OPINION

European Economic and Social Committee

Additional considerations on the euro area economic policy 2022

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[own-initiative opinion]
Recommendation for a Council recommendation on the economic policy of the euro area
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1. **Conclusions and recommendations**

1.1 The EESC notes that the current economic development of the euro area and the European Union is characterised by a particularly high level of economic, geo-economic and political uncertainty. This uncertainty stems from two ongoing systemic shocks, i.e. the continued prevalence of COVID-19 and Russia's invasion of Ukraine. There is also a new risk associated with fragmentation across sectors of international trade, payments, capital and financial markets, including manufacturing, research and transport. The systemic risks have led to a huge build-up of public debt and growth in inflation. However, tackling climate change remains the biggest challenge facing the euro area and EU Member States.

1.2 The EESC reiterates that the fight against the continued prevalence of COVID-19 is far from over. Therefore, all substantive and systemic measures should be taken to tackle the disease, while at the same time preparing for other potential epidemics and pandemics. The EESC stresses, as confirmed by the experience of the past two years, that the highest rate of return on investment is in the health sector.

1.3 The EESC supports an end to the Russian aggression and the war in Ukraine and the restoration of Ukraine's territorial integrity. This can create the conditions for resilient, inclusive and sustainable economic growth in the eurozone countries and in the Member States of the European Union.

1.4 The EESC is closely following the very unfavourable inflationary trends, which stem mainly from rising commodity, food and energy prices, including supply chain disruption. In this situation, raising interest rates is not a particularly effective tool. A monetary policy that is too tight may also increase recessionary risks and may delay private investments in the energy transition that are so urgently needed. Therefore, the EESC recommends that the ECB conduct an adequate proportionality assessment, carefully analysing the side-effects of a tightened monetary policy and its consequences for long-term price stability targets. However, the EESC encourages the European Central Bank to lower core inflation without compromising the economic recovery of the EU. Because of the aforementioned risks, the ECB should proceed cautiously in normalising monetary policy.

1.5 In view of sharply rising energy and food prices, the EESC recommends that national economic policy-makers set up a functioning and effective social safety net for the most vulnerable population groups, including the most affected segments of the middle class, where nobody is left behind.

1.6 The EESC is concerned about the ongoing build-up in public debt. It therefore recommends that steps be taken towards medium-term fiscal consolidation. With a view to replenishing national budgets, the EESC sees scope for equitable taxation and with it the effective use of public funds.

1.7 The EESC points out that the activation of the general escape clause as a result of COVID-19 was the right decision. Although it has been extended until 2023, a further extension will need to be considered should the systemic risks persist. The EESC therefore expects the European Commission to prepare, without delay, concrete steps to reform the Stability and Growth Pact.

1.8 Despite the progress made towards establishing a financial union, all substantive and systemic measures to complete the Banking Union and the Capital Markets Union need to be adopted and implemented. In this regard, the EESC calls on the organisations responsible and the competent institutions to join forces to create a financial union.

1.9 The EESC highlights the negative impact of fragmentation. It points to the instability of the sovereign bond market in euro area markets. The EESC therefore welcomes the European Central Bank's announcement of 15 June 2022 on the preparation of measures to tackle fragmentation in the euro area.

1.10 The EESC supports the transformation of the euro area economies. At the same time, it points to the existential risk associated with climate change. In light of this, and despite the unforeseen complex geo-economic developments, it recommends a shift to renewable energy sources and the use of financial resources available under the recovery plan as well as other financial resources, including the support of private sector financing.

1.11 Like other EU countries, euro area countries are currently faced with systemic shocks, risks and threats. Therefore, given the critical period in which humanity finds itself, the EESC calls on all countries and competent international institutions to work together to address all historically unprecedented systemic shocks, risks and threats that the world is currently facing. Delaying the adoption and implementation of measures may have far-reaching consequences, not only in terms of material loss, but also – and above all – in terms of human life.

2. Background and context

2.1 There are currently two systemic real shocks – COVID-19 and Russia's invasion of Ukraine – which, alongside the subsequent geo-economic fragmentation, have resulted in a high degree of uncertainty. What is more, rising commodity and food prices have led to significant socio-economic risks in both the euro area and the EU. In light of the existential threat posed by climate change, one of the greatest challenges for the euro area and EU Member States is the transition to a green economy.

2.2 Today's economic developments are being accompanied by unprecedented real external shocks in euro area countries. Therefore, from the point of view of the underlying macroeconomic indicators, these developments cannot be viewed as stable. In addition, some specific euro area Member States face long-standing structural challenges on their path towards building sustainable, resilient and inclusive economies.

2.3 Prior to these two systemic shocks, inflation was relatively low in almost all euro area Member States. Relatively lower inflation rates were recorded even before the onset of the climate crisis, and some euro area countries even experienced deflation. Today's inflation dynamics require making extensive use of the ECB's toolbox. Currently, inflation is one of the greatest risks to sustainable, resilient and inclusive economic growth in the euro area. Reducing and stabilising inflation and keeping it within the inflation target, i.e. below 2%, cannot be achieved without appropriate changes to the European Central Bank's monetary policy. In this context, the Governing Council have taken the action needed to fulfil the ECB's mandate to pursue price stability and to safeguard financial stability. In the near future, it is important that the ECB proceeds cautiously in normalising monetary policy.

2.4 Inflation is the highest it has been since the creation of the European monetary union. It stems from a whole series of factors that led to gradually rising inflation rates even during the deepening global COVID-19 crisis. The economic recovery in the euro area now under way has further exacerbated this negative trend as a result of reduced supply. Russia's invasion of Ukraine has also contributed to higher prices. It is legitimate to ask to what extent the European Central Bank's monetary policy, using all available instruments at its disposal, can slow inflation growth and gradually return it to, and keep it within, the declared inflation target, without jeopardising the single currency's stability and the economic recovery from the COVID-19 crisis.

2.5 Current inflation trends are neither temporary nor short-term (as noted in autumn 2021), but reveal a high degree of uncertainty. In the second half of last year, price increases were mainly driven by energy prices, disruption of supply chains, an unusually steep rise in commodity prices and higher transport costs. Given that the reasons for current price dynamics are complex, monetary policy alone will not manage to curtail inflation. What is needed is a diversification of energy imports and thus reduced dependence on supplies from Russia. Diversification also offers euro area Member States an historic opportunity to embark on urgent structural reforms (e.g. administrative reforms, judicial reforms, reforms to strengthen the rule of law) and reduce dependence on imports of traditional energy inputs. In addition to this, market intervention to control current volatile prices dynamics in the energy market is needed. In this respect, the EESC welcomes the Commission proposal for an emergency intervention to address high energy prices.

2.6 At the same time, there is evidence that many companies have been able to expand their unit profits despite rising energy prices. ECB analysis shows that profits have been a key contributor to overall domestic inflation as companies passed on higher costs and shielded off and expanded profit margins. Market interventions in the energy sector might also curtail price dynamics.

2.7 Current price increases are mainly linked to supply. This trend is adversely affecting euro area competitiveness, leading to higher costs and putting upward pressure on wages and salaries at a time of economic downturn. Should this adverse pattern continue, it could potentially lead to stagflation (although currently not present in the euro area countries as a whole). In historical terms, stagflation was recorded almost 40 years ago. It cannot be ruled out that if external systemic shocks continue, it might result in undesirable stagflation. On the other hand, the EESC points to possible adverse effects on demand if low and middle-income earners are impacted by real wages losses.

2.8 In 2021, there was a relatively favourable trend in economic growth across euro area Member States, with no expectation of a sharp slowdown in investment and trade flows as a result of high levels of economic uncertainty. The global COVID-19 crisis may deepen the divide in economic growth in the euro area if structural reforms are not adopted and implemented. This trend towards divergence may have a major impact on convergence and exacerbate this adverse development across euro area Member States.

2.9 In the short term, the outlook for potential investment growth is not encouraging. The instruments adopted for the post-COVID recovery (Recovery and Resilience Facility) have started to become somewhat subdued as a result of the investment uncertainty caused by the war in Ukraine. It is therefore important that individual economies are able to cope with the continued disruption of trade and investment flows and with the continued uncertainty of the global economy, but mainly the high level of uncertainty in the euro area Member States.

2.10 The economic slowdown also stems from the significant energy price rises facing households. Some Member States have taken measures to tackle price growth in the form of subsidies, changes to VAT, including additional social contributions, and social energy tariffs for households on the lowest incomes. There is therefore a need to rethink the efficient use of energy in households and to change energy consumption habits. Rising energy prices have led to a gradual displacement of other items from the consumer basket, for which there has now been a fall in demand. What is more, higher energy prices for households are leading to a change in the pattern of household consumption and a significant drop in the consumption of certain consumer items. However, energy is a basic good and can only be reduced to a limited extent, meaning that poorer households in particular will suffer from these price hikes.

2.11 COVID-19 has had a very negative impact on public finances in euro area Member States. The general escape clause of the Stability and Growth Pact was activated in March 2020 to tackle the COVID-19 crisis. The State Aid Temporary Framework was also set up, allowing large-scale use of fiscal stimulus to support the business sector but also to maintain social stability.

2.12 The fiscal response and the contraction in output have resulted in a significant increase in government debt ratios, particularly in some high-debt Member States. Continuing to ensure public debt sustainability through a gradual reduction of public debt is of paramount importance. Given that energy prices will continue to remain at a high level in the medium-term, a review of market and price-building mechanisms, together with further fiscal support measures, will be necessary in order to support households and companies particularly affected by energy price increases.

2.13 Increased spending on security and other critical priorities may lead to a temporary decline in the euro area's economic position in the world economy. Against this backdrop, euro area Member States are facing the major challenge of moving towards sustainable economic growth and maintaining the share of the euro area economy vis-à-vis other global competitors, using all available tools coupled with effective individual policies, including diplomatic tools.

2.14 More recently, the euro exchange rate has fallen against the US dollar as a result of adverse geopolitical developments, a decline that started in May 2021. The depreciation of the euro, the second largest reserve currency, stems mainly from the different monetary policies pursued by the European Central Bank and the Federal Reserve System (FED).

2.15 Drawing on the above analyses, the European Commission has presented its economic outlook (July 2022), which is chiefly determined by developments in Ukraine. This outlook assumes that, this year, economic growth will be 2.7% in the EU Member States and 2.6% in the euro area, falling to 1.5% and 1.4% next year, according to Commission forecasts. The average inflation rate is projected to reach 7.6% in the EU and 7.6% in the euro area this year whereas, next year, inflation is expected to fall to 4.6% and 4% respectively.

3. General comments

3.1 The EESC stresses that the short- but also medium-term economic development of the euro area countries is, and has the potential to be, strongly influenced by the impact of Russia's invasion of Ukraine. This adverse development is systemic and there is no parallel in post-war history. It is therefore very difficult to compare it with other shocks that have historically had a negative impact on economic developments in the euro area. In any case, there is a very high degree of uncertainty which makes it harder to determine the outlook for future developments.

3.2 The EESC points out that the trajectory of the underlying macroeconomic and microeconomic indicators in the euro area countries is not encouraging. The level of uncertainty is especially high. In particular, there are a number of unknown variables that may affect the already extremely high levels of uncertainty, mainly of a geopolitical and economic nature.

3.3 The EESC views the inflation trend as posing a high risk to socio-economic progress in the euro area countries. The current inflation risk is mainly linked to supply and disruption of value chains. Developments in Ukraine, particularly in the area of energy inputs, including commodity prices, together with measures to contain the spread of COVID-19, have led to changes on the supply side.

3.4 Today's inflation dynamics require making extensive use of the ECB's toolbox to achieve price stability using accommodative monetary policy. The ECB should proceed cautiously in normalising monetary policy. What is more, it is expected that monetary policy will continue to support economic policy in the euro area member countries.

3.5 The EESC stresses that the inflation risk has not been contained in the Member States and attempts to eliminate it are only partial. Given the ongoing unfavourable trend in inflation and its impact on households, coupled with developments in competitiveness, the EESC calls on all competent and responsible institutions to adopt and implement all urgent measures to offset the negative price shocks. At the same time, turbulence in the sovereign bonds market in the euro area must be prevented[1].

3.6 The EESC welcomes the publication of the REPowerEU programme. It expects this programme to contribute to a gradual reduction of dependence on energy inputs from the Russian Federation. It also offers the possibility to gradually eliminate the greatest cost risks which are a major threat to price stability in euro area countries.

1 The EESC therefore welcomes the ECB's announcement of 15 June 2022 that it intends to work on an instrument to combat fragmentation in the euro area.

3.7 The EESC expects REPowerEU to make two further key contributions: (i) REPowerEU could stimulate a major increase in investment in selected sectors and areas, thus realising an idea that pre-dates Russia's invasion of Ukraine. The basic idea is that this year will be significant in terms of growth in investment, especially in selected areas of public interest; (ii) REPowerEU should also make a substantial contribution to the most important structural changes facing the current generation and thus meet the key objectives of making euro area economies more competitive, sustainable and resilient, in pursuit of the headline targets set out in the Green Deal.

3.8 The EESC is closely monitoring how investment is being fundamentally re-allocated, compared to original investment plans. Investment growth can be expected to be lower in sectors linked to energy restructuring and the implementation of the Green Deal priorities for EU countries. It is unclear what the outlook will be in sectors and areas that are not directly linked. Against this backdrop, it will be important to see the development of small and medium-sized enterprises in traditional economic sectors (not strategically necessary or seeking world class excellence), using potential opportunities in individual regions.

3.9 The EESC strongly supports giving due consideration not only to meeting current critical priorities but also to ensuring uniform innovation performance across regions, the euro area and the EU as a whole. Underestimating this goal may exacerbate divergent trends between regions in the euro area and the EU Member States.

3.10 The EESC welcomes the possibility of stronger convergence thanks to growth in the formerly less developed euro area Member States, which over the long term have been growing at a higher rate than the euro area average. In this context, it should be noted that COVID-19 and the current war in Ukraine may lead to a deepening and divergent process in the euro area Member States, which is not conducive to achieving the basic ideas set out in the Maastricht Treaty.

3.11 The EESC welcomes and supports the ongoing debate on the design of the new institutional framework for public finances in the EU Member States. In this context, the Committee points out that updating the Stability and Growth Pact's fiscal rules is associated above all with the challenge of reconciling financial sustainability with clear public investment needs.

3.12 The EESC sees scope for mutual coordination and links between different types of policies aimed at ensuring sustainable public debt. Furthermore, in justified cases there is a need to support fiscal strategies in line with a medium-term approach to fiscal correction that is geared towards recovery and resilience. The Committee expects realistic and workable solutions to be reached, resulting in a platform on public finances which should be implemented without delay.

3.13 Given that public budgets are under strain following the COVID-19 crisis, further compensatory measures to support households and companies to cope with the energy crisis must be targeted and effective. The EESC rightly understands and respects the current reasons for safeguarding security, humanitarian and social needs and their impact on national budgets in the euro area. In this context, the EESC welcomes the Commission's decision to prolong the activation of the escape clause of the Stability and Growth Pact, and calls on the Commission to put forward concrete reform proposals for the Stability and Growth Pact as soon as possible.

3.14 The EESC has repeatedly stated that, as in the past, and even more so today, greater efforts are needed to strengthen the euro area's position in the international context. Currently, euro area economies are facing new challenges linked to the overall security risk and structural changes. In addition, economic and political developments may affect the position of the euro in the international monetary and payment system. Ending the Russian aggression and the war in Ukraine and restoring Ukraine's territorial integrity may lead to a revival of the world economy and to a stronger euro area economy within it.

4. Specific comments

4.1 The EESC is convinced that, in order to ensure relative socio-economic stability in the euro area Member States, against the prevailing backdrop of high levels of geopolitical and economic uncertainty, linked to the risks of rising inflation and growing public debt, it will be important to focus on the right priorities when drawing on Recovery and Resilience Facility (RRF) funds. This instrument enables EU Member States to jointly issue bonds on the capital markets, and has so far been very effective. The EESC would therefore very much welcome its practical use in future too. In this connection, the EESC sees scope for using the RRF beyond 2026.

4.2 The EESC stresses that Russia's ongoing invasion of Ukraine may lead to an unwanted recession and even stagflation in certain euro area countries. Therefore, careful monitoring of these adverse developments, and pre-emptive action to deal with them, is needed now more than ever.

4.3 The EESC notes that unemployment and labour market trends point to relative stability. At the same time, the Committee highlights relatively large discrepancies between national unemployment rates compared to the pre-2008 period. Structural unemployment is prevalent in some euro area Member States, coupled with a shortage of skilled labour. It is this relative shortage of highly skilled labour that does not allow sufficient scope to increase competitiveness in selected sectors and areas. In this context, the EESC notes that there is still sufficient, and as yet untapped, scope for upskilling and reskilling within the euro area Member States and the EU.

4.4 The EESC is very concerned about the negative trends in inequality and about rising poverty in the euro area Member States and across the EU. Inequality in the broadest sense of the term is, to a large extent, also the legacy of the global financial crisis. COVID-19 has further exacerbated this adverse trend. Rising energy and food prices are currently affecting the most vulnerable population groups, as well as low- and middle-income households. For this reason, the EESC urgently calls on all competent institutions to set up a social safety net that works effectively and where nobody is left behind.

4.5 The EESC draws attention once again to the possible and unforeseen development of further mutations, pandemics and epidemics. The emergence and rapid spread of COVID-19 revealed that the health sector was highly unprepared for the pandemic. More in-depth preparation, but above all a more responsible policy by all competent bodies and institutions in this area, is therefore imperative. The EESC notes that, as developments over the past two years have shown, the greatest return on investment comes from investment in health and prevention.

4.6 The EESC stresses that supporting the provision of additional liquidity since the outbreak of COVID-19 has been the right decision. However, given that some particular operations were suspended, it will now be necessary to focus on ensuring the solvency of certain businesses. Additional liquidity will also be needed to support post-pandemic growth. The EESC therefore considers it crucial to push ahead with the establishment of the Capital Markets Union and the Banking Union.

4.7 The EESC points out that a process of fragmentation in the world economy is under way. Russia's invasion of Ukraine has led to fragmentation in international trade, international payments, international currency-financial relations, international transport, international science and research, global value chains, and in other areas too. This process has had a very negative impact on socio-economic developments in the euro area countries.

4.8 The EESC notes that the current high level of economic and geo-economic uncertainty, accompanied by high risks, is the most complex situation in the entire history of the European integration project. Given the unpredictability of future socio-economic developments, there is a strong need for the competent institutions to adopt and implement a whole host of measures to reduce and eliminate external shocks to the economies of the euro area Member States.

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The president of the European Economic and Social Committee