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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS

The EU economy after COVID-19: implications for economic governance

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1. Introduction

The Commission presented a Communication on the EU economic governance review in February 2020. ([1, 2]) The Communication highlighted a number of strengths and weaknesses facing the economic governance framework (Box 1) and opened a public debate on the basis of its findings. This debate was put on hold shortly afterwards due to the need to focus on the immediate challenges posed by the outbreak of COVID-19. The Commission pledged to relaunch the debate once the recovery took hold. ([3]) In the meantime, reports on the review were adopted by: the European Economic and Social Committee in September 2020; the Committee of Regions in December 2020; and the European Parliament in July 2021. ([4]) The European Court of Auditors also published two special reports on the implementation of the EU fiscal rules. ([5])

This Communication assesses the implications of the changed circumstances for economic governance following the COVID-19 crisis and relaunches the public debate on the review of the framework. This Communication complements the assessment published in February 2020 and follows President von der Leyen's announcement of the relaunch of the public debate in her State of the European Union address on 15 September 2021. The aim of the public debate is to build a consensus on the way forward well in time for 2023.

2. Medium to long-term economic trends in the EU

The EU economy already faced several long-term structural challenges before the COVID-19 crisis. First, despite pre-pandemic improvements in labour market performance, a rapidly-ageing population threatened to eventually reduce labour supply and thus EU growth potential. Second, weak productivity growth acted as a drag on economic growth and the EU was lagging behind China and the United States in the process of digital transformation. Third, the very substantial socio-economic costs of climate change were

(1) A comprehensive framework governs EU economic policy coordination. It consists of the EU fiscal policy framework (the Stability and Growth Pact, the European Semester, and requirements for national fiscal frameworks), the Macroeconomic Imbalances Procedure, and the framework for macroeconomic financial assistance programmes.

(2) European Commission (2020), 'Economic governance review', COM(2020) 55 final of 5 February 2020.

(3) European Commission (2021), 'One year since the outbreak of COVID-19: fiscal policy response', COM(2021) 105 final of 3 March 2021.

(4) Opinion of the European Economic and Social Committee on the economic governance review, OJ C 429, 11.12.2020, p. 227; Opinion of the European Committee of the Regions on the economic governance review, OJ C 37, 2.2.2021, p. 28; European Parliament resolution of 8 July 2021 on the review of the macroeconomic legislative framework for a better impact on Europe's real economy and improved transparency of decision-making and democratic accountability.

(5) European Court of Auditors (2016), 'Special report No 10/2016: Further improvements needed to ensure effective implementation of the excessive deficit procedure'; and European Court of Auditors (2018), 'Special report no 18/2018: Is the main objective of the preventive arm of the Stability and Growth Pact delivered?'

manifesting themselves with increasing clarity and urgency. Fourth, rising income and wealth inequality, territorial disparities within and among Member States, and unequal access to education and skills, were holding back economic growth and creating strain in the EU's social fabric.

Climate challenges and environmental degradation require forceful and swift action. Climate change and the deterioration of the environment are materialising. Temperatures are rising and countries around the world are enduring catastrophic weather-related events with an alarming frequency. The goal of the Paris Agreement to limit global warming to well below 2 degrees Celsius and pursue efforts to limit the temperature increase to 1.5 degrees, compared to pre-industrial levels, is at risk unless greenhouse emissions are reduced drastically. ([6]) About 1 million species are threatened with extinction, many within the next few decades. ([7]) These trends can become a source of systemic risks if left unaddressed. This requires sustained private and public investment to support the green transition (Box 2) and to cushion its impact on the most vulnerable.

Digital transformation is already happening but should be accelerated. The COVID-19 crisis has accelerated the digitalisation of our economies and societies. The lockdowns have boosted online services and e-commerce. EU citizens have experienced first-hand how teleworking, telemedicine, online shopping and digitalised administrative services have the potential to improve the quality of life and economic outcomes. However, a significant share of the population has weak digital skills and faced difficulties in accessing the new digital environment, with risks of widening social divides. The crisis has also exposed the divide between digitally-apt businesses and those yet to adopt digital solutions, and highlighted the gap between well-connected urban areas and rural or remote areas. Meanwhile, the growing shortage of digital skills, the limitations of digital infrastructures, delays in adoption of new technologies by governments and businesses, and dependencies in a number of key technologies such as semiconductors have brought to the fore significant challenges to the EU's digital ambitions. The EU has to take urgent and ambitious action.

Boosting socio-economic resilience is essential to improve Europe's growth potential and job creation and to reach the Sustainable Development Goals. Resilience is the ability to withstand and cope not only with challenges but also to undergo transitions in a sustainable, fair and democratic manner. Less resilient Member States, territories and sectors found it harder to withstand and respond to the crisis. ([8]) Differences in resilience across the EU also have a bearing on social, economic and territorial cohesion, as well as convergence within the euro area and the effectiveness of the single monetary policy. Effective and well-designed active labour market policies and social protection systems, investment in education and skills, and sound public finances can strengthen resilience and increase potential growth. Member States focused on implementing such necessary reforms in the aftermath of the

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(6) Intergovernmental Panel on Climate Change (2021), 'Climate Change 2021: The Physical Science Basis'. Contribution of WG I to the Sixth Assessment Report.

(7) Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (2019), 'Summary for policymakers of the global assessment report on biodiversity and ecosystem services'.

(8) European Commission (2020), '2020 Strategic Foresight Report, Charting the course towards a more resilient Europe', COM(2020) 493 final of 9 September 2020.

global financial crisis but the momentum faded over time, with progress becoming uneven across Member States and policy areas. The strong interdependencies between our economies within the Single Market and Economic and Monetary Union underline the need to coordinate national policies. Full implementation of the 2030 Agenda for Sustainable Development remains a key factor in strengthening resilience and delivering on the twin transitions.

The COVID-19 crisis has made these challenges more visible and more urgent. Addressing them offers transformative opportunities but also requires major investments and reforms. Investment spending and reform momentum will need to increase compared to the pre-COVID period, when public investment dropped below levels needed to keep the stock of public capital stable as a share of GDP and a wide range of reforms remained to be implemented.

The firepower of EUR 2 trillion of the new Multi-annual Financial Framework and Next Generation EU, and in particular the Recovery and Resilience Facility (RRF), will help Member States address these challenges. The RRF is providing EUR 338 billion in non-repayable support and up to EUR 386 billion in loans (in current prices) to support investments and structural reforms until 2026, on top of about EUR 500 billion provided for by other EU funds. ([9]) This large-scale funding will help bring Member States on a recovery path, while making their economies and societies more resilient and better prepared for the future by supporting the green and digital transitions. This effort was supplemented by REACT-EU, financed under Next Generation EU. ([10])

(9) This figure includes national co-financing. The implementation of cohesion policy spans up to 2029.

(10) REACT-EU provided a further EUR 50.6 billion to strengthen cohesion policy funds in 2021 and 2022 for crisis repair measures and as a bridge to the long-term recovery plan under the RRF.

3. Impact and implications of the COVID-19 crisis

3.1. Impact of the crisis

A significant economic contraction followed by a stronger-than-expected but uneven recovery

The COVID-19 pandemic led to a severe economic downturn but the recovery has taken hold. The pandemic resulted in an unprecedented contraction in EU economic activity in 2020. However, thanks to strong policy support, accelerated vaccine rollout and, where possible, the gradual easing of pandemic-related restrictions, growth resumed forcefully in spring 2021. Economic developments over the summer suggest that the third quarter will register continued robust growth, not least thanks to the re-opening of our societies and resumption of travel. Economic activity is then expected to remain sustained for several quarters ahead, pushing the EU economy from recovery into expansion. At least 19 Member States are expected to reach their 2019 levels of GDP this year, while all others are expected to reach that level in the course of next year. Similarly, EU trade in goods with non-EU countries recovered strongly in the first half of 2021. Nonetheless, uncertainty and risks surrounding the outlook remain high, in particular linked to uncertainty about the future trajectory of the pandemic, inflation, energy prices, shortages in the labour market, and bottlenecks in international supply chains.

The labour market impact has been cushioned by policy support measures. Employment contracted mildly compared with the recorded loss in output. Thanks to the widespread use of short-time work and other job retention schemes – backed by the new EU instrument for temporary support to mitigate unemployment risks in an emergency (SURE) – the adjustment was largely confined to a reduction in hours worked. As the economy recovers, unemployment rates have started to decline across the EU and the unemployment rate is now just ½ pp. above the pre-crisis level. However, employment gaps compared with the pre-crisis period remain significant in some regions and sectors across the EU while labour shortages have started to re-emerge in others. Moving forward, transitions between jobs, firms and sectors may generate some frictions as newly-created jobs often have higher or different skills requirements than the jobs that have been lost, which calls for adequate labour market policy interventions to ease adjustments.

Pandemic-related disruptions increased pre-existing economic, social and territorial divergences, and made the achievement of the Sustainable Development Goals even more challenging. ([11]) The economic impact of the pandemic varied across Member States and across economic activities ([12]) due to the differing severity of the health situation, the stringency and duration of mitigation measures put in place, and differences in economic structures. Countries with sizeable cross-border tourism sectors were especially affected by travel restrictions. Within countries, low-skilled workers and young people, as well as regions dependent on tourism and other personal contact services were the most affected. Overall,

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([11]) European Commission (2021), 'Sustainable development in the European Union — Monitoring report on progress towards the SDGs in an EU context — 2021 edition.'

([12]) Online services and e-commerce have been boosted by the lockdowns, while other industries, such as manufacturing of durable goods and freight transport, experienced only short-lived reductions in turnover or even saw their activity increase. At the same time, contact-intensive industries suffered significant losses and are recovering more slowly.

while less severe than initially expected, divergences between Member States, regions, sectors and generations have increased. The crisis highlighted the essential need to uphold the free movement of persons, goods, services and capital in the Single Market and the need to work together to strengthen its resilience to disruptions.

The necessary fiscal response has led to higher and more heterogeneous debt levels

Public finances took a considerable hit as a result of the severe recession and the necessary policy response, with increased fiscal divergence between Member States. Deficits and debt ratios have soared in all Member States, with the EU headline deficit increasing to about 7% of GDP in 2020 from 0.5% of GDP in 2019, and the aggregate debt ratio jumping by 13 pps. of GDP to 92% of GDP at the end of 2020. ([13]) Deficits and debt ratios are expected to remain above pre-pandemic levels in the coming years. Member States with high levels of public debt have been among those most affected by the economic fallout of the COVID-19 crisis because of the severity of the health situation, the measures put in place to shore up public health as well as the structure of their economies, including sizeable cross-border tourism sectors. As a result, these Member States recorded some of the steepest increases in debt ratios. On top of direct fiscal stimulus, governments also provided private-sector liquidity support of nearly 20% of GDP, mostly in the form of public guarantees to companies and tax deferrals. ([14]) The take-up of those public guarantees varied significantly across Member States. Any possible impact on public finances depends on the extent these guarantees will be called.

While public debt ratios have increased, measures of the Recovery and Resilience Plans to increase growth potential will support fiscal sustainability. High debt ratios are expected to persist, remaining above pre-pandemic levels in about a third of Member States over the next decade. ([15]) They will increase further if COVID-related guarantees are called or interest rates increase. In the longer term, spending related to population ageing and climate change may also impact fiscal sustainability. At the same time, several factors can support fiscal sustainability: longer debt maturities; relatively stable financing sources with a diversified and large investor base; and favourable interest-growth differentials. Importantly, the successful implementation of fiscal and growth-enhancing reforms and investments under the RRF and cohesion policy funds, supported by the Commission through the Technical Support Instrument, is expected to support potential growth, contributing to improving fiscal sustainability and maintaining favourable financing conditions.

Investment needs are pressing

Investment needs are substantial and the RRF will help to address them until 2026. The EU's commitment to the twin transitions, enshrined in the EU Green Deal and the EU digital

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([13]) Figures taken from the Commission 2021 spring forecast.

([14]) These measures prevented liquidity shortages from turning into solvency problems, facilitated the continued provision of credit to the economy by the banking sector, and enabled an efficient pass-through of favourable financing conditions to all economic sectors.

([15]) Nearly two thirds of Member States face medium or high sustainability risks in the medium term, according to the conventional Commission classification, compared with only a third before the crisis. See European Commission (2021), 'The 2021 Stability and Convergence Programmes: an Overview, with an Assessment of the Euro Area Fiscal Stance.'

strategy, will require additional annual private and public investment of about EUR 650 billion over the next decade (Box 2). ([16]) The investment needed to support the digital transition and the EU's open strategic autonomy ([17]) has become more evident during the pandemic, highlighting the need for secure and fast internet connectivity, access to digital services, the importance of digital education and skills across society, and addressing the EU's dependencies with respect to key digital capacities. Additional investment is also needed to improve the EU's economic and social resilience, including in healthcare, education and training, research and development, innovation, and transport. While the cohesion policy funds will continue to help Member States address these needs, the RRF will also support these efforts through a mix of non-repayable support and loan financing but this funding is temporary. Ultimately, ensuring economic and social resilience and meeting the goals of the twin transitions will require a persistent and sizeable increase in both public and private investment in Member States that is sustained beyond 2026. In general, addressing these pressing needs will also require further efforts to promote private investment, including through the completion of capital markets union. Furthermore, the EU taxonomy for sustainable activities will help shift private investment to where it is most needed from the climate and environmental action perspective.

Post-pandemic fiscal adjustment should go hand-in-hand with improving the quality of public finances. RRF support will contribute to the recovery and lift potential growth only if it finances *additional* productive and high-quality investment. That is, public investment funded by the RRF should come on top of sustained nationally-financed investment. Therefore, promoting nationally-financed investment for the twin transition and strengthening economic and social resilience will be critical. If RRF support does not result in additional investment, it will temporarily reduce deficits and debt ratios but without a positive effect on potential growth in the medium to long term, thus leading to a deterioration in the composition of public spending. Where debt ratios are very elevated, promoting nationally-financed investment will require clear prioritisation of expenditures and efforts to improve the overall composition and quality of public finances.

The ongoing correction of macroeconomic imbalances has encountered a setback

The crisis has had an uneven impact across households and corporates but supportive policy action has cushioned the shock, including on the banking sector. First, while the number of job losses has overall been limited, they have been more frequent among low- and medium-skilled workers. Similarly, young workers and other new entrants to the labour market have been most affected. These trends can increase inequalities in our societies and call for further policy action to re-skill and up-skill. The Porto Declaration of 8 May 2021 reaffirmed EU Leaders' commitment to the European Pillar of Social Rights as a fundamental element of the recovery. Second, while corporates have had to resort to additional credit to meet working capital needs, the COVID-19 crisis has overall not resulted in an increase in

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(16) Estimated investment needs are based on the Impact Assessment for the revision of the Renewable Energy Directive (SWD(2021) 621) and the Staff Working Document accompanying the Next Generation EU package (SWD(2020) 98).

(17) European Commission (2021), "2021 Strategic Foresight Report, The EU's capacity and freedom to act," COM(2021) 750 final of 8 September 2021.

insolvencies. ([18])The increased targeting of support measures is ongoing. In view of the remaining vulnerabilities, the phasing out of support programs should be done gradually. Third, thanks to their strong capital ratios and high liquidity buffers, banks were able to keep providing credit to the economy. The suspension of dividend payments and some temporary regulatory relief also provided a breathing space for banks. The increase in non-performing loans has been contained but asset quality should be closely monitored. Fourth, dynamic house and financial asset prices entail additional risks.

The COVID-19 crisis has aggravated a number of pre-existing vulnerabilities. Internal imbalances related to high government and private debt have increased, driven by the drop in GDP in 2020 and measures taken to address the COVID-19 crisis. Pre-pandemic dynamic house price trends persisted and mortgage debt continued to grow significantly in some countries. Current account deficits widened in countries dependent on tourism revenues. At the same time, the correction of current account surpluses has stalled. Moving forward, new imbalances may emerge as a result of structural transformations accelerated by the COVID-19 crisis. Labour shortages, global value chain bottlenecks and strategic dependencies could have an impact on relative prices and competitiveness. The accelerated digital transition and shifts in consumption patterns could lead to skills mismatches and frictional unemployment coexisting with labour shortages.

3.2. Response to the crisis

National policy response and the full use of flexibility within EU regulatory frameworks

The unprecedented and coordinated policy response to the COVID-19 crisis has been successful in cushioning the impact of the crisis. The response to the crisis was carried out forcefully at both the national and EU levels. This was done in a coordinated manner and took various complementary forms. The activation of the general escape clause of the Stability and Growth Pact, agreement on the State Aid Temporary Framework (subsequently amended several times to take account of the evolution of the situation and the needs of businesses), the Coronavirus Response Investment Initiatives (which provided exceptional flexibility to redirect cohesion policy funds where most needed), and the set-up of emergency instruments such as SURE happened quickly. ([19]) Subsequent actions by the Commission and recommendations from the Council reflected the need for close economic policy coordination throughout the pandemic. Decisive EU-level action ensured the development, speedy procurement and coordinated distribution of COVID-19 vaccines. Beyond efforts to mitigate the impact of the crisis, dedicated temporary EU instruments have helped foster the recovery, and promote sustainable and inclusive growth. In this context, the Commission's

([18]) Certain companies, including small and medium enterprises, have increased their leverage as a result of the crisis, making them more vulnerable and potentially in need of recapitalisation.

([19]) OJ L 99, 31.3.2020, p. 5–8. In April 2020, the Coronavirus Response Investment Initiative gave Member States an upfront cash injection of over EUR 20 billion from the EU cohesion policy funds extending the scope of support of the funds, providing immediate liquidity and giving flexibility in programme amendments. This allowed the mobilisation of more than EUR 23 billion for emergency support to the health and education systems, small and medium firms, and to the protection of jobs and the most vulnerable groups. See https://cohesiondata.ec.europa.eu/stories/s/4e2z-pw8r.

commitment to the 2030 Agenda and the Sustainable Development Goals provided a compass to 'building back better' and leaving no one behind.

Faced with severe public health and economic crises, Member States quickly adopted wide-ranging fiscal support measures. The national policy responses was facilitated by the timely use of existing flexibilities within relevant EU frameworks. The total fiscal response of EU Member States – including automatic stabilisers triggered by strong social safety nets – is estimated at almost 19% of GDP in 2020-2022. ([20]) On top of this, EU Member States provided substantial liquidity supports to firms, in the form of state guarantees and tax deferrals. Monetary policy complemented fiscal policy efforts. This joint and coordinated policy response was successful as the impact of the COVID-19 crisis on unemployment, economic and social divergences, corporate insolvencies, and non-performing loans has been far less severe than originally anticipated.

New EU instruments mitigated the impact of the crisis

SURE has been essential to support European labour markets. This rapidly-created safety net is providing cheap loans to Member States allowing them to support workers and firms during the crisis. It is also supporting the recovery and limiting scarring in the labour market. The EU has so far approved over EUR 94 billion in SURE loans to 19 requesting Member States, of which almost EUR 90 billion has already been disbursed. SURE has helped to protect over 31 million people (including 8½ million self-employed workers) against unemployment risks and supported over 2½ million firms during the pandemic. SURE-supported national labour market measures have helped prevent unemployment for about 1½ million people in 2020 and are contributing to the recovery. ([21])

The European Central Bank has implemented a broad set of monetary policy measures, which also supported the transmission of fiscal policy measures. The monetary policy response has consisted mainly of additional asset purchases and liquidity-provision operations to euro area banks. To enhance banks' access to these operations, the European Central Bank also took a number of measures to ease collateral requirements. These measures have contributed to preserving favourable financing conditions for all sectors of the economy, including governments, throughout the pandemic, underpinning economic activity and safeguarding medium-term price stability. The mutually-reinforcing effects of fiscal and monetary policies have been crucial for alleviating the impact of the crisis and is supporting the recovery.

Other instruments created at EU and euro area level have also played their part. The Pan-European Guarantee Fund, created by the European Investment Bank Group, is expected to mobilise up to EUR 200 billion (1.4% of EU GDP) of additional financing to support to small and medium companies. As of 31 August 2021, the financing volume approved amounted to EUR 18 billion, which is expected to mobilise investments amounting to some EUR 144 billion. The European Stability Mechanism's Pandemic Crisis Support instrument,

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([20]) The estimates are based on the cumulative changes in primary budget balances in 2020-2022 relative to 2019, and include a conservative estimate of the impact of RRF non-repayable support.

([21]) European Commission (2021), 'SURE: One year on', COM(2021) 596 final of 22 September 2021.

worth up to EUR 240 billion (2.0% of euro area GDP), remains available and has also contributed to anchor confidence in the EU policy response.

Exiting the crisis and preparing for the future

The RRF will promote an investment-rich recovery and growth-enhancing reforms, increase potential growth, and mitigate fiscal challenges. Its effective implementation will make the EU economy more sustainable, inclusive, resilient and better prepared for the twin transitions while helping mitigate the risk of socio-economic divergences. ([22]) Measures financed by the RRF with non-repayable support will make it possible to fund high-quality investment projects and cover costs of productivity-enhancing reforms without giving rise to higher deficits and debt. RRF financing will thus contribute to Member States' efforts to support the economic recovery, fostering higher potential growth and gradually improving underlying fiscal positions. RRF non-repayable support and other sources of EU financing notably the cohesion policy funds, will provide support of about 0.5% of GDP per year in 2021 and 2022. Overall, public investment, financed by both national sources and the RRF, is forecast to increase to 3.5% of GDP in both 2021 and 2022.

3.3. Implications for the economic governance review

The COVID-19 crisis has further underlined the challenges facing the economic governance framework. Almost two years after the Commission published its review of the economic governance framework, the main conclusions remain valid (Box 1). The crisis has made many of them even more relevant. First, public debt ratios have increased further, highlighting the challenge of a gradual, sustained and growth-friendly reduction to prudent debt levels. Second, public investment will need to be sustained at high levels for years to come, highlighting the importance of a good composition and quality of public finances to ensure sustainable and inclusive growth. Third, counter-cyclical discretionary fiscal policy, together with temporary EU fiscal support tools, has proved highly effective in cushioning the impact of this exceptional crisis in a timely and efficient manner, highlighting the importance of creating fiscal room in normal times for deployment in times of crisis. Fourth, the effective policy response has underscored the importance of strong policy coordination, including between different policy and funding tools, and between the EU and national levels. Fifth, the rapid evolution of the crisis illustrated the difficulties associated with using indicators that are not observable and attempting to design rules that seek to cater for all possible circumstances. Sixth, the correction of macroeconomic imbalances has been interrupted and new vulnerabilities are emerging, highlighting the importance of preventing and addressing risks and divergences in a timely way. The relaunched review should combine the Commission's earlier findings, as set out in the February 2020 Communication, with the lessons from the crisis. This will allow for reflection on an economic governance framework that can fully support Member States in tackling post-COVID macroeconomic challenges.

([22]) The allocation of the RRF non-repayable support is commensurate to the actual needs of Member States, with higher contributions for Member States with a relatively low GDP per capita and those hit hardest by the crisis. Due to pre-existing challenges, such as higher-than-average unemployment, these Member States face higher risks of not being able to recover rapidly from the crisis.

EU fiscal rules

Reducing high and divergent public debt ratios in a sustainable, growth-friendly manner will be a key post-crisis challenge. When economic conditions allow, resuming a path of reduction in public debt-to-GDP ratios will be essential for maintaining sound public finances, avoiding persistent fiscal divergence between Member States, preserving favourable financing conditions for the public and private sectors, and preventing episodes of market stress that would result in costly spillovers. A strong economic recovery and sustained economic growth are essential for successful, continuous and sustainable reduction in debt ratios. While an overly-large upfront reduction in debt-ratios would entail a high social and economic cost and be counter-productive, in particular against the background of constrained monetary policy and the risk of economic scarring, a realistic, gradual and sustained reduction of public debt remains important also to rebuild buffers before the next downturn.

The stabilisation role of coordinated discretionary fiscal policy has proved to be crucial in the COVID-19 crisis. The COVID-19 crisis has highlighted the positive role that counter-cyclical discretionary fiscal policy and European coordination can play in responding to large economic shocks, and containing their social fallout. Complemented by the monetary policy actions taken by the ECB and national central banks, and facilitated by the activation of the general escape clause of the SGP, the coordinated and consensual fiscal policy response has been effective in addressing the immediate challenge of a sizeable economic shock, instilling confidence and reducing the risk of scarring. This also reflects the effectiveness of the stabilisation role of fiscal policy in the current context of low interest rates. However, the ability to provide fiscal stimulus in bad times requires building fiscal buffers in good times. Reinforcing counter-cyclicality in the EU fiscal framework could strengthen the medium-term dimension of fiscal policy and, thus, the ability of national fiscal policy to respond to economic fluctuations.

A growth-friendly composition of public finances should promote investment and support sustained, sustainable and inclusive growth. National budgets will have to play their role, with substantial though temporary support from the RRF. At the same time, public funding should not replace or crowd out private investment when no market failure exists. Overall, this underlines the importance of quality and composition of public finances. This should include a reflection on what is the appropriate role of the economic governance framework to incentivise national investment and reforms. Promoting green, digital and resilience-enhancing public investment deserves special attention, given the long-term challenges facing our economy.

Achieving the overarching goals of simplification, stronger national ownership and better enforcement remains highly relevant. Whereas the current fiscal framework has included elements of flexibility and discretion through a complex set of interpretative provisions, an effective application of economic judgement within a rules-based framework needs to be done in a transparent manner. This calls for *simpler* fiscal rules using *observable* indicators for measuring compliance. It also includes considering whether a clear focus on 'gross policy errors', as set out in the Treaty, based on clearly defined objectives and a stronger involvement of national institutions, could contribute to a more effective

implementation of the surveillance framework. These goals are interconnected. In particular, a simpler framework contributes to increased ownership, better communication, and lower political costs for enforcement and compliance.

Strong national fiscal frameworks can contribute to an effective economic governance framework. During the COVID-19 crisis, national fiscal frameworks, including national independent fiscal institutions, were able to swiftly adjust to the changing circumstances. This suggests that a possible strengthening of their roles is worth considering. At the same time, the wide diversity in independent fiscal institutions' legal mandates, performance and resources calls for an alignment with best practices across Member States with due consideration of differences in national institutional settings. Other issues that need to be considered include strategies to promote medium-term and green budgeting, public investment management, and ways to better reflect risks from climate change in budgetary planning.

Macroeconomic Imbalances Procedure

Returning to a path of convergence between Member States is essential. Preventing and correcting macroeconomic imbalances enhances Member States' ability to respond to shocks and supports economic convergence. Unwinding the build-up of internal and external vulnerabilities will help consolidate the recovery and strengthen long-term growth. The asymmetric impact of the crisis and heightened divergences (albeit less than expected) highlight the importance of reducing both current account deficits and persistent and large current account surpluses. Reducing external imbalances will also be crucial to create positive demand spillovers across Member States, in particular within the euro area under a constrained monetary policy.

A well-functioning Macroeconomic Imbalance Procedure (MIP) can help. The possible emergence of new imbalances as a result of structural transformations accelerated by the COVID-19 crisis stresses the importance for the MIP surveillance framework to timely identify the build-up of imbalances so that they can be addressed early on. The MIP can also foster multilateral dialogue on macroeconomic challenges and support policy coordination, as experienced in the swift and aligned response of Member States to the COVID-19 crisis. Multilateral dialogue enhances the national ownership of policy actions needed to address the identified vulnerabilities. Since the introduction of the MIP, many Member States have been effective in reducing the severity of their imbalances over time. Nevertheless, the persistence of imbalances in some cases warrants further reflection on how the implementation and design of the MIP, including the Excessive Imbalance Procedure, could foster national ownership and enhance its political traction.

Multiple surveillance streams partially overlap but the links have not always been fully exploited. While the integration of the MIP and the SGP within the framework of the European Semester has helped to strengthen the interaction between those surveillance strands, there is further scope to make them work better together while avoiding overlaps between them when addressing at the same time macroeconomic imbalances, potential growth challenges and risks to fiscal sustainability. MIP surveillance may also have so far

insufficiently taken account of interactions between new emerging economic challenges, notably related to climate change and other environmental pressures.

Lessons from the RRF

Lessons from the successful EU policy response to the crisis, and in particular the RRF framework and its governance, can be useful for the review of the economic governance framework. The Parliament and the Council, based on a proposal from the Commission, agreed on a policy and governance framework for the RRF that aims to have common EU objectives reflected in coordinated action at Member State level. ([23]) Member States designed their national Recovery and Resilience Plans, covering investment and reforms, addressing country-specific challenges and EU policy priorities. On the basis of those plans, the Commission engaged in constructive and intense policy dialogues with Member States, leading to an improved mutual understanding of the challenges and policy priorities at national and EU levels. These dialogues have helped to build trust and ownership, and are intended to deliver transformative reforms and investments. The outcome of that dialogue has been reflected in a Commission proposal for a Council Implementing Decision, setting out the agreed reforms and investments, which is subsequently endorsed by the Council.

A transparent assessment and monitoring framework enhanced mutual trust and will underpin the implementation of the RRF. Implementation will be monitored and assessed against specific milestones and targets proposed by the Member State, assessed and approved by the Commission, and endorsed by the Council. With its performance-based nature and close monitoring and scrutiny mechanisms, the RRF provides a consistent strategy to support reforms and public investment, and boost potential growth to address the twin transition needs. Each national plan has to devote a minimum of 37% of the allocated funds to climate action and 20% to digital. ([24]) Monitoring of these targets provides credibility to the RRF's climate and digital objectives. The Facility will also contribute to the implementation of the European Pillar of Social Rights thanks to the funding devoted to employment and social measures, and promoting equal opportunities for all.

The RRF's commitment-based approach to policy coordination, with strong national ownership of policy design and outcomes, is expected to support implementation of agreed reforms and investments. This approach takes into account the complexities that arise from the simultaneous pursuit of various national and EU objectives, in a context of differences in socioeconomic structures and national preferences. It underpins ownership and trust. Rapidly-evolving developments since the start of the pandemic (and even before it) have illustrated the difficulty of designing comprehensive rules that are able to cater for all possible circumstances. The same issues are relevant in the broader context of economic governance. For instance, in the fiscal domain, preserving the credibility of the framework

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([23]) The EU policy priorities are represented by six policy pillars that should guide the implementation of the RRF: green transition; digital transformation; smart, sustainable and inclusive growth, productivity and competitiveness; social and territorial cohesion; health, economic, social and institutional resilience; and policies for the next generation, children and the youth.

([24]) In addition to the climate target, individual measures need to respect the '*do no significant harm principle*' in relation to the environmental objectives, demonstrated through an assessment as set out in a technical guidance published by the Commission.

requires that the objectives of fiscal sustainability, macroeconomic stabilisation and the quality of public finances are all appropriately addressed already at the planning stage, thus resulting in well-defined adjustment paths. Taking into account the lessons from the RRF, the economic governance review should consider how national ownership, mutual trust, the effective delivery of the framework on its key objectives, and the interplay between economic and fiscal dimensions can be best ensured.

Going forward, the European Semester will remain the reference framework for conducting integrated surveillance and the coordination of economic and employment policies in the EU. The European Semester has shown its merits in improving the coordination of economic and employment policies. However, it will need to be adapted to new challenges arising from the green and digital transitions and to the need for stronger resilience. The European Semester, with its broader scope, will complement the implementation of the Recovery and Resilience Plans, which set the reform and investment agenda for the years to come. The two processes will be intrinsically linked, making the best use of the existing synergies and without creating overlaps.

Issues for debate

There are eleven key questions for the public debate, as reflected in the updated online survey. Taking into account the experience with the existing legal framework prior to the COVID-19 outbreak (Box 1), the impact of the crisis and the challenges described above, the 9 questions guiding the public debate included in the Communication of February 2020 ([25]) have been complemented by two additional questions, while one question has been slightly reformulated, as follows:

New question: In what respects can the design, governance and operation of the RRF provide useful insights in terms of economic governance through improved ownership, mutual trust, enforcement and interplay between the economic and fiscal dimensions?

New question: Considering how the COVID-19 crisis has reshaped our economies, are there any other challenges that the economic governance framework should factor in beyond those identified so far?

Reformulated question: In light of the wide-ranging impact of the COVID-19 crisis and the new temporary policy tools that have been launched in response to it, how can the framework – including the Stability and Growth Pact, the Macroeconomic Imbalances Procedure and, more broadly, the European Semester – best ensure an adequate and coordinated policy response at the EU and national levels?

4. Conclusions

The Commission invites the other institutions and all stakeholders to engage in the public debate on the economic governance review. The Commission looks forward to an inclusive debate with the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions, the European Central Bank, national

([25]) European Commission (2020), 'Economic governance review', COM(2020) 55 final of 5 February 2020.

central banks, national governments and parliaments as well as a wide range of stakeholders, including social partners, academia, civil society organisations, independent fiscal institutions and national productivity boards. The debate will take place through various fora, including dedicated meetings, seminars, workshops and an online survey. The online survey has been relaunched today and citizens, organisations and public authorities are invited to submit their contributions by 31 December 2021. ([26]) The Commission's dedicated economic governance website will serve as a hub for information on the various listening events that the Commission will organise. ([27]) The Commission will also evaluate information and feedback gathered during other events organised by stakeholders across the EU.

A wide-ranging and inclusive engagement with all stakeholders is necessary to build a broad-based consensus. The effective functioning of the surveillance framework is the collective responsibility of all Member States, EU institutions and key stakeholders. The public debate will help to build consensus amongst all. This is important for the effectiveness of economic surveillance in the Union. Through its initiatives, the Commission will promote dialogue and mutual understanding among stakeholders, with the objective of formulating a widely-shared approach on the way forward.

The Commission will consider all views expressed during the public debate. In the first quarter of 2022, the Commission will provide guidance for fiscal policy for the period ahead, with the purpose of facilitating the coordination of fiscal policies and the preparation of Member States' Stability and Convergence Programmes. The guidance will reflect the global economic situation, the specific situation of each Member State and the discussion on the economic governance framework. The Commission will provide orientations on possible changes to the economic governance framework with the objective of achieving a broad-based consensus on the way forward well in time for 2023.

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(26) Please use the following link: https://ec.europa.eu/eusurvey/runner/Public-debate-on-the-review-of-the-EU-economic-governance

(27) See: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/economic-governance-review_en

Box 1: Summary of the February 2020 Communication on the economic governance review

The February 2020 Communication assessed the effectiveness of the economic governance framework in achieving its key objectives. These objectives are: (i) ensuring sustainable government finances and growth, and avoiding macroeconomic imbalances; (ii) providing an integrated surveillance framework that supports coordination of economic policies, in particular in the euro area; and (iii) promoting the macroeconomic convergence in the EU.

The Communication found that the economic governance framework had been successful in reducing public debt levels, correcting existing macroeconomic imbalances, supporting a gradual convergence of Member States' economic performances, and a better coordination of economic policies. The Communication also pointed to issues related to Member States' low potential growth, persistently low inflation, and continually high public debt levels in certain Member States. Furthermore, the Communication reasoned that the surveillance framework should help tackle today's and tomorrow's most pressing economic, demographic and environmental challenges.

The fiscal framework

The fiscal surveillance framework had been successful in encouraging Member States to return to sound budgetary positions by reducing their deficits and putting debt ratios on a downward path. However, the preventive arm of the framework had been less effective than the corrective arm. While the aggregate debt-to-GDP ratio began to decline in 2015, debt dynamics had widely diverged across Member States. The framework did not ensure a sufficient differentiation between Member States with markedly different fiscal positions, sustainability risks and other vulnerabilities.

The Communication emphasised that Member States' fiscal policies remained pro-cyclical. The ability to steer the euro area fiscal stance had been limited, in the absence of a central fiscal capacity with stabilisation features. Moreover, the fiscal framework had not sufficiently preserved the level of public investment during periods of fiscal consolidation, while public finances had not become growth-friendlier. The Communication also highlighted the complexity of the EU fiscal rules, including the multiplicity of indicators and the reliance on unobservable variables. The framework lacked transparency and its complexity hampered ownership and predictability. Finally, the development of national fiscal frameworks and independent fiscal institutions had increased national ownership of fiscal discipline. However, the effectiveness of national frameworks differed across Member States.

The Macroeconomic Imbalance Procedure

The MIP widened the scope of the surveillance framework but the interplay between the MIP and the SGP had been insufficient. For example, the link between fiscal sustainability and macroeconomic imbalances could have been further developed. Moreover, MIP surveillance had not sufficiently taken into account interactions with emerging economic challenges, notably relating to climate change and other environmental pressures. While the MIP had helped to raise awareness of macroeconomic imbalances, it had not led to sustained reforms in Member States where imbalances persist. The MIP had been more successful in reducing current account deficits than it had been in reducing persistent and large current account surpluses. Finally, since the MIP was introduced in a context of existing imbalances, its effectiveness in preventing the accumulation of new imbalances, vulnerabilities and risks remained to be tested.

Euro-area Member States experiencing, or threatened with, serious difficulties with financial stability

Mechanisms providing financial support to euro-area Member States experiencing difficulties related to financial stability were developed starting in 2010, leading to the establishment of the European Stability Mechanism. While all euro-area Member States that received financial assistance successfully returned to markets at reasonable financing rates, more attention could be given to the national ownership of programmes in the future, as well as to transparency and accountability.

Box 2: Green and digital investment needs

The additional private and public investment needs in relation to the twin transitions and their policy objectives are estimated at nearly EUR 650 billion per year until 2030. ([1]) The green transition accounts for EUR 520 billion each year, or 80% of these needs, with nearly 60% of the total for climate and energy policy.

Green transition

The climate transition will inevitably lead to an accelerated obsolescence of certain existing capital stock. This does not necessarily mean that growth will decline but is likely to lead to a change in the composition of growth as more resources will have to be devoted to investment and less to consumption. ([2])

The increase in investment needs in the energy and transport sectors is estimated to be around EUR 390 billion per year. ([3]) The increase of more than 50% compared to the historical trend is mostly driven by climate and energy policies to decarbonise our economy but it also reflects the energy and transport needs of an expanding economy. ([4]) On average, this represents an increase of around 2.1 percentage points of the share of energy and transport investment in GDP compared to the historical trend. It includes investment in the power grid, power plants, industrial boilers and new fuels production and distribution, as well as investments in building insulation, energy renovation and vehicle purchasing costs and other transport sector investments. ([5]) Infrastructure investment needs for transport are partly included. ([6]) These estimates do not factor in future climate adaptation needs such as investments dedicated to making existing assets more resilient to climate change or increased costs due to more frequent extreme weather events.

For the other environmental areas, the investment gap to achieve the policy objectives is estimated to be around EUR 130 billion per year. This estimate reflects the investment needs for environmental policy areas such as environmental protection, including biodiversity, resource management and circular economy. ([7])

Whereas a substantial share of the investment will be borne by the private sector, public investment will have to increase as well.

Digital transformation

The overall investment gaps to deliver on a digital transformation in the EU is estimated to be about EUR 125 billion per year. ([8]) This figure includes investment gaps in communication networks, digital skills development and the development of key digital capacities and technologies, such as cloud, semiconductors and artificial intelligence but does not cover the digitalisation of public services and some other dimensions.

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(1) The investment needs for the various policies come from different sources and reflects different approaches (see footnotes 3, 7 and 8), and provide an order of magnitude.

(2) Pisani-Ferry, J. (2021), 'Climate Policy is Macroeconomic Policy, and the Implications Will Be Significant', PIIE Policy Brief 21-20, August 2021.

(3) See the Impact Assessments for the 55% policy proposals, among others the Impact Assessment for the revision of the Renewable Energy Directive (SWD(2021) 621 final).

(4) Around EUR 1 trillion is required to be invested annually in the energy and transport sectors for the 2021-2030 period. These estimates reflect investment needs to meet the economy's energy and transport needs as well as increased investment needs due to higher climate and energy policy ambitions. These estimates include lower projected costs for energy and transport technologies such as renewable energy and battery costs. EUR 650 billion stems from the transport sector, mainly representing the purchasing cost of vehicles. This includes vehicles bought by private households, which are normally accounted as a durable good in national accounts, not an investment.

(5) The investment needs are derived from a partial equilibrium model of the energy and transport system. Figures include investment in new assets or capacity, including the replacement of existing assets at the end of their economic lifetime. The replacement of existing assets can be accelerated due to policy choices, for instance the phase-out of fossil fuel-based power generation capacity, or because of changing market conditions that make their operation uneconomic.

(6) They include investment in recharging or refuelling stations but do not include for example investments in rail or road infrastructure.

(7) European Commission (2020), 'Staff Working Document accompanying the Next Generation EU package', SWD (2020) 98.

(8) Ibid.