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Directorate-General for Economic and Financial Affairs

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COMMISSION STAFF WORKING DOCUMENT

2023 Report on the euro area

Accompanying the document

Recommendation for a COUNCIL RECOMMENDATION

on the economic policy of the euro area

{COM(2022) 782 final}

Introduction

The euro area report is the staff working document accompanying the Commission's recommendations on a Council recommendation on the economic policy of euro area Member States. It provides an analysis of recent economic developments and key policy challenges focusing on issues that are relevant for the euro area. This report should be read in conjunction with the Annual Sustainable Growth Survey,([1]) which outlines the key policy priorities and guidelines for the year ahead, the Alert Mechanism Report,([2]) which provides an analysis of potential macroeconomic imbalances that may hinder the proper functioning of Member State economies, the Economic and Monetary Union or the EU as a whole, and the Commission proposal for a Joint Employment Report,([3]) which provides a yearly update on the employment and social situation.

This report provides an analysis of the economic outlook for the euro area and of the related key policy challenges (Section 1). Taking into account the impact of the COVID-19 pandemic, the report looks into the emerging risks of divergence stemming from the ongoing energy crisis, and in particular from high and vastly different inflation rates recorded across the euro area (Section 2). This situation increases the need for coordinated fiscal and monetary policies, also taking into account sustainability constraints and the need to continue supporting public investment in the green and digital transition (Section 3). The high inflation recorded in the euro area also poses several structural policy challenges to increase the resilience of the economy (Section 4). These are in particular related to developments on the labour market and to social policy. The report also assesses the impact of the high inflation on financial markets, the related normalisation in monetary policy, and the recent deterioration in the economic outlook, both as regards financial integration and macro-financial stability (Section 5).

([1]) Annual Sustainable Growth Survey 2023, COM (2022) 780.

([2]) Alert Mechanism Report 2023, COM (2022) 781.

([3]) Commission proposal for a Joint Employment Report, COM (2022) 783.

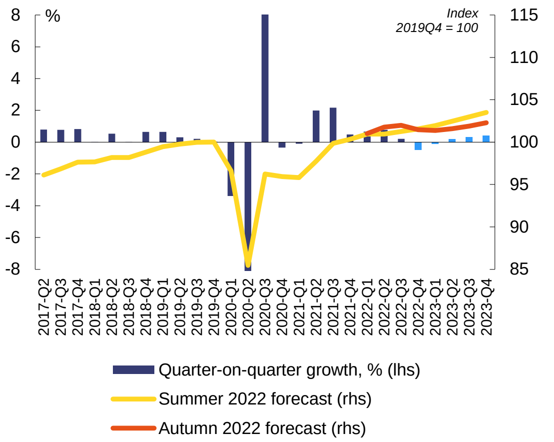
1. ECONOMIC OUTLOOK AND POLICY CHALLENGES

Macroeconomic developments

Economic developments in the euro area reflect the uncertain global and geopolitical environment. In the first half of 2022, economic activity in the euro area was supported by the positive momentum stemming from the re-opening of the economy following the COVID-19 pandemic. The improving labour market, the large household savings accumulated during the pandemic, favourable financing conditions, and the deployment of the Recovery and Resilience Facility (RRF) led to solid GDP growth. However, the increase in global energy prices, heightened uncertainty and renewed supply chain disruptions induced by Russia's war of aggression against Ukraine are set to result in a deceleration of economic activity in the second half of the year. Over the summer of 2022, the Commission's economic sentiment indicator dropped below its long-term average. In particular, consumer confidence plummeted to levels below those during the pandemic. ([4]) Altogether, GDP for the euro area is expected to grow by 3.2 % in 2022 but with a much weaker growth outlook.

The energy crisis has led to a downward revision of growth forecasts for 2023. Further gas and electricity price increases since the beginning of July, the technical recession in the US and the sharp drop in activity in China, together with deteriorated economic sentiment point to negative growth in the last quarter of 2022 and a weak recovery afterward. According to the Commission's autumn forecast, real GDP in the euro area is now expected to grow by 0.3% in 2023, with a stagnating private consumption, 0.5 % growth in investment, and only a negligible external sector contribution to GDP growth.

Graph 1.1: **GDP growth in the euro area**



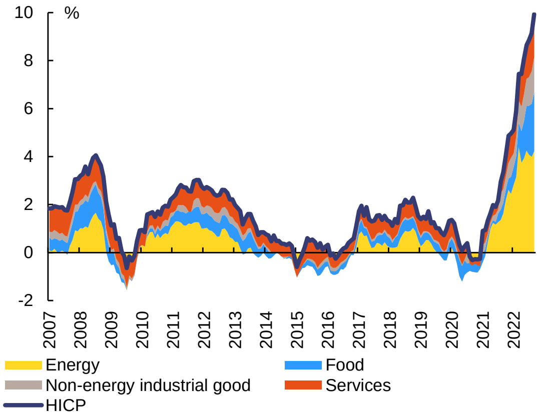
(1) For Q2-2020 (-11.5) and Q3-2020 (+12.6) quarterly growth rate not visible. The light blue bars of quarterly growth based on the Commission's autumn forecast.
Source: Eurostat, European Commission.

Increases in the price of energy and other commodities have been fuelling inflation. Energy commodity and electricity prices already started accelerating in the last quarter of 2021 and have skyrocketed in 2022 following Russia's invasion of Ukraine. Other commodity prices, including cereals and metals, have also experienced a rapid increase. Although agricultural commodity prices have moderated, the Russian blockade of Ukrainian wheat exports, shortage of fertilisers, extreme weather patterns and food export restrictions imposed by some countries have pushed prices higher than in 2021. Prices of industrial metals have retreated from peaks recorded in the first half of the year, though some metals remain well above their 2021 levels. The depreciation of the euro against the US dollar, driven by earlier monetary tightening in the US, has reinforced the terms-of-trade shock linked to energy and other commodity prices (European Commission, 2022d).

([4]) See the latest European Commission's business and consumer surveys: https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/business-and-consumer-surveys_en

Inflation has broadened across the economy and is expected to remain elevated in the coming months. Over 2022, inflation has repeatedly exceeded expectations. In October 2022, annual harmonised index of consumer prices (HICP) inflation stood at 10.7 %, its highest level since the euro was launched, a record breached every month over the last 12 months. As higher energy costs have gradually spread to other goods, price increases have been broadening across categories and HICP inflation is expected to average 8.5 % in 2022.

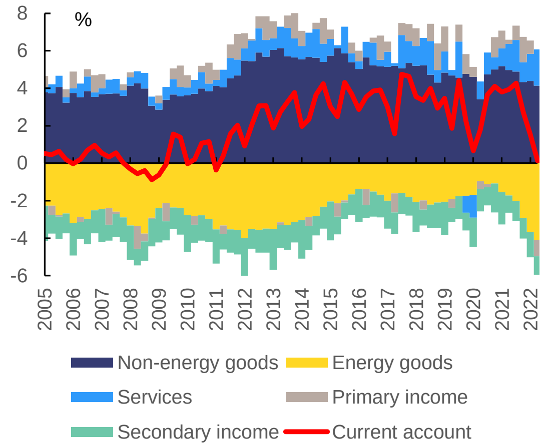
Graph 1.2: **HICP and its components in the euro area, 2007-2022 (annual changes; monthly data)**



Source: Eurostat.

Inflation pressures are expected to ease gradually. The European Central Bank (ECB) has taken steps to start normalising monetary policy and thereby ensure that long-term expectations remain anchored (see Section 2). Despite record inflation rates, wage dynamics appear moderated so far (see Section 4). This weighs on spending power of workers but limits the persistence of high inflation. Mending global supply bottlenecks and the expected weakening consumption should remove some pressure from core inflation. Accordingly, price growth is expected to gradually decelerate, with HICP inflation projected at 6.1 % in 2023 and 2.6 % in 2024 (European Commission, 2022d).

Graph 1.3: **Current account balance of the euro area, 2005-2022, % of GDP**

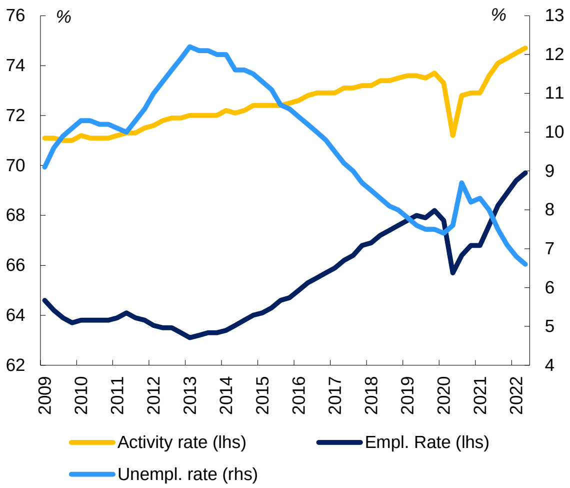


Source: European Commission.

The current account surplus for the euro area has receded. Over 2022, the deteriorating energy balance was the most relevant factor behind a reduction in the euro area current account surplus (Graph 1.3). Meanwhile, the strong variation in energy dependency across euro area Member States has translated in discrepancies in current account dynamics (see Section 3), in some cases increasing risks of external imbalances. Over the medium term, while measures taken to support investment, and in particular the RRF (IMF, 2022a), are set to reduce the surplus, current account developments remain uncertain and will be driven by dynamics on the energy markets.

The labour market has shown resilience and continued to improve. In the first quarter of 2022, total hours worked in the euro area surpassed the pre-pandemic level, while the employment rate (20-64 years old) was 74.3 % in the second quarter, 1.6 points higher than the best pre-pandemic reading (Graph 1.4). The unemployment rate also reached a record low, at 6.6 % in September 2022, and vacancies and labour shortages continued to increase (see Section 4). While the deteriorating economic outlook for 2023 is set to weigh on labour market dynamics, unemployment is expected to remain close to historical lows, at 7.2 % for 2023.

Graph 1.4: **Labour market developments in the euro area, 2009-2022**

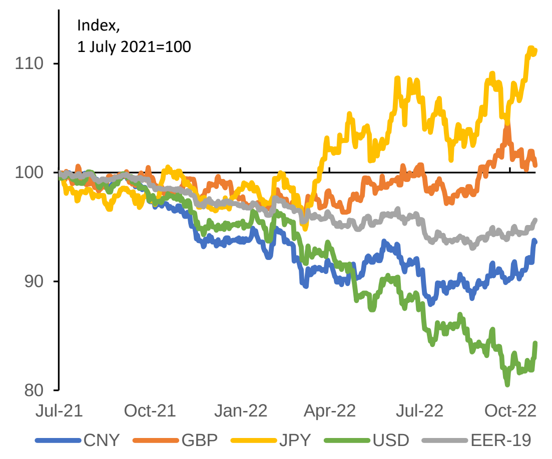


(1) Employment and activity rates, as a percentage of the population aged 15-64. Unemployment rate calculated as percentage of the population aged 15-74 in the labour force. Euro area-19.
Source: Eurostat.

The European financial system remains stable and resilient, albeit in an environment of elevated and increasing risks. Financial market risks have increased as global financial conditions have tightened on the back of on-going monetary policy normalisation (ESRB, 2022). The war in Ukraine has led to increased volatility in financial markets, creating new pockets of risks. On the other hand, the actions by the ECB have ensured that its monetary policy can be duly transmitted across the euro area. This, together with the continuing roll-out of NextGenerationEU, has mitigated the risk of financial fragmentation. While rising interest rates and high inflation are set to represent a risk to financial markets, strong balance sheets protect banks from adverse developments. In contrast, their structurally low profitability remains a significant challenge.

The dollar's nominal exchange rate has appreciated substantially. The strength of the dollar against the euro – an appreciation of around 14% between the beginning of January and the end of October 2022 – and other global currencies (Graph 1.5) should be understood against the background of earlier and stronger increases in interest rates in the US given the different sources of inflation in Europe and the US. Moreover, the euro area's exposure to geopolitical risks and its geographic and economic proximity to Ukraine and Russia has also played a role in exchange rate markets.

Graph 1.5: **Value of the euro against selected currencies**



(1) EER-19: Effective exchange rate compared to 19 trading partners including AU, CA, DK, HK, JP, NO, SG, KR, SE, CH, GB, US, BG, CZ, HU, PL, RO, CN, HR
Source: ECB.

Future macroeconomic developments depend on the roll-out of policies, evolution of the war and commodity markets. Russia's aggression against Ukraine represents a negative supply shock that affects the real economy and fuels inflation. High gas price levels could strengthen these stagflationary forces. Second-round effects could prolong price pressures and lead to a sharper tightening of financial conditions that would not only weigh on growth, but also on financing costs. At the same time, recent falls in oil prices and other commodity prices should ease inflation.

Policy implications

Ensuring an appropriate policy response to high inflation and a deteriorating economic outlook is a significant policy challenge. It calls for the coordination of fiscal, social, and structural policies. While the COVID-19 crisis did not result in sharp divergences across the euro area, thanks to an effective policy response, the energy crisis is having a more varied impact. As the energy crisis puts the external positions of euro area Member States under pressure, a coordination of their economic policies remains a key component to help avert divergences that would alter the good functioning of the monetary union (see Section 2).

Both monetary and fiscal policy authorities are confronted with trade-offs. The ECB has started the process of monetary policy normalisation, also announcing its intention to address signs of financial fragmentation that would risk hindering an even transmission of monetary policy. Meanwhile, the euro area fiscal policy has remained supportive in 2022. While the economic outlook for 2023 is deteriorating, the upward revision in the inflation outlook suggests that a broad-based fiscal expansion would not be warranted as it would fuel inflationary pressure. By contrast, support to vulnerable households and companies most affected by the energy crisis would be best achieved by targeted and temporary measures, while retaining incentives to promote energy efficiency. Based on the draft budgetary plans submitted by euro area Member States, the fiscal stance is projected to be broadly neutral in 2023 (see Section3).

Calibrated wage developments would support the spending power of workers while helping to ease price pressure. The euro area labour markets are strong, and labour shortages surged as economies recovered from the pandemic. Despite the tight labour market, nominal wages have only partly adjusted to rising consumer prices. While this has averted a potential second-round increase in inflation, it has resulted in significant losses in workers' spending power and will contribute to the expected deceleration in private consumption in 2023. Nominal wages are expected to accelerate in 2023 but would still lag the still high inflation. Labour market policies, through their impact on wages, social dialogue and collective bargaining are key to achieving overall wage developments that mitigate the loss in spending power of workers (in particular for low-income workers), while reflecting productivity developments and averting the risk of driving inflation expectations further up (see Section 4).

Supply side policies can also contribute to lower inflation pressures. The increasing price – and decreasing availability – of energy makes the EU's green transition priority even more pressing. In that respect, implementation of the RRF – an EU-wide instrument but with specific relevance for the euro area – and REPowerEU in addition to the cohesion policy funds should increase energy efficiency as well as alternative renewable energy sources in the EU. This should help make the euro area more resilient. Structural policies can also help companies re-gain part of the competitiveness losses linked to the energy supply shock. Developing skills and reducing skill shortages, through education and training and active labour market policy, contribute to productivity growth. Measures to improve the functioning of product and service markets in the euro area, which includes reducing barriers to competition, creating a more supportive business environment and more effective insolvency regimes, support the effective allocation of resources and productivity gains (see Section 4).

Risks to financial stability require continued monitoring. Financial conditions have tightened on the back of monetary policy normalisation. Against the background of deteriorating balance sheets in the private sector, higher interest rates could lead to repayment difficulties. They could also contribute to asset price corrections, for example in the still buoyant housing market. In that context, further progress on the Banking Union could support greater financial stability. Actions to strengthen the Capital Markets Union (CMU) would elicit private risk sharing and avert financial fragmentation risks. The CMU could also spur long-term financing of innovation needed to support the green and digital transition (see Section 5).

Box 1.1: **The euro area in the European Union**

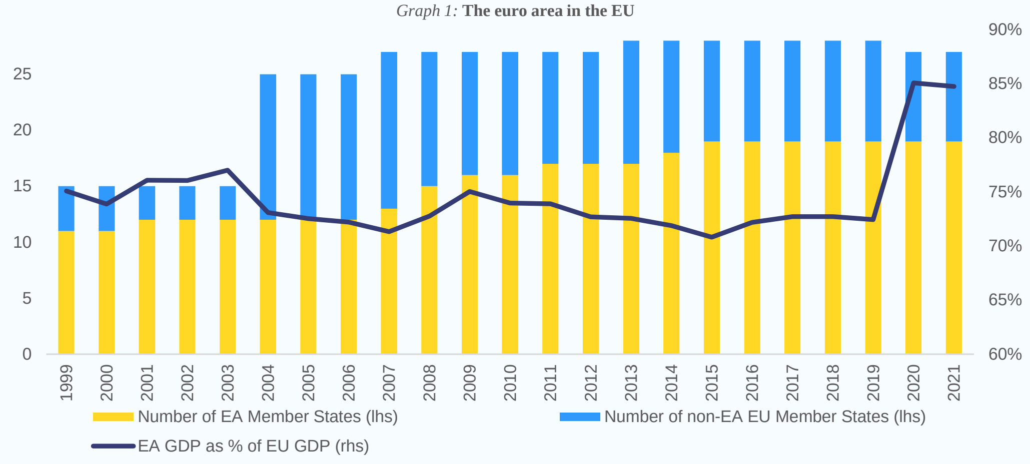
The euro area now represents 85% of the EU's economy. The euro was launched in 1999 with 11 EU Member States adopting the common currency. The euro area has been composed of 19 countries since 2015, following a series of enlargements. After the UK left the EU, the share of the euro area in EU GDP jumped from around 72% (EU-28) to 85% (EU-27). The euro area will soon encompass 20 EU Member States. All EU Member States except Denmark are supposed to adopt the common currency.

On 1 January 2023, Croatia will join the euro area as the 20th member. The Commission's 2022 convergence report – assessing the progress that Bulgaria, Czechia, Croatia, Hungary, Poland, Romania and Sweden have made on joining the euro area – concluded that Croatia fulfilled the four nominal convergence criteria (price stability, public finances, exchange rate, and long-term interest rate) and its legislation was fully compatible with the requirements of the Treaty on the Functioning of the EU. The ECB's convergence report complemented the Commission's assessment. On 12 July 2022, the Economic and Financial Affairs Council adopted legal acts to enable Croatia to introduce the euro. After joining the euro area, the Croatian Central Bank will become part of the Eurosystem, while the Croatian Minister of Finance will participate in the Eurogroup meetings. Croatia has already made steps to join the Banking Union and become a member of the European Stability Mechanism. In parallel, Bulgaria has been participating in the EU's Exchange Rate Mechanism (ERM-II) since 10 July 2020 as it seeks to adopt the euro.

The architecture of the euro area has changed considerably since the launch of the common currency. When the euro was created in 1999, monetary policy was centralised, while fiscal and structural policies were left with national governments. The coordination risk arising from the decentralisation of fiscal policies was identified early on as a potentially destabilising factor. This led to the creation of a framework for economic policy surveillance and coordination. The global financial crisis and the sovereign debt crisis underlined vulnerabilities in the euro area, revealing risks linked to financial interlinkages and macroeconomic imbalances. The crises led to the creation of the European Stability Mechanism. Due to a lack of consensus, some of the work launched at the time, in particular the Banking Union, is still in progress 10 years later.

The delineation between euro area and EU issues has become increasingly blurred. The processes that are most relevant for the future macro-financial stability of the euro area (Banking Union, single market) are adopted via EU legislation. The new crisis management tools – the Recovery and Resilience Facility and the European Instrument for Temporary Support to Mitigate Unemployment Risks in an Emergency (SURE) – address the entire EU rather than focusing only on the euro area. Albeit temporary, the new instruments strengthen the monetary union architecture. Reflecting the increasing relevance of the EU level, the long-term priorities of the EU such as the European Green Deal and digital transformation cover all EU Member States.

Graph 1: **The euro area in the EU**



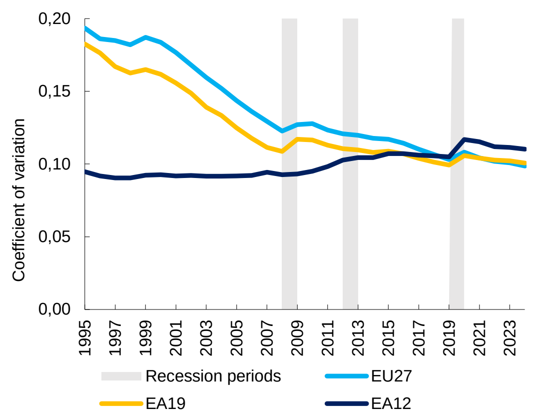
2. STATE OF PLAY ON CONVERGENCE

Large inflation differentials coupled with the deterioration in economic conditions cast a shadow on the prospects for convergence in the euro area. In the aftermath of the COVID-19 pandemic, the depth and speed of economic contractions and recoveries have been very different across Member States. This raises concerns about potential scarring effects and their impact on convergence. The external shocks of 2022 have resulted in new sources of divergence, as energy mixes, the level of energy dependency on Russia and national economic policies to mitigate the impact of the energy crisis vary considerably across the euro area.

Impact of COVID-19 crisis on convergence

The COVID-19 pandemic has led to deep, though largely transitory, divergences in macroeconomic performances. The GDP contraction following the COVID-19 shock in 2020 was much larger than during the 2008 global financial crisis. The bold policy response to the pandemic at EU and national level mitigated the negative socio-economic impact of the crisis, supporting businesses, protecting incomes and preserving jobs. This enabled a strong rebound in economic activity, with euro area GDP already reaching its pre-COVID-19 level by the end of 2021, with the dispersion of income per head expected to be broadly back to its pre-crisis levels (5) (Graph 2.1). Similarly, the standard deviation of output gaps in the euro area Member States widened in 2020, but immediately declined on the back of the economy rebounding. (Graph 2.2).

Graph 2.1: **Dispersion in level of real GDP per capita in the euro area and the EU**



(1) Dispersion is measured by the coefficient of variation in the level of real GDP per capita in purchasing power standards (PPS). (2) All aggregates are defined in fixed composition. (3) The euro area-12 aggregate includes the founding Member States of the euro area and Greece.
Source: Commission's calculations based on the AMECO database.

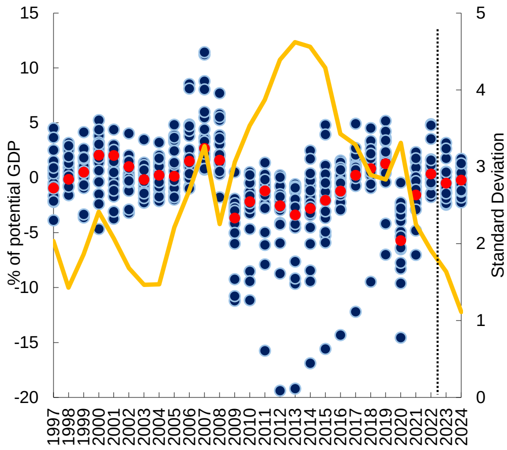
Despite a quick recovery from the COVID-19 crisis, investment was more affected in the euro area than, for example, in the US. Annual gross fixed capital formation in the euro area returned to pre-pandemic level in less than 2 years. (6) This rapid recovery contrasts with the decade after the global financial crisis, which was marked by a sustained slump in capital accumulation. However, in the US gross fixed capital formation decreased less than in the euro area and has recovered at a much faster pace, returning to its pre-crisis level at the end of 2020 and continuing on previous trend since then (Graph 2.3, Licchetta et al., 2022). There is a risk that tighter financial conditions and the large corporate debt burden accumulated

(5) Having increased in the aftermath of the pandemic, dispersion in income per capita was expected to return to its declining trend by 2022, according to the spring 2022 forecast.

(6) In the euro area, the impact of COVID-19 on gross fixed capital formation (along with other components of GDP) reflects in part the intensity of lockdown measures to contain the spread of the virus, with more stringent lockdowns (and consequent lower mobility) associated with lower investment. See also Licchetta and Meyermans (2022).

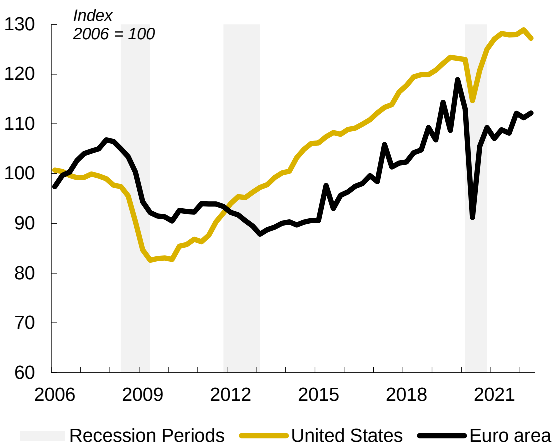
during the pandemic in the euro area might act as a drag on investment in future.

Graph 2.2: **Output gaps in the euro area (1997-2023) and dispersion of output gaps**



(1) Blue points refer to the output gap of different euro area Member States in each year. Red points refer to the output gap of the euro area. (2) The yellow line refers to the standard deviation of euro area output gaps (right-hand side).
Source: Commission's calculations based on the AMECO database.

Graph 2.3: **Gross fixed capital formation in the euro area and the US (2006-2022)**

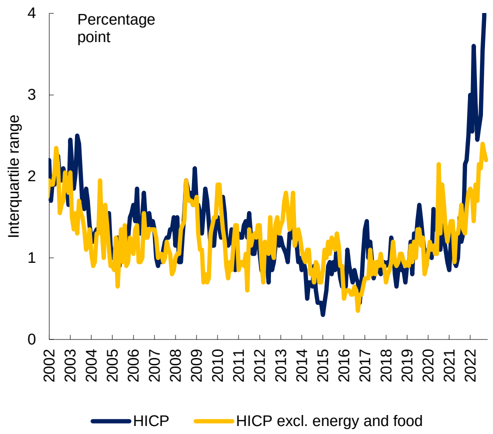


(1) Gross fixed capital formation, volume estimates, fixed purchasing power standards. Shaded area refers to euro area recessions (CEPR).
Source: OECD (2022).

Divergence risks

The recent inflation surge is largely linked to supply constraints. The inflationary pressures in the euro area since 2021 have been largely driven by supply side disruptions. However, after being very weak during the pandemic, there are signs of demand pressures on prices. Analysis of producer prices at sectoral level suggests that around 80% of the increase in producer prices in industry in the euro area over the past four quarters can be attributed to supply shortages and only 20% to demand pressures (Pasimeni, 2022). Recent ECB analyses also suggest a predominantly supply-driven characteristic to the recent increase in inflation, although the exact contribution was different. (7)

Graph 2.4: **Interquartile range in headline and core inflation**



Source: Commission's calculations based on Eurostat.

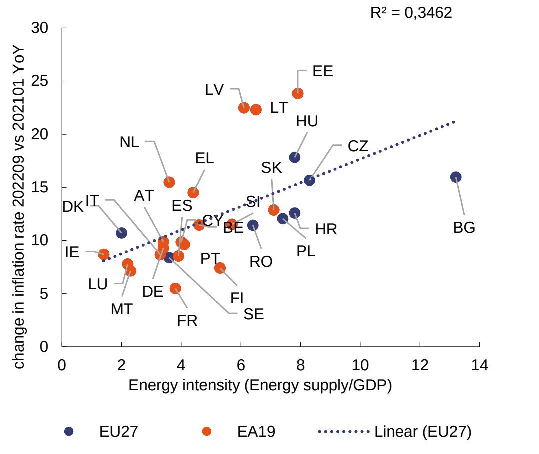
Given higher inflation, large differences in headline (and core) inflation rates across Member States have emerged. The annual inflation rates ranged from 7.1 % in France to 22.4 % in Estonia in October 2022. The inflation dispersion rate, as measured by the interquartile range, spiked in 2021 and 2022 both for general inflation and to a lesser extent for core inflation (Graph 2.4). Although intra-euro area dispersion has been mainly

(7) See ECB macroeconomic briefing at the Economic Policy Centre, 30 September 2022 and ECB (2022), Account of the monetary policy meeting of the Governing Council 7-8 September 2022.

driven by changes in inflation in the Baltics, stark differences exist among all Member States. Different sensitivities to energy prices, above all Russian gas, as well as different shares of energy and food in the consumption baskets played a role (Beynet and Goujard, 2022).

The degree of energy intensity ([8]) is an important driver of inflation differentials. Eastern European countries experienced the largest shock given their higher energy intensity (Graph 2.5). Cross-country differences in policies to mitigate the impact of the high inflation can also explain some of the differentials. In particular, energy price caps or freezes implemented in some Member States have reduced energy inflation for consumers (for example in France), though at a large cost (see Section 3). In this context, the EU has taken a number of initiatives to reduce energy prices and improve energy security (see Box 2.1).

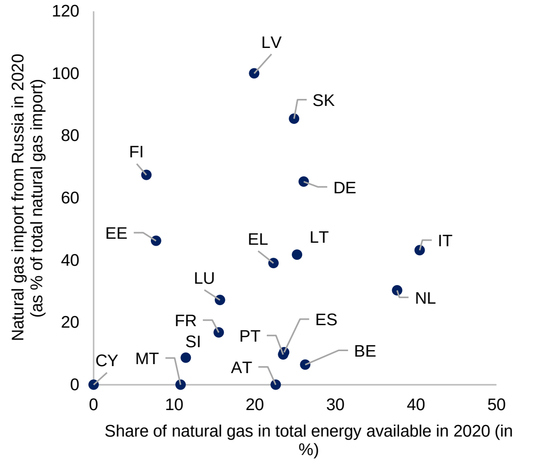
Graph 2.5: **Energy intensity and change in inflation rate since January 2021**



Source: Eurostat and the International Energy Agency.

Inflation differentials make it more challenging to conduct monetary policy. To the extent that they are temporary and linked to the energy supply shock, inflation differentials have only a limited impact on policy. ([9]) However, large or persistent differences in inflation rates may make a single monetary policy less effective. Real interest rates may end up being too low in countries with high inflation, with a monetary policy having a limited impact on demand and being too high for countries with lower inflation (Beynet and Goujard, 2022).

Graph 2.6: **Natural gas imports from Russia and share of gas in energy mix**



Source: Eurostat.

Beyond inflation, the energy crisis has very different macroeconomic impacts in the euro area. Heightened uncertainty and higher commodity and energy prices are expected to put all euro area Member States on a weak real GDP growth path. Nevertheless, differences in sectoral specialisation, proximity to the conflict, trade exposure to Russia, Belarus and Ukraine, and dependency on energy fuel imports from Russia are key sources of divergence (Graph 2.6). Member States have been very swift in diversifying away from Russian energy. In September 2021, Russian gas accounted for 41% of EU gas imports. In September 2022, this fell to 9% ([10]). However, many euro area countries remain vulnerable to further gas pipeline shutdowns. Furthermore, differences in available fiscal space and insufficient policy coordination among Member States constitute further drivers of divergence, which may

([8]) Energy intensity is defined as the ratio of global total energy supply per unit of gross domestic product (GDP).

([9]) Higher inflation in countries more affected by the energy shock may have a stabilising effect by lowering real interest rates to offset the impact of higher energy costs on domestic consumption.

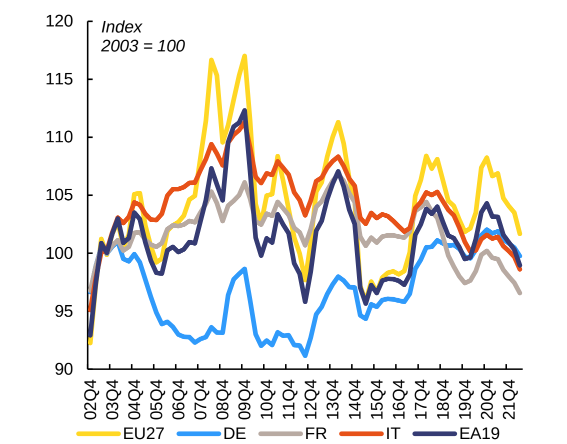
([10]) European Commission's estimations based on data from the European Network of Transmission Operators for Gas.

impact confidence, investment and growth prospects (see Section 3).

Competitiveness risks

Changes in relative competitiveness across euro area Member States are important adjustment channels but may also exacerbate vulnerabilities. Within the monetary union, as exchange rates cannot adjust, changes in nominal costs and prices are the main channel to adjust following asymmetric shocks impacting real exchange rates across countries. However, a lasting gap between countries may lead to external weaknesses. In particular, drifts in competitiveness between countries within the euro area in the years preceding the global financial crisis contributed to deteriorated external positions and to large deleveraging pressures experienced in some Member States in the aftermath of the crisis.

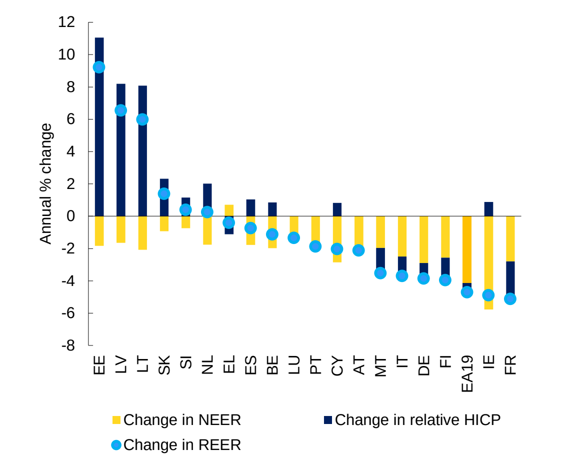
Graph 2.7: **Real effective exchange rate based on unit labour costs for selected euro area Member States**



Source: Eurostat.

The increase in energy prices is set to result in competitiveness differentials within the euro area. Energy intensity differs between sectors and countries within the euro area. Member States with energy-intensive industries are set to see a significant deterioration in their relative competitiveness (see Section 4). In that respect, the different range of measures taken by governments to limit the impact of higher energy prices on corporates may contribute to intra-euro area competitiveness developments and may also negatively affect the integrity of the single market. If energy prices remain permanently higher in the EU than in other regions, euro area firms will become less competitive than their international counterparts.

Graph 2.8: **Change in the real effective exchange rate between January 2021 and July 2022**



(1) The real effective exchange rate based on the harmonised index of consumer prices.
Source: Commission's calculations.

In addition to energy inputs, wages are a key determinant of costs and competitiveness developments. In 2022, the dispersion among Member States in the changes in employee compensation and unit labour costs increased somewhat. Wage growth differentials due to institutional factors (including indexation and multi-year contracts, see Section 4) across the euro area could feed into divergence. However, the wage growth patterns have not translated into a significant shift in competitiveness so far. In particular, they have not reversed the competitiveness gains recorded in the past few years by countries that experienced competitiveness losses prior to the global financial crisis (Graph 2.7). The risk that wage and inflation divergences become entrenched also depends on the features of wage setting mechanisms.

Box 2.1: **Energy policy packages at EU level in 2022**

The Commission has put forward a series of policy packages over the course of 2021 and 2022 to respond to rising energy prices and to ensure security of energy supply in Europe while reducing dependence on Russian fossil fuels. This box presents the main packages and highlights the key actions:

1. TOOLBOX FOR ACTION AND SUPPORT (OCTOBER 2021)

The Communication aims to provide coherence to the response in Member States and at EU level to rising energy prices. It provides options for short term, and medium-term measures that Member States can take and announced steps the Commission would take at EU level. Short-term measures include the option for Member States to provide time limited compensation measures and direct support to energy-poor end-users, or provide more targeted support to industry in compliance with state aid rules. The Commission committed to investigate possible anti-competitive behaviour and enhance its international energy outreach. Additionally, a set of measures for the medium-term was announced, which has been followed up by the various proposals covered below.

2. REPOWEREU COMMUNICATION AND THE TEMPORARY CRISIS FRAMEWORK (MARCH 2022) AND REPOWEREU PLAN (MAY 2022)

The REPowerEU Communication, including the related plan, sets out actions to reduce our dependence on Russian fossil fuels by fast forwarding the clean energy transition and achieve a more resilient energy system. Importantly, the Communication also announced a self-standing Temporary Crisis Framework for state aid.

The Temporary Crisis Framework complements the existing State aid toolbox by including measures providing compensation to companies for damages directly suffered due to exceptional circumstances as well as the additional costs incurred due to exceptionally high gas and electricity prices, with safeguards for the overall aid provided. A further amendment also enables Member States to provide aid for accelerating the rollout of renewable energy, storage, and renewable heat relevant for REPowerEU, the decarbonation of industrial production processes, and additional reduction of electricity consumption.

The REPowerEU Plan puts forward a set of short- and medium-term measures including inter-alia:

- Short-term measures: build new energy partnerships with reliable suppliers, requirement to fill gas storage to 80% of capacity by 1 November 2022, rapid roll out of solar and wind energy projects combined with renewable hydrogen deployment, and EU Save Energy communication providing recommendations to citizens and firms.

- Medium-term measures: a REPowerEU chapter to be included in the revised recovery and resilience plans supported by an additional financial envelope of EUR 20 billion, increased EU 2030 energy efficiency and renewable energy targets going beyond the Fit-for-55 proposal, new legislation and recommendations for faster permitting of renewables, and accelerated production of hydrogen by building 17.5 GW of electrolysers by 2025 to fuel EU industry.

3. ACTIONS TO REDUCE THE DEMAND FOR GAS (JULY 2022) AND ELECTRICITY BILLS (SEPTEMBER 2022)

- Reduction in demand for gas: Voluntary reduction target of 15% from 1 August 2022 to 31 March 2023. If a gap emerges between supply and demand, the Regulation creates the possibility to call a ‘Union Alert’ and impose mandatory reductions on all Member States. The Commission also put forward a European Gas Demand Reduction Plan, which consists in guidelines to protect households, essential users and industries from a gas shortage and help Member States to reduce gas demand.

- Reduction in electricity demand: mandatory reduction target of 5% in peak hours (defined as 10 hours each month with highest prices) and a general 10% reduction target for all consumers until March 2023.

- Cap on market revenues from inframarginal technologies: Applicable to market revenues from the sale of electricity produced from technologies whose marginal costs are lower than the cap (e.g. wind, solar, geothermal, nuclear, etc.). the inframarginal revenue cap is set at €180 EUR/MWh and is estimated to collect up to EUR 117 billion annually.

(Continued on the next page)

Box (continued)

- One-off solidarity contribution from fossil fuel companies: A levy of 33% is proposed to be applied to (an estimation of) the profits of oil, gas, coal, and refinery companies that exceed those by 20% of previous years, which is estimated to generate around EUR 25 billion.

4. ENERGY EMERGENCY: PREPARING, PURCHASING AND PROTECTING THE EU TOGETHER (OCTOBER 2022)

The Commission proposed that the Council adopts the following actions, but they still need to be adopted by the Council (as of 15 November):

- Joint gas purchasing: A temporary joint purchasing tool is proposed to be developed, by early spring 2023, ahead of the next storage filling season. It would be mandatory for Member States to participate for volumes equivalent to at least 15% of their storage filling requirements for next year.

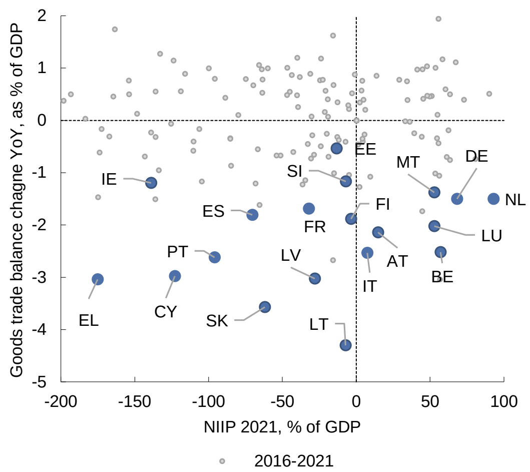
- Development of a new complementary benchmark for LNG: The proposal tasks the European Agency for the Cooperation of Energy Regulators ('ACER') to create a benchmark of the EU's LNG imports by collecting real-time information on all daily transactions, offering a fairer and more transparent price index, as an alternative to the Title Transfer Facility (TTF).Until the benchmark is in place, a Gas Market Correction mechanism is proposed to establish a maximum dynamic price at which natural gas transactions can take place in the TTF spot markets under specific conditions.

- Intra-day price volatility management mechanism: the proposal lays down a requirement for trading venues to establish a new temporary intra-day price spike cap mechanism aimed at limiting large price movements in electricity and gas derivatives contracts within the same trading day.

The real depreciation of the euro since 2021 will provide only a modest boost to competitiveness. The real effective exchange rate, which is a measure of competitiveness, has depreciated by around 6% between January 2021 and July 2022 (Graph 2.8). While such a depreciation would in principle support exports, it also results in higher input costs for firms, especially as global energy commodities are traded in the US dollars, putting additional pressure on profitability.

Divergences in current account balances have widened on the back of deteriorating energy balance. The COVID-19 crisis led to a temporarily lower euro area's current account surplus. The changes to external balances during the pandemic were driven to a large extent by sectorial dynamics, and in particular by the reliance on contact-intensive services and tourism. For instance, the moderate surplus observed in previous years in Spain shrunk, whereas the Portuguese economy moved back to a moderate deficit, while the Greek deficit deepened. The recent jump in energy prices has resulted in a deterioration in the balance of trade in energy goods. Together with the slowdown in China and monetary tightening in the US, this adds to the deteriorating of the overall trade balances throughout the euro area (Graph 2.9), which contributes to worsening of the current account balances (European Commission, 2022c).

Graph 2.9: **Trade balance (including energy balance) and net international investment position (NIIP) as of June 2022**



Source: Commission's calculations based on Eurostat.

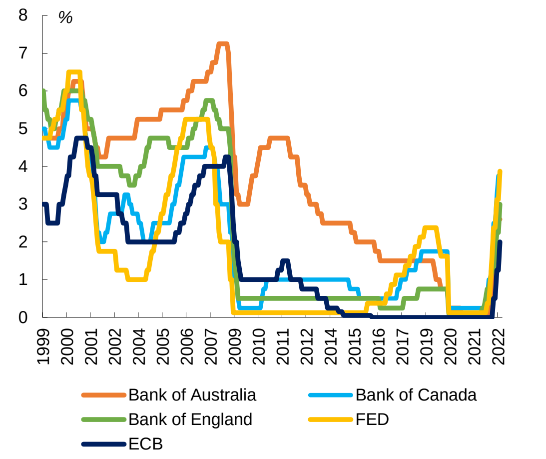
3. FISCAL AND MONETARY POLICY MIX

The challenging economic conditions are posing dilemmas to the policy mix in the euro area. In the face of rapidly increasing inflation, the ECB has embarked on a process of monetary policy normalisation. Striking the right balance between helping the most vulnerable households and firms, repairing supply chain disruptions and safeguarding investments without undermining the actions of the ECB and avoiding blurring energy price signals is a significant challenge for national governments. Potential effects of fiscal policy on inflation, in a context where investments are needed for the green and digital transitions and energy security, are particularly relevant. Debt sustainability will continue to be a concern, in particular given the large public debt inherited from the pandemic.

Monetary policy stance

The surge in inflation led to a rapid adjustment of the monetary policy stance globally. For more than a decade, central banks around the world have been implementing extraordinary measures to fend off deflationary risks, raise inflation and support financial stability. This has brought policy rates close to or below zero (Graph 3.1) and led to the adoption of unconventional monetary policy measures by the major central banks. Against a background of rising inflation, central banks in advanced economies started normalising their policies, albeit at different speeds, reflecting the underlying macroeconomic contexts. The Bank of England already started to gradually increase the key policy rate at the end of 2021. In the US, the Federal Reserve started to increase interest rates in March 2022 and accelerated monetary tightening in July 2022, with most central banks following suit. This translated into a substantial tightening of global financial conditions over the course of 2022.

Graph 3.1: **Key policy rates at leading central banks**



Source: Bank for International Settlements database.

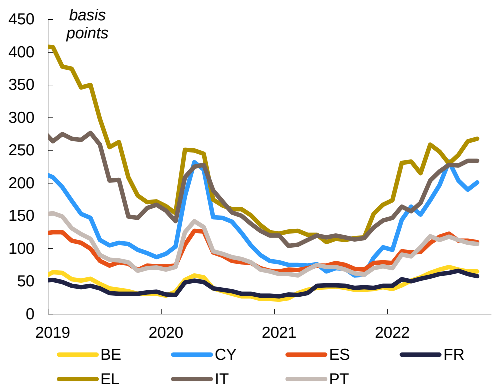
The ECB initiated policy normalisation at the end of 2021. In December 2021, it started to phase out the temporary measures taken to address the pandemic. (11) At its Governing Council meetings, the ECB accelerated its policy normalisation by hiking policy rates by 50 basis points in July 2022 and 75 basis points twice, in September and October, bringing the interest rate on the main refinancing operations to 2.0 %.

The ECB has indicated that the normalisation of interest rates would continue. While policy rates have now exited negative territories, the ECB Governing Council has indicated that further interest rate increases would be necessary in order to bring inflation in line with the ECB's inflation objective of 2% over the medium term. Given

(11) The ECB conducted its last operation under the third series of its targeted long-term refinancing operations (TLTRO III) in December 2021 and announced a progressive phase-out of its temporary pandemic collateral easing measures between July 2022 and March 2024. The ECB ended its net asset purchases under the Pandemic Emergency Purchase Program (PEPP) at the end of March 2022 and the Asset Purchase Programme in July 2022.

the large uncertainty clouding the outlook, the ECB's future policy rate decisions will remain data-dependent, with the Governing Council adopting a meeting-by-meeting approach to its monetary policy. The ECB has indicated that the complex situation justifies this approach. Unlike some other advanced economies, the euro area has been facing excess demand to a much lesser extent, but rather a series of negative supply shocks.

Graph 3.2: **Sovereign bond spreads in selected euro area Member States**



Source: ECB.

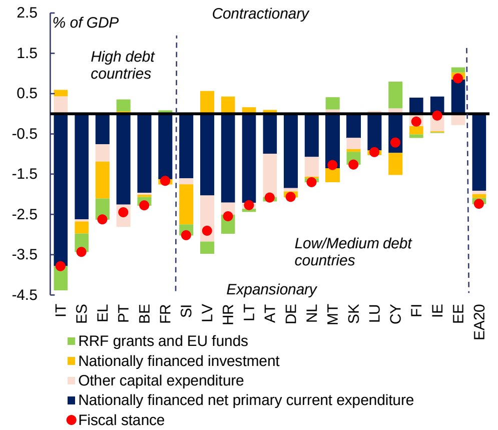
An even transmission of the policy stance across the euro area is a precondition for monetary policy to deliver on its mandate. In this respect, tackling risks of financial fragmentation remains crucial. Sovereign yields in the euro area have been on an upward trend since mid-2021. Over the course of 2022, until the end of October, interest rates on long-term government bonds have increased on average by 2.6 percentage points, with the highest increases recorded in Latvia, Cyprus, Greece and Italy. This means that sovereign spreads have widened, although to a limited extent (Graph 3.2). While fragmentation risks have been contained, the ECB has announced its Transmission Protection Instrument, with eligibility criteria that are linked to EU economic surveillance, to counteract disorderly market dynamics. (12)

(12) Eligibility will be decided by the ECB's Governing Council based, among other things, on the following four criteria: (i) compliance with the EU fiscal framework; (ii) absence of severe macroeconomic imbalances; (iii) fiscal sustainability; and (iv) compliance with sound and sustainable macroeconomic policy.

Fiscal policy stance

The euro area fiscal stance has continued to be very supportive in 2022. Based on the Commission 2022 autumn forecast, the euro area fiscal stance has been expansionary in 2022, at around 2¼ % of GDP, after expansions of 1¼ % and ¼ % of GDP recorded in 2021 and 2020, respectively. An expansionary fiscal stance is projected in almost all euro area Member States, including high-debt Member States, driven by increasing net primary current expenditure (Graph 3.3). More than half of the expansion is related to measures taken by governments to mitigate the impact of high energy prices. The expansionary stance has helped support the economy while potentially adding to inflationary pressures and weighing on the fiscal position of several Member States, including those with high debt. Investment and expenditure paid for by the RRF, which contribute to enhancing the supply side of the euro area economy, are set to contribute to the expansionary stance.

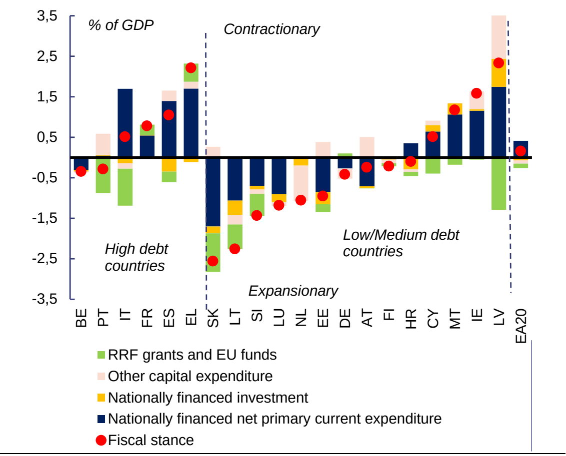
Graph 3.3: **Fiscal stance in 2022**



Source: Commission's calculations.

For 2023, the euro area fiscal stance is currently projected to turn broadly neutral, conditional on the planned roll-back of energy-related measures. The Commission 2022 autumn forecast, which incorporates information provided in the 2023 Draft Budgetary Plans, indicates that the euro area fiscal stance would become less supportive in 2023. At the same time, the fiscal stance is forecast to be uneven across Member States (Graph 3.4). This neutral stance is driven by a slightly contractionary net primary current expenditure that, in turn, is related to the roll-back of energy-related measures relative to 2022 currently planned in the DBPs.

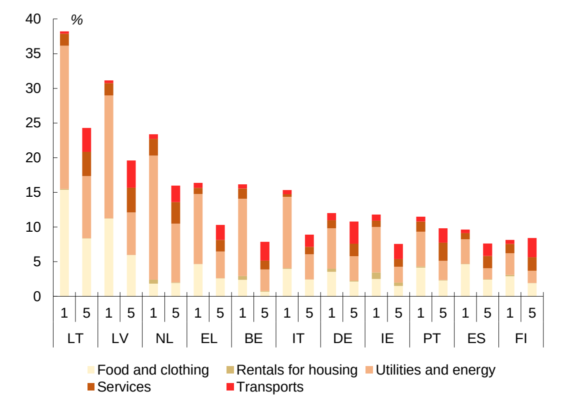
Graph 3.4: **Fiscal stance in 2023**



Source: Commission's calculations.

Nationally and EU-financed investment is expected to expand in 2023. Nationally financed investment and expenditure financed by the RRF grants and other EU funds, including cohesion policy funds, are set to contribute ¼ % of GDP to the fiscal stance in 2023. This would help reduce reliance on imported fossil-fuel energy, in particular from Russia. It would also have a positive impact on potential growth and thus on fiscal sustainability in the medium term. Overall, the 2023 euro area fiscal stance and its composition appear to be broadly consistent with the need to not add to the high inflationary pressures. However, this assessment could change depending on (i) the prolongation of existing or the adoption of new energy measures; and (ii) the development of energy prices and their actual budgetary impact. Going forward, fiscal policy needs to remain agile to respond to risks linked to the high inflation environment.

Graph 3.5: **Inflation rate and contributions by quintile (Semptember 2022 y-o-y)**



(1) The chart shows the aggregate level of inflation and its contributions in the first and fifth quintile of consumption and the contribution of each item. Data available only for selected Member States.
Source: Villani and Vidal Lorda, 2022JRC analysis.

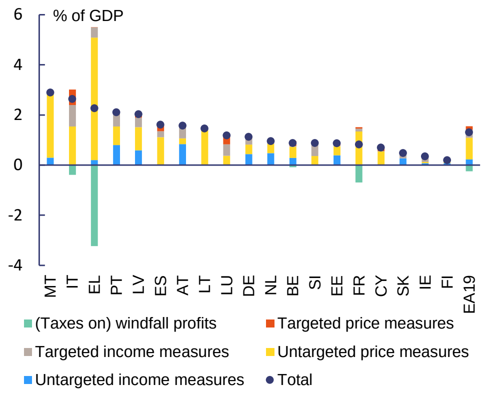
The current energy price shock has significant social and distributional impacts, calling for adequate and targeted policy support. Higher energy and food prices tend to have a disproportionate impact on low- and middle-income households because household energy and food represent a higher share of their consumption (see Graph 3.5). Only few countries showed the opposite trend, where the top quintile experiences higher inflation levels. (13) Beyond the impact on their consumption baskets, low-income household also have a more limited ability to use savings, and they have fewer means to invest in energy-saving solutions.

Governments in the euro area have taken several measures to mitigate the impact of high energy prices on households and heavily exposed firms. These measures have included direct price interventions, changes in VAT and excise duties, cash and in-kind benefits, and other measures, such as safeguards for the basic or uninterrupted supply of energy services. In 2022, the net budgetary cost of such discretionary measures (which are specific as a reaction to the energy crisis, and exclude other fiscal measures that have been adopted as a reaction to general inflation) is estimated at 1.3 % of GDP in the

(13) For additional analysis on the differential impact of inflation on households, see the Joint Employment Report 2023.

euro area. Three criteria are important when assessing energy-related measures: (i) fiscal affordability; (ii) the social and distributional impact; (iii) the impact on the demand for energy. Overall, the Commission's analysis shows that price measures represented 65 % of the total budgetary impact and only 20% of all measures were targeted income measures to vulnerable households or energy intensive companies (European Commission, 2022d).

Graph 3.6: **Budgetary impact of energy measures across the euro area in 2022**



Source: Commission's calculations.

There is a considerable potential to improve the quality and affordability of energy measures during their implementation, or when they are revised. Almost all fiscal measures that have been adopted to protect households from the high energy prices create distortive effects and ultimately increase demand for energy. With energy price projections to remain elevated, the measures will also become increasingly costly to national budgets to keep in place. It is therefore essential to focus on measures that least distort the price signal on energy demand, implement them on a temporary basis and target vulnerable households and firms. In addition, there is a need to continue strengthening a targeted approach, also to maintain capacities for mitigating social impacts and maintaining fiscal affordability for the necessary period ([14]). In this respect, measures to directly support the income of the vulnerable households are preferable to price measures (e.g. cuts in indirect taxation) that aim to reduce the price paid by consumers.

A more coordinated EU approach could help to address a number of these issues, as well as limit macroeconomic spillovers. Even though the energy price paid by households and firms might remain at a relatively lower level in Member States implementing more generous price measures, it would contribute to pushing up energy prices in the rest of the Union because of supply constraints. This might trigger a race to the top in providing budgetary support, with governments trying to outbid each other, increasing risks to fiscal sustainability especially of the more vulnerable Member States. In that respect, agreement on a common approach to replace broad-based price measures with an appropriately calibrated and targeted two-tier energy pricing system, with a lower price applied on a pre-defined consumption, would improve the protection of vulnerable households and companies, preserve incentives to reduce energy consumption and be more fiscally sustainable. The success of such a system would depend on the exact calibration, in terms of the applied regulated price and the associated volume threshold set, in order to limit the fiscal costs, support economic stabilisation, and leave the price signal in place (on the last unit consumed) to incentivise energy savings. Targeted income support and support to undertake energy efficiency actions and increase renewables can still complement such an energy pricing system.

Public finances face significant challenges. In times of stretched public finances and low growth, fiscal policy will have to strike the right balance between strengthening sustainability and coping with increasing but necessary fiscal costs. Expenditure reviews are a valid tool to direct public spending towards high priority areas. In particular, governments are called on to increase investments for the green and digital transition and energy security. Shifting taxes from labour taxation towards environmental

([14]) This was also recognised by the Eurogroup in its statement on 'Fiscal policy response to high energy prices and inflationary pressures' published in October 2022.

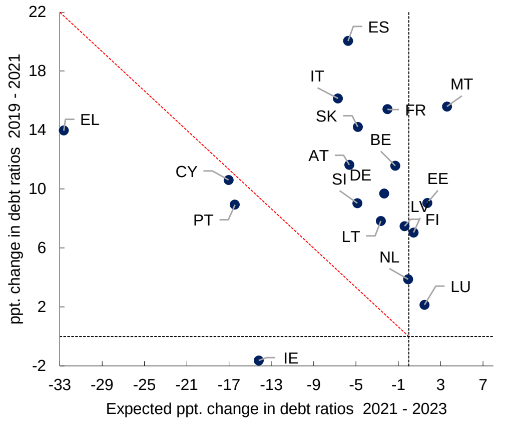
taxes in line with the ‘polluter pays’ principle can also play a role, supporting both the green transition and job creation, while being budget-neutral. Higher defence spending may also be necessary in several Member States. In addition, governments will have to face costs related to climate change and ageing, while ensuring that the tax systems remain appropriate and competitive in the global context. This highlights the need to carefully design fiscal policy and strengthen public financial management, through efficient frameworks for public investment management and green budgeting in order to address recovery and resilience needs.

Debt dynamics and sustainability

The COVID-19 pandemic has left a legacy of record-high debt in the euro area. Public finances took a serious hit as a result of the crisis. After reaching 7 % of GDP in 2020, its highest level since the launch of the euro at, the aggregate government deficit in the euro area is expected to decline to 3.7 % of GDP in 2023 and 3.3 % in 2024. The large deficit ratios in the years of the pandemic led to broad-based increases in public debts. For the euro area as a whole, debt reached a historical peak of 99 % of GDP in 2020. It is expected to drop to 93.7 % in 2022 and to decline further to 92.5% of GDP in 2023 and 91.6 % in 2024, still around 6 percentage points above its pre-COVID level.

In 2023, public debts are expected to remain much above pre-pandemic levels in most Member States. By 2023, only Ireland, Greece, Cyprus and Portugal are projected to return below their pre-pandemic debt ratios (Graph 3.7). In several Member States, including those with large public debt, the government deficit is expected to remain above the 3 % of GDP threshold over 2023 and 2024. In a general manner, the pandemic has increased the dispersion in public debt ratios throughout the euro area.

Graph 3.7: **Changes in public debt ratios**



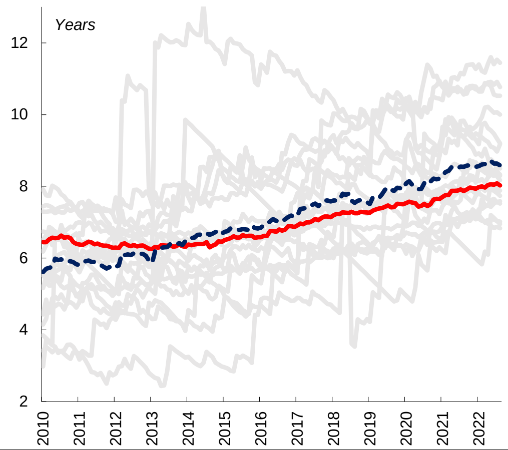
(1) With few exceptions, countries which recorded the highest increase in debt are not expected to reduce it significantly by 2023.
Source: AMECO.

Over the medium term, euro area debt is set to increase again, in the absence of new measures. Projections ([15]) show that, under the assumption of unchanged fiscal policy, the debt ratio would decline slightly until the late 2020s for the euro area as a whole. Low interest expenditure is an important factor that helps reduce projected debt. As from the 2030s, the rising cost of ageing, coupled with higher interest expenditure and lower nominal growth, would reverse the debt dynamics.

High inflation does not permanently improve debt dynamics. In the short term, debt-to-GDP ratios might fall faster because of the higher nominal GDP growth. In the longer term, however, the increase in interest rates will eventually feed into a higher debt burden. Given that the average debt maturity in most euro area Member States is higher than a few years ago (Graph 3.8), this will happen only gradually, although a few Member States with a higher share of inflation-linked bonds will see a more rapid increase in debt service costs. More importantly the damaging impact that persistent inflation could have on growth prospects would be detrimental to long-term debt dynamics and would affect sustainability.

([15]) Methodology based on the 2021 Fiscal Sustainability Report and updated on the basis of the 2022 Autumn Forecast.

Graph 3.8: **Average (residual) maturity of government debt (securities) in the euro area and Member States**



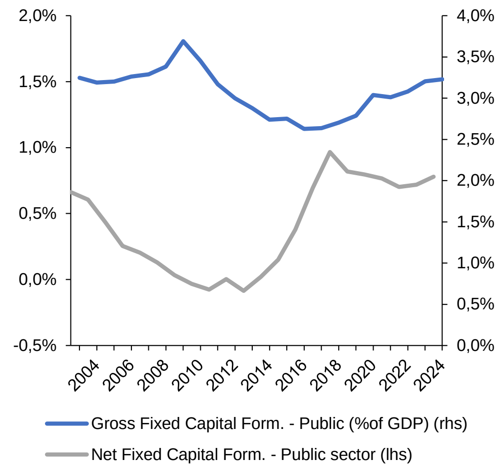
(1) Grey lines refer to euro area Member States. Red line refers to the weighted euro area average. Dotted line refers to the simple euro area average.
Source: ECB.

Public investment needs

The euro area has been suffering from low levels of investment. In the years following the global financial crisis both public and private gross fixed capital formation as a share of GDP decreased by 3.7 percentage points and only started to gradually recover from 2014. In 2021, the investment ratio was still 1.2 percentage points lower than in 2007. In Member States with large deleveraging needs, fiscal consolidation led to particularly acute contraction in public investment, with a detrimental impact on long-term growth.

The RRF and REPowerEU support investment-friendly fiscal strategies. Learning from the years following the global financial crisis, the policy response to the COVID-19 crisis has put the emphasis on supporting investment. In particular, fiscal policy guidance provided by the Commission and the Council has insisted on the need to support public investment to finance the green and digital transition. In the euro area, the aggregate public investment-to-GDP ratio is projected to increase from 2.8 % in 2019 to 3.2 % in 2023, as almost all Member States are expected to spend more on public investment than they did before the pandemic. Around a quarter of that increase is related to investment financed by the EU, especially the RRF and cohesion policy funds. (16) The scale of the challenge linked to the green and digital transition, or the repair of supply chain disruptions is very large. (17) While private investment is set to cover a large share of the effort, maintaining a high level of public investment will remain important.

Graph 3.9: **Gross and net capital formation in the public sector (% of GDP)**



Source: AMECO.

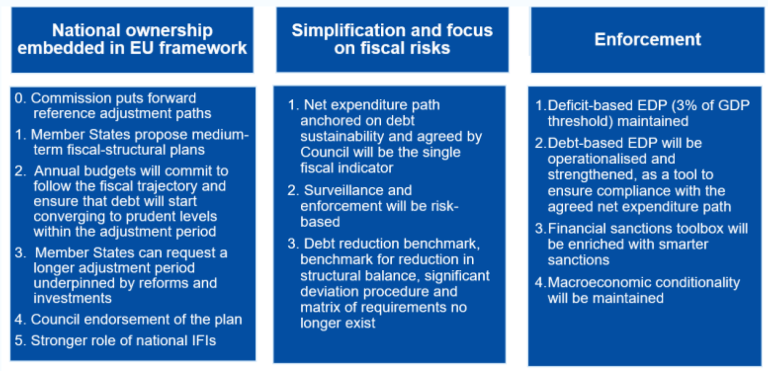
(16) Between March 2020 and November 2022 cohesion policy funds payments to euro area Member States exceeded EUR 82 billion.

(17) The additional annual investment needs in the EU, including both private and public investment, are estimated at around EUR 650 billion per year up to 2030.

Box 3.1: Commission's orientations for a reform of the economic governance framework

On 9 November 2022, the Commission presented a Communication outlining orientations for a reform of the economic governance framework ([1]). The orientations seek to create a transparent, simplified and more integrated architecture for macro-fiscal surveillance in order to ensure debt sustainability and promote sustainable growth. **A revised EU fiscal framework should simplify the fiscal rules and focus on fiscal risks.** National medium-term macro-fiscal plans would be the cornerstone of the new framework and surveillance will focus on policies that put debt sustainability at risk. Fiscal trajectories should be based on medium-term plans proposed by the Member State and endorsed by the Council. The plans would set the net expenditure path for 4 years and the fiscal path would be anchored on debt and expressed in (net) expenditure ceilings.

- **The revised framework should increase national ownership** by providing leeway to Member States in proposing fiscal trajectories, within a common EU framework that has sustainable growth and risks to debt sustainability as a common basis. Reform and investment commitments could allow for a longer fiscal adjustment period. National fiscal institutions would be strengthened.
- **Enforcement should be strengthened** as a necessary counterpart of providing more leeway to Member States to set their adjustment path**.** Assessment of compliance and enforcement would be carried out on a continuous basis, in particular based on the annual progress reports and EDP data notifications. For euro area Member States, the Commission would also assess compliance of the draft budgetary plans with the agreed multiannual net primary expenditure path in the autumn. The Treaty reference values (3% of GDP deficit threshold and 60% of GDP debt threshold) will be maintained. The Excessive Deficit Procedure (EDP) would be preserved and strengthened, with a credible debt-based EDP in case of deviations from the agreed path for Member States with debt above 60% of GDP. The range of sanctions would be broadened, for instance by adding reputational sanctions. The effective use of financial sanctions would be de-constrained by lowering their amounts.



The communication also proposes a more effective framework to detect and correct imbalances, as well as a more focused and streamlined post-programme surveillance framework assessing the repayment capacity of Member States that have benefited from financial assistance programmes.

- **The Macroeconomic Imbalance Procedure (MIP) would be strengthened** through enhanced dialogue between the Commission and Member States to achieve higher policy traction. The assessment of imbalances would be made more forward-looking and more focus would be given to trend developments that are expected to be sustained, as well as to policies that have been implemented to correct imbalances. In addition, the reform would also give more visibility to the EU and euro area dimension of the imbalances.
- **Post-programme surveillance should be conducted with clear objectives.** In particular, post-programme surveillance would focus on assessing repayment capacity, monitoring the implementation of unfinished reforms, and assessing whether corrective measures are needed in the context of concerns for repayment capacity or continued market access.

([1]) Communication on orientations for a reform of the EU economic governance framework, COM(2022) 583 final

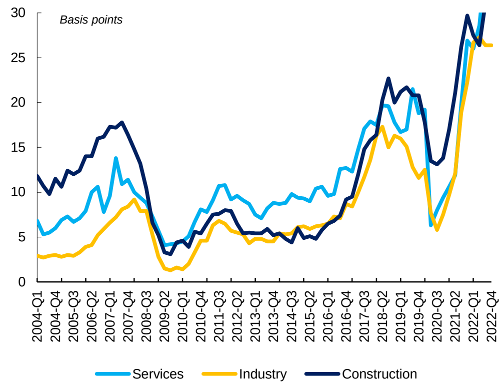
4. STRUCTURAL CHALLENGES

Labour market and supply side developments are important drivers of the euro area response to the energy shock. Beside the monetary and fiscal policy response, long-term price developments, and their impact on the economy will depend on structural features of the economies. Labour market dynamics and wage developments, and in particular the extent to which inflation translates into second-round effects on wages, will be a key driver in determining the response of euro area economies to the on-going inflation shock. Beyond labour and social policy, productivity growth and the ability to maintain an efficient allocation of capital will contribute to address the surge in inflation and mitigate the risk of divergences. Labour market and supply side policies therefore remain critical for the resilience of the euro area and long-term growth.

Labour market developments and policies

Labour markets in the euro area are strong. Unemployment rates are below pre-pandemic levels – at 6.6% in September 2022 – the lowest since the euro was launched, while output is just above its pre-COVID-19 level (see Section 1). While employment recovered rapidly after the pandemic, labour shortages ([18]) also surged (Graph 4.1). According to the European business and consumer surveys ([19]), labour shortages were rapidly rising since 2016. The COVID-19 interrupted this increase, but shortages returned quickly in 2021 on the back of the economy reopening and reached new highs in 2022, constraining companies' ability to respond to demand. ([20]) Labour shortages are influenced by cyclical and structural factors, such as ageing, skills shortages, changes to the patterns of labour mobility, migration and, in some sectors and occupations, poor working conditions. ([21])

Graph 4.1: **Labour shortages reported by employers in the euro area**



Source: European Business and Consumer Survey.

There are significant differences at country and sectoral level. At country level, countries with high labour market slack are also the ones that still have comparatively low vacancy rates. Spain and Greece have vacancy rates below 1%, ([22]) while labour markets have been very tight in the Netherlands, Belgium, Austria and Germany (Graph 4.2). At sectoral

([18]) Labour shortages emerge when employers cannot find the workers they need to fill open vacancies.

([19]) The European business and consumer surveys collect data from employers on their difficulties in filling vacancies.

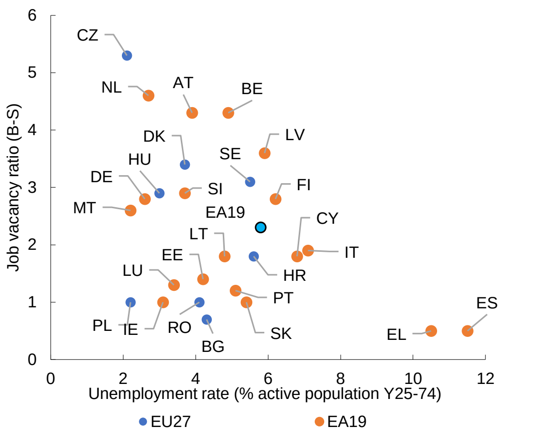
([20]) On the drivers of the upward trend in labour shortages including demographic change, skills shortages, the rapid technological progress and the creation of new jobs due to green and digital transitions see the Commission proposal for a Joint Employment Report 2023.

([21]) See European Commission (forthcoming), 'Labour market and wage developments in Europe, Annual Review 2022', *Directorate-General for Employment, Social Affairs and Inclusion*.

([22]) Unemployment has dropped significantly in Greece and Spain from 17.1% and 16.3%, respectively, in the third quarter of 2020 to 12.2% and 12.5% in the second quarter of 2022.

level, with the exception of ICT, sectors with the highest vacancy rates in 2022, including food and accomodation and construction, are also those that recorded the largest declines in employment over the course of the pandemic. This implies that part of the shortages could still be related to the economy reopening and might therefore be temporary (Graph 4.3).

Graph 4.2: **Vacancies and unemployment across EU Member States in the first quarter of 2022**



(1) Note: Data are seasonally adjusted.
Source: Eurostat.

There is little evidence of job matching problems getting worse (Kiss et al., 2022)**.** After the COVID-19 outbreak, concerns were raised over a possible decrease in the efficiency of labour market matching associated with large-scale sectoral reallocation needs, highlighting the importance of the active labour market policies including reskilling and upskilling. In particular, the pandemic has accelerated the adoption of digital tools and strengthened the shift away from lower-skilled jobs towards higher-skilled jobs and less routine-intensive occupations. ([23]) However, a large part of the sector-specific shocks related to the pandemic proved temporary. Recent evidence shows that labour market mismatch (where employee qualifications do not match job requirements or are not used on the job) picked up after the COVID-19 outbreak but started to ease in 2021, both across sectors and skill groups.

EU policies have helped make the labour markets resilient and help Member States prepare for an inclusive twin transition. For example, the European Pillar of Social Rights Action Plan sets targets for 2030 on employment, skills, and poverty reduction. ([24]) Meanwhile, the Commission Recommendation on Effective Active Support to Employment provides a framework to manage reallocation pressures, also related to the twin transition. The measures promoted by the recommendation are still appropriate for addressing ongoing labour market reallocation, stimulating job creation and facilitating job-to-job transitions. ([25]) Moreover, the Council Recommendation of 16 June 2022 on ensuring a fair transition towards climate neutrality outlines among other things employment and skills policies to support smooth labour market transitions and to equip people with skills for the green transition to help reduce labour shortages in sectors that contribute to climate and environmental objectives.

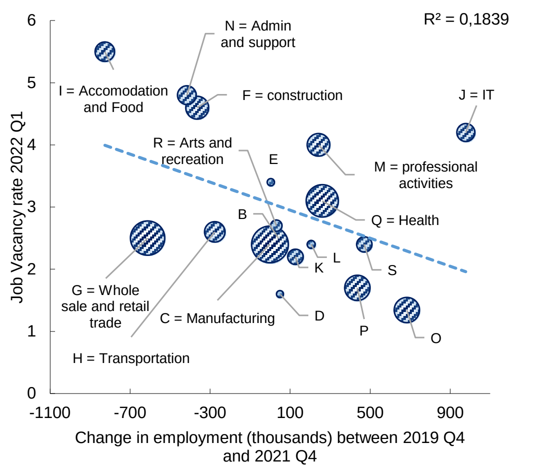
Investment in quality education and training is key to mitigating labour and skills shortages. Promoting job quality and tackling barriers to labour market integration for certain groups that are currently underrepresented, including vulnerable groups, can expand the available workforce. For example, by addressing gaps in childcare availability, providing individual support to people with a migrant background so they can integrate in the labour market, promoting active ageing and making working environments more accessible to people with a disability. Facilitating labour mobility and migration can also help address local shortages. This would require a better coordination, among other things in the area of social security and digitised data exchanges, and further alignment of national labour mobility regulations and monitoring procedures between Member States. Migration policy could be coupled with support for more

([23]) It is estimated that 90% of jobs require digital skills. However, in 2021 only 54% of adults in the EU had basic digital skills (European Commission, 2019).

([24]) See the Commission proposal for a Joint Employment Report 2023 for details.

([25]) See also the Council's recommendation on ensuring a fair transition towards climate neutrality 'Council takes action to ensure green transition is fair and inclusive' effective active labour market policies and skills development to address the impact of demographic change on the EU labour markets. This is reflected among other things in the Skills and Talent package recently adopted by the Commission. The European Year on Skills 2023 will further promote effective and inclusive investment in training and upskilling, to harness the full potential of the European workforce and make sure that skills are aligned with labour market needs.

Graph 4.3: **Change in employment and job vacancy rate in the euro area in Q1-2022**

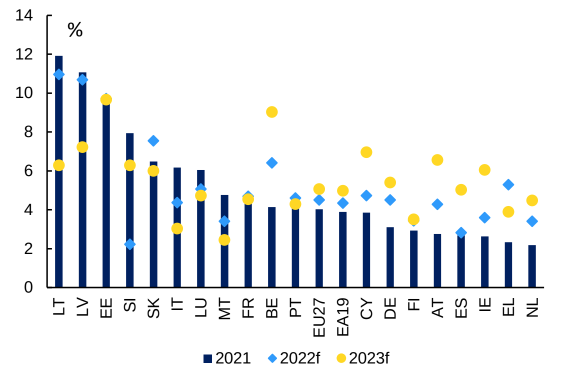


Note: The size of the bubble indicates the size of employment in the sector. B= Mining and quarrying; C=Manufacturing; D=Electricity, gas, steam and air conditioning supply; E=Water supply; F=Construction; G=Wholesale and retail trade, repair of motor vehicles and motorcycles; H=Transportation and storage; I= Accommodation and food service activities; J= Information and communication; K= Financial and insurance activities; L= Property activities; M= Professional, scientific and technical activities; N= Administrative and support service activities; O= Public administration and defence; P= Education; Q= Human health and social work activities; R= Arts, entertainment and recreation; S = Other services activities.
Source: Eurostat.

Wage developments

The acceleration in inflation in 2022 resulted in losses in spending power for wage earners. The autumn forecast projects compensation per employee to increase in the euro area by 4.2 % in 2022 and by 4.9 % in 2023. These growth rates are above those recorded before the pandemic (2.2% in the euro area in 2019). However, such increases remain well below inflation, which is projected to reach average 8.5 % in 2022 (Graph 4.4). In 2023, the Commission's autumn forecast considers that the purchasing power of household would continue to decrease as nominal wages are expected to be outpaced by inflation. Only in 2024 would households recoup part of the losses.

Graph 4.4: **Nominal compensation per employee**



Source: AMECO.

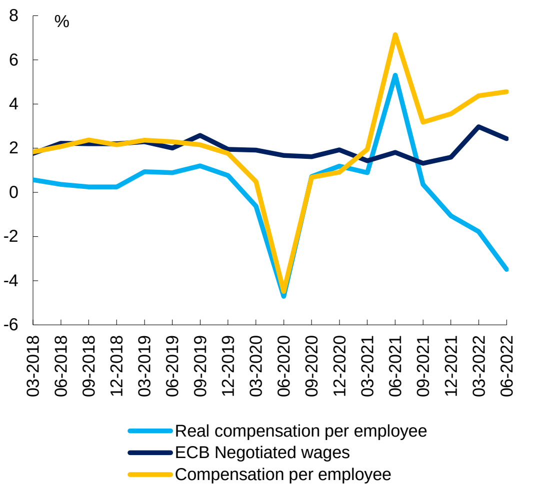
Anchored inflation expectations are critical to avoiding a wage-price spiral. ([26]) Most measures of longer-term inflation expectations derived from financial markets and from expert surveys stand at around 2 %. ([27]) The extent to which wage-price spirals could develop would depend on a broad set of macroeconomic conditions (that could derail inflation expectations) and institutional factors, including prevailing wage setting practices (that is, whether wage increases are based on past or expected inflation). Declining spending power due to high and persistent inflation tends to raise demands for compensation. In turn, this could contribute to further feeding inflationary pressures. In case wages would be set with the expectation that prices will rise persistently and at a high pace, this could contribute to

([26]) A wage-price loop entails mutually reinforcing increases in wages and prices leading to more persistent inflation. See BIS (2022a) and BIS (2022b).

([27]) However, the ECB Survey of Professional Forecasters for the second quarter of 2022 highlighted longer-term inflation expectations being revised upward rather than downward, although the mode of the distribution was clearly at 2.0%.

making this expectation self-fulfilling. ([28]) Fundamentally, the credibility of monetary policy acts as a safeguard against the de-anchoring of inflation expectations. At the same time, the promotion of collective bargaining, in line with prevailing national practices, social dialogue and social partner involvement helps mitigate the inflationary pressures and the risk of a wage-price spiral by promoting the coordination of wage setting and better incorporating the macro-economic context.

Graph 4.5: **Nominal and real compensation for employee and ECB indicator of negotiated wages (y-o-y changes)**



Source: Eurostat and ECB.

Second-round effects have remained moderate so far. The annual growth rate of negotiated wages in the euro area increased from 1.6% at the end of 2021 to 2.8% in the first quarter of 2022, although this was mainly due to one-off payments to employees in Germany (estimated at around 1 percentage point) (Graph 4.5). More recently, negotiated wage growth decelerated to 2.4% in the second quarter of 2022 and remained below actual and expected inflation overall. Compensation per employee – a broader measure of wage growth – accelerated in nominal terms in the second quarter of 2022, but fell in real terms. At the same time, profits across a range of industries have risen markedly. This might suggest that many firms have so far increased their selling prices beyond the increase in the energy cost and in the wage bill. ([29]) However, it must be noted that inflation differences can become entrenched through other channels (e.g., expectations or indexation mechanisms).

Policies can help address the loss in spending power of wage earners. Given the gap between the increase in prices and in wages, the spending power of workers has eroded in 2022 and is expected to continue doing so in 2023. The impact has been particularly strong among low-wage workers. Regular minimum wage updates would help maintain the spending power of low-wage earners. ([30]) The adoption of the EU minimum wage directive ([31]) is expected to create positive momentum for measures that boost adequate minimum wages. The strengthening of collective bargaining, in line with national practices, could also help ensure that wages respond to macroeconomic conditions, preserving both spending power and employment. In addition, several targeted and temporary policies may address spending power losses compatibly with stable inflation. For instance, the targeted use of social benefits and wider tax brackets (to avoid 'fiscal drag', where inflation pushes more taxpayers to pay higher tax rates) can also alleviate the loss of spending power.

Supply side challenges

Higher energy prices and supply chain challenges put pressure on the corporate sector. The impact of the energy shock is uneven across sectors, with the energy-intensive sectors, among which upstream production processes, affected the most.

([28]) *Ex-post* inflation indexation plays a relevant role only in a few countries (Belgium, Cyprus, Luxembourg, Malta).

([29]) See also speech by Isabel Schnabel at a panel on the "Fight against inflation" at the IV Edition Foro La Toja. La Toja, 30 September 2022.

([30]) See also the Commission proposal for a Joint Employment Report (2022) for an assessment of how minimum wages declined in real terms in 2021 and in the first half of 2022.

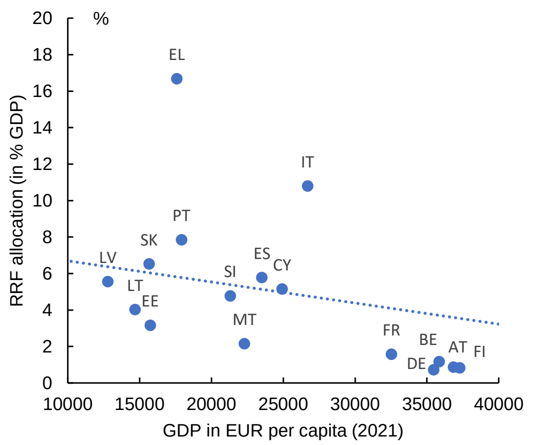
([31]) Directive 2022/2041 of 19 October 2022 on adequate minimum wages in the European Union.

Depending on the intensity of competition and on the industrial structure, increases in production costs may result in lower margins and higher prices being passed onto consumers across sectors. Manufacturing firms (especially those in energy-intensive sectors) are more exposed to international competition than services and their ability to increase prices is more constrained. (32) EU industry is also more affected than industry in other parts of the world because of its greater exposure to foreign sources of energy, in particular from Russia. To the extent that part of the increase in the price of energy is set to be permanent, this would induce a need to increase energy efficiency and the production of low-carbon energy, as well as reallocate resources away from the most energy intensive sectors (Herrera et al., 2019, IMF, 2022b).

Support provided to companies across the euro area takes a variety of forms. Current energy measures range from liquidity support to financial support to help them pay the energy bills. Soaring energy prices and the current volatility mean that a number of otherwise viable firms that are able to pass through producer price increases, including energy companies, may face temporary liquidity constraints (see Section 5). Depending on their design, measures to reduce the impact of energy prices on corporates, in particular if they are not temporary, may reduce incentives to increase energy efficiency. Addressing the problem of late payments would also reduce the burden on companies.

State aid rules at EU-level set conditions for support to firms, but fiscal concerns and risks of fragmentation remain. Following the Russian invasion of Ukraine, the European Commission adopted a temporary crisis framework (TCF) for state aid measures to support the economy. The framework contains a set of requirements based on a two-tier approach. (33) However, beyond compliance with state aid rules, fiscal space and the need to maintain a level playing field remain crucial constraints in providing support to firms across the euro area and the EU. Providing support in an asymmetrical way could create imbalances in the competitive positions of the euro area (and EU) Member States and a fragmentation of the single market, leading the Eurogroup to call for preserving "the level playing field and integrity of the financial market". (34). Moreover, there is a risk of a race to the top in budgetary support, increasing risks to fiscal sustainability, especially for the more vulnerable Member States.

Graph 4.6: **RRF allocation and GDP per capita**



Source: Eurostat, Commission analysis.

The RRF and cohesion policy funds remain key tools to make the euro area more

(32) A recent European Investment Bank assessment of the impact of high energy prices on EU firms suggests that, unless prices adjust, a doubling in energy prices could increase the proportion of firms losing money from 8% to 15% and the risk of default from 10% to 17% over 1 year (EIB, 2022).

(33) As a general principle the TCF allows support for the costs that exceed by 150% the average costs of gas or electricity of the beneficiary in 2021. It is applicable for a share of consumption and the overall aid per beneficiary cannot exceed 50% of the eligible cost and cannot exceed EUR 4 million at any given point in time. For energy intensive firms or certain energy intensive firms active in specific sectors listed in the TCF the overall aid provided may be higher provided certain conditions are respected. Undertakings that receive aid exceeding EUR 50 million per year must submit a plan to improve their environmental performance. The conditions listed above are subject to changes depending on amendments to the TCF over time. Only the legal text of the TCF should be referred to for exact conditions.

(34) See the Eurogroup statement on 'Fiscal policy response to high energy prices and inflationary pressures' published in October 2022.

resilient and to promote convergence, including by financing investments and reforms to reduce dependency on fossil fuels and primary raw materials. The key driving financial allocation under the RRF benefit euro area Member States that record lower than average GDP per capita (Graph 4.6). The instrument will thus contribute to greater convergence in the euro area in the long run. In addition, the investment and reforms included in the plans of euro area Member States are set to help deliver on the euro area policy priorities (see Annex 2), thus supporting greater growth and resilience of the euro area. These relate in particular to reforms of the labour market, taxation, business regulatory environment and education systems. For the euro area, more than 60% of the reforms included in the national recovery and resilience plans directly respond to the euro area challenges identified in the context of the European Semester. This objective has been further strengthened by the REPowerEU proposal. It put forward a set of measures to achieve energy savings, diversify energy supplies, substitute fossil fuels, and accelerate Europe's clean energy transition.

Supply side measures can support productivity growth and make the business environment more conducive to private investment. Although the recovery and resilience plans add to public expenditure, in a medium run they will contribute to mitigation of inflationary pressures due to the offsetting effects of greater productivity on a back of the committed reforms (see Section 3). Total factor productivity growth, which was already low in the euro area before the global financial crisis, has slowed down since then with marked differences across countries and regions. ([35]) Reforms that improve the business environment and quality of public administration can support faster productivity growth and more efficient allocation of resources across sectors. A supportive business environment can also stimulate private investment. Given the expected contribution of the private sector to fill the investment gap linked to the green and digital transition, a number of Member States have included measures on this in their recovery and resilience plans.

Increasing the effectiveness of insolvency systems across the euro area would support the economy. Available indicators suggest that insolvency outcomes in the euro area are less efficient than in top-performing countries. In addition, divergences exist across Member States on a number of issues, including the time it takes to liquidate a company and the value that creditors can recover (Couthino et al., 2022). These divergences are among the factors that hamper cross-border investment, as they create legal uncertainty over the outcomes of insolvency proceedings and lead to high information and learning costs for cross-border creditors and hinder the development of the Capital Markets Union.

Reducing entry barriers contributes to lower prices and makes the economy more resilient. By lowering transaction costs and increasing the resilience of national economies (for example through increased labour mobility in case of shocks), the EU's single market promotes growth and makes euro area economies more dynamic. 2023 marks the 30th anniversary of the single market and the COVID-19 crisis showed that keeping the single market open is an essential component of resilience. In the longer term, more competitive sectors and countries tend to experience lower inflation. Since the adoption of the Services Directive in 2006, there was only a small decrease in the absolute level of barriers. More reform efforts are needed to remove regulatory and administrative barriers faced by service providers when operating in the single market (Barbero Jimenez, 2022, European Commission, 2022a). Nevertheless, the reforms implemented between 2006 and 2017 would result in discounted cumulative gains of 2.1% of GDP by 2027. Furthermore, if Member States were more ambitious in implementing reforms (so they reach the

([35]) The process of convergence in the euro area slowed significantly following the global financial crisis with a fall in investment rates of many converging countries and gradual reduction in total factor productivity growth (a key driver of income convergence) playing an important role in the slowdown. See Licchetta and Mattozzi (2022).

average of the five least restrictive Member States), the additional growth potential is estimated to be 2.5% of GDP. This calls for renewed efforts to remove barriers to entry and improve competition in products and services.

5. FINANCIAL INTEGRATION AND MACRO-FINANCIAL STABILITY

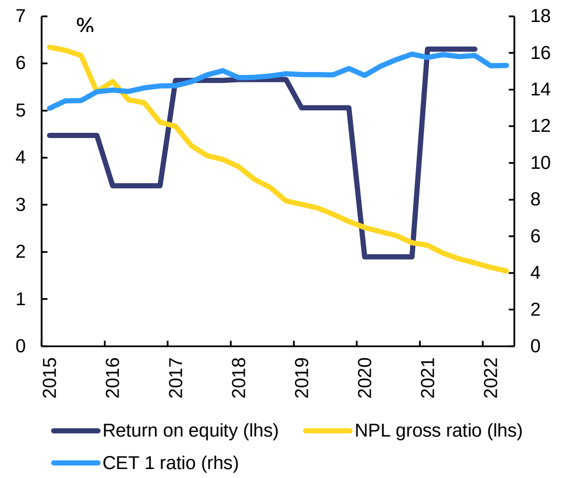
The European financial system proved resilient throughout the COVID-19 crisis. Despite the sharp reduction in activity and a temporary shift to lower profitability, euro area banks were able to maintain and improve their capital position. In particular, and thanks also to the government support schemes put in place for companies and households, non-performing loans (NPLs) continued to decrease over the last two years.

Nevertheless, the recent deterioration in the economic outlook and normalisation of monetary policy give raise to new challenges. Global market conditions have tightened, and new sources of vulnerability have appeared, linked in particular to the Russian aggression in Ukraine and volatility in energy markets. Against this background, renewed policy attention is needed to address financial risks and avoid fragmentation. More generally, further progress is warranted to strengthen the euro area's financial architecture.

Recent trends in the euro area financial sector

The financial integration of the euro area resumed rapidly after the COVID-19 crisis, also thanks to a strong policy response. In the first few months of 2020, the different impact of COVID-19 across euro area Member States, together with increased risk aversion led to sharp financial fragmentation. In particular, sovereign yields and spreads increased rapidly. However, following the ECB announcement of a set of monetary policy and banking supervision measures and decisions on NextGenerationEU, financial integration rebounded (ECB, 2022a), with a reduction in sovereign spreads compared to the pre-crisis period (for more details, see European Commission, 2021a). Overall, resilience shown throughout the COVID-19 crisis is down to the efforts made to gradually strengthen the euro area financial system, and in particular banking institutions. The ongoing economic downturn combined with monetary policy tightening has again led to widening spreads, although so far these have remained relatively contained thanks to the ECB's anti-fragmentation tools (see Section 3).

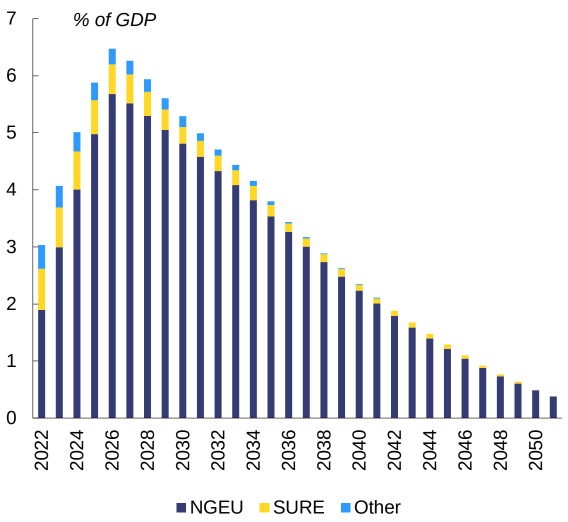
Graph 5.1: **Euro area bank stability indicators**



(1) NPL ratio covers gross non-performing debt instruments as a percentage of total gross debt instruments.
Source: ECB.

The banking sector benefits from strong balance sheets and resilient business-models, but low profitability remains a challenge. Banks included in the European Banking Authority's Risk Dashboard have maintained strong capital levels throughout the COVID-19 crisis. NPLs continued to decrease throughout 2020 and 2021. In 2022, NPL ratios dropped more slowly, and some deterioration of banks' asset quality is likely to occur. The aggregate profitability of the banking sector, whose low level is a concern for resilience and stability (see e.g., Andersson et al., 2018), recovered in 2021 after registering a COVID-19-related blip in 2020. (Graph 5.1). The euro area banks' return on equity is expected to be lower in 2022 than in 2021 on the back of weaker economic activity and weaker sovereign, corporate and households' positions. However, the increase in interest rates supports banks' net interest margins. In addition, with the ECB's deposit rate now above zero, banks will start to receive income on their excess reserves. Euro-area banks' overall direct exposure to Russia, Belarus and Ukraine is limited, and is restricted to a large extent to locally funded subsidiaries and branches. Nevertheless, the large exposure of domestic banks to their sovereigns (Graph 5.3) means that tensions on sovereign markets in the euro area could affect credit provision and financial stability. Overall, the profitability outlook for euro area banks remains mixed.

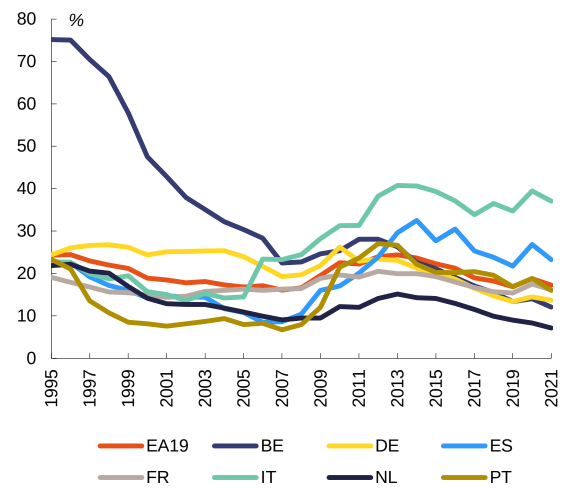
Graph 5.2: **Outstanding EU issuance as % of projected euro area GDP**



(1) Other include the European Financial Stabilisation Mechanism, macro-financial assistance to non-EU partners, the balance of payments assistance facility for non-euro area Member States, and Euratom loans.
Source: European Commission.

The large bond issuance by the EU contributes to the stability of the euro area banking system. The lack of a sufficiently large and diversified pool of euro-denominated safe assets is among the factors contributing to domestic bias in the euro area banking sector, which is an impediment to its resilience. In that respect, the EU's increased issuance of euro-denominated safe assets to finance the implementation of SURE ([36]) and NextGenerationEU can contribute to a more stable banking system. The EU's share in the net issuance (calculated as the total of euro denominated issuances by AA/AAA issuers) increased from less than 1% of the total AAA and AA issuances in 2019 to 12% in 2020 and to 27% in 2021 (European Commission, 2022b). EU issuances are expected to exceed 6% of the euro area's GDP in 2026. The increased liquidity of EU bonds and EU bills (securities with a shorter maturity of below 1 year) is viewed favourably by the majority of EU primary dealers and provides liquidity to all parts of the yield curve. Although it is too early to assess the exact impact of EU issuances on strengthening EU financial stability, the additional supply of euro safe assets provides alternatives to domestic sovereign bonds for banks' treasuries. The issuances have also made the EU one of the largest social bond and green bond issuers in the world.

Graph 5.3: **Evolution of sovereign debt holdings by domestic banks, ratio to GDP, 1995-2021**



(1) Consolidated gross government debt.
Source: ECB.

([36]) The European instrument for temporary Support to mitigate Unemployment Risks in an Emergency, https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en

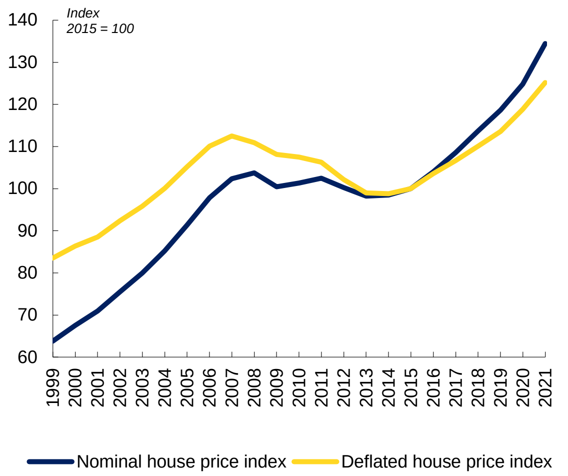
The impact of the energy crisis and the increase in financing costs since early 2022 have resulted in tighter access to finance. The ECB bank lending survey points to a sharp tightening in credit standards in the euro area in the third quarter of 2022 for both firms and households. A further tightening in standards is expected, including higher financing costs (ECB 2022b). In parallel, stock markets in major advanced economies lost value throughout the first half of 2022. Against this background, euro area investment funds have reduced the credit risk of their portfolios by selling high-yield corporate bonds and lower-rated sovereign bonds. Nevertheless, their exposure to economic sectors with high gas usage exposes them to the economic impact of the energy crisis (ECB, 2022c). Overall, the issuance of equities and high-yield corporate bonds declined sharply, pointing to increasing difficulties for large companies to obtain access to finance.

Risks emerging in the current context

Private sector balance sheets are set to be affected due to higher interest rates and the energy crisis. The corporate sector weathered the COVID-19 crisis much better than initially feared thanks in particular to large-scale government support. Corporate insolvencies remain below pre-pandemic levels even though most payment moratoria have expired. Weak growth prospects, together with a combination of rapidly rising producer prices and higher funding costs could lead to a rise in NPLs. Risks differ across sectors, depending among others on their energy intensity and pricing power (see also Section 2). Despite overall sound balance sheets, late payments may increase for low-income households. This might be particularly the case in Member States with variable rate mortgages.

The current volatility in the energy markets has resulted in financial stress for some energy companies. The high energy prices have benefited energy producers that use relatively cheap forms of electricity generation (for example nuclear or renewable electricity). By contrast, energy companies that had to purchase gas at high prices but were not in a position to pass price increases on to customers face significant profits pressure. Even for companies that are otherwise still profitable, the sharp rise in gas and electricity prices has led financial market operators to require increasing amounts of collateral to secure derivatives trades used to hedge future gas and electricity sales. This has resulted in liquidity stress for some energy companies. Several Member States have developed guarantees and financial instruments to ensure that energy market participants have sufficient liquidity to operate. [37]

Graph 5.4: **Property price trends in the 19 euro area countries between 1999 and 2021, 2015=100**



(1) Real house prices are deflated by the consumption expenditure deflator.
Source: European Commission.

Housing markets have been experiencing buoyant growth, leading to a build-up of vulnerabilities. House price growth, which remained strong throughout the previous decade, continued during the pandemic. In the last quarter of 2021, house prices increased by almost 9% year-on-year and, as pointed out in the Alert Mechanism Report, are

[37] See the European Securities and Markets Authority's and the European Banking Authority's responses to the Commission on the current level of margins and of excessive volatility in energy derivatives markets (22 September 2022 and 29 September 2022, respectively).

overvalued by more than 20% in seven euro area countries (LU, AT, PT, NL, DE, FR, and BE) (European Commission, 2022c). High-frequency data for 2022 suggest that growth continued into spring 2022, although this price dynamic is likely to slow down. Rising interest rates and reduced real household income are set to weigh on house prices and could trigger a correction in prices in Member States with large overvaluations. Prices have stabilised in the commercial property sector, but the overall conditions remain challenging due to the post-pandemic drop in occupancy rates. A pronounced correction in the commercial property market could have a negative impact on the financial sector and limit its ability to provide financing to non-financial corporations (ECB, 2022c).

Policies to improve financial integration and stability

A more integrated European capital market could facilitate risk sharing between euro area Member States. Fragmentation of the euro area capital markets prevents cross-border flows of equity and credit that would improve private risk sharing. More market integration would facilitate investment in profitable businesses irrespective of their location, provide capital for the green and digital transition and make the euro area more immune to shocks. Further progress in the Capital Markets Union would bring stronger cross-border flows of equity and would help reduce corporate leverage and reliance on bank lending. Integrating the capital markets requires considerable approximation of national laws, and several actions are now under way (see Box 5.1). In particular, effective, and more harmonised insolvency frameworks in the euro area could help the economy maintain credit by facilitating the cleaning up of bank balance sheets and by spurring cross-border investment over the longer term (see also Section 4).

The use of macro-prudential tools helps to build resilience and reduce risks stemming from the private sector. In a recent warning (ESRB, 2022), the ESRB pleads to preserve or further build up macro-prudential buffers to support credit institutions' resilience and enable the authorities to release these buffers, if and when risks materialise and negatively impact credit institutions' balance sheets. At the same time, macro-prudential policy decisions need to consider Member State-specific macro-financial outlooks and banking sector conditions, to limit the risk of procyclicality. To reflect on developments in the challenges met by macro-prudential authorities, including the vulnerabilities linked to the developments of non-bank financial institutions and market-based finance, the European Commission has conducted a series of consultations to identify the shortcomings in the existing EU macro-prudential framework for the banking sector. Future legislative reviews of the macro-prudential framework may further enhance its effectiveness, efficiency, and consistency, with a view to possibly simplifying it.

Further progress on the Banking Union would make the euro area banks more resilient. The two established pillars of the Banking Union (common supervision and resolution framework for banks) help strengthen the euro area banks. Work on setting up a European deposit insurance scheme, the third pillar of the Banking Union, continues (see Box 5.1). Further progress on the Banking Union could contribute to a more integrated single market for banking services and greater diversification of banks' sovereign bond holdings.

A digital euro could unlock a number of benefits for the euro area economy, so its design needs to be carefully chosen. As a new form of central bank money for use in retail payments, a digital euro would be complementary to cash. As such, it could nonetheless safeguard the key role of public money for the monetary system and for financial inclusion. In addition, its introduction could help support the digitalisation of the economy, further spur innovation in retail payments and beyond, and support the EU's objective of open strategic autonomy. At the same time, the digital euro's design needs to address a number of important trade-offs, for

Box 5.1: **Stocktake of recent proposals to deepen the Economic and Monetary Union**

In June 2015, the Five Presidents' Report outlined a number of proposals and an indicative roadmap to further deepen the Economic and Monetary Union. ([1]) This report resulted in a number of specific results, including the creation of the European Fiscal Board or the set-up of a network of national productivity boards. The report also called for completing the **Banking Union** and launching the **Capital Markets Union**. Substantial progress was made on both initiatives, although several milestones are still to be reached.

The **Banking Union** includes three pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), and the European deposit insurance scheme (EDIS). While the SSM and the SRM have both been rolled out and are in use, further progress is needed on the EDIS. The EDIS proposal, according to which bank deposits under EUR 100 000 in the euro area, would be collectively protected, has not been adopted by the co-legislators (the European Parliament and the Council of the EU). In June 2022, the Eurogroup invited the Commission to bring forward legislative proposals focusing on the review of the crisis management and deposit insurance framework. ([2]) As part of the work on the Banking Union, Member States agreed to broaden the role of the European Stability Mechanism (ESM) to provide a common backstop to the Single Resolution Fund. Member States have agreed on the revised ESM and it must now be ratified by the parliaments of the 19 euro area countries.

The Commission proposed several initiatives to build a **Capital Markets Union**. After the proposals included in the initial 2015 action plan were adopted and implemented, the Commission proposed a follow-up agenda in 2021. ([3]) Proposals include legislation to: i) improve investors' access to information (e.g. a 'European single access point' collating company information, or giving investors better access to near real-time trading data), ii) increase the attractiveness of long-term investment funds for investors, iii) facilitate cross-border settlement and the development of a more integrated post-trading market in the EU, and iv) harmonise some requirements for alternative investment funds. The Commission also plans proposals on i) harmonising some aspects of corporate insolvency procedures, enabling companies – in particular small and medium-sized businesses – to be listed on public markets, and ii) increasing participation of retail investors by providing more suitable information to improve their protection.

([1]) Juncker J-C et al. (2022), Completing Europe's Economic and Monetary Union, available at https://ec.europa.eu/info/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en

([2]) https://www.consilium.europa.eu/en/press/press-releases/2022/06/16/eurogroup-statement-on-the-future-of-the-banking-union-of-16-june-2022/

([3]) https://ec.europa.eu/commission/presscorner/detail/en/ip_21_6251

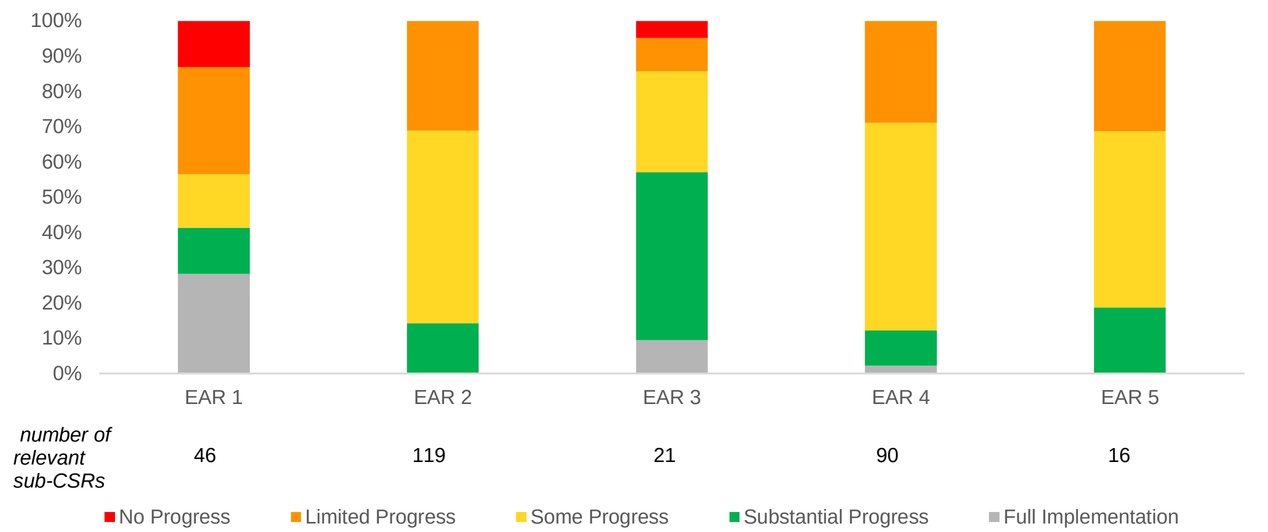
instance between privacy and countering money laundering risks, and will need to limit potential adverse repercussions on financial intermediation and stability. The Commission is preparing a legislative proposal that would establish the digital euro and regulate its key aspects. The proposal is to be put forward in the first half of 2023, with a possible introduction of the digital euro by the ECB in 2026.

ANNEXES

The implementation of the 2022 euro area recommendations (EARs) can be assessed through the progress on the relevant country-specific recommendations (CSRs). Euro area recommendations are taken into account when addressing CSRs to euro area Member States in the context of the European Semester. Accordingly, progress in the implementation of EAR-relevant CSRs provides an estimate of the degree of implementation of the EARs (Graph A1.1). In general, the number of EAR-relevant sub-CSRs varies regarding different EARs, with a clear focus on labour market and business environment.

Overall, while the implementation of EAR-relevant CSRs shows some progress, implementation is uneven across policy areas. While the CSRs related to fiscal policy (EAR 1) generally show a good progress, the measures linked in particular to sustainability of public finances (e.g. pension reforms) present a much lower level of implementation. In spite of the large number of sub-CSR addressing labour market, social policy and tax reform (EAR 2), reform in those areas is slow. Only 14% of the relevant sub-CSR have recorded substantial progress over the last two years, which may be linked to the fact that such reforms are difficult to put in motion. By contrast reforms of corporate support (EAR 3), although they have been proposed in relatively fewer countries, have generally been well implemented. These relate in general to liquidity support for companies, in particular small and medium enterprises. Measures related to business environment (EAR 4) are generally implemented with a slower pace, as reducing the regulatory burden and barriers to entry can be a long-lasting process. Relatively few sub-CSRs respond to the EAR 5 (supporting macro-financial stability, monitoring banking asset quality, non-performing loans and making progress in the completion of the Banking Union) and the implementation in these fields is moderate.

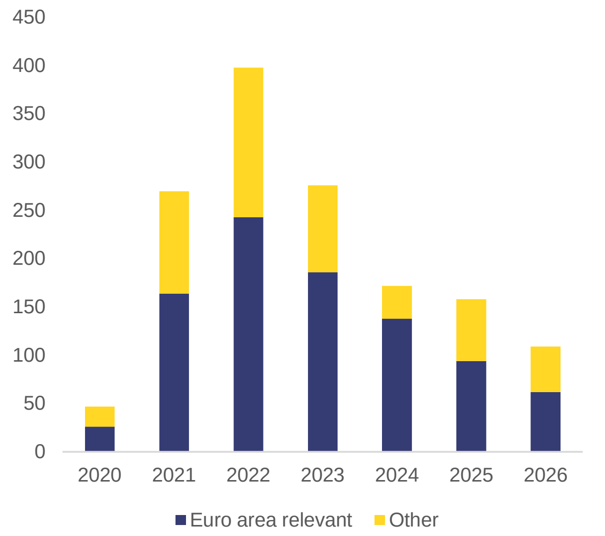
Graph A1.1: **Implementation of EAR-relevant country-specific recommendations (CSRs)**



(1) Analysis at sub-CSR level. CSRs and sub-CSRs for 2019 and 2020 are grouped according to 2022 EARs.
Source: European Commission analysis based on the CeSaR database.

The implementation of the Recovery and Resilience Facility (RRF) is well on track. Overall, Member States are progressing with reaching the milestones and targets for the reform and investment agenda in a timely manner. Until now, implementation of the recovery and resilience plans (RRPs) has led to around 31 % of the RRF funds committed to the euro area Member States being disbursed, with over EUR 50.8 billion paid in pre-financing and EUR 76.7 billion of grants and loans paid after milestones and targets were reached. This confirms the RRF's crucial role in providing immediate financial support to the Member States, especially given the recent surge of inflation and rise in interest rates. By supporting investment in projects of strategic importance (e.g., cybersecurity and critical energy infrastructure), the RRF also helps to bolster the EU's crisis preparedness and response capacity, therefore boosting the EU's strategic autonomy.

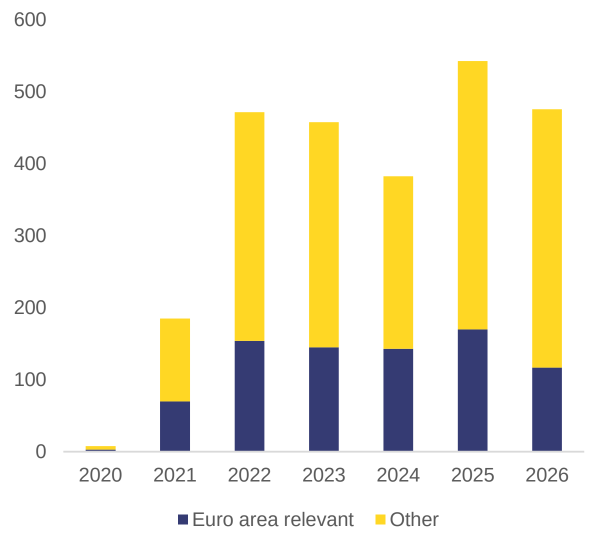
Graph A2.1: **Reform milestones and targets planned in RRPs**



(1) Numbers reported relate to the number of milestones and targets planned for a given year.
Source: European Commission.

The implementation of the recovery and resilience plans (RRPs) will help achieve through a number of channels euro area policies that were identified as priorities. Together with strong policy measures at national level, the RRF helps prevent economic divergences between Member States after COVID-19. In particular, it has helped maintain a positive investment dynamic. In a longer-term perspective, the RRF is meant to help achieve long-term income convergence and growth. Modelling exercises confirm that the RRF's impact on growth will initially mainly come through additional capital deepening (more capital being invested per worker), a direct stabilisation effect. In the longer run, and provided implementation proceeds as planned, the increase in potential output will come mainly from greater productivity. In that respect, the reforms planned as part of the RRPs will play an important role in helping the euro area to work better. [38]

Graph A2.2: **Investment milestones and targets planned in RRPs**



(1) Numbers reported relate to the number of milestones and targets planned for a given year.
Source: European Commission.

Investment and reforms included in recovery and resilience plans contribute to achieving the euro area priorities. Mapping the various investments and reforms planned in the RRPs against the euro area recommendations of 2022 shows a good match. About 30% of the milestones and targets corresponding to investment planned over 2021-2026 respond to the EAR 2022. For reforms, this ratio is slightly above 60%. More in detail, the various policy areas addressed in the EAR 2022 are covered in a heterogeneous manner. For the 2022 EAR 1, which addresses supportive fiscal policy stance and fiscal policy coordination underpinning sustainable

(38) Bankowski et al. (2022), The economic impact of NextGenerationEU: a euro area perspective, Occasional paper series, ECB.

and inclusive recovery, euro area RRPs take into account measures on healthcare and pension systems that aim at, among others, quality and sustainability of public spending. Priorities in the 2022 EAR 2 (taxation, labour market challenges, education and social protection systems, including regional dispersion aspects) are also well covered by the measures planed by Member States. On the 2022 EAR 3, providing for monitoring of the effectiveness of the policy support for companies (including access to finance), solvency support for viable firms and capacity of insolvency frameworks, many Member States took measures effectively supporting the business sector prior to RRPs submission. However, measures on insolvency frameworks and private indebtedness are addressed to a lower extent. As regards 2022 EAR 4, Member States have taken a large number of measures to improve business regulatory environment, and some of their RRPs are also effectively addressing a number of challenges regarding public administration. For the 2022 EAR 5 on, among other things, ensuring the macro-financial stability, the need to address non-performing loans and the completion of the Banking Union, relatively fewer measures are taken by the Members States in their RRPs.

Table A3.1: **Main macroeconomic indicators of the euro area**

		2021		Annual percentage change						
		bn EUR curr. prices	% of GDP	03-18	2019	2020	2021	2022	2023	2024
GDP		12370,8	100,0	1,2	1,6	-6,1	5,3	3,2	0,3	1,5
Private consumption		6322,1	51,1	0,9	1,4	-7,7	3,8	3,7	0,1	1,5
Public consumption		2730,6	22,1	1,3	1,7	1,0	4,3	1,4	0,3	0,8
Gross fixed capital formation		2713,9	21,9	1,0	6,9	-6,2	3,6	2,8	0,5	2,3
Exports (goods and services)		6096,3	49,3	3,8	2,8	-9,0	10,6	6,6	2,0	3,4
Imports (goods and services)		5618,6	45,4	3,7	4,8	-8,5	8,4	6,8	1,9	3,5
GNI (GDP deflator)		12466,0	100,8	1,3	1,4	-6,4	5,9	3,3	0,1	1,5
Contributions to GDP growth	Domestic demand			1,0	2,5	-5,3	3,7	2,8	0,2	1,5
	Inventories			0,0	-0,2	-0,3	0,3	0,2	0,0	0,0
	Net exports			0,2	-0,7	-0,5	1,3	0,2	0,1	0,1
Employment				0,4	1,3	-3,3	1,4	2,0	0,2	0,7
Unemployment rate (a)				9,7	7,6	8,0	7,7	6,8	7,2	7,0
Compensation of employees / head				2,2	2,2	1,0	3,9	4,2	4,9	3,6
Unit labour costs whole economy				1,4	1,9	4,6	0,1	3,0	4,8	2,7
Saving rate of households (b)				12,8	13,2	19,7	17,9	14,5	14,1	13,9
GDP deflator				1,5	1,7	1,8	2,1	4,6	5,3	3,4
Harmonised index of consumer prices				1,7	1,2	0,3	2,6	8,5	6,1	2,6
Terms of trade goods				-0,1	0,8	1,7	-3,4	-6,1	0,7	1,4
Trade balance (goods) (c)				1,9	2,8	3,2	2,6	0,0	0,3	0,8
Current account balance (c)				1,6	2,7	2,6	3,5	1,5	1,9	2,4
General government balance (c)				-2,7	-0,6	-7,0	-5,1	-3,5	-3,7	-3,3
Structural budget balance (d)				-2,3	-1,2	-3,8	-4,2	-3,6	-3,4	-3,2
General government gross debt (c)				82,1	85,7	99,0	97,1	93,6	92,3	91,4

(a) as % of total labour force, (b) gross saving divided by adjusted gross disposable income, (c) as a % of GDP, (d) as a % of potential GDP

Source: European Commission, autumn 2022 forecast

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