# Executive summary

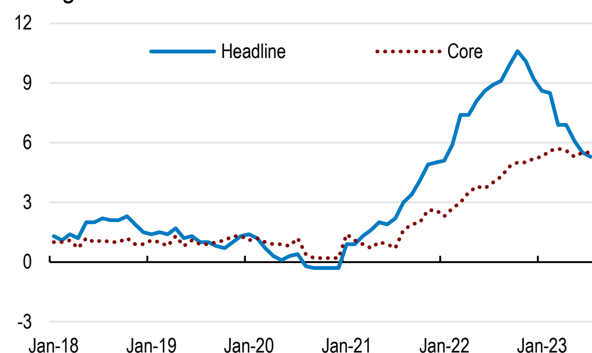
## The economic recovery has been disrupted by external shocks

**The European recovery has been hit hard by the energy crisis following the onset of Russia's war of aggression against Ukraine.** The post-pandemic rebound in GDP has faded as the impacts of the war unfolded, driving energy prices higher and causing new supply chain disruptions. While private consumption was supported by resilient labour markets, gross fixed capital formation suffered from input shortages and elevated uncertainty.

**Increases in energy and food prices have been stoking inflation** (Figure 1), triggering monetary policy tightening by the ECB. Inflation has become broad-based, underlining the need for a continuation of restrictive monetary and fiscal policy.

### Figure 1. Euro area inflation has surged

Harmonised index of consumer prices, 12-month % change




Note: Core inflation excludes volatile energy, food, alcohol and tobacco prices.
Source: Eurostat Harmonised index of consumer prices (HICP) database.

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**Resolute policy reaction by the European Commission and EU Council helped mitigate the impact of the recent negative shocks.** The EU took measures to help ensure short-term energy security and alleviate the effects of high energy prices on firms and households. However, some EU policies, such as the gas price cap, were insufficiently targeted, reducing incentives to lower consumption.

**Lower energy prices and recovering private consumption will gradually lift growth going forward**, but elevated interest rates will continue to weigh on private investment (Table 1). Another spike in energy prices could reignite the energy crisis and restrictive monetary policy could expose financial sector vulnerabilities.

### Table 1. Growth in the euro area has slowed

| | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|
| Real GDP (% change) | 5.5 | 3.5 | 0.9 | 1.5 |
| Private consumption (% change) | 3.7 | 4.4 | 0.2 | 1.5 |
| Gross fixed capital formation (% change) | 3.6 | 3.7 | 0.6 | 1.4 |
| Harmonised index of consumer prices (% change) | 2.5 | 8.3 | 5.8 | 3.2 |
| Unemployment rate (%) | 7.7 | 6.7 | 6.7 | 6.6 |
| Fiscal balance (% of potential GDP) | -3.5 | -3.0 | -2.4 | -2.1 |
| Public debt (Maastricht, % of GDP) | 97.3 | 93.2 | 92.3 | 92.0 |

Note: Euro area countries that are also members of the OECD (17).
Source: OECD Economic Outlook 113 database.

## Monetary policy needs to reduce inflation durably

**Headline inflation has moderated, but core inflation remains high** and wage growth is accelerating. Monetary policy rates have been raised steadily since July 2022 to bring inflation back to the 2% target. Second-round effects, with past inflation feeding into higher prices and wage demands, must be limited to secure a decline in inflation and prevent a wage-price spiral. Monetary policy needs to remain restrictive until underlying inflationary pressures are lowered durably.

**Higher interest rates are amplifying financial vulnerabilities**, especially in countries with high levels of private debt and a high share of variable mortgages. Although banks remain well-capitalised and their balance sheets sound, the authorities should use macroprudential policies and other targeted instruments to address financial sector risks as needed. In the medium term, policies addressing long-standing weaknesses of the banking sector, such as overcapacity and low profitability, should continue, as well as completion of the Banking Union.

## Fiscal spending must be targeted and sustainable

**Fiscal policy must become sufficiently restrictive.** Measures to mitigate the energy crisis

have further increased public debt and must become more targeted and eventually withdrawn even if energy prices do not decrease further. At the same time, the Next Generation EU (NGEU) programmes should be implemented efficiently to minimise inflationary pressures and help boost potential growth in the medium term.

**The Commission's proposal to reform the economic governance framework is a step in the right direction.** Compliance with EU fiscal rules in the pre-pandemic period had been partial, resulting in insufficiently countercyclical fiscal policy and insufficiently declining or rising public debt. Stronger emphasis on fiscal sustainability and multiannual planning could significantly improve fiscal outcomes. Better compliance could be achieved by giving a stronger role to national fiscal councils and through carefully designed and consistently applied sanctions.

## Boosting inclusive growth through a stronger and deeper Single Market

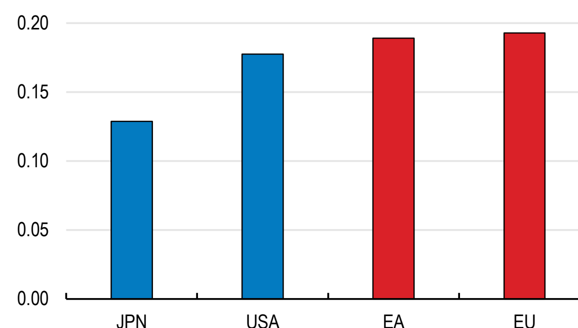
**The Single Market provides a level playing field, opening opportunities for firms to grow and innovate.** While state support, such as subsidies, may be warranted, it should be provided without distorting competition in favour of firms located in countries with more fiscal resources. Rather, EU policies and instruments could help set consistent framework conditions and facilitate adaptation to structural change, for example by providing an early-stage support for green R&D and innovation at the EU level.

**Barriers to the Single Market, especially in the provision of services, remain high** (Figure 2). Improving labour mobility, for example by further simplifying the rules for posting workers, would help for some services. However, digital services trade is held back by continuing differences in regulatory practice. Differing material efficiency standards and fragmented waste regulation hamper progress towards the circular economy and add to the shortage of critical raw materials.

**Despite progress in fighting corruption, challenges remain.** EU institutions should continue to coordinate national efforts to ensure the effectiveness of public spending and maintain trust. As outlined in the Commission's new proposal for a Directive, aligning minimum standards across countries and strengthening prevention measures could improve the effectiveness of the EU anti-corruption framework. Rules on transparency and lobbying for Members of the European Parliament should also be reinforced.

**Figure 2. Trade in services remains restricted**

Average Services Trade Restrictiveness Index, 2022




Note: The Services Trade Restrictiveness Index (STRI) takes values between zero and one, one being the most restrictive. The index is based on laws and regulations in force on 31 October 2022.
Source: OECD Services Trade Restrictiveness Index (STRI) database.

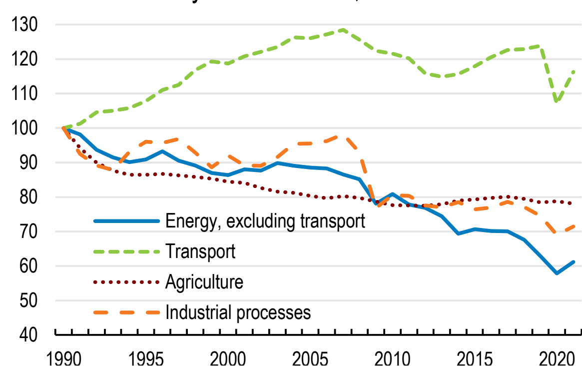
## Accelerating the green transition

**Greenhouse gas (GHG) emissions have been reduced by a fifth over the past decade.** Emission reductions happened mostly in sectors covered by the Emission Trading System (ETS), including energy and energy-intensive industry, while sectors not covered by the ETS (notably agriculture and transport) have contributed little (Figure 3). More action is needed across all sectors, but particularly in non-ETS sectors, to achieve the ambitious net-zero target by 2050. This entails using the entire toolbox of mitigation policies, including stronger carbon pricing, subsidies, and regulatory measures.

**There is a need for greater harmonisation of carbon prices, before raising them gradually.** The uneven coverage of the ETS across sectors and differences across national tax systems impose heterogeneous abatement incentives across countries and activities, leading to higher costs of achieving climate targets. Industry continues to receive most emission allowances free of charge. Reducing emissions in non-ETS sectors calls for extending carbon pricing to agriculture.

**Figure 3. Agriculture and transport have contributed little to emissions reduction**

GHG emissions by source sector, index 1990 = 100




Note: Excluding land-use, land-use change and forestry (LULUCF).
Source: OECD Environment Statistics database.

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**Investment in the green transition is held back by shallow capital markets.** In contrast with peer economies, the involvement of venture capital and institutional investors remains limited, reflecting a high regulatory burden. Deeper capital markets could support the development and growth of new clean technologies. In addition, better disclosure of climate-related risks is needed to reduce such risks in the financial system. In this regard, the EU has already adopted climate-related disclosure requirements for financial markets and banks and is currently working on extending disclosure requirements to large firms, while the ECB will only accept collateral that meets the EU's sustainability criteria.

**More integrated wholesale electricity markets are key for the energy transition and achieving energy security.** However, insufficient cross-border electricity connections hamper such integration. Moreover, retail electricity markets remain fragmented along national boundaries due to price regulation. Regulated retail prices below market prices leave energy providers with little incentives to invest. Price regulation also reduces energy saving incentives and discourages consumers from reducing peak demand.

**Generous government support for renewables, including feed-in-tariffs, mostly benefits cost-competitive technologies such as solar and wind**. In contrast, there is room to further increase the use of competitive auctions. The recent relaxation of state-aid rules may lead to higher subsidies for solar and wind, raising concerns about the effectiveness of public support as it may lead to a subsidy race within the EU and between the EU and other countries. Moreover, EU regulations encourage the use of unsustainable woody biomass, which can be more emission-intensive than coal.

**The Common Agricultural Policy has not been effective in reducing emissions in agriculture over the past decade**. For instance, direct payments to farmers keep livestock numbers high and promote the agricultural use of drained peatlands, despite their negative impact on the climate. In addition, mitigation measures are voluntary and have a low potential to reduce emissions.

**Emissions in road transport are on the rise**, reflecting an ageing car fleet that relies heavily on fossil fuels. Emissions only fell during the pandemic. More stringent vehicle emission standards and an extension of the ETS carbon price to road transportation, as envisaged by the new EU ETS 2 from 2027, will help reduce emissions. This should be complemented with taxation of fuels based on environmental performance. However, tax exemptions and reduced tax rates for fossil fuels for aviation and shipping continue to undermine climate policy. Moreover, cross-border rail traffic remains underdeveloped, despite having on average lower emissions per passenger than other forms of transportation. This reflects high and often discriminatory locomotive lease prices, rail charges and parking fees for foreign train operators.

## Limiting reallocation costs from the green transition

**The green transition requires more efficient labour reallocation.** Labour mobility across EU countries is relatively low. One barrier to labour mobility is an abundance of occupational entry barriers. Other barriers to cross-border mobility include limited portability of unemployment benefits and rigid housing markets.

**EU funding aims to help most affected regions manage the employment effects of the green transition.** However, funding for mobility and training could be better tailored to local labour market needs. As regions develop their "Just Transition Plans", greater efforts are needed to identify and address the drivers of low training and job-to-job transitions.

| Main findings | Key recommendations |
|---|---|
| **Reduce inflation durably and protect financial stability** | |
| Inflation has become more broadly based and more dispersed across euro area countries. | Maintain a restrictive monetary policy stance, as needed and depending on data, to ensure inflation expectations remain firmly anchored and inflation decreases durably toward its medium-term target. |
| Increasing interest rates raise risks to financial stability. Risks are on the rise in the commercial and residential housing sectors degrading asset quality of banks and the non-bank financial sector. | Continue to use macroprudential policy, including countercyclical capital buffers, to bolster the resilience of the banking sector. |
| The European banking system is not well integrated. Fragmentation in supervision and oversight as well as inconsistencies in national insolvency frameworks are obstacles to further financial integration. | Complete the Banking Union by addressing all outstanding issues in a holistic manner. |
| **Enhance fiscal sustainability** | |
| A broadly neutral fiscal stance and backloading of the fiscal effort to 2024 weakens the effect of the ongoing monetary policy tightening. | Implement prudent fiscal policy, consistent with the return of inflation to target, while ensuring that income support for high energy prices is temporary and targeted and preserves energy saving incentives. |
| The Stability and Growth Pact has not delivered countercyclical fiscal policy or ensured a downward path to more prudent debt levels. | Refocus fiscal rules on debt sustainability and multiannual expenditure plans. |
| **Protect the Single Market while strengthening resilience and autonomy** | |
| Most state support lies outside the scope of the EU state-aid rules, which have been relaxed during the pandemic. | Protect the Single Market and avoid relaxing the state-aid rules further. |
| European support for renewables production is considerable. Effective use of existing EU resources could help meet investment needs. | Re-direct existing EU budgetary resources towards support for green R&D, innovation and early-stage support coordinated at the EU level. |
| Digital and green transitions are hampered by continuing fragmentation of regulations and standards across the EU. | Coordinate harmonization of national regulations and their alignment with EU rules for digital services provision, the circular economy and building codes. |
| **Strengthen the anti-corruption framework** | |
| Corruption reduces economic efficiency, leads to waste of public resources and undermines citizens' trust in public institutions. | Continue to co-ordinate national efforts to fight corruption and fraud.<br>Align minimum standards across countries and strengthen prevention measures. |
| **Accelerate the green transition** | |
| The uneven coverage of the EU Emission Trading System (ETS) across sectors and differences across national tax systems impose heterogeneous abatement incentives across countries and sectors.<br>Energy taxation maintains inequalities in tax treatment across sectors and different uses of energy. Reduced rates and tax exemptions for environmentally harmful fossil fuels, including heating gas, aviation, and maritime fuels, continue to undermine decarbonisation efforts. | Continue expanding the coverage of ETS, for instance in agriculture, by establishing emission monitoring and reporting systems (e.g., for emissions from livestock and fertiliser use) and including emissions of large emitters.<br>Bring forward the phase out of free emission allowances.<br>Revise the Energy Taxation Directive to introduce minimum tax rates for fossil fuels based on energy content and environmental performance, and broaden the tax base by phasing-out exemptions and reduced rates for fossil fuels. Announce clear time paths for the evolution of minimum tax rates for fossil fuels. |
| There is a lack of risk capital for financing new sustainable technologies. | Promote the Capital Markets Union by reviewing the regulatory burden on institutional investors. |
| Government support for renewables remains high and mostly benefits cost-competitive solar and wind. There is room to further increase the use of competitive auctions. | Ensure that the EU state-aid framework allows government subsidies only for renewable technologies that are not yet competitive. |
| EU regulations encourage the use of emission-intensive biomass for energy. | Ensure that EU countries do not support the use of unsustainable biomass by revising the Renewable Energy Directive and excluding unsustainable biomass from the taxonomy of sustainable activities. |
| Retail electricity markets are fragmented along national boundaries, reflecting price regulation. Insufficient investment in cross-border grid connections slows down the integration of wholesale electricity markets. | Ensure that EU countries phase out regulated retail electricity prices by fully implementing the EU Directive on Common Rules for the Internal Market for Electricity.<br>Increase investment in cross-border grid connections by diverting EU funds to the Connecting Europe Facility. |
| Direct payments continue to promote the environmentally harmful use of drained peatlands. Direct payments to agricultural producers based on livestock numbers have increased. | Remove support for the agricultural use of drained peatlands.<br>Gradually withdraw direct payments for high livestock numbers. |
| International rail traffic remains underdeveloped. | Ensure non-discrimination in locomotive lease prices and rail track charges for domestic and foreign trains. |
| **Limit the reallocation costs from the green transition** | |
| Occupational entry barriers reduce labour mobility. | Continue efforts to reduce occupational entry barriers. |
| Spending efficiency is a concern for the inflow of EU funds under the Just Transition Fund. | Concentrate future funding for alleviating the socio-economic impacts of the green transition on mobility support and training, and make it conditional on labour market outcomes. |

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