1 Key Policy Insights

The recovery in the European Union and euro area has been disrupted by the energy price shock and the cost-of-living crisis that followed Russia's war of aggression against Ukraine. EU policies helped avoid a severe downturn, but the near-term outlook is clouded by uncertainty and downside risks. Monetary and fiscal policy need to remain restrictive to lower underlying inflationary pressures. Fiscal sustainability should be grounded in efficient public spending and improved economic governance. To facilitate structural change, barriers in the Single Market need to be reduced further and complemented by an efficient early-stage support for green innovation.

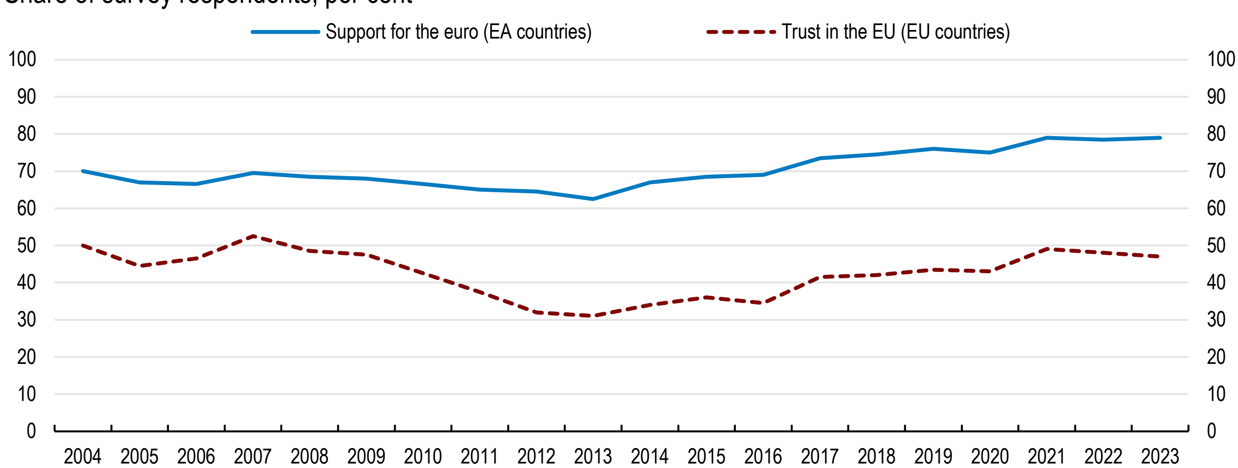
The European Union is tackling critical challenges

The COVID-19 pandemic has brought multiple challenges and uncovered existing weaknesses, which elicited new policy responses at the EU level. Recovery from the pandemic has been cut short by ongoing global supply chain disruptions, increasing energy and commodity market pressures and high uncertainty following Russia's unprovoked war of aggression against Ukraine. These mostly external shocks have turned 2022 into a particularly difficult year for Europe. War is taking place on European soil creating a humanitarian crisis and significant disruptions to economic activity. Inflation in the euro area and the EU has reached levels not seen in advanced economies in decades, and growing trade tensions coupled with increasingly protectionist industrial policies are endangering the rules-based international economic order. In the presence of these immediate challenges, more long-term tasks such as climate-change mitigation and the digital transition are in the danger of fading into the background.

The policy response of the European institutions, both at the EU and euro area level, has been robust and creative. The EU continues to provide substantial humanitarian, military and financial support to Ukraine, so far amounting to EUR 55 billion. The EU also succeeded in coordinating an effective and timely reaction to the energy crisis, strengthening energy security. The ECB has tightened monetary policy, albeit belatedly, to tame inflation. The European Commission has followed with reform proposals aimed at improvements in economic governance important for the functioning of the Economic and Monetary Union (EMU). This work has paid off: unlike in the aftermath of the global financial crisis, trust in the EU has been preserved and even strengthened, while support for the common currency, which welcomed Croatia as a new member at the start of this year, is at a historical high (Figure 1.1). The EU and the euro area are acknowledged by their citizens as effective protection mechanisms, useful for addressing both immediate risks and long-term challenges.

Figure 1.1. Trust in the EU has been preserved and support for the euro is unprecedented

Share of survey respondents, per cent



Note: Surveyed respondents were asked the following questions: (1) "Are you for or against a European economic and monetary union with one single currency, the euro?", and (2) "Do you tend to trust the European Union institutions?". The series "In favour of European economic and monetary integration" (blue line) refers to respondents in the euro area countries, while the series "Trusting the EU institutions" (dotted brown line) refers to respondents in the European Union countries.
Source: Standard Eurobarometer 98 - Winter 2022-2023, https://europa.eu/eurobarometer/surveys/detail/2872
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However, the challenges that lie ahead may be as large as those recently confronted. Over the past decade, greenhouse gas emission reductions happened mostly in sectors covered by the Emission Trading System (ETS). In contrast, sectors not covered by the ETS have contributed little to emission reduction. Aggregate labour productivity has been trending downwards for decades, as in other major economies. In the EU, labour productivity growth that soared in 2021, in the aftermath of the pandemic, has dropped to 0.7% in 2022.

Monetary policy must continue its restrictive stance to durably reduce inflation, while taking financial stability into account. Fiscal policy needs to support monetary policy, ensuring that the macroeconomic policy mix for the euro area is sufficiently restrictive to bring down inflation. That means better targeting of the fiscal support and implementing the Next Generation EU and the National Recovery and Resilience Plans efficiently to ensure that the fiscal stimulus from additional public investment does not push up inflation in the medium term. The EMU institutional architecture has to be renovated and the complex set of EU fiscal rules replaced by a system of economic governance that will improve both compliance with and national ownership of the rules.

Macroeconomic stabilisation can be helped by further developing the Single Market, which would alleviate cost and price pressures by expanding long-term productive capacity of EU countries. The Next Generation EU programme will provide some of the considerable investment needed to make the Single Market work for the green and digital transitions. But public investment will have to be accompanied by more private capital, and alleviating financing constraints, particularly for small and medium-sized firms, is key for meeting the environmental challenges. More also needs to be done in removing the persistent barriers in services trade and augmenting labour mobility. In addition, the harmonisation of national regulations with EU rules in the area of circular economy and construction can directly help fulfil the ambitious emission reduction targets.

Apart from ensuring a level-playing field, growing the Single Market entails an appropriately calibrated industrial policy enhancing resilience and supporting productive capabilities. Further relaxation of the state-aid rules risks creating uneven conditions across countries, reflecting the amount of fiscal space in the various countries rather than opportunity costs and synergies. Instead of harmful subsidisation races, the EU could focus on international co-operation to avoid new dependencies and join the efforts of governments and businesses to improve risk preparedness.

Looking ahead, a key challenge is to accelerate decarbonisation efforts in Europe. This requires that all sectors contribute to emission reductions and calls for an extension of emission trading to agriculture and transportation. Such efforts should be complemented by measures to shift to cleaner energy and improve energy efficiency.

Against this background, the Survey has three main messages:

- Monetary and fiscal policies must provide sufficiently restrictive macroeconomic conditions to bring down inflation and ensure that inflation expectations remain firmly anchored at the 2% target. The economic governance reform, which could help improve fiscal outcomes, is an integral part of this effort.
- The Single Market is an essential driver of long-term growth with considerable potential for further deepening. Beyond providing a level playing field, the Single Market could be leveraged to enhance resilience. Further reducing existing barriers to services trade and labour mobility, while protecting workers’ rights, will also facilitate the digital and green transitions. Continuing to fight corruption and fraud is necessary to strengthen trust in public institutions.
- The green transition requires further efforts to reduce emissions by using the entire toolbox of mitigation policies, including carbon pricing and regulatory measures. This entails greater harmonisation of carbon prices across countries and sectors, before raising them gradually. Also, more integrated electricity markets will be key for the energy transition and achieving energy security.

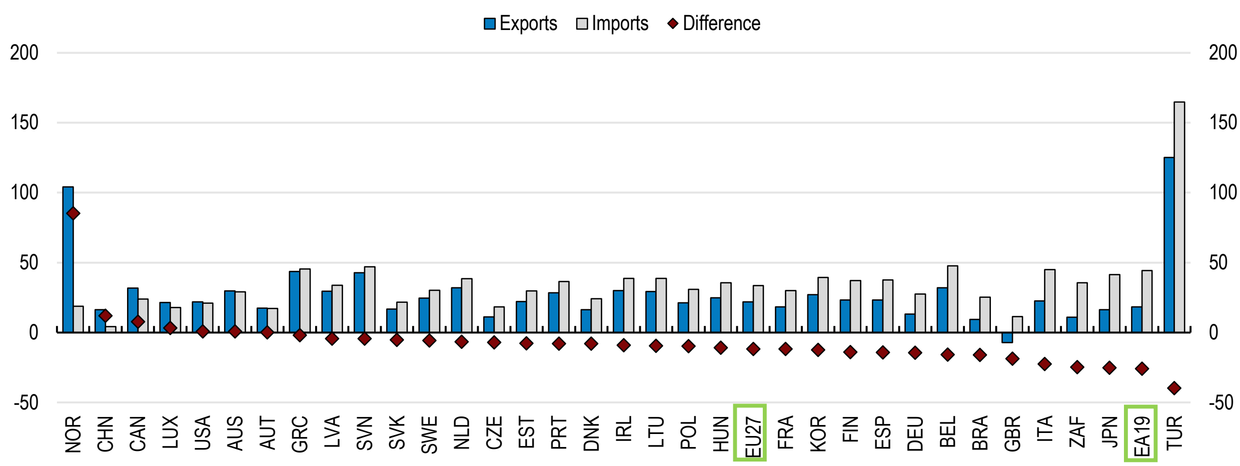
Economic recovery has been slow and uneven

The recovery has been hampered by the energy crisis and high inflation

Europe has been hit hard by Russia's unprovoked war of aggression against Ukraine and the energy crisis that followed. In the wake of the pandemic, growth rebounded in 2022, reflecting government support of about 1.2% of EU GDP to households and firms, as well as improvements in global supply chains and stronger demand from global reopening. Even so, the large negative terms-of-trade shock that sharply increased prices of imports, such as energy, relative to export prices, has been persistent and heterogenous across European countries, reflecting varying energy needs and supply chains. It amounted to a considerable transfer of wealth away from Europe (Figure 1.2), which continued, despite lower imports of energy and gradually decreasing energy prices, to contribute negatively to economic growth until the third quarter.

Figure 1.2. Europe has been hit strongly by the energy crisis

Per cent changes in trade in goods values



Note: March-July 2022 compared with the same months of 2021.
Source: OECD International Trade Statistics database.

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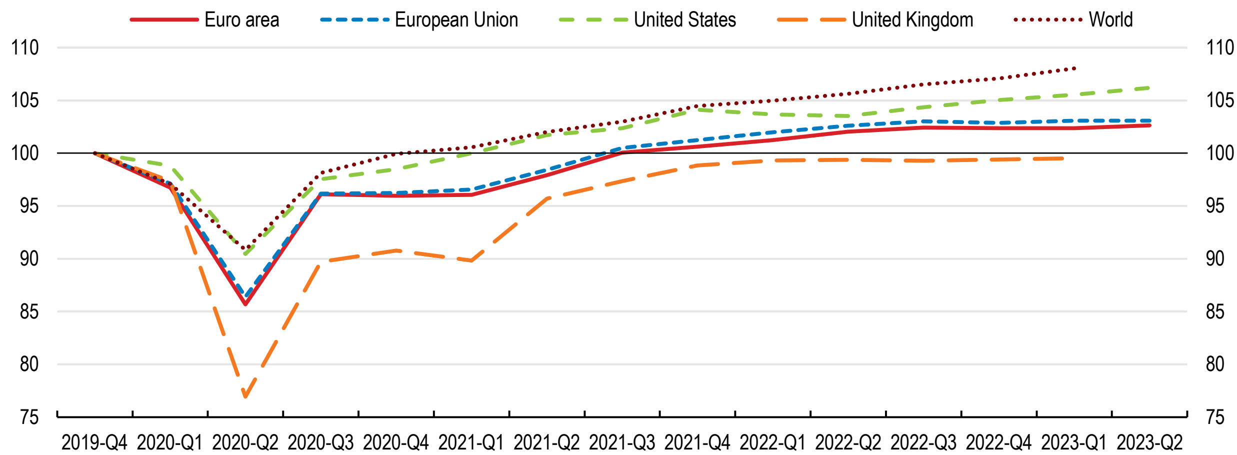
The EU economy has contained the adverse impact of the war in Ukraine and the surge in energy prices thanks to coordinated and timely policy action. The measures resulted in rapid diversification of supply and a sizeable fall in gas consumption. The sharp deterioration of the terms of trade in 2021 and 2022 was greater in the EU than in many advanced economies. Policy actions at the EU and national levels helped enhance resilience and mitigate the negative effects on household income and productive capacity. Gradually declining energy prices have recently helped reverse the negative terms-of-trade shock and reduced production cost pressures.

The recovery of European economies has been lagging other regions (Figure 1.3). GDP growth slowed to 3.5% in 2022 in both the EU and the euro area, following a rebound from the pandemic that resulted in growth above 5% in 2021. Private consumption remained resilient, supported by continuing employment gains, a further decrease in the savings rate and fiscal support mitigating the energy crisis. Consumer spending on services continued to increase and durable goods consumption grew markedly in the second half of 2022, reflecting reduced supply chain disruptions. Increasing interest rates and elevated uncertainty have had limited effects on gross fixed capital formation so far. The contribution of gross fixed capital formation to GDP growth has been complemented by an improved trade balance driven by the recent decline in energy prices.

Figure 1.3. The rebound in GDP growth has been relatively weak

Real GDP, index 2019-Q4 = 100



Note: Data refers to the euro area including 19 countries.
Source: OECD Economic Outlook: Statistics and Projections database; and Eurostat National Accounts database.

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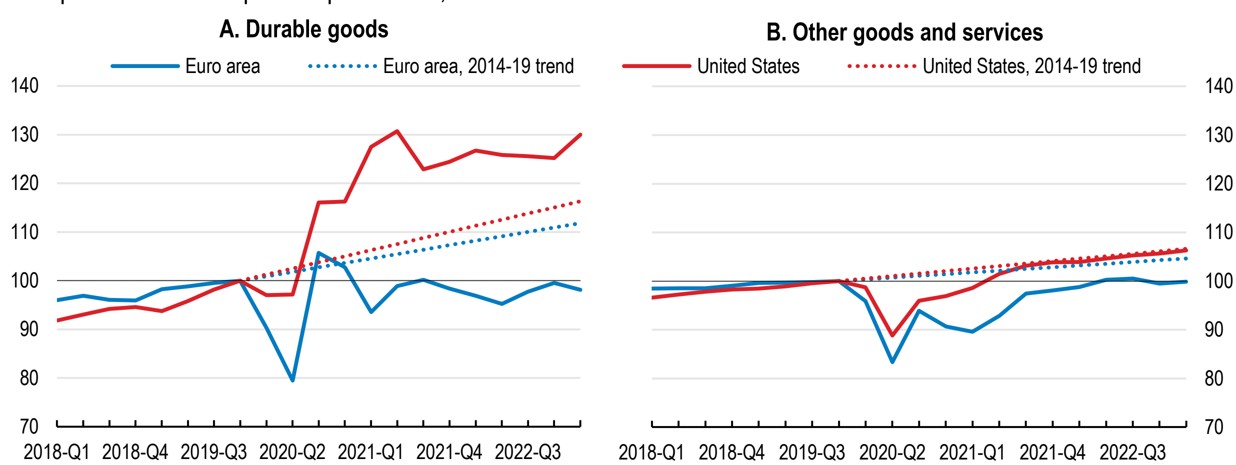
The relatively slow recovery reflects the negative terms-of-trade shock from the war in Ukraine as well as sluggish private consumption during most of the pandemic period and weak investment, both of which pre-date the war. As discussed in the 2021 *OECD Economic Survey of the European Union* (OECD, 2021[1]), the resurgence of the pandemic in the autumn of 2020 and a new wave of infections in the first months of 2021 forced EU countries to impose additional containment measures, which further delayed the recovery (Figure 1.4). Similarly, the weak level of euro area investment can be linked to a sharp contraction during the first wave of the COVID-19 pandemic followed by a slow rebound, although these dynamics are driven to large extent by the investment data for Ireland (Figure 1.5).

Figure 1.4. The rebound in consumption has been limited

Real personal consumption expenditures, index 2019-Q4 = 100



Note: Other goods consist of semi-durable and non-durable goods. Only euro area member countries that are also members of the OECD (17 countries) are considered.
Source: OECD National Accounts database; and OECD calculations.

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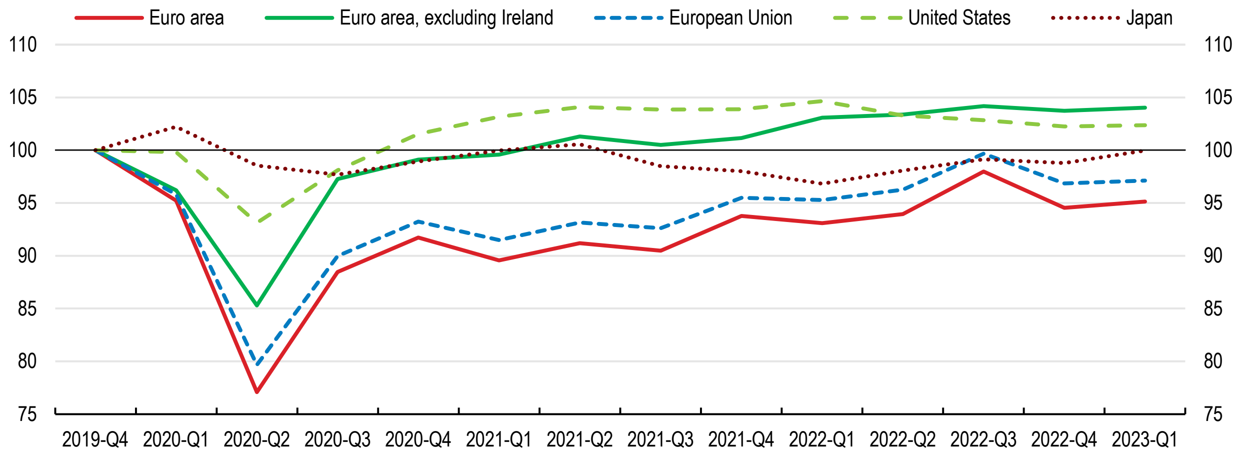
Figure 1.5. Investment in the euro area continued to recover in 2022

Real gross fixed capital formation, index 2019-Q4 = 100



Note: Data refers to euro area member countries that are also members of the OECD (17 countries) and to the 27 EU Member countries.
Source: OECD Economic Outlook: Statistics and Projections database.

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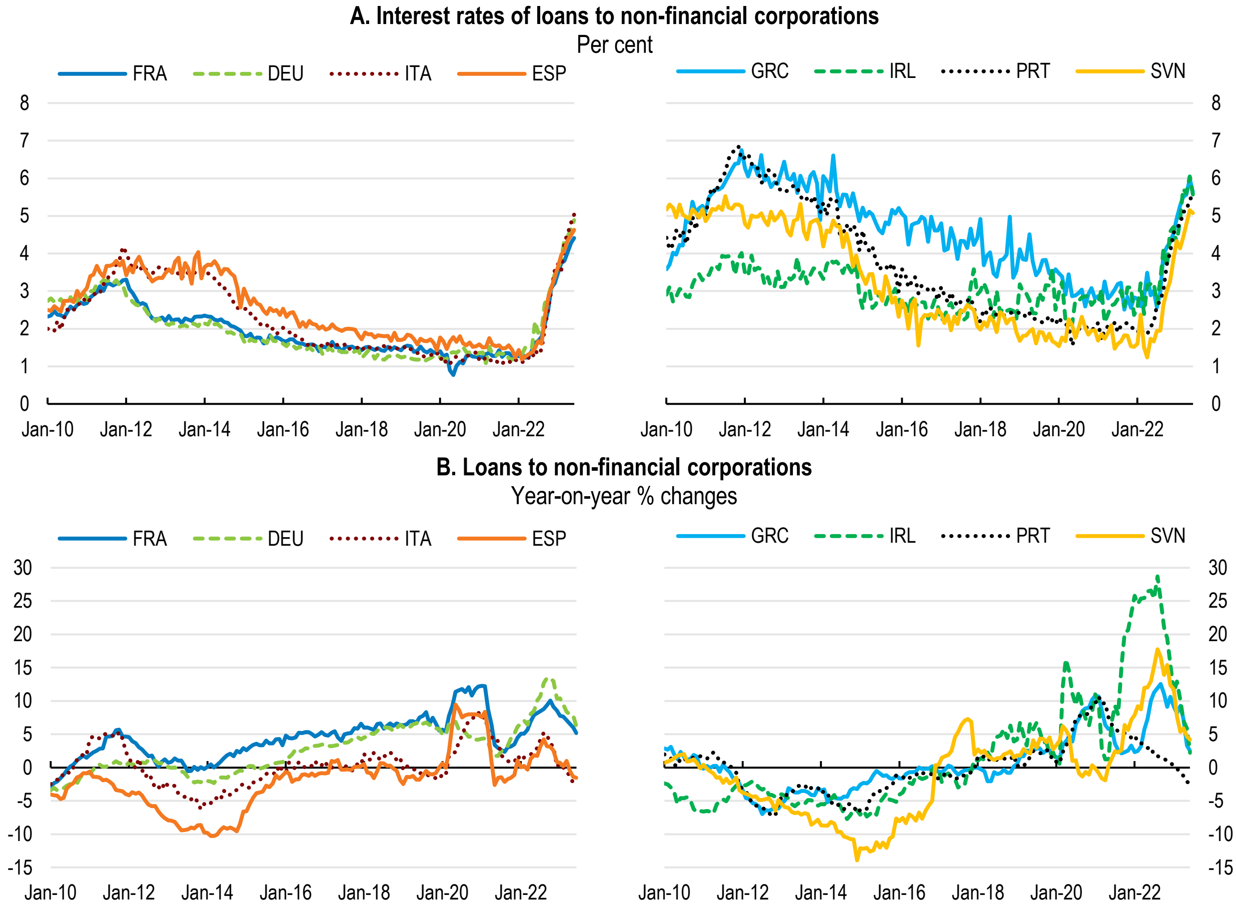
Increases in the prices of energy and food have been fuelling inflation. The negative terms-of-trade shock has exacerbated price pressures associated with post-pandemic fragmentation of global supply chains. To deliver on its mandate of price stability and to prevent inflation expectations from de-anchoring, the ECB has accelerated tightening monetary policy in July 2022, having put in place the Transmission Protection Instrument, raising policy interest rates by 400 basis points in less than eleven months. Nevertheless, the start of the tightening may have been too late (Darvas and Martins, 2022[2]). The corresponding increase in lending interest rates and tighter credit standards triggered a slowdown in credit provision to both firms and households, further weighing on the recovery and aggravating existing financial vulnerabilities (Figure 1.6).

The labour market recovery continued in 2022 with employment exceeding the pre-pandemic level, but with considerable heterogeneity across sectors. Labour market slack decreased markedly in the information and communication technology sector and construction, while employment in manufacturing and some service sectors was still lower than before the pandemic. Labour market tightness is reflected in the unemployment rate, which is at historically low levels in both the EU and the euro area, while job vacancy rates are unprecedently high (Figure 1.7). Wage growth indicators picked up in the third and fourth quarter of 2022, recording the strongest increase, at an annual rate of 3.9%, in services. Labour market tightness is projected to continue, reflecting continuing labour shortages in many countries. Nominal wage growth is projected to accelerate as increased efforts to obtain compensation for recent inflation could lead to upward pressures in wage negotiations. Although wage shares and profit margins currently appear close to their historical averages, GDP deflator decomposition suggests increasing unit profits at the aggregate level (Figure 1.8). While a full recovery of the lost purchasing power could trigger de-anchoring of inflation expectations, increasing unit profits point to some room for non-inflationary wage increases.

Figure 1.6. Higher borrowing costs have reduced credit growth



Note: New business loans with an initial rate fixation period of less than one year. Loans other than revolving loans and overdrafts, convenience and extended credit card debt. In Panel A, loans of up to 1 year for Greece. In Panel B, loans adjusted for credit and securitisation.
Source: ECB MFI Interest Rate Statistics database.

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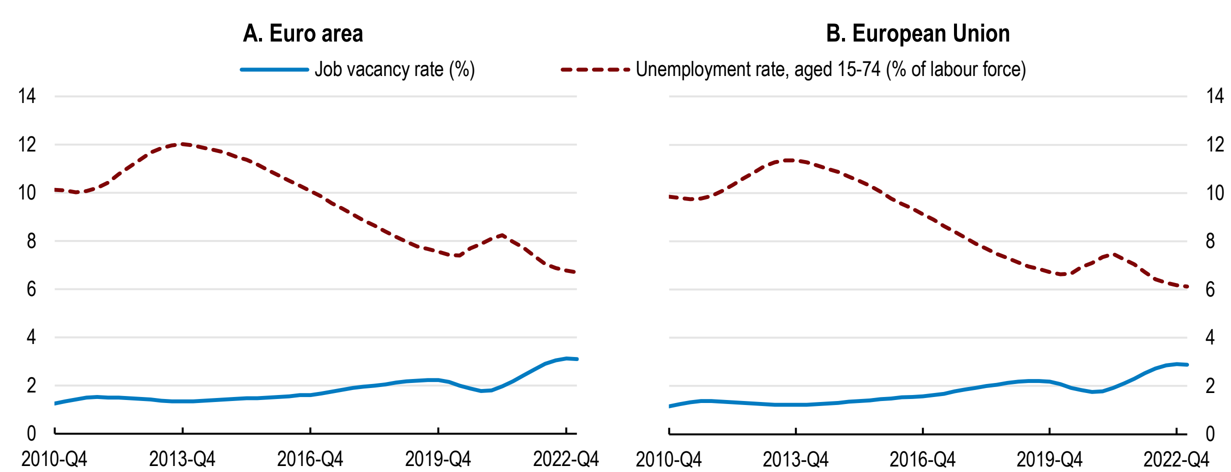
Figure 1.7. The unemployment rate is historically low and job vacancies have increased



Note: Four quarter moving average rates. Data refers to the euro area including 20 countries and to the 27 EU Member countries.
Source: Eurostat Job Vacancy Statistics database; Eurostat Labour Market Statistics database; and OECD calculations.

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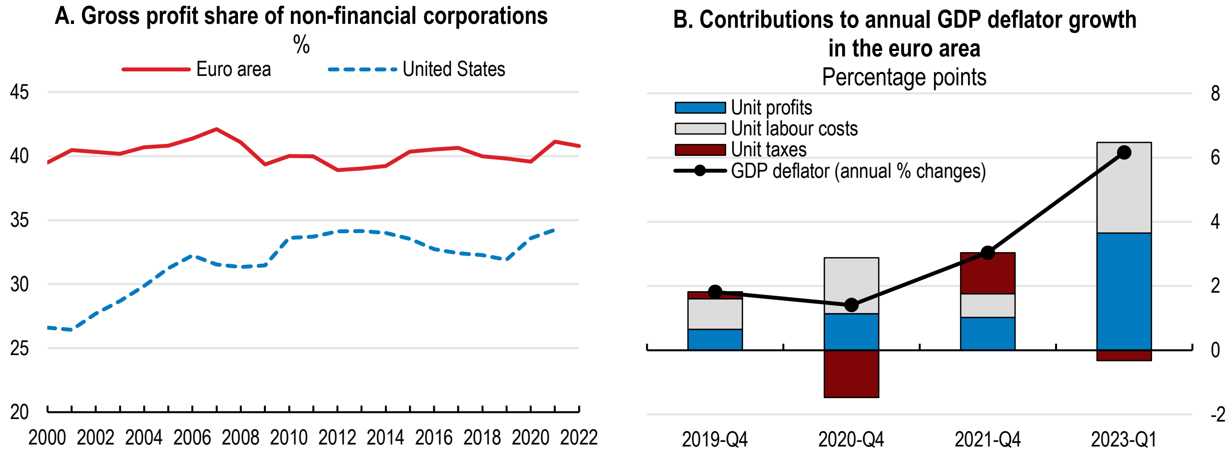
Figure 1.8. Profit share remains close to the historical average, but unit profits are increasing



Note: In Panel A, the indicator is calculated as gross operating surplus and mixed income over gross value added for the non-financial corporate sector (S11). In both Panel A and Panel B, data refers to the euro area including 19 countries.
Source: Eurostat Non-financial Transactions database; Eurostat Labour Cost Index database; OECD Annual Sectoral Accounts database; Eurostat National Accounts database; OECD calculations.

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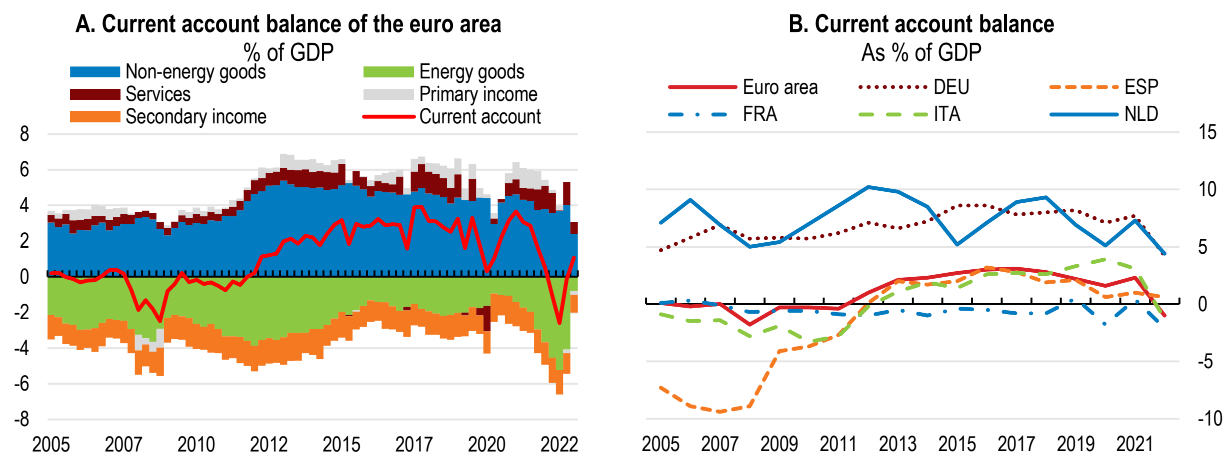
After a prolonged period of current account surpluses, the euro area's current account balance has deteriorated sharply, mainly driven by expensive energy imports (Figure 1.9). At the same time, the strong variation in energy dependency together with varying energy needs led to discrepancies in current account dynamics, increasing risks of external imbalances in some countries (European Commission, 2022[3]).

Figure 1.9. The current account balance reflects expensive energy imports



Note: Data refers to the euro area including 20 countries as of 2013 and 19 countries from 2005 to 2012.
Source: Eurostat Balance of Payments database; Eurostat International Trade by SITC database; Eurostat National Accounts database; and OECD calculations.

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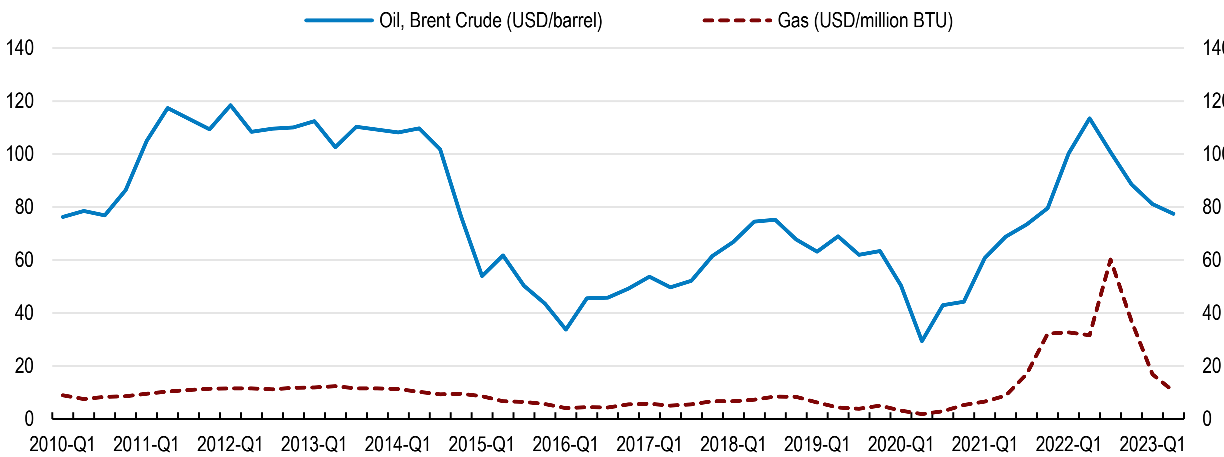
A forceful policy response helped to reduce the fallout from the energy crisis

The energy crisis has abated in 2023 reflecting both stronger supply and lower-than-expected demand. European firms have been resilient during the energy price crisis. Many firms managed to reduce gas consumption significantly when elevated energy prices continued to incentivise fuel-switching and energy efficiency measures, while maintaining high levels of production. For example, in Germany where about 60% of industrial companies use natural gas, 75% of gas-dependent firms were able to reduce gas consumption without cutting production, while some 40% reported further room for consumption reduction

(Pittel and Schultz, 2022[4]). Mild weather conditions also lowered heating requirements, ensuring inventory levels 20% above their long-term average at end-2022. As a result of these favourable developments, gas and oil prices have declined significantly (Figure 1.10). A continuing exclusion of gas imports from Russia also appears manageable, as the integration of European countries into the global liquified natural gas (LNG) market progresses (Albrizio et al., 2022[5]). Even in the absence of Russian gas, adherence to the voluntary 15% gas demand reduction plan would help fill up the storage capacities next winter.

Figure 1.10. Energy prices have been volatile

Energy prices in U.S. dollars



Source: Refinitiv; and Oxford Economics

StatLink https://stat.link/zobfjy

The adjustment during the energy crisis has been helped by tailored policy responses at EU level, including both measures to strengthen supply and reduce demand. In addition to the short-term measures focused on alleviating tensions in natural gas markets (Box 1.1), the Commission proposed measures concerning other sources of energy. These include the cap on extraordinary market revenues from electric power generation, a mandatory reduction target for peak hours demand and a one-off solidarity contribution from fossil fuel companies (European Commission, 2022[3]). As discussed in detail in Chapter 2, some of these measures cannot be sufficiently targeted or reduce incentives for energy savings and should not be introduced, at least not in their current proposed form.

The EU should refrain from overly generous price-capping mechanisms, which in any case should be carefully designed to minimise negative effects on energy savings. As discussed in Chapter 2, measures to mitigate the impact of high energy prices included a cap on wholesale gas prices at EU level. However, this mechanism suffers from several problems. It may imperil the functioning of the Internal Energy market and reduce gas imports into the EU. A price cap also contradicts the Emission Trading System, which aims at raising energy costs to incentivise investment in renewables. Importantly, price regulation cannot really be targeted and thus it risks reducing energy saving incentives, contradicting EU-wide efforts to improve energy efficiency.

Joint gas purchasing was proposed as a tool to leverage the EU's purchasing power as a major gas importer and prevent companies and countries outbidding each other and thereby driving up gas prices. However, the proposed mechanism seems impractical and in need of improvement (Barnes, 2022[6]). Since the demand aggregation mechanism is mandatory up to the 15% of the gas storage facilities (see above), while participation in joint purchasing remains voluntary, it is not clear how much gas will be bought through the scheme. It is possible that it will not have much impact. The Commission estimates the maximum amount prescribed by demand aggregation at about 13.5 bcm (European Commission, 2022[7]), less than 4% of total EU annual gas consumption of more than 400 bcm. Moreover, the Title Transfer Facility (TTF) is a functioning wholesale market that already effectively represents the purchasing power of the EU. On the contrary, the Joint Purchasing IT Tool agreed in December 2022 seems to be duplicating the role of current LNG aggregators such as trading houses, oil and gas companies, as well as European utility companies that have signed long term LNG purchase contracts with producers. In addition, smaller buyers who are sometimes seen as beneficiaries of joint purchasing, can already access smaller-size contracts at the TTF and current market pricing with reference to TTF traded prices effectively provides demand aggregation. The new demand aggregation tool, however, requires a cumbersome assessment of potential negative effects of purchasing consortia on competition and places broad notification obligations on the gas sector, which may be unattractive for large companies (Hancher and Levitt, 2023[8]).

Box 1.1. EU measures to ease strains on natural gas markets

Alongside the longer-term structural measures in the Fit for 55 package and the REPowerEU plan (Chapter 2), additional short-term measures were introduced to make European gas markets more resilient:

Minimum gas storage obligations: Requirement to fill gas storage to 80% of capacity by November 2022 and to 90% ahead of all following winters. Several EU Member States adopted more stringent regulations, aiming for higher filling targets.

A regulation on coordinated demand reduction measures for gas: A voluntary reduction by 15% in gas demand between August 2022 and March 2024, compared to the average over the five previous years. The reduction target could become mandatory in case the EU initiates a crisis-level alert.

Energy diplomacy: the EU intensified its international outreach to strengthen energy partnerships with key natural gas and LNG suppliers, including Algeria, Azerbaijan, Norway and the United States.

Joint Gas Purchasing Mechanism: adopted in December 2022, it will facilitate the coordination of gas purchases at the EU level using a two-step process (Regulation 2022/2576). The first step requires demand aggregation with volumes equivalent to 15% of the gas needed to fill a country's storage facilities to 90% of capacity and the second involves voluntary participation in joint purchasing.

Enhanced solidarity: in December 2022 the EU Council adopted new rules for sharing natural gas amongst EU countries in case of an emergency. These rules will be triggered only if member states have not concluded bilateral agreements setting the modalities of solidarity.

New floating storage regasification units and the expansion of existing regasification terminals will provide the EU with 25% more regasification capacity in 2023 compared to 2021. This represents an increase of around 40 bcm annually.

Market correction mechanism (a wholesale gas price cap): EU energy Ministers reached a political agreement on the rules for a temporary one-year mechanism starting on 15 February 2023. The instrument imposes a safety price ceiling on the month-ahead Title Transfer Facility (TTF) derivatives and will be automatically activated if the month-ahead TTF price exceeds €180/MWh for three working days or if the TTF price is €35 higher than a reference price for LNG and non-LNG contracts on global markets for the same three working days. The Agency for Cooperation of Energy Regulators (ACER) was entrusted with monitoring and publishing these market corrections.

Source: International Energy Agency (2023[9]).

Growth will slow down in 2023, gradually picking up in 2024

Growth in the euro area is projected to slow to 0.9% in 2023, despite the support that robust labour markets and declining headline inflation will provide to real incomes and private consumption, before gradually strengthening in 2024. The benefits of lower energy prices and declining inflation are projected to help the growth momentum to gradually pick up, bringing average annual growth in 2024 to 1.5% (Table 1.1).

Growth in the European Union will follow a similar profile and rebound in 2024 to 1.5% year-on-year on the back of stronger private consumption (Table 1.2).

Headline consumer price inflation is projected to moderate, while core inflation will remain sticky. With the sharp rises of energy prices in 2022 still working their way through the economy and with monetary policy tightening having begun later than in the United States, both headline and core inflation are projected to remain above target in the euro area for longer. Annual headline inflation in the euro area is projected to come down from 8.3% in 2022 to 5.8% in 2023 and remain above 3% in 2024. Core inflation in the euro area, which kept increasing throughout 2022, is projected to decrease to 5.4% in 2023, before easing further to 3.6% in 2024.

Table 1.1. Macroeconomic indicators and projections for the euro area

	2019	2020	2021	2022	2023[1]	2024[1]
	Current prices (EUR Billions)	Annual percentage change, volume (2015 prices)				
Gross domestic product (GDP)	11956.4	-6.2	5.5	3.5	0.9	1.5
Private consumption	6363.3	-7.8	3.7	4.4	0.2	1.5
Government consumption	2450.2	0.9	4.4	1.3	-0.2	0.9
Gross fixed capital formation	2653.4	-6.2	3.6	3.7	0.6	1.4
Housing	631.3	-3.3	7.8	1.4	. .	. .
Final domestic demand	11466.9	-5.6	3.8	3.5	0.2	1.4
Stockbuilding[2]	. .	-0.3	0.3	0.3	-0.1	0.0
Total domestic demand	11551.1	-5.8	4.1	3.8	0.0	1.4
Exports of goods and services	5738.4	-9.4	11.1	7.3	2.1	2.9
Imports of goods and services	5333.0	-8.8	8.8	8.3	0.8	2.7
Net exports[2]	405.4	-0.6	1.4	-0.2	0.7	0.2
Memorandum items						
Potential GDP		1.6	1.6	1.4	1.2	1.1
Output gap (% of potential GDP)		-6.4	-3.0	-1.0	-1.3	-1.0
Employment		-1.5	1.5	2.8	1.1	0.5
Unemployment rate (% of labour force)		7.9	7.7	6.7	6.7	6.6
GDP deflator		1.9	2.1	4.6	5.7	3.0
Harmonised index of consumer prices		0.3	2.5	8.3	5.8	3.2
Harmonised index of core inflation[3]		0.7	1.5	4.0	5.4	3.6
Household saving ratio, net (% of household disposable income)		13.6	11.5	7.7[1]	7.4	6.7
Current account balance (% of GDP)		2.6	4.2	1.2	2.4	2.6
General government fiscal balance (% of GDP)		-7.1	-5.3	-3.7	-2.9	-2.2
Underlying general government fiscal balance (% of potential GDP)		-2.9	-3.5	-3.0	-2.4	-2.1
Underlying government primary fiscal balance (% of potential GDP)		-1.7	-2.3	-1.5	-1.0	-0.5
General government debt, Maastricht definition (% of GDP)		99.3	97.3	93.2	92.3	92.0
General government net debt (% of GDP)		75.9	70.8	57.0	56.4	56.2
Three-month money market rate, average		-0.4	-0.5	0.3	3.2	3.4
Ten-year government bond yield, average		0.0	0.0	1.8	3.3	3.7

Note: Data refers to euro area member countries that are also members of the OECD (17 countries).
1. OECD estimates.
2. Contribution to changes in real GDP.
3. Index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 113 database.

Risks to projections are tilted to the downside (Table 1.3). The disruption from the Russian invasion of Ukraine is likely to continue to weigh on global output through the impact on uncertainty, continuing risks to food and energy security, and the ongoing adjustments in commodity markets as price caps and embargos on Russian energy take full effect. The risk of critical energy shortages in the 2023-24 winter has diminished but not disappeared. Supply from Russia in 2023 is likely to be minimal, in contrast to the early months of 2022, and the likely rebound in demand in China will increase competition for tight global LNG supply. This could push energy prices up again, resulting in another spike in consumer prices and further economic dislocation. Risks of higher prices also remain in oil markets, given recent production cuts by oil exporters and considerable uncertainty as to how Western sanctions on oil and oil products from Russia will affect global supply.

Table 1.2. Macroeconomic indicators and projections for the European Union

	2019	2020	2021	2022	2023[1]	2024[1]
	Current prices (EUR billions)	Annual percentage change, volume (2015 prices)				
Gross domestic product (GDP)	17856.4	-5.9	5.6	3.6	0.9	1.5
Private consumption	9501.4	-7.2	4.1	4.1	-0.1	1.6
Government consumption	3645.8	1.0	4.2	1.0	-0.2	1.1
Gross fixed capital formation	3944.3	-5.5	3.9	3.9	0.6	1.4
Final domestic demand	17090.1	-5.1	4.1	3.3	0.1	1.4
Stockbuilding[2]	. .	-0.4	0.7	0.5	. .	. .
Total domestic demand	17225.7	-5.4	4.8	3.8	-0.1	1.4
Exports of goods and services	8872.3	-8.8	11.0	7.5	2.4	3.0
Imports of goods and services	8243.5	-8.2	9.9	8.2	0.9	2.7
Net exports[2]	. .	-0.6	0.9	0.0	. .	. .
Memorandum items						
Potential GDP		1.7	1.7	1.6	1.4	1.3
Output gap (% of potential GDP)		-6.0	-2.6	-0.6	-1.2	-0.9
Employment		-1.3	1.5	2.4	0.8	0.4
Unemployment rate (% of labour force)		7.3	7.1	6.2	6.3	6.2
GDP deflator		2.2	2.5	5.4	6.2	3.2
Harmonised index of consumer prices		0.6	2.8	9.1	6.7	3.4
Harmonised index of core inflation[3]		1.0	1.7	4.7	6.0	3.7
Household saving ratio, net (% of household disposable income)		13.0	10.6	7.1[1]	6.9	6.3
Current account balance (% of GDP)		2.8	4.0	1.2	2.4	2.6
General government fiscal balance (% of GDP)		-6.9	-4.9	-3.5	-2.9	-2.3
Underlying general government fiscal balance (% of potential GDP)		-2.9	-3.3	-3.1	-2.6	-2.2
Underlying government primary fiscal balance (% of potential GDP)		-1.7	-2.1	-1.6	-1.1	-0.6
General government debt, Maastricht definition (% of GDP)		93.5	91.3	87.4	86.9	86.7
General government net debt (% of GDP)		69.5	64.3	52.0	51.8	51.7
Three-month money market rate, average		-0.3	-0.4	1.0	3.8	3.9

Note: Data refers to European Union member countries that are also members of the OECD (22 countries).
1. OECD estimates.
2. Contribution to changes in real GDP.
3. Index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 113 database.

Trade-related tensions remain a concern. The standoff between the United States and China goes on and the cumulative coverage of goods-related import restrictions imposed by G20 countries has increased, including new export restrictions on food, animal feed and fertilisers. Medium-term risks to growth and inflation related to the ongoing fragmentation of global value chains are also rising.

The scale and duration of the monetary tightening required to durably lower inflation is uncertain. Continued cost pressures or an upward drift in inflation expectations could require the ECB to keep policy rates higher for longer, further dampening growth and potentially exposing financial sector vulnerabilities. Potential losses at banks or non-bank financial institutions from loan defaults or residential and commercial real estate exposures could intensify the drag on economic activity. On the upside, a durable and timely conclusion of the war in Ukraine could alleviate upward pressure on energy and food prices. A stronger recovery in China could also add to external demand.

Table 1.3. Events that could lead to a major deterioration in the outlook

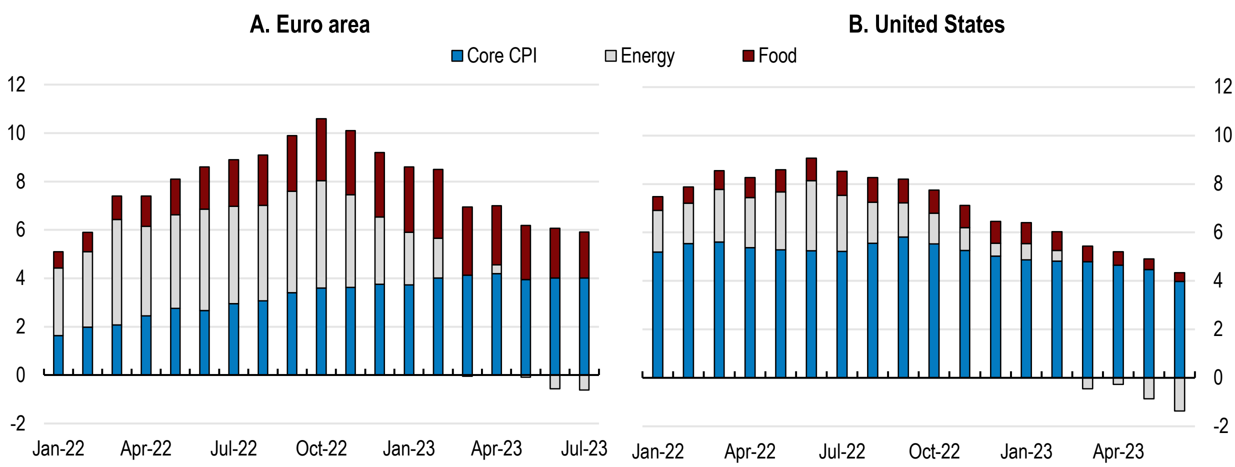
Vulnerability	Possible outcomes
The energy crisis may be rekindled by higher demand for LNG from China or unintended effects on global supply of Western sanctions on Russian oil.	A new energy price shock could lead to another spike in consumer prices, necessitating additional monetary policy tightening and dampening growth.
Trade tensions may deteriorate further, extending the scope of export restrictions.	Further fragmentation of global supply chains and barriers to trade would weigh on growth and contribute to inflationary pressures.
Interest rates may need to be higher for longer to durably reduce inflation.	Bank and non-bank losses from defaulting loans and real estate exposures could necessitate write-offs, further limiting lending, dampening growth and exposing existing financial sector vulnerabilities.

Monetary policy is broadly appropriate but financial risks are increasing

Headline inflation in the euro area remains to a large extent driven by supply-side factors (Figure 1.11). Despite lower-than-expected energy inflation at the end of 2022, food and energy prices remain the largest contributors to euro area headline inflation. At the same time, core inflation has continued to increase. The share of core items registering monthly inflation rates above their typical monthly patterns increased in December to well above 80%, the highest level in 2022 (European Commission, 2023[10]). However, interpreting the increase in inflation as demand-driven or supply-driven is not straightforward and the price changes in most cases reflect a mix of both factors, at least in OECD economies (Barnard and Koh, 2023[11]). The ECB also finds that the initial surge in core inflation in the euro area was mainly supply-driven but that supply and demand factors have played broadly similar roles in recent months (Gonçalves and Koester, 2022[12]).

Figure 1.11. Headline inflation mainly reflects a negative terms-of-trade shock from energy and food

Contributions to annual inflation growth, percentage points



Note: Food includes non-alcoholic beverages. Euro area includes 19 countries.
Source: OECD Price Statistics database; and Eurostat.

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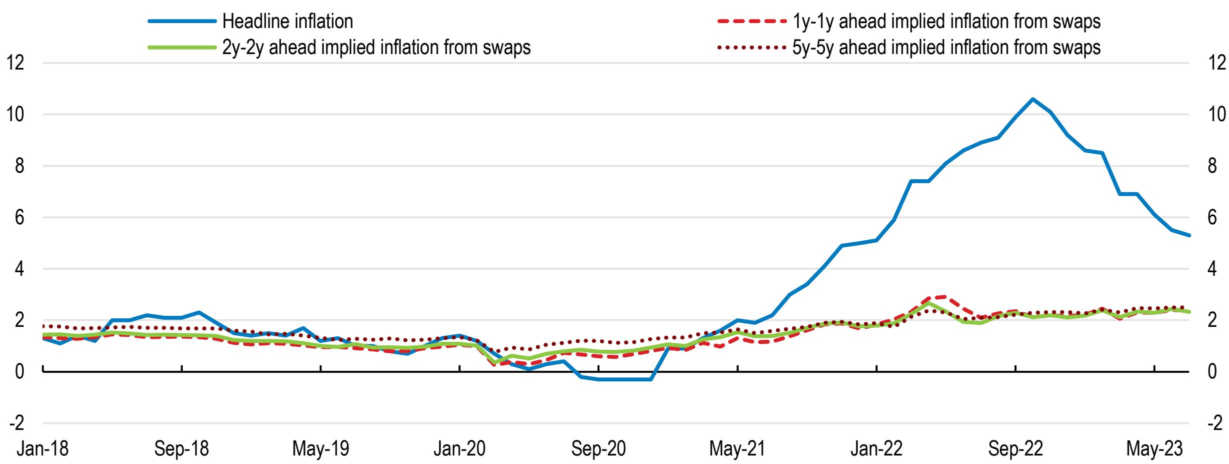
The ECB should continue its data-dependent approach to policy

Beyond the demand-driven part of the inflation spike, the standard monetary policy prescription is to "look through" supply shocks that are not assessed to leave a lasting effect on potential output (Bodenstein, Erceg and Guerrieri, 2008[13]). However, negative supply shocks from high energy prices and the war may turn out to be persistent or even permanent, durably reducing potential output. In such a situation, monetary policy tightening is necessary to align demand with permanently lower productive capacity. In addition, and notwithstanding the implications for potential output, monetary policy should react strongly if supply shocks risk de-anchoring inflation expectations (Brainard, 2022[14]). While simple in theory, this policy is difficult to implement, due to the challenges of assessing potential output in real time – even more so when uncertainty is high and more muted policy reaction may be warranted (Orphanides, 2003[15]).

In the current situation, the need to anchor inflation expectations may be stronger than the considerations regarding the negative effects on output. When inflation is already high, prolonging the period of high inflation increases the risk that inflation expectations adjust upward, putting medium-term price stability at risk (Schnabel, 2022[16]). Although market-based measures suggest that inflation expectations remain anchored, they appear to be pointing to a prolonged period of above-target inflation (Figure 1.12). Survey-based measures of short-term inflation expectations paint a similarly concerning picture. Inflation expectations of households in the euro area have been trending upwards for several quarters and surveys among professional forecasters remain similarly elevated (Figure 1.13).

Figure 1.12. Market-based inflation expectations appear above the 2% target

Headline inflation and inflation expectations from swaps, 12-month % change



Note: Data refer to the euro area including 19 countries.
Source: Refinitiv; and Eurostat

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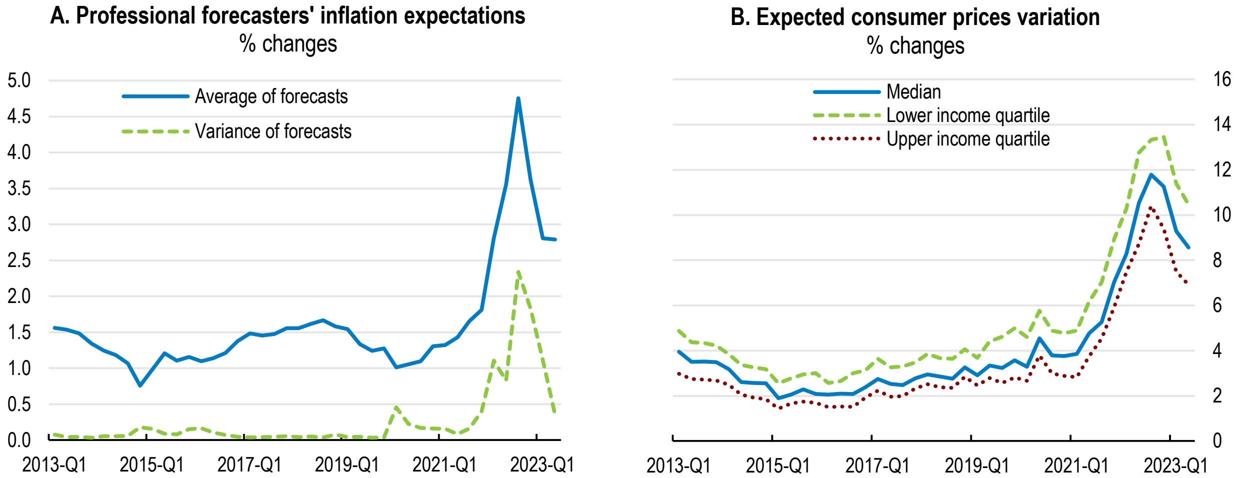
Second-round inflation effects must be minimised, as they could prolong the costly period of disinflation and potentially trigger a wage-price spiral. Judging from the past, the risks appear limited. The comparison of 22 historical episodes similar to the current situation, characterised by rising inflation, positive nominal wage growth, declining real wages, and declining unemployment, shows that wage-price spirals did not take hold on average (IMF, 2022[17]). Instead, inflation edged down and the unemployment rate stabilised following such episodes, mostly driven by monetary policy tightening, which helped to keep inflation contained. The post-COVID-19 episode also provides only limited evidence that most advanced economies may be entering a wage-price spiral, while profit margins may have increased in some sectors. The correlation between wage growth and inflation has declined over recent decades and other institutional factors, such as the high degree of firms' pricing power, declining collective bargaining power and falling trade union membership seem to be limiting the risk of a wage-price spiral developing (Boissay et al., 2022[18]).

Figure 1.13. Survey-based short-term inflation expectations have also increased



Note: Data refer to the euro area aggregate. In Panel A, data are based on the ECB Survey of Professional Forecasters (SPF) and refer to the inflation expectations for the next 12 months. In Panel B, data refer to the responses to the question "By how many per cent do you expect consumer prices to go up/down in the next 12 months?" contained in the European Commission Consumer opinion survey.
Source: ECB Survey of Professional Forecasters; European Commission, Business and consumer surveys, https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/business-and-consumer-surveys_en ; and OECD calculations

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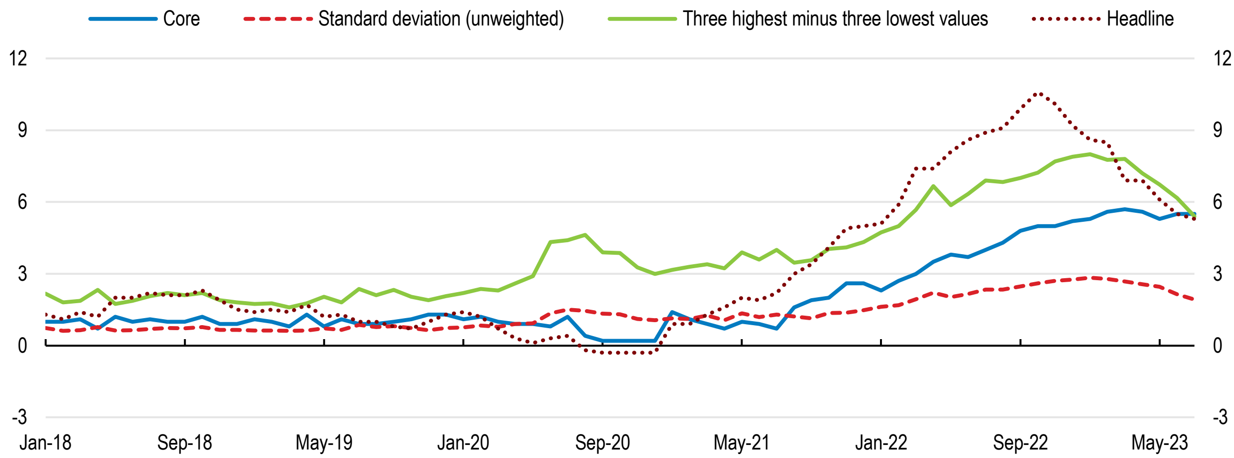
However, important caveats point to the need for continued vigilance. Data patterns from the past may not be representative of current circumstances, especially if the COVID-19 shock caused a large structural break. Differences across economies and over time in structural factors, such as union density, coverage and centralisation of wage bargaining may affect wage-setting processes. Policymakers may need to respond aggressively to supply-side shocks, especially when inflation is high and rising (IMF, 2022[17]). The risk of a wage-price spiral also depends on how firms and workers form their expectations for wages and prices. More adaptive and backward-looking expectations will require stronger monetary policy responses to reduce the risks of de-anchoring. Finally, the flat profile of nominal wages in the wake of an inflationary shock cannot be taken for granted. Wage pressures are rising in euro area more broadly, especially in countries with persistent shortages of labour (for example in Germany) or semi-automatic wage indexation (as in Belgium, Luxembourg). The impact of high inflation has been discernible in the latest wage agreements in Germany (Deutsche Bundesbank, 2023[19]) or has been projected to translate into hourly labour cost growth in the private sector of 8.5% p.a. in 2023 in Belgium (NBB, 2022[20]).

Although risks around the growth outlook have become more balanced, risks to inflation remain skewed to the upside. While headline inflation has peaked, core inflation in the euro area is still trending upward and becoming more dispersed (Figure 1.14). Core inflation appears sticky despite a swift and considerable tightening of financial conditions suggesting that changes in policy rates in the euro area are being quickly reflected in credit conditions and yields on market-based debt (Figure 1.15). The stickiness of core inflation may reflect expectations of a shallow economic slowdown partly driven by decreasing energy prices following the successful replacement of energy imports from Russia.

Moreover, bringing inflation under control may involve output losses. Looking at the historical record, there seems to be no post-1950 precedent for a sizeable disinflation induced by the central bank in the United States, Canada, Germany or the United Kingdom that does not entail substantial economic sacrifice or a recession (Cecchetti et al., 2023[21]). Analysis of the sacrifice ratios – the increases in slack associated with reductions in inflation – during large disinflationary episodes in the United States and other major economies seems to suggest that disinflation is always accompanied by a recession, although the costs of disinflation can differ markedly across episodes. Disinflation is further complicated by the strong labour market with record-low unemployment rate and historically high job vacancy rate (Figure 1.16). This situation suggests strong aggregate activity, at least given the current state of supply-side constraints, as well as difficult labour market matching, due to both higher reallocation needs and a lower matching efficiency. Given that structural factors, such as labour reallocation and matching efficiency, cannot be influenced by monetary policy, the decrease in inflation seems unlikely without a corresponding increase in the unemployment rate in the short run (Blanchard, Domash and Summers, 2022[22]). At the same time, the Beveridge curve dynamics in the EU may be more benign, reflecting the widespread use of job-retention schemes during the pandemic (Lam and Solovyeva, 2023[23]).

Figure 1.14. Headline inflation has peaked but core inflation continues to trend upwards

Consumer price inflation, 12-month % change.



Note: Data refer to the euro area including 19 countries. Core inflation excludes volatile energy, food, alcohol and tobacco prices.
Source: Eurostat Harmonised index of consumer prices (HICP) database; and OECD calculations

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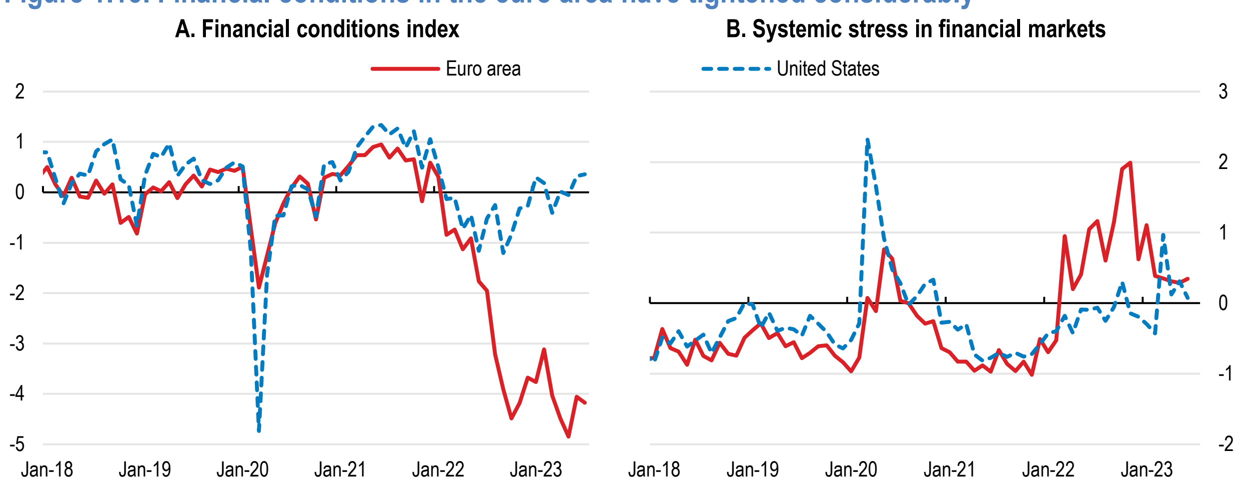
Figure 1.15. Financial conditions in the euro area have tightened considerably



Note: The Bloomberg Financial Conditions Index (FCI) is an equally weighted sum of sub-indexes that track financial stress in money, bond and equity markets. The index assesses both the availability of financing and its cost. The FCI is standardised to show the number of standard deviations above or below its average value from 1994 (for the US) and 1999 (for the euro area) to mid-2008 (the Z-score). Hence, a positive (negative) value indicates expansionary (restrictive) financial conditions compared to the level prior to the Global Financial Crisis. Data are shown up to July 2023.
Financial markets stress for the euro area is the ECB composite indicator of systemic stress combining 15 mainly market-based financial stress measures. For the US, it is the Kansas City Financial Stress Index based on 11 financial market variables. The indicators are standardised to show the number of standard deviations above or below their average value over the period 2007-2023. A positive (negative) value indicates high (low) systemic stress in the financial markets. Data are shown up to June 2023.
Source: Bloomberg; Refinitiv; and OECD calculations.

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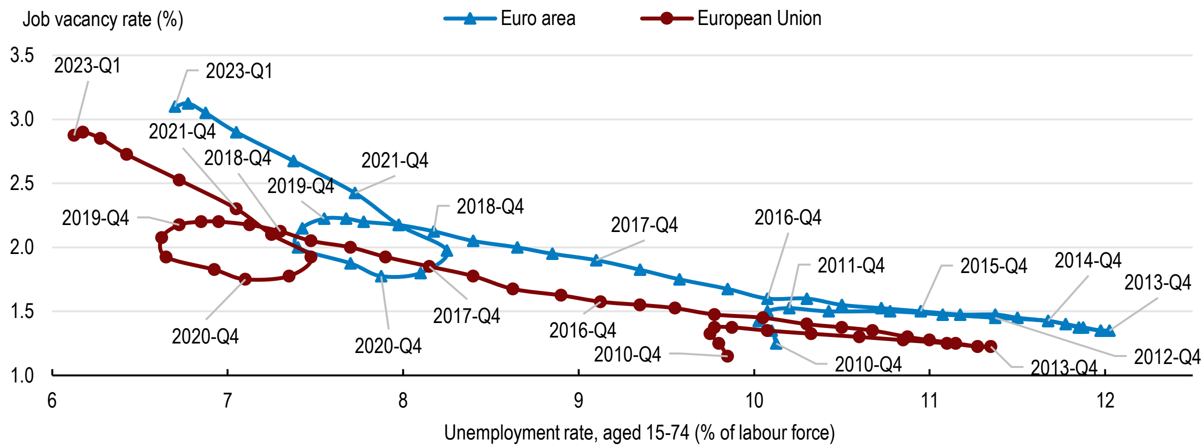
Figure 1.16. The high number of vacancies suggests costly disinflation



Note: Four quarter moving average rates. Data refers to the euro area including 20 countries and to the 27 EU Member countries.
Source: Eurostat Job Vacancy Statistics database; Eurostat Labour Market Statistics database; and OECD calculations.

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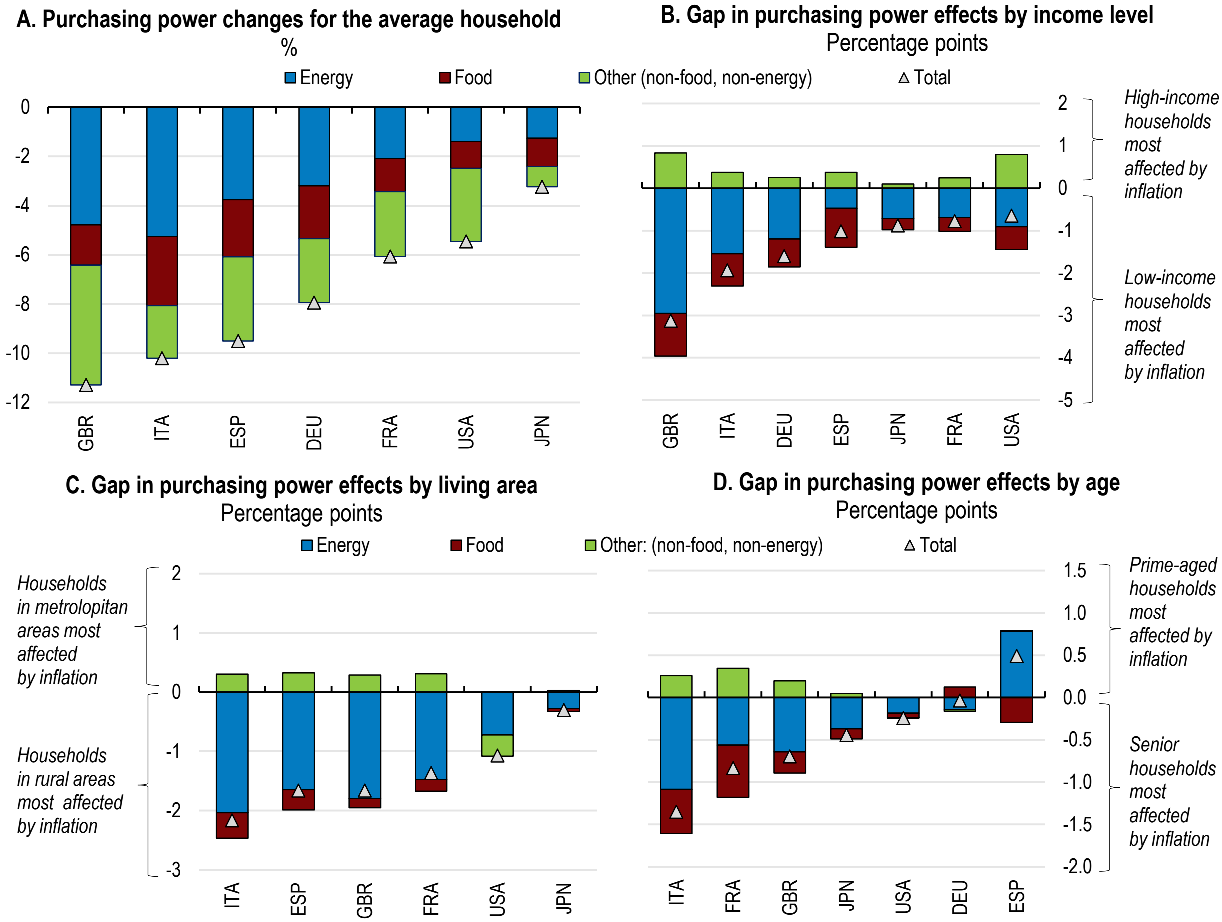
The ECB should stay determined to bring inflation back to target in a timely manner to prevent current high inflation from becoming entrenched in expectations. This requires clearly communicating the risks that inflationary pressures may be more persistent than expected and that a restrictive monetary policy stance will continue until there evidence of a sustained decline in inflation. The ECB needs to keep raising interest rates for as long as needed to put inflation back on a sustainable path towards the 2% target, which implies tightening monetary policy by more if fiscal policy stays overly accommodative. Determined policy action by the ECB has already led to a considerable tightening of the policy interest rates, which is projected to continue. The restrictive monetary policy stance is welcome. Given the high degree of uncertainty about the speed at which higher interest rates take effect and the potential spillovers from policy in other countries, a carefully calibrated approach based on incoming data is appropriate.

Inflation has distributional implications, but they are beyond the ECB's mandate

The effects of high inflation are more pronounced for low-income households. The global negative price shock following the Russian aggression against Ukraine had heterogenous inflationary effects across countries and households. The effects across countries depended on the role of Russian energy imports in overall energy needs and availability of alternative energy sources. The effects across households varied due to differences in consumption shares between low-income and high-income households, differences in the goods and services within each consumption category and differences in the ability to buffer cost-of-living increases through savings or borrowing (Causa et al., 2022[24])

The difference between the inflation rate in the lowest and highest income quintiles has been negligible between 2011 and 2021, but it increased sharply from 0.1 percentage points in September 2021 to 1.9 percentage points in September 2022 (Osbat et al., 2022[25]). The effect on the purchasing power of the average household has been mainly driven by energy and food prices (Figure 1.17, Panel A). Low-income and rural households, and the elderly were generally more exposed to the price shock than the average household, although purchasing power losses of these groups are heterogenous across countries (Figure 1.17, Panels B, C, D). Living on low income is often not the most important vulnerability compared to living in a small, isolated village and being elderly, which are both major vulnerability factors. Differences in energy spending are indeed more pronounced across place of residence than across households' incomes. At the same time, differences in energy spending do not systematically vary with age in all countries. For example, in Spain the elderly are less affected by energy prices than prime-aged persons.

Figure 1.17. Distributional effects of inflation are highest for low-income, rural, and senior households



Note: Data show the average household's decline in purchasing power following changes in consumer prices between August 2021 and August 2022. In Panels C and D, data show the gap in purchasing power (following changes in consumer prices) between two household types, namely low- relative to high-income, living in rural relative to living in metropolitan areas, and senior relative to prime-aged, respectively.
Source: (Causa et al., 2022[24])

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Since only governments have the mandate and tools to address distributional issues (Schnabel, 2022[16]), central bank policy cannot substitute for effective social security and other fiscal assistance. Including inequality as a specific mandate could also threaten central bank's independence. Hence, the ECB should continue focussing on its primary objective of maintaining price stability, and, without prejudice to that objective, on other objectives laid out in the Treaty on the Functioning of the EU.

One such example is the ECB's role in supporting the green transition. Climate change mitigation requires mainly policies by governments. However, as far as the primary mandate of price stability allows, the ECB is contributing to this effort by incorporating climate change considerations into its monetary policy framework (Box 1.2). This effort for incorporating climate change is an ongoing project and may require adjustments as monetary policy changes. For example, the ECB implements the changes to its corporate bond portfolio through adjustments to reinvestments of maturing securities. The ongoing reduction in reinvestments will constrain the ECB's ability to decarbonise its corporate bond portfolio and may have to be replaced by another policy, possibly based on the stock-based approach. Similarly, the measures limiting the share of marketable assets issued by entities with a high carbon footprint that can be pledged as collateral are expected to have initially only a small impact on ECB counterparties (Schnabel, 2023[26]).

Box 1.2. Greening the ECB’s monetary policy operations

The measures incorporating climate change into ECB monetary policy operations follow the ECB’s climate action plan and include rules for corporate bond purchases, collateral framework, disclosure requirements and risk management. Their aim is to reduce climate-related financial risks on the Eurosystem’s balance sheet, encourage transparency and assist in the transition to a greener economy. They are implemented without prejudice to the ECB's primary objective of price stability. In particular, the following measures have been adopted:

- **Corporate bond holdings:** in October 2022, the ECB started gradually decarbonising its corporate bond holdings by tilting them towards issuers with lower greenhouse gas emissions, more ambitious carbon reduction targets and better climate-related disclosures. Tilting is to be implemented through the reinvestment of the sizeable redemptions expected over the coming years. At the same time, the volume of corporate bond purchases will continue to be determined solely by monetary policy considerations.
- **Collateral framework:** before the end of 2024, the ECB plans to limit the share of assets issued by issuers with a high carbon footprint that can be pledged as collateral when borrowing from the ECB. This measure, at first applying only to marketable debt instruments of non-financial corporations, will reduce climate-related risks in Eurosystem credit operations. Additionally, the ECB has started in 2022 to consider climate change risks when reviewing haircuts – reductions to the value of collateral reflecting its riskiness – applied to corporate bonds.
- **Climate-related disclosure requirements for collateral:** depending on the implementation date of the Corporate Sustainability Reporting Directive (CSRD), probably from 2026, the ECB will only accept marketable assets and credit claims from companies and debtors that meet the Corporate Sustainability Reporting Directive (CSRD). This will help improve disclosure and generate better data for financial institutions, investors and civil society. Since a significant fraction of the assets that can be pledged as collateral, such as asset-backed securities and covered bonds, do not fall under the CSRD, the ECB will continue to encourage further disclosures of climate-related data.
- **Risk assessment and risk management:** the ECB will continue to improve its risk assessment tools and capabilities related to climate-related risks. By the end of 2024, the Eurosystem will also start using common minimum standards for national central banks’ assessment of climate-related risks for credit rating purposes.
- **Statistics on climate-related risks and green finance:** to improve awareness regarding the climate-related risks in the financial sector and better monitor developments in green finance, the ECB in January 2023 published a first set of climate-related statistical indicators, covering indicators on sustainable finance, carbon emissions and physical risks.

The effect of these policy announcements and actions can already be seen in the bond markets. For example, following the announcement of the ECB’s climate action plan at the end of the 2021 Monetary Policy Strategy Review, yields-to-maturity of green bonds eligible for ECB operations decreased compared to equivalent conventional bonds. Furthermore, green bond issuance by firms incorporated in the euro area increased.

Source: ECB (2022[27]); Eliet-Doilet and Maino (2022[28]).

Unconventional policies should be gradually withdrawn

Following the increases in policy interest rate, which remains the key instrument for setting the monetary policy stance, the ECB has also started a gradual and predictable reduction of its monetary policy bond portfolio. The pace of reduction amounts to EUR 15 billion per month on average from March to June 2023, followed by discontinuation of reinvestments under the ECB's Asset Purchase Programme from July 2023. At the same time, the ECB's flexibility built into the Pandemic Emergency Purchase Programme, the Transmission Protection Instrument and the Outright Monetary Transactions, allow swift responses to potential fragmentation in financial markets that would hamper monetary policy transmission.

However, the withdrawal of the monetary stimulus provided by the ECB's large-scale asset purchases may entail some risks. Looking at the experience with the Fed's reversal of asset purchases since 2017, there seems to be no matching decrease in the balance sheet of commercial banks, including reductions in bank deposits and outstanding credit lines to corporations. This could make the financial sector more sensitive to potential liquidity shocks and necessitate further liquidity provision by the central bank, as happened in the United States during the repo spike episode in September 2019 and the dash for cash in March 2020 (Acharya et al., 2022[29]).

Banks' asymmetric responses to the provision and withdrawal of monetary stimulus need to be closely monitored and managed. There are different reasons why banks may react differently to quantitative easing, which seems to expand claims on liquidity, and quantitative tightening, which does not appear to reduce these claims. One possibility is that quantitative easing, unlike quantitative tightening, had both market liquidity effects and additional effects from signalling the easier monetary policy stance when rates were at the effective lower bound. Another is moral hazard, as banks rely on the central bank to repeat its past interventions when market liquidity seizes up, or an unintended effect of regulation, where new rules could have succeeded in making banks hold reserves but made it cheaper to finance reserves with new claims on liquidity, such as credit lines (Acharya et al., 2022[29]). The discrepancy between aggregate claims on liquidity and aggregate reserves needs to be monitored and, if excessive, its levels should be managed counter-cyclically.

The appropriate speed of the ECB's quantitative tightening and the modalities, under which the unconventional measures are withdrawn, remains uncertain. It is possible that quantitative tightening is progressing too slowly. Relying on short-term rate increases without quickly reducing central bank balance sheets is likely to increase the interest rate exposure of the central bank, leading to losses on existing positions. Without the demand-reducing effects of balance sheet reduction, it is also possible that short-term interest rates will have to rise higher than would otherwise be needed (Turner, 2022[30]). To reduce uncertainty and limit interest rate increases, the ECB could provide a quantified medium-term strategy of asset sales together with a contingency plan for responding to large or disruptive movements in market rates. The existing instruments, such as the Transmission Protection Instrument, which aims at preventing unwarranted financial market dynamics threatening monetary policy transmission, could be complemented by contingency plans for dealing with other possible shocks.

Higher interest rates are beginning to weigh on the economy

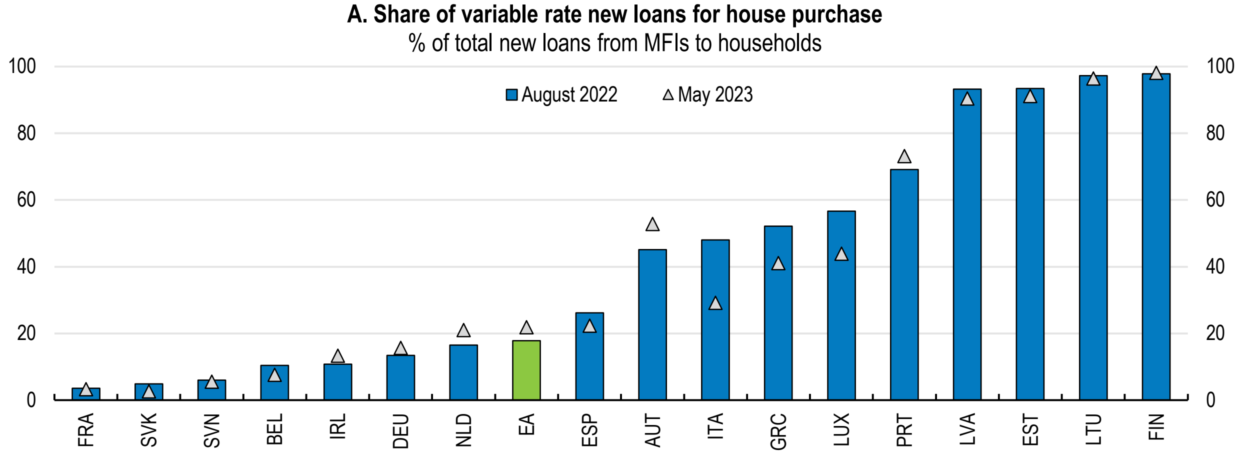
Higher policy interest rates have triggered repricing across asset classes and generated sizeable unrealised losses on the bond portfolios held by financial institutions. Although banks tend to benefit from higher interest rates on aggregate, as profitability increases, this may not be the case for all banks. Strains from tighter monetary policy have appeared in parts of the banking sector and could intensify as monetary policy continues to tighten, especially among nonbank financial intermediaries, such as pension funds and insurers (Garcia Pascual, Natalucci and Piontek, 2023[31]). Bank lending has moderated across euro area countries, reflecting decreases in both supply and demand. On the supply side, euro area banks made sizeable voluntary repayments of loans from Targeted Longer-Term Refinancing Operations (TLTRO) between November 2022 and February 2023. In addition, tighter credit standards reflect higher risk perception and declining risk tolerance of banks. Loan demand by firms has decreased due to weakening fixed investment, while falling strongly for households across euro area countries. Weak loan demand of households reflects higher lending rates as well as lower consumer confidence and deteriorating prospects in the housing market (ECB, 2023[32]).

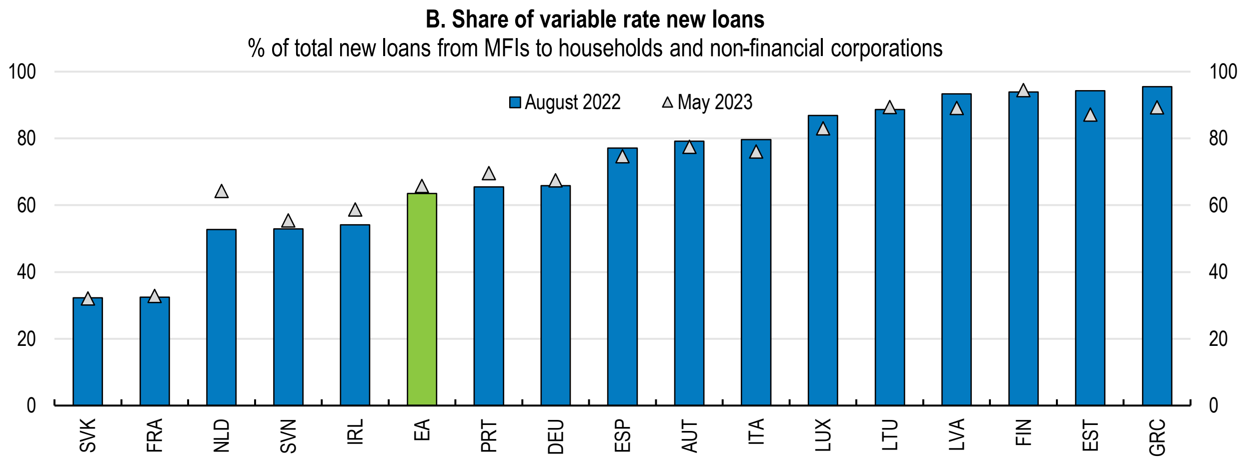
Rising interest rates on mortgages amplify the financial vulnerability of households, especially in countries with a high level of private debt and high shares of variable rate mortgages. Bank lending rates for household mortgages similarly continued to rise, reaching more than 3% per annum in January 2023, up from 1.33% the year before, while consumers expect them to increase further over the next 12 months. Higher rates on new mortgages and declining real incomes have led to a sharp fall in the demand for mortgages. The impact of higher interest rates on the housing sector is still building up and will continue to weigh on growth. The drag on growth will come through negative effects on residential investment, especially in countries with a high share of variable rate loans, and on consumption, by reducing disposable income and housing wealth. These developments in the residential housing sector pose financial stability risks, too. While the share of homeowners with a mortgage is relatively low in large euro area countries, the share of variable rate mortgages has recently increased (Figure 1.18, panel A). The increased share of variable rate mortgages points to growing exposure of euro area households to rising interest rates (Figure 1.18, panel B).

House prices in the EU have been resilient in the first half of 2022 but started to decline in most EU countries in the last quarter of 2022. Since the trough in 2013, house prices have been increasing steadily and the COVID-19 pandemic further accelerated this trend (Figure 1.19, panel A). In many countries, house prices decoupled strongly from rental prices (Figure 1.19, panel B). The Commission's methodology indicates that house prices are now overvalued in more than a half of the euro area countries (Frayne et al., 2022[33]) and more substantial correction cannot be ruled out, despite favourable labour market conditions and the borrower-based macroprudential measures introduced recently in many countries (ECB, 2022[34]). While higher interest rates may impair households' ability to repay their variable rate mortgages, a housing market correction would lower the value of collateral and require banks to provision against potential losses. Hence, the residential real estate risks need to be carefully monitored. If needed, these risks should be addressed by further macroprudential tools, such as increasing capital buffers and additional tightening of borrower-based measures (Valderrama, 2023[35]), while avoiding procyclical effects.

In some countries, both households and firms are highly indebted and thus vulnerable to increases in financing costs. High levels of non-financial corporations' debt threaten a wave of bankruptcies. The number of bankruptcies among EU firms increased steadily in the fourth quarter of 2022. This was partly driven by a restart of courts' activity after the pandemic and the withdrawal or phase-out of fiscal support (Figure 1.20). The situation varied across countries, but the largest increase in bankruptcies was in services sectors, such as accommodation and transportation, partly reflecting withdrawal of the pandemic support. In addition, cyclical risks related to heightened inflation and tighter financing conditions in the commercial real estate sector have increased, with potential systemic impact on the financial system and the real economy (ESRB, 2023[36]). The cyclical factors are exacerbated by a shift towards e-commerce, increased demand for flexibility in leasable office space related to a rise in mobile and hybrid working models as well as climate-related policies, such as stricter building standards.

Figure 1.18. Variable rate mortgages and loans are common in many countries





Note: Euro area includes 19 countries. Variable rate loans include loans with floating rate or initial rate fixed for a period of up to 1 year. In Panel A, November 2021 for Greece instead of August 2022. In Panel B, July 2022 for Finland and Luxembourg, and June 2022 for Greece instead of August 2022.
Source: ECB; Eurostat; and OECD calculations.

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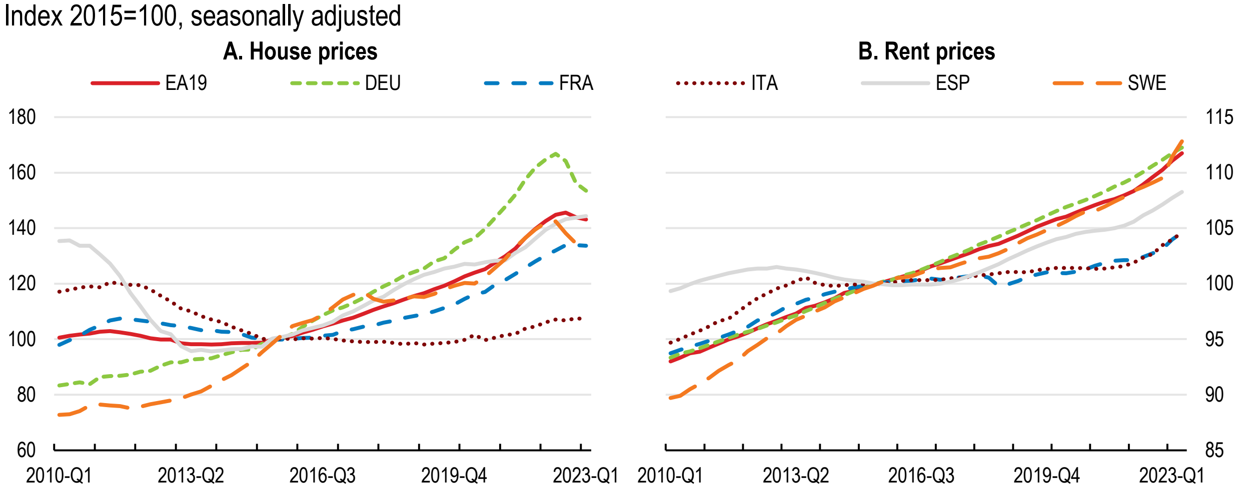
Figure 1.19. House prices have deviated strongly from rent prices in most countries

Index 2015=100, seasonally adjusted



Note: In panel A, the latest observation is 2023Q1. In panel B the latest observation is 2023Q2.
Source: OECD Price Statistics database; and OECD calculations.

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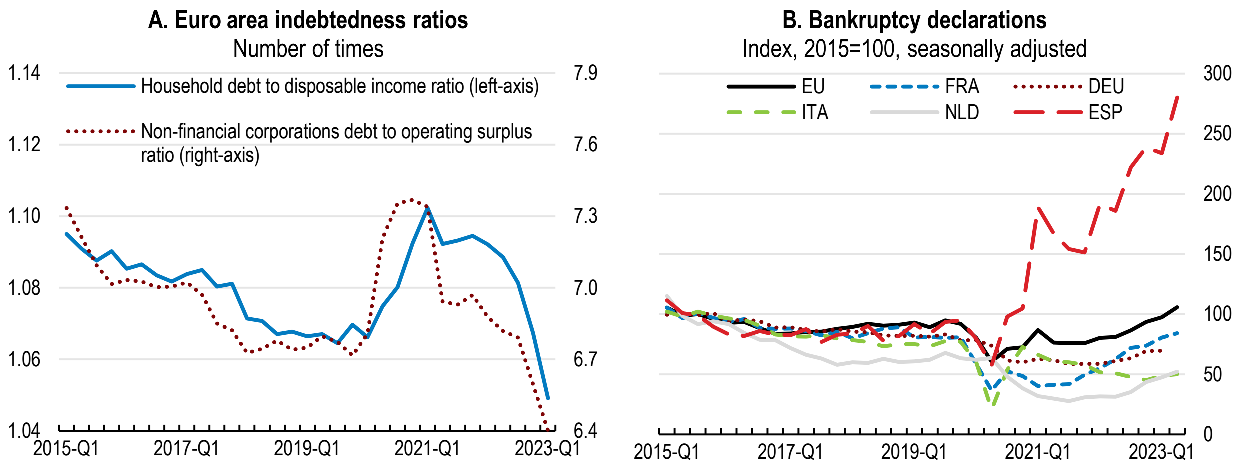
Figure 1.20. Households and firms remain highly indebted, and bankruptcies are increasing



Note: In Panel A, data refer to the euro area including 19 member countries. Debt is computed as the sum of the following liability categories in the financial balance sheet of the institutional sector: currency and deposits (AF2), debt securities (AF3), loans (AF4), insurance, pension, and standardised guarantees (AF6), and other accounts payable (AF8).
Source: Eurostat Financial Balance Sheets database; Eurostat Non-financial Transactions database; Eurostat Business Registration and Bankruptcy Index database; and OECD calculations.

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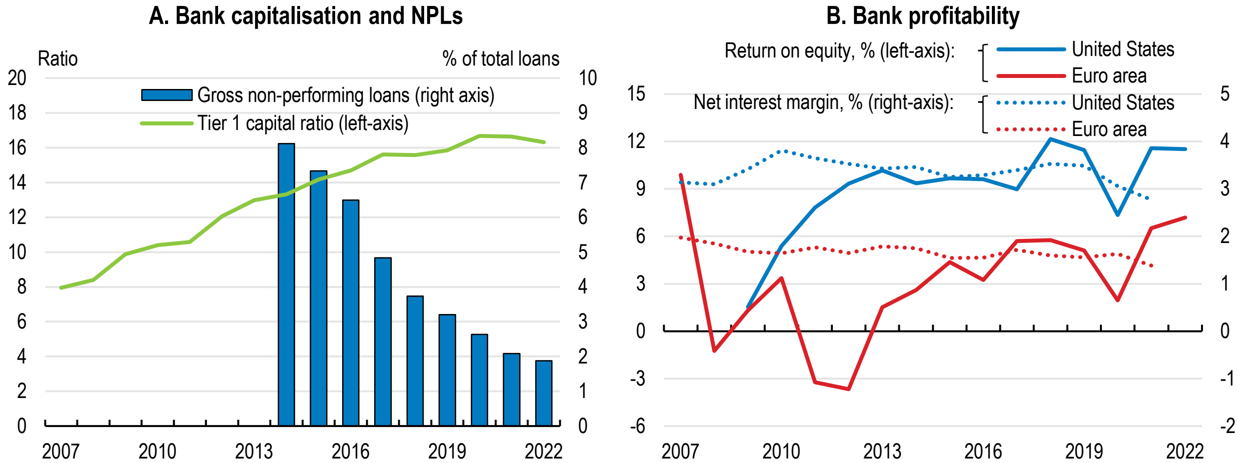
Macroprudential tools can help increase resilience to financial sector risks from private debt exposures. Preserving and building up macroprudential buffers could support the resilience of banks and other credit institutions by strengthening their ability to absorb losses. Macroprudential buffers should be used in conjunction with other tools, such as prudent risk management practices, and set according to country-specific macro-financial outlooks and banking sector conditions to limit procyclicality (ESRB, 2022[37]). Even at the current late stage of the financial cycle, countries with macro-financial imbalances may increase macroprudential buffers, taking into account the existing levels of capital and the ability of banks to generate profits (ECB, 2022[34]). For example, further build-up of releasable buffers, such as the countercyclical capital buffer, may be desirable when conditions allow. These buffers can be released immediately when adverse developments materialise, improving the capacity of authorities to provide relief to the banking sector.

Financial sector integration needs to be stepped up

Overall, European banks hold good quality assets, although the recent market tensions led to a large fall in bank equity prices, increasing the cost of new capital. In addition, the recent deterioration in loan portfolios of banks suggest an increase in credit risk. Until recently, rising interest rates have mainly bolstered short-term profitability, reflecting wider profit margins and still limited loan loss provisions. However, bank profitability may worsen if market turmoil intensifies and threats to asset quality result in higher provisioning needs and increasing stocks of non-performing loans (Figure 1.21). Since Russia's invasion of Ukraine, loans to energy-intensive firms have seen higher probabilities of default than loans to other firms. With higher interest rates, banks will also face higher credit risks from exposures to residential real estate markets, as erosion of real disposable income and savings through inflation further weakens the debt servicing capacity of households (ECB, 2022[34]).

Figure 1.21. European banks are well capitalised, but profitability is relatively low



Note: In Panel A, Tier 1 capital ratio refers to regulatory Tier 1 capital to risk-weighted assets. In Panel B, net interest margin corresponds to the accounting value of bank's net interest revenue as a share of its average interest-bearing (total earning) assets.
Source: ECB; IMF Financial Soundness Indicators database; and World Bank Global Financial Development database.

StatLink https://stat.link/espwth

Banking sector policies must address long-standing issues as well as new challenges, such as digitalisation and the green transition. Structural weaknesses include low cost-efficiency, limited revenue diversification and overcapacity in parts of the banking sector. Accelerated digitalisation could help remedy some of these issues, albeit at a cost of greater cyber risks (ECB, 2022[34]). The banking sector seems to have too many institutions that are less profitable than competitors. For example, in 2019 the market share of the top five US banks was 43% of consolidated domestic assets, as against 23% in the euro area (Gabrieli, Marionnet and Sammeth, 2021[38]). Consolidation of the banking sector through cross-border mergers could help improve profitability and reduce overbanking. Compared to domestic consolidation, cross-border mergers could enhance the effects of geographic diversification and encourage the emergence of larger European banks better equipped to compete with their international counterparts. In addition, a consolidated, more profitable banking sector would be in a stronger position to finance the transition to a greener economy and deal with its climate-related exposures.

The EU financial system remains highly bank-dominated and fragmented along national lines, which is unlikely to change in the short or medium term. While two pillars of the banking union, the Single Supervisory Mechanism and the Single Resolution Mechanism, are in place, the third pillar – a common deposit protection scheme – has not yet been achieved. Immediate further steps towards the completion of the banking union involve the review of the Crisis Management and Deposit Insurance (CMDI) framework (Eurogroup, 2022[39]). Hence, the recent Commission's proposal to reform the CMDI framework (European Commission, 2023[40]) is a step in the right direction. In addition, the banking union could be deepened by ending the reliance on legislative constraints that ring-fence capital and liquidity of cross-border groups along national lines (Enria, 2022[41]). Progress with the banking union will also help advance the capital markets union (Véron, 2014[42]).

Progress on the banking and capital market union has recently been limited. Some headway has been achieved on bank crisis management, including the proposal for harmonized handling of small and mid-sized failing banks and a parallel evaluation of State aid rules for banks in line with the reformed crisis management framework. Since the June 2022 Eurogroup meeting, no progress has been made on the other streams of work. As for the capital markets union, recent significant developments include steps towards a European Single Access Point for corporate disclosures and a post-trade consolidated tape, as well as a single dataset of prices and volumes for securities traded in the EU, proposed in November 2021. In December 2022, the Commission followed up with proposals regarding EU clearing services, harmonisation of certain corporate insolvency rules and simplifying the administrative burden associated with listing on stock exchanges. These steps are welcome, but they need to be followed by further bold steps to defragment European capital markets, as discussed in the 2021 *OECD Economic Survey of the euro area* (OECD, 2021[43]). Given the multiple trade-offs involved and political sensitivity, the completion of the banking union and capital markets union should be high on the list of priorities for the next Commission after the 2024 European Parliament elections (Table 1.4).

Table 1.4. Monetary and macroprudential policy measures taken since the last Survey

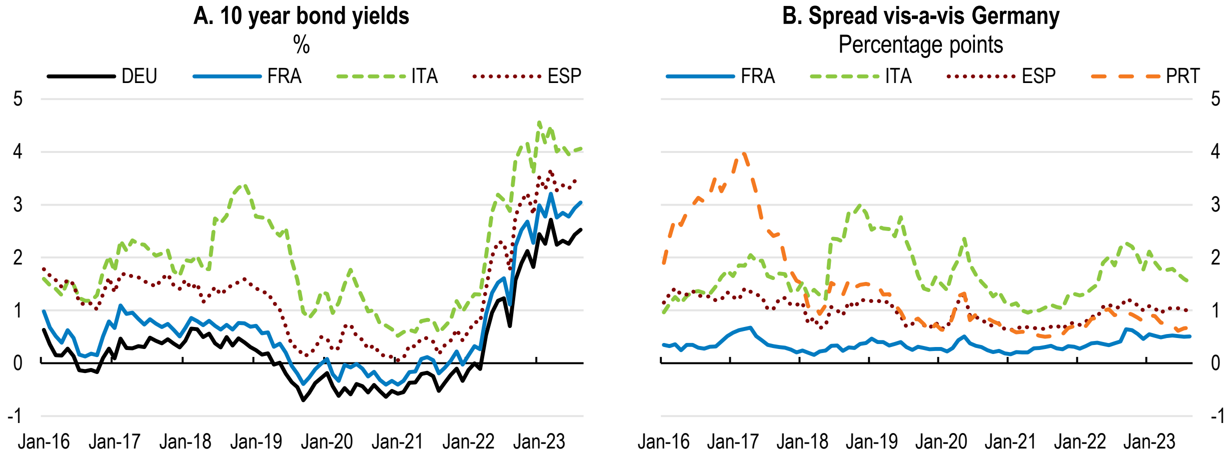
Main recommendations of the 2021 Survey	Action taken since 2021
Keeping monetary policy accommodative	
Continue monetary policy accommodation until inflation robustly converges toward the ECB objective.	In response to the surge in inflation since 2021, the ECB initiated monetary policy normalisation in December 2021 to ensure that inflation returns to the 2% medium-term target. Measures taken include the end of net asset purchases, a cumulative increase in ECB policy rates by 375 basis points, changes to the longer-term refinancing operations, and a gradual reduction of the APP portfolio.
In its next strategic review, the ECB could consider moving towards average inflation targeting in case the inflation objective is not met.	The next strategy review is planned for 2025.
Exit from pandemic-related financial measures should be gradual. Capital and equity buffers should be rebuilt gradually.	Vulnerabilities posing medium-term risks accumulated throughout the pandemic period and relate to residential real estate as well as to strong credit growth and increasing indebtedness in the non-financial private sector. To address them, by end-2022 a significant number of countries participating in European banking supervision decided to gradually rebuild or maintain macroprudential capital buffers (countercyclical capital buffer and a sectoral systemic risk buffer).
Take stock of the effectiveness of recently adopted new tools and the suspension of self-imposed limits to the asset purchase programme, prolonging them if needed.	The ECB evaluates the effectiveness of non-standard monetary policy measures on an ongoing basis. Net asset purchases have stopped in the first half of 2022, a gradual reduction in the APP securities portfolio is taking place since March 2023, while reinvestments are to end in July 2023.
Enhance the economic resilience of the euro area by completing the Banking and the Capital Markets Unions.	As of April 2023, the Commission has completed 14 of the 16 actions to which it committed in the 2020 Capital Markets Union action plan. On the Banking Union, the Commission in April 2023 proposed reviews of crisis management and deposit insurance framework (CMDI), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD). The CMDI review aims at better applying the framework, in particular to small and medium-sized banks, and enhancing the use of industry-funded safety nets.

Fiscal policy needs to become sufficiently restrictive

The challenging economic environment underlines the importance of the appropriate policy mix in the euro area. While the ECB has been tightening monetary policy to keep historically high and persistent inflation under control, fiscal support is being provided to help cushion the impact of high energy costs on households and companies. Short-term fiscal actions to cushion living standards need to avoid a further persistent stimulus to demand at a time of high inflation while maintaining energy saving incentives, thereby ensuring consistency with monetary policy and avoiding adverse effects on fiscal sustainability (OECD, 2022[44]).

Monetary policy tightening has led to higher costs of borrowing for firms and households and also pushed up interest rates on sovereign borrowing. While refinancing costs for governments increased, sovereign bond spreads have remained stable for most countries and even declined for Italy, Greece and the non-euro area EU countries (Figure 1.22). However, the risk remains that, to the extent that governments continue to issue new bonds beyond simply rolling over maturing debt, the excess supply under tightening financial conditions will lead to greater competition for investors' demand, pushing sovereign yields further up (Schroeder and Bouvet, 2023[45]).

Figure 1.22. Sovereign borrowing costs increased while the spreads moderated



Source: Refinitiv; and OECD calculations.

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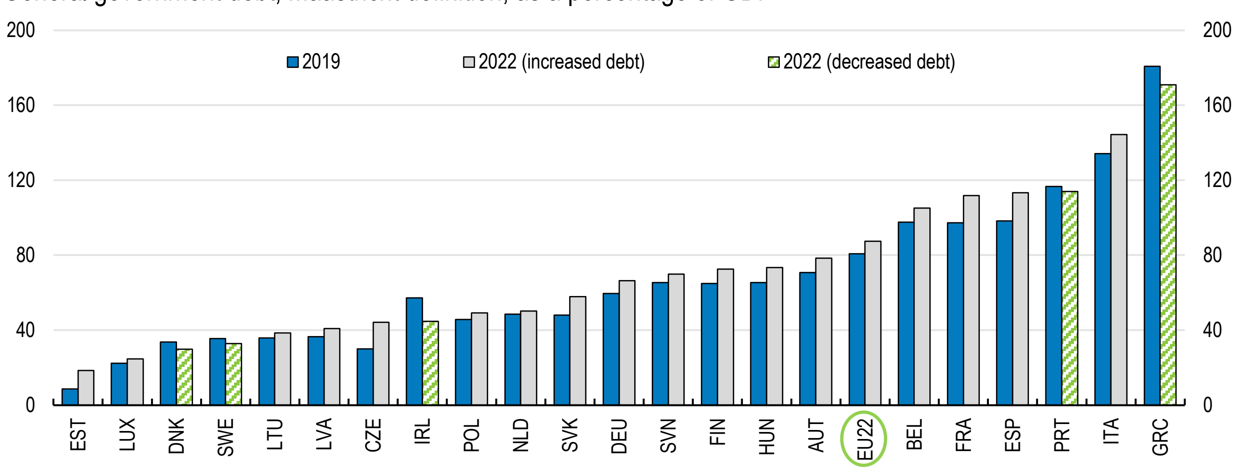
Public debt ratios in the European Union have increased following the disbursement of the unprecedented pandemic and energy crisis support (Figure 1.23). Initially, higher inflation triggered by supply chain disruptions and higher energy and food prices lowered debt-to-GDP ratios, due to a temporary boost in nominal GDP. However, the ensuing decline in real growth, higher interest payments and deteriorating primary deficits eventually pushed up public debt ratios above the pre-pandemic levels.

Figure 1.23. Public debt increased from pre-pandemic levels in most countries

General government debt, Maastricht definition, as a percentage of GDP



Note: Data refers to the European Union member countries that are also members of the OECD (22 countries).
Source: OECD Economic Outlook: Statistics and Projections database

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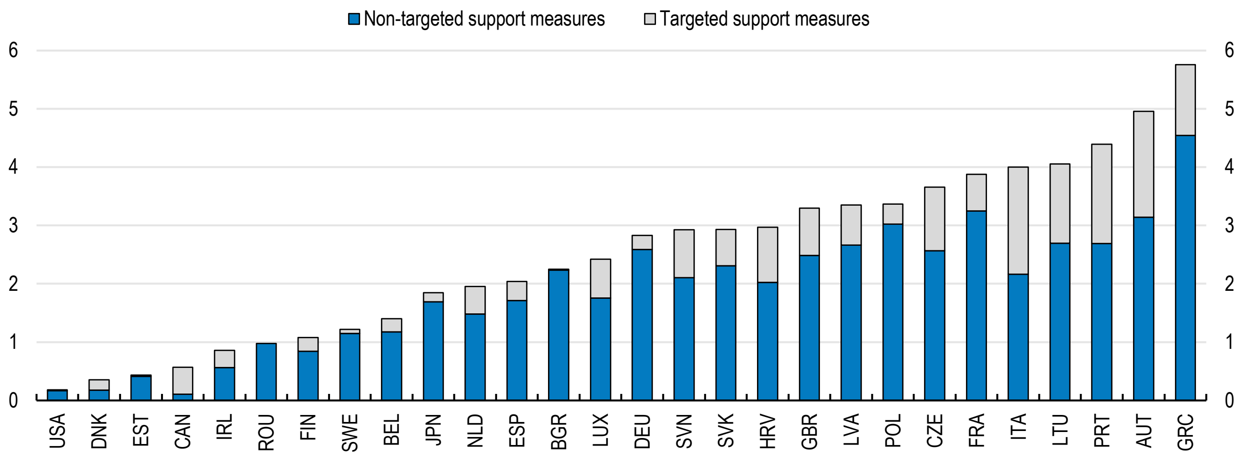
Fiscal support to cushion the impact of high energy costs has been high and mostly untargeted (Figure 1.24). Support to energy consumers amounted to more than 2% of GDP in some EU countries, well above the 0.7% of GDP in the median OECD economy. Price support, such as reduced taxes and reduced or regulated prices, has dominated income support and was largely untargeted. Income support, including transfers and tax credits to consumers, was better targeted to vulnerable households. However, non-targeted income support measures, such as private transportation subsidies for employees driving to work, are not infrequent. Price support measures are relatively simple to introduce and communicate, but they weaken incentives to reduce energy use, provide disproportionate support to better-off households and risk further stoking energy and consumer price inflation as well as its distributional implications. There is a strong case for gradually withdrawing broad fiscal support. Targeted support for vulnerable households inadequately covered by the general social protection system may still be needed, especially since vulnerability to high energy prices also depends on other factors than income, such as the inability to renovate energy-inefficient dwellings and high energy needs due to age or geographical factors (Pisu et al., 2023[46]).

Figure 1.24. Fiscal support during the energy crisis was mostly untargeted

Announced spending on energy support measures, % of GDP, 2022-23



Note: Support measures are taken in gross terms, i.e., not accounting for the effect of possible accompanying energy-related revenue-increasing measures, such as windfall profit taxes on energy companies. Where government plans have been announced but not legislated, they are incorporated if it is deemed clear that they will be implemented in a shape close to that announced. Gross fiscal costs reflect a combination of official estimates and assumptions on how energy prices and energy consumption may evolve when the support measures are in place. Costs are estimates for announced spending over 2022 and 2023, naturally subject to greater uncertainty in the current year. Measures corresponding to categories "Credit and equity support" and "Other" have been excluded. When a given measure spans more than one year, its total fiscal costs are assumed to be uniformly spread across months. For measures with no officially announced end-date, an expiry date is assumed and the fraction of the gross fiscal costs that pertains to 2022-23 has been retained. The current vintage of the database has a cut-off date of 20 April 2023.
Source: OECD Energy Support Measures Tracker

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Ensuring effective targeting going forward may require improvements to existing administrative data along with development of targeted measures that go beyond standard welfare benefits. The digital transformation provides an opportunity to develop agile targeting instruments based on data collection (such as smart meters) and management that leverages innovative digital tools introduced by tax administrations during the COVID-19 pandemic (Causa et al., 2022[24]). However, income support policies based on energy consumption reduce the incentives to save. Over time, priority should be given to investing in capacities for vulnerable consumers to shift their energy consumption to alternative fuels. In addition to targeted support, measures need to shift energy consumption toward clean energy sources consistent with net-zero emission targets. Financial support for energy efficient improvements in housing and use of electric light-duty vehicles are two relevant areas of policy intervention. To promote the use of environmentally friendly vehicles, measures to expand the deployment of charging capacity are needed.

Planned public investment may be delayed

The Next Generation EU (NGEU) programme offers a historic opportunity to foster potential growth and transform the economy, but its implementation may fuel inflationary pressures. The main instrument of the NGEU programme agreed in reaction to the COVID-19 pandemic is the Recovery and Resilience Facility (RRF) financed by joint borrowing at EU level. Governments are correctly addressing the energy crisis through public investment and decisive structural reforms that may boost potential growth and help deliver the green and digital transitions. However, the disbursements under the NGEU and RRF are expected to stay high until the end of the programme in 2026 and elevate public investment. An efficient implementation of the investment projects and reforms envisaged in the National Recovery and Resilience Plans (NRRP) may help reduce the inflationary pressure but will not avoid it completely. Moreover, several euro area countries have postponed their disbursement requests and some structural reforms required as preconditions for paying out the funds needed to be clarified to avoid ambiguities. In other cases, procurement contracts needed to be revised due to high inflation or raw material and labour shortages. The various delays led to an underspending of funds in 2021 and 2022 compared to the initial NRRPs, which may be difficult to correct and could severely test the absorption capacity of the recipient countries.

Experience with the absorption of EU funds from the Multiannual Financial Framework (MFF) suggests caution. By the end of 2020, only 60% of EU funds under the 2014-20 MFF had been absorbed in the four biggest euro area countries. In the previous budget period 2007-13, an additional period of three years was needed to get the absorption rates close to 100%. Given that the NGEU funds, comprising the RRF, other NGEU components and the REPowerEU funds available to euro area countries, amount to almost four times the funding available under the regular 2021-27 MFF (Dorrucci and Freier, 2023[47]), it is possible that the six-year horizon of the RRF will not be sufficient. Moreover, the definition of milestones and targets in the RRF Regulation focuses on inputs and outputs, such as specific reforms and investment plans, rather than on result indicators (Darvas and Welslau, 2023[48]). For example, the positive impact of the RRF on the green transition may not be adequately assured through existing milestones and targets (Hindriks et al., 2022[49]).

Disbursement of the NGEU funds must minimise the risk of overstimulating the economy. The short-term effect of additional public expenditure will add to inflation, which will only be contained in the medium-term, as inflationary pressures associated with the NGEU are offset by the disinflationary effect of greater productive capacity (Bankowski et al., 2022[50]). Moreover, inflationary effects in some countries may be more noticeable. To avoid short-term inflationary effects and support monetary policy tightening, the fiscal policy stance should remain sufficiently restrictive. In this respect, following the activation of the general escape clause under the SGP during 2020-2023, delays in clarifying the EU fiscal framework risk contributing to higher inflation and weakening perceptions regarding the necessary fiscal stabilisation.

The EU budget (multiannual financial framework) is relatively small, just about 1% of EU GDP in annual terms, which is not commensurate with the pursuit of macroeconomic stabilisation objectives. About two thirds of the revenue to the EU budget comes from national budgets. The rest comes from other sources, such as customs duties paid on goods imported from outside the EU and a small percentage of the value added tax collected by each EU country. In principle, the EU budget financed within the multiannual financial framework must be balanced. However, some activities, such as the 807 billion euro for the NGEU and the 99 billion euro for the temporary Support to mitigate Unemployment Risks in an Emergency (SURE) programmes are financed by issuing EU bonds. The EU budget is a key policy tool to support regional growth and convergence. Its largest spending items - cohesion policy and the Common Agricultural Policy (CAP), complemented in the current budgetary period by one-off NGEU spending - share explicit concerns of balanced territorial development, as described in the 2021 *OECD Economic Survey of the European Union* (OECD, 2021[1]).

A broad reform of economic governance is needed

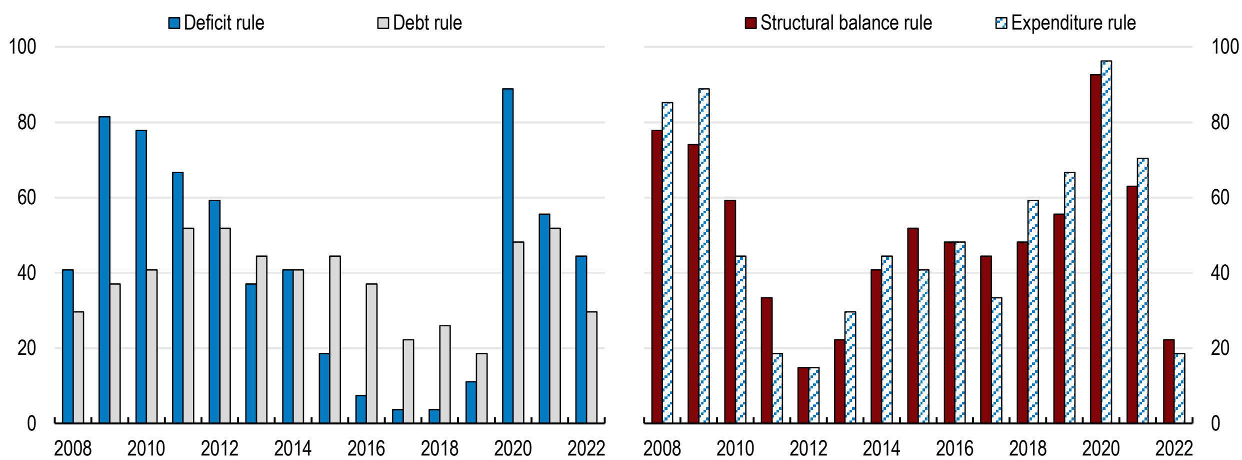
The European fiscal framework has shown some limitations in the past in addressing both sustainability and cyclicality issues in a rule-oriented setting, as discussed in the 2021 *OECD Economic Survey of the euro area* (OECD, 2021[43]). The Stability and Growth Pact (SGP) has gone through substantial evolutions over time to better reflect fiscal policy needs, fill surveillance gaps and improve enforcement. However, increased flexibility was provided at the cost of increasing complexity, with a proliferation of numerical targets and procedures. At the same time, the framework failed to prevent a trend increase in the debt ratio in most countries and to encourage sufficiently countercyclical national fiscal policies. Historically, in the pre-pandemic period, countries with fiscal space tended to have positive output gaps, reducing the need for fiscal stimulus. Conversely, fiscal consolidation in the past was often associated with low public investment as countries prioritised current spending, at the expense of meeting investment needs.

The European fiscal framework interacts with and may be reinforced by market discipline, including through the credit risk premium. It has been argued that in practice market discipline may be too weak, allowing borrowers to run up debts that become increasingly difficult to service. Recent research using data for 71 countries for the period 1981-2015 concludes that, in general, market signals matter more for fiscal discipline than fiscal rules. In addition, in the EU and OECD countries, unlike in emerging economies, market signals tend to reinforce the discipline implied by fiscal rules (Agnello, Castro and Sousa, 2023[51]).

Crucially, compliance with the rules has been partial (Figure 1.25): average compliance with the rules across EU countries between 1998 and 2019, before the activation of the general escape clause, amounted to 64% for the deficit rule and 71% for the debt rule. Compliance was unsurprisingly lower for countries with high debt levels (Larch et al., 2022[52]). Lower compliance rates also tended to go along with a larger country size and a weaker tradition of national independent fiscal institutions (Larch, Malzubris and Santacroce, 2023[53]).

Figure 1.25. Compliance with fiscal rules has been partial

Share of European Union countries non-compliant with EU fiscal rules, per cent



Note: Data refer to the 27 EU Member countries. Compliance rules are the following: (i) deficit rule, a country is considered compliant if the budget balance of the general government is equal or larger than -3% of GDP or, in case the -3% of GDP threshold is breached, the deviation remains small (max. 0.5% of GDP) and limited to one year; (ii) debt rule, a country is considered compliant if the debt-to-GDP ratio is below 60% of GDP or if the excess above 60% of GDP has been declining by 1/20 on average over the past three years; (iii) structural balance rule, a country is considered compliant if the structural budget balance of the general government is at or above the medium-term objective (MTO) or, in case the MTO has not been reached yet, the annual improvement of the structural budget balance is equal or higher than 0.5% of GDP, or by the remaining distance to the MTO if smaller than 0.5% ; (iv) expenditure rule, a country is considered complaint if the annual rate of growth of primary government expenditure, net of discretionary revenue measures and one-offs, is at or below the ten-year average of the nominal rate of potential output growth minus the convergence margin necessary to ensure an adjustment of the structural budget deficit in line with the structural balance rule.

Source: EFB Secretariat Compliance Tracker, https://commission.europa.eu/business-economy-euro/economic-and-fiscal-policy-coordination/european-fiscal-board-efb/compliance-tracker_en; and OECD calculations.

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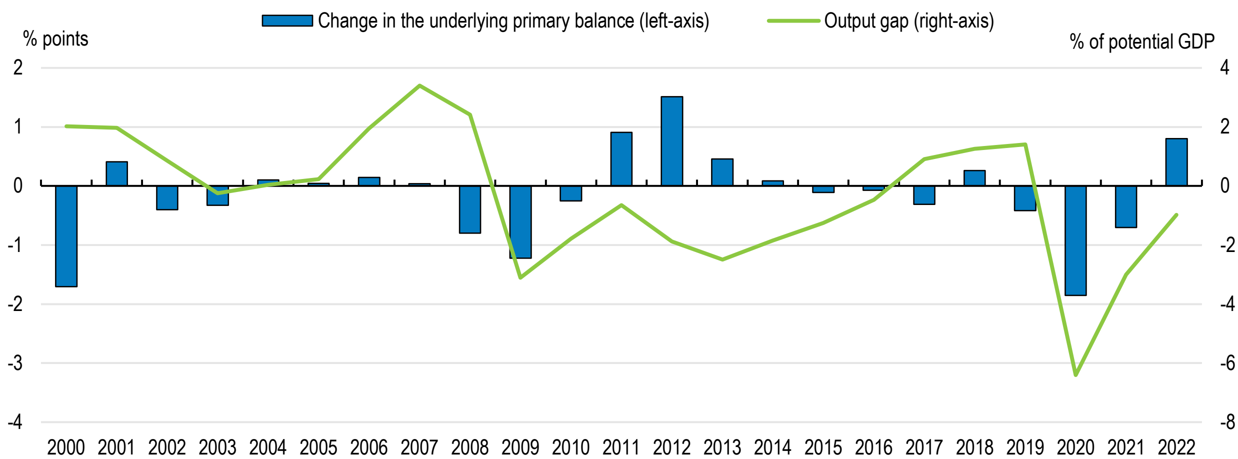
Countercyclical fiscal policy should provide aggregate demand support in downturns, consistent with long-term fiscal sustainability. In practice however, fiscal policies have often been procyclical, resulting in insufficient buildup of fiscal buffers during economic good times and fiscal tightening in bad times. While the 2008-09 Global Financial Crisis and the start of the COVID-19 pandemic in 2020 were two periods of sizeable counter-cyclical expansion, the euro area has not yet experienced an episode of sizable counter-cyclical fiscal tightening nor a significant strengthening of fiscal buffers in good times. The pro-cyclical consolidation in 2012-13 took place during the sovereign debt crisis, leading to weak growth, heightened market pressures and concerns about debt sustainability in some countries (Figure 1.26). Pro-cyclicality has reflected government policy choices, market access and weak compliance with the Medium-Term Objective set in structural terms and the Expenditure Benchmark rules. The resolve for countercyclical fiscal policy seems to be lacking from the start: looking at fiscal policies ex ante, using the information available at the time of budget planning, they appear to be neither pro-cyclical nor counter-cyclical (Larch, Orseau and van der Wielen, 2021[54]; Gootjes and de Haan, 2022[55]). However, one source of the pro-cyclicality is a persistent optimism regarding expected economic growth rates on which fiscal spending plans are based (Beetsma et al., 2022[56]). The Commission's Commonly Agreed Methodology (CAM) for assessing potential output has also led to large revisions to the structural balance and, even with averaging over ten years, to potential growth (Barnes and Casey, 2019[57]).

Figure 1.26. Fiscal policy was often procyclical



Note: Data refers to euro area member countries that are also members of the OECD (17 countries).
Source: OECD Economic Outlook: Statistics and Projections database

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To improve economic governance, the Commission has proposed revisions to the fiscal framework, to be put in place as soon as possible after the general escape clause triggered by the pandemic expires at the end of 2023 (Box 1.3). This proposal is a step forward from the current framework, for at least two reasons. First, it bases the medium-term fiscal adjustment on a comprehensive assessment of debt sustainability risks, which considers country-specific circumstances, including projected borrowing costs, ageing costs and the overall impact of fiscal consolidation and structural reforms on growth rather than simple numerical metrics (Blanchard, Sapir and Zettelmeyer, 2022[58]). It also relies less on unobserved variables like the structural balance, making more use of medium-term projections. Second, annual net expenditure ceilings set in terms of spending levels are a simpler and more stable operational target than the cyclically adjusted fiscal balance currently used by the SGP.

The EU fiscal framework is in transition. While the general escape clause of the SGP will be deactivated at the end of 2023, the new legal framework, which depends on the outcome of the ongoing review, is not yet in place. To allow for an effective bridge to the future set of fiscal rules, which will depend on negotiations among EU countries (ECOFIN, 2023[59]), some elements of the Commission's reform proposal will be incorporated to the fiscal surveillance cycle that starts in spring 2023 with the issuance of fiscal country-specific recommendations (European Commission, 2023[60]). The draft budgetary plans for 2024 will be assessed by the Commission in autumn 2023 based on the spring 2023 amended fiscal country-specific recommendations (CSR). The Commission has invited member countries to submit Stability and Convergence Programmes including their medium-term fiscal and structural plans. In turn, the Commission will include in its fiscal CSRs for 2024 both quantitative requirements and qualitative guidance on planned investment and energy measures. The fiscal CSRs will also be quantified in terms of net primary expenditure, as outlined in the reform proposal, and differentiated depending on national public debt challenges.

Box 1.3. The Commission's Economic Governance Reform Proposal

In addition to the reference values of 3% and 60% of GDP for deficit and debt, the EU fiscal governance framework notably involves the following numerical thresholds and rules:

- **The one twentieth debt rule**: when debt is above 60% of GDP, the annual debt reduction over three years should be at last one twentieth of the debt in excess of the 60% threshold.
- **The country-specific medium-term budgetary objective (MTO)**: between -1% of GDP and balance or surplus, corrected for cyclical effects and one-off temporary measures. The objective is revised every three years, or when major structural reforms are implemented.
- **The expenditure benchmark**: the net growth rate of government spending below or equal to a medium-term potential economic growth rate, depending on compliance with the MTO.

The Commission's proposal aims to increase the medium-term orientation of the rules, simplify the framework and increase national ownership. It centres on replacing the preventive arm of the Stability and Growth Pact with a national medium-term adjustment plan anchored in debt sustainability analysis. The reference values of 3% and 60% of GDP for deficit and debt, respectively, are to be maintained and integrated in the new framework. However, the one-twentieth debt rule, which has proven difficult to apply, and the Medium-Term Objective (MTO) for the structural balance and the Expenditure Benchmark based on potential growth would no longer be used.

The Commission would propose a multiannual adjustment path (the so-called *technical trajectory*) in terms of the level of net primary expenditure (defined as expenditure net of discretionary revenue and excluding interest expenditure as well as cyclical unemployment expenditure to allow the full working of automatic stabilisers) for countries with a debt-to-GDP ratio above 60% or a deficit above 3% of GDP, ranging from four to seven years and using an existing debt sustainability analysis (DSA) methodology agreed with member states. These countries will have to put debt on a plausibly downward path by the end of the four-year adjustment period at the latest, based on the assumption of unchanged policy settings. The reference path would also be set to ensure that the deficit remains below 3% of GDP over the medium term defined as the 10 years after the adjustment period. For countries with a deficit below 3% of GDP and a debt-to-GDP ratio below 60%, the Commission will, instead of a technical trajectory, calculate the structural primary balance needed to keep the deficit below 3%.

After a discussion with the Commission, countries would then submit a "medium-term fiscal structural plan" outlining their fiscal adjustment and structural reform commitments. To prevent backloading of fiscal consolidation, the average annual adjustment foreseen in the national plan should not be lower than the average over the entire adjustment period. Moreover, the debt-to-GDP ratio at the end of the "planning horizon" must be smaller than the initial value. Additional flexibility, in terms of a more gradual adjustment path than the standard four-year horizon, could be envisaged in the presence of priority reforms and investment commitments. To ensure equal treatment, the Commission would assess the trade-off between reforms and the speed of adjustment based on a common EU framework. The final step would be the adoption or rejection of the plan by the Council of the EU. If a country and the Commission cannot agree, the reference adjustment path originally prepared by the Commission would be used for fiscal surveillance and enforcement. The national fiscal structural plans will also cover policies needed to address macroeconomic imbalances. In case of insufficient progress, an excessive imbalances procedure would be opened and the country would be asked to submit a revised fiscal structural plan to the Council.

Enforcement will continue to follow the excessive deficit procedure (EDP). For countries with a deficit above 3% of GDP, the minimum annual improvement of 0.5% of GDP is proposed. For countries with public debt above 60% of GDP, the debt-based EDP would be triggered by failure to comply with the endorsed expenditure path. Failure to comply with the agreed path, or in case of negative circumstances, with the amended path, would lead to sanctions, including possible suspension of EU financing, fines, and other reputational sanctions. While some new enforcement measures are envisaged, the overall aim is to strengthen national ownership, as countries sign up to the plan. No changes were proposed to the legal framework of the Macroeconomic Imbalances Procedure.

Source: European Commission (2022[61]), European Commission (2023[62]), European Commission (2023[63]), Darvas (2023[64]) and Blanchard, Sapir and Zettelmeyer (2022[58]).

Importantly, in the transition period, countries will set fiscal targets in their medium-term fiscal plans, which will form the base for their own fiscal CSRs. The Commission stands ready to propose fiscal CSRs in line with national targets, provided they are consistent with the criteria set out in the reform orientations, notably that they keep public debt on a downward path (or at a prudent level for low-debt countries) and the budget deficit below 3% over the medium term (European Commission, 2023[60]). Given the risk that the new fiscal framework may not be finalised in this legislative period, this approach allows a gradual evolution of fiscal surveillance. The new framework emphasises a multiannual medium-term perspective, while introducing common safeguards to ensure debt sustainability, which both aim to ensure that the fiscal effort is not postponed in good times. This may help reduce the procyclicality of fiscal policy observed in the past, depending on the choices made in finalising the proposal.

Stronger fiscal councils could help improve compliance more than reliance on sanctions

Important elements of the revised fiscal framework and its enforcement remain to be decided. For example, the requirements imposed on the reference path and the national medium-term fiscal plans may be too vague and may not be sufficient to ensure debt sustainability. Fiscal adjustment is meant to ensure both a fiscal deficit of less than 3% of GDP and a "plausibly declining" debt path after four to seven years, which may not be sufficiently ambitious for a high-debt-risk country (Blanchard, Sapir and Zettelmeyer, 2022[58]). Debt sustainability analysis, despite recent analytical refinements, remains very sensitive to modest changes in assumptions (European Fiscal Board, 2022[65]). One of the objectives of the reform is to increase national ownership to improve compliance and budgetary outcomes. Greater adherence by national politicians, parliaments and citizens could help to ensure better outcomes, as is already the case in many countries with low debt. While national authorities may play a more active role in agreeing their adjustment paths, the proposal details the Commission's role, while being less specific on upgrading the role of national independent fiscal institutions (IFIs). This entails a risk that the national policy discussions will not engage sufficiently with the new framework, which would be inconsistent with the stated aim of strengthening national ownership and the role of IFIs.

Empowering national fiscal councils and providing them with sufficient resources is key to improve national ownership (Wyplosz, 2022[66]). Independent fiscal institutions, such as fiscal councils, are essential in building credibility of fiscal policy at the national level by enhancing transparency and accountability. They can help to enrich the political debate about public finances and increase the medium-term focus. Effective fiscal councils have a measurable impact on the design and implementation of fiscal policy. In addition, more media visibility of the IFIs makes fiscal rules more effective as measured by higher rule compliance (Mohl et al., 2021[67]).

Fiscal surveillance could be partially delegated from the European to the national level, provided that an adequate fiscal framework is in place and budgetary outcomes remain satisfactory (Thygesen et al., 2022[68]). Assessments of IFIs should contribute to the analysis behind the initial medium-term adjustment path for the Council of the EU (ECOFIN), including oversight or preparation of the assumptions underlying the macroeconomic projections and debt sustainability analysis. Most national IFIs already produce debt sustainability assessments and this role can be developed further (The Network of EU Independent Fiscal Institutions, 2021[69]). Under the new framework, the IFIs could also be responsible for the assessment of discretionary revenue measures. At the start of the excessive deficit or debt procedure, the IFIs could be tasked with assessing the relevant country-specific factors. For the IFIs to become effective watchdogs of national macro-fiscal management, minimum standards for mandates, resources, expertise, and access to information should be established in EU legislation (Arnold et al., 2022[70]) and gradually implemented, reflecting the experience of the IFIs and existing best practice (OECD, 2014[71]). Making the European Fiscal Board institutionally independent and endowing it with sufficient resources would also help to strengthen discussion of fiscal issues at the European level.

The Commission's proposal maintains the reliance on sanctions, which has a poor record and needs to be improved. It is sometimes argued that the enforcement of fiscal rules could be strengthened through other EU policy instruments, such as the EU cohesion policy (Larch et al., 2022[52]). EU law allows the Commission to suspend European Structural and Investment Funds (ESIF) in case of insufficient action under the EDP. Given that cohesion funds represent a large part of the EU budget, this could serve as a credible incentive. However, in practice this provision has never led to any actual loss of funds. Similarly, the introduction of reverse qualified majority voting (RQMV) in 2011 did not result in imposing more granular SGP sanctions. This meant a more decisive role for the Commission in a situation of a split vote in the Council because a qualified majority of voting countries would be needed to overturn a Commission recommendation. Although this innovation was expected to result in a quasi-automatic implementation of the stricter SGP rules, this did not happen (European Fiscal Board, 2019[72]). Instead, the Commission in 2016 decided to de facto relinquish SGP sanctions for non-compliance against Spain and Portugal by setting their level to zero (Larch et al., 2022[52]). This episode has been linked to a generalized lack of SGP ownership, both by the countries and the Commission, or to the perception that sanctions, even when ineffectual, are limiting national sovereignty (Mangov et al., 2019[73]).

Table 1.5. Improving the European fiscal arrangement

Main recommendations of the 2021 Survey	Action taken since 2021
Evaluate the fiscal framework with the aim to better ensure sustainable government finances, sufficient counter-cyclicality and greater ownership.	In November 2022, Commission's orientations for the economic governance reform reviewed the key concerns, including complexity, pace of debt reduction, incentives for reforms and investment, national ownership and enforcement.
Improve fiscal policy making by strengthening the involvement of independent fiscal institutions, enhancing medium-term budgetary frameworks, and by considering positive incentives.	The April 2023 legislative proposals outlined a reformed fiscal framework relying on medium-term orientation and national ownership. The framework aims at credible reduction of high debt levels and promotion of sustainable and inclusive growth, while also envisaging a stronger role for national IFIs.
Swiftly implement national recovery and resilience plans to deliver structural reforms and investments based on sound cost-benefit analysis.	The progress on RRP implementation is continuously monitored, also in the context of the European Semester. The implementation of the RRF is ongoing. A total of EUR 153 billion have been disbursed as of May 2023.
Rigorously assess the economic impact of SURE and Next Generation EU as they could provide a valuable input to the debate on the completion of the EMU architecture.	The Commission has assessed the economic impact of SURE in its bi-annual reports and plans to evaluate SURE by 2024Q3, as recommended by the ECA.
Among other options, consider adopting an expenditure rule anchored to a debt ratio target.	The April 2023 legislative proposals emphasize expenditure developments (net of revenue-increasing or decreasing fiscal policy measures), which will serve as a basis for setting countries' fiscal adjustment paths and carrying out annual fiscal surveillance.

The Single Market must be protected and deepened

The Single Market has contributed considerably to economic growth in the European Union. Recent estimates put the real GDP level impact of the Single Market since its inception between 9% and 12% (in

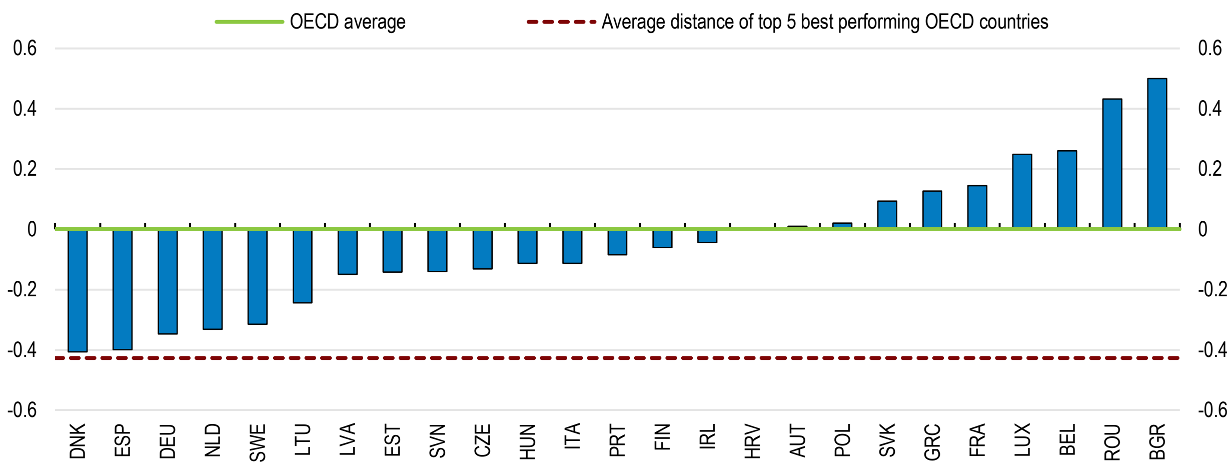
’t Veld, 2019[74]) (Lehtimäki and Sondermann, 2020[75]). Effective implementation and enforcement of Single Market rules is also crucial to preserve EU resilience to economic shocks. However, continued efforts to address persistent barriers, including the promotion of cross-border provision of services, are needed (European Commission, 2023[76]). The digital, telecommunications and financial services markets remain particularly fragmented (OECD, 2023[77]).

Improving product market regulations further would deepen the Single Market

The OECD product market regulation (PMR) indicators show that existing barriers to competition in the best performing EU countries are about as low as in the strongest OECD performers. Most EU countries perform well in this respect. Yet, in some member countries regulatory barriers to competition remain high despite decades of EU membership (Figure 1.27).

Figure 1.27. Most EU countries perform well in PMR, but some barriers remain

Distance between PMR indicator scores for EU countries and the OECD



Note: The Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable. Scores range from 0 to 6 and increase with restrictiveness (data refer to 2018).
Source: OECD Product Market Regulation database.

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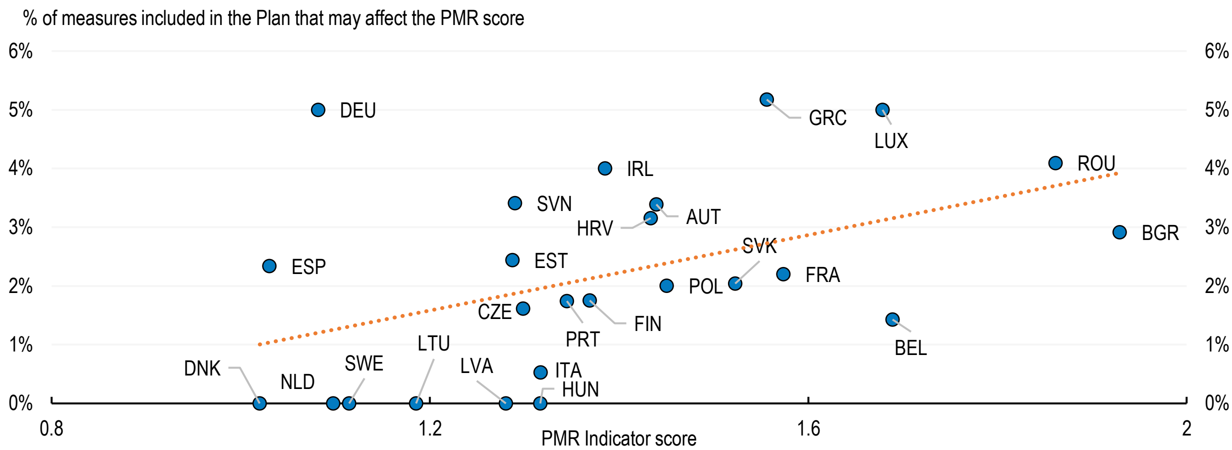
Current reform programmes, if fully implemented, are likely to strengthen the Single Market, particularly in countries with more restrictive PMRs. To benefit from the Recovery and Resilience facility, EU countries submitted national Recovery and Resilience Plans to the Commission, outlining investment plans and regulatory reforms addressing country-specific recommendations from the European Semester. Some reforms relate directly to PMR, while many investments aim to improve the infrastructure in network sectors, the regulatory set-up of which is assessed in the PMR indicators (Vitale and Terrero, 2022[78]). If fully implemented, the national Recovery and Resilience Plans will bring clear benefits for countries most in need of improving their PMR (Figure 1.28).

Potential benefits of fully implementing the national Recovery and Resilience plans suggest that regulatory fragmentation continues to hamper digital trade. The OECD Digital Services Trade Restrictiveness Index has remained stable across developed economies (Figure 1.29). Although the average level of restrictiveness in the European Union and the euro area is low compared to other world regions, Europe is not improving its position vis-à-vis economies such as the U.S., the U.K. and to lesser extent Japan. For example, EU countries maintain policies that impede trade in digitally enabled services, such as performance requirements, limitations on downloading and streaming, or restrictions on online advertising. Despite the implementation of the General Data Protection and the Free Flow of Non-Personal Data

Regulations, the lack of harmonisation of cybersecurity requirements in the EU may also impede the free flow of non-personal data.

Figure 1.28. National Plans address regulatory weaknesses identified by the PMR indicators

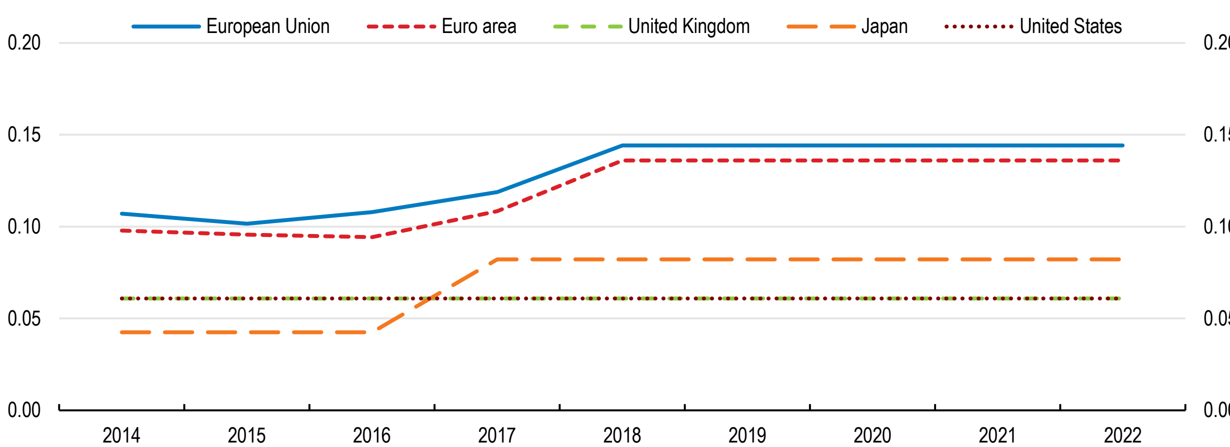


Note: The Product Market Regulation (PMR) indicator is a composite index that encompasses a set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable. Scores range from 0 to 6 and increase with restrictiveness (data refer to 2018). The horizontal axis shows the 2018 PMR indicator score for each EU country. The orange dotted line shows the correlation between PMR values and the share of measures included in the country Plan that may affect the PMR score.
Source: OECD Product Market Regulation database.

StatLink https://stat.link/4vlspy

Figure 1.29. European countries maintain regulatory barriers in digital trade

Evolution of services regulatory environment for digital trade, digital STRI averages



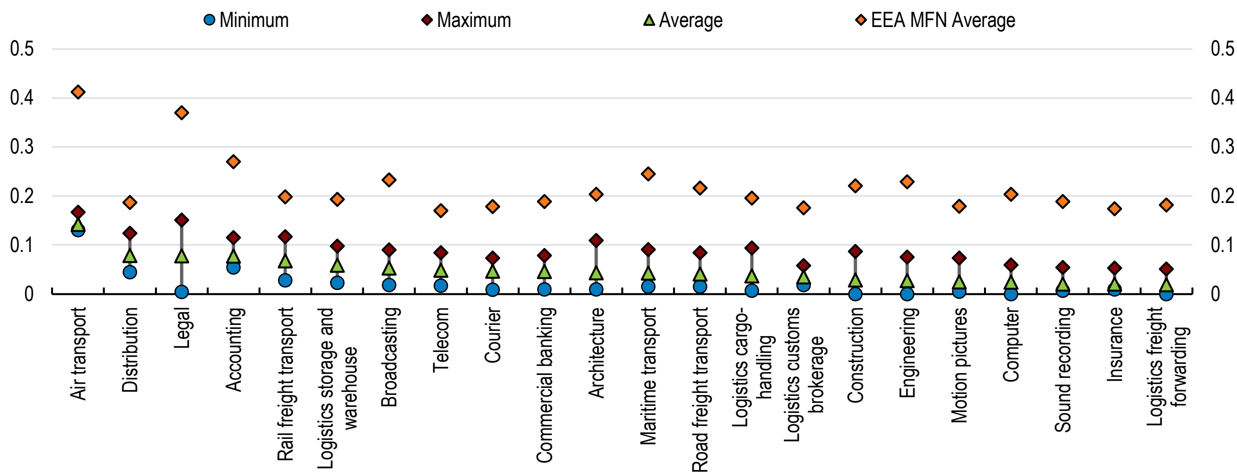
Note: The OECD Digital STRI identifies, catalogues and quantifies barriers that affect trade in digitally enabled services. The Digital STRI indices take values between zero and one, one being the most restrictive.
Data refer to European Union and euro area member countries that are also members of the OECD (22 and 17 countries, respectively).
Source: OECD Digital Services Trade Restrictiveness Index (Digital STRI) database.

StatLink https://stat.link/z49rcd

Some restrictions remain within the Single Market, driven both by EU rules and national regulations, demonstrating the potential for further market integration in many services sectors (Figure 1.30). These include restrictions on foreign entry in air transport and distribution as well as licensing requirements for legal services. Between 2014 and 2021, the regulatory environment in the European Economic Area (EEA) became more liberal in courier and telecommunications, while progress in insurance and other financial services has been limited (Figure 1.31). In 2021-22, trade liberalisation within the EEA continued in distribution services, commercial banking, and insurance. The most recent reforms in 2021 included financial services liberalisations in Iceland and Finland and the liberalisation in distribution services in Germany (OECD, 2022[79]).

Figure 1.30. Barriers in some services sectors within the Single Market remain high

Intra-EEA Services Trade Restrictiveness Index average, minimum and maximum scores by sector, 2022

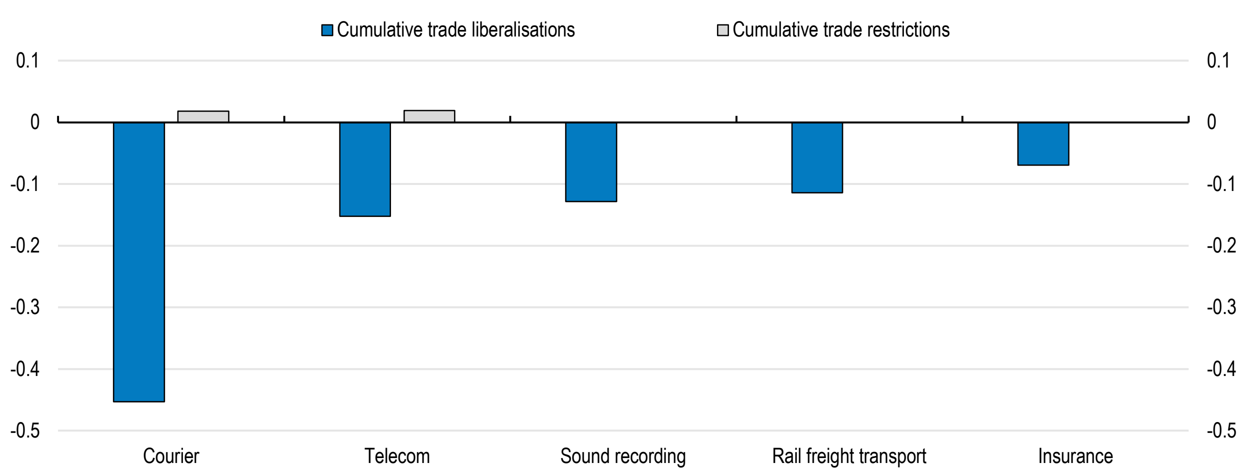


Note: The STRI indices take values between zero and one, one being the most restrictive. The intra-EEA STRI quantifies barriers to services trade within the Single Market of the EEA. By contrast, the STRI database records measures on a Most Favoured Nations (MFN) basis, where preferential trade agreements are not taken into account. Air transport and road freight cover only commercial establishment (with accompanying movement of people). The Intra-EEA STRI regulatory database covers 24 EEA members (GBR is excluded).
Source: OECD Intra-EEA Services Trade Restrictiveness Index (STRI) database

StatLink https://stat.link/old13x

Figure 1.31. Within the Single Market, trade was liberalised in courier and telecommunication services

Intra-EEA services trade policy changes, 2014-22, percentage point



Note: The STRI indices take values between zero and one, one being the most restrictive. The intra-EEA STRI quantifies barriers to services trade within the Single Market of the EEA. The Intra-EEA STRI regulatory database covers 24 EEA members (GBR is excluded).
Source: OECD Intra-EEA Services Trade Restrictiveness Index (STRI) database

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Strong state aid framework is needed to protect the level playing field

State aid rules have been relaxed several times since the beginning of 2020, using the flexibility foreseen in the Treaty to remedy serious economic disturbances. As part of the Temporary Framework for state aid introduced in reaction to the COVID-19 pandemic, the Commission temporarily relaxed and simplified access to aid. Moreover, following Russia's unprovoked war of aggression against Ukraine, a Temporary Crisis Framework expanded support for increased energy costs as well as specific renewable energy and decarbonisation technologies (Box 1.4)

Box 1.4 The EU State aid framework has been relaxed to address serious disturbances

The EU State aid rules govern the provision of State aid to companies, including direct grants, tax advantages, repayable advantages, guarantees, loans or equity. The rules aim to protect competition and ensure a level playing field for all companies within the Single Market. To be compatible with EU rules, State aid must be necessary, proportionate, transparent, compatible with the internal market and not adversely affect competition. State aid can also contribute to economic development and job creation in underdeveloped regions (Article 107 of the Treaty of the Functioning of the European Union). If the Commission decides that State aid is incompatible with the rules, it will order a country to recover the aid from the beneficiary. For example, Ryanair was ordered in 2019 to return EUR 8.5 million of State aid received through the Association for the Promotion of Touristic and Economic Flows (APFTE) in Montpellier.

Countries are required to notify the Commission of any aid that does not fulfil the requirements of the regulations on the basis of art. 108 (4) TFEU (the so-called Block Exemptions Regulation), and the Commission approves such aid on a case-by-case basis. Under the General Block Exemption Regulation, aid to small and medium-sized enterprises (SMEs) and large companies can be exempted under specific conditions, provided it does not exceed certain notification thresholds. For example, aid for research, development and innovation, can be allowed up to certain thresholds and maximum aid intensities. Countries can provide to companies small amounts of State aid (so-called "*de minimis*" aid) without notification, up to EUR 200,000 over three years.

During the COVID-19 pandemic, the Commission adopted the State Aid Temporary Framework to use the full flexibility foreseen under State aid rules and support the economy. Under the Temporary Framework, the Commission approved nearly 950 national measures (out of more than 1300 notified) for SMEs and large businesses in many sectors, including farmers, airlines and COVID-related research, amounting to nearly EUR 3.2 trillion, an upper bound on actual spending (European Commission, 2022[80]).

The Temporary Crisis Framework was adopted in response to Russia's invasion of Ukraine, which led to another sharp increase in already elevated energy prices. The new elements of the framework aimed to (i) facilitate access to liquidity for energy companies and other affected firms, (ii) simplify requirements for support to companies affected by the high cost of energy, and (iii) extend measures to support the reduction of electricity demand.

Note: *) The eligible costs are the difference between the unit price of natural gas and electricity paid by the undertaking (as a final consumer) in each month between 1 February and 31 December, 2022, and twice the unit price paid on average during 2021.
Source: European Commission (2021[81]), European Commission (2022[80])

The current level of flexibility risks distorting the level playing field provided by the Single Market. By January 2023, some EUR 672 billion of State aid had been approved under the Temporary Crisis Framework, overwhelmingly by large EU countries, Germany, France and Italy, who notified, respectively, 53%, 24% and 7% of the total amount (Vestager, 2023[82]). However, this includes guarantees and other categories and does not mean that the nominal amounts were fully disbursed. To gauge the impact of the

Temporary Crisis Framework, one can also compare total aid notified or reported in 2020 with that notified or reported in 2019. First, there is an upward shift in aid, as all countries notified or reported more aid in 2020 than in 2019. Second, the aid distributed in 2020 tended to further increase in countries that were already subsidising a lot in 2019 (Kleinmann et al., 2023[83]). An unbalanced distribution of state aid under the Temporary Crisis and Transition Framework, would raise concerns that countries with the most fiscal space may be able to provide excessive support, at a risk for the integrity of the Single Market.

The existing EU legal framework, particularly the 2022 Guidelines on State aid for climate, environmental protection and energy, already allows for green subsidies justified by environmental externalities and climate protection (European Commission, 2022[84]). Recently, the Commission has temporarily, until end-2025, enlarged through the Temporary Crisis and Transition Framework the scope of existing simplified provisions for State aid to all renewable energy technologies, eliminated the need for open tenders for less mature technologies previously required under EU rules, and further increased the notification thresholds for State aid (Box 1.5). These measures need to be assessed in the future and adjusted, if necessary, to minimise potential harmful effects on competition. In particular, introduction of anti-relocation investment aid for green investment, could lead to harmful subsidisation races.

Box 1.5. The Green Deal Industrial Plan entails further relaxation of State aid rules

The February 2023 Communication on the Green Deal Industrial Plan for the Net-Zero Age aims at scaling up the EU's carbon neutral manufacturing capacities and supporting the use of sustainable materials in construction and other sectors. It also proposes measures to enhance the competitiveness of Europe's carbon neutral industries. The premise of the Plan is the need to massively increase the technological development as well as manufacturing of net-zero products and scale up the supply of renewable energy in the next decade. The Plan is based on four pillars: (i) a predictable and simplified regulatory environment, (ii) faster access to funding, (iii) skills and (iv) open trade for resilient supply chains. The first two pillars are most directly relevant for the Single Market.

Predictable and simplified regulatory environment

To improve the regulatory environment, the Commission presented in 2023 three key proposals:

- A Net-Zero Industry Act to support industrial manufacturing capacity and strategic multi-country projects in net-zero products. The measures will include faster permitting, streamlining the identification of common projects and developing European standards promoting the roll-out of key technologies. The support for strategic multi-country projects aims at ensuring that all countries could develop their innovative industries.
- A Critical Raw Materials Act to ensure access to materials vital for manufacturing of net-zero technologies and products by strengthening international engagement, facilitating extraction, processing and recycling, while ensuring high environmental standards.
- Electricity market reform, as part of the RePowerEU Plan.

Faster access to financing

To accelerate access to financial support, the Commission temporarily relaxed State aid rules further, using the flexibility foreseen in the Treaty to remedy serious economic disturbances, moving from the existing Temporary Crisis Framework to a modified Temporary Crisis and Transition Framework. In particular, the relaxation aims for faster approvals for certain transactions.

The new framework extends the simplified provisions for renewable aid deployment to all renewable technologies, eliminating the need for open tenders for less mature technologies and extending deadlines for completing projects that receive support. It also further relaxes rules for aid to decarbonise industrial processes by allowing linking aid to standard percentages of investment costs and adding a more flexible ceiling per beneficiary in aid schemes fulfilling specific conditions. Moreover, it provides enhanced investment support schemes for the production of strategic net-zero technologies and additional aid for new projects in strategic net-zero value chains. Finally, the Commission amended the General Block Exemption Regulation. The amendment grants EU countries more flexibility to design and implement support measures in sectors that are key for the green transition. It also introduces more possibilities for support for IPCEI-like projects in research and development. These measures, together with the code of good practices for Important Projects of Common European Interest (IPCEI) that was prepared by the Commission, could also streamline and simplify the approval of IPCEI projects.

To avoid fragmenting the Single Market due to varying levels of national support, the Commission also proposes to increase EU-level funding through several channels:

- The InvestEU Programme, which supports EU public and private investments in net-zero technologies and industrial innovation and in collaboration with the European Investment Bank, the European Investment Fund and other participating institutions has so far provided guarantee agreements worth EUR 21 billion. The program targets high-risk SMEs and midcaps lacking sufficient collateral and prioritizes cross-border investment (European Commission, 2023[76])
- The Innovation Fund, which supports innovative technological solutions and strategies reducing carbon emissions in energy-intensive industries and energy storage. The Commission plans to launch a competitive bid in autumn 2023 for supporting the production of renewable hydrogen and expand this mechanism to other net-zero technology areas including batteries as well as electrolysers.
- In the medium term, the Commission proposes to create a European Sovereignty Fund to preserve a European technological lead in key fields related to the green and digital transitions.

The Commission acknowledges that the Green Deal Industrial Plan will require significant investment from private sources and emphasizes the role of a fully developed Capital Markets Union in improving access to finance for individuals and firms.

Source: European Commission (2023[85])

The EU can help increase resilience

Post-pandemic changes in the geopolitical environment and the green and digital transitions are leading the EU to reconsider the approach to industrial policy beyond regulating a large internal market. The Commission has proposed several policy measures aimed at strengthening market resilience, such as the Single Market Emergency Instrument providing solidarity in case of future crises. The EU also continues to alleviate its strategic dependencies through new industrial alliances and increased efforts in regulation and setting of standards (European Commission, 2021[86]). These policies are steps in the right direction and should be developed further, while carefully considering their limitations and preserving an open economy. Economic resilience requirements may justify joint procurement procedures, build-up of strategic reserves of key products as well as better identification of risks and rapid response networks facilitating public-private co-operation in responding to crises. Similarly, well-designed measures addressing market failures within the EU or beyond may be useful in situations when benefits exceed costs. However, strategic autonomy policies may lead to trade inefficiencies. Such interventions generate trade diversion – increased trade within the EU – which is insufficient to compensate for the induced loss of external trade (Bauer, 2022[87]). Hence, EU action should continue to be guided by proportionality and adherence to the principles of multilateralism and rules-based free trade.

A related concern is that a shortage of critical raw materials will undermine the EU's strategic autonomy and slow down the expansion of the green and digital transitions. The EU is highly dependent on the import of raw materials needed for batteries and wind turbines, including lithium, nickel, cobalt for batteries as well as rare earths for permanent magnets, and plans to diversify imports through new trade agreements with Australia and Chile. In addition, the supply of critical raw materials within the EU is constrained by long permitting processes (Bobba et al., 2020[88]). The European Commission proposed to designate strategic raw material projects as of public interest and encourages EU countries to shorten lengthy approval processes to two years for extraction projects and one year for processing and recycling projects (European Commission, 2023[89]). Swift implementation of the proposal would eventually reduce EU's dependence on imports of strategic raw materials.

The aim of EU industrial policy should be to create sound framework conditions and facilitate adaptation to structural change. Public funding needs to be used proportionately to address market failures, with a view to triggering additional private investment that would not have taken place otherwise (OECD, 2020[90]). Rather than relaxing rules for state aid, multiplying potential distortions and market fragmentation, multi-country approaches could be leveraged to provide support open to all firms across the Single Market. For example, Important Projects of Common European Interest (IPCEI) support pooling of public resources across several countries in areas where markets alone cannot deliver breakthrough innovation.

IPCEIs are an expanding support tool for projects in the field of research, development and innovation that the private sector alone cannot finance. They involve state aid with specific rules and substantial amounts of financing compared to other channels of public support. For example, the three IPCEIs adopted by the end of 2021 – one project on microelectronics and two on the battery value chain – involved almost EUR 8 billion of public funding complemented by EUR 20 billion of private funds (Eisl, 2022[91]). However, the framework suffers from a lack of broad-based participation of SMEs and firms from some EU countries, which the Commission recently aimed to address by amending the GBER. Another major flaw is the lack of transparency on the decision to invest public funds and on project governance. Not enough information on existing IPCEIs is available to enable monitoring of the efficient spending of public funds or the distortive effects on competition. In cases where public interest in efficient use of public funds outweighs the interest of private companies in limited disclosure, this information should be published in an accessible and timely manner (Poitiers and Weil, 2022[92]).

The governance of IPCEIs needs to be significantly improved to achieve better coordination and harmonisation across countries and more equal access for enterprises. Despite their potential role in EU industrial policy IPCEIs are national exercises with wide variation in procedures and reporting. This creates unnecessary burdens for enterprises, which simplification and harmonisation of rules at the EU level could help reduce. This would help future IPCEI projects, supported by an exchange forum for sharing national best practices. Moreover, better support for enterprise applicants at the EU level could help alleviate the cross-country differences in technical and administrative capacities. For example, such support service could provide training on how to write IPCEI applications, collect project ideas from enterprises and advise on how to best align them with IPCEI requirements. Finally, the Commission needs to allocate sufficient resources, including administrative capacity, to ensure a comprehensive assessment as well as swift implementation of IPCEIs (Eisl, 2022[93]).

The EU could also expand subsidies for green R&D, innovation and early-stage deployment of next-generation green technologies. For such early-stage projects, EU support should rely on instruments, which are administratively simple and allow to target support also to small firms. While large firms can sometimes play an anchor role, it is important to ensure that smaller players are also supported, since disruptive new technology solutions are often developed by new young firms. To avoid harming the Single Market's level playing field, these support measures should be allocated at an EU level, consist mostly of grants and aim at high-risk early-stage technologies (Tagliapietra and Veugelers, 2021[94]).

Policy tools other than subsidies, such as streamlined regulations for permitting procedures and green public procurement can be efficient in developing green technologies. The temporary emergency regulation to fast-track permits for renewable energy infrastructure and grids (Regulation 2022/2577) agreed in December 2022 and faster permitting in legislative proposals on critical raw materials and net zero industry from March 2023 are thus a step in the right direction. Public procurement amounts to about 14% of the EU's GDP and makes up a large share of the market in areas like transport, construction and health services. In these sectors, the purchasing decisions of public authorities can encourage green innovation by giving start-ups access to economies of scale (Mazzucato, 2013[95]). Similarly, by introducing sustainability requirements, the EU could prioritize clean technologies produced to European standards without resorting to more contentious measures, such as local content requirements (Kleinmann et al., 2023[83]).

The EU could also seek to obtain an exemption from the U.S. Inflation reduction Act (IRA) provisions on the electric vehicle tax credits and local content requirements (LCRs) for batteries components and critical minerals. Several possibilities for doing so have been suggested, including expanding the definition of a free trade agreement in the IRA legislation to include agreements under discussion or plurilateral agreements (Bouët, 2023[96]). Bilateral negotiations regarding the IRA implementation have been going on since October 2022 and have already produced results, such as the relaxation of provisions on leased cars provided by EU companies.

Avoiding market fragmentation to spur progress towards a digital and green economy

Deepening the Single Market is important for the digital and green transitions. Further harmonisation and the mutual recognition of standards allow businesses to sell their products and services across borders, with competition leading to lower prices and innovation (see above). However, important obstacles remain, including fragmented regulatory frameworks for digital markets and the circular economy.

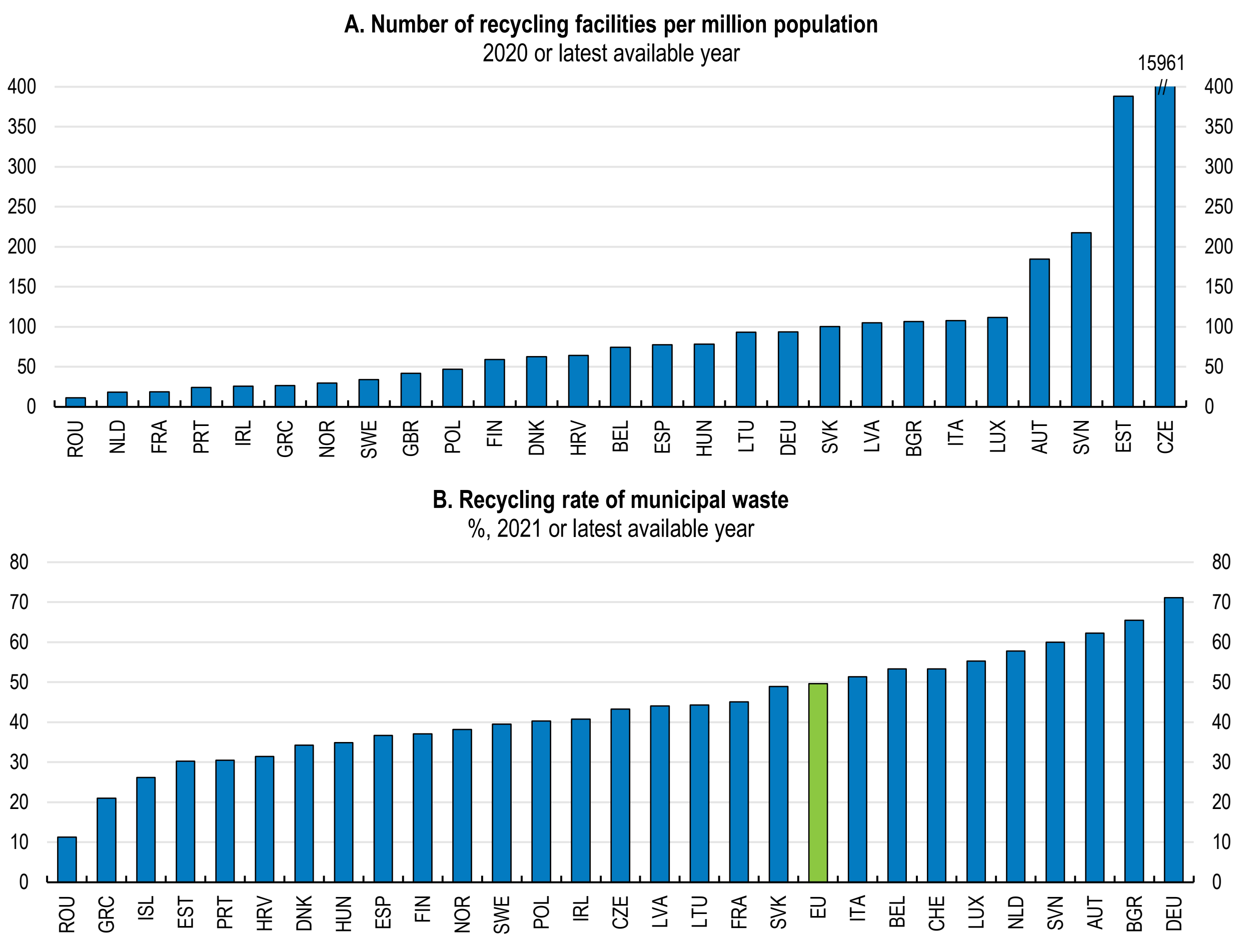
The Digital Markets Act (DMA) of 2022 gives the European Commission powers to designate large online platforms as “gatekeepers”, which will be subject to certain obligations, including a ban on ranking their own services ahead of rivals and an obligation to allow users to access their own data and take them to other competing services. The Commission has the powers to carry out market investigations in relation to the gatekeeper function of large online platforms. In case of systematic infringement of the DMA, the Commission may impose behavioural or structural remedies. The latter can range from forced divestments against companies up to the break-up of platforms (European Commission, 2022[97]). Indeed, in the area covered by the act – core services of large online platforms designated as gatekeepers – the DMA will reduce fragmentation in digital markets because EU countries are prohibited from imposing further obligations on gatekeepers with the same purpose as the DMA. However, the DMA applies only to a limited number of undertakings designated as gatekeepers in relation to a limited number of core platform services. It does little to mitigate regulatory fragmentation in areas falling outside of its scope. Moreover, both EU competition law and the national competition rules continue to apply. In Germany, for instance, online platforms can be subject to additional and more stringent competition rules, provided that the undertaking is of paramount significance for competition across markets in Germany. The DMA allows the German authorities to apply these competition rules with respect to undertakings other than gatekeepers under the DMA or to impose further obligations on gatekeepers. Accordingly, there can be differences in the obligations imposed on platforms within the EU. Such variation in rules faced by firms could hamper the growth of European digital platforms and opens the door to regulatory arbitrage. Thus, there is a need for stronger harmonisation of national regulations on online platforms in areas outside the scope of the DMA.

National rules for the circular economy often contradict EU-wide harmonisation efforts, such as material efficiency standards for electronics and electronic waste. For instance, France introduced material efficiency standards for smartphones despite work at the EU level covering the same product categories. This may lead to inconsistencies between EU and national measures. In addition, implementation of European legislation regarding electronic waste is uneven and differs among countries, hindering the free movement of goods and creating new bureaucratic costs. For example, certain used electronic goods and photovoltaic modules are classified as electronic waste in Germany, which means they cannot be sold to other EU countries, despite buyers willing to repair and continue using them (Pinto and Renda, 2022[98]).

Looking ahead, reducing the material use of electronic devices is important for sustainability and the circular economy. To reduce material use and negative environmental impacts of products more broadly, the EU Commission proposed in 2022 common reparability and re-use requirements for goods placed in the Single Market, including electronics, as well as improved information on products through a digital product passport (European Commission, 2022[99]). Such common requirements and material efficiency standards are welcome. The EU should ensure that national rules and standards for material efficiency and electronic waste are aligned with EU rules to ensure a level playing field. Reducing material use will also help the green transition, as emissions embedded in electronic devices are projected to rise from 1% of EU GHG emissions in 2020 to 3% in 2025 (The Shift Project, 2019[100]; IEA, 2022[101]; Freitag et al., 2021[102]).

A more secure supply of raw materials will also require higher recycling rates, as envisaged by the EU Critical Raw Materials Act (European Commission, 2023[89]). However, fragmented waste regulation across EU countries hampers the development of secondary markets for recycled raw materials. Such markets can help reduce the need to extract raw materials and the associated environmental impacts. For instance, different technical standards for recycled materials hinder cross-border trade (European Environment Agency, 2022[103]). Moreover, low user charges often render secondary material markets uncompetitive, with only four EU countries having set up full cost recovery charges that also include environmental costs (Salvetti, 2021[104]). This results in small, fragmented markets and largely varying waste recycling rates across EU countries (Figure 1.32). Hence, waste regulations should be harmonised to promote efficient markets for secondary raw materials. This entails introducing common Ecodesign standards to bolster recycling of raw materials as described in more detail in the 2021 *OECD Economic Survey of the European Union* (OECD, 2021[1]).

Figure 1.32. Recycling rates of waste differ across EU countries



Note: In Panel B, data refers to the 27 EU Member countries.
Source: Eurostat Waste database; Eurostat Population database; Eurostat Sustainable development indicators database; and OECD calculations.

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More harmonisation is also needed in building codes to reduce fragmentation among EU countries and even regions. Diverging technical standards for buildings reduce competition and lead to higher costs as architects, developers, and builders limit their services to national or local markets. A similar fragmentation prevails in standards for construction materials (European Commission, 2022[105]). A related issue is the lack of information about raw materials used in a building. Such information is essential for recycling strategies in the construction industry. Material passports, for example, could provide detailed specifications of raw materials used in a building but they require common standards for construction materials (World Bank, 2022[106]). Harmonised construction standards will lower the costs of the green transition. Another area for more harmonisation is energy efficiency standards for buildings (Chapter 2).

Increased labour mobility can mitigate skills shortages and deepen the Single Market

Labour mobility in the EU can act as a balancing tool for domestic labour markets experiencing excessive slack or tightness. After a decrease in labour mobility during the pandemic, labour mobility picked up in 2021. The most prevalent category in 2021 consisted of long-term movers, about 8 million persons in working age according to LFS data, followed by 2.2 million posted workers and 1.7 million cross-border workers. About 81% of EU movers or 6.5 million individuals were active on the labour market in 2021, compared to 79% of nationals and 70% of third-country nationals (European Commission, 2023[107]). Despite the stock of active movers constantly increasing from 2012 to 2021, cross-country flows of workers remain too limited to significantly reduce unemployment in origin countries (Elsner and Zimmermann, 2016[108]).

The remaining issues hindering labour mobility in the EU include the recognition of professional and academic qualifications across jurisdictions, which is still often made on a case-by-case basis as well as linguistic and cultural diversities, which could be alleviated by an enhanced Erasmus+ program offering resources for learning and training abroad to young people. Moreover, improvements in the portability of pension rights and the exportability of unemployment benefits as well as full implementation of the Electronic Exchange of Social Security Information (EESSI) system would enable quicker calculations of workers' social security benefits and favour labour mobility. Policies that could help support intra-EU labour mobility are discussed in detail in Chapter 2 and the 2021 *OECD Economic Survey of the euro area* (OECD, 2021[43]).

The posting of workers to another country is a common form of short-term labour mobility in the EU. However, it is quantitatively limited and concentrated among several EU countries, such as Poland, Germany, France and Belgium. In 2021, there were about 2.2 million posted workers and 3.6 million of work postings in the EU, alongside 1.7 million cross-border workers (European Commission, 2023[107]), representing together about 2% of total EU employment. European legislation in this area – the Posting of Workers Directive and its Enforcement Directive – aims at ensuring equal treatment of posted and regular workers in the host country regarding minimum wage, remuneration, working hours and safety. However, businesses, in particular SMEs, continue to view the administrative burden stemming from rules on the posting of workers as one of the main Single Market obstacles (Eurochambers, 2019[109]). The administrative requirements are often heavy, and the regulatory burden continues to vary across countries. Language barriers and the need to translate contracts and other documents can often increase costs. As a result, the recently estimated effort required to register a posting to Austria and Germany is 66 minutes, to Italy 71 minutes, and to France 80 minutes (Stiftung Familienunternehmen, 2023[110]). Since companies need to register their posted workers in the host country, the burden of national regulation falls mainly on foreign companies, and national administrations have limited incentives to improve their services.

Harmonised EU-wide rules defining standard documentation requirements and a common list of exemptions would help reduce the costs associated with posting of workers. Similarly, merging the application process for posted workers and A1 certificates required for reporting social security contributions while abroad would help simplify posting requirements. Further exempting short-term work, such as repairs, maintenance services or emergency assignments, from positing requirements under the Directives could also be considered.

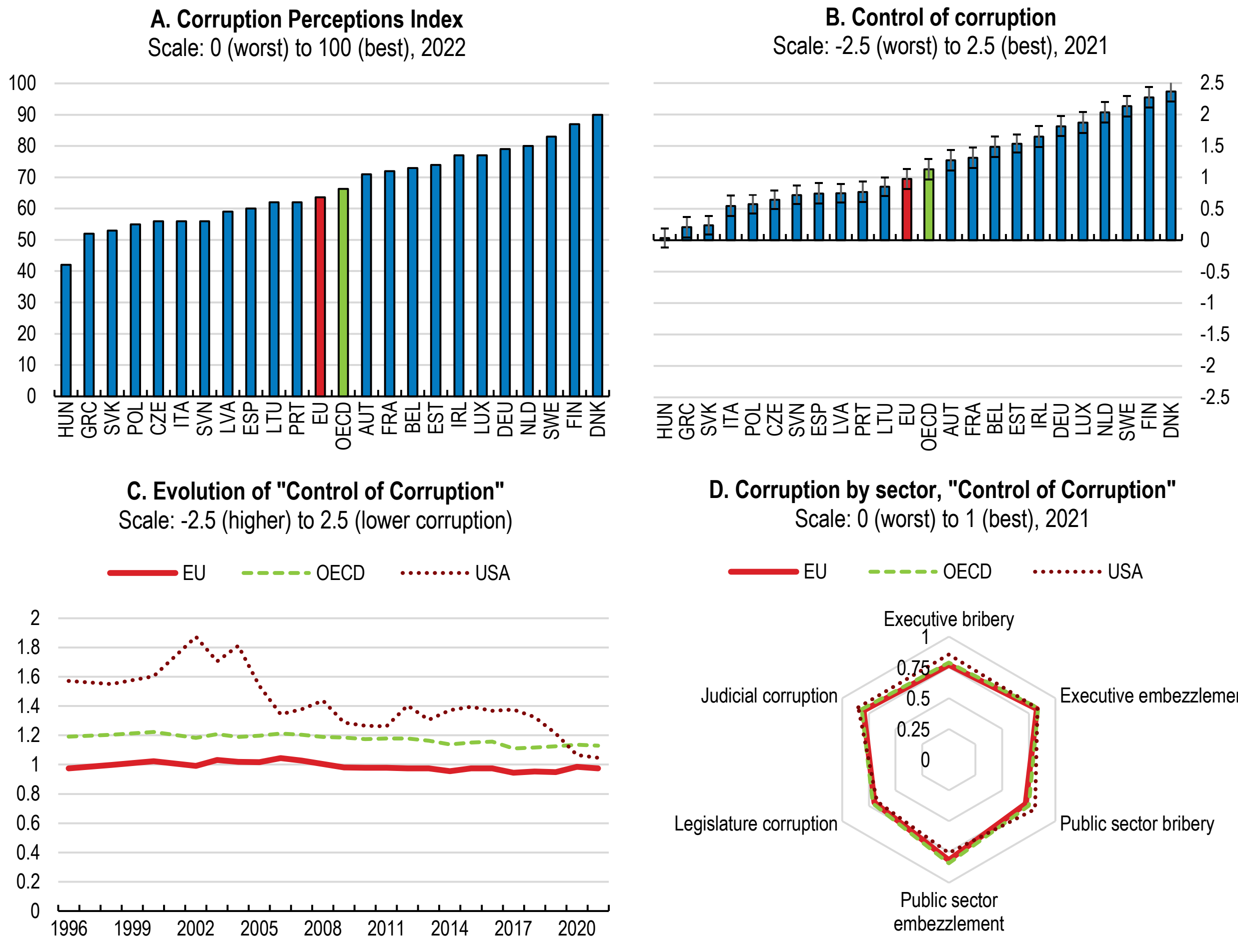
Table 1.6. Supporting an inclusive recovery across the EU

Main recommendations of the 2021 Survey	Action taken since 2021
Introduce requirements for the use of digital tools to provide information on products, including on their recycling and repair possibilities.	The Commission proposed in March 2022 the digital product passport (DPP) as part of the new Ecodesign for Sustainable Products Regulation (ESPR). If adopted, this new tool will allow digital access to sustainability information for all products covered by the regulation.
Conduct pilot projects to introduce innovative circular economy business models, such as digital-based ride sharing.	No action taken.
Develop a methodology for providing information on durability for selected products and integrate it in the Ecodesign Directive.	The ESPR is meant to replace the existing Ecodesign Directive, extending it to more products and more environmental aspects beyond energy efficiency. The existing approach is complemented by incentives to boost demand for sustainable products, for example through mandatory green public procurement criteria.

Strengthening the anti-corruption framework of EU countries and institutions

Corruption reduces economic efficiency, leads to waste of public resources, widens economic and social inequalities, and undermines citizens' trust in public institutions (OECD, 2017[111]). The Commission has a leading role in coordinating and fostering the implementation of an anti-corruption framework across EU countries with multiple areas of intervention, such as the judicial system, anti-money-laundering (AML), whistle-blowers' protection, investigation and prosecution of high-level corruption cases, transparency and lobbying (European Commission, 2023[112]) (EUCRIM, 2020[113]). Despite progress made in these areas, challenges remain as the effectiveness of the legislative and policy frameworks varies across the EU and the perception of corruption is relatively high in some countries (Figure 1.33). The new anti-corruption package (see below), launched by the Commission in May 2023, aims at further strengthening the anti-corruption framework and harmonising rules across countries (European Commission, 2023[114]) (European Commission, 2023[115]).

Figure 1.33. The perception of corruption is high in some EU countries



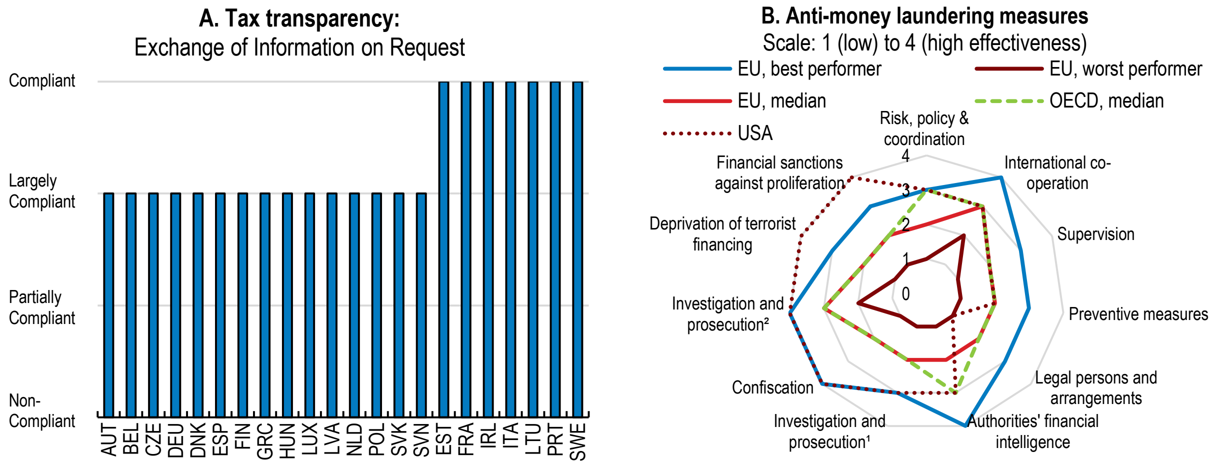
Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the “Control of Corruption” indicator by the Varieties of Democracy Project.

Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Project, V-Dem Dataset v12.

StatLink https://stat.link/k4b7cx

In the area of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), the Commission proposed four legislative instruments in July 2021, notably a new regulation (AMLR) and a directive (AMLD), a regulation establishing a new AML Authority (AMLA), and a revised regulation on transfers of funds expanding traceability requirements to crypto-assets (European Commission, 2021[116]). The European Parliament and the Council reached a political agreement on the revised regulation on transfer of funds in June 2022. The Council adopted its position on the proposals between June and December 2022, while the responsible committees in the European Parliament adopted their position at the end of March 2023, hence opening the way to the “trilogue” negotiations for the adoption of the new “EU AML rulebook” and the new AMLA Regulation (Figure 1.34) (European Council, 2022[117]) (EUCRIM, 2022[118]). The new measures proposed include the extension of AML requirements to operators involved on behalf of third country nationals in the context of investor residence schemes and crowdfunding service providers, and the extension of due diligence measures obligations on all customers of crypto-asset service providers for transactions over 1 000 euro (European Commission, 2021[119]) (European Commission, 2021[120]). Finally, the legislative package proposes more detailed and harmonised rules on beneficial ownership aiming to improve transparency through better identification of complex multi-layered ownership and control structures, and contains a provision preventing traders in goods or services from accepting cash payments of over 10 000 euro for a single purchase while allowing member states to maintain lower ceilings for large cash transactions. (European Commission, 2021[121]).

Figure 1.34. Anti-money laundering measures can be strengthened



Note: Panel A summarises the overall assessment on the exchange of information in practice from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows results from the ongoing second round when available, otherwise first round results are displayed. Panel B shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution[1]" refers to money laundering. "Investigation and prosecution[2]" refers to terrorist financing.

Source: OECD Secretariat's own calculation based on the materials from the Global Forum on Transparency and Exchange of Information for Tax Purposes; and OECD, Financial Action Task Force (FATF).

StatLink https://stat.link/givr49

The new AML/CFT proposal provides a list of minimum categories of information to which financial intelligence units (FIUs) must have access in order to improve their ability to conduct strategic and operational analysis, disseminate the results to the competent national and EU investigative authorities and reply to requests for information by their counterparts from other member states. FIUs are central national agencies disseminating financial intelligence to competent authorities investigating and prosecuting money laundering, its predicate offences and terrorist financing. The new measures contained in the package would continue to also grant access to information in the beneficial ownership register for some natural and legal persons with legitimate interest, such as journalists and civil society organisations. In the 5th AML Directive, access to such information was granted to any member of the public. In November 2022, the EU's Court of Justice judged this provision to be invalid, as it infringed the Charter of Fundamental Rights in the matter of personal data protection and respect for private life (Court of Justice of the EU, 2022[122]). AML/CTF measures should ensure that information on beneficial ownership of companies can be accessed by users pursuing anti-money laundering objectives, while also determining sufficient data protection safeguards. This aspect should be considered during the "trilogue" negotiations.

Until now, the AML/CFT supervision has been led at national level and characterised by uneven effectiveness, quality and resources (European Commission, 2021[123]). The proposed new Authority (AMLA) would coordinate national supervisory authorities to ensure uniform implementation of EU rules and elimination of differences in national practices. The Authority would ensure the proper functioning of the EU supervisory system, including by coordinating mutual assistance and thematic reviews. It would also supervise some entities in the financial sector (including crypto asset service providers), with sanctioning powers in case of breaches of the AML requirements. The Authority would also have coordination and oversight powers in the non-financial sector. Finally, it would enhance cooperation as well as the exchange of information among EU financial intelligence units. This could improve the detection and handling of major money laundering cases, which often involve several EU countries, especially if it will become fully operational at the end of 2026. The Authority would gradually take over the European Banking Authority's competencies in AML/CFT (European Commission, 2021[116]).

Investigation and prosecution of cases related to fraud and violation of EU financial interest have improved. The adoption in 2017 of the Directive on the fight against fraud to protect the Union's financial interests by means of criminal law (the "PIF Directive") and the amendment of the "OLAF Regulation" governing the European Anti-Fraud Office (OLAF) have strengthened the financial protection of the EU budget, as discussed in the 2021 *OECD Economic Survey of the European Union* (EUCRIM, 2021[124]; OECD, 2021[1]). The "PIF Directive" is an essential instrument for the harmonisation of criminal law across the member states in the area of crimes against the Union budget, which are investigated and prosecuted by the EPPO. The amended "OLAF Regulation" introduced improvements for the cooperation between the EPPO and OLAF, which is responsible for administrative investigations. Overall, in 2021, following OLAF's reporting, the EPPO opened investigations on crimes with damage estimated at €2.2 billion (OLAF, 2022[125]) (EPPO, 2021[126]).

Future EPPO-OLAF cooperation can help to improve the indictment rate, as the share of cases submitted to national judicial authorities that resulted in indictment is currently low, at 35% between 2017 and 2021 (OLAF, 2022[125]). Since OLAF's powers are limited to administrative investigations and recommendations, any follow-up and criminal prosecutions remain in the hands of the national judicial authorities. Further strengthening cooperation between OLAF and countries' judicial actors can help to reduce the number of OLAF recommendations that are dismissed at an early stage by national authorities. Moreover, the full transposition of the "PIF Directive", setting the EPPO's area of intervention, needs to be concluded as early as possible. Currently, there are 17 infringement procedures ongoing mainly in relation to the non-conformity of transposition of the definition of criminal offences (i.e., fraud, corruption and misappropriation), sanctions and limitation periods (European Commission, 2022[127]). Also, processes for the definition and finalisation of the EPPO's bilateral working arrangements with non-participating countries (currently five) advance at different speeds and should be accelerated (European Commission, 2021[128]).

While OLAF's anti-fraud supervision is important, countries should improve and build up their national anti-fraud capacities. The Union Anti-Fraud Programme (UAFP) launched by OLAF in 2021 was established for this purpose and commands a budget of €181 million to be allocated over the period 2021-27. The UAFP budget is devoted to activities strengthening the cooperation and assistance between national authorities, for example to prevent and detect custom irregularities (OLAF, 2022[125]). OLAF's support to customs authorities has been particularly evident in the context of the green transition and sustainable development. Given that the green transition is among the top priorities of the Commission (Chapter 2) and the volume of EU funds allocated is sizable, OLAF has conducted investigations in 2021 that helped prevent illicit trade of environmentally harmful goods, such as waste, pesticides and gases, including refrigerant gases - potent greenhouse gases on which the EU has imposed an import threshold. In the area of green funding protection, OLAF issued 10 financial recommendations in 2021 on the recovery of misused funds, whose recipients were proposed to be included in the debarment list of the Early Detection and Exclusion System (EDES) (OLAF, 2022[125]).

EDES, the EU's debarment tool for excluding persons or entities that represent risks to the Union's financial interests from receiving EU funds, is a powerful instrument for the prevention of fraud, corruption, participation in a criminal organisation as well as tax evasion and insolvency, such as non-payment of taxes or social security contributions (OECD, 2021[129]). Like the 5th AML Directive (discussed above), EDES has faced constrains regarding publication of information on persons and entities representing risk. To ensure compliance with the Charter of Fundamental Rights in the area of personal data protection, publication was limited to the most severe cases. Moreover, the scope of EDES' intervention is restricted to economic operators receiving EU Funds under direct or indirect management, representing only 24% of the EU budget. The Commission has already put forward a proposal to amend the Financial Regulation, to extend EDES to also cover funds disbursed under shared management and direct management with member states (e.g., the Recovery and Resilience Facility). As recommended by the European Parliament, member states should also consider excluding persons and entities on the EDES debarment list from national government budget funding (European Commission, 2018[130]) (European Commission, 2019[131]) (European Parliament, 2021[132]) (European Court of Auditors, 2022[133]).

The recently introduced Conditionality Regulation is another tool to protect the EU's financial interest, which applies to all EU funds. The regulation became applicable in January 2021 and sets the criteria for the application of different budgetary measures, such as the suspension of payments from the EU budget to countries that breach the principles of the "rule of law", such as legal certainty, independence of the judicial system, separation of powers, non-discrimination and prohibition of arbitrariness of the executive powers. The regulation applies where such breaches affect or seriously risk affecting the sound financial management of the EU budget or the protection of the financial interests of the EU (European Parliament and Council, 2020[134]). In February 2022, the EU's Court of Justice dismissed the actions brought by two member states questioning the conformity of the Regulation with the EU Treaties (Court of Justice of the EU, 2022[135]). The Conditionality Regulation mechanism was formally used for the first time by the Commission in April 2022, with regard to one member state. Breaches were found in compliance with EU principles in the areas of public procurement, the effectiveness of prosecutorial action and the fight against corruption (European Commission, 2022[136]) (European Commission, 2022[137]). In December 2022, the Council adopted measures suspending 55% of the Commission's budget commitments with the country (amounting to approximately €6.3 billion), concerning three operational programmes under the EU Cohesion Policy, and prohibiting entry into new legal commitments with any public interest trusts (or entities maintained by them) where the Commission implements the EU budget under direct or indirect management (European Council, 2022[138]).

As of 2022, the Commission is also making recommendations to EU member countries in its annual Rule of Law report, which covers the fight against corruption as one of its four pillars. The objective is to help countries to identify areas where challenges remain and encourage them to put in place the necessary reforms to fully comply with the EU's "rule of law" principles. For example, concerns remain with respect to the full and timely transposition of the 2019 whistle-blower protection Directive, which aims to strengthen and harmonise protection across countries. Whistle-blower protection is an important building block of the EU's fight against corruption but infringement procedures started in January 2022 are still ongoing, as eight member states have not notified the full transposition of the Directive. It is important that the transposition process is accelerated (European Commission, 2023[139]) (European Commission, 2022[140]) (European Commission, 2022[141]) (European Commission, 2022[142]).

Challenges also remain in the investigation and prosecution of high-level corruption cases (European Commission, 2022[137]). Short statutes of limitations and inefficient procedures for lifting immunities are among the factors hindering the finalisation of complex high-level cases, especially when combined with lengthy court proceedings. As a consequence, in some EU countries, results in tackling high-level corruption are still limited, both in terms of investigation and final convictions. On the other hand, good practices in other countries have produced positive results. For example, the use of digital tools in the justice system helped improve the efficiency of judicial proceedings and reduce their length (European Commission, 2022[143]). Furthermore, the extension of the statutes of limitation for corruption cases has reduced the risk of impunity for this type of misconducts (European Commission, 2022[144]). This was also achieved by establishing ad hoc parliamentary investigation committees, to tighten the scrutiny of political corruption cases, and with the institution of a dedicated central office responsible for investigation of high-level corruption cases (European Commission, 2022[145]) (European Commission, 2022[146]). However, countries' commitment is uneven and a more coordinated and operational approach could foster progress in this field.

The Commission launched a new anti-corruption package in May 2023 (European Commission, 2022[147]) (European Commission, 2023[114]) (European Commission, 2023[115]). The proposals for a new directive on combating corruption through criminal law will have to be adopted by the European Parliament and the

Council before becoming effective, while the establishment of a dedicated sanction regime to target "corruption worldwide" under the Common Foreign and Security Policy (CFSP) will have to be approved by the Council. Measures under consideration aim to improve the effectiveness of the EU framework for fighting corruption, for example by dealing with existing legislative and operational barriers and limited prevention measures. Aligning minimum standards across countries, setting minimum rules and boosting coordination at the EU level could improve the effectiveness of anti-corruption measures in several areas. To this end, the proposed Directive would update the EU legislative framework, including by incorporating international standards, such as those in the UN Convention Against Corruption (UNCAC). The aim is to ensure that all forms of corruption are criminalised in all member states, that legal persons may also be held responsible for such offences, that aggravating and mitigating circumstances are harmonised and that offences incur effective, proportionate and dissuasive penalties. The proposed Directive also has a focus on prevention and requires that countries analyse and reduce the risk of corruption, including through building their own information and awareness-raising campaign to create a culture of integrity, but also through the research and education system and civil-society participation programmes. Furthermore, the proposal aims to strengthen enforcement, by providing minimum rules to reduce obstacles to effective investigation and prosecution, such as difficult procedures for lifting immunities or short statutes of limitation for corruption offences.

Further efforts are also needed to strengthen public integrity in EU institutions. In December 2022, a corruption scandal related to lack of controls in the European Parliament underscored deficiencies in the integrity framework in EU institutions. Investigations have resulted in charges with membership of a criminal organization, corruption and money laundering for some members of the European Parliament and connected NGOs, related to presumed bribes from third-country authorities to influence Parliament decisions. While investigations are ongoing, in January 2023 the European Parliament reacted by announcing new measures and tightening existing rules on transparency and lobbying. For example, the obligation to publish information on meetings with lobbyists or campaign groups will be extended to all legislators and members of their staff, while until now this requirement only concerned some Parliamentarians (European Parliament, 2023[148]). Rules on revolving doors will become stricter, by limiting the access to the Parliament of former members. Informal groups promoting external interests will also be prohibited. More substantial measures, such as the creation of an EU-wide independent ethics body as well as an inquiry into corruption in the Parliament have also been announced but will require more time to be implemented (European Parliament, 2022[149]) (European Parliament, 2022[150]) (European Parliament, 2023[151]). Despite these welcome proposals and immediate actions, the scandals may have worsened perceptions of corruption by EU citizens and businesses. Similarly, this may have had a negative impact on trust in EU public institutions worldwide. (European Commission, 2022[152]) (Eurofound, 2022[153]). An in-depth analysis of the deficiencies in the EU's public integrity framework and swift implementation of the announced measures are crucial to rebuilt trust in European institutions.

Table 1.7. Past recommendations on anti-corruption policies

Main recommendations of the 2021 Survey	Action taken since 2021
Step up national efforts to fight corruption and fraud, notably through full and timely transposition of relevant Directives and stronger co-operation with dedicated EU bodies.	The 2022 annual Rule of Law report introduced recommendations to help countries to identify areas where challenges remain and reforms are necessary to fight corruption. The Commission presented an anti-corruption package in May 2023, including proposals for a Directive on combating corruption through criminal law and establishing a dedicated sanctions regime to target serious acts of "corruption worldwide" under the Common Foreign and Security Policy. 17 infringement procedures opened in 2022 in relation to the non-conformity of transposition of the "PIF Directive".
Enforce the suspension of payments from the EU budget or other measures in case of relevant breaches of the rule of law. Assess in due time the effectiveness of the measures adopted and consider tightening this conditionality if needed.	Following breaches of the principles of the rule of law in a member state affecting the EU budget, in December 2022, the Council adopted measures to suspend a share of commitments under certain programmes and prohibit entering into new legal commitments with certain entities.
Set up an independent EU direct anti-money laundering (AML) supervisor and increase co-operation between national authorities.	The Commission proposed four legislative instruments in July 2021, notably a new regulation (AMLR) and a directive (AMLD), a regulation establishing a new AML Authority (AMLA), and a revised regulation on transfers of funds expanding traceability requirements to crypto-assets. The package is currently under "trilogue" negotiations.
Ensure full and timely transposition of the "whistleblower Directive" into national legislation and increase whistleblower protection also in cases of breaches of national law.	Notification of formal letters to 24 countries in January 2022 to ensure the full transposition of the "whistleblower Directive". Infringement procedures started in February 2023 on 8 member countries in relation to the non-conformity of transposition of the Directive.

Table 1.8. Recommendations on selected policies of the Key Policy Insights Chapter

Main findings	Recommendations (Key in bold)
Reduce inflation durably and protect financial stability through targeted policies	
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.** Clearly communicate the need to prevent second-round effects of inflation including through wage-price spirals and rising profit margins. Continue the process of quantitative tightening, in a gradual and predictable manner.
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.** Use targeted instruments to address individual vulnerabilities, if needed. Continue to manage financial risks through effective supervision and resolution plans.
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.** Harmonise the use of national deposit guarantee schemes and the rules for resolution of banks.
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.** Phase out the EU gas price cap. Continue providing technical support to help implement Next Generation EU spending plans.
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.** Consider strengthening the role and institutional framework for national IFIs. Make the European Fiscal Board institutionally independent and provide it with sufficient resources.
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.** Improve the governance of the Important Projects of Common European Interest framework and speed up the approval process.
The size of the European support for renewables production is considerable. Effective use of existing EU resources could avoid further common borrowing.	**Re-direct existing EU budgetary resources towards support for green R&D, innovation and early-stage support coordinated at the EU level.** To ensure efficient use of the NGEU funds, focus on result indicators and allow more flexibility in national recovery and resilience plans.
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**. Streamline the permitting procedures for new projects in the area of critical raw materials and clean technologies. Introduce sustainability requirements to prioritize clean technologies produced to European standards. Introduce harmonised Ecodesign standards to bolster circularity and recycling of raw materials.

Increase labour mobility	
The administrative requirements for posting of workers are often onerous and the regulatory and administrative burden continues to vary across countries.	Reduce the costs of posting workers by introducing a common EU declaration system and harmonized documentation requirements, including exemptions.
Strengthen the anti-corruption framework	
Corruption reduces economic efficiency, leads to waste of public resources and undermines citizens' trust in public institutions.	**Continue to coordinate national efforts to fight corruption and fraud.** **Align minimum standards across countries and strengthen prevention measures.**
Rules to protect the EU's financial interest have been strengthened but challenges remain, notably in the transposition of Directives and the prevention of fraud and financial crimes.	Ensure that information on beneficial ownership of companies and on persons/entities representing risks to the Union's financial interest can be accessed by users pursuing anti-money laundering and anti-fraud objectives, while determining sufficient protection of personal data in compliance with the Charter of Fundamental Rights. Extend the Early Detection and Exclusion System's (EDES) scrutiny to economic operators that are under shared management.
Lack of controls and misuse of resources in the European Parliament revealed weaknesses in public integrity and rules on transparency and lobbying.	Accelerate the establishment of an EU-wide independent ethics body and strengthen rules on transparency and lobbying regulating the activity of Members of Parliament.

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