removal of agency risk for STS and calibrate both CRR and Solvency 2 to the actual, evidenced performance of these instruments. Another required step – in line with the issue of competitive disadvantage – is to level the playing field with other asset-based products so that disclosure and due diligence requirements are equalised across asset classes.

For a detailed analysis the reader can check earlier publications such as "Securitisation: the indispensable reform"[9]

Conclusion

To meet with confidence the challenges it faces, the European Union needs to widen the two financing channels available to mobilise the available savings of its citizens. Securitisation can do this.

It can widen the bank channel by allowing banks to bring into the financial system non-bank capital and thereby both increase their lending envelope and their return on equity. The former generates more funding for the economy, the latter generates the type of returns on equity necessary for European banks to compete on the global stage with their US and Chinese counterparts. This securitisation can do whilst also providing systemic stability to this broader banking system.

It is also the only tool that can widen, within a reasonable timeframe and in sufficient volume, the European capital markets so as to convey the substantial savings of EU citizens to their own economy and their own climate and digital transformations.

To do this, though, a miscalibrated and punitive regulatory framework must give way to a sound, evidence based and coherent one.

9. Eurofi Policy Note: https://www.eurofi.net/wp-content/uploads/2021/12/securitisation_the-indispensable-reform_ljubljana_september-2021.pdf

Banking Union challenges

4

Banking Union: what way out of the current deadlock?

Note written by Didier Cahen and Alicia Valroff

In response to the EU sovereign debt crisis (2011-2012), the European Union launched the Banking Union project to safeguard financial stability, deliver a safer banking sector, reduce the sovereign-bank nexus and protect taxpayers from the cost of bank failures. The Banking Union, currently covering 21 Eurozone countries, is also open to other EU Member States.

The Single Supervisory Mechanism (SSM, created in 2014) has helped promote a resilient banking sector, but the banking market remains too fragmented and over-banked in Europe, and market concentration has only progressed at domestic level. The SSM and the Single Resolution Mechanism (SRM, created in 2014) has failed to provide the expected degree of cross-border banking integration in the EU: in particular, transnational banking groups are unable to manage their capital, liquidity and MREL liabilities on a consolidated basis, and the market for retail banking services has not progressed.

European banking markets remain fragmented, and the home-host dilemma has not been resolved. As a result, the Banking Union project has remained in a deadlock for years.

This paper aims at proposing ways forward to get out of the political deadlock and progress in the completion of the Banking Union, which is defined in this paper as the combination of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the European Deposit Insurance Scheme (EDIS).

The first part of this paper describes the benefits that a genuine Banking Union would bring about in terms of competitiveness for the EU banking sector. The second part focuses on the existing loopholes in the design of the Banking Union that make it fragmented and suboptimal. The third part assesses the ways forward that have been identified but that have been hampered by the prevalence of national interests over European ones. Eventually, the fourth part explores potential ways out of the deadlock and guidelines to resume making meaningful progress on the Banking Union.

1. A genuine Banking Union would be beneficial for the competitiveness of the EU banking sector

A genuine Banking Union would offer several benefits to the EU banking sector, and *a fortiori* to the EU financial sector as a whole. The first section shows that completing the Banking Union would foster the integration of banking markets and consequently make the allocation of resources across the EU economy more efficient. The second section focuses on the synergies existing between the Banking Union and the Capital Markets Union: advancing on both these projects would reinforce the EU financial sector. The third section however explains that one should not overestimate the benefits the EU would reap from having a genuine Banking Union.

1.1 A genuine Banking Union would accelerate the integration of banking markets, which is a prerequisite for a more effective allocation of resources across the EU economy

A genuine Banking Union would promote a better integration of EU banking markets – *i.e.* banking markets where banks operate within the Euro area as they would in their home jurisdiction – which in turn would foster a more effective allocation of resources across the Eurozone (*e.g.*, companies would be able to tap wider and cheaper sources of bank funding) in addition to achieving a better diversification of risks. In such a context, transnational banking groups of the Euro area would be considered as unique entities from an operational, regulatory and supervisory perspective, and not as a sum of separate subsidiaries ("the solo approach"). In other words, the EU legislative framework would recognize transnational banking groups at the consolidated level.

Therefore, an effective Banking Union would improve the development of transnational and competitive banking groups in the EU which would help Eurozone's excess savings to circulate across borders to parts of Europe where most attractive investment opportunities exist: any company in any Member States could finance its investment projects through any subsidiary or branch located anywhere in the Banking Union.

Resilient transnational banking groups would also enhance private risk sharing mechanisms: if there are transnational banks that operate in various parts of the Union, they can offset any losses made in the recession-hit region with gains in another one and can continue to provide credit to sound borrowers. Depositors would also contribute to the financing of a more diversified pool of assets which would insure them against shocks specific to their home country.

Furthermore, the Banking Union is a crucial step towards a genuine Economic and Monetary Union as it allows for the consistent application of EU banking rules in the participating countries, leading to a resilient banking sector. Moreover, it improves the efficiency of the transmission of the monetary policy, for which banking activities play an essential role in the Euro area.

1.2 Apparent synergies exist between the Banking Union and Capital Markets Union

Having a fully-fledged Banking Union would also contribute to the development of the Capital Markets Union (CMU) which would benefits investment and competitiveness of the EU.
Indeed, Banking Union and Capital Markets Union are "mutually reinforcing initiatives that can bring the Single Market for financial services to the next level[1]" as banks and capital markets complement each other in financing the real economy. More precisely, V. Constâncio explains that "a more resilient banking system supports the smooth functioning of capital markets. For example, resilient banks are more likely to act as market makers for certain capital markets instruments and may ideally buffer extreme price movements in times of crisis. Furthermore, well-capitalized banks are less likely to be forced to fire sale certain asset classes. This leads to less market disruptions in time of crisis".

Reciprocally, capital markets union supports Banking Union: more integrated and jointly regulated capital markets would support cross-border activities and resilience of banks. V. Constâncio highlights that "in a significantly more integrated capital market, banks would no longer need to develop local expertise for each national capital market. They could exploit cross-border economies of scale more easily by offering similar or even the same products and services in another Member State. By operating in a larger, integrated market, banks would likely increase the cross-border holdings of assets and be able to build larger and more diversified collateral pools for securitized products and covered bonds".

Eventually, the Banking Union, together with the CMU may play a significant role in enhancing the open strategic autonomy of the EU and strengthening confidence in the euro. Strategic autonomy requires, among other things, converging EU economies, a strong and widely used currency, and a resilient, competitive and thriving financial sector. These, in turn, would greatly benefit from *e.g.* a Eurozone safe asset, deep capital markets and a single banking market.

1.3 Nonetheless, the benefits of the Banking Union should not be overestimated

Progress on the Banking Union requires above all economic convergence between the largest Member States (Germany, France, Italy, Spain) to restore trust amongst European leaders, without which cooperation is not possible. Economic convergence and sound public finances in all parts of the EU are essential to restore trust among Member States, break the sovereign-bank doom loop[2], foster the creation of a EU safe asset and reach a European agreement on European Deposit Insurance Scheme (EDIS).

Moreover, progress on the Banking Union and the CMU has been hampered by an adverse monetary and economic environment for more than a decade: interest rates are systematically lower in Europe compared to the US, leading Member States with excess savings such as Germany and the Netherlands to invest in the US instead of countries with low GDP per capita such as Spain, Italy, Portugal and Greece as it is better remunerated in the US, and economic growth is higher in the US than in the EU, especially because of the economic heterogeneities between the main Member States and the lack of common policy regarding industry, energy, defense, etc.

Cross country differences in approaches regarding state aid and bank taxes are other hurdles to progress in the Banking Union. While state aid creates obstacles for competition across the EU because they are asymmetrically granted by Member States, bank tax proposals in one country spread turbulence across the EU as was seen in the case of EU banks' stock prices and the Italian bank tax proposal[3].

1. V. Constâncio, "Synergies between Banking Union and capital markets union", keynote speech at the joint conference of the European Commission and the European Central Bank on European Financial Integration, 19 May 2017.
2. Except if we had EDIS and if banks had diversified sovereign bond portfolios and diversified lending portfolios, which is not the case at the time this note is written.
3. "On August 7, 2023, Italy's vice-president M. Salvini unexpectedly announced a 40% tax on bank windfall profits (…) The markets responded spectacularly, send Italian bank shares plummeting on the Milan Stock Exchange." Source: "Italy announces tax on bank windfall profits, causing stock to plummet", Le Monde, 9 August 2023.

Beyond this adverse economic environment, the development of the CMU requires adjustments that are not linked to progress in the Banking Union:

- Similar interest rates on the euro and the US dollar in order to avoid capital outflows,
- Long-term saving products[4] (*e.g.* pension funds),
- Stimulation of household investment in equity-like products (taking into account EU retail savers' aversion to risk); this links with the EU Retail Investment Strategy,
- An effective EU market for securitization,
- Rules that do not disincentivize equity financing (listed or not),
- Consolidation and centralized supervision of post-trade market infrastructure located on EU territory,
- (Progressive) harmonization of EU "securities, corporate and insolvency laws".
- A combination of a top-down approach – with a single rulebook regarding listing, market abuse, products, etc, and a bottom-up approach – where each Member State works on developing its capital market.

Besides, having a fully-fledged Banking Union would not in itself create a single market for retail banking services[5]. This requires harmonization of legal, fiscal and consumer protection rules. Transnational banking groups would thus not fully benefit from economies of scale. Consequently, cross-border mergers would still be impeded by this fragmentation, and also by the Basel prudential requirements that increase capital requirements according to the size of the balance sheet. Indeed, Global Systemically Important Banks (GSIBs) are allocated by the Financial Stability Board into five "buckets" of ascending levels of systemic importance, and of accordingly ascending levels of additional capital requirements[6].

Finally, it has to be kept in mind that a major challenge in the Banking Union is to achieve the goals of an unrestricted single market while simultaneously allowing for competitive national subsystems. Steps towards further integration must have the entirety of the EU's diversified banking sector in mind. Measuring the proper functioning of the Banking Union should not solely focus on the existence of so-called "European champions" in the banking sector. This is not the silver bullet to create an even more stable and better functioning banking industry for Europe, its customers and the real economy.

2. Loopholes in the design of the Banking Union make it fragmented and suboptimal

Significant progress has been made on the Banking Union since the creation of the SSM and the SRM in 2014. The European banking sector has shown remarkable resilience amid the Covid-19 crisis, the war in Ukraine and the banking turmoil of Spring 2023. Yet, loopholes exist and make the Banking Union fragmented and suboptimal. The first section explains the issue persisting around the resolution for some domestic Less Significant Institutions (LSIs). The second section explores other key issues such as economic divergence, the home-host dilemma, the sovereign-bank nexus and ring-fencing practices that hinder progress on the Banking Union. The third section shows that the existing fragmentation undermines the profitability and competitiveness of the EU banking sector, and that as a result, EU banks lag behind international peers.

2.1 The SSM have enhanced the resilience of the EU banking system and the EU framework regarding bank resolution has progressed even if there remain issues for the resolution of some domestic Less Significant Institutions (LSIs)

The conception of the Banking Union relied on three pillars: the first one is supervision, the second one is resolution, and the third one – which is still a matter of discussion among Member States – is the creation of the European Deposit Insurance Scheme (EDIS).

The first pillar of the Banking Union is the Single Supervisory Mechanism (SSM), a new system of banking supervision comprising the ECB and the national authorities, directly supervising the 115 most significant banks of the Euro area (holding almost 82% of European assets). The enhanced regulatory and supervisory reforms implemented in the last 10 years have proved effective: the European banking sector has shown remarkable resilience during the banking turmoil of the Spring 2023.

The second pillar of the Banking Union is the Single Resolution Mechanism (SRM) as well, which objective is to protect financial stability and the taxpayer by planning for and managing bank failures. This pillar needs improvements as national authorities continue to distrust the European framework, especially regarding Crisis Management and Deposit Insurance (CMDI).

4. Long-term saving products improve the financing of pension regimes (*e.g.* 401K in the US), improve the competitiveness of market activities in Europe and favor the development of EU asset managers.

5. See 2.1.

6. For instance, a GSIB allocated in the first bucket face an additional CET1 capital requirement of 1% of its total Risk-Weighted Assets (RWA). For the second bucket the additional CET1 capital requirement equals 1.5% of total RWA, for the third bucket the buffer equals 2% of total RWA, for the fourth bucket 2.5% of total RWA, and the fifth bucket would trigger a 3.5% buffer and remains for now only "dissuasive". Source: "The impact of the identification of GSIBs on their business model", ACPR, Banque de France, 15 March 2018.

European rules on resolution have often been divisive because there have been in the past discrepancies about the definition of Public Interest (PI) between the SRB and national resolution authorities. Yet, the EU framework has been seriously reinforced over the last decade, in particular for large banks: according to the SRB[7], 97 out of 113 banking groups under the SRB's remit are prepared for resolution and have built up their capabilities to comply with the SRB's Expectations for Banks (EfB) and the steady state MREL[8] target[9]. Additionally, the Single Resolution Fund (SRF) has reached 1% of covered deposits, marking the end of the SRF build-up phase.

The ESM has set aside €68 billion as an additional guarantee. This backstop to the SRF can only be used if the new treaty signed in 2021 enters into force, and that cannot happen unless all Euro area members ratify it. 19 countries ratified it. However, the Italian Parliament voted against. This new treaty could be presented again to the Italian parliament after six months.

One could hope that the progress achieved on the EU bank resolution framework would at least partly dispel the concerns of host jurisdictions and encourage them to lift some ring-fencing practices[10], especially regarding liquidity management in cross-border banking groups. Such a decision could send a positive signal to authorities and banks to resume making progress on the Banking Union. However, this is not the case at this stage (*see 2.2*).

On 18 April 2023, the European Commission published its proposal concerning the review of the BRDD, SRMR, DGSD and daisy Chains Directive – the Crisis Management and Deposit Insurance Proposal (CMDI). The EU Commission proposed in particular a new public interest assessment criterion that would increase the number of banks be put in resolution in case of their failure. Of the circa 2 000 Less Significant Institutions (LSIs) in the Banking Union, 68 were earmarked for resolution at the end of 2022. Out of these 68 banks, 25 still had a shortfall with respect to the final MREL target at the end of 2022.

The CMDI proposal is likely to bring additional banks into the scope of resolution, with the objective of strengthening financial stability and avoiding value depletion (where a transfer strategy is less costly than a liquidation). It changes the criteria to determine which bank goes in resolution (*i.e.* the so-called public interest assessment) but the decision on this matter remains a discretion of the relevant resolution authorities.

This expansion of the scope will impact banks that are likely to present, even when MREL compliant, the characteristics described above. This is why CMDI also aims at enhancing the funding options for financing these banks' market exits in resolution. The DGS Bridge would absorb losses the bank in lieu of deposits after MREL has been depleted up to the level of the 8% TOLF.

CMDI, in fact, proposes to make more practicable the possibility of using Deposit Guarantee Schemes (DGS) in resolution. In order to achieve its objectives, CMDI removes the DGS super priority, introduces a single-tier depositor preference and some harmonization of the Least Cost Test (LCT). In other words, CMDI proposes to modify the creditor hierarchy position of the DGS by putting it to the same level of uncovered depositors. This amendment, necessary to increase funding in resolution, was met by a strong opposition from the industry.

A European Deposits Insurance Scheme (EDIS) is considered the third pillar of the Banking Union. In November 2015, the EU Commission submitted a proposal for EDIS. No political agreement was reached ever since. Support within the industry has also been limited. With EDIS, about 2.200 smaller and regional banks organized in networks would lose their Institutional Protection Schemes (IPS) as they were not taken into consideration by the EDIS proposal. Large banking groups see costs of setting up EDIS outweighing its benefits.

2.2 The Banking Union faces a number of issues

Ten years after its creation, the Banking Union has not been completed as several key issues persist.

The EU banking sector is hampered by the heterogeneous economic situations of Member States which fosters distrust among national authorities and the SSM and the SRB.

The intensity of fiscal and economic divergences between EU countries as well as some Member States' fear that they will have limited influence over European decisions makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself" and creates a climate of mistrust between Member States. Additionally, these economic divergences give EU policy makers a hard time agreeing on a European safe asset as well on mutualized European Deposit Insurance Scheme (EDIS) and thus complete the Banking Union.

The heterogeneous economic situations are particularly displayed by the differences in public debt levels and

7. "SRB Bi-annual reporting note to the Eurogroup", Single Resolution Board, November 2023.
8. Minimum requirement for own funds and eligible liabilities (MREL) is one of the key tools in resolvability, ensuring that banks maintain a minimum amount of equity and debt to support an effective resolution.
9. Therefore, as of December 2023, the 16 remaining groups under the remit of the SRB would go into liquidation.
10. See 2.2.

current account balances from one Member States to another. For instance, over the past years, Germany has had a government debt fluctuating around 60% of its GDP while France has had a debt fluctuating between 110 and 115% of its GDP, and Italy's government debt has exceeded 140% of its GDP. Similarly, in 2022, one can observe important current account imbalances between Member States: while Germany's current account balance stood at 4.2% of its GDP, France and Italy displayed current account deficits of respectively -2.1% and -1.3% of their GDP[11].

As long as Member States follow this diverging trend, no significant progress towards the completion of the Banking Union, the CMU and the EMU will be achieved as Member States do not collaborate because they do not trust one another, and continued diverging trends in economic development mean there is not sufficient convergence within the EU, which is a prerequisite for a deeper Banking Union.

In his interview for the *Eurofi Magazine* (February 2024), A. Weber explains that "core countries with strong economic fundamentals fear that Banking Union could lead to sharing the financial burdens of less stable economies without adequate safeguards. Conversely, countries with higher public debt are more inclined towards mechanisms that facilitate risk sharing, hoping for potential fiscal relief or stability benefits. In contrast, countries with healthier fiscal positions prioritise risk reduction over risk sharing, fearing that integration could expose them to the fiscal irresponsibilities of others. More concretely, proposals that imply mutualising debt or risks (*e.g.*, through a common deposit insurance scheme as part of the Banking Union) face resistance from countries wary of underwriting the risks of others without stringent controls or are simply held hostage to negotiate a broader set of European agreements. This has been a stumbling block for any political agreement to pursue deeper integration in banking and capital markets".

The sovereign-bank nexus persists because of endlessly too high fiscal deficits in certain Member States.

Even though EU banks have now higher capital and liquidity ratios than they did in 2012 and that the EU banking sector proved resilient[12] during the banking turmoil of the Spring 2023, the Banking Union did not achieve its objective to break the sovereign-bank nexus, which is a threat to financial stability.

The persistence of the sovereign-bank loop is not the result of a dysfunction of the SSM or the SRB, but the consequence of fiscal slippage in some countries that have been exacerbated by the Covid-19 crisis (*i.e.* the budgetary excesses are encouraging banks to contribute to finance these deficits).

Indeed, according to EBA statistics[13], the domestic sovereign exposure of EU/EEA banks in December 2022 stood at 5.7% relative to their total assets, and at 101% compared to their capital, which means that the risk concentrated on domestic sovereign is still looming despite the downward trend. These figures are 9.9% and 160% for Italy, and 18.2% and 239.7% for Poland. Roughly 50% of banks' total sovereign exposures is to their home sovereign[14].

In November 2023, S&P Global Ratings wrote that Eurozone countries have not broken the link between public finances and banks and that investors could refocus on that vulnerability in 2024. "In light of weak economic growth, potential differences in the speed and magnitude of monetary and fiscal policies could bring the sovereign-bank nexus back under market scrutiny," S&P analysts explained. This doom loop dominated the EU sovereign debt crisis in 2010-2012; with increasing supply of government bonds and existing incentives to hold sovereign debt securities, banks may be tempted to increase their exposure to their sovereign but should have in mind the risks incurred. The sovereign doom loop could even increase with quantitative tightening, especially in highly indebted countries.

The EU banking sector is fragmented along national lines.

Ring-fencing occurs when host authorities take regulatory and supervisory action in order to secure bank financial resources within their own jurisdictions. There are no host supervisors anymore in the Banking Union, but the distinction between home and host authorities and the "national bias" still exist for banks operating across borders in the Banking Union under the remit of the SSM.

Indeed, national supervisors still fear that capital and liquidity could be trapped in other individual Member States or inadequately allocated from their own viewpoint if a pan-European banking group fails. This perception is particularly acute in countries that are strongly dependent on banks part of groups headquartered in other Member States for the financing of their economies. Furthermore, banks cannot create truly pan-Eurozone business because they must deal with a patchwork of national authorities' different views on macroprudential rules and conduct.

Ring-fencing policies are applied to capital, liquidities and MREL liabilities.

The obstacles to the integrated management of bank capital and liquidity within cross-border groups operating in the Banking Union remain persistent and fragment banking markets. While recognized in 2013 by the fourth Capital Requirements Directive (CRD4), capital and liquidity waivers remain at the discretion of the national supervisors, which are most often

11. See Macroeconomic Scoreboard, Eurofi, February 2024.
12. The Euro area banking sector's resilience to adverse shocks was also confirmed by the results of the European Banking Authority's 2023 EU-wide stress test.
13. Data from the EBA's Risk Dashboard.
14. See "Banking Fragmentation Issues in the EU", Eurofi Regulatory Update, September 2023.

reluctant to use them. In practice, all capital and liquidity ratios are applied at both solo and (sub-) consolidated levels, notwithstanding the possibility of waivers allowed by the legislation.

Calculations by the ECB Banking Supervision show that, in the absence of cross-border liquidity waivers – as it is currently the case – the combination of the European and national provisions prevents around EUR 250 bn of High-Quality Liquid Assets from moving freely within the Banking Union[15].

Excessive flexibility in the EU macroprudential framework also encourages ring-fencing measures. The legal framework for macroprudential tools grant flexibility to national designated authorities. The ECB can only intervene in the case of EU harmonized measures but many national macroprudential power are explicitly or *de facto* left at national level. Macroprudential decisions such as the level of certain capital buffers are still decided by national authorities, with scattered mandates for micro- and macroprudential authorities. There is currently no authority that is responsible for reviewing the aggregate capital requirements for a bank against its actual risk profile, which can lead to excessive capital requirements for even banks with low-risk balance sheets.

Moreover, several host authorities tend to submit any dividend distribution to their approval.
Several Member States tend to submit dividend distribution from subsidiaries to parent entities within cross-border banking groups to their approval, even if these distributions are organized at group level and thus should be supervised by the group supervisor in line with the different macroprudential measures taken, as well as with views to make the group more resilient and agile at the consolidated level.

Eventually, subsidiaries of European transnational groups can be required to have increased Pillar 2 Requirements (P2R). P2R is a legally binding bank-specific capital requirement which applies in addition to the minimum capital requirement (known as Pillar 1) where the latter underestimates or does not cover certain risks. The numerous instances where different P2R are applied by host supervisors to the same European banking group also illustrate the fragmentation of the EU Banking Union and the lack of harmonization within it. Indeed, even if the SSM is officially in charge of determining the level of P2R, including management buffers and Pillar 2 Guidance for subsidiaries, host countries can – most of the time successfully – submit their proposals to the SSM to increase such levels in order to protect their economy.

Root causes of ring-fencing practices have been identified but continue to exist.
First, ring-fencing is deeply rooted in the general lack of trust that is mainly due to economic and fiscal divergences between the largest Member States described above which prevents the creation of a EU safe asset that would enhance the diversification of risks.

The second root cause of ring-fencing measures is the bad memories of the EU sovereign debt crisis (2011-2012) in certain Member States such as Luxemburg or Belgium where some foreign banks have taken over national leading banks.

Eventually, host authorities are concerned with ensuring the financing of their national economic activities, and for some of them especially their public deficits. To do so, they ring-fence to keep the capital in the subsidiaries.

The market for retail banking services progresses too slowly: the lack of uniform standards, products and protection rules at the EU level is a barrier to an integrated European banking market which discourages cross-border banking.
Despite the EU Single Rulebook and the ECB's clarification of the supervisory approach to consolidation, a number of traditional factors such as legal systems, languages and custom remain and fragment banking markets. Additionally, the EU Commission explains that "differences in taxation, borrower protection, or anti money laundering provisions at Member State level result in bank-specific entry and adjustment costs that discourages cross-border banking". For example, there is no single EU-wide loan registry as it is the case in the US.

Moreover, there is a significant diversity in terms of banking products leading to the fragmentation of the EU banking landscape. For instance, banks in countries like Spain, Italy and Germany offer variable interest rates and are therefore directly affected by the ECB's rising interest rates whereas French banks mostly offer fixed interest rates.

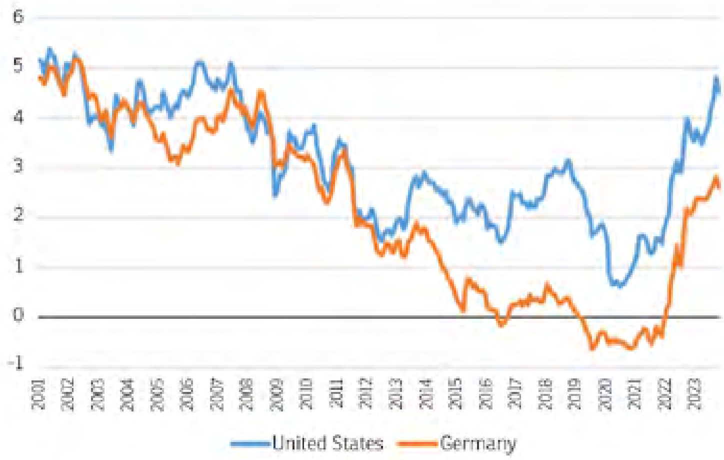
Such differences prevent banks from sharing processes and systems across European countries. Large banks consequently miss scale advantage when moving into new European markets and this undermines the potential for Europeanisation.

The Banking Union is hampered by the lack of cooperation among Member States.
Overall, progress on the Banking Union is hampered by the lack of cooperation. One example of that is the outcome of the proposals of the Eurogroup of December 2021 in order to complete the Banking Union. The Eurogroup proposed 4 areas to explore:

- To strengthen the framework for the management of failing banks in the EU,

15. "How can we make the most of an incomplete Banking Union?", Speech by A. Enria at the Eurofi Financial Forum, Ljubljana, 9 September 2021.

CHART 1.
10-year sovereign bond yields (%) in the United States and Germany



Source: OECD
Note: Note: the German government bond yield is considered as a benchmark for a EU safe asset and thus can be compared to the US government bond yield

- To create a more robust common protection scheme for depositors,
- To facilitate a more integrated single banking market for banking service,
- To encourage greater diversification of banks' sovereign bond holding in the EU

After 18 months of discussions, the Eurogroup decided in June 2022 to only focus on strengthening the Crisis Management and Deposit Insurance (CMDI) framework – which is not a central issue as mentioned above. In the meantime, no further concrete steps are contemplated in order to improve the single banking market or to tackle the sovereign-bank nexus.

Banking integration in Europe remains limited and the EU lacks private risk sharing mechanisms.
Private risk sharing mechanisms work through the credit channel (cross-border lending and borrowing) and the capital market channel (diversified private investment portfolios across Euro area countries). The more risk is shared through banks and markets, the fewer fiscal mechanisms are needed on the public side to address failures. Banking integration through private risk sharing mechanisms is essential to strengthen the EMU but the EU currently lacks such mechanisms. As A. Enria already stated in 2018[16], since 2007 in the Euro area, the credit channel has acted more as a shock amplifier than a shock absorber.

Cross-border assets held by banks in the Euro area have hardly changed since the launch of the Banking Union project. Furthermore, the cross-border integration of the sector has progressed at a snail's pace in recent years, including after the establishment of the single European banking supervision in 2014. Indeed, the share of cross-border loans to households and cross-border deposits from households in the Euro area remain negligible, a little above 1%.

2.3 Fragmentation undermines the profitability and competitiveness of the EU banking sector and as a result, EU banks lag behind international competitors

Fragmentation leads the European banking sector to struggle with excess capacity as cross-border Mergers and Acquisitions (M&A) activities among banks in Europe have drastically diminished since 2000.

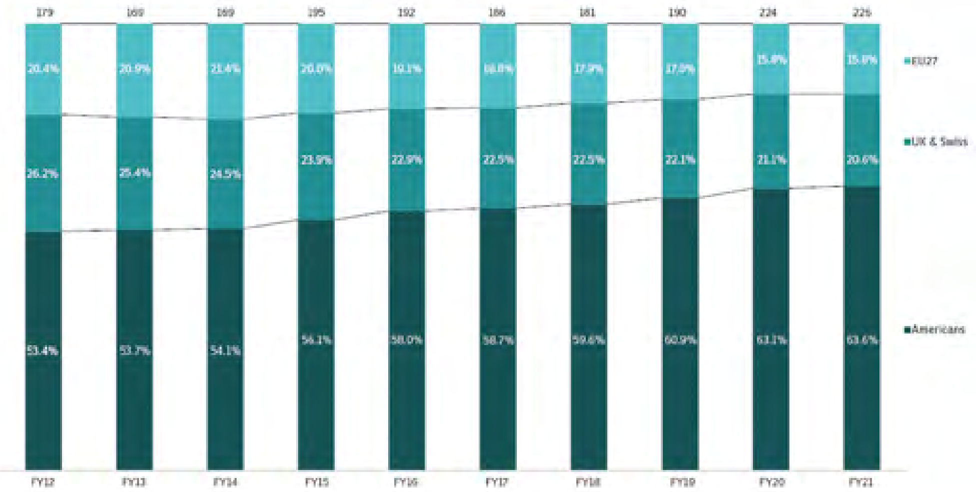
As a result, the EU banking sector is overcrowded, which puts pressure on banks' margins. Excess capacity also goes side by side with cost inefficiencies, which are two of the factors behind the structurally low profitability of EU banks. This is a real issue insofar as about 70% of the economic activity in the EU is funded through bank loans: the profitability of banks in the EU is all the more important as it being persistently weak can pose a risk to financial stability and to the EU strategic autonomy. Additionally, the ECB financial stability review of November 2023 highlights that bank stocks' low valuations – which is driven by political and regulatory uncertainty on top of economic expectations – may also pose a risk to financial stability.

In contrast, the profitability of American banks is fostered by several elements. First, growth in the US is stronger than in the EU: Since 1995, real US gross domestic product has increased more than 90 per cent, against the Euro area's more than 50 per cent.
Interest rates are also structurally higher in the US than in the EU as evidenced by Chart 1.

Lasting low interest rates, as can be seen on Chart 1, have had negative consequences on EU banks profitability until 2022: it compressed net interest margins – which penalized them *vis-à-vis* their American counterparts. Indeed, net interest income represented 50% of EU banks' net operating income, and Profit and Loss (P&L) were made of more than 50% of credit and loan related activities.

16. A. Enria, Fragmentation in banking markets: crisis legacy and the challenge of Brexit, EBA, 17 September 2018.

CHART 2.
The market share evolution of EU banks in the global CIB market vs US banks (%)



Source: EBF

Furthermore, US banks benefit from a consolidated single market for banking services, which means that there is less competition than in Europe and American banks thus have a higher pricing power, which increase their revenue. Unlike the EU which has 27 Member States, the US is a single country, with a deep and liquid market for Treasury bonds, a consolidated post-trade infrastructure (DTCC) and one set of law regarding securities, corporate and insolvency. Additionally, the US has a genuine market for securitization with Government-Supported Enterprises (GSEs) such as Freddie Mac and Fanny Mae, and benefits from a strong equity financing ecosystem, including long-term saving products (*e.g.* 401K). Eventually, US retail savers are usually more prone to taking risks than European savers.

The overall profitability of EU banks – except during the Covid-19 pandemic – has improved but remains behind that of US peers.

At the beginning of 2008, the market capitalization of the top Eurozone bank was very similar to that of the top American bank. At the beginning of this year, JPMorgan Chase represented more than the first 10 Eurozone banks combined. The profitability of the European banking sector has eroded to be much lower than the other international players. Since 2008, EU banks have been weakened by poor growth, lasting negative interest rates, market fragmentation and lack of scale.

Chart 2 shows that European banks are losing ground to competitors, especially US banks that have a market share four times higher than EU banks. EU banks also have a CIB market share inferior to that of UK and Swiss banks.

3. Ways forward have been identified but are hampered by the prevalence of national interests over European interests

During the Eurofi Financial Forum of September 2023, officials and industrial representatives have emphasized the need for a mindset shift regarding the completion of the Banking Union and the integration of banking markets. Several ways forward have been identified, but their implementation requires significant will and effort. The first section outlines the main advantages and drawbacks of branchification as well as the reason why banks are reluctant to branchify retail activities. The second section explains that credible support provided by parent companies to Euro area subsidiaries based on European law and European authorities is another way forward to solve the home-host dilemma.

3.1 Branchification offers real benefits for wholesale banking, but branchifying retail activities is impeded by Member States

Branchification is the process of merging all existing subsidiaries into the parent company and only operating through the branches of a single, unified legal entity.

Benefits from branchification include "clearer governance and accountabilities, simpler and more effective balance sheet and liquidity management, avoidance of many duplicated requirements on subsidiaries (capital, liquidity, MREL...), ability to cater for large financing needs (scale benefits from a large balance sheet), one prudential supervisor, improved resolvability, and reduced reporting burden", explains J. Vesala[17], Head of Group Credit at Nordea.

17. J. Vesala, "Why there is little cross-border branching in the EU", Views, the Eurofi Magazine, September 2023.

Many obstacles remain and prevent banks from undergoing this transformation.

Branchification is very difficult to implement in banks that offer retail services as host jurisdictions are often opposed to such a legal structure. It is extremely burdensome and complicated for banks to do business in a country on a daily basis against the directives of the country's government, so it is easier for banks to keep their subsidiaries and avoid possible retaliation. Furthermore, even with a branch structure, national conduct rules need to be followed, and complex and varying macroprudential rules create unnecessary uncertainty that discourages banks from branchifying.

Additionally, technical obstacles to branchification exist and include legal hurdles and a pressure from host jurisdictions. Though Nordea chose this structure, J. Vesala acknowledges that "the process of branchification remains complex and cumbersome, even in the Nordic region. The challenges include transition uncertainties and the operational burden taking the focus away from regular banking business". For instance, banks aiming to convert a subsidiary into a branch may face problems for the treatment of the contributions to the local Deposit Guarantee Schemes (DGSs). There is no, or at best very limited "portability" of contributions between DGSs. This may represent a technical roadblock to convert a subsidiary in a branch but it is a technical issue that could be addressed.

3.2 Credible support provided by parent companies to Euro area subsidiaries based on European law and enforced by European authorities is another way forward to solve the home-host dilemma

Authorities in the host Member States may be concerned that, in the event of a crisis, the parent entity might refuse to support local subsidiaries. To address these concerns, European transnational banking groups that wish to operate in an integrated way could decide to commit to providing credible guarantees to each subsidiary located in the Euro area in case of difficulty and before a possible resolution situation ("the outright group support").

This "outright group support" would consist of mobilizing the own funds of the Group to support any difficulties of a subsidiary located in the Euro area. Since the level of own funds and the creation of MRELs have considerably increased the solvency of EU banking groups, they should be able to face up to any difficulty of their subsidiary located in the Euro area.

This group support should be based on EU law and enforced by EU authorities. It could be enshrined in groups' recovery plans and approved by the supervisory authority – the ECB – which would be neutral, pursuing neither a home nor a host agenda.

This would also ensure that the parent company has the necessary own funds to face the possible needs of their subsidiaries. This commitment is the key condition for these banking groups to define prudential requirements at the consolidated level.

The SSM recognized that such a solution already proposed in a 2018 Eurofi paper, would, at least foster a more positive attitude from national authorities, creating the conditions for legislative change to happen sooner. Yet, due to the lack of confidence among Member States, it is not possible to implement it yet.

4. What to do?

One must acknowledge that a complete Banking Union would accelerate the integration of the European banking market with no national ring-fencing. Additionally, it is precisely the current degree of fiscal and economic convergence that makes idiosyncratic shocks more likely – and, therefore, the need of a fully functioning Banking Union that could prevent such a destabilizing spiral.

For several years, the Banking Union has been characterized by the absence of solutions to solve the "home-host" dilemma and is currently in a deadlock. Paradoxically, all stakeholders seem content with the situation: some host countries benefit from the capital of large groups' subsidiaries to contribute to the funding of their public debt and of their national financial needs and favor their particular interests to the detriment of the European ones. Moreover, European G-SIBs are reluctant to grow too much in order not to cross the threshold that requires larger buckets and are satisfied with not having to pay additional financial contribution which would further hurt their profitability (*e.g.* for EDIS).

We are not living in an ideal European community: national interests prevail over European objectives and benefits. Indeed, the solutions submitted are not supported by European political leaders. Moreover, the reinforcement and the rise of extremism and anti-European nationalism exacerbate this tendency to refuse to advance in the European construction and leave European projects in a sort of paralysis.

This is not doomed to be eternally the case, but without strong awareness and a willingness to act together as a European community, nothing will change, and the EU will remain in the deadlock it has been in for years now. This passivity and inaction are accompanied by the return of nationalism which takes precedence over European common interests.

In such a context, there is a need to:

- Re-establish discipline in the public finances of Eurozone overindebted Member States (France, Italy, Belgium...). In the tense current global context, fiscally virtuous countries face a number of difficulties and will not in addition incur the risks of paying for the slippage.
- Once all Member States have made sustainable adjustments to be close to fiscal balance, progress towards the Banking Union and the CMU will be possible as soon as all stakeholders – Member States, banks and financial institutions, display determination to cooperate and as the Commission empowers itself to conduct projects.

Baron Louis, Minister of Finance in France said to his government around 1820:
- "Faites-moi de la bonne politique et je vous ferai de la bonne finance", which can be translated as "Make good policies, and I will bring you good finance".

We could say under his tutelage and inspiration:
"Do the structural reforms, eliminate excessive disequilibria, converge our economies symmetrically, show a little more kindness on risk sharing and I will bring you a Banking Union".

In other words, it is not only the Union that makes the Force, but also the Force that makes the Union: only strong Member States – which have corrected their fiscal imbalances and are effectively converging economically among themselves – will make Europe stronger.

EU Sustainability Policies

5

Sustainable Finance and Biodiversity: the beginning of a crucial journey

Note written for EUROFI by Jean-François Pons, Alphalex-Consult

"Nature, to be commanded, must be obeyed", Francis Bacon

The financial sector is increasingly concerned by Environmental, Social and Governance (ESG) issues. Since the Paris Agreement in December 2015, the fight against climate change has become a priority in Europe, where it is supported by growing regulation and supervision. We are also seeing the first steps in the same direction in the rest of the world with the standards of the International Sustainability Standard Board (ISSB) published in July 2023.

Protecting biodiversity (or nature) has also become a political priority:

- at European level, where it forms part of the Green Deal alongside climate change and other environmental objectives (water, circular economy, pollution);
- at international level, where the Kunming-Montreal Agreement signed in December 2022 is the biodiversity equivalent of the Paris climate agreement.

Protecting biodiversity is also part of the solution to climate change, as biodiversity strengthens the carbon absorption capacity of the earth and the oceans[1].

There is a strong economic case for supporting this political priority, as described in many reports (see selective biography in annex) : the degradation of biodiversity has already negative consequences for many economic actors and communities and its continuing increase represents a strong menace for our future.

This new priority is beginning to apply to the financial sector and will do so increasingly in application of European regulations and the implementation at international level of the recommendations of the Taskforce for Nature-related Financial Disclosures (TFND), the final version of which was published in September 2023.

1. Biodiversity is one of the priorities of the European Union's Green Deal

The Green Deal, whose objectives were adopted by the European Union in 2020, includes **six priorities: the fight against climate change, the protection of biodiversity, the fight against pollution, the preservation of aquatic and marine resources, the fight against waste and the development of the circular economy.**

To date, around forty regulations have been adopted or have been the subject of political agreement for these various objectives.

The European Union has just adopted a regulation on nature restoration – not without difficulty in the European Parliament. The regulation stipulates that Member States must implement restoration measures in at least 20% of the EU's land areas and 20% of its seas by 2030.

The rules of sustainable transparency for financial and non-financial companies also apply to biodiversity (*see number 3 below*).

2. The Kunming-Montreal Agreement of December 2022 is the biodiversity equivalent of the Paris climate agreement

The United Nations Conference on Biodiversity (COP15) which began in Kunming (China), ended in Montreal, Canada, on 19 December 2022, with a historic agreement to guide global action in favour of nature until 2030. Representatives of 188 governments attended and signed the agreement, although it is regrettable that the United States, absent from the COP since its inception in 1992, did not sign.

1. https://www.un.org/fr/climatechange/science/climate-issues/biodiversity

COP15 resulted in the adoption of the Global Biodiversity Framework (GBF), which includes **four global objectives for the protection of nature:**

- to halt the extinction of endangered species due to human activity and reduce the extinction rate of all species by a factor of ten by 2050;
- to use and manage biodiversity sustainably to ensure that nature's contributions to humanity are valued, maintained and enhanced;
- share equitably the benefits arising from the use of genetic resources and information on the digital sequences of genetic resources;
- and to ensure that adequate means of implementing the Global Framework for Biodiversity are available to all parties, in particular the least developed countries and small island developing states.

The agreement includes **concrete measures to halt and reverse the loss of nature, in particular by protecting 30% of the planet and 30% of degraded ecosystems by 2030.**

The agreement[2] also contains **commitments in favour of the transparency of business activities** (*target 15.a*): "Monitor, assess and disclose regularly and transparently their risks, dependencies and impacts on biodiversity, in particular by imposing requirements on all large companies, transnational corporations and financial institutions throughout their operations, supply and value chains and portfolios".

Finally, it contains a **commitment to increase funding for biodiversity programmes**, particularly for developing countries (*target 19*): "Substantially and progressively increase the level of financial resources from all sources, in an effective, timely and easily accessible manner, including domestic, international, public and private resources to implement national biodiversity strategies and action plans, by mobilising by 2030 at least $200 billion per year, in particular by:

- increasing total international financial resources related to biodiversity from developed countries, including official development assistance, and from countries voluntarily assuming the obligations of developed countries, to developing countries, in particular least developed countries and small island developing states, as well as countries with economies in transition, to at least USD 20 billion per year by 2025, and at least USD 30 billion per year by 2030;
- leveraging private finance, promoting blended finance, implementing strategies to raise new and additional resources, and encouraging the private sector to invest in biodiversity, including through impact funds and other instruments;
- stimulating innovative systems such as payments for ecosystem services, green bonds, biodiversity offsets and credits, benefit-sharing mechanisms, and environmental and social guarantees".

The regulation on nature restoration agreed by the EU political institutions is fully in line with the Kunming-Montréal Agreement.

3. The challenge of the transparency requirements for financial and non-financial companies

For a company, **the first action to take in favor of biodiversity is to measure its impact and its dependency *vis-à-vis* biodiversity**. Companies which have a significant impact and/or dependency should then re-orient their business strategies accordingly. Transparency requirements have the objective to induce or oblige companies to do this measurement and eventually the necessary re-orientation of its strategy, but also to create a pool of data which will be useful for the economic and the financial sector, and for the other stakeholders.

1) **In France**, a pioneering country on this subject, under Article 29 of the 2019 Energy and Climate Act, **financial investors must publish an annual report on the impact and dependence of their portfolio on biodiversity.** This law is based on the "comply or explain" principle.

The first publications took place in July 2022. The results of these publications are mixed, as shown by a specific ADEME report[3] : a few good performers (*e.g.* Mirova calculated its biodiversity footprint on the scope of listed shares, BNPParibasAM calculated this synthetic index on 70% of assets invested in companies), but the vast majority of investors only responded very partially (*e.g.* Covea was unable to publish quantified targets, others only published on some of their funds) and above all more than half of the thousand investors concerned postponed this publication until the following year.

2) **In the European Union, the CSRD** (Corporate Sustainability Reporting Directive) requires large companies **to publish information on this**

2. Text of the Kunming-Montreal Agreement: https://www.cbd.int/doc/c/0bde/b7c0/00c058bbfd77574515f170bd/cop-15-l-25-fr.pdf
3. ADEME: "Article 29 LEC, statistical study on 2022 reports", March 2023. https://climate-transparency-hub.ademe.fr/wp-content/uploads/2023/04/analyse_statistique_article29lec_mars2023_librairie-ademe.pdf

impact by 2025 (2024 accounts), and the ESRS (European Sustainability Reporting Standards) include information on strategy, governance and risks, as well as numerous indicators relating to the company's impact on biodiversity and the protection of ecosystems.

Several of these indicators are only requested if they are significant for the company concerned; this is the so-called "materiality test". This test has not yet been sufficiently clarified by legislation and would at least benefit from guidelines from the European authorities: the Commission and/or EFRAG, the European Financial Reporting Advisory Group, which advises the Commission on sustainable reporting standards.

A concrete difficulty of implementing this framework comes from the scarcity of relevant data and their heterogeneity, and thus the difficulty to compare them and aggregate them.

3) **At global level, the TFND (Taskforce for Financial-related Nature Disclosure) is proposing a reporting framework**[4] inspired by the TCFD (Taskforce on Climate-related Financial Disclosures), which also inspired the ISSB standards. The TFND has worked with EFRAG to ensure that their recommendations are compatible with the EU regulation.

At the outset, the Taskforce recognised that the central challenge to design a set of nature-related recommended disclosures was to strike the best possible balance between the complexity of the science and the creation of practical recommendations that enable cost-effective action within an annual corporate reporting cycle that is subject to third-party assurance.The framework is compatible with simple materiality (whereby a company discloses the impact of an environmental risk that may have a financial impact on it) and double materiality (whereby a company must also disclose its environmental impacts even if there is no clear financial risk linked to it). The European Union applies double materiality, while corporates of the rest of the world generally apply single materiality on a voluntary basis.

The TFND framework focuses on 4 areas: 1) governance, including the explanation of the links between nature and business models; **2)strategy and finance; 3)risk management;** and **4)the metrics used and targets set**. The fourth area is, like for the implementation of the EU regulation, the most difficult.

The TFND advocates a **prioritisation approach** by the company, which must be integrated into its strategy, and recommends the publication of quantified objectives and indicators. It is therefore a framework for reflection and guidance for companies. The TFND will be publishing sector-specific guides in the coming months, the first of which will be for financial institutions (with metrics comparable to SFDR's Principal Adverse Impacts).

At the Davos meeting last January, the TFND published the list of the **320 organizations which have committed to implement its recommandations**. They are present in 46 countries on the five continents. They represent an astronomical sum of assets: about $4 trillion accumulated market capitalization for companies, and $14 trillion in assets under management on the finance side.

As we know from the English people, "the proof of the pudding is in the eating": we will have to wait now for the implementation of the framework to be sure that it represents a significant progress in front of the huge challenge of nature preservation and restoration.

4) **Also at global level, the Network for Greening the Financial System** (NGFS, a network of central banks and financial supervisors, of which around a hundred countries are members) **published a "Conceptual Framework"**[5] , intended for central banks and financial supervisors, and therefore for the financial sector.

The framework aims to 1) identify the sources of physical and transition risks; 2) assess economic risks; and 3) assess risks to the financial system.

This conceptual framework will be enriched and completed by the end of the first half of 2024 at the latest. In particular, there is a need for scenarios to assess future risks.

4. Development of measurement tools

Apart from the lack of relevant and of quality data, another important challenge for the inclusion of biodiversity in the reporting framework of financial and non-financial companies is that **there is not a synthetic indicator** as clearly related to the objective (and thus easy to understand) **as the tonne of CO2 emitted for the fight against climate change.**

4. TFND Taskforce for Nature-related Financial Disclosures (TFND): "Recommendations", September 2023, amended in November 2023 https://tnfd.global/publication/recommendations-of-the-taskforce-on-nature-related-financial-disclosures/

5. NGFS: "Conceptual framework on biodiversity", September 2023. https://www.ngfs.net/sites/default/files/medias/documents/ngfs_conceptual-framework-on-nature-related-risks.pdf

The IPBES (International Platform for Biodiversity and Ecosystem Services), the equivalent of the IPCC(International Platform for Climate Change) for biodiversity, recommends that priority be given to measuring land artificialisation, overexploitation of nature (deforestation, overfishing, etc.) and greenhouse gas emissions, with their impact on land, water and the sea.

Three countries lead the way in publishing biodiversity indicators: France, the Netherlands and the United Kingdom.

In France, *CDC-Biodiversité* and Iceberg Data Lab have each developed a methodology for measuring a company's impact on biodiversity.

In 2020, *CDC-Biodiversité* launched a biodiversity footprint measurement tool (with a group of companies). In particular, it provides an impact score expressed in MSA.km². To give two simple examples, 1 car park represents an MSA (Mean Species Abundance) of 0, and a natural forest an MSA of 100%. The MSA level is then multiplied by the surface area impacted to give a score in MSA.km². For the moment, this tool has not been developed to cover maritime sector nor invasive species.

In their annual reports, BNPParibasAM published a figure of 8,000 MSA.km² on 70% of invested assets and Schneider a figure of 3,600 MSA.km².

Iceberg Data Lab has developed another method for calculating the Corporate Biodiversity Footprint, which measures the degradation of the company's natural environment in terms of land use, the deposition of nitrogen compounds, greenhouse gas emissions and the quantity of toxic elements discharged. Example: Danone's biodiversity footprint, calculated using this method, reached 10,486 km² in 2021, more than the surface area of Lebanon.

Interest in this type of synthetic indicator is bound to increase with the publication of sustainable reporting standards required by European Union regulations and by transition plans that include biodiversity.

To overcome the problem of insufficient data, CDC-Biodiversité has worked with Carbon4Finance and financial investors to build a database covering 5,000 companies. They also want to disseminate their tool internationally. TFND could recognise this tool, which would facilitate its dissemination.

5. The commitment of many financial and non-financial companies

As with the fight against climate change, several coalitions of major companies, NGOs and experts are beginning to work on protecting biodiversity.

This is the aim of **the Science Based Targets Network (SBTN)**, a global coalition of over 80 environmental non-profit and mission organisations, which has published the first corporate science-based nature targets[6] . These nature targets build on and complement the existing climate targets, which have been set by over 2,600 companies as part of the Science Based Targets Initiative (SBTI). They should enable companies to assess their environmental impacts and set targets, starting with freshwater and soil, in order to reduce their negative impacts and increase their positive impacts on nature and people. More specifically, the first nature targets will help companies to improve their impacts on freshwater quality (specific to nitrogen and phosphorus) and quantity, and to protect and restore ecosystems. To achieve a balance between scientific rigor and feasibility, **more than 200 organisations have already helped shape the initial methods, tools and guidelines**. This includes 115 companies, the majority of which participate in the SBTN's corporate engagement programme – representing some 20 sectors in 25 countries with over $4 bn in market capitalisation. SBTN also provides guidance to all companies to help them holistically assess and prioritise their environmental impacts, starting with freshwater and soil quality.

In the financial sector, the **Finance for Biodiversity Pledge** (FBP) was launched in September 2020 and now has 153 signatories from 24 countries representing total assets of $21,400 billion. They have decided to work together to share the different methodologies for measuring biodiversity, to conduct a policy of active dialogue with the companies in which they are shareholders to reduce their negative impacts, and to set targets to reduce the negative impact of their portfolios and increase their positive impact. The Finance for Biodiversity Foundation, created by the BPF signatories, has published a guide for financial companies "Act now! The why and how of biodiversity integration of financial institutions[7]". This guide provides financial companies with advice and recommendations on how to integrate biodiversity into their strategy and decision-making process, by measuring their impact and setting targets.

6. SBTN: "The first science-based targets for nature", May 2023. https://sciencebasedtargetsnetwork.org/how-it-works/the-first-science-based-targets-for-nature/

7. Finance for Biodiversity Foundation: "Act now! The why and how of biodiversity integration of financial institutions", December 2022. https://www.financeforbiodiversity.org/publications/act-now-the-why-and-how-of-biodiversity-integration-by-financial-institutions.

More recently, 190 investors have come together in the **Nature Action 100** Initiative, created in December 2022 in Montreal at COP15. This initiative is intended to be the counterpart of Climate Action 100+, dedicated to biodiversity issues. These investors have just drawn up a list of 100 companies which they will hold to account. Eight economic sectors in particular are being targeted for their high impact on nature, including agri-food, mining and distribution. These 100 companies (including Amazon, BASF, Carrefour, Danone, Glencore, L'Oréal, McDonald's, Pfizer and Solvay) have been listed because of their significant negative impact on biodiversity and the heavy dependence of their business model on natural resources. As in the case of climate change, Nature Action 100 plans to launch a collective shareholder dialogue with major companies to ask them to shed light on the means they are using to preserve biodiversity, as part of the global framework on biodiversity set out in the Kunming-Montreal Accord.

6. The need for strong growth in public and, above all, private funding

Preserving and restoring biodiversity requires substantial funding. According to the Dasgupta report of 2021, **this funding amounts to around $100 billion per year, but this leaves a funding gap of around $700 billion** according to COP15 estimates, including $200 billion for developing countries. Until now, the funding has come mainly from the public sector (subsidies, funding from public development banks), with some additional funding from the NGOs and foundations most committed to nature conservation, but there is relatively little private funding, especially in developing countries. Public funding must continue, because it is often a question of financing the protection and restoration of public assets (a maritime shoreline, for example). But a sharp increase in private funding is needed, primarily to improve the impact of companies on nature. Even in the case of public assets, private funding is necessary, in partnership with public funding (and/or NGOs and foundations) to develop activities that create incomes and jobs (for example in the maritime sector: sustainable tourism, aquaculture, responsible fishing, algae and plastic treatment, etc.).

The protection of biodiversity can benefit from specific financing, in particular Green Bonds or Blue Bonds for the maritime sector. To my knowledge, there is no estimate of the volume of Green Bonds devoted to biodiversity. It is certainly much lower than the amount invested in renewable energies, for example. As for Blue Bonds, which finance almost exclusively actions to protect marine biodiversity, they will amount to just $5 billion between 2018 and 2022 (source: Environmental Finance[8]). There are also funds specialising in biodiversity, which have been launched by European and American asset managers.

New financial initiatives have been taken to protect biodiversity of developing countries: debt-for-nature swaps. In June 2023, Ecuador has negotiated the fourth "debt-for-nature swap" dedicated to the protection of marine ecosystems, after Seychelles, Belize and Barbados. Ecuador's debt-for-nature swap provides for the redemption of $1.63 billion at 40% of their face value, financed by the issue of Blue Bonds by an ad hoc entity, which then grants a loan to the country. It must contribute to conservation programmes in the Galapagos Islands area. In addition to the debt rebate of over $1 billion, the transaction is expected to unlock over $300 million for conservation over 18 years. The blue bonds were issued with an interest rate three times lower than Ecuador's traditional debt, thanks to the provision of guarantees by the Inter-American Development Bank and the International Development Finance Corporation.

Finally, many financial investors also have a **policy of shareholder engagement** on this issue, as shown by the example of the Nature Action 100 initiative mentioned above. Another example: **a hundred or so European green funds exclude investing in sectors that have a negative impact on biodiversity**: palm oil, deforestation, destruction of animal species' habitats, etc.

Conclusion

Protecting and restoring biodiversity has become a major political objective in the European Union and in many countries around the world, although it is regrettable that this is not the case in the United States. It is also based on a very solid economic analysis which shows that the continuous deterioration of biodiversity has already today very negative consequences and is a growing menace for our future.

To achieve this objective, the European Union and many countries around the world are taking action

8. Environmental finance: "ICMA publishes blue bond guide...", September 2023. https://www.environmental-finance.com/content/news/icma-publishes-blue-bond-guide-in-big-step-forward-for-market.html

and asking financial and non-financial companies first to measure their impact on nature, and then to progressively reduce it as transparently as possible. **Many financial and non-financial companies have taken action to meet these objectives**, supported by the development of new analysis and measurement tools.

Implementing this policy will require serious efforts on the part of businesses, often in partnership with the public sector, at a time when the economic situation is not brilliant and when the energy transition also needs to be made. But the energy transition and the protection of biodiversity go hand in hand, and improving the situation for one also benefits the other.

We are only at the beginning of the development of this policy. There will be two significant tests of the growing importance of biodiversity protection worldwide, notably for the financial sector:

- **The first one will be the implementation of the EU reporting framework on biodiversity and the TFND framework around the globe.** This implementation is challenging because of the complexity of the measurements and the lack of data, but development of specific tools and cooperation between financial and non-financial companies, and also with supervisors (like the NGFS) should help to progressively overcome the difficulties.
- **The second and most important test will be the growth in investment and funding devoted to it**. The most reliable estimates point to a global funding requirement of $700 billion a year between now and 2030, including $200 billion in developing countries. Public funding, which is currently predominant, needs to be further increased, particularly for the poorest countries, with the support of the Multilateral Development Banks. And private funding needs to do more than just support it: it needs to take over, and therefore increase much faster. At a recent conference, an official of the International Finance Corporation (IFC), a subsidiary of the World Bank, estimated that «funding for biodiversity protection could exceed funding for climate change»[9] ; and an official of the American asset manager Fidelity said that «biodiversity is the strongest investment trend in our lifetime»[10] ... However, these judgements appear to be optimistic for the time being.

Companies committed to preserving and restoring biodiversity have yet to show that their commitments also have a decisive impact in terms of investment and financing.

For the fight against climate change, strategic adaptations have generally started, even if they need to be accelerated. For the preservation and restoration of biodiversity, we are only at the beginning of the journey, which will have to be continued with growing efforts.

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After the Green Taxonomy, a "Good Transition" label?

Note written for EUROFI by Jean-François Pons, Alphalex-Consult

"... Transitioning away from fossil fuels in energy systems, in a just, orderly and equitable manner, accelerating action in this critical decade, so as to achieve net zero by 2050 in keeping with the science..."
(extract from the final declaration of COP28 in Dubai)

The elaboration of an EU "green" taxonomy has taken many years of work and discussions for experts, European political institutions, financial and non-financial corporates, lobbies, NGOs and other interested parties. The result is a very long and detailed list of economic activities which can be considered as "green", most of them in the condition that they respect pre-defined parameters.

The beginning of the implementation of the green taxonomy in 2024 will show what is the concrete interest of this reform. The "green asset ratio" will probably be under or around 5% for most of the financial actors, but this should not disappoint observers: it will only reflect the part of the economy which corresponds to the list of green activities in the EU taxonomy.

There exists a large consensus today for thinking that the most important challenge related to climate is not a dramatic growth of green activities, but the "transitioning away from fossile fuels in energy systems", to use the language of COP28. This means a strong and continuous decrease of fossile energy consumption by enterprises, households, States and local authorities, and a strong and continuous decline of fossile energy production. In this regard, the decarbonation of carbon-intensive companies is as important as the growth of green activities.

There are different way of trying to bring transparency in the transition and to make clear to a large public (including small investors) which company is following a "good transition" (aligned with the Paris Agreement):

- Publication of transition plans by corporates, as envisaged by the EU regulation;
- Elaboration of a taxonomy of transition, with two or three colors adding to the green, as it was envisaged by the Sustainable Finance Platform experts advising the European Commission, or as it has been recently decided in Singapore;
- Creation of a label of "good transition", on the basis of a framework approved by EU political and supervisory authorities.

This article will comment these options and try to explain why the 3d one should be explored.

1. The publication of transition plans : a medium-term progress but with limits

The EU legal framework foresees the publication of transition plans by large corporates. The Corporate Sustainability Due Diligence Directive (CS3D), which should be finally agreed by the EU political institutions in the coming weeks, would make these publications obligatory. Financial supervisors will also look at the transition plans of the banks and insurances according to the EU regulation on these entities.

This is a welcome progress for transparency in the fight against climate change, but which raises the following difficulties:

- Uncertainties on the development of a transition plan by a company: for instance which baseline scenario(s) (sectoral, national, EU, worldwide) to take into account?
- How to compare transition plans from a company to another?
- How to assess "good transition" plans and "insufficient transition" plans?

These difficulties have for consequence that the large public will probably have no clear indication for at least a number of years on the selection of companies which are on a "good transition" track, and that other indicators would be welcomed to assess which corporate follow a good trajectory of reduction of its greenhouse emissions and which corporate does not.

2. A quadricolor or tricolor taxonomy : a long and complex process

- **The project of a EU quadricolor taxonomy**

The European Platform on Sustainable Finance, a group of experts advising the European Commission, has proposed a new classification in February 2023. This "transition taxonomy" adds new categories, in addition to green activities listed in the initial regulation. "We realized that we had to look at the economy as a whole, greening is necessary everywhere", said the rapporteur of the platform on this mission. This report responded to a request from the European Commission of January 2021, to determine the means to finance companies in transition. Platform members, without establishing a new list rather, have widened the sectorization of the economy into four categories:

- Green activities as defined by the initial taxonomy, which generates a substantial contribution for climate and do not harm the environmental objectives of the European Union;
- Intermediate activities, of "amber" color, which do not cause environmental damage to the meaning of the "Do no significant harm" (DNSH) criterion of the taxonomy but which also have no contribution significant to EU objectives;
- Harmful activities, red in colour, which must be stopped urgently;
- Activities with low environmental impact, colorless.

The objective of the Platform was to define categories that encourage companies to migrate from red to amber, then to green, and to attract the necessary funding to enable them to make this transition. "It could be used to set targets for our entire portfolio", said an insurer, member of the platform.

But the development of the green taxonomy has shown how complex it is to define a list of green activities under certain parameters, with divergences between experts, between NGOs and representatives of the sectors concerned, and political controversies which could be very strong. The development of an EU quadricolor taxonomy would be an Herculean task and take many years. We cannot wait as long to know which companies are implementing a "good transition" and which do not.

- **The Singapore tricolor taxonomy**

On December 3rd, 2023, the Monetary Authority of Singapore launched the Singapore-Asia Taxonomy for Sustainable Finance. It is the world's first multi-sector transition taxonomy, covering eight key sectors to define both green and transition activities. The innovation is that it uses a traffic light system with three colours: "green" for environmentally sustainable activities, "amber" for transition activities and a third category "red" that is ineligible. Transition activities are those that encompass existing infrastructure and activities that fall short of green thresholds but are on a trajectory towards net-zero emissions or which contribute to net-zero outcomes. In order to achieve a trajectory consistent with the goal of restricting global warming to 1.5 degrees Celsius, specific time-bound transition thresholds have been established, each with its own sunset date. Activities are required to either align with the 1.5°C pathway by the designated sunset date or face reclassification into the "ineligible activities" category.

This initiative seems to have avoided some of the difficulties which have just been underlined for the quadricolor proposal of the Sustainable Finance Platform. There are two reasons for this difference :

- It is much easier for a single authority of a single State to define a list of tricolor activities than for an EU legislation for 27 member countries;
- Instead of looking at all the economic activities, Singapore has chosen to focus on eight key sectors, which makes the process simpler but which will not give a full picture of all the corporates which have to transition away from fossil fuels.

It is too early to have an assessment of the remaining complexity and difficulties of the process. Compared to the EU framework, this taxonomy will also be probably less ambitious to take into account Asian specificities.

3. A "Good Transition" label

There are a number of ESG labels in the EU, most of them covering mainly one or a few EU countries.

These labels are useful but they do not provide a precise information on the energy transition.

Thence the idea to create a new label focused on the climate trajectory of large companies. It should in principle provide a very useful and critical information and a powerful incentive for transitioning away from fossile energy consumption and production. This label could complement existing labels which have their usefulness. For the financial sector, besides the green asset ratio, there could be a "good transition asset ratio" based on activities which are really transitioning to net zero.

Difficulties:

The first difficulty is of course how to assess which corporates implement a good transition and which ones do not. And to do it without the complexity of the present framework on the green taxonomy.

A second difficulty is about who is doing this assessment and on which basis.

Possible ways forward :

This assessment should be based on sectoral trajectories which will be themselves based on national transition plans and, if possible, EU transition plans. That supposes some work for national governments and for the EU Commission, in concertation with the interested parties, but this work is more than needed if we want real clarity on the concrete implementation of the Green Deal and the reaching of its targets of -55% of ges in 2030 and net zero in 2050. There exist already scenarios of transition, from the International Energy Agency or from Science Based Targets Initiative (SBTI). Some member States have already published national plans, including sectoral ones, like France.

Then the acid test of "good transition" should be simple: if a corporate is doing as well or better than the trajectory of its economic sector, it will be rewarded by a "good transition" label. And vice versa.

Who should take the responsibility of the assessment? It seems better that it should not be public authorities, because it may create the same kind of difficulty than defining a taxonomy. Labelling institutions, which work generally in cooperation with public authorities and with diverse stakeholders (scientists, NGOs...) and which are already well engaged in ESG labelling, could probably deliver this new label, preferably at the EU level. The governance framework of the Green Bonds is also an interesting example in that regard. To avoid criticism of conflict of interest or greenwashing, the methodology used should be made as transparent as possible.

Conclusion

There is a growing demand, including from a large public, for knowing as clearly as possible on which path of energy transition are the large companies, and amongst them, the financial institutions. The EU "green taxonomy" does not give this information. More extensive taxonomies including transition activities need a very complex work and will at least take many years to be developed.

The publication of transition plans will be a first welcome progress in the coming years, but their evaluation by third parties will probably not be easy and the general public will be probably confused by controversies.

The creation of a "good transition" ratio, preferably at the EU level and based on sectoral trajectories defined under the responsibility of the political authorities, seems a path worth exploring. Recently, the French association *Les Ateliers du Futur* has provided a good example of what this label could look like: it has identified three major European groups, ArcelorMittal, Engie and Schneider Electrics, describing them as the "good students" of transition. The criteria considered is that these firms are in the best position to reduce emissions, thanks to their financial resources and the technologies they developed to do so. It is interesting to see that a carbon-intensive company like ArcelorMittal can be considered a "good student" thanks to its committed strategy to decarbonize. This example illustrates the added value that a "good transition" label could bring in the sustainable reporting framework [1].

1. https://www.lesechos.fr/industrie-services/energie-environnement/engie-schneider-electric-et-arcelormittal-bons-eleves-du-climat-2074860

The implementation of the Green Deal Legislative Programme: mission largely accomplished

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2023 has now been established as the warmest year in recorded history. The director of the Copernicus Climate Change Service (C3S), Carlo Buontempo indicated that "as long as greenhouse gas concentrations keep rising, we can't expect different outcomes from those seen this year. Reaching net zero as soon as possible is an effective way to manage our climate risks.[1]" In this context of global warming, the European Union introduced in 2020 the European Green Deal, and the **Climate Law**[2], which sets a legally binding EU-wide and economy-wide common target of net-zero greenhouse gas (GHG) emissions by 2050 and comprises the target to cut GHG emissions by 55% by 2030. This gave birth to the Fit for 55 legislative package and all the related texts which will be evoked in this paper. The Green Deal legislative programme contains more than 40 proposals from the European Commission.

As well as constraints, **the Green Deal opens opportunities for investment**. The growth of green finance is, like every other market, a question of supply and of demand. For instance, a growth in sales of electric vehicles triggers a growth in loans to finance these acquisitions, itself largely influenced by the EU legislation which has set the end of the sales of cars fueled by fossil fuels by 2035. The same goes for energy efficiency in industry or housing following more stringent standards. **The advancement of the Green Deal Programme is therefore not only of importance for ecological reasons: it will also have implications for the demand and for the growth of sustainable finance in the coming years.**

First assessments of the implementation of the Green Deal Legislative Program were published in the Eurofi *Regulatory Update* of April 2023 and of October 2023. Since these publications, new texts have been approved by the European political institutions, others have become legislation, and others have been proposed by the Commission. As the menace of the European elections and of a European Parliament that will be less inclined towards green measures looms, a new assessment of the measures passed and proposed is necessary.

This article will review Green Deal legislation and propositions of legislation designed to reduce greenhouse gas emissions. More specifically, **we will concentrate on specific sectors, those of energy, industry, transport, buildings and nature protection and restoration, which are most likely to foster important green investments and green finance**. Finally, we will recall the few legislative proposals which are still under discussion.

1. Energy

The production and the consumption of energy represents, within the EU, more than 75% of the emitted GHG. The Green Deal focuses on three principles for the transition towards clean energy: ensuring a secure and affordable energy supply for the EU, creating an integrated, interconnected and digitized energy market, and prioritizing energy efficiency.

This has been done through several measures.

1.1 ETS

- **ETS: new benchmark for free allocations**

The first set of measures is the **reform of the Emissions Trading Scheme (ETS)**, in order to progressively increase carbon pricing. Set up in 2003 as the first market tool of its kind, the EU ETS is now under its fourth trading phase (2021-2030). The legislative framework for phase 4 of the EU ETS was first revised in 2018, but given the EU's new climate targets, the Commission has proposed to strengthen the mechanism even more, with the

1. Record warm November consolidates 2023 as the warmest year. (s. d.). Copernicus. https://climate.copernicus.eu/record-warm-november-consolidates-2023-warmest-year#:~:text=The%20extraordinary%20global%20November%20temperatures,Climate%20Change%20Service%20(C3S)
2. Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law'). Link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R1119

objective to have a carbon pricing in line with the Fit for 55 objectives. The Commission Implementing Regulation on benchmarks values for free allocation of emission allowances 2021-2025[3] was published in March 2021 by the Commission. The requirements for phase IV of the EU ETS will be revised from 2024 onwards by an agreement between Parliament and Council reached as part of the negotiations on the "Fit for 55 – Adjustment to the -55% target" package.

- **Market Stability Reserve**

The allowances system of the ETS is dealt with under the **Market Stability Reserve** which has recently been reviewed. To expedite the absorption of the excess allowances and promote market stability, the proposal[4] – which the co legislators did not change – maintains the current elevated annual allowance intake rate. Indeed, the proposal sustains the existing doubled intake rate of 24% and retains a minimum of 200 million allowances in the reserve until December 31, 2030, the conclusion of Phase IV of the EU ETS. The decision entered into force on May 15th, 2023, after being published in April.[5]

1.2 Energy infrastructure

- **TEN-E regulation**

Energy efficiency and the reduction of its GHG emissions has also been tackled on the continent through energy infrastructure regulation. The revision of the **TEN-E regulation**[6] provides a set of instructions for the prompt advancement and interoperability of the priority corridors and areas of energy infrastructure across Europe. The instructions specify the criteria for identifying projects of common interest (PCIs) and mutual interest (PMIs), while also expanding upon the previous guidelines. This updated version has an **extended scope**: it now includes smart electricity grids and electricity storage, hydrogen networks and power-to-gas, as well as projects with third countries; but it excludes natural gas. It also simplifies procedures to grant permits and proposes the creation of a one-stop-shop for offshore grid development. The revised TEN-E regulation entered into force in June 2022.

1.3 Renewable energies

The Green Deal has sought to decrease GHG emissions from the energy sector by encouraging the use of green energy itself, notably with the renewable energy directive, the energy efficiency directive and sector specific encouragements.

- **Renewable energy directive (RED3)**

In March 2023, the legislators reached a political agreement on the **Renewable Energy Directive**, agreeing to increase the share of renewable energy in the EU's overall energy consumption to 42.5% by 2030, with an additional 2.5% indicative top up to reach 45%. All member states are expected to contribute to this shared objective. Furthermore, the legislators have concurred on more ambitious targets specific to various sectors, including transport, industry, buildings, and district heating and cooling. The aim is to accelerate the incorporation of renewable energy sources in sectors where the progress has been comparatively slower. Specific dispositions include an indicative target of at least 49% of renewable energy share in buildings by 2030, and a target of 5.5% of use for advanced biofuels in the transport industry by 2030. The text has now been adopted.[7]

- **Delegated Acts on RFNBOs (Renewable Fuels of Non-Biological Origin)**

The Commission has published three delegated acts, after an initial agreement in interinstitutional dialogue. Two of them are of particular importance, as they complete the **implementation of the Renewable energy directive**[8]. The delegated Act on renewable liquid and gaseous transport fuels of non-biological origin[9] provides a methodology to ensure that the electricity used to produce

3. Commission Implementing Regulation (EU) 2021/447 of 12 March 2021 determining revised benchmark values for free allocation of emission allowances for the period from 2021 to 2025 pursuant to Article 10a (2) of Directive 2003/87/EC of the European Parliament and of the Council (Text with EEA relevance). Link: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32021R0447
4. Proposal for a DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Decision (EU) 2015/1814 as regards the amount of allowances to be placed in the market stability reserve for the Union greenhouse gas emission trading scheme until 2030. Link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0571
5. Revision of the market stability reserve for the EU emissions trading system: Fit for 55 package | Think Tank | European Parliament. (n.d.). https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2022)698896
6. Regulation (EU) 2022/869 of the European Parliament and of the Council of 30 May 2022 on guidelines for trans-European energy infrastructure, amending Regulations (EC) No 715/2009, (EU) 2019/942 and (EU) 2019/943 and Directives 2009/73/EC and (EU) 2019/944, and repealing Regulation (EU) No 347/2013. Link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32022R0869
7. Council and Parliament reach provisional deal on renewable energy directive. (2023, 30 mars). European Council. https://www.consilium.europa.eu/en/press/press-releases/2023/03/30/council-and-parliament-reach-provisional-deal-on-renewable-energy-directive/
8. Directive (EU) 2018/2001 of the European Parliament and of the Council of 11 December 2018 on the promotion of the use of energy from renewable sources (recast) (Text with EEA relevance.) Link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32018L2001 This Directive is currently under reviewal as well
9. Commission Delegated Regulation (EU) …/... of 10.2.2023 supplementing Directive (EU) 2018/2001 of the European Parliament and of the Council by establishing a Union methodology setting out detailed rules to produce renewable liquid and gaseous transport fuels of non-biological origin. Link: https://energy.ec.europa.eu/system/files/2023-02/C_2023_1087_1_EN_ACT_part1_v8.pdf

renewable liquid and gaseous transport fuels of non-biological origin (the so called "RFNBOs") is indeed of renewable origin, while the delegated Act on GHG emissions savings of recycled carbon fuels[10] sets a minimum threshold and gives a methodology for assessing GHG emissions savings from RFNBOs.

1.4 Energy efficiency

- **Energy Efficiency Directive**

The **Energy Efficiency Directive** was published in the Official Journal in September 2023, following a revision of a directive adopted in 2012 and already updated in 2018. It officially enforces the principle of 'energy efficiency first' as a foundational element of EU energy policy, granting it legal status for the first time. In practical terms, this mandates that EU member states must take into account energy efficiency in all pertinent policy and significant investment choices within both the energy and non-energy sectors. It requires among others, a binding 11.7% cut in energy consumption by 2030, doubling annual savings goals. It tackles energy poverty, mandates audits for companies, and ensures competence in energy professionals[11].

- **Updated EU rules to decarbonize gas markets and promote hydrogen**

On the 8th of December 2023, a provisional agreement was reached on the **updated EU rules to decarbonize the gas market and create a hydrogen market**. This new regulation will promote renewable and low-carbon gases, in order to ensure security and affordability. This supports both the EU's climate neutrality goal by 2050, and the RePower EU plan to reduce reliance on Russian fossil fuel imports. Key aspects of this update include infrastructure planning for a decarbonized gas sector, facilitating integration of renewable gases, and introducing a certification system. The deal establishes a phased market design for hydrogen, restricting long-term contracts for fossil gas. Security measures for energy, crisis management procedures and provisions for cybersecurity risks are also part of the revised rules[12].

- **Regulation on methane emissions reduction in the energy sector**

Before the beginning of the COP28, a provisional agreement was reached between the co-legislators in November 2023 on a **Regulation on Methane Emission**s. This new legislation aims to cut methane emissions both in the European energy sector and in global supply chains. It includes improved measurement, reporting and verification, as well as mandatory leak detection and repair. The Commission's proposal prioritize accurate measrement through independent verification and prompt mitigation[13].

1.5 Carbon border adjustment

- **Regulation on a Carbon Border Adjustment Mechanism**

Another highly debated text creating a **Carbon Border Adjustment Mechanism (CBAM)**[14] **was voted**, proposed to complement the ETS. Starting in 2026, EU importers will be required to pay a financial adjustment by surrendering CBAM certificates that align with the emissions integrated into their imports. The objective is to prevent the relocation of carbon-intensive industries outside of the EU (known as "carbon leakage"), which could compromise the EU's ambitious climate targets, this policy aims to incentivize producers in third-party countries that export to the EU to adopt low-carbon technologies, and to ensure that the price of imports more accurately reflects their carbon footprint. The CBAM regulation officially entered into force the day following its publication in the Official Journal of the EU on 16th May 2023.[15]

2. Industry

As part of the response to the Covid-19 pandemic and to the imminent threat of climate change and global warming, the Green Deal also introduces a new industrial strategy for Europe, which "will lead the twin green and digital transitions" in order for Europe to become "even more competitive globally"[16].

10. Commission Delegated Regulation (EU) …/… of 10.2.2023 supplementing Directive (EU) 2018/2001 of the European Parliament and of the Council by establishing a minimum threshold for greenhouse gas emissions savings of recycled carbon fuels and by specifying a methodology for assessing greenhouse gas emissions savings from renewable liquid and gaseous transport fuels of non-biological origin and from recycled carbon fuels. Link: https://energy.ec.europa.eu/system/files/2023-02/C_2023_1086_1_EN_ACT_part1_v5.pdf
11. Energy Efficiency Directive. (s. d.). Energy. https://energy.ec.europa.eu/topics/energy-efficiency/energy-efficiency-targets-directive-and-rules/energy-efficiency-directive_en
12. Press corner. (s. d.). European Commission - European Commission. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_6085
13. Methane emissions. (s. d.). Energy. https://energy.ec.europa.eu/topics/oil-gas-and-coal/methane-emissions_en#:~:text=As%20announced%20in%20the%20EU,Council%20on%2015%20November%202023
14. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a carbon border adjustment mechanism. Link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52021PC0564
15. Carbon Border Adjustment Mechanism. (s. d.). Taxation and Customs Union. https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en
16. Industry and the green Deal. (s. d.). European Commission. https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/industry-and-green-deal_en

2.1 The Green Deal Industrial Plan

In February 2023, the European Commission released the **Green Deal Industrial Plan**, with a self-proclaimed aim "to provide a more supportive environment for the scaling up of the EU's manufacturing capacity for the net-zero technologies and products required to meet Europe's ambitious climate targets." In this document, the Commission presents a project for several acts to come. Importantly and notably, one of the pillars of this plan is to speed up investment and financing for clean tech production in Europe, both public and private financing, which it says are necessary in order to fund the green transition[17].

The following acts, regulations or rules are part of the Green Deal Industrial Plan which have been the object of a political agreement.

- **Reform of the Electricity Market Design**

In December 2023, the Council and the European Parliament reached a provisional political agreement on the **reform of the Electricity Market**. Measures included in the reform are a better protection for consumers, notably through fixed prices and fixed term contracts, more stability and competitiveness for companies, through two-way contracts for difference, and increased green electricity, with new rules made to integrate renewable energy into the system more easily[18].

The Green Deal Industrial Plan comprises other measures, such as a **regulatory framework for batteries** (which has come into force in August 2023) and a **regulation for the eco-design for sustainable products**[19] (provisional agreement reached in December 2023).

2.2 Revision of the industrial emissions directive

In November 2023, the Parliament, the Commission and the Council managed to secure a political agreement on the **Industrial Emissions Directive**. The agreement focuses on stricter rules to combat pollution, improve emission reporting and monitoring, and set more effective pollution limits. The accord addresses intensive farming operations, and states that the directive will gradually encompass large agricultural facilities, battery production installations, and non-energy ores mining activities. Some activities will remain excluded from the scope of the directive, notably cattle farming operations. The agreement also introduces a new Industrial Emissions Portal set to replace the current European Pollutant Release and Transfer Register[20].

3. Buildings

3.1 Energy performance of buildings directive[21]

Buildings are currently responsible for 40% of total energy consumption in the EU, and 36% of its energy related greenhouse gas emissions. More than 4 out of 5 buildings within European countries were constructed before 2000, resulting in poor energy performance and efficiency. If the EU is to reduce its emissions by 55% by 2035 and to become the first carbon-neutral continent by 2050, reducing emission from buildings is a significant part of the solution. This explains the importance of the political agreement on the **Energy Performance of Buildings Directive**, with which the legislator intends to reduce the average primary electricity use of residential buildings by 16% by 2030, and 20-22% by 2035. This will be done primarily through the renovation of the worst-performing buildings. In order to fight energy poverty, the EU also encourages national governments to finance measures incentivizing and accompanying renovations for the most vulnerable customers (and the worst-performing buildings)[22]. The agreement calls for existing buildings to be carbon-neutral by 2050. The same target applies to new buildings by 2030 and from 2028 for new buildings occupied or owned by public authorities[23].

In addition, the deal calls for a gradual phase-out of boilers powered by fossil fuels. Subsidies for the installation of stand-alone boilers powered by fossil fuels are already forbidden starting from January 2025. It also encourages each member state to establish a national Building Renovation Plan to implement a strategy in order to decarbonize the building stocks, and address the

17. Press corner. (s. d.-b). European Commission - European Commission. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_510
18. Electricity market reform. (2023, 21 December). European Council. https://www.consilium.europa.eu/en/policies/electricity-market-reform/
19. Eco-design for sustainable products Regulation. (s. d.). European Commission. https://commission.europa.eu/energy-climate-change-environment/standards-tools-and-labels/products-labelling-rules-and-requirements/sustainable-products/ecodesign-sustainable-products-regulation_en
20. Industrial Emissions Directive. (2023, 18 décembre). Environment. https://environment.ec.europa.eu/topics/industrial-emissions-and-safety/industrial-emissions-directive_en
21. Fit for 55: Delivering on the proposals. (s. d.). European Commission. https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/delivering-european-green-deal/fit-55-delivering-proposals_en
22. Press corner. (s. d.-c). European Commission - European Commission. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_6423
23. Schmitt, F. (2023, 8 décembre). Chantier titanesque : Bruxelles exige des bâtiments neutres en carbone d'ici à 2050. Les Echos. https://www.lesechos.fr/industrie-services/energie-environnement/bruxelles-exige-des-batiments-neutres-en-carbone-dici-2050-2040224

challenges of the sector, such as financing, training and attracting skilled workers.

3.2 ETS II for the building sector

In December 2022, the European Parliament and the Council of the EU agreed to establish a **distinct emissions trading system, called ETS II, implemented for emissions from fuel distribution in the road transport and building sectors**. In April 2023, this new ETS was adopted. It is set to launch in 2027. The system will help regulate fuel suppliers rather than end-consumers. It will also put an absolute cap on emissions, with a goal to decrease them to reach the EU-set goal of carbon neutrality by 2050. The newly introduced ETS 2 is designed to complement the sectoral scope of the EU ETS, expanding the reach of carbon pricing at the EU level to encompass all major sectors of the economy, excluding agriculture and land-use activities[24] [25].

4. Transports

4.1 An extended ETS to the transports

- **ETS: integration of CORSIA**

A revision of aviation rules[26] in the **EU ETS** has been adopted to ensure that Member States notify EU-based airlines of their offsetting obligations for the year 2021 under **CORSIA**[27]. In April 2023, the effort further continued, as the directive for the revision of EU ETS as regards aviation was adopted by the co-legislators. Its main proposal is to ensure that the sector contributes to the EU's climate targets through increased auctioning of allowances, with an end to free allowances from 2027, applying the linear reduction of aviation allowances. It also allows to integrate within the revised ETS, the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), applying it to international flights departing from or arriving at an airport inside the European Economic Area.[28] The phasing out of free allowances will occur one year earlier than proposed by the Commission, and full auctioning will be reached by 2026. A mandatory reporting, verification, and monitoring (MRV) framework for non-CO2 emissions from aviation is required to be implemented from 2025 and evaluated in 2027.

- **ETS for maritime sector and emissions reduction**

In July, a text was adopted, allowing for the extension of the **Emission Trading Scheme for the maritime sector**. Starting in January 2024, the EU's Emissions Trading System will be extended to cover emissions from all large ships entering EU ports, regardless of their flag. The co legislators agreed to the cutting of emissions from EU ETS sectors – which will now also encompass the maritime industry – by 63% relative to 2005 levels by 2030. To accomplish this, the proposal[29] involves increasing the yearly linear emissions reduction factor from 2.2% to 4.2%.

Under this, 50% of emissions from voyages starting or ending outside of the EU and 100% of emissions that occur between two EU ports and when ships are within EU ports are considered. In practice, this means that shipping companies will have to purchase and use EU ETS emission allowances for each CO2 ton emission reported[30]. It entered into force on the 1st of January 2024.

- **ETS II for the road transport sector**

The recently launched ETS II also encompasses the road sector, encouraging low-emissions mobility. It will enter into force in 2027, with a goal of bringing emissions down by 42% by 2030 compared to 2005 levels[31].

24. EU Emissions Trading System for buildings and road transport ("EU ETS 2"). (n.d.). International Carbon Action Partnership. https://icapcarbonaction.com/en/ets/eu-emissions-trading-system-buildings-and-road-transport-eu-ets-2
25. Proposal for a DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Decision (EU) 2015/1814 as regards the amount of allowances to be placed in the market stability reserve for the Union greenhouse gas emission trading scheme until 2030. Link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0571
26. Decision (EU) 2023/136 of the European Parliament and of the Council of 18 January 2023 amending Directive 2003/87/EC as regards the notification of offsetting in respect of a global market-based measure for aircraft operators based in the Union (Text with EEA relevance). Link: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32023D0136
27. The Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) of the International Civil Aviation Organization (ICAO) requires countries to ensure that airlines based in those countries offset CO2 emissions that exceed the relevant baseline (2019 CO2 emissions) by international credits.
28. Aviation's contribution to European Union climate action: Revision of EU ETS as regards aviation | Think Tank | European Parliament. (n.d.). https://www.europarl.europa.eu/thinktank/en/document/EPRS_BRI(2022)698882
29. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757. Link: https://ec.europa.eu/transparency/documents-register/detail?ref=COM(2021)551&lang=en
30. Reducing emissions from the shipping sector. (n.d.). Climate Action. https://climate.ec.europa.eu/eu-action/transport-emissions/reducing-emissions-shipping-sector_en
31. ETS 2: Buildings, road transport and additional sectors. (s. d.). Climate Action. https://climate.ec.europa.eu/eu-action/eu-emissions-trading-system-eu-ets/ets-2-buildings-road-transport-and-additional-sectors_en#:~:text=The%20ETS%202%2C%20which%20will,auctioned%20to%20provide%20market%20liquidity

4.2 Alternative fuels

- **Alternative Fuel Infrastructure**

In March of 2023, a political agreement was reached between the European Parliament and the Council on an ambitious **alternative fuel's infrastructure law**. The new regulation would enforce targets for electric recharging and hydrogen refueling infrastructure in roads, maritime ports, inland waterway ports, and stationary aircraft across the EU. This move addresses consumer worries about vehicle recharging/refueling accessibility and aims to create a user-friendly experience with transparent pricing, consistent payment options, and unified customer information throughout the EU. It includes provisions according to which for every registered battery-electric car in each member state, a power output of 1.3kW must be provided by publicly accessible recharging infrastructure.[32]

- **ReFuelEU aviation initiative**

Also regarding transportation, the Council and the European Parliament reached a provisional political agreement in April 2023 on a **proposal designed to reduce carbon emissions in the aviation sector** and to create a level playing field for a sustainable air transport in April 2023. This proposal's objective is to enhance the demand for and availability of sustainable aviation fuels (SAF), while concurrently ensuring uniform conditions within the EU air transport market. Its aim is also to align air travel with the EU's climate objectives for 2030 and 2050. It intends to address the existing challenges that have impeded SAF development, including limited supply and considerably higher costs in comparison to traditional fossil fuels.[33]

- **Regulation on fuels for the maritime sector**

Debates on **Fuel EU Maritime**[34] have ended, as the Council and the Parliament adopted on July 25th, 2023, a new law to decarbonize the maritime sector. Following the Parliament's recommendations, it required a more stringent reduction in the greenhouse gas intensity of energy used on ships than the Commission. These reductions have a first deadline of 2035 with 20% by that year, 38% from 2040, 64% by 2045, and 80% by 2050. The report also proposes a target of 2% for the use of non-biological renewable fuels starting from 2030, the establishment of an Ocean Fund is recommended to enhance ships' energy efficiency and support investments that aim to decarbonize maritime transport.[35]

4.3 Reduction of emissions from the road sector

Cars and vans account for about half of global transport carbon dioxide emissions[36]. The decarbonation of the sector is both an opportunity in terms of reduction of pollution, and for the finance sector, as the important and fast changes will require massive investments.

- **Regulation on emissions from cars and vans**

Emissions from Cars and Vans[37] were finally agreed after last minute discussions with Germany which was threatening to withdraw from the agreed political agreement. In comparison to the CO2 emission targets applicable in 2021, the emissions of new passenger cars registered in the EU must be lowered by 55%, while new vans must exhibit a 50% reduction in emissions. By 2035, new passenger cars and vans must exhibit a 100% reduction in CO2 emissions, meaning all new vehicles must have zero emissions. The incentive for low and zero-emission vehicles will no longer apply from 2030. The compromise finally reached with Germany will allow the sale of internal combustion engines after 2035 if they run on e-fuels. The regulation was adopted in April 2023.[38]

- **Regulation on CO2 emissions for new trucks and urban buses**

On January 18th, 2024, the European Parliament and the Council agreed on a provisional political agreement **strengthening CO2 emissions standards for new duty vehicles**. The agreement set ambitious targets for emissions of HDVs,

32. Press corner. (s. d.-d). European Commission - European Commission. https://ec.europa.eu/commission/presscorner/detail/en/IP_23_1867
33. Council and Parliament agree to decarbonize the aviation sector. (2023, April 25). European Council. https://www.consilium.europa.eu/en/press/press-releases/2023/04/25/council-and-parliament-agree-to-decarbonise-the-aviation-sector/
34. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the use of renewable and low-carbon fuels in maritime transport and amending Directive 2009/16/EC. Link: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=COM:2021:562:FIN
35. Fuel EU maritime initiative: Council adopts new law to decarbonize the maritime sector. (2023, July 25). European Council. https://www.consilium.europa.eu/en/press/press-releases/2023/07/25/fueleu-maritime-initiative-council-adopts-new-law-to-decarbonise-the-maritime-sector/
36. Fleck, A. (2023, 22 September). Cars cause biggest share of transportation CO2 emissions. Statista Daily Data. https://www.statista.com/chart/30890/estimated-share-of-co2-emissions-in-the-transportation-sector/#:~:text=Cars%20and%20vans%20accounted%20for,laden%20mode%20of%20transport%20worldwide
37. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) 2019/631 as regards strengthening the CO2 emission performance standards for new passenger cars and new light commercial vehicles in line with the Union's increased climate ambition. Link: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52021PC0556
38. CO_2 emission performance standards for cars and vans. (n.d.). Climate Action. https://climate.ec.europa.eu/eu-action/transport-emissions/road-transport-reducing-co2-emissions-vehicles/co2-emission-performance-standards-cars-and-vans_en

putting the bar at -45% for 2030-2034, -65% for 2035-2039 and -90% as of 2040, compared to 2019 levels. The scope of the regulation was also increased, in order to include almost all trucks, urban buses, long-distance buses and trailers. Under this agreement, new urban buses will have to reduce emissions by 90% as of 2030 and have zero-emissions by 2035[39].

5. Nature preservation and restoration

Biodiversity in the EU is rapidly declining, due to pollution (both by gases and through the release of chemicals in nature), climate change, habitat loss and the proliferation of invasive species[40]. The European Union today estimates up to 80% of its habitats to be in poor condition. Through different measures, the EU aims to restore and to protect natural environments and species.

5.1 Nature restoration law

In November 2023, a political agreement was reached on the **Nature Restoration Law** between the co-legislators after a strong fight of the EPP (European People's Party) group in the European Parliament against the proposal of the European Commission, which was softened and adopted by a tight vote at the European Parliament. This law proposes a restoration objective for at least 30% of the EU's deteriorated land and sea areas by 2030, and 90% of its ecosystems in need of restoration by 2050. It includes targets such as reversing the decline of pollinator populations by 2030, achieving an upward trend for standing and lying deadwood, uneven-aged forests, and the stock of organic carbon, increasing grassland butterflies and farmland birds in order to enhance the stock of organic carbon in cropland mineral soils, or restoring marine habitats such as seagrass beds or sediment bottoms that offer climate change mitigation[41].

5.2 Other acts regarding nature preservation and biodiversity

- **Delegated Act on chemical hazard classes**

In 2022, the Commission published a **delegated act concerning new chemical hazard classes**[42], and determining the classification, labelling and packaging of substances and mixtures, notably endocrine disruptors. It seeks to ensure an important level of protection of human health and the environment. This comes as a revision of the regulation on the Classification, Labelling and Packaging of Substances and Mixtures (CLP)[43], which entered into force in January 2009.

- **Regulation on land use and forestry**

The **regulation on land use, land use change and forestry (LULUCF)** was revised in 2023 for the period up to 2030[44]. It aims to reverse the current trend of declining removals in the land sector, to deliver 310 million tons of CO2 equivalent (MtCO2e) removals from the LULUCF sector by 2030 and make it neutral by 2035. Starting in 2026, the sector must achieve a net removal of emissions, and each member State will be responsible for a specific number of removals to be accomplished by 2030. The revised regulations include more stringent reporting guidelines, increased transparency, and a review process by 2025 to ensure compliance. Between 2026 and 2029, if reporting indicates insufficient progress towards their national targets, Member States may face an extra penalty of 8% on their 2030 removal target.[45]

- **Regulation on deforestation-free products**

In May 2023, the regulation on **deforestation-free products** was adopted[46]. The proposal establishes a responsibility of reasonable care on operators who sell certain commodities or products within the EU market or export them outside the EU. The primary catalyst for these procedures is the increase in agricultural territory, which is associated with the manufacturing of goods like soy, beef, palm oil, timber, cocoa, coffee, rubber,

39. Press corner. European Commission - European Commission. (2024, January 18). https://ec.europa.eu/commission/presscorner/detail/en/ip_24_287
40. Restauration de la nature. (2023, 10 novembre). Conseil Européen. https://www.consilium.europa.eu/fr/policies/nature-restoration/
41. The EU # Nature Restoration Law. (2023, 19 décembre). Environment. https://environment.ec.europa.eu/topics/nature-and-biodiversity/nature-restoration-law_en
42. Commission Delegated Regulation (EU) …/... of 19.12.2022 amending Regulation (EC) No 1272/2008 as regards hazard classes and criteria for the classification, labelling and packaging of substances and mixtures. Link: https://eur-lex.europa.eu/resource.html?uri=cellar:7f8116e9-7fc3-11ed-9887-01aa75ed71a1.0016.02/DOC_1&format=PDF
43. EUR-LEX - 02008R1272-20221217 - EN - EUR-LEX. (s. d.). https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02008R1272-20221217
44. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulations (EU) 2018/841 as regards the scope, simplifying the compliance rules, setting out the targets of the Member States for 2030 and committing to the collective achievement of climate neutrality by 2035 in the land use, forestry, and agriculture sector, and (EU) 2018/1999 as regards improvement in monitoring, reporting, tracking of progress and review. Link: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52021PC0554
45. Land use sector. (n.d.). Climate Action. https://climate.ec.europa.eu/eu-action/land-use-sector_en#:~:text=Environment%20Agency%2C%202022-,EU%20rules%20on%20land%20use,use%20change%20and%20forestry%20(LULUCF)&text=The%20LULUCF%20Regulation%20was%20revised,CO2%20equivalent%20by%202030.
46. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010. Link: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52021PC0706

and certain items derived from them, including leather, chocolate, tires, and furniture. As a significant economic entity and consumer of these deforestation and forest degradation-associated commodities, the EU shares a portion of the responsibility for this issue and is striving to take a leading role in addressing it. The objective is to ensure that the goods have been manufactured in compliance with the legislation of the country of production and that the land used for production has not undergone deforestation or forest degradation after 31 December 2020.[47]

- **Common Fisheries Policy (CFP)**

A preliminary accord has also been reached concerning **updated regulations aimed at preventing overfishing**. The revision of the fisheries control system modernizes the approach to monitoring fishing activities, ensuring that both EU vessels and those operating within EU waters adhere to the guidelines laid out in the Common Fisheries Policy (CFP). The principal amendments to existing regulations governing fishing vessel control are the revision of the sanctioning system, an enhanced traceability along the supply chains, and the obligation of reporting of their catches for individuals engaging in recreational fishing for specific species.[48]

6. Circular economy

6.1 Regulation on batteries and waste batteries

On July 28th, 2023, the EU official journal published the **regulation on batteries and waste batteries**[49] which sets compulsory standards for all batteries that are introduced in the EU market. Starting from 2024, there will be a gradual implementation of sustainability requirements, and extended producer responsibility provisions will begin to be enforced in mid-2025. By the end of 2027, the minimum collection targets for waste portable batteries will be established at 63%, and this figure will increase to 73% by the end of 2030, specific collection targets for waste light means of transport batteries will be introduced, with a target of 51% by the end of 2028 and 61% by the end of 2031. Lastly, there will be a material recovery target of 50% for lithium, which will be set by the end of 2027, and this target will increase to 80% by the end of 2031. The objective of the new regulations is to advance a circular economy by overseeing batteries across their complete lifecycle. As a result, the regulations set forth stipulations for the end-of-life phase, encompassing objectives for collection and responsibilities, as well as targets for material recovery and extended accountability for producers[50].

6.2 Regulation on waste shipments

In November, a political agreement was also reached on the future **Regulation on Waste Shipments**. The agreement aims to enhance waste recovery and reuse while ensuring that exported waste does not harm the environment or human health. Notable provisions include a ban on internal EU waste disposal, with exceptions subject to stricter conditions as previously. Intracommunity transfers for recycling will require prior notification and informed consent. The regulation also introduces the digitization of information exchange on waste transfers. It prohibits EU member states from exporting waste for disposal to third countries and exporting hazardous waste for valorization to non-OECD nations. The agreement addresses the exportation of plastic waste, forbidding it for non-OECD countries and enforcing stricter conditions for export to OECD countries[51]. It was voted in the Parliament at the beginning of January 2024.

7. Legislative proposals under discussion

More than 30 texts have now been the object of a political agreement or have entered into force. What remains at stake are the texts that have been announced by the Commission but have yet to be approved by the other European institutions.

7.1 The Green Deal Industrial Plan

Numerous proposals of the **Green Deal Industrial Plan** were introduced in March 2023, but have yet to be the object of a political agreement between the co-legislators.

47. Regulation on deforestation-free products. (N.d.). Environnent. https://environment.ec.europa.eu/topics/forests/deforestation/regulation-deforestation-free-products_en
48. Council strikes deal on new rules to combat overfishing. (2023, May 31). European Council. https://www.consilium.europa.eu/en/press/press-releases/2023/05/31/council-strikes-deal-on-new-rules-to-combat-overfishing/
49. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL concerning batteries and waste batteries, repealing Directive 2006/66/EC, and amending Regulation (EU) No 2019/1020. Link:https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52020PC0798
50. Council adopts new regulation on batteries and waste batteries. (2023, July 10). European Council. https://www.consilium.europa.eu/en/press/press-releases/2023/07/10/council-adopts-new-regulation-on-batteries-and-waste-batteries/
51. Waste shipments: Council and Parliament reach agreement on more efficient and updated rules. (2024, 3 janvier). European Council. https://www.consilium.europa.eu/en/press/press-releases/2023/11/17/waste-shipments-council-and-parliament-reach-agreement-on-more-efficient-and-updated-rules/

- **Net-Zero Industry Act**

The European Commission proposed the **Net-Zero Industry Act** in March 2023. It is set to enhance competitiveness and resilience while accelerating net-zero technology development. As such, the act categorizes technologies, with strategic ones set to receive additional benefits. The technologies listed include solar, renewables, batteries, and carbon capture. The proposal sets a benchmark for the manufacturing capacity of the strategic net-zero technologies to at least 40% of the EU's annual deployment needs by 2030 and targets 50 million tons of CO_2 storage capacity.

To further develop these technologies, the act establishes Net-Zero Academies for skills development, aiming to train 100,000 learners in each technology within three years of their establishment.

The creation of the Net-Zero Europe Platform will aim to foster collaboration and advice on financing for strategic projects, while the Net-Zero Industrial Partnerships should promote global adoption of net-zero technologies[52].

- **Critical Raw Materials Act**

Also in March, the **Critical Raw Materials Act** was presented. It seeks to ensure the EU's access to "a secure, diversified, affordable, and sustainable supply of critical raw materials." Internal actions under the act include updating the list of critical and strategic raw materials, supporting strategic projects, and promoting research, innovation, and skills. The act also focuses on circularity and sustainability, with requirements for waste collection and recycling. Internationally, the EU plans with this act to diversify its critical raw material imports, strengthen global engagement, and combat unfair practices[53].

7.2 The greening freight transport package

In July 2023, the European Commission proposed the **Greening Freight Transport Package**, a set of measures in order to make freight transport more efficient and more sustainable, aligning with the Green Deal's target to reduce transport emissions by 90% by 2050. The proposition aims to optimize rail infrastructure use, improve intercountry coordination and increase reliability, ultimately attracting freight companies to rail. The proposal also addresses the use of heavier vehicles in cross-border traffic and encourages intermodal transport. A proposition for a methodological approach to calculate greenhouse gas emissions is also proposed, enabling operators to benchmark services, while providing consumers with more informed choices.

7.3 Regulation on packaging and packaging waste

In December 2023, the European Council adopted its negotiating position on new rules for more sustainable packaging in the EU, on the **Regulation on packaging and packaging waste**. The proposal establishes requirements to ensure that packaging is safe and sustainable, requiring notably that all packaging is recyclable and that substances which have been described as "substances of concern" are minimized in packaging. In order to reduce waste, the proposal sets re-use targets for packaging, restricting the use of certain types of single-use packaging and requiring companies to minimize the packaging used. The proposal also aims to ensure that packaging is collected, sorted and recycled once the packaging becomes waste.

CONCLUSION

Because of the next European elections, and as the Belgian presidency of the European Union begins, time is running out for the current Parliament to pass more Green Deal legislations.

- The Green Deal legislative programme has been a success so far: more than 30 texts have already been adopted since 2021, almost all in line with the ambitions announced by the European Commission.

These regulations combine objectives and standards to be met according to a timetable. Many of those laws already have **a real economic impact**, as seen for instance in the rapid growth of electric vehicles.

There have however been declarations by the industries concerned, notably in the aviation and the automobile sector, which show that there will be challenges to reach the objectives set out by the regulations.

More recently some regulations were adopted by a slight majority, like the nature restoration law, and only after striking down some of their most strict clauses. To this day, no significant green proposal has been adopted in the agricultural sector.

52. The Net-Zero Industry Act. (s. d.). Internal Market, Industry, Entrepreneurship and SMEs. https://single-market-economy.ec.europa.eu/industry/sustainability/net-zero-industry-act_en
53. Press corner. (s. d.-d). European Commission - European Commission. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_1661

- **The implementation of the Green Deal will be progressive in the coming years and its real impact will then have to be assessed**.

There have been recently a growing anti-green backlash in some European countries contributing to the increase of extreme right votes. The European People Party, which has the most important group in the European Parliament, recently showed an opposition to some Green Deal proposals, in line with this evolution. In this context, **the next European elections will be a test on the Green Deal**. It seems improbable that the implementation of the regulations already adopted can be stopped, but amendments on objectives, standards and timetable are always possible and above all the continuation of the Green deal, through adoption of new objectives for 2040 and eventual new regulations, will have to be defined.

Notes

ABOUT EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

OUR OBJECTIVES

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

OUR APPROACH

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two-yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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