CHAPTER 1: The EU macroeconomic environment

The EU's macroeconomic policy-stance was contractionary in 2023, both in the monetary and fiscal spheres. The ECB continued to fight the 'beast' of inflation, even though its diagnosis of the latter's cause is wrong. Further, the fiscal policy guidelines set by the European Commission for member states, aimed to fight the 'beast' of the public debt in addition to that of inflation. It is these two 'beasts' with which the EU is mainly concerned in terms of its macroeconomic policy, even though it finds itself in the midst of, as per the introduction, a deepening polycrisis. The Council decision on SGP reform, following the SGP Review, confirms and locks in this priority of concerns. As a result, the EU economy developed the downside risks apparent already in 2022, duly stagnating in 2023. Its GDP grew at a meagre 0.6% on average while ten member states recorded negative growth rates, including Germany (-0.3%) (Table 1). According to the latest report from the European Commission, there was no 'solid growth driver', as private consumption on aggregate had stagnated, both private and public investment increased only marginally, while bank lending declined in many member states.[1]

1.1. Wrong solutions to the wrong problems in macroeconomic policy

With regard to monetary policy, the ECB continued its Quantitative Tightening (QT), embarked on in mid-2022. Between July 2022 and September 2023, it raised its key rates ten consecutive times from 0% to 4.5%, reaching a level not seen since the late 1990s.[2] Although zero interest rates are an anomaly, these aggressive hikes risk inducing a recession. In addition, the ECB is removing liquidity from the system through the banks repaying the loans, obtained on favourable terms during the pandemic (PEPP), and by unwinding its bond holdings acquired under its asset purchase programmes (APP)[3]. By October 2023, the ECB had shed €1.77 trillion or 20% of its total assets since the peak in June 2022. Overall, the ECB's QT policies have led to an increase in nominal interest rates and to a reduction in bank lending, thus hurting both households and businesses, as well as weighing on public finances and diverting resources from other uses.

---

[1] European Commission (2023, November 23). *European Economic Forecast Autumn 2023*, Institutional Paper 258. Available at: https://economy-finance.ec.europa.eu/publications/european-economic-forecast-autumn-2023_en

[2] Rate of Main Refinancing Operations (fixed rate tenders), providing the bulk of liquidity in the Eurozone banking system.

[3] The Asset Purchase Programme (APP) started in 2014, and the Pandemic Emergency Purchase Programme (PEPP) started in March 2020.

So-called ‘second-round effects’ of rapid wage-inflation is clearly a key concern of the ECB in this context. But this is the wrong solution to the wrong problem. More specifically, the rate of inflation which appeared in late 2021 was largely the result of high energy and commodity prices, supply chain disruptions and higher transportation costs resulting from the lifting of the pandemic lockdowns and other restrictions in 2020-2021. Once these extraneous factors had been largely removed, the rate of inflation predictably declined, suggesting clearly that the fear of second round effects was misplaced. In October 2023 the rate of inflation, measured by the Harmonised Index of Consumer Prices, stood at 2.9% in the Eurozone and at 3.6% in the EU, having dropped from 10.6% and 11.5% respectively one year earlier. During this period, the annual rate of energy-price inflation fell from 41.5% in October 2022 to -11.2% in October 2023, accounting for a significant part of the downward inflation trend in the EU. Thus EU inflation cannot be attributed to ‘demand pull’ factors or to the risk of a wage-price spiral becoming embedded in the EU economy. Nominal wages lagged behind inflation both in 2022 and in 2023, while the ratio of employee compensation (wages & employers’ social contributions) to GDP declined by 0.3% over the 20-year period 2002-2022.[4] By contrast, the profit ratio increased by 0.6% over the same period.

The ECB’s contractionary monetary policy was accompanied by a corresponding fiscal policy at EU-level, which is projected to continue throughout 2024 and 2025. More specifically, the temporary pandemic-related measures have been phased out, while energy-related measures and fiscal subsidies for private investment are also being gradually phased out. Echoing the ECB’s concerns, the Commission’s 2024 Report on the Eurozone warns that “… *the euro area faces uncertainty as to whether wages can be adjusted to recoup losses in purchasing power without driving up inflation. The risks of higher-than-expected inflation therefore remain strong. This, in turn, would result in stronger monetary reaction that would adversely impact growth*”.[5] Thus, also the Commission raises the prospect of inflation generated by a wage-price spiral, even though the evidence does not support this claim.

The Commission is further concerned with fiscal sustainability and rebuilding ‘fiscal space’ after the pandemic and energy crisis related measures had increased public expenditure. It calls on member states to ‘*adopt coordinated and prudent fiscal policies to keep debt at prudent levels or put debt ratios on a plausibly downward path*’.[6] This requirement overlooks the fact that the economies of EU member states are

[4] Eurostat (2023). *Annual national accounts – evolution of the income components of GDP*. Available at: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Annual_national_accounts_-_evolution_of_the_income_components_of_GDP

[5] European Commission (2023b, November 21). *2024 Report on the Euro Area*. Available at: https://economy-finance.ec.europa.eu/publications/2024-euro-area-report_en

[6] Ibid, p. 5

interconnected and that when they all try to save, none will be able, as the paradox of thrift teaches us.

In 2023, six member states recorded a debt level above 100% each (Table 1); their collective share of the total EU GDP amounted to 44%[7]. Another six member states recorded a debt level above 60% each, with a collective share of the EU GDP was equal to 31%. Thus, 12 economies accounting for 75% of total EU GDP are advised to simultaneously follow contractionary fiscal policies!

This is not to say that a high public debt is not a source for concern, mainly due to the dominance of financial markets, which are eager to speculate where they perceive a high yield-high risk investment potential. However, attempting to reduce public debt under conditions of economic stagnation and rising interest rates, as well as against a divided political system, as the far-right gains ground across Europe and the world, is a socially damaging and politically undesirable recipe for EU's economy and society.

1.2. Disparities, Inequality, and Poverty

The European Commission has noted that the 'strength of the labour market was the main force behind the growth outlook' in 2023.[8] This view, however, tends to overlook the disparities in unemployment rates across member states and social groups. While the aggregate EU-level rate of unemployment has declined to 6.6% of the labour force, it is considerably higher in certain countries (Table 1). Also, specific groups of workers – women, the young, disabled – face higher unemployment rates and more difficult working conditions than the average. Further, more jobs do not necessarily mean better jobs. Only 15.6% of EU employment is in the industrial sector, while 73.5% is in the services sector[9]. Even though there are good and bad jobs in all sectors, most temporary, part-time and lower paid jobs are to be found in the services sector. The difficult conditions faced by large sections of the population are further reflected in high levels of inequality and poverty. Thus, the average income of the top quintile (20%) of the population in the EU is nearly 5 times that of the bottom quintile. This ratio is considerably higher in certain countries, notably in Southern Europe and in the CEEs (Table 1). In addition, 22% of the EU population was at risk of poverty or social exclusion in 2022, while 31.5% were unable to face unexpected financial expenses and 28.6% could not afford to pay for one week's holiday away from home[10]. Schematic as these

---

[7] The latest available GDP statistics are for 2022.

[8] European Commission (2023a). *European Economic Forecast Autumn 2023*, Institutional Paper 258, p. 3

[9] The sectoral employment data refers to 2022

[10] European Commission (2023). *Key figures on Europe*. Available at: https://ec.europa.eu/eurostat/documents/15216629/17706595/KS-EI-23-001-EN-N.pdf/5df7a393-8461-9270-7eaa-91a4b1c2acc6

social indicators are, they point to the urgent need for adequate public services and for the effective support of the vulnerable sections of society.

A misconceived policy of fiscal austerity to fight inflation cannot but exacerbate an already tense social situation in the EU. As argued in Chapter 2, the contractionary macroeconomic policies and the predictable stagnation of the EU economy have led to a general crisis of distribution, social reproduction and social care. Furthermore, the return of fiscal discipline, signified by the reactivation of the SGP as of 2024, severely limits the capacity of member states to implement progressive social policies.

1.3. The revision of the EU fiscal governance framework

The SGP was established by way of a Protocol annexed to the Treaty on the EU in 1997. On December 20, 2023 the Council agreed on a revision of the Pact, following a Review that had been launched already in February 2020. Formally, the review was compulsory under Two Pack and Six Pack legislation, but it was also generally acknowledged that the Pact was not fit for purpose and in need of revision. The Commission itself acknowledged that there was a need to improve the balance between the stability requirements and the need for mobilising capital investments for the digital and green transition. Other needs outlined include the simplification and clarification of rules as well as the enhancement of member state ownership of the SGP process.[11]

The SGP was suspended through the so-called General Escape Clause (GEC) in March 2020, as it would have been impossible to conduct macroeconomic policy in accordance with its rules under Covid-19 conditions. Further, in view of the Ukraine war, the suspension of the SGP was extended up to the end of 2023. The new fiscal rules thus were due to come into effect as of 2024.

In April 2023, the European Commission published its legislative proposals, introducing the following main elements:

- National medium-term fiscal/structural 4-year plans, which may be extended to seven years under certain conditions.
- The starting point for such national plans is the so-called ‘technical trajectory’ or fiscal adjustment path, drawn up by the Commission on the basis of a Debt Sustainability Analysis (DSA).

[11] European Commission (2021). *The EU economy after COVID-19: Implications for economic governance Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, and the Committee of the Regions* COM (2021) 662 final; Friis, J., Torre, R. and Buti, M. (2022). *How to make the EU fiscal framework fit for challenges of this decade*. Vox EU. Available at: https://cepr.org/voxeu/columns/how-make-eu-fiscal-framework-fit-challenges-decade.

- Member states with a government deficit above 3% of GDP or public debt above 60% of GDP, must ensure that debt was put on 'plausibly downward' paths, or remained at 'prudent' levels, and that the deficit was reduced and maintained below 3% of GDP in the medium term.
- The main operational indicator is net primary expenditure target (expenditure net of interest, cyclical unemployment and welfare spending and one-off revenues), which will serve as the basis for conducting annual fiscal surveillance over the lifetime of the national plans.

Although the above elements constitute some improvement on the existing rules, the core principles of the SGP were not changed in the Commission proposal. In particular, the parameters of 3% and 60% for the deficit/GDP and debt/GDP ratios remained intact, while further numerical targets were added, mostly by way of a concession to Germany:

- The fiscal adjustment must be proportional over the first four years of the plan.
- The debt/GDP ratio must be lower at the end of the period of the plan than at the beginning.
- Where the deficit exceeds 3% of GDP, a minimum fiscal adjustment of 0.5% of GDP per year is required.
- Net expenditure growth must be below that of medium-term potential output growth.

After long negotiations, the European Council reached an agreement on December 21st 2023, to be negotiated with the European Parliament.[12] This contains additional constraints on member states' fiscal policies. In particular, the notion of 'safeguards' is introduced:

- The 'debt sustainability safeguard' amounts to a minimum annual reduction in the debt/GDP ratio of 1% of GDP, where the debt exceeds 90% of GDP, and of 0.5% of GDP where it is between 60% and 90% of GDP.
- The 'deficit resilience safeguard' is set at 1.5% of GDP relative to the reference value of 3% of GDP, while the annual reduction to reach this margin is equal to 0.4% of GDP or 0.25% where the adjustment period is 7 years.

Furthermore, the Excessive Deficit Procedure (EDP) is triggered when the deficit is *not close to balance or in surplus*; while the deficit is considered to be close to balance if it does not exceed 0.5% of GDP. By way of a palliative, over the period 2025-2027 the fiscal adjustment under the EDP will take account of the increase in interest rates, thus

[12] European Council (2023, December 21). *Economic governance review: Council agrees on reform of fiscal rules,* [Press Release]. Available at: https://www.consilium.europa.eu/en/press/press-releases/2023/12/21/economic-governance-review-council-agrees-on-reform-of-fiscal-rules

postponing the full effect of the new fiscal rules for a few years and the approaching electoral cycle for many EU governments.

Also, government military expenditure is considered a "relevant factor when assessing the existence of an excessive deficit".[13] This is by way of "acknowledging the rising geopolitical tensions and security challenges and the corresponding need for member states to build up their capabilities".[14] In this sense, militarisation appears to be prioritised over tackling climate change and other elements of the polycrisis, which have been weighing on Europe and the world for many years

Overall, the proposal for the reform of the SGP agreed by the European Council signifies in many respects a return to the past. In particular, the revised SGP bears many of the paradoxes associated with its previous version, while it contains additional ones, the most salient of which are as follows:

- The national plans are supposed to promote debt sustainability, as well as socio-ecological sustainability. However, debt sustainability takes clear precedence.
- The Maastricht parameters for the deficit and debt ratios, 3% and 60% of GDP respectively, are maintained in spite of their arbitrariness, while the proliferation of numerical targets reinforces the 'one-size-fits-all' notion of fiscal policy and surveillance.
- The SGP remains pre-Keynesian in its conception, insofar as it emphasizes low and declining fiscal benchmarks, thus ignoring the 'paradox of thrift'.
- In spite of the pronouncements of EU institutions and the emphasis which national plans are expected to place on the green and digital transformation, as well as on climate change, no special fiscal treatment of the necessary investment is provided. Proposals by civil society movements and trade unions to include a Golden Rule, whereby public investments promoting the transition towards a green and digital Europe are exempted from the fiscal rules, were rejected.
- By contrast, special treatment is reserved for government investment in defence, which is symptomatic of not only the increased militarisation of the EU, but also of its order of priorities at a time of a polycrisis plaguing European society.
- The overarching roles of the Commission as well as the absence of the European Parliament and national parliaments in the decision-making process, raise concerns about political legitimacy. Debt Sustainability Analysis is highly dependent on

[13] European Commission (2023) *Proposal for a COUNCIL REGULATION amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure*, COM (2023) 241 final, p. 7. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52023PC0241

[14] Ibid

assumptions that are made about growth- and interest-rates, where Commission assumptions are privileged[15]

1.4. Alternative proposals

EU macroeconomic policy has an inbuilt deflationary bias and will continue to be particularly detrimental for the ability of member states in the European periphery to implement technological and socio-ecological transformation (see chapter 3). For this to change, the policy-paradigm needs to shift from one of monetary and fiscal austerity to one of sustainability on all fronts. Similarly, the focus must shift from policy as an end in itself to policy as a means to an end, where the end should be to support an ecologically sustainable, socially equitable and inclusive growth with full employment and quality jobs.

In particular, the EU must enhance its efforts to deal with the climate change crisis. Phasing out its dependence on fossil fuels will require meticulous planning and the deployment of huge resources. For that reason, we reiterate the alternative public investment programme as outlined in the three most recent Euromemoranda. Certain projects will have to be at EU-level, while others at national level will require EU support, given the different fiscal capacities of the member states. The social dimension of the transition to a cleaner, green environment also needs to be explicitly taken into account and catered for. Impoverishing parts of society in the process is not only ethically unacceptable, but also politically dangerous.

While ecological and social transformation is critically important, the technological advancement of the EU economy is long overdue. Whereas the USA has successfully entered the era of digitization and of AI, Europe is lagging behind the US and China in an increasing number of high-tech sectors. In spite of EU initiatives, such as the Green Deal, the Just Transition Fund, the new Digital Strategy and the RRF, fiscal austerity continues to hold back investment in the EU by comparison to the USA and Japan. For example, in 2023 total investment increased by 1.6% in the USA and 2% in Japan but only by an average of 1.2% in the EU, declining in ten of its member states.

The EU is at a critical juncture marked by a multiplicity of crises. It is imperative that a radical, progressive policy shift is made. Elements of such a shift are as follows:

- A Europe-wide plan, in close co-ordination with corresponding national plans, to promote an ecological and social transformation. Furthermore, accelerating the

[15] Wyplosz, C. (2022). Reform of the Stability and Growth Pact: The Commission's proposal could be a missed opportunity. *VoxEU*. available at: https://cepr.org/voxeu/columns/reform-stability-and-growth-pact-commissions-proposal-could-be-missed-opportunity.

technological transformation in the EU's industrial sector is essential to support the necessary economic and social adjustment.

- For the above policy priorities to be realised, fiscal policy needs to be supported by monetary policy, rather than the other way round, as is the case at present. Further, fiscal policy must move away from the prevailing deflationary notions and the obsession with inflation.
- As already stressed in our Memorandum 2023, the inflation-problem should be dealt with through fiscal policy, including selective cuts in indirect taxation of essential goods and services, higher taxation for particular sectors and sections of the population, price controls in sectors of strategic importance (energy, rent, essential food items), support for the middle-and-low-income households suffering from the cost-of-living crisis, and for businesses that have problems meeting increased energy bills.
- Similarly, monetary policy must concern itself with economic, socio-ecological sustainability as a more general goal. The ECB's mandate should be expanded to include full employment in addition to inflation-control, while the return to a 2% inflation target is no longer appropriate for current needs. Instead, a target of 4% would appear to be closer to current policy requirements.
- At the same time, EU-wide funding measures will be necessary, including (i) an investment fund covering the needs of both EU-level transition projects and of complementary national ones; (ii) an enlarged EU budget corresponding to 5% of GNI, financed by new fiscal resources, including taxation of the super-wealthy and of the windfall profits of corporations which had benefited from the crisis, such as energy companies and banks; (iii) a permanent EU central fiscal capacity backed by common borrowing.
- The above approach is contrary to the philosophy of the SGP in its old as well as revised form. The EU's revised fiscal rules are unlikely to succeed where the previous SGP versions failed. An alternative framework is needed where (i) the focus of policy is shifted from observing numerical benchmarks to broader policy targets; (ii) guidelines are set by fiscal standards, rather than rigid rules; (iii) attention is paid to the cost of servicing the public debt relative to GDP, rather than its level; (iv) a 'golden rule' is included, exempting net public investment aimed at the ecological and social transition from budgetary balance rules.
- Last but not least, it is necessary to stress yet again that EU economic governance should be embedded in a democratic participatory framework, where the European Parliament participates in decision-making, oversees its implementation, and holds the European Commission and the ECB accountable.

Table 1   Basic EU economic and social indicators, 2023

Region	Country	Real GDP - % change on preceding year	HICP annual average % change on preceding year	Unemployment - Number of unemployed as % labour force	Real compensation of employees per head - %change over preceding year	Ratio of Top 20% to bottom 20% of income earners (2021)	Net lending (+) or net borrowing (-), general government as % of GDP	Gross debt, general government as % GDP
	Euro area	**0.6**	**5.6**	**6.6**	**-0.3**	**4.79**	**-3.2**	**90.4**
	EU	**0.6**	**6.5**	**6.0**	**-0.4**	**4.74**	**-3.2**	**83.1**
Nordic	Finland	**0.1**	**4.4**	**7.2**	**0.7**	**3.75**	**-2.4**	**74.3**
	Denmark	**1.2**	**3.6**	**4.6**	**0.4**	**4.03**	**2.6**	**30.3**
	Sweden	**-0.5**	**5.7**	**7.6**	**-3.7**	**4.36**	**-0.2**	**30.4**
Western Europe	Austria	**-0.5**	**7.7**	**5.3**	**1.4**	**4.27**	**-2.6**	**76.3**
	Belgium	**1.4**	**2.4**	**5.6**	**2.2**	**3.57**	**-4.9**	**106.3**
	France	**1.0**	**5.8**	**7.2**	**-0.9**	**4.6**	**-4.8**	**109.6**
	Germany	**-0.3**	**6.2**	**3.1**	**-0.6**	**4.35**	**-2.2**	**64.8**
	Ireland	**-0.9**	**5.3**	**4.2**	**-0.1**	**4.07**	**0.9**	**43.0**
	Luxembourg	**-0.6**	**3.2**	**5.5**	**2.1**	**4.54**	**-1.9**	**26.8**
	Netherlands	**0.6**	**4.6**	**3.6**	**-2.3**	**3.94**	**-0.5**	**47.1**
Southern Europe	Cyprus	**2.2**	**4.1**	**6.4**	**0.9**	**4.28**	**2.3**	**78.4**
	Greece	**2.4**	**4.3**	**11.4**	**1.1**	**5.25**	**-2.3**	**160.2**
	Italy	**0.7**	**6.1**	**7.6**	**-1.4**	**5.62**	**-5.3**	**139.8**
	Malta	**4.0**	**5.7**	**2.7**	**-1.4**	**4.75**	**-5.1**	**53.3**
	Portugal	**2.2**	**5.5**	**6.5**	**2.4**	**5.13**	**0.8**	**103.4**
	Spain	**2.4**	**3.6**	**12.1**	**1.1**	**5.63**	**-4.1**	**107.5**
Eastern Europe	Czechia	**-0.4**	**12.2**	**2.4**	**-1.6**	**3.48**	**-3.8**	**44.7**
	Estonia	**-2.6**	**9.4**	**7.0**	**-1.0**	**5.39**	**-2.9**	**19.2**
	Latvia	**-0.2**	**9.6**	**6.8**	**0.8**	**6.33**	**-3.2**	**41.7**
	Lithuania	**-0.4**	**8.8**	**6.8**	**1.2**	**6.39**	**-1.6**	**37.3**
	Slovakia	**1.3**	**10.8**	**5.7**	**-0.4**	**3.12**	**-5.7**	**56.7**
	Slovenia	**1.3**	**7.5**	**3.6**	**1.6**	**3.28**	**-3.7**	**69.3**
	Bulgaria	**2.0**	**8.8**	**4.2**	**1.7**	**7.3**	**-3.0**	**23.5**
	Croatia	**2.6**	**8.1**	**6.5**	**2.6**	**4.58**	**-0.1**	**60.8**
	Hungary	**-0.7**	**17.2**	**4.1**	**-2.6**	**3.99**	**-5.8**	**69.9**
	Poland	**0.4**	**11.1**	**3.0**	**0.2**	**3.91**	**-5.8**	**50.9**
	Romania	**2.2**	**9.8**	**5.4**	**4.8**	**6.0**	**-6.3**	**47.9**
Non EU	**UK**	**0.6**	**7.3**	**4.3**	**-0.7**	**6.2**	**-3.7**	**97.8**
	Japan	**1.9**	**3.3**	**2.5**	**0.7**	**6.2**	**-6.6**	**263.0**
	USA	**2.4**	**4.2**	**3.7**	**0.0**	**8.6**	**-8.0**	**123**

Source: European Commission (2023). *European Economic Forecast Autumn 2023*, Institutional Paper 258.