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A manifesto to ehnance the EUs global role. Marco Buti sets out the key elements

Christine Lagarde discusses the future of international regulation

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THE EUROPEAN TRADE AND FINANCE PLATFORM

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The EU at the time of the New Cold War: A Manifesto

Ahead of next June's European Parliament elections Marco Buti *et al* set out key elements that could form the basis for a new political contract capable of enhancing the global role of the EU

Ahead of next June's European Parliament elections, in this column a group of distinguished former senior European policymakers, eminent personalities and leading academics present their take on the challenges facing the European Union and chart a course for an ambitious way forward.

Writing in a personal capacity, the authors set out seven key elements that could form the basis for a new political contract capable of re-establishing trust, strengthening solidarity, boosting the Union's ability to act in the interests of all its citizens, and enhancing the global role of the EU. The signatories, while fully supporting the general lines of this Manifesto, might not necessarily agree on each specific aspect.

The long-lasting war in Ukraine and the deepening of the conflict between the US and China are the defining moments of our time. A new world order is in the making and, if the EU remains a half-baked construction, it will not play a role in shaping it.

The US and China are economic and political areas, the EU is not. A third global actor would make the international system more stable. The EU should strive to give multilateralism a new chance and avoid a pure logic of power in international relations which would make everyone worse off.

The geopolitical stance and role of the EU will crucially depend on reconciling its domestic and international agendas. To do so, European leaders must acknowledge that the EU's current socioeconomic, institutional, and, ultimately, political model is not sustainable in a post-pandemic world characterised by 'hot' and 'cold' wars.

From a socioeconomic standpoint, the dependence on external demand, the gradual drift away from the technological frontier, the risk of losing the leadership in the fight against climate change, a stagnant demography, and the progressive undermining of social cohesion are calling into question the main tenets of the European economic and social model.

Institutionally, a decision-making process that only produces notable advances during major crises – and is subject to decision-reversal when the pressure abates – is inconsistent with the need to project a coherent stance domestically and globally.

A new political contract capable of re-establishing trust, strengthening solidarity, boosting the Union's ability to act in the interests of all its citizens, and enhancing the global role of the EU

Two persistent conflicts are stretching the political fabric of the EU to the limit: (1) the traditional 'North-South' conflict of interest along the solidarity/responsibility dimension; and, compounding this, (2) an 'East-West' conflict of values along the integration/national sovereignty dimension. Recent political changes in several member states increase the geographical complexity of these conflicts.

Economic and social weaknesses, institutional inconsistency, and political tensions are bound to increase and lead to paralysis of the EU as it faces the prospect of enlargement to 35+ members.

A new synthesis is needed leading to a new political contract.

A useful starting point is identifying the avenues not to be pursued. The denial of the climate challenge, the short-sightedness of a rear-guard mercantilism, the temptations of technological protectionism and withdrawal from international value chains, the sirens of demographic autarchy, and the outsourcing of defence and security would be tantamount to the demise of the EU and its irrelevance in global governance.

These false solutions would not only hinder any positive evolution, but they would also weaken EU's strengths such as the working of the Single Market and the comparative advantages in terms of environmental standard, welfare state, and regulation.

Searching for a new path is key not so much for the superior wellbeing of 'Europe', but for allowing its members to effectively pursue their long-term domestic and external goals. The time has come to acknowledge that nationalism is contrary to the national interest, that member states' national sovereignty is ineffective unless it is redefined in terms of European sovereignty, and that the supply of European public goods is crucial to satisfy national demands for economic, social, and political security.

To address today's key challenges, an approach encompassing the European dimension is unavoidable. Reaching the technological frontier will require mobilising private and public resources that no member state can do alone.

To effectively pursue the green, digital, and artificial intelligence transitions, we need to complete the Banking Union and to operationalise the Capital Markets Union to allocate public and private resources to projects that are 'long in ideas and short in collaterals'.

Joining up forces and funds at the EU level will be needed to meet the immense task of reconstructing Ukraine. Ensuring Europe's safety in a world of increasing threats and isolationist temptations and moving towards strategic autonomy will require pooling sovereignty at EU level in defence and security.

To tackle effectively the challenge of immigration, a new relationship between the EU and Africa will have to be established. This will have to be based on cooperative agreements that cannot be reduced to limiting migrants' departures, and on a new model of inclusion created in EU member states specifically through education, skilling, and job opportunities.

In all these matters, member states will need to decide collectively whether they want to be joint leaders or isolated followers. If their choice is to lead, it will become necessary to empower the EU accordingly. This does not mean fast-forwarding to an unrealistic European federation.

Instead, it calls for a new articulation between national policies (horizontal coordination) and between the national and the EU level (vertical coordination). We could label this evolution a 'gradual and pragmatic federalism'.

During the last 15 years, the EU has been hit by a series of exogenous shocks, partly common to the other areas and partly idiosyncratic. The EU has learned the huge cost to be paid for wrong or untimely responses to these shocks.

Reacting to the pandemic and to the fallout from the war and the energy crisis via procyclical fiscal policies and overburdened monetary policies, as in the period 2011–2019, would have been a dramatic mistake.

Instead, the EU adopted a radically new policy mix and several institutional innovations. With the centralisation of the supply of vaccines, the setting up of the NextGenerationEU recovery plan, the coordination of national energy policies, the 'Fit for 55' climate measures, and the joint programmes to support Ukraine, a new EU multilevel governance system has come to the fore.

What has emerged is a complex web of relationships between the member states and the Union. A strong and growing role has been attributed to the European Commission, based on Article 122 of the Treaty which empowers the EU to take exceptional measures under exceptional situations. This has created a bond that even the more Eurosceptic governments cannot disregard.

Its positive aspect is the confirmation that the EU has the willingness and the resources (as well as a fresh ingenuity) to bounce back under extreme stress. The negative aspect is the fragility of an institutional construction that is squeezed between the lack of time, the transient nature of these tasks, and the related search for short-term compromises.

This negative aspect is made evident by the strengthening of uncertainty and instability due to reliance on one-off resources. A less evident but even more important problem is a systematic attempt to build ad hoc processes to replace the lack of legal and institutional competences.

To meet the current and future challenges, the EU will need to equip itself with a combination of a stable regulatory framework and adequate budgetary powers. Long-lasting open work streams such as Banking Union and Capital Markets Union should be brought to a positive conclusion, overcoming the sterile debate on risk sharing versus risk reduction.

Over two decades after the launch of the euro, the goal of achieving Fiscal Union has to be put on the table. Short of that, the EU will not be successful in pursuing its green and digital agendas and will continue to be at the mercy of external events, thus remaining vulnerable domestically and on the global scene.

A gradual and pragmatic federalism should include the following seven elements:

1. A fundamental reform of the EU budget built on a permanent or, at least, recurrent central fiscal capacity to supply European public goods in the triple green, digital, and social transition, backed by credible own resources. Adequate and stable funds will have to be allocated to the reconstruction of Ukraine.

2. New fiscal rules to pursue economic and social convergence within the EU and meet the necessary conditions for long-term economic growth and sustainable public finances.

3. A decisive move towards the construction of integrated and deep European financial markets based on the issuance of a European safe asset and the definition of a fully-fledged crisis management system.

4. An industrial policy fostering the shift to a new EU 'business model' that combines innovative productions, effective services, high-quality education systems and well-trained workers, building on the successes of the SURE programme launched during the pandemic.

5. A revamped state aid policy aimed at strengthening – and not undermining – the Single Market and new European tools to safeguard the EU's role in international value chains. In short, the goal should not be 'made in Europe', but 'made with Europe'.

6. A common education and training strategy as well as concrete programmes for including migrants in EU labour markets, as a fundamental stepping-stone of an EU immigration policy.

7. An EU security and defence policy within NATO, but having sufficient autonomy and visibility, thereby robust to possible renewed isolationist tendencies in the US after the November 2024 elections.

Pursuing this ambitious agenda will require rebuilding trust between EU member states; between national governments, the European Commission, and the European Parliament; and, ultimately, between European institutions and European citizens. In this endeavour, a key role should be played by the 'Erasmus Generation', who are Europe's most effective ambassadors.

Rebuilding trust in the EU would entail the recognition that the winners of yesterday are not the winners of today or tomorrow. In a world of endemic uncertainty and repeated shocks, to avoid zero-sum games, an insurance-based solidarity is needed where support will depend on who suffers more from the shocks.

Mutual trust, two-way solidarity, a permanent central fiscal capacity supplying economic and non-economic European public goods, a new industrial policy buttressing EU strategic autonomy, and the social inclusion of the weaker components of society are the ingredients to gradually build a pragmatic federalism.

The latter cannot be put in place via one-off agreements based on purely intergovernmental arrangements triggered only under extreme circumstances. New and stable EU competences, backed by appropriate resources in the areas mentioned above, are required.

A key tenet of a gradual and pragmatic federalism will be the rethinking of the voting system in the EU Council: to avoid paralysis in the decision-making process, voting needs to be reformed in advance of future EU enlargements.

Let us be aware that there are flexible ways to allow isolated dissent not to become a veto, whilst at the same time protecting the dissenting member from the effects of the decision. Institutional reform should also include the possibility, in well-identified areas where there is a need but not yet the agreement to push forward the integration frontier, to proceed with variable geometry and member states' 'clubs'.

This Manifesto argues that moving towards a gradual and pragmatic federalism is key for the EU's future at home and abroad. This cannot be done by stealth via a sort of 'permanent article 122' regime. The full implementation of the agenda will require changes in the Treaty, but important steps can also be taken before such a reform.

It cannot be done at once. When clarity on the policy, institutional, and political agenda is reached, national and EU leaders should explain to European citizens why setting up more effective and efficient EU institutions is not an obscure 'Brussels' prerogative, but a decisive development to safeguard the future of our communities, and most notably that of young generations.

The campaign for the forthcoming European Parliament provides this opportunity. It should not be wasted. ■

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This Manifesto can also be found here. Anyone wishing to support the Manifesto, should express her/his interest by writing to Marco Buti and Marcello Messori at: Europe.manifesto2024@gmail.com

Governance at a turning point

International governance has brough indisputable benefits, but mistrust has grown. Christine Lagarde calls for policymakers to focus on citizens' priorities whilst being courageous and accountable

Good governance is a crucial issue in these uncertain and challenging times. Two aspects of good governance are the protection of liberties and the need for integration. In my view, these aspects also apply to governance in a broader sense, particularly regarding individuals and governments. And they are especially important for supranational governance, as there is often a tension between the need for closer integration – which is likely to advance prosperity – and the wish for greater protection of liberties.

In fact, it's this tension that leads to rules-based systems and institutions emerging as countries work together voluntarily to forge supranational governance structures. And as international cooperation becomes stronger and more complex, supranational governance must also be strengthened to support it.

But in recent decades we have also seen an imbalance emerge between the authority delegated to supranational governance and its legitimacy in the eyes of citizens. That is partly because supranational governance, by promoting the expansion of economic integration, has also contributed to weakening its own legitimacy.

Today this lack of legitimacy brings us to a turning point where we must either deepen supranational governance or accept its decline. However, I am confident that we can find a way forward by meeting three essential conditions.

First, by aligning governance with, and focusing it on, people's priorities. This is what I will call the function.

Next, by using the right forms of governance to effectively respond to people's concerns. I will refer to this as the form.

And finally, by striving to fulfil that function and serve the public, with what I will describe as courageous and accountable leadership.

The development of global governance

When countries have objectives that they cannot achieve on their own, or face challenges that go beyond their individual capabilities, they are motivated to cooperate internationally. This leads them to voluntarily accept some limits to their autonomy.

Mistrust has materialised as protectionism, withdrawal, retreat and populist tendencies, eroding the foundations of supranational governance, leading to political movements seeking to regain control, and to our world fragmenting into competing blocs

It could, for example, involve reciprocal market access to promote international trade or a concerted ban on certain products or practices in order to protect the global commons.

But the more countries cooperate internationally, the greater the associated risks. Countries are exposed to unfair competition from trading partners, to spillover effects from other countries' financial markets and to non-compliance with agreements on protecting the global commons, such as treaties on the environment.

That is why supranational governance is needed to mitigate these risks and achieve fair outcomes for all involved. In this sense, governance resides in setting the 'rules of the game' in advance and then ensuring that they are fairly adhered to.

This type of governance can take different forms, ranging from creating international institutions to setting global rules and establishing standardisation bodies, or even more informal standards. But crucially, governments agree to this governance, submitting to certain constraints in return for a better response to a need they are unable to meet on their own.

However, there is an inherent correlation between the complexity of interactions among governments - particularly in terms of economic integration – and the authority that needs to be delegated to supranational governance to ensure that outcomes remain fair.

When international cooperation efforts remain fairly straightforward, the authority granted to global governance is often limited. After the Second World War, for example, the Bretton Woods agreements were signed globally, while the common market was set up in Europe.

However, these governance arrangements focused mainly on promoting a stable environment for trade in intermediate goods. This reflected the limited scope of economic integration at that time, characterised by capital controls, fixed exchange rates, and high tariff and non-tariff barriers for services.

As interactions become more complex, however, there is a need for that governance to deepen. Look at the EU, for example. To promote economic growth, the countries decided in the late 1980s to transform the common market into a single market, covering capital and services. But a single market is inherently riskier.

It exposes people to greater risks from harmful products or to unfair sales practices in jurisdictions that are less well-regulated, as well as to anti-competitive behaviours such as subsidies. And the risks of financial spillovers increase, too.

So the powers of competition authorities and financial regulators had to be strengthened. That's why in Europe we delegated authority for competition and external trade to the European Commission. Much later, and at the cost of suffering the consequences of not having it in place at the time of the financial crisis, we did the same thing for banking supervision. And we of course also launched a common currency to prevent the Single Market from being undermined by competitive devaluations.

Research has shown that the capacity of supranational governance to issue guidelines and interpret standards increased by around 50% over this period[1]. This triggered a self-fulfilling process, whereby greater economic integration led to deeper governance, which then led to greater economic integration – that is what we know as globalisation.

There have been multiple benefits: across a sample of 147 countries, a one-point increase in globalisation measures was associated with a 0.3% increase in the growth rate in those countries over five years, with lower- and middle-income countries benefiting even more[2].

Hundreds of millions of people in emerging markets have been lifted out of poverty. Europe has benefited from globalisation too. Between 2000 and 2017, jobs related to exports to the rest of the world increased by two-thirds to 36 million[3].

Tensions inherent to global governance

But at the time we were not fully aware of the tension inherent in this process. Michael Zürn, an expert on international relations understood it clearly, however, and he developed a conceptual framework in which the growing powers of global governance lead to a lack of legitimacy, followed by a descent into conflict[4].

All forms of governance need legitimacy. In other words, people need to feel that authority is being exercised wisely. But supranational governance cannot draw its legitimacy from the same sources as national authorities, such as elections or referendums. In practice, it must obtain its legitimacy through expertise and impartiality.

Expertise can confer legitimacy provided that supranational bodies are seen not only as competent, but also as uniquely able to build a framework for sustainable prosperity by virtue of having a supranational perspective that national governments lack.

Similarly, impartiality can confer legitimacy if supranational governance is seen as a way of ensuring that all parties respect the rules of the game and of adjudicating decisions fairly among all members, strong or weak – something that national governments cannot do either.

In this way, there may be long periods in which supranational governance is perceived as legitimate. After the Second World War, for example, public support for supranational governance was very strong, fuelled by the painful memories of the costs of non-cooperation.

A survey conducted in 1952 asked: *"In general, are you for or against efforts to unify Western Europe?"* The results revealed that 82% of West Germans embraced the idea, as did 78% of British respondents and 63% in France[5].

But compared with sources of democratic legitimacy, expertise and impartiality are rather fragile, as they can be weakened by major crises or shifts in power dynamics. By enabling deeper economic integration, supranational governance increases the likelihood of that weakness – as we have seen over the past 15 years.

First, we witnessed the great financial crisis, followed by the euro crisis, both of which led to volatile crossborder capital flows. These episodes undermined faith in the idea that free markets regulated by supranational bodies were essential for sustained prosperity. This mistrust was famously summed up in the declaration by UK government minister Michael Gove that people *"have had enough of experts."*

These crises caused the credit bubble that had fuelled growth in the early 2000s to burst, revealing the growing inequalities created by globalisation. Over the past 50 years the income gap between OECD countries has risen to unprecedented levels[6], exposing the limitations of resorting to debt to mask such disparities. This realisation was a further blow to the notion of legitimacy founded on expertise.

Global governance has also been a victim of its own success: the impressive increase in wealth and the growth in the international influence of emerging countries. These new powers, especially China, have legitimately demanded fair representation, becoming less inclined to submit to the governance of others.

This has led to the impartial nature of global governance being questioned on two fronts. On the one hand, emerging powers considered that global bodies overly favoured the interests of their main stakeholders and were too resistant to change.

On the other hand, the former powers considered that the newer powers had no intention of playing fair. They therefore considered the rules, institutions and standards of global governance to be inadequate.

And as the global economy expanded, climate change was accelerating behind the scenes, with various international agreements barely making a dent in global carbon emissions. This suggests that even in areas of clear common interest, supranational governance was falling short.

So supranational governance is under threat from all sides, as various groups seek to bend it to their own interests. This is a sign of our times: fragmentation of the global order, gridlock in many international fora, the emergence of populist parties and groups of states coming together to forge new agreements better suited to their interests.

Is there a way of countering this trend?
It is vital that we strive to do so, because global governance is a necessary condition for maintaining international cooperation. We will not be able to preserve its many benefits if we let all that we have achieved go into retreat.

But global governance has to address its legitimacy deficit. And since it cannot draw on democratic legitimacy, the only way of restoring it is to tackle the challenges – such as economic insecurity, climate insecurity and geopolitical tensions – to which it has partly contributed, and that have undermined its claims to expertise and impartiality.

To do this, let me describe three possible ways of responding: function, form and leadership.

Three conditions for strengthening global governance

Function

Let's start with the function of global governance. In order to thrive, global governance must offer solutions in the areas in which people feel most at risk today. If it doesn't, the logical response would be to erect new barriers and reverse international cooperation.

In Europe, we have already seen this process unfold. For example, when the global financial crisis and the euro crisis exposed vulnerabilities in the banking sector, some wanted to dial back on integration. But we instead collectively responded by making the EU responsible for banking supervision and by addressing the issues that had come to light.

Similarly, when Europe found itself facing another external shock in the form of a pandemic, we reacted by putting in place the European recovery plan and recovery fund (NextGenerationEU). These helped to avert the threat that the virus would have a deeply unequal impact on European economies – especially those most dependent on tourism – which could have caused a new rift in our Union.

In both cases, rather than reversing economic and financial integration, we strengthened our governance to make integration more secure. We made sure that the competences of the EU matched what Europeans expect of it. In doing so, we clearly bolstered the legitimacy of the EU. Today, support for the euro and for the EU stands at 79% and 65% respectively[7].

Can this be done with today's challenges? The good news is that many of the issues citizens feel most insecure about are precisely the ones where they want stronger European governance.

Around two-thirds of Europeans are convinced that the European Union represents a bastion of stability in a world in crisis. Almost nine in ten Europeans agree that tackling climate change can help improve their health and well-being, and the same proportion expresses support for the environmental objectives of the European Green Deal[8].

Citizens realise that, although some of these problems result partly from a more globalised world, the answer does not lie in turning in on ourselves, but in taking action at a level that best allows us to deal with the issues effectively. And this means deepening integration.

In the future, it will be crucial to harness this spirit of collaboration to confront new challenges in areas of common interest such as security, defence, climate or mass migration.

Form

After function comes form. The form should mould itself to the function, creating the conditions for supranational governance to deliver on the issues prioritised by citizens. This means great care should be taken when choosing an appropriate governance method.

We can build multilateral governance using either decentralised rules or centralised institutions. Although the first approach might appear to be the more attractive option owing to easy acceptance and because it keeps power at national level, it actually makes it more difficult to achieve governance objectives.

This is because rules are subject to a trade-off between credibility and flexibility. They are either rigid in order to be credible or vary according to circumstances in order to be flexible. But it is almost impossible to create a rule that successfully reconciles the two. All too often, attempts to find middle ground end up achieving neither.

Take the exchange rate mechanism as an example. It was created in the 1970s to stabilise exchange rates between European countries, initially operating according to strict rules that allowed a maximum fluctuation of 2.25% from the central rates. This system was severely tested in the 1980s, however, by increased capital flows and speculation. And it had to be made more flexible as a result.

But the system had to be relaxed to such an extent that it lost all credibility as a reference point for exchange rates, with fluctuation margins reaching 15% in 1993. This failure clearly showed the benefits of taking an institutional approach to European monetary integration, which then led to the adoption of the euro.

These benefits stemmed from the fact that institutions are not faced with that trade-off. When they have a clearly defined mandate and deliver on it, they become more credible. And when they have operational independence, they can be flexible and adapt to changing circumstances as they arise.

Let me illustrate this with the example of the ECB. Since it was created, the ECB has faced unforeseen challenges as it has carried out its mandate. But the Treaty combines our price stability mandate with discretion over the tools we can use to fulfil that mandate.

This enabled us to use unconventional policy tools during the financial crisis, the recession and the pandemic to ensure that inflation remained in line with our target. Managing these complex situations would have been difficult if we had strictly adhered to fixed rules or had been limited to using conventional tools.

However, I am not naive as to the difficulties in moving from a rules-based to an institutional approach. I recognise that creating or changing institutions requires considerable political capital. This poses a challenge in specific political circumstances or situations where progress has stalled.

But that cannot be used to justify inaction, because political courage can sometimes prevail over resignation and because there are other forms of governance, such as informal institutions, that can help us address the global challenges we are facing.

Llet me take climate finance as an example. Numerous initiatives have emerged in this area under the aegis of the G20, providing a powerful channel for collective action in the wake of the crisis. Initiatives such as the Task Force on Climate-related Financial Disclosures have been set up, creating a framework encouraging companies to disclose information on the climate change-related financial risks in their economic and financial activities.

Similarly, the Glasgow Financial Alliance for Net Zero, a global coalition of leading financial institutions, has committed to accelerating the decarbonisation of the economy. And the Network for Greening the Financial System, a coalition of central banks keen to align their actions with the pressing need to tackle climate change, circulates scenarios and analyses among all its members.

Although these are voluntary actions, their widespread adoption by thousands of organisations can create powerful incentives to address the challenges we face, bringing benefits such as speed, efficiency and adaptability.

It is crucial that such initiatives are led by players with a genuine concern for the common good, because if they are not, other entities motivated by profit gains or market share could quickly fill the void, sometimes with less clear motives.

Leadership

The third and final condition that I would like to mention is leadership. Even if we give governance the right function and implement it in the right form, this does not mean that the outcome will be the right one. Institutions need courageous and accountable leadership in order to take the right decisions.

Faced with complex and uncertain global challenges, the *"courage to act"*[9], as Ben Bernanke said, is essential. Leaders must show an unwavering determination to use all of the tools available to them, in line with their mandate, to achieve their goals.

This is a truth I have experienced throughout my entire career: as Finance Minister in France, as IMF Managing Director, and now at the helm of the ECB. Crises are insidious and unpredictable in nature, and every crisis is different. There is no textbook setting out the perfect approach to take. But time is always in short supply and risks inevitably have to be taken, while the outcome is inherently uncertain.

More recently, we faced an unprecedented crisis with the pandemic. These were extraordinary times, and the creation of the €1.85 trillion pandemic emergency purchase programme (PEPP) to shield the economy from the impact of the pandemic was an extraordinary response. But it was necessary to combat the deflation we could have seen if we had not acted.

Effective leaders must therefore give their institutions the resources they need to act, all the while being accountable for their actions. When taking decisions that break with precedent, leaders must always keep in mind that they will have to account for those decisions. This keeps them within the limits of their mandate and focused on the public interest, and it prevents them from being tempted to go too far.

We saw this again in the case of the PEPP, as we meticulously prepared for the implementation of the programme with this in mind. We strictly complied with the requirements and safeguards considered necessary by the Court of Justice of the European Union in its judgments on our past actions, thereby ensuring that our measures were fully compatible with the Treaty.

So, in striving for effective leadership, courage and accountability must go hand in hand.

Conclusion

International cooperation is a powerful force that has shaped our recent history. It has brought indisputable benefits, propelling the world towards unprecedented development, creating wealth, providing access to scientific and technical progress in an increasing number of countries and building multilateral institutions that have defined the post-war era.

But it would be a mistake to disregard the challenges that have arisen on this path. Inequalities, unresolved global crises and the loss of institutions' legitimacy have sown doubt in the minds of our fellow citizens.

This mistrust has materialised as protectionism, withdrawal, retreat and populist tendencies, eroding the foundations of supranational governance, leading to political movements seeking to regain control, and to our world fragmenting into competing blocs.

Today, the supranational governance that underpins international cooperation is at a critical turning point: either it is strengthened or it goes into decline. The choice is between a world that seeks to reconcile differences and create prosperity for all, or retreat into a world without cooperation, perhaps even one of confrontation.

I do, however, see a way forward. If supranational governance can be aligned with and focused on citizens' priorities, take the most effective form to achieve those priorities, and be led with courage while being held accountable, then it will be able to rise to the challenge it is facing.

But we should also remember that all supranational governance structures have emerged from an era shaped by the devastating consequences of a failure to cooperate and open conflicts between countries, while deep-rooted fears were taking hold.

In these decisive moments, I am inspired by the legacy of an eminent member of the Académie française and a pioneer in the fight for women's rights, Simone Veil. She chose to have her ceremonial sword engraved with the number 78651, representing her deportation to Auschwitz, alongside Europe's motto: *"United in diversity."*

Let us not forget our past. Let's work together for a fairer, more sustainable and more prosperous world. The choice before us must be guided by a shared vision of unity, cooperation and mutual respect, which our future generations deserve. ■

Christine Lagarde is President of the European Central Bank

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Reboot of the UK-EU relationship in financial services regulation

Brexit poses unique challenges for policymakers in the EU. Thorsten Beck and Christy Ann Petit assess the EU's equivalence policy and present options for deepening regulatory cooperation

Brexit continues to pose unique challenges for financial sector policymakers in the EU, as the most important financial centre in Europe is now outside its regulatory framework (Macrae *et al* 2016, Jackson, 2016). The UK, on the other hand, considers its financial sector a potential growth engine at the global level and has initiated regulatory reforms to strengthen its status as a global financial centre (Edinburgh Reforms 2022, TIGRR Report 2021, Portes 2023).

Regulatory divergence between the UK and EU is all but assured, even if the UK only decides not to follow EU regulatory changes or adopt the new rules in EU financial and banking regulations (passive divergence). This is not to mention active divergence, whereby the UK would change inherited EU rules following the Financial Services and Markets Act (FSMA) 2023 and the (new) missions granted to UK regulators in lieu of legislators.

A new chapter in financial sector cooperation?

On 27 June 2023, the UK and the EU signed a Memorandum of Understanding (MoU) establishing a framework for financial services regulatory cooperation. The Windsor Framework agreement paved a new way forward for the Protocol on Ireland/Northern Ireland in February 2023, which in turn unlocked cooperation between the UK and the EU in different areas such as financial services and the UK's access to Union programmes.

Following the signing of the MoU, a joint EU-UK financial regulatory forum will be established and will take place for the first time this autumn to discuss regulatory changes and issues of common interest – including market developments, financial stability issues, and fostering enhanced EU-UK cooperation ahead of global forums such as the Federation of Small Businesses (FSB) and the Basel Committee on Banking Supervision (BCBS). The MoU implements the joint declaration attached to the Trade and Cooperation Agreement (TCA) from 2020.

In a report for the European Parliament's ECON Committee, we summarise and discuss recent trends in financial sector legislation and regulation in the UK, divergence between the EU and the UK, and the threats posed by such divergence for financial stability in the EU (Petit and Beck 2023).

Divergence between financial sector regulation in the UK and the EU will happen through reforms on both sides. Functioning and effective regulatory cooperation, however, can limit negative repercussions from such divergence

Critically, we assess the equivalence policy and strategy of the EU towards the UK. We also discuss the options to deepen regulatory cooperation while ensuring financial stability, market integrity, and competitiveness.

The developments since the completion of our report, including the signing of the MoU and the establishment of the joint EU-UK regulatory forum, have – in our opinion – not changed our general assessment, namely, that even if cooperation will be favoured and sustained at a working level among authorities, it will remain limited and dependent on the political environment, and regulatory divergence is all but guaranteed.

The new UK regulatory approach: growth and international competitiveness

The UK's renewed approach to regulation will lead to the transfer of most rules from the statutory level to the regulators' rulebook. FSMA, which received royal assent at the end of June 2023, will give greater responsibility to regulators. The bill intends to amend, repeal, or replace retained EU law in the financial services and insurance sector.

In addition, secondary objectives are added for regulators to *"facilitate, subject to aligning with relevant international standards, the international competitiveness of the UK economy (including in particular the financial services sector) and its growth in the medium to long term"* (Hunt 2022).

Following FSMA, secondary objectives include the competition objective, and the competitiveness and growth objective for the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). This change differentiates the UK regulators' mandate from its EU counterparts, whose mandate is safeguarding financial stability, market integrity, and investor protection, while maintaining a level playing field in the EU Single Market.

Divergence, but how much?

Divergence of UK regulation from EU regulation is a given outcome of Brexit. Active divergence would occur when the UK *"deliberately legislates to move away from retained EU Law"* (Reland *et al* 2022). Passive divergence would reflect the UK not keeping up with EU legislative changes, including newly adopted legislation.

The UK has already undertaken initiatives that could result in regulatory divergence from the EU in several areas:

The implementation of the final Basel III reforms will differ between the UK and the EU both in timeline and substance. The EU reached a provisional inter-institutional agreement in June 2023, deviating from the Basel III agreements on several grounds, inter alia through adaptations based on proportionality concerns for small entities, and a specific implementation of the output floor that risks lowering regulatory capital. The current Spanish presidency of the Council intends to finalise the CRD6 and CRR3 to maintain an entry into force in January 2025. As regards the UK, the Basel III implementation is postponed until July 2025 (instead of January), with two policy statements setting potential deviations from Basel III (expected at the end of 2023 and in 2024).

- Both the UK and the EU are reviewing the Solvency II regulatory framework for insurers, with the objective of fuelling more equity investment by insurers through different regulatory adjustments. Following the FSMA, the UK's PRA unveiled its proposed matching adjustment rules in September 2023, which forms part of the implementation of the Solvency II review and would allow insurers to make broader and quicker investments in MA portfolios, ultimately giving a more significant role to the life insurance sector in the UK economy.

- The UK aims to reform different aspects of its wholesale markets regime and capital market sector, though these reforms are considered low impact.

- The UK aims to become a global centre for fintech and crypto assets through several regulatory and supervisory initiatives, including a financial market infrastructure sandbox that is already up and running, a FinTech hub at the Bank of England, and encouraging the development and use of stablecoins. The EU has a different approach, which will lead most likely to active divergence, with markets in crypto assets (MiCA) regulated as of 2024 and further regulation tightening.

- *Greening Finance: A Roadmap to Sustainable Investing*, published in 2021, stipulates that the UK Green Taxonomy will adopt the EU's six environmental objectives. In March 2023, the UK government published its Green Finance Strategy and a consultation on the regime for economic, social, and governance (ESG) ratings providers. The UK government has yet to release its consultation on the UK Green Taxonomy, expected in Autumn 2023, but some divergence is to be expected from the EU's version.

While divergence between the EU and the UK may be considered minimal before the adoption of FSMA, we can expect substantial divergence across different segments of the financial sector during the next five to ten years (for further details, check the scenarios-based analysis in Petit and Beck 2023).

From TCA to Windsor

While the TCA is extensive, it includes a very thin chapter on the financial sector, with only eight out of 783 articles directly covering this sector. Deeper cooperation in the financial sector was held back until earlier this year by the stand-off over the Northern Ireland/Ireland Protocol.

The resolution of this conflict through the Windsor Framework allows for closer cooperation and building mutual trust, with the MoU on financial services regulatory cooperation finally signed by the EU and the UK on 27 June 2023.

A thin basis for cooperation

Will this MoU and the Joint Regulatory Forum be a major change in financial sector cooperation between the EU and the UK, and limit regulatory divergence? We would strongly discourage such hope and disagree with such a promise.

Under the MoU arrangements, there is no certainty of continuity and stability of the cooperation channels. A careful look at the MoU shows an emphasis on 'exchanges of views and analysis' and 'dialogue'. Furthermore, the MoU provides that 'regulatory cooperation should not restrict the ability of either [the EU or the UK] to implement regulatory, supervisory or other legal measures that it considers appropriate', thereby making cooperation dependent on the broader (political and economic) circumstances.

There is a reason why the financial sector was excluded in the first place from the TCA (any reference to trade in services explicitly exclude the financial sector). While allowing entry of foreign financial institutions and market participants into a country's banking system, countries insist on national regulatory autonomy and the independence of supervisory power for a reason, and are loath to share it.

And while it is true that recent decades have seen an increase in global and cross-border cooperation (especially after 2008), the sovereignty principle rules strongly in the financial sector policy framework (Beck and Wagner 2013 2016). In a few instances, countries formally integrate regulatory and supervisory power in a shared system, such as in the case of the banking union (Petit 2022).

It is therefore not surprising that the EU is reluctant to move towards systematic equivalence in the financial sector and relies on only a thin cooperation framework embodied by the recently signed MoU, choosing instead a sector-specific equivalence agreement with the UK.

Equivalence granted by the EU in the financial sector exists currently with the UK in only one area, namely, central clearing counterparties (CCPs). Even here, this equivalence decision is temporary (extended until mid-2025), with a clear political will in the EU to attract more euro clearing away from London into the Single Market and preferably into the euro area.

The European Commission legislative proposal for clearing at the end of 2022 showed a further tightening of an equivalence regime in the financial sector. In the medium term, the Joint Forum may undertake dialogue on equivalence decisions, but this will remain contentious for some time.

Looking forward

Divergence between financial sector regulation in the UK and the EU will happen through reforms on both sides. Functioning and effective regulatory cooperation, however, can limit negative repercussions from such divergence. The resolution of the conflict around the Northern Ireland Protocol with the Windsor Framework has paved the way for closer cooperation between regulatory authorities in the UK and the EU, following the adoption of the MoU on financial services regulatory cooperation.

Some supporting measures for cooperation, despite their non-binding nature, may follow the meeting of the Joint EU-UK Regulatory Forum in autumn 2023. However, such cooperation will face limits, not to mention the fluctuating political environment across the channel. ■

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Making sense of the Commission's fiscal governance reform plan

The European Commission has proposed fiscal governance reform. Lucio Pench offers proposals to enhance institutional self-commitment to implementation, with reputational consequences for non-implementation

Executive summary

The European Commission's April 2023 proposals for the reform of European Union fiscal governance revolve around the principles of fiscal sustainability and national ownership.

While the criterion of sustainability is at the centre of the proposals, its practical implications for the assessment of compliance of national medium-term fiscal-structural plans with the new fiscal rules have been blurred by a proliferation of additional criteria or safeguards. These include a requirement for a country's debt level at the end of the medium-term horizon to be lower than at the beginning.

This Policy Brief argues that the fiscal sustainability criterion, which the legislative proposals formulate in broad qualitative terms (public debt being on *"a plausibly downward path … or … staying at prudent levels"*) can be operationalised to ensure the objective of de-risking of public debt, ie. the eventual removal of situations in which debt poses a high sustainability risk.

Specifically, for a plan to satisfy the sustainability criterion, it should ensure that the country in question graduates out of the high-risk category or does not fall into it.

It is further argued that the additional criteria or safeguards have limited value added and hamper the overall readability of the proposed reform.

This proliferation of criteria should not be taken as compromising the fundamentals of the reform, however: a careful textual and contextual reading of the relevant legal provisions allows for an 'overall assessment' by the

Commission and the Council of the medium-term plans submitted by EU countries, in which compliance with the additional safeguards could be given a subordinated role relative to the sustainability criterion.

Ideally, a clarification of the methodology for assessing compliance with the debt-sustainability criterion would allow the additional safeguards to be dispensed with.

Political concerns lay behind the demand for additional safeguards, but these should be addressed through institutional rather than rule-based solutions. Implementation and enforcement will be critical.

This Policy Brief offers proposals to enhance institutional self-commitment to implementation, with reputational consequences for non-implementation.

The proposed reform lacks an explicit methodology by which EU countries' medium-term fiscal- structural plans will be assessed

1 Introduction

In April 2023, the European Commission published long-awaited proposals on reform of European Union fiscal governance – the system for monitoring the budgetary frameworks in EU member countries.

The proposed reform is informed by two high-level principles: fiscal sustainability and national ownership. Unsustainable fiscal policies in EU countries pose risks for the smooth functioning and ultimately the integrity of the euro.

This provides the rationale for an EU fiscal framework on the top of national frameworks put in place by countries according to their national preferences. Meanwhile, enhancing national ownership of the EU fiscal framework – meaning active buy-in and participation of EU countries rather than just a rule-taking role – is necessary for the framework to be implemented effectively.

Fiscal sovereignty in Europe's economic and monetary union, notwithstanding a prohibition on excessive government deficits, remains firmly in the hands of national governments.

Under the Commission's proposals, the two high-level principles would be delivered on by EU countries issuing medium-term fiscal-structural plans. These would set out fiscal-adjustment paths that reflect national preferences, subject to constraints intended to prevent risks to sustainability. Once endorsed by EU countries meeting in the Council of the EU, the adjustment paths in the plans would become the benchmark against which national policies are measured.

Compliance would then be assessed through a single indicator: primary expenditure net of discretionary revenue measures and cyclical unemployment expenditure ('net expenditure').

As the new approach can only occur within the boundaries set by the EU Treaty, the natural means of enforcement will be the existing Excessive Deficit Procedure (EDP)[1], under which countries with excessive debts can be required to take corrective action.

This includes retaining the 3 percent of GDP government deficit threshold, beyond which the EDP is triggered automatically for countries with debt in excess of 60 percent of GDP.

Prior to the publication of the proposals, the Commission set out the main elements and their underlying economic and political philosophy in an outline plan published in November 2022 (European Commission, 2022). EU finance ministers responded to this outline in a March 2023 communique (Council of the EU, 2023).

When the April 2023 proposals were published, they included a regulation amending the EDP and a regulation on the medium-term structural fiscal plans (European Commission 2023b, 2023c), thus encompassing the two 'arms' of the Stability and Growth Pact (SGP), which sets out the EU's fiscal governance rules.

In a number of respects, the April 2023 proposals differed from the reform that was communicated in November 2022. This reflected the need for legislation to be formulated differently to a policy communication, but some changes also arguably represent a substantive departure from the reform's high-level principles.

In particular, the proposed reform lacks an explicit methodology by which EU countries' medium-term plans will be assessed and adds new fiscal criteria EU countries must meet. These changes threaten to undermine the balance between fiscal sustainability and national ownership, compromising the latter without improving on the former.

This Policy Brief analyses the legislative proposals in light of the objective of guarding against risks stemming from irresponsible behaviour of fiscally sovereign countries, while giving those countries as much autonomy as possible to act according to their preferences.

It focuses in particular on the process prior to submission by countries of their medium-term plans and the European Commission's involvement in this, on the precise meaning of the sustainability criterion, and on potential tension between the main objective of the reform and new fiscal criteria included in the proposals.

2 Who needs early fiscal guidance?

The Commission's reform plan envisages countries with certain risk characteristics receiving guidance from the Commission before they draft their medium-term plans. Early guidance would take the form of a so-called 'technical trajectory', or a stylised simulation of a trajectory for the primary balance[2] that would ensure convergence of debt to prudent levels by the end of the adjustment period.

This has been criticised as an attempt by the Commission to pre-empt the choices of EU countries on how they intend to bring debt down to prudent levels, thus clashing with the principle of national ownership (Blanchard *et al* 2022). However, there are legal and technical reasons why the envisaged guidance is meant to be just that: only guidance.

Legally, the only reference for assessing a country's compliance with the EU fiscal rules is the adjustment path that is eventually included in the Council decision endorsing that country's medium-term plan. This is irrespective of what the early guidance issued by the Commission, or even the requirements on adjustment set in the legislation, might say[3].

Technically, the adjustment path eventually endorsed by the Council can be expected to differ from the Commission's technical trajectory, even if both are intended to satisfy the same sustainability criterion.

This is because the starting point for the Commission's projections are standard assumptions for the estimate of potential output, notably excluding the effects of reforms and investments (other than those already included in the Commission's short-term forecasts).

The Commission's projections also incorporate one-size-fits-all assumptions on the closure of the output gap, the response of (non-discretionary) revenue to the cycle and the size of multipliers. Inflation and interest rates are also projected based on (market-derived) assumptions.

But when these standard assumptions are replaced by assumptions reflecting country-specific situations, there may be valid reasons[4] why national plans differ from the projections.

To allow for this, the fiscal governance reform proposals envisage a technical dialogue phase, involving national authorities and the Commission services, before the official submission to the Commission of national medium-term plans.

Critics of the proposal who accuse the Commission of trying to pre-empt the choices of EU countries might have overlooked these legal and technical issues around the Commission guidance because they can only be inferred from a careful reading the legislative proposals and because they were only implicit in the November 2022 outline plan.

What did change, however, between the outline plan and final proposals, was the approach to selecting the countries that would be given 'technical trajectories'.

Selecting a subset of countries for early guidance based on risk characteristics makes sense, as higher risk justifies a greater degree of intrusiveness from the EU level. In its 2022 outline plan, the Commission said early guidance ('reference multiannual adjustment path') was intended for countries characterised by high or medium sustainability risk, according to the Commission's risk assessment methodology[5].

But the legislative proposals replaced this categorisation with one based on the Treaty reference values: the Commission would issue early guidance in the form of 'technical trajectories' to countries with debt in excess of 60 percent of GDP or a deficit in excess of 3 percent of GDP.

Singling out countries that are in apparent breach of the deficit and debt thresholds in the Treaty has the apparent advantage of simplicity. However, it creates potential confusion about the meaning of the risk signal, and, relatedly, of fiscal sustainability, which continues to be the central criterion for assessing fiscal-structural plans.

The reason for the potential confusion is that countries might have a deficit in excess of 3 percent of GDP or even debt above 60 percent of GDP while their fiscal trajectories do not pose risks to sustainability. Probably less frequently, countries might also have deficits and debts below the thresholds, but fiscal trajectories that do raise sustainability concerns.

The reason for this dissonance is that fiscal sustainability is essentially a directional concept, requiring the evaluation of the underlying trajectory of debt, which cannot be captured adequately by a snapshot figure for debt (and even less by that for a deficit).

In practice, how problematic is this change between the outline plan and the final proposals in the approach to selecting countries for early guidance? A tentative answer can be given by comparing the current positions of EU countries according to the deficit/debt classification and the sustainability risk classification (Table 1).

Table 1. Countries that would be selected for early guidance according to sustainability risk classification and deficit/debt classification

	Debt > 60% of GDP AND/OR *deficit* > 3% GDP (2024)	**Debt < of GDP AND deficit < 3% of GDP (2024)**
High sustainability risk (2033 horizon)	***BE*, EL, *ES*, *FR*, *IT*, PT, *HU*, SK**	
Medium sustainability risk (2033 horizon)	**DE, CY, HR, *MT*, NL, *SI*, FI *PL*, RO**	**CZ, BG**
Low sustainability risk (2033 horizon)	**AT**	**DK, EE, IE, LV, LT, LU, SE**

Source: Bruegel based on European Commission (2023a) and European Commission (2023e). Note: Countries underlined have debt > 60% of GDP, countries in italics have deficits > 3% of GDP.

The answer looks reassuring: nearly all the countries in the high or medium sustainability risk categories would be captured by the debt/deficit signal. Conversely, countries at low sustainability risk are generally shown to comply with the debt/deficit criterion.

Nevertheless, the comparison highlights two cases of misleading signals regarding the need for early fiscal guidance. Czechia and Bulgaria would not be issued technical trajectories, since currently their debts are below 60 percent of GDP and their deficits fall below 3 percent of GDP.

However, their fiscal trajectories are a cause for concern in the medium term, mainly owing to increasing pensions-related expenditure with no adequate measures being taken to contain it.

These cases could be characterised as 'false negatives'[6]. Austria, by contrast, would be a 'false positive': according to the sustainability risk methodology, its debt trajectory gives no reason for concern. However, Austria would be issued a technical trajectory because its debt ratio is currently in excess of 60 percent of GDP.

If 2022 observed data is applied instead forecasts for 2024, an even clearer false positive emerges. Estonia, the country with the lowest debt ratio in the EU, would be singled out for early guidance, owing to a deficit still in excess of 3 percent of GDP.

This would clearly make little economic sense. More generally, for a country with a debt ratio that is projected to stay below 60 percent, any fiscal trajectory that keeps the debt ratio below 60 percent (and the deficit ratio below 3 percent) should in principle be satisfactory.

Faced with such false positive cases, the Commission might wish to refrain from issuing early guidance, for example by indicating that any trajectory not in breach of the two numerical references would do. This would however contradict the ostensible prescription of the legislation.

To conclude, the change between the November 2022 outline plan and the April 2023 proposals in the approach to selecting the countries that should receive early guidance from the Commission has resulted in a degradation of the signal that guidance is supposed to give about the state and prospects of the public finance of those countries[7].

However, as long as fiscal sustainability remains the central criterion for the Commission to design the trajectories and, more importantly, for it to assess the actual fiscal plans submitted by EU countries, the loss of analytical rigour at the early stage of the process might be considered a relatively minor concession to a political demand for simple numerical benchmarks. It is important therefore to evaluate the sustainability criterion and its operational meaning.

3 Making sense of the sustainability criterion

At the core of the proposed new fiscal framework is a sustainability criterion, which is meant to serve two purposes. First, it is a requirement for the technical trajectory to be issued by the Commission in advance of the submission by EU countries of their medium-term plans. Second, it serves as a reference for the assessment by the Commission of the plans, with a view to eventual endorsement by the Council.

Reflecting these two different though related functions, the sustainability criterion is included in two separate chapters of the legislative proposal[8], with the same formulation (emphasis added):

"… whether the national medium-term fiscal-structural plan ensures that public debt is put or kept on a plausibly downward path by the end of the adjustment period at the latest, or stays at prudent levels …

"… whether the government deficit is maintained below the 3% of GDP reference value in the absence of further budgetary measures over a period of 10 years"[9].

As far as the technical trajectories are concerned, an annex to the regulation[10] gives two conditions for *"the methodology for assessment of plausibility"*:

"[the] public debt ratio should be declining, or stay at prudent levels, under the deterministic scenarios of the Commission's medium-term public debt projection framework described in the Debt Sustainability Monitor 2022;

"… the risk of the public debt ratio not decreasing in the 5 years following the adjustment period of the national medium-term plan is sufficiently low. The risk is assessed with the help of the Commission's stochastic analysis."

The provision on maintaining the deficit below the 3 percent of GDP threshold does not demand particular explanation. The meanings of 'downward path' or 'prudent levels', however, are left unspecified.

It seems reasonable to interpret the sustainability criterion on the basis of the Commission's medium-term risk-assessment methodology (European Commission, 2023a). This is based on a consideration of both the projected level of debt and its trajectory (augmented by the deterministic and stochastic stress tests referred to under the 'plausibility' qualification). This methodology allows operational meaning to be given to the notion of *"downward path … or … prudent levels."*

However, the application of this risk-assessment methodology to the assessment of the medium-term plans, rather than use for risk classification of countries, would require adaptation, which would need to be discussed and agreed.

The need to adapt arises because the original risk classification methodology is applied to a 10-year extension of the Commission short-term (two years) forecast with unchanged policies, whereas for assessing countries' plans, it should be applied to a 10-year unchanged-policy extension of the plans, which themselves would contain the policy adjustment needed to reduce the sustainability risk.

The Commission might want to assess the plans simply by comparison with the technical trajectories, using an algorithm that simplifies the risk-assessment methodology. However, as explained in section 2, there are valid reasons why countries' plans might depart from the technical trajectories.

In the light of these lacunae in the proposed legislation, we have attempted to derive the sustainability criterion from the Commission risk assessment methodology (see the Annex for details). Specifically, a country's compliance with the debt-sustainability criterion is taken to mean it would avoid being classified as high-risk according to the Commission medium-term risk assessment methodology or, to put it concisely, de-risking of public debt.

Being based on a well-defined methodology, this definition would give a conceptually more robust answer to the questions that are bound to arise about the meaning of *"downward path … or … prudent levels"* than a simple reference to the technical trajectories produced by the Commission, for which the underlying algorithm, moreover, is left unexplained by the proposed legislation.

Whether explicitly deduced from the Commission risk-assessment methodology or inferred inductively from the design of the technical trajectories, the sustainability criterion is meant to be sufficient to ensure the de-risking of public debt.

However, in the legislative proposal the sustainability criterion is supplemented by additional fiscal criteria or 'safeguards'. These are examined in section 4.

4 Are the additional safeguards meaningful and worthwhile?

Like the sustainability criterion, the formulation of the additional fiscal criteria (or safeguards) plays two roles in the legislative proposal: as a requirement for the technical trajectories, and as a reference for the assessment of the medium-term plans.

However, the requirements for the technical trajectories include a criterion related to the growth of net primary expenditure relative to the growth of the economy, which is not found among the references for the assessment of the medium-term plans.

Moreover, its formulation does not make sense for countries for which debt is already on a trajectory that complies with the sustainability criterion, and it is redundant for the others[11]. Conversely, the references for the assessment for the medium-term plans include a criterion (related to the adjustment toward the 3 percent of GDP deficit threshold), which is not found among the requirements for the technical trajectories.

Moreover, its formulation potentially interferes with the EDP[12]. The formulation of these two criteria contains redundancies and inconsistencies that are likely to prevent their effective application.

The examination below therefore focuses on the two additional criteria that are meant to apply to both the technical trajectories and the assessment of the medium-term plans: the no-backloading criterion and the initial debt level criterion.

The first additional criterion can be interpreted as a reinforcement of the sustainability criterion, in the sense of avoiding backloading of the adjustment needed to reach the fiscal position that would satisfy the sustainability criterion:

"… the fiscal adjustment effort over the period of the national medium-term fiscal structural plan is at least proportional to the total effort over the entire adjustment period"[13].

In other words, while the overall amount of adjustment is meant to reflect national preferences subject to the constraint of debt sustainability, the distribution of the adjustment is expected to be broadly proportionate across the adjustment period, ie. one that avoids shifting the burden of the adjustment to the future[14].

The second additional fiscal criterion, by contrast, has the potential to interfere with the sustainability criterion. It relates to the (initial) level of debt:

"… the public debt ratio at the end of the planning horizon is below the public debt ratio in the year before the start of the technical trajectory"[15].

An immediate problem emerges in the case of countries that, based on their current positions, would be classified as low risk. For these countries, satisfying the sustainability criterion would essentially require confirming that the projected debt level will not exceed 60 percent of GDP and that the deficit will stay below 3 percent of GDP.

Adding a criterion requiring the debt ratio at the end of the adjustment period to be lower than at the start of it would amount to a fundamental distortion of the sustainability criterion. The case of Estonia (section 2) is illustrative.

Reading the additional debt level criterion in isolation would imply that Estonia, a low-risk country with one of the lowest debt ratios in the EU, should not contemplate any increase in the debt ratio from its current levels, eg. to finance a defence programme.

This would be clearly at odds with the rationale of the reform of fiscal governance – to ensure debt sustainability while otherwise giving countries the flexibility to set their own policies – and would arguably be even in violation of the general principles of proportionality and subsidiarity.

Less clearcut is the case of countries that are expected to adjust to put their debts on a downward trajectory in order to satisfy the sustainability criterion. It is essentially an empirical question whether or not the adjustment required to satisfy the sustainability requirement will be enough to bring the debt to its pre-adjustment level by the end of the adjustment.

For high-risk countries, satisfying the debt-sustainability criterion implies putting the debt ratio on an unambiguous downward trajectory. However, adding the condition that the debt ratio should be already lower at the end of the adjustment period than at the beginning may in some cases require additional adjustment, which might stand in the way of the reforms and investments that the proposed fiscal framework is meant to encourage[16].

In sum, the additional criterion related to the debt level at the end of the adjustment period appears superfluous, especially as the concern that governments may fail to adjust early enough is already addressed by the no-backloading criterion.

Arguably, however, the proliferation of criteria, likely motivated by political concerns (discussed below), would not, as currently framed, compromise the fundamentals of the proposed reform.

The reason for this is that the legislative proposal makes a clear distinction between: 1) the early guidance to be provided by the Commission in the form of technical trajectories, and 2) the medium-term plans submitted by countries for assessment by the Commission and eventual endorsement by the Council.

Although related, the two exercises are separate. Crucially, the difference extends to the role played in the two exercises by the sustainability criterion and the additional criteria. Compliance with the criteria is a requirement for the production of the technical trajectories by the Commission, but only a reference for the endorsement of the medium-term plans by the Council, following their assessment by the Commission.

Concretely, this means that even if the current formulation of the additional criteria is maintained, for the purposes of assessing and endorsing the plans, the Commission and the Council should be able to make an overall assessment of the medium-term plans submitted by EU countries, in which compliance with the additional fiscal criteria, in particular, the initial debt level criterion, could be given a subordinated role relative to the sustainability criterion.

The central role of the sustainability criterion conforms to the systematic logic of the reform. It is also supported by a careful reading of the proposed legislative provisions. In particular, the sustainability criterion is explicitly included among the requirements that EU countries shall comply with in the national medium-term fiscal plans, which is not the case for the additional fiscal criteria[17].

The proposed approach would therefore be in line with the terms of the proposed legislation. Moreover, it is clearly supported by a contextual or systematic interpretation, ie. one that is *"based on the premise that the legislator is a rational actor"* (Leanerts and Gutiérrez-Fons, 2013).

5 Conclusion and policy implications

The Commission's EU fiscal governance reform proposals revolve around the principles of fiscal sustainability and national ownership. While the criterion of sustainability remains at the core of the proposals, its practical implications for the assessment of the compliance of national medium-term plans with the new fiscal rules have been blurred by additional criteria.

The blurring of the sustainability criterion corresponds with an apparent intent to downgrade the role of the Commission debt-sustainability methodology, which however remains the principal tool to give operational meaning to fiscal sustainability in a comprehensive and consistent manner.

However confusing, the departures from the sustainability criterion may be less important than they seem, as the letter and the spirit of the proposed legislation effectively allow the additional criteria to be set aside if an overall assessment of a country's fiscal plan concludes that it plausibly meets the requirement of ensuring that debt is set on a downward path, or stays at a prudent level.

To increase the conceptual consistency and the overall readability of the reform proposals, the following changes should be made:

- Restore the sustainability risk classification, which is regularly updated by the Commission in its Debt Sustainability Monitor, as the screening device for selecting the countries that should be issued with technical trajectories.

  Merging the high-risk and medium-risk categories could help assuage concerns about stigmatisation. If this move is considered politically not viable, it should at least be clarified that a deficit in excess of 3 percent of GDP should not be a sufficient reason for issuing a technical trajectory, if the country is classified as low risk.

- Clarify the methodology for assessing whether the debt sustainability criterion of *"plausibly downward path … or staying at prudent levels"* is satisfied, in particular how it relates to the analogous concepts in the Commission medium-term risk assessment methodology.

- Following a clarification of the methodology underlying the debt-sustainability criterion, do away with the additional criteria or safeguards, other than the no-backloading criterion. If an additional safeguard in the form of a numerical rule is considered necessary, this could be a requirement for the debt ratio to decline by 1 percent each year from the end of the adjustment period, for as long as it exceeds 60 percent of GDP.

There may however be an unstated reason behind the demand for additional safeguards: the concern that the Commission might not be sufficiently rigorous in assessing national medium-term plans, especially those of countries at high risk in terms of fiscal sustainability.

Guidance in the form of technical trajectories is meant to pre-empt gross slippages from the fiscal sustainability criterion before EU countries submit their plans for examination by the Commission and the Council.

However, as explained in section 2, this can only be indicative, for legal and technical reasons. The question is therefore how to allow 'reasonable' departures of the national plans from the technical trajectories while excluding abuse, ie. the endorsement of plans that ostensibly respect the sustainability criterion, but only as a consequence of biased macroeconomic and fiscal assumptions. This is essentially a question of judgement and therefore best addressed by institutional rather than rule-based solutions.

Three not necessarily mutually exclusive solutions suggest themselves:

- The Commission and the Council should assess plans and correct for bias, at least beyond a certain threshold. This is the natural solution consistent with the institutional balance in the EU Treaties, and explicitly envisaged by the Commission in its outline proposals of November 2022.

- National fiscal councils (independent fiscal institutions, IFIs) should be required to vet the national plans before their submission to the EU. The Commission in November 2022 envisaged the fiscal councils providing opinions on national plans as inputs into the Commission's and Council's assessments.

  The legislative proposals dropped this provision, probably reflecting the negative language on the IFIs in the March 2023 ECOFIN Council conclusions (Council of the EU, 2023)[18].

  However, one could expect a strengthening of the role of IFIs as a result of the proposal for amending the directive on budgetary frameworks, which the Commission presented at the same time (European Commission, 2023d). The proposed revision of the directive reflects the broader aim of enhancing national ownership of EU fiscal governance by favouring the development of complementary home-grown rules and institutions.

  In particular, the revision would allow IFIs to assess fiscal trajectories in the medium term, including in terms of de-risking of public debt, if there is a will to do so[19].

- An independent advisory body at EU level could provide an assessment of the plans, in particular for evidence of bias, ahead of the official assessments by the Commission and the Council. The Commission proposals do not elaborate on this solution.

However, the Commission's November 2022 outline proposals, and the text introducing the current legislative proposals[20], contain a reference to a possible review of the role of the European Fiscal Board (EFB), the Commission's in-house independent advisory body on fiscal policy surveillance.

The ECOFIN Council conclusions also suggested that *"a stronger role for the European Fiscal Board in the economic governance should be explored"* (Council of the EU, 2023). Upgrading the legal status of the EFB, currently based on a decision of the Commission in principle revocable at will, could be a significant step in this direction.

A final consideration relates to the exclusive focus of the additional safeguards that are being sought on the conditions that national plans should satisfy ex ante, as opposed to those for their implementation and enforcement.

However, as also acknowledged by the Commission in its review (European Commission, 2020), enforcement has been the weakest link of the entire EU fiscal framework, especially where it was most needed[21].

In the Commission's November 2022 outline plan, greater leeway for national governments in setting out adjustment was balanced explicitly by the recognition of the need for greater enforcement. In particular, the Commission envisaged that, in case of material deviations from the adjustment path in the national plan as endorsed by the Council, the opening of the EDP should be the default option, specifically, for high sustainability risk countries.

The legislative proposals for the reform of the EDP regulation essentially reflect the same position, in particular, by highlighting the risk to sustainability ('substantial debt challenge') as a discriminating relevant factor when deciding whether to open an EDP following a deviation from the adjustment path.

Experience however may suggest a certain scepticism about the effective willingness of the Commission and the Council to adhere to the prescription of starting an EDP for a country that has not breached the 3 percent of GDP deficit threshold.

The Treaty envisages this possibility for countries in breach of the 60 percent of GDP debt threshold, but the lack of specification of the conditions under which the breach of the debt threshold should lead to an EDP was long taken as a reason for ignoring the provision.

The attempt to operationalise the debt criterion of the EDP in the 2011 reform package known as the Six-Pack, through the so-called 1/20 debt reduction rule[22] was a failure, as ways were always found to avoid its application.

Following the protracted suspension of the EU fiscal rules since the outbreak of the COVID-19 crisis through recourse to the so-called General Escape Clause, some may even doubt the willingness of the Commission and the Council to place in EDP the countries still in breach of the 3 percent of GDP deficit threshold, in spite of the explicit commitment of the Commission to do so from 2024.

Enforcing fiscal rules on fiscal sovereigns is an inherently difficult, if not intractable, problem (Debrun and Jonung, 2019). An approach based on self-commitment and reputational consequences is more likely to work than one based on external impositions and sanctions.

The Commission in November 2022 was already clearly leaning in the direction of reputational sanctions, by acknowledging that macroeconomically visible pecuniary sanctions are counterproductive and symbolic penalties stand a better chance of being applied effectively.

Self-commitment and reputational consequences, however, should be enhanced at each stage of implementation and for all the parties involved. In this connection, while clearly not solving all problems, a useful initiative might be to revisit the European Council's 1997 resolution on the Stability and Growth Pact, in which, at the inception of the SGP, EU countries, the Council and the Commission committed to timely and rigorous implementation of the Pact (European Council, 1997).

The content of the resolution should be updated to reflect the reformed fiscal framework, eg. references should be updated to include the medium-term fiscal plans, and the conditions for triggering the EDP should include not only the breach of the 3 percent of GDP deficit threshold, but also a material deviation from the adjustment path in the plan, specifically, for countries with 'substantial debt challenges'.

Unambiguous commitments on the part of the Commission and the Council should help counter doubts about their willingness to open deficit-based EDPs, and to deploy the debt-based EDP to enforce the necessary correction of the deviations from the adjustment path in the medium-term plans.

In this connection, EU countries should vote in line with the proposals of the Commission to place a country in an EDP, including in cases of debt-based EDPs. A genuine commitment to enforce the new rules, grounded in fiscal sustainability and national ownership, seems a more promising reform avenue than insisting on the application of extra layers of rules that lack clear economic rationale and sincere political buy-in. ■

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Annex: Deriving the sustainability criterion from the Commission sustainability risk assessment methodology

The way the level of debt and its trajectory are jointly considered in the Commission risk assessment methodology combines two risk categorisations: one based on debt thresholds and the other based on the shape of the trajectory. Specifically:

- Based on debt thresholds, countries are classified as high, medium or low risk, depending on whether the debt ratio at the end of the projection period is above 90, between 90 and 60, or below 60.

- Based the shape of the trajectory, countries are classified as high, medium or low risk, depending on whether the trajectory during the projection period is failing to decline (or declining only at the end of the projection period), declining at least from mid-point of the projection, or continuously declining throughout the projection period.

Note that projected debt levels and their trajectories are evaluated based on unchanged policies, ie. excluding the effect of measures additional to those already in place on the primary balance, which is the driver of the debt trajectory, given the assumptions on growth and interest rates. Note also that the projections assuming unchanged policies are made over a horizon of ten years from the end of the adjustment period.

Jointly considering the risk categorisation for the level of debt level and its trajectory allows for a consistent interpretation of the *"downward path … or … prudent levels"* sustainability criterion. Specifically:

- A country at high risk based on the projected debt level will satisfy the sustainability criterion only if the projected debt trajectory can be characterised as low risk. In other words, since the projected debt level cannot be considered prudent, the projected debt trajectory should be unambiguously downward;

- A country at medium risk based on the projected debt level will satisfy the sustainability criterion provided that the projected debt trajectory cannot be characterised as high risk. In other words, the projected debt level can be considered prudent if the projected debt trajectory is not upwards;

- A country at low at low risk based on the projected debt level will satisfy the sustainability criterion regardless of the projected debt trajectory. In other words, as long as the project- ed debt level can be considered to be unambiguously prudent, there is no reason to be concerned with the trajectory.

Having thus reached a preliminary risk classification based on the level of debt and its trajectory under the baseline projection, its plausibility is tested through stress tests, both deterministic and stochastic. Note that stress tests can only 'notch up' (but not down) the preliminary risk classification.

In particular, a country classified initially as at medium risk would be reclassified as high risk, if either one of the alternative deterministic stress tests or the stochastic stress test gives a high-risk signal[23].

A 'notching up' of the risk classification due to the stress tests implies that the country concerned should plan a larger adjustment in order to pass the stress tests. Note also that the construction of the stochastic stress test implies that, in order to comply with it, countries classified as medium risk on the projected debt level are effectively bound to exhibit a continuously declining debt trajectory[24].

Table 2 summarises the process for reaching a conclusion on the compliance of the adjustment path with the sustainability criterion[25].

Table 2. Assessing compliance with the sustainability criterion

Projected baseline debt level (10 years after the end of adjustment period)	Projected baseline debt trajectory (over 10 years from the end of adjustment period)	Stress tests on baseline projection (deterministic and stochastic*)	Compliance with sustainabilty criterion
Debt level staying above 90% of GDP (high risk)	Continuously decreasing trajectory (low risk)	No (alternative) deterministic scenario yielding high-risk classification for stochastic stress test giving high probability of debt not stabilising*	Compliance
		Any other case	Non-compliance
	Any other trajectory (medium or high risk)	Any	Non-compliance
Debt level staying between 60% and 90% of GDP (medium risk)	Continuously decreasing trajectory (low risk)	Any	Compliance
	Debt peaking by mid-point of projection y (or earlier) (medium risk)	No (alternative) deterministic scenario yielding high-risk classification for stochastic stress test giving high probability of debt not stabilising*	Compliance
		Any other case	Non-compliance
	Any other trajectory (high risk)	Any	Non-compliance
Debt level staying below 60% of GDP (low risk)	Any trajectory	Any	Compliance

Note: (*) The stochastic stress test is differentiated based on the initial, not end-period, debt level.
Source: Bruegel based on European Commission (2023a).

Note that compliance with the debt-sustainability criterion is taken to mean avoidance of high-risk classification according to the Commission medium-term risk assessment methodology or, to put it concisely, de-risking of public debt.

While this interpretation is not confirmed explicitly by the April 2023 draft legislation, only by keeping in the background the Commission risk assessment methodology it is possible to make overall sense of the proposal for the reform of the EU fiscal framework and in particular of the *"downward path … or … prudent levels"* sustainability criterion.

Specifically, readings of the sustainability criterion that ignore the Commission risk assessment methodology tend to run into internal inconsistencies. For example, it would hardly make sense to require a downward projected debt trajectory from a country with a projected debt level that is considered to be prudent, ie. staying below 60 percent of GDP, and therefore not to pose a risk to the euro.

Note also that, while not explicitly mentioned in the context of the *"downward path … or … prudent levels"* sustainability criterion, the relevance of the Commission risk classification, specifically, as regards the distinction between 'high risk' member states and the others, is confirmed by at least two provisions in the Commission reform proposals, namely, on the intensity of the reform and investment commitments required for an extension of the adjustment period[26], and on the materiality of a deviation from the adjustment path for the opening of an excessive deficit procedure[27].

In sum, a reading of the sustainability criterion in terms of de-risking of public debt, in turn operationalised based on the Commission risk assessment methodology, appears justified on both substantive and contextual grounds.

Endnotes

1. See https://economy-finance.ec.europa.eu/economic-and-fiscal-governance/stability-and-growth-pact/corrective-arm-excessive-deficit-procedure_en

2. The legislative proposal (European Commission, 2023b, Art. 2) defines the technical trajectory in terms of "net expenditure", ie. primary expenditure net of discretionary revenue measures and cyclical unemployment expenditure. Taking into account the standard assumptions incorporated in the construction of the trajectory, net expenditure can be equated with the primary balance.

3. To illustrate with an example, the adjustment prescribed in the recommendation addressed by the Council to a member state country that is subject to the EDP will prevail over the general provisions of the EDP regulation on the content of such recommendation, such as the requirement for a "minimum annual adjustment of at least 0.5% of GDP as a benchmark".

4. The legislative proposal explicitly acknowledges the possibility for the adjustment plan to differ from the technical trajectory, while requiring the concerned member state to provide an economic justification (European Commission, 2023b, Art. 11 (2)): "Where the national-medium-term fiscal-structural plan includes a higher net expenditure trajectory than in the technical trajectory issued by the Commission pursuant to Article 5, the Member State shall provide in its plan sound and verifiable economic arguments explaining the difference".

5. The Commission's November 2022 outline plan used the terms "substantial debt challenge" and "moderate debt challenge", instead of 'high' and 'low' sustainability risk, which are the terms used in the Commission's risk assessment methodology (European Commission, 2023b). This Policy Brief retains the terminology of the Commission risk assessment methodology because it is clearer.

6. To some extent, the 'false negative' case of countries not captured by debt/deficit classification while being at medium or high risk according to the sustainability risk classification is addressed by the following additional provision on early guidance (European Commission, 2023b, Art. 7 (2)): "For Member States having a government deficit below the 3% of GDP reference value and public debt below the 60% of GDP reference value, the Commission shall provide technical *information regarding the structural primary balance necessary to ensure that the headline deficit is maintained below the 3% of GDP reference value without any additional policy measures over a 10-year period after the end of the national medium-term fiscal-structural plan".*

7. One may wonder whether or not the result was intended. It is worth noting that the conclusions adopted by EU finance ministers (Council of the EU, 2023) following the presentation of the November 2022 Commission outline, do not contain demands in this sense. However, the change may reflect the concerns of countries keen to avoid the stigma of being labelled high risk in the application of the EU fiscal framework, for example because of a risk of downgrading by rating agencies. At the same time, countries with low debt may not be averse to, and may even welcome, early guidance from the Commission, for domestic political reasons, namely, in the expectation of receiving support for fiscal trajectories that are more demanding than objective consideration of sustainability risk would justify. This expectation however will be disappointed, if the Commission acknowledges that any trajectory will do, provided the breach of the two numerical references (60 percent and 3 percent of GDP) is avoided.

8. Respectively, Chapter III (The Technical Trajectory) and Chapter IV (National Medium-term Fiscal-Structural Plans), in European Commission (2023b).

9. European Commission (2023b), Art. 6 (a) and (b) and Art. 15 (2) (a) and (c). The provision on maintaining the deficit below the 3 percent of GDP threshold reflects the idea, already set out by the Commission in November 2022, that, irrespective of the degree of risk posed by the level and the trajectory of debt, the fiscal structural plan should ensure ex-ante respect for the commonly acknowledged reference limit for the deficit introduced by the Maastricht Treaty.

10. European Commission (2023b), Annex V.

11. The additional fiscal criterion, which applies only to the requirements for the technical trajectories, relates to the fiscal adjustment over the horizon of the plan (Art. 6 (e): "National net expenditure growth remains below medium-term output growth, on average, as a rule over the horizon of the plan". The formulation is equivalent to requiring a positive adjustment in the primary structural balance over the horizon of the plan. This is already required by the sustainability criterion if the country concerned has not yet reached the level of the primary balance resulting in a debt trajectory that *satisfies the "downward path … or … prudent level" condition. In this case, the additional criterion is simply redundant. However, if the country concerned has already reached the required level of the primary balance (for example, because its debt ratio is projected to stay below 60 percent), then the additional criterion should simply not apply.*

12. The additional fiscal criterion, which applies only to the assessment of the medium-term plans, relates to the respect of the 3 percent of GDP deficit threshold throughout the duration of the medium-term plan (European Commission 2023b, Art. 15 (2) (b) and (c): "whether the government deficit is maintained below the 3% of GDP reference value throughout the duration of the plan or whether the government deficit returns swiftly below the 3% of GDP reference value at the latest by the end of the adjustment period when the deficit is above this reference value at the time of submission of the national medium-term fiscal-structural plan …" and "whether for the years that the Member State concerned is expected to have a deficit above the 3% of GDP reference value, and the excess is not close and temporary, the fiscal adjustment is consistent with the benchmark referred to under Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure." The meaning of this criterion is difficult to ascertain, specifically, against the concurrent provisions in the same proposal and the EDP regulation. The sustainability criterion already contains a provision requiring that the fiscal position to be reached at the end of the adjustment period ensures that the deficit stays below 3 percent of GDP at unchanged policies for the following ten years. This requirement alone should be more than sufficient to ensure that a country starting from a deficit above 3 percent of GDP should be reducing it throughout the adjustment period. Therefore, the additional criterion appears redundant with respect to provisions already contained in the proposal. It also introduces a potential interference with the provisions in the EDP regulation. One could expect a breach of the 3 percent of GDP deficit threshold to result in the country concerned being placed in an EDP, in which case the fiscal adjustment would be exclusively dictated by the relevant EDP recommendation. Should the breach of the 3 percent of GDP deficit threshold not result in the country concerned being placed in an EDP (a carefully circumscribed possibility under the EDP regulation), this would signal that its public finance situation does not give cause for concern, in which case it would make little sense for the fiscal adjustment to be dictated by the law. In conclusion, the

additional criterion related to the 3 percent deficit threshold appears devoid of effet utile, if not actually contradicting other provisions of EU law.
13. European Commission (2023b), Art. 6 (c) and Art. 15 (2) (d).
14. A literal reading of the formulation of the no-backloading criterion would seem to allow for any distribution of the total adjustment within the default four-year adjustment period (while imposing that, in case of extension of the adjustment period to seven years on account of reforms and investments, broadly four sevenths of the total adjustment should take place in the first four years). A systematic and contextual interpretation of the legislation, as favoured in this Policy Brief, would solve the ambiguity (noted by Darvas, 2023).
15. European Commission (2023b), Art. 6 (d) and Art. 15 (2) (e).
16. Darvas et al (2023) presented simulations of the technical trajectories showing that France would be the only country for which the debt-level criterion would imply additional adjustment, in the case of a four-year adjustment period. Bulgaria would also be included, assuming that the criterion would apply also to low-debt countries, which is what its literal formulation would imply, but which would not make economic or legal sense, as explained.
17. European Commission (2023b), Art. 12: "The national medium-term fiscal-structural plan shall: (a) ensure the fiscal adjustment necessary to put or keep public debt on a plausibly downward path by the end of the adjustment period at the latest, or remain at prudent levels, and to bring and maintain the government deficit below the 3% of GDP reference value over the medium term." None of the additional fiscal criteria are included.
18. The Council conclusions explicitly stated that "IFIs should not play a role in the design phase of the national plans" (Council of the EU, 2023).
19. Specifically, Art. 8(4) of the revised budgetary framework directive entrusts the IFIs with "producing the annual macroeconomic and budgetary forecasts underlying the government's medium-term planning or endorsing those used by the budgetary authorities" and with "producing assessments on the impacts of policies on fiscal sustainability and sustainable and inclusive growth or endorsing those provided by the budgetary authorities". Moreover, Art. 8(5) prescribes that "Member States shall ensure that the budgetary authorities of the Member State concerned comply with

the assessments or opinions issued by the institutions in the context of the tasks referred to in paragraph 4. Where such budgetary authorities do not comply with those assessments or opinions, they shall publicly justify the decision not to comply within a month from the issuance of such assessments or opinions."

20. European Commission (2023b), Explanatory Memorandum, point 5.

21. "These observations … suggest the enforcement of the fiscal rules did not make a material difference in cases where the enforcement of fiscal discipline was most necessary" (European Commission, 2020, p.7).

22 The debt reduction rule, more properly characterised as a benchmark, since it provides a numerical trigger for the overall assessment of the case for opening an EDP, prescribes that the gap between a country's debt level and the 60 percent reference should be reduced by 1/20th annually (on average over three years).

23. Likewise, a country classified as low risk would be reclassified as medium risk if either one of deterministic stress tests gives a high-risk signal, or two of the deterministic stress tests give a medium-risk signal, or the stochastic stress test gives a medium-risk signal (by construction, the stochastic stress test cannot give a high-risk signal for a low-risk country). Note however that a notching up from low to medium risk is not relevant for the assessment for the sustainability criterion, the rationale for which is that of ensuring that countries avoid a high-risk classification.

24. The stochastic stress test is formulated in terms of probability of debt not stabilising over the initial five year of the projection period. For countries with an initial debt ratio between 60 and 90, the test gives a high-risk result if the probability exceeds 60 percent. This will be necessarily the case if the debt ratio is increasing in the baseline projection.

25. The Commission risk assessment methodology includes, in addition to the debt level and the debt trajectory, a third criterion for assessing the baseline projection, namely the fiscal consolidation space. This is assessed based on the percentile rank of the average structural primary during the projection calculated against the historical record for the country (the lower the percentile rank, intuitively, the less space the country has to improve on its historical record). This criterion is omitted in the interpretation of the sustainability criterion because to refers to unchanged policy projections as opposed to adjustment plans: it would be internally inconsistent to fail an adjustment plan because it incorporates an adjustment that is 'too ambitious' by historical standards.

26. European Commission (2023b), Art. 13 (2). It reads (emphasis added): "The set of reform and investment commitments underpinning an extension of the adjustment period, shall be commensurate with ***the degree of public debt challenges*** *and challenges to medium-term growth in the Member State concerned".*
27. European Commission (2023c), Art. (3). It reads (emphasis added): "The Commission, when preparing a report under Article 126(3) TFEU, shall take into account as a key relevant factor the degree of debt challenges in the Member State concerned. ***In particular, where the Member State faces substantial public debt challenges according to the most recent Debt Sustainability Monitor, it shall be considered a key factor leading to the opening of an excessive deficit procedure as a rule.*** *The Commission shall also take into account all other relevant factors as indicated in Article 126(3) TFEU, in so far as they significantly affect the assessment of compliance with the deficit and debt criteria by the Member State concerned."*

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In for a penny, in for a pound

The EU's Stability and Growth Pact has been struggling with enforcement since inception. Georg Kirchsteiger and Martin Larch consider the enforcement dilemma of EU fiscal rules

The EU's Stability and Growth Pact has been struggling with enforcement since inception. Although some member states honour the EU's fiscal rules more by their breach than their observance, financial sanctions under the Pact have never been applied.

This column argues that their effectiveness is overshadowed by the understanding that, in the event of a major economic shock, virtuous countries will come to their rescue to ensure the survival of the entire system. Unless this underlying issue is addressed, the effectiveness of financial sanctions will remain limited.

The effectiveness of fiscal rules crucially hinges on their enforceability. This notion looms large in the relevant literature starting with the seminal work by Kopits and Symansky (1998), who characterised the stylised profile of an 'ideal' fiscal rule. It also applies to the Stability and Growth Pact (SGP), a coordination device of the EU aimed to ensure the smooth functioning of the Economic and Monetary Union (EMU)[1].

From today's perspective, the track record of the SGP has been mixed at best. Since inception, some member states have regularly and significantly deviated from the course of action implied by the EU fiscal rules (Larch *et al* 2023). Yet, despite a dismal compliance record by a comparatively small group of countries the EU never managed to deploy the financial sanctions set out in the SGP.

Right now, the EU's fiscal framework is on the cusp of a new legislative reform – the fourth – where the objective of strengthening enforcement features prominently once again. The official narrative underpinning the reform proposal underscores stronger enforcement via a more consistent recourse to financial sanctions as the necessary counterweight to more flexible and country-specific fiscal adjustment requirements.

Drawing on basic elements of game theory, in a recent paper we show that all valiant attempts to strengthen the SGP's enforcement will produce limited effects unless a number of politically charged but fundamental issues are addressed (Kirchsteiger and Larch 2023).

The EU needs to find credible ways to (i) consistently impose meaningful sanctions in the event of non-compliance; (ii) link financial support in the wake of major shocks to a meaningful but not too harsh degree of macro-conditionality; and, most importantly, (iii) strengthen the resilience of member states to major economic shocks.

Very little progress is being made towards strengthening the resilience of EU member states to major economic shocks. In particular, elements fuelling the bank-sovereign doom loop remain largely unaddressed

The underlying problem of the SGP's enforcement dilemma is straightforward: countries with a time-tested preference for looser fiscal policy know the risks of non-compliance with the EU fiscal rules are not random, ensuring a blocking minority against the imposition of sanctions.

They also know that in the event of a very large negative shock, their own fiscal vulnerability can produce collateral damage for the fiscally prudent countries. Hence, when standing on the brink of a much bigger adversity, the prudent countries will accept paying for the survival of the EMU even if they formally committed not to do so.

A brief flashback

The SGP's enforcement dilemma has deep roots. It originates in the diverging motivations of the 12 member states who in the early 1990s decided to introduce the euro. Countries with a propensity to run government deficits supported the introduction of the single currency because, weary of trailing the low inflation policy of the Bundesbank within the European Exchange Rate Mechanism (ERM), they wanted to have a say in the prospective joint monetary authority.

In contrast, the Deutschmark bloc, who had enjoyed macroeconomic stability for some time already, wanted to extend its model to the EU as a whole. In essence, two distinct groups of countries sought to export their respective approach of macroeconomic policy making to the other (eg. Lucarelli 2013, Buti and Larch 2019)[2].

The governance framework emerging from this collision of diverging motivations seemed to tick all boxes necessary to dissuade countries from flouting the fiscal rules: it defined a strict mandate for the ECB with a clear and sole focus on inflation, outlined a procedure for correcting excessive government deficits in the member states – including financial sanctions – and banned any form of monetary financing or bailouts of governments.

In addition, to assuage remaining concerns, the then German Finance Minister Theo Waigel convinced his peers and EU leaders to adopt additional legislative provisions aimed to ensure budgetary discipline beyond the broad perimeters set out in the Treaty – the SGP was borne.

The dilemma of SGP enforcement dissected

The dilemma of SGP enforcement can be illustrated by a simple stylised model[3]. Think of the EU as two groups of countries: Group D tends to run deficits and accumulates growing levels of debt, while Group S runs sustainable fiscal policies[4]. The implementation of the SGP can be characterised as taking place in three stages.

In stage 1 – it can encompass several annual EU surveillance cycles – Group D decides whether to run a budget deficit or a more prudent fiscal policy. Based on experience, Group D has an incentive to run deficits, ie. it expects some immediate (economic or political) payoff.

If Group D's policy choices lead to an excessive deficit and the governments do not take corrective measures, the Council of the European Union can impose a fine.

In stage 2, a negative shock hits. If Group D implemented prudent policies in stage 1, it would be able cope on its own regardless of the size of the shock. In contrast, if Group D runs deficits, it is in trouble and can ask Group S for help.

In the event of a major downturn, the reassessment of sovereign risks by financial markets makes the fiscal position of Group D unsustainable, producing negative spillovers on Group D through contagion effects threatening the stability of the EMU as a whole.

If Group D asks for help in stage 2, Group S decides whether to help or not in stage 3. If it agrees to help, EMU meltdown is averted. Group S bears the costs of the transfer but attaches certain conditions, which produce social and political costs in Group D.

Figure 1 summarises the different stages of our simple model. The outcome of the strategic interaction between the two groups of countries is revealed by reasoning backward from stage 3.

In the event of a major economic downturn, the EMU can collapse for two reasons: either Group S refuses to step in, or Group D does not ask for help. It is plausible to assume that the collapse of the EMU is the worst outcome for Group S. Hence, it will decide to help in stage 3 as long as the transfer to Group D is lower than the damage caused by the EMU collapse.

Group D will ask for help in stage 2 if the macro-conditionality attached to the transfer is not heavier than the costs of lifting the burden alone. This also means that Group S has an incentive not to make conditionality too harsh, because otherwise Group D may refuse help.

An interesting corollary of this is that an external power intent on weakening the EU may have an interest in promising help to Group D.

Finally, in stage 1, Group D will decide to run a prudent fiscal policy only if the costs of a possible fine and of macro-conditionality exceed the short term (economic or political) benefits of running a deficit.

Since by experience Group D is likely to form a blocking minority in the Council against fines, the decision of pursuing prudent fiscal policies versus accumulating debt boils down to the type of macro conditionality attached to transfers from Group S.

Figure 1. Stylised presentation of SGP implementation

Think forward

Stage (1) Group D sets its fiscal policy

- Group D decides to either run deficits, which over time lead to an accumulation og government debt, or a more prudent course of action. This stage can encompass several annual budget cycles.
- By experience, Group D countires enjoy a short-term (economic and political) benefit from running deficits.
- The Council of the EU, which brings together Group D and Group S, can decide to impose financial sanctions in case Group D countries do not take measures to correct excessive deficits. The outcome of the vote is determined by the distribution of risks of non-compliance across countries.

Stage (2) A major negative economic shock hits Group D and the rest of the EU

- Group D decides whether to ask the rest of the EU (Group S) for financial support.
- If Group D chooses a prudent fiscal ploicy in stage (1) it can weather the shock on its own.
- If Group D runs deficits in stage (1) the reassessment of sovereign risks by financial markets makes the fiscal position of Group D unsustainable, producing negative spillovers on Group S through contagion effects threatening the stability of the EMU as a whole.
- If Group D asks for financial support it has to accept policy conditions, which produces (economic and political) costs; see stage (3).

Stage (3) Group S decides whether to offer financial support to Group D

- If Group S offers financial support, EMU meltdown is avertged.
- EMU meltdown is the worst possible outcome for Group S.
- Group S bears the costs of the financial support but attaches policy conditions, which produce social and political costs for Group D.

Reason backward

As long as Group D has a blocking minority in the Council, financial sanctions will not be applied. Hence, the decision of Group D mainly depends on the policy conditions in the event of a major economic shock.

As long as the costs of the policy conditions are not higher than the costs of lifting the burden alone, Group D will ask for financial support. Hence, policy conditions cannot be too strict (or a non-EU power may offer help).

As long as the cransfer to Group D is smaller than the cost of an EMU meltdown Group S will provide financial support if asked by Group D.

Note: The EU is assumed to consist of two groups of countries: Group D prefers running budget deficits; Group S prefers sustainable public finances

In sum, the dissuasive power of the EU fiscal rules is limited. First, deficit-prone countries command enough votes in the Council to block financial sanctions. Second, they know the EU will not seal its own demise by refusing financial support to troubled countries in the event of a major economic shock.

Finally, the macro-conditionality attach to financial support cannot be too strict because receiving countries my find them excessive or drive them into the hands of non-EU powers.

Conclusions

The stylised narrative emerging from our simple model nicely reproduces the main outcomes of SGP implementation since 1997. They highlight the impact of both the political economy in the Council and of systemic risks on the credibility of financial sanctions. They also raise the question of whether the SGP was not bound to fail from the start.

To be fair, the group of experts who prepared the blueprint for the EMU – the Delors Committee – had in mind a very different scenario. It did not anticipate the systemic risks that would afflict the EMU during the global financial crisis and after.

It also envisaged a completely different implementation of the excessive deficit procedure, namely one that would circumvent the political economy in the Council and rely on 'binding' and 'enforceable' instruments.

The advent of systemic risks and the political economy in the Council completely changed the enforceability of EU fiscal rules. Our simple model shows why. If we exclude shocks that threaten the existence of the EMU, a 'no-bailout' of Group D does not lead to the worst possible outcome for Group S. Second, Group D cannot block fines and the size of sanctions matters.

In the ongoing debate on how to reform the SGP, enforcement plays once again a key role. However, the reform proposal does not aim to address the issues that effectively weigh on the dissuasive power of sanctions.

Most importantly, the governance framework around the implementation of the SGP remains unchanged and the initial size of potential sanctions, which deficit-prone countries would have to weigh against the benefit of running deficits, is meant to be reduced.

At the same time, very little progress is being made towards strengthening the resilience of EU member states to major economic shocks. In particular, elements fuelling the bank-sovereign doom loop remain largely unaddressed.

As long as spillover effects from imprudent fiscal policies in individual member states are not mitigated, the threat of financial sanctions or harsh macro conditionality lack credibility. ■

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Endnotes

1. See Larch and Jonung (2014) for a succinct presentation of the SGP.

2. The architects of the EMU – the Delors Committee – were perfectly aware of the division of member states. A paper produced at the early stages of the committee's work explicitly acknowledged the "widely diverging 'propensities to run deficits' prevailing in the various European countries". It was this insight that finally led the committee to propose arrangements constraining fiscal policy lest the EMU encountered political tensions and/or pressure on the ECB to relax monetary policy.

3. The full model is presented in our Kirchsteiger and Larch (2023).

4. The exact composition of the two groups may change over time as individual countries can and have switched side, but each group usually safeguards at least a blocking minority in the Council.

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Improving the contestability of e-commerce in two jurisdictions

Improving competition in digital markets is a priority for the governments in both the United States and Europe. Fiona Scott Morton considers how Amazon's alleged conduct controls prices on rival marketplaces

Executive summary

Antitrust cases against Amazon in the United States reveal that the e-commerce giant has developed algorithms that mimic price protection contracts called MFNs (from most-favoured nations, a term borrowed from international trade), despite the company saying publicly that it ended the contracts themselves some years ago.

MFNs are well known in antitrust enforcement for their anticompetitive effects: higher prices and less entry. The complaints describe how Amazon demotes merchants from its coveted Buy Box if Amazon finds a lower price on a rival e-commerce site, creating an incentive for merchants to set higher prices on rival sites.

The European Union, the Digital Markets Act bans such contracts. This would be a good remedy for the US as well as it would restore competition with minimal harmful side effects. The US complaints describe a different scheme that penalises brands if Amazon must reduce its retail prices to match a rival retailer. The EU may have to pursue this conduct under Article 102 of the Treaty on the Functioning of the European Union that prohibits abuse of dominance.

Both the US Federal Trade Commission (FTC) and the European Commission have found that Amazon's policy of tying its own logistics service to Amazon Prime status raises entry barriers to rivals. The European Union remedy redesigns the Buy Box and allows rival logistics services access to consumers.

This remedy provides a useful benchmark to consider in designing remedies for the FTC and for California, which is also pursuing an antitrust case against Amazon. In general, both the US and the EU gain from the enforcement actions of the other.

1 Introduction

Improving competition in digital markets is a priority for the governments in both the United States and Europe. In the European Union, this can be seen in the Digital Services Act, the Data Act, and most importantly, the Digital Markets Act. In the US, the desire for more competition can be seen in the Biden Administration's appointments of leaders of the antitrust agencies who have brought several antitrust cases against digital platforms.

Amazon is one of the big-tech companies that receives regular criticism from politicians and the media. In the US, several antitrust cases against Amazon are currently in litigation, including those brought by the state of California (filed September 2022; Superior Court of the State of California, 2022) and the Federal Trade Commission and 17 states (filed September 2023; FTC, 2023).

These cases may have a bearing on enforcement against Amazon in Europe, where regulators have also been busy: an antitrust case brought against Amazon by the European Commission was resolved with commitments in December 2022 and commitments were also accepted in 2023 by the United Kingdom Competition and Markets Authority[1].

In addition, the European Commission has designated Amazon's e-commerce business as a core platform service[2], meaning it will have to comply with the EU Digital Markets Act (Regulation (EU) 2022/1925) beginning in March 2024.

The conduct described in the US complaints against Amazon harms competition between online stores and among the merchants who sell via them. The first harm is the suppression of price competition between e-commerce platforms.

The second harm occurs when Amazon's market power reduces competition in the logistics that merchants use to support their e-commerce sales. If they are available, independent logistics firms lower the cost of entry of rival e-commerce platforms and thereby increase competition. The evidence in this context unearthed in the US investigations is highly relevant to successful enforcement in the EU.

Meanwhile, Amazon's commitments to the European Commission, and DMA provisions that apply to Amazon's core platform services, should increase contestability and fairness in e-commerce markets. As this Policy Brief details, the combination of these policies can be effective in giving merchants more choices and lowering barriers to entry to Amazon's competitors.

The US lags behind Europe in competition enforcement of e-commerce and US authorities can learn from European solutions

The US lags behind Europe in competition enforcement of e-commerce, and so US authorities can learn from such European solutions. Likewise EU regulators can learn from US antitrust enforcement. Regulators on both sides of the Atlantic can build on the enforcement activities of each other. More robust solutions will create more contestability and fairness for consumers and businesses.

2 Stifling price competition

2.1 How Amazon's alleged conduct controls prices on rival marketplaces

The California and FTC complaints both accuse Amazon of operating what are effectively 'platform MFNs' (most-favoured nation commitments, a term borrowed from international trade) for third-party marketplace sellers and the brand representatives.

Platform MFNs are requirements that third-party sellers on a platform, in this case a marketplace, set prices for the same good on competing marketplaces that are at least as high as those found on the platform requiring the MFN.

The MFN thus controls prices on the seller's own website and on competing marketplaces. These contracts end price competition between marketplaces because all prices for the good are the same. Furthermore, a merchant selling on a marketplace with lower fees cannot pass those lower fees through to consumers in the form of lower prices, without – under the terms of the MFN – also lowering the price of the good on the primary platform, in this case Amazon, which has higher fees.

Therefore, a lower-priced entrant platform has no way to attract customers with lower prices if it wants to sell the products of merchants covered by the Amazon platform MFN. For this reason, platform MFNs also limit competition between marketplaces (Baker and Scott Morton, 2018).

A large economics literature[3] confirms these intuitions: sellers will choose to set high prices on all competing sites to match those on a large platform with an MFN. This harms competition in goods. Second, the competing marketplace now has no reason to lower its fees, since it cannot gain more business that way. This harms competition between the marketplaces themselves and deters entry of more efficient marketplaces.

This economic logic is well-known among enforcers. MFN contracts have therefore been a frequent target of enforcement efforts in many industries. In 2013 Germany and the UK opened investigations into Amazon's MFN contracts, which caused the company to abandon them in Europe (Bundeskartellamt, 2013).

In 2019, at the instigation of Senator Richard Blumenthal (not the FTC), Amazon voluntarily ended its MFN contracts in the United States. Observers might well think, therefore, that the anticompetitive effects of these contracts are gone.

2.2 *De-jure* versus *de-facto* MFNs

However, the US lawsuits set out the steps Amazon took to purposefully recreate the effects of the MFN contracts after it ended them formally. Both the California and FTC complaints describe the replacement tactics Amazon has used to control off-platform prices through the Amazon Standards for Brands policy (ASB), the Marketplace Fair Pricing Policy, the Seller Code of Conduct and Select Competitor – Featured Offer Disqualification (SC-FOD) (Superior Court of the State of California, 2022 (hereafter 'Cal Comp') paragraph 125; FTC, 2023 (hereafter FTC), paragraphs 276, 297).

If a seller's prices are lower on a rival site (FTC ¶ 277), Amazon downgrades the listing of the good, and removes it from eligibility for the 'Buy Box' or 'featured offer' (FTC ¶ 84) (the Buy Box is the familiar box on the top right of the Amazon product page; it shows one seller that Amazon has chosen and, by virtue of the design of the box, is made more prominent than any other seller).

Given Amazon's huge consumer base, and the fact that 98 percent of purchases occur through users choosing the seller in the Buy Box (FTC ¶ 85), an excluded merchant is likely to lose significant sales with this downgrade.

Furthermore, the California and FTC complaints are detailed in their evidence that Amazon's managers were aware of the purpose of the programmes. For example, SC-FOD was designed to enforce the contractual MFN's *"expectations and policies,"* which *"had not changed"* (FTC ¶ 276). The FTC complaint states:

"At one time, Amazon designated only the very largest online stores as 'Select Competitors' for purposes of SC-FOD. After dropping the price parity clause from its Business Solutions Agreement, Amazon exponentially expanded its classification of 'Select Competitors.'[…] According to a senior Amazon executive, Amazon expanded the designation of Select Competitors] to make "the punitive aspect" of SC-FOD "more effective"" (FTC ¶ 280).

Both complaints explain that Amazon's Standards for Brands, or ASB programme, contractually requires certain third-party sellers to *"ensure that their products' prices on other online stores are as high or higher than their prices on Amazon at least 95% of the time"* and imposes additional restrictions on sellers' inventory and Amazon Prime membership[4] so they effectively cannot sell anywhere but on Amazon (FTC ¶¶ 291-2; Cal Comp ¶¶ 145-8).

As with the SC-FOD programme, Amazon was clear about why it penalised ASB sellers who did not meet the programme's requirements: *"Amazon told those punished ASB sellers that they were being sanctioned because 'customers considering your products could have easily found your products cheaper at another major retailer, and may have chosen to shop elsewhere'"* (FTC ¶ 297).

These statements should raise concerns in all jurisdictions that Amazon's contractual MFNs were only a small part of the competition problem.

2.3 How Amazon's alleged conduct controls prices on rival retail sites

The California complaint describes behaviour that also creates an effective MFN in Amazon's retail operation. Amazon's retail business differs from the marketplace business because Amazon itself buys goods at wholesale prices, owns those goods, and then sells them via its own website at prices it chooses. A marketplace, by contrast, hosts independent merchants that control what they sell and how it is delivered, and set their own prices.

As described in the complaint, brands that sell wholesale to Amazon fare even worse than re-sellers because of another MFN-like scheme. Amazon requires brands to agree to a contract called a Minimum Margin Agreement (Cal Comp ¶¶175-204). Amazon uses an algorithm to reduce its retail prices if it finds a lower price for the same product on a rival website, such as Walmart.com.

But the brand Amazon buys from wholesale remains responsible for maintaining Amazon's profit margin. The brand must therefore make up the difference between the price initially set by Amazon, and the lower price that Amazon has matched. This is true even though the brand itself does not choose the retail price in either setting; the online stores have that responsibility.

The result of this scheme is that whenever Walmart.com, for example, has a sale on a certain product or brand, Amazon matches the sale price, and its profit margin may fall below its target level. If so, Amazon requires the brand to compensate it for the new low price.

Naturally, this penalty causes the brand to want to sell to Walmart.com at a high enough wholesale price so that Amazon's retail price will always be lower than Walmart's. In general, a brand does not want to offer discounts to Walmart because that might encourage a sale that would cause the brand to suffer if Walmart.com decides to lower prices for any reason, eg. to attract consumers to its store.

The brand might even withdraw from Walmart.com altogether if such sales cause it to owe large sums to Amazon. Internal Amazon documents acknowledge the *"punitive aspect"* of this scheme (FTC ¶ 282). The anticompetitive impact of this programme is the same as an MFN in its ability to raise prices at rival stores.

2.4 What remedies would restore vigorous price competition?

Assuming that the allegations about MFNs described in the preceding subsections are proved, agencies or courts will need to impose remedies to restore the lost competition. The simplest remedy is to ban MFNs entirely: wide MFNs (which cover prices in rival e-commerce stores), narrow MFNs (which cover prices on the website of the brand itself) and any conduct that creates the same incentives as an MFN. The EU has already banned MFNs in Article 5(3) of the Digital Markets Act.

To explain the impact of an MFN ban on the strategies of all parties, it is useful to consider two questions. First, for the MFN to be triggered, a rival must offer a lower price.

Why is a rival e-commerce store setting a retail price lower than Amazon's price?

1. The rival store has lower costs of operation than Amazon;

2. The rival platform bought the good from its manufacturer for a lower price; or

3. The rival platform has a different strategy or weaker market position than Amazon and lower prices are the best way to attract consumers.

These answers are standard manifestations of competition that benefits consumers. If prices are lower on a rival e-commerce site for any of these reasons, consumers gain, and the law should not permit Amazon to implement contracts or policies that suppress that competition.

If Amazon wishes to retain customers after this MFN is banned, it can bring down its fees or raise its value. Likewise, Amazon can bargain for a lower price from the manufacturer, or possibly cut its costs by making its own-label version of the product.

The second question when assessing the potential impact of an MFN ban has to do with re-sellers:

Why is a third-party reseller setting a price on Amazon that is higher than on other platforms?

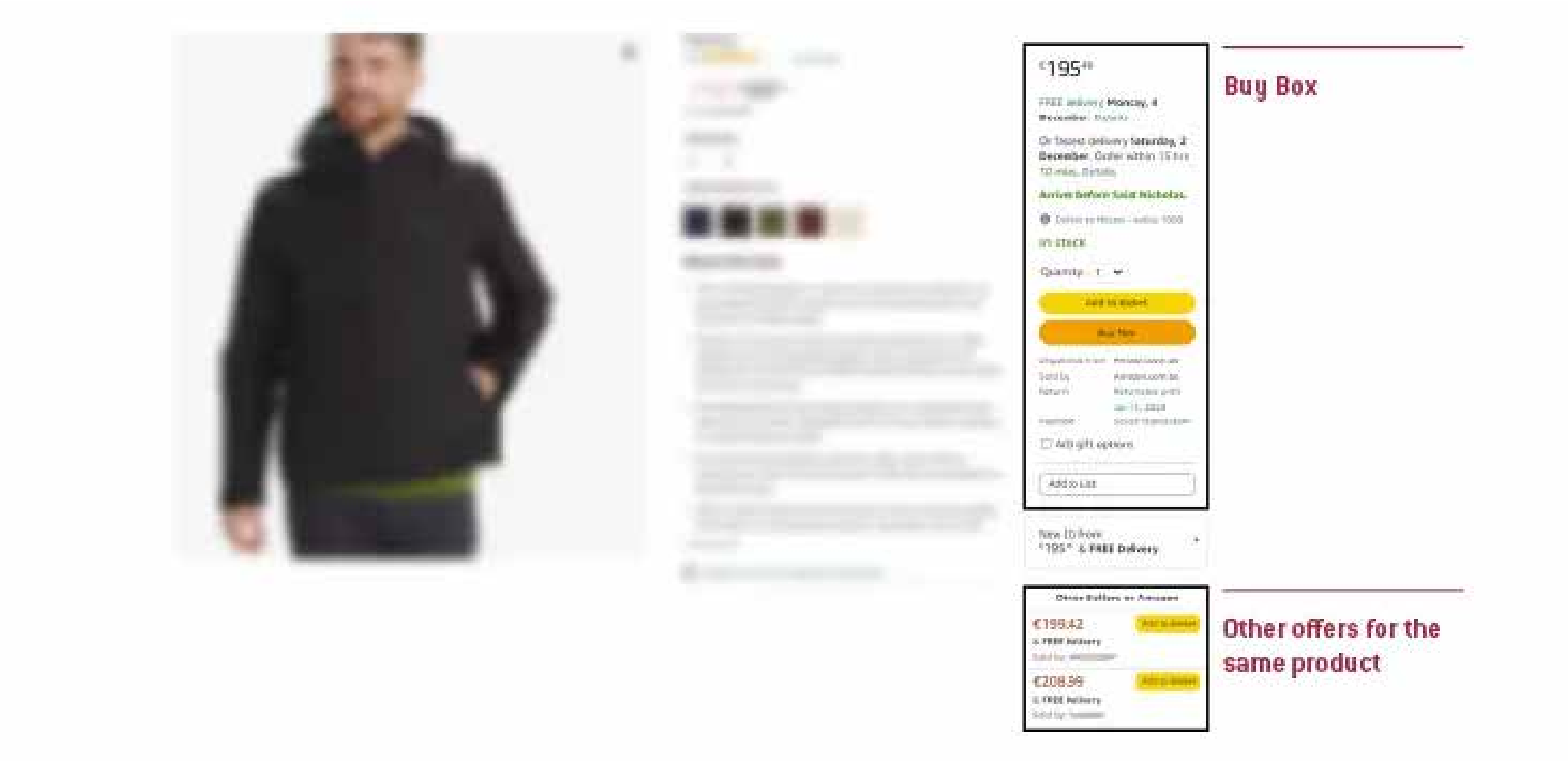
4. It thinks Amazon shoppers are inattentive and not price-responsive and is exploiting them with a high price; or

5. Its costs are lower on rival platforms because those platforms' fees are lower.

A reseller is not violating competition laws if it chooses to set different prices in different distribution channels for reasons such as differences in cost or demand. But, of course, this conduct hurts Amazon shoppers and Amazon's brand. A remedy that restores the lost competition in fees (5) should ideally allow Amazon to protect its own consumers from any possible exploitation in (4).

Handily, Amazon has already built the tool needed to combat the possible exploitation in (4): the Buy Box. When third-party sellers list on Amazon, the firm's algorithm evaluates their offers and puts the one that meets its criteria into the Buy Box (see the annex for an illustration). Consumers with ranking bias and default bias tend to purchase

Annex: The Buy Box



the option in the Buy Box, meaning that the winning seller typically obtains 98 percent of sales (according to the FTC complaint).

If Amazon's algorithm weights high prices negatively, a third-party seller engaging in the exploitation in (4) would be expected to sell very little because it is not in the Buy Box and, if any diligent consumers search the listing, they will find an exploitative price – which will limit sales.

The design of the Buy Box means it can be used legitimately by Amazon to defend consumers on Amazon Marketplace from exploitation by high-priced sellers. Thus, it duplicates the pro-competitive impact of the MFN without the anticompetitive element and can be used to replace it when the MFN is banned. Because the Buy Box is only for prices on the Amazon platform, it does not duplicate the restraint on horizontal competition that characterises an MFN.

Now consider the case of a product sold by only one reseller on Amazon, and which that re-seller is pricing in an exploitative manner. The Buy Box cannot fix this problem. However, Amazon has the incentive and ability to recruit another reseller to its platform. Entry will be attractive for the new seller because undercutting the incumbent's exploitative price still allows for a healthy margin.

Thus, both Amazon and rival third-party sellers have an incentive to defeat the conduct described in (4), while Amazon has the information to identify the opportunity and the ability to facilitate entry of lower-priced rivals.

If there is only one original seller of the product, such as the brand itself, there is also nothing for the Buy Box to leverage. But Amazon has procompetitive tools to combat this strategy. For example, the brand's listing on the search-results page could truthfully explain to the customer what the brand's regular list price is and could recommend substitute products on Amazon that are not overpriced – all without removing the ability to buy the brand in the normal way.

An Amazon premium here could occur because the cost of selling is higher on Amazon. If the brand finds the costs of selling on Amazon to be higher than on other platforms, either because of advertising that is effectively required, or high fees charged by the platform, it may build those costs into the price it charges.

This is a normal feature of competition. Customers will evaluate the benefits of the Amazon platform (OneClick purchasing, fast delivery, saved addresses) and compare them to the price difference. If the latter outweighs the former, the customer will leave Amazon to buy the brand for a lower price elsewhere.

A reasonable concern is that a ban on MFNs will lead to inefficient free-riding (showrooming). This occurs when sellers use the dominant platform to display their product and attract buyers, but then encourage those buyers to purchase off the platform, thereby avoiding the platform's fees. This can reduce below the optimal level the incentive to build and invest in a platform.

However, a consumer who sees a product on Amazon and searches for the seller's page to buy it at a lower price is giving up all the services of Amazon: saved payment, saved addresses and quick delivery times. Amazon itself touts the superiority of its services and the stickiness it creates with time- and attention-strapped consumers.

The government complaints contain quotations from managers at the company that acknowledge high switching costs for consumers (FTC ¶ 182). For these reasons, free-riding may be minimal.

3 Stifling entry of competitors

3.1 The link between shopping and fulfilment

Additional allegedly illegal conduct described by the FTC relates to the tying of fulfilment by Amazon (FBA) membership to participation in Prime (and therefore sales, as noted above). Formerly, merchants could use their own fulfilment and delivery services within the Prime programme (called SFP, or seller-fulfilled Prime) (FTC ¶ 400).

The merchants that participated in SFP could have their listings qualify for Prime, and therefore the Buy Box, but also could send out those items using a logistics provider of their choice, rather than using Amazon.

This is important because such a merchant can then also fulfil sales from rival e-commerce platforms with the same logistics infrastructure they use for Amazon sales. This promotes the entry of rival e-commerce marketplaces because, by virtue of hosting the same sellers on their platforms, their delivery quality and cost is similar to Amazon's.

When Amazon banned SFP or made it difficult[5], most Amazon merchants turned to FBA, which does not have this beneficial effect on rival marketplaces.

The FTC's complaint emphasises this impact on competition, namely that the decline in availability of independent fulfilment and logistics services at scale reduced entry and growth of rival e-commerce stores. When SFP reduced multihoming across e-commerce marketplaces, that reduced competition between marketplaces (FTC ¶ 405).

Amazon executives appreciated the value of the lessened competition, according to the FTC complaint. An Amazon executive stated that the mere prospect of increased competition for fulfilment services *"keeps me up at night"* (FTC ¶ 391).

Another executive *"explained to his colleagues that he had an 'oh crap' moment when he realized that this was 'fundamentally weakening [Amazon's] competitive advantage in the US as sellers are now incented [sic] to run their own warehouses and enable other marketplaces with inventory that in FBA would only be available to our customers"* (FTC ¶ 31).

3.2 Fairness concerns

The FTC complaint tracks the concerns expressed by the European Commission about the way in which the design of the Buy Box effectively required sellers to participate in Prime and therefore to use FBA. However, that similarity masks an interesting element to the European case. The Italian competition authority started its investigation[6] because local rival logistics operators wanted to be included by Amazon on an equal basis to Amazon's logistics.

The conflict with Amazon arose because of the possibility that rival logistics providers have slower delivery times. The open question is whether Amazon treats rival logistics providers as consumer prefer (by performance) or in a way that favours Amazon's logistics services.

The European Commission case also demonstrates a view that the treatment of merchants was unfair in that Amazon's own products were ranked higher than equivalent rivals and the Buy Box incentives were extremely sharp.

In other words, if a merchant did not get into the Buy Box (which required buying FBA), their sales dropped almost to zero, while their Amazon ranking may only have been very slightly lower than the winner's rank.

Such a strong response becomes unfair to sellers if there is any bias or imprecision in the ranking. This concern for fairness is conceptually distinct from the competition, but is a feature of European antitrust enforcement.

However, the fairness element is not central to the argument of illegality in either case. Since a merchant will not use a logistics service that causes exclusion from the Buy Box, the Amazon policy linking FBA, Prime and the Buy Box has an exclusionary impact on rival logistics providers.

These policies prevent merchants from multihoming (offering their goods on multiple marketplaces), which in turn creates an unnecessary barrier to entry of rival marketplaces. The link to competition is fundamental.

And importantly, while the quality of current rivals may be poor, that does not invalidate this theory of harm. Under different rules logistics providers would have different incentives to invest. If a rival could serve merchants within the Amazon Prime programme, it would have the incentive to invest to improve its quality so that merchants would select it, and this would generate competition in logistics.

If the Amazon algorithm is, in fact, downgrading products that consumers prefer, this lowers the quality of the service and should cause consumers to switch to a rival store. If rival stores can more easily enter because rival logistics are available, then competition between merchants will improve.

If the Amazon algorithm only ranks products according to attributes valued by consumers – with no bias or distortion – competition among those merchants will intensify and consumers will benefit.

3.3 Remedies to protect competition in fulfilment

A simple remedy to apply in the United States would be the restoration of the Amazon SFP pro-gramme, which was shown to be technically feasible and popular with merchants (see section 4.1). Merchants would always be free to choose Amazon's fulfilment service. It is likely Amazon would want to establish quality standards for rival delivery services to qualify for Prime, in order to maintain the reputation of the Amazon brand for quality and reliability.

Information reported in both the EU and US has shown that Amazon previously tracked such performance. Maintaining quality standards to ensure consumers have a good user experience is a perfectly procompetitive policy, provided the standards are transparent and are applied fairly. If so, a delivery service with a proven quality can be used by merchants in SFP, and their listings will be treated equivalently to those delivered by Amazon.

The European Commission has taken two approaches to a remedy. The prohibition decision was resolved with commitments that Amazon implemented in 2022 (Amazon, 2022):

To address the Buy Box concern, Amazon proposed to commit to:

- *treat all sellers equally when ranking the offers for the purposes of the selection of the Buy Box winner;*

- *display a second competing offer to the Buy Box winner if there is a second offer from a different seller that is sufficiently differentiated from the first one on price and/or delivery. Both offers will display the same descriptive information and provide the same purchasing experience.*

To address the Prime concerns Amazon proposed to commit to:

- *set non-discriminatory conditions and criteria for the qualification of marketplace sellers and offers to Prime;*

- *allow Prime sellers to freely choose any carrier for their logistics and delivery services and negotiate terms directly with the carrier of their choice;*

- *not use any information obtained through Prime about the terms and performance of third-party carriers, for its own logistics services."*

Notice that the Buy Box rule in these commitments will be a less-effective replacement for an explicit MFN – as argued above – because it cannot steer users to less-expensive option as forcefully. The results of this combination of commitment and DMA ban will need to be studied to evaluate if the former weakens the latter.

4 The role of the DMA in promoting competition in ecommerce

4.1 DMA rules

One might think that Europe is ahead of the US in banning MFNs because Amazon gave up its MFN contracts in Europe in 2013 (Bundeskartellamt, 2013). But the US litigation evidence raises the possibility that the company effectively replicated the prohibition on sellers discounting off the Amazon platform by other means – and this could have been true in Europe as well.

It is therefore unclear whether the outcomes (prices and entry) Europe has experienced in the last ten years reflect competition effectively free of MFNs or not.

The European Digital Markets Act (Article 5(3)) again bans MFNs for the core platform services designated by the European Commission. Amazon's retail business is a CPS and therefore must comply with Article 5(3) by March 2024. If the processes and algorithms described above are being used in Amazon's European operations today, these will surely be viewed as violating the DMA and would have to be changed.

The DMA also explicitly permits disintermediation of the platform in Article 5(4). It says that gatekeepers, or the hard-to-avoid digital giants covered by the DMA:

"… shall allow business users, free of charge, to communicate and promote offers, including under different conditions, to end users acquired via its core platform service or through other channels, and to conclude contracts with those end users, regardless of whether, for that purpose, they use the core platform services of the gatekeeper."

Juxtaposing this wording with text from Amazon's Seller Code of Conduct in the US is informative[7]:

"Circumventing the Sales Process: You may not attempt to circumvent the Amazon sales process or divert Amazon customers to another website. This means that you may not provide links or messages that prompt users to visit any external website or complete a transaction elsewhere."

Article 6(5) of the DMA requires gatekeepers to not rank their own services and products more favourably than those of third parties. This rule backs up, or duplicates, one of the Buy Box commitments and might affect Amazon's house brands and retail products relative to the products of third-party sellers on Amazon Marketplace.

It also likely applies to Amazon's Prime fulfilment and delivery service (FBA). FBA should not automatically be ranked favourably relative to services of third-party sellers, but rather the ranking conditions should be *"transparent, fair and non-discriminatory."*

Amazon itself has the ability to measure how well SFP serves customers; it found that over 95 percent of the time, SFP met the delivery requirements set by Amazon (FTC ¶ 401). Under this rule, it would seem that a product delivered by a rival service that is as fast and reliable will cause the product to be ranked equivalently to one being delivered by Amazon Prime, all else being equal.

Importantly, in addition to Articles 5(3) and 5(4), the DMA also contains an anti-circumvention rule in Article 13. If Amazon devised methods to effectively replace the platform MFN contracts, they could be considered circumvention of 5(3) and 5(4).

Such an interpretation is sup-ported by statements in the FTC complaint against Amazon such as *"replacement of a contractual price parity term with an expansion of SC-FOD would appear to be] not only trivial but a trick and an attempt to garner goodwill with policymakers amid increasing competition concerns"* (FTC ¶ 15).

4.2 The effectiveness of the DMA

The Commission defined Amazon's core platform service to be its marketplace services, not its retail services. Therefore, the de-facto MFN that operates through the retail channel, the Minimum Margin Agreement, may not be governed by the DMA.

The EU competition authority may want to bring an antitrust case against Amazon's retail MFN under Article 102 of the Treaty on the Functioning of the EU (prohibiting abuse of dominance). In this way the antitrust law would complement the DMA and fill an enforcement gap. This package of enforcement outcomes such as price and quality in the EU e-commerce marketplace.

Rival e-commerce sites that do not require costly advertising and/or have lower participation fees will enable merchants to set lower prices there and attract consumers with those lower prices[8]. Because of the prohibition on MFNs, those merchants will not be penalised by Amazon for the price differential.

In a setting of unfettered competition we may see consumers leave Amazon in pursuit of lower prices, or we may see consumers choose to pay more for the quality they are accustomed to and stay with Amazon. Either outcome is a manifestation of competition. Business users will be free to set the prices they want on each distribution channel they use, and end users will therefore have more choice and lower prices.

DMA Article 13 prohibiting circumvention will play an important role in enforcement of the other Articles needed to create competition in e-commerce. Because it is clearly straightforward to create algorithms and policies that mimic the effect of a contractual MFN, enforcers will need to develop processes or tests to monitor compliance under DMA Article 5(3), or the ban on MFNs will achieve almost nothing.

Successful enforcement will advance the DMA's contestability and fairness goals. The ban on MFNs increases contestability both on the platform and between platforms. Safeguarding merchants' freedom to contract differently across distribution channels and the equitable ranking of offers enhances fairness between different business users, as well as between business users and the platform's offerings.

5 Conclusions and policy recommendations

Soon there will be evidence of the effectiveness of the newly-mandated choice architecture of the Buy Box and its algorithm. Enforcers, merchants and Amazon will be able to measure the performance of third-party fulfilment and delivery, which will be very helpful to policy development. The changes should cause products without Prime shipping and lower prices to appear higher in the organic ranking, which could reduce the influence of Prime.

However, advertised products may fill the search results page so that shoppers do not see these highly-ranked inexpensive products. Such a poor user experience might cause consumers to shop elsewhere, and if the MFN provision (DMA Article 5(3)) is enforced, competitors to which consumers can switch will enter.

Even better, switching consumers can use their rights under DMA Article 6(9) to choose to port their personal data, including addresses, recurring purchases and methods of payment, to their new accounts with rivals.

Enforcers in the US should pursue a simple ban on platform MFNs because it will likely pre-serve competition between platforms with minimal negative impact. An effective remedy would also be to ban conduct and contracts similar to MFNs in Amazon's retail business, such as the Minimum Margin contracts.

If all those contracts – and the establishment of any similar programme that achieves the same anticompetitive ends – are prohibited, price competition will be able to flourish online. Given the policies Amazon seems to have adopted to replace MFNs in practice, both elements of the remedy are crucial.

In Europe, the main enforcement challenge seems to be possibility of de-facto MFNs enforced through carefully designed algorithms. Amazon's March 2024 compliance report to the European Commission may need to include information describing whether Amazon tracks the prices of its sellers on other platforms, and if it does, what actions Amazon takes after it finds sellers charging less outside Amazon's marketplace.

The answers to these questions are critical to demonstrate the gatekeeper is in compliance with the DMA.
The Commission may find the information revealed in the US litigation to be helpful as it interprets Amazon's compliance reports, as well as in any Article 102 litigation.

The case of Amazon illustrates that different parts of the DMA can work together to create a whole that is greater than the list of those parts. Eliminating MFNs allows for lower prices on rival sites, while a consumer's ability to port her data allows for easy switching to those sites. Unbiased rankings allow the best choices to rise to the top of the search results page, including choices fulfilled by a rival logistics provider. That rival logistics provider in turn can support entry in e-commerce. And the entrant can attract customers with a differentiated strategy which cannot be blocked by incumbents using MFN-equivalent policies or practices. The addition of the Buy Box redesign adds to the force of this combination.

Making sure this cluster of policies is effective at increasing contestability and fairness will require measurement of outcomes as well as inputs. What choices appear in the Buy Box and how do consumers respond to different design choices in the shopping environment? Measurement of the performance of all parties providing fulfilment and logistics will likewise be critical to policy evaluation.

The more effective these European Commission enforcement changes are – the MFN enforcement, portability of data, the Buy Box design and the increased shipping options – the more likely it is that they will be exported to other jurisdictions facing similar problems, whether from Amazon or another local dominant e-commerce platform.

In the United States, third-party sellers and brands will want California and the FTC to demand the European solutions if they are shown to be successful. Litigation in the US moves so slowly that there will be plenty of time to evaluate the outcomes of the existing EU antitrust commitments and the DMA before any US remedy would need to be chosen.

Moreover, a judge would likely find it attractive to choose a remedy that reduces the possibility of negative unanticipated outcomes in the marketplace. A solution that has been tried in Europe and has succeeded there is much less risky to impose on US consumers.

Additionally, Amazon cannot argue that such a remedy is costly or difficult from an engineering point of view because the company will already have built and deployed it in Europe. But this cheerful picture depends on the effectiveness and success of the new European enforcement package. ■

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Endnotes

1. See European Commission press release of 22 December 2022, 'Antitrust: Commission accepts commitments by Amazon barring it from using marketplace seller data, and ensuring equal access to Buy Box and Prime'. The UK CMA has already agreed commitments (CMA, 2023). In addition, the Italian Competition Authority levied a substantial fine of more than €1 billion; see press release of 9 December 2021, 'A528 - Italian Competition Authority: Amazon fined over € 1,128 billion for abusing its dominant position'.

2. See European Commission press release of 6 September 2023, 'Digital Markets Act: Commission designates six gatekeepers'.

3. See for example Cooper (1986), Salop (1986), Scott Morton (1997), Moshary (2015) and Baker and Chevalier (2013).

4. Amazon Prime is a paid subscription service that gives certain premium benefits to customers, including faster delivery of goods and access to music and other services.

5. FTC ¶ 408. Amazon wanted to minimise any potential backlash from SFP sellers, so in 2019 Amazon let sellers already in SFP remain, while blocking new enrolment. Critically, Amazon communicated to those sellers who were already in SFP that it expected them to fulfil orders themselves, rather than using independent fulfilment providers. Amazon's internal analyses showed that sellers using independent fulfilment ser-vices met Amazon's stringent SFP standards more often than sellers fulfilling orders themselves. For example, in the last quarter before Amazon suspended enrolment, SFP sellers using independent fulfilment providers satisfied Amazon's delivery requirement 98.4 percent of the time (compared to 96 percent for all SFP sellers), and satisfied Amazon's shipping requirement 99.8 percent of the time (compared to 96.8 percent for all SFP sellers).

6. See footnote 1.

7. See https://m.media-amazon.com/images/G/65/rainier/help/Selling_Policies_and_Seller_Code_of_Conduct_SG_new_version_clean_PDF.pdf.

8. FTC ¶ 236. The FTC complaint quotes one Amazon executive as acknowledging that the advertising costs are "likely to be passed down to the customer and result in higher prices for customers"; Amazon founder Jeff Bezos is quoted as *instructing executives to "accept more 'defects'" (the term for junk advertisements) because the advertising revenue to Amazon is more than the sales it loses from the degradation in search quality and higher prices. See FTC ¶ 5.*

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Disclosure: Within the last three years the author has engaged in antitrust consulting for a range of healthcare companies, government plaintiffs and the digital platforms Amazon and Microsoft. The author's Amazon engagement ended more than two years ago and predates the US complaints discussed in this article.

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The ‘pay-or-consent’ challenge for platform regulators

Users expect online services to be free but some digital platforms are now offering pay-or-consent options. Christophe Carugati considers how competition dynamics are affected

Meta-owned Facebook's original slogan, *"it's free and always will be"*, illustrates what most users think about paying for online services. So far, Meta and other digital firms have offered most of their services for free to encourage user enrolment. Yet, free services are not really free. Most are funded by an advertising model built on users' personal data.

There has been an ongoing clash between this model and European Union regulations, including the General Data Protection Regulation (GDPR) and the Digital Markets Act (DMA), which make it harder for these ad-funded services to rely on personal data.

Increasingly, EU laws require users to give explicit consent to the collection and use of their personal data, whether is it collected inside (on-platform, eg. only from Facebook) or outside the platform (off-platform, eg. from applications and websites).

Several GDPR-related rulings against Meta in Germany[1], Ireland[2], Norway[3] and in Luxembourg by the European Court of Justice (CJEU)[4] have confirmed that platforms can only collect and use data with the user's explicit consent.

The DMA imposes additional obligations on gatekeepers – inevitable service gateways – that provide core platform services, including Meta-owned Facebook and Instagram[5], to request consent as per the GDPR for collection and use of off-Meta data for personalised advertising (Recitals 36 and 37 and Article 5(2)(a) DMA). In response to the legal developments, Meta now relies on consent to collect on-Meta and off-Meta data[6].

In addition, on 30 October 2023, Meta also said it will now offer a paid, ad-free version of its flagship products, Facebook and Instagram, to users who do not want to consent to the use of their data (the ad-free paid version). An ad-supported free version of these services will continue to be available if users do consent. In other words, Meta is now providing a pay-or-consent offer similar to a paywall.

This pay-or-consent offer might affect the dynamics of competition in platform markets. Users will have three options: 1) pay for the ad-free version if they do not want to give consent; 2) use the ad-supported free version if they do consent; or 3) find a competing provider if they are unwilling to pay or to give consent.

It is up to the DPAs and the Commission to define whether the ability to pay for Meta's ad-free version, or to use competing services constitutes sufficient alternatives if users want to withhold consent

However, whether Meta can propose the ad-supported free version with the requirement to give consent to data use is legally a grey area. The GDPR requires a genuine choice, meaning users must have a real choice between accepting and refusing consent. For users who are unwilling to pay and unable to switch to an alternative provider, the only realistic option is to use the ad-supported free version, which only allows users to give consent.

National data protection authorities (DPAs) enforcing the GDPR, and the European Commission as the enforcer of the DMA might consider this offer non-compliant, requiring Meta to offer its ad-supported free version with an accept or decline consent offer, as Meta offer its services currently.

The pay-or-consent offer

The legality of the pay-or-consent offer is a grey area. National data protection authorities (DPAs) have different views about the practice's legality, as the GDPR requires that users have a genuine choice between accepting or declining consent. This depends on whether users have realistic alternatives to the ad-supported free version when they want to withhold consent.

Pay-or-consent models are, for example, illegal in Belgium[7] but legal in France[8]. However, the French data protection authority imposes strict conditions. Users must have an alternative if they do not want to pay, and the payment must be appropriate.

The economic rationale behind this payment is that digital firms have the right to be compensated for the advertising revenue they lose because they are unable to offer personalised advertising that relies on trackers that track the user's web activity. The CJEU[9] and the DMA (Recitals 36 and 37 DMA) also consider that a paid version is legal if users who decline consent can access an equivalent service for an appropriate payment.

The existence of alternatives

The first question authorities will have to answer is whether the ad-free paid version constitutes a realistic alternative to the ad-supported free version. Empirical studies have found that the answer is no. In a survey of 11,151 respondents (Akman, 2022), only 9 percent were willing to pay to continue using Facebook, were it to start charging a €5 monthly fee for the same quality service.

Akman (2022) also found that 42 percent dislike being targeted by advertising, while 46 percent dislike data collection based on their activities, but are nevertheless unwilling to pay for ad-free services. Only 7 percent and 10 percent, respectively, would rather pay a fee for ad-free services, or have ad-funded services collect data on their activities.

The upshot is that most users will not pay, irrespective of the amount, even for a higher quality ad-free version. Accordingly, the paid version is unlikely to be a realistic alternative for most users because in practice they will not pay.

A second question is whether competing services, including, in relation to Facebook, Snapchat, TikTok and BeReal, constitute realistic alternatives to the ad-supported free version. The answer to this will depend, first, on whether the competing services offer a free version with the ability for the user to accept or refuse consent.

Second, it will depend on whether Meta users face barriers to switching due to factors including functionality, size of the user base, network effects and the ability to move data and their contacts to a competing service effortlessly and in a timely way. Two scenarios are possible:

1. If users face switching barriers, users who are unwilling to pay in practice will have no choice but to use Meta's

ad-supported free version. This will leave them facing consent as the only option for access to Meta's ad-supported free version. Users could also stop using Meta services, but they would lose their connection with friends/followers. It is unlikely that users will stop using Meta's services if they use these services as the main gateway to connect with their followers. Accordingly, the ad-supported free version will unlikely be legal.

2. If users do not face barriers to switching, they might switch to competing services. The latter will compete to attract users who want to switch. New entrants might even appear on the market. Newcomers will likely offer only a free version of their services to encourage user enrolment. Existing alternatives might propose paid versions of their services to diversify their revenue streams, alongside a free version that enables users to accept or refuse consent to attract users unwilling to consent to Meta's ad-supported free service. In this scenario, the ad-supported free version will likely be legal. The Meta pay or consent offer might even facilitate the DMA contestability objective of easing entry barriers, as it might incentivise Meta users to switch to competing providers. However, this scenario is highly hypothetical as users might not be able to fully move from Meta's services to competing providers because of Meta's position as a main gateway for billions of users and businesses.

The consequences of the absence of genuine choice

It is up to the DPAs and the Commission to define whether the ability to pay for Meta's ad-free version, or to use competing services constitutes sufficient alternatives if users want to withhold consent. If the answer is no because, in practice, users will not pay and will not switch because of high barriers to switching, then the ad-supported free version is unlikely to be legal under the GDPR and the DMA, as consent is the only choice for those wanting to access the ad-supported free version.

In particular, the DMA explicitly prohibits gatekeepers from subverting the user's autonomy to choose (Article 13(6) DMA), which is likely to be the case if users can only accept consent. If users have no genuine choice, Meta will still be able to offer an ad- free paid version.

But, if Meta wants to keep its ad-supported free version, it will have to ensure that the ad-supported version provides a choice between accepting and declining consent, similar to today's 'accept-or-decline' offer, as opposed to the pay-or-consent offer. ■

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3. See Datatilsynet press release of 31 October 2023, 'Datatilsynets vedtak mot Meta utvides til EU/EØS og gjøres permanent', and European Data Protection Board statement of 1 November 2023, 'EDPB Urgent Binding Decision on processing of personal data for behavioural advertising by Meta'.

4. C-252/21 Meta Platforms and Others, ECLI:EU:C:2023:537, 4 July 2023, para. 1117.

5. European Commission press release of 6 September 2023, 'Commission Designates Six Gatekeepers Under the Digital Markets Act'.

6. Meta, 'Facebook and Instagram to Offer Subscription for No Ads in Europe', 30 October 2023.

7. Data Protection Authority press release of 20 October 2023, 'L'APD publie une checklist pour une utilisation correcte des cookies'.

8. Commission Nationale de l'Informatique et des Libertés press release of 16 May 2022, 'Cookie walls : La CNIL Publie des Premiers Critères d'évaluation'.

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On the way to a sustainable economy

Sabine Mauderer argues that reducing uncertainty about climate change will help us to embrace the opportunities of the green transition

Introduction

Let me begin with a cliché: markets do not like uncertainty. Why? Because dealing with uncertainty tends to be stressful and complex. Unfortunately, when it comes to climate change, there is a lot of uncertainty – many unknowns. Climate change itself, however, is a certainty. Just look outside the window for proof.

Facts on the table

It is Climate Week. Flashback to early June: you would have urged me to stay indoors. Wildfires up in Canada had brought toxic smoke to New York City and turned the skies orange. There is no denying that climate change is on our doorstep.

Let me give you some figures: assuming current policies, physical risks – such as losses due to droughts or rising sea levels – could lead to an almost eight percent loss of global GDP by 2050[1]. To put this staggering figure into perspective: the global financial crisis of 2008 led to a GDP loss of around four percent.

The facts are on the table: climate change will have consequences for all of us. That much is certain. Having said that, when it comes to understanding how climate change will affect us, the picture is less clear-cut. This lack of understanding is incredibly worrying.

It may contribute to the lack of urgency that current climate policies reflect all too often. This underlines the importance of reducing uncertainty. Let's shed some light on climate risks!

The role of central banks

This is where central banks come into play. Dealing with financial risks is our bread-and-butter business. This ample expertise can help to strengthen the understanding of climate-related risks.

The Network for Greening the Financial System (NGFS) – of which I am the Vice Chair – is pooling the expertise of almost 130 central banks and supervisors from all over the world. One of our flagship products is climate scenarios.

They help assess how different pathways for emissions and climate policies might affect the economy and the financial system. To give you an example: in the US, heat stress could reduce labour productivity by almost 4 percentage points by 2050[2]. And heat stress is just one of many factors. Therefore, it is important to design holistic models for climate scenarios.

Companies should include transition plans in their broader strategy. In fact, they should be part of their risk management. Transition plans are not only about risks, but also about opportunities

Scenarios explore different plausible futures and hence contribute to reducing uncertainty. Supervisors use them for their climate stress tests. Financial institutions can use them for their in-house risk management, including for measuring Climate Value-at-Risk.

To improve the usability of the scenarios, the NGFS is continuously updating and fine-tuning them. The next update which is due later this year aims to make the scenarios more granular across sectors and regions.

Compass for the journey to net zero

Scenarios offer us a glimpse of what the future might look like. With the current climate policies, the world in 2050 does not look too great, to say the least. That will be 27 years from now. A bit less than that, 26 years ago, in 1997, the movie *Titanic* hit the theatres.

You all know the fate of the ship that was hailed as being unsinkable and that tried to steer away from the iceberg when it was too late. The window to act on climate change is closing but there is still some time to turn the ship.

Shifting the economy towards a net zero future calls for all hands-on deck. Companies must embark on a journey of adjusting their business models. Transition plans can be a powerful tool to guide the way. At the NGFS, we recognise their importance. We have started our initial work on assessing the use of transition plans and will press ahead with this.

In early summer, we published the first findings from a stock-take among members[3]: we found that, while their importance was acknowledged, a common understanding on this new topic is still lacking. I want to highlight three findings:

- What does it mean exactly for a company to be 'transitioning' – where to?
- If a transition plan is drawn up, what information can and should it provide?
- To achieve the credibility that markets need, the question of checking their accuracy needs to be answered.

At the NGFS, we will continue to work on these issues. We intend to provide more information on the data that users need and find in transition plans early next year.

Despite further work to come, let me share some of the insights we have already gained to move towards a common understanding: Transition plans are a roadmap for companies. They translate a corporate vision of a net zero future into tangible actions - by outlining concrete steps and milestones and by looking beyond the usual strategy horizon.

Companies should include transition plans in their broader strategy. In fact, they should be part of their risk management. Transition plans are not only about risks, but also about opportunities. Companies can show investors that they are ready for a net zero future. And financial institutions can benefit from transition plans, too.

They can use them to manage their own risk, but also assess whether a company is investable. That way, financial institutions can hold corporates to their commitments and enforce market discipline.

With these uses and benefits in mind, I very much welcome and highly appreciate the announcement made by US Secretary of the Treasury Janet Yellen[4]. Her presentation of the *Principles for Net Zero Financing & Investment* is an important step in the development of transition financing generally.

But even more so specifically: if you go straight to the very first principle, you will see that the US Treasury, too, recommends that:

For any voluntary net zero commitment to be credible, it should be accompanied by a net zero transition plan.

I could not agree more.

Looking ahead

Let me wrap up. Reducing uncertainty about climate change will help us to embrace the opportunities of the green transition.

In a decade or so, we will have realised: the green economy is just the economy. There can be no healthy economy without a healthy planet! ■

Sabine Mauderer is a Member of the Executive Board of the Deutsche Bundesbank

Endnotes

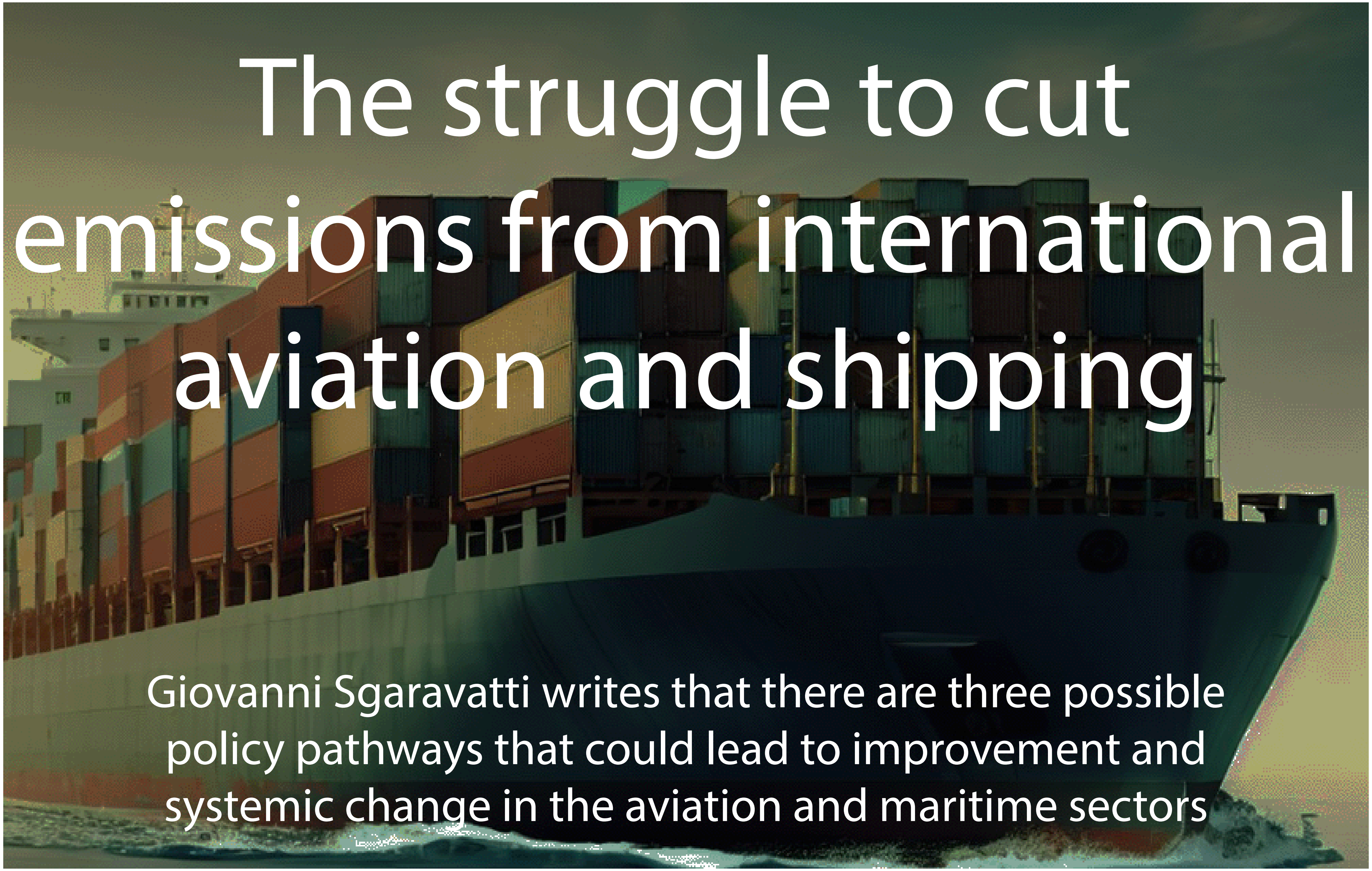
1. Network for Greening the Financial System: NGFS scenarios for central banks and supervisors, September 2022.

2. Climate Analytics: Climate impact explorer – Relative change in labour productivity due to heat stress in United States, based on NGFS scenarios.

3. Network for Greening the Financial System: Stocktake on Financial Institutions' Transition Plans and their Relevance to Micro-prudential Authorities, May 2023.

4. United States Department of the Treasury: Remarks by Secretary of the Treasury Janet L Yellen in New York on Treasury's Principles for Net-Zero Financing & Investment, 19 September 2023.

This article is based on a speech delivered at the MSCI Climate Week Conference "The climate transition: embracing opportunity & accelerating change", New York City, 20 September 2023.



The struggle to cut emissions from international aviation and shipping

Giovanni Sgaravatti writes that there are three possible policy pathways that could lead to improvement and systemic change in the aviation and maritime sectors

In combination, international aviation and shipping contribute about 3 percent of greenhouse gases put into the atmosphere each year. Emissions in 2022 from international aviation were 436 million tonnes of carbon dioxide equivalent, while from international shipping the figure was 706 Mt/CO_2eq – about the same as Germany (746 Mt of CO_2eq)[1]. If within-country emissions are also counted, the figures rise significantly[2].

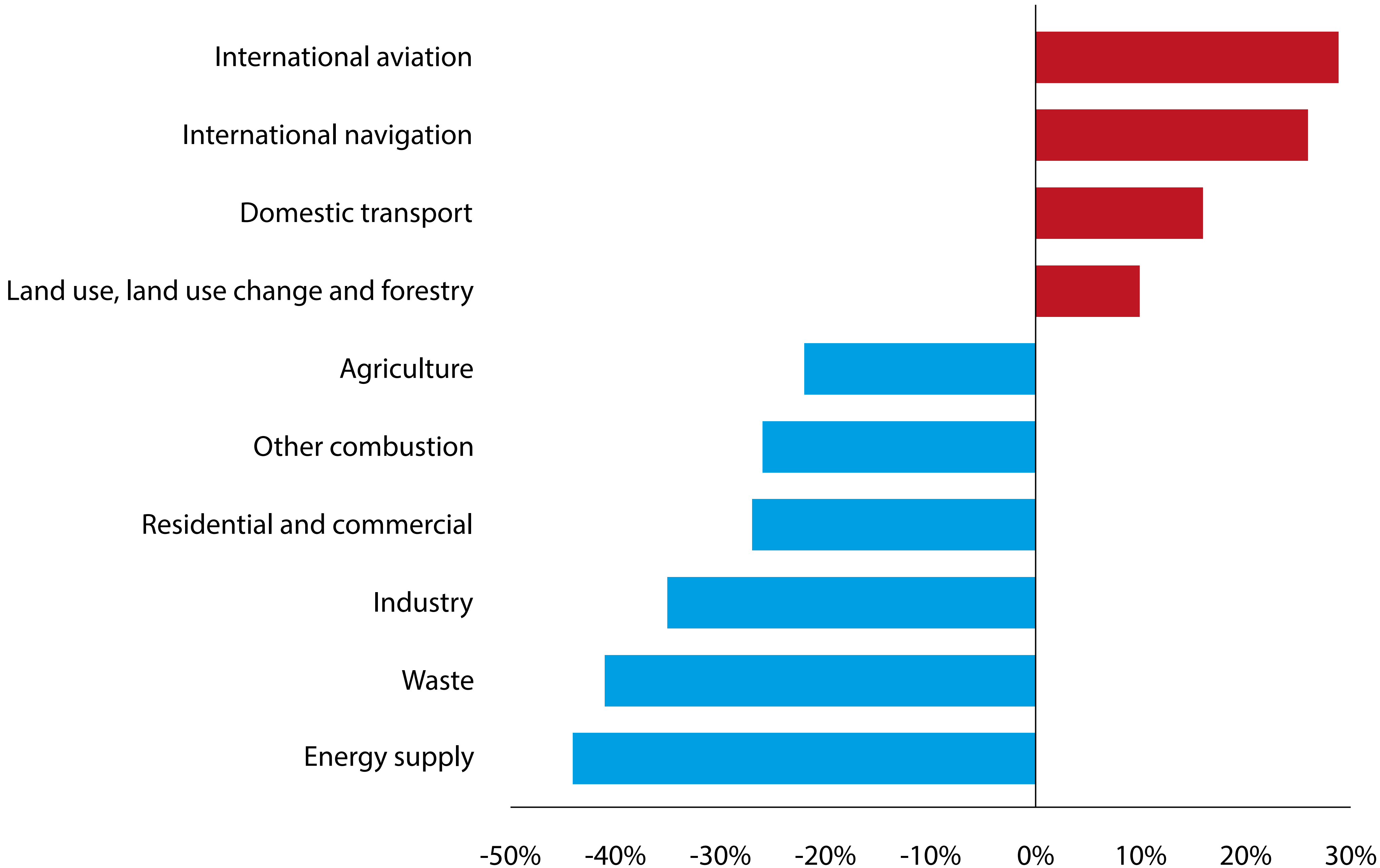
So far, there has been a persistent failure to reduce these emissions. In the European Union, where overall emissions have dropped by 30 percent since 1990, emissions from international aviation and shipping increased by more than in any other economic sector – by 29 percent and 26 percent respectively (Figure 1).

A fundamental obstacle in dealing with shipping and aviation is the labelling of much of their emissions as 'international' under United Nations Framework Convention on Climate Change (UNFCCC) reporting. This accounting feature, a legacy of the Kyoto Protocol, means governments have less of an incentive to decarbonise the two sectors. They are not obliged to include clear emissions reduction pathways for the international portion of aviation and shipping in their Nationally Determined Contributions (NDCs)[3].

Furthermore, as they operate across borders, they escape national carbon-pricing schemes. The current accounting model, combined with the lack of a global carbon price, makes it very hard to impose the polluter-pays principle on international aviation and shipping.

Aviation and shipping companies also receive special tax treatment. Neither sector pays value-added tax or excise duties on fuel (unlike the railway and road transport sectors). Their special tax status gives them a competitive advantage over other modes of transportation.

Figure 1. EU27 relative percentage change in greenhouse-gas emissions, 1990-2021



Note: Domestic transport includes the domestic share of emissions from aviation and navigation.
Source: European Environmental Agency.

This is particularly evident in aviation, where transporting passengers is five times more emissions-intensive than by train[4], but buying a flight in Europe is cheaper than the equivalent train ticket in 70 percent of instances (Doll *et al* 2020; Greenpeace, 2023).

Companies in the two sectors also tend to profit from low corporate taxes, as they have more freedom to register anywhere in the world than other types of businesses. In maritime shipping for example, the majority of companies are registered in jurisdictions such as Liberia and Panama[5], which have minimal corporate income tax rates[6] (McCow, 2023).

The EU already plays a fundamental role in shaping the debate and pushing climate action – a role that it is often under-appreciated – but there is scope to do even more in international aviation and shipping emissions

Recent developments and consensus building

Emissions reductions for international aviation and shipping are agreed internationally. On 7 July 2023, the International Maritime Organisation (IMO) agreed a new worldwide strategy on emission reduction targets for shipping (IMO, 2023).

For the first time, the agreement set targets for 2030 (an emissions reduction of between 20 percent and 30 percent compared to 2008) and 2040 (between 70 percent and 80 percent), with an overall goal of reaching net zero emissions by, or around, 2050. This represents a tremendous step forward compared to the IMO's 2018 strategy, which aimed to only halve emissions by 2050.

However, even the more ambitious targets fall short of putting the sector on a trajectory aligned with limiting global warming to 1.5°C above pre-industrial levels and would deplete the sector's 1.5°C carbon budget (12 gigatonnes of CO_2eq) by as early as 2032 (Bonello *et al* 2023; Comer and Carvalho, 2023[7]).

International aviation meanwhile has established the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) and has a 'Long-Term Global Aspirational Goal' of net zero emissions by 2050, agreed within the International Civil Aviation Organization (ICAO, 2022).

This represents a raising of the level of climate ambition for international aviation but is even less 1.5°C-aligned than the IMO deal as it does not provide any intermediary targets.

Setting distant aspirational goals with no clear pathway on how to achieve them risks depleting the sectoral carbon budget, as it incentivises delaying of investments and regulation needed to limit global warming.

A clear decarbonisation pathway is particularly important for these two sectors as ships and airplanes have long asset-replacement cycles, meaning that the emissions performance of ships and planes built now will be locked-in for decades.

Moreover, the new IMO and ICAO targets are not legally binding[8] and do not attribute specific emission-reduction goals to individual states, raising doubts about whether they will ever be achieved.

The European Union has taken some steps to bring aviation and shipping emissions within the scope of its climate laws. Intra-EU flights are covered by the EU emissions trading scheme (ETS)[9].

From January 2024 the EU will extend the ETS to cover CO_2 emissions from all large ships (of 5,000 gross tonnage and above) entering EU ports, regardless of the flag they carry. The system will gradually cover up to half of emissions from voyages starting or ending outside the EU and all of the emissions generated between two EU ports (European Commission, 2023).

The EU has also adopted laws setting limits on the carbon intensity of shipping fuels and promoting alternatives (the so-called FuelEU Maritime initiative) and is working to finalise a similar rule on aviation fuels (RefuelEU Aviation)[10].

The way forward

The frameworks under which international climate agreements work for aviation and maritime shipping thus remain inadequate. In this context, three possible policy pathways could lead to improvement.

First the UNFCCC should change its accounting method to allocate international emissions to the countries of departure and arrival of ships and planes. One option would be to split the emissions of the trips equally between the countries of departure and arrival, similar to what the EU does between its member states.

Second, new binding measures should be incorporated into international treaties, and the reach and scope of existing measures should be extended. For example, the IMO is working on a new GHG Fuel Standard on carbon intensity limits on fuels for ships, which has the potential to have a great impact in curbing emissions.

If incorporated in the International Convention for the Prevention of Pollution from Ships (MARPOL), it would also be legally binding.

Third, introducing compulsory minimum excise duties worldwide on the fossil fuels used by the two industries would represent a source of public revenues that could be used to finance climate action, and would be an incentive for the companies operating in aviation and maritime shipping to speed-up their transitions away from fossil fuels[11].

Otherwise, a climate tax on flight tickets similar to that envisaged in France[12] – with revenues invested in climate mitigation and adaptation policies – could be designed easily to be both progressive and climate friendly.

The EU is already in a leading position. The bloc should persist in its regional efforts to decarbonise the two sectors. Finding alliances with other countries or blocs might be a powerful and faster way to push for systemic change than waiting for concerted action at the UN.

More than 40 percent the global shipping fleet transits through the EU every year. For the EU plus the US, Japan, South Korea and Australia, the figure is 75 percent (Mingozzi *et al* 2022). Therefore, regional action can be the main driver of international change, as has already been seen with other EU rules on shipping that prompted adoption at the UN level[13].

For civil aviation, global manufacturing is dominated by two companies – Airbus and Boeing – registered in Europe and the US. An agreement on new production standards and alignment of targets and incentives for sustainable aviation fuels would be incredibly impactful on the global stage.

Stricter energy efficiency requirements applied to ship and airplane design and construction, engine technologies and operations[14] can also help reduce emissions.

Better incentives for companies to use sustainable fuels should be prioritised over carbon intensity target-setting. Carbon-intensity targets risk persuading companies to use only marginally less-polluting fuels (such as LNG for the shipping industry; Clark *et al* 2020), which would also result in stranded assets.

On international aviation, the first phase of ICAO's CORSIA carbon offsetting scheme ends in 2026. If by then the scheme proves to be insufficient, the EU should apply the ETS to all flights departing from or landing in its airports – in the same fashion as done for international shipping.

The EU tried this before, in 2012, but ultimately decided against it in the face of an unfavourable reaction from the US and other countries. Though doing so now will still be politically difficult, the international context is more favourable than in 2012 (as shown by the success in incorporating international shipping into the ETS).

The fact that alternative fuels for long-distance air travel are not yet available at scale cannot be a justification for failing to price the sector's externalities correctly. A price of €50/tonne of CO_2eq could increase the cost of a return ticket from Berlin to New York by about €100[15], or 16 percent of the average ticket price in economy class.

This would have the twofold effect of dissuading some international travel and raising about €3.5 billion per year in revenues[16], which could be channelled to scale up research into sustainable fuels.

The EU already plays a fundamental role in shaping the debate and pushing climate action – a role that it is often under-appreciated – but there is scope to do even more in international aviation and shipping emissions, especially through cooperation with the United States and other major allied economies. ■

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Endnotes

1. See International Energy Agency webpages on aviation and international shipping.

2. In 2018, total shipping and aviation each emitted about 1,000 Mt/CO_2eq, which combined exceed Russia's annual emissions (IMO, 2020).

3. NDCs are countries' self-defined national climate pledges under the Paris Agreement, detailing what they will do to help meet the global goal to limit the temperature rise to 1.5°C, adapt to climate impacts and ensure sufficient finance to support these efforts.

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6. John D McCown, '$34.7B Container Shipping Net In 4Q22', LinkedIn, 3 April 2023.

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‘Home-grown’ innovation has costs as well as benefits

The EU is insecure about its tech inferiority. Fiona Scott Morton and Cameron Steger argue that Europe can improve its innovation systems, but should not try to copy the US approach

Many European leaders express concern, or even dismay, that Europe is unable to launch and grow its own tech giants like those in the US[1]. This reflects European insecurity about tech inferiority that goes back at least as far as France's Plan Calcul in the 1960s.

Europe wants the benefits that large, innovative firms create for their home economies. These include high-skill employment, increased tax revenues and early adoption of new technologies. The rise of a single big tech firm may even contribute to the growth of an entrepreneurial ecosystem that spurs yet more home-grown innovation.

But the US style of innovation also has appreciable costs that European policymakers should weigh before their hand-wringing gets too vigorous. Articulating whether these costs are acceptable or not in Europe enables clear thinking about European policy reforms.

The steps US-based platforms need to take to achieve their huge size and market power create substantial costs for the home society. Very fast moving and lightly regulated US venture capital markets generate many frauds and failures. Elizabeth Holmes, founder of Theranos, a health-tech company[2], and Sam Bankman-Fried, founder of FTX Trading, a crypto exchange, are examples of these problems[3].

Financial frauds are not unique to the United States – Markus Braun of German payment provider Wirecard[4] comes to mind – but a funding system prizing rapidity, flexibility, early identification of trends and cult of personality is more vulnerable.

VC funding is flexible in part because it does not have to be based on fundamentals. Firms become popular because of word of mouth in the venture capital community of Silicon Valley or a short-lived technical trend, rather than solid fundamentals, are more likely to experience a downturn later (Pontikes and Barnett, 2016).

Even firms that have a solid value proposition may experience an adverse macroeconomic shock or technological change. When stock prices drop due to fads or fundamentals, startups are effectively required to lay off substantial fractions of their workforce with no warning.

Carefully crafting policies that promote homegrown innovation while reflecting European values is the best that can be done

Since the beginning of 2023, tech firms have laid off nearly 225,000 employees, with Google, Amazon, Microsoft and Meta collectively accounting for more than a quarter of these layoffs[5].

Burdens for workers

Quickly growing tech firms with young founders often hire rapidly without establishing proper human resource practices. Disproportionately often, managers are young, male, have no training in management and need to grow the firm quickly; this combination can result in employee harm.

Activision, a video game publisher, made headlines in 2021 for its 'frat bro' culture that facilitated sexual harassment and workplace discrimination toward women[6]. In 2022, Google agreed to a $118 million settlement in response to a class action lawsuit alleging that the tech giant systematically underpays female employees[7].

In September 2023, the US Equal Employment Opportunity Commission filed a lawsuit accusing Tesla of discriminating against Black employees, who are allegedly given worse assignments than white workers and fired if they complain[8].

The intense pressure to perform creates working conditions that are unacceptable for many. Since his 2022 acquisition of Twitter, Elon Musk has slashed the tech giant's staff by 80 percent and rolled back its work-from-home policy, with the expectation that the remaining employees work upwards of 84-hour weeks to compensate[9].

Long work hours are standard at Musk's companies, with SpaceX workers known to joke that a 60-hour week is working 'part-time'[10]. Silicon Valley tech firms are known to offer employees free meals and other benefits designed to keep them in the office for as long as possible.

Although benefits such as free meals may be innocuous, tech firms including Meta, Google, Netflix, Uber and Apple may even have begun covering the cost of elective egg freezing for employees to avoid the immediate costs of parental leave[11]. Many of the startup behaviours Americans view as normal – and which may be necessary to succeed – are not compatible with European norms or laws.

'Consumption costs'

As well as these 'production costs', the US model of innovation may have 'consumption costs' associated with being an innovation producer of this type. Citizens in a society that venerates these firms and their accomplishments may be the first users of the new technologies.

Meanwhile, the leadership of the jurisdiction may be slower to act to mitigate harms from a home-grown product. It is a well-known problem that the political power of corporations is often deployed against regulation that would limit their profits. Big tech platforms have spent large sums on US lobbying to ensure that effective regulations governing user health and safety, as well as market competition, are not adopted in their home country[12].

Often the benefits of a new digital technology are at least superficially clear: the services are convenient and 'free' to consumers. The risks to individuals and society can be harder to see at first, particularly if they arise from business models and market power that develop over time.

Instagram is now known to harm teenage girls' mental health, Facebook is alleged to have enabled genocide and vaccine denial while Twitter has permitted threats to the physical security of citizens[13]. Despite the growing evidence of harms from social media, regulators in the US have taken zero steps to make these services safer[14]. Europe, by contrast, has adopted the Digital Services Act which came into force in September 2023.

Consumption benefits

Of course, there are significant benefits to being the host country for innovation. These benefits, however, do not include investment opportunities and consumption opportunities, because global capital markets and trade allow people globally to participate in these aspects of big tech.

For example, many non-Americans own US corporations, both public and private. Consider the Norwegian or Saudi sovereign wealth funds, pension funds around the world, and wealthy individuals from every continent. Foreign investors owned approximately 40 percent of total US equity (Rosenthal and Burke, 2020). The Saudi sovereign wealth fund alone owns nearly $10 billion in US-listed stocks, including minority stakes in Boeing, Facebook and Citigroup[15].

Finally, the consumers of the innovation created by these American technology platforms are spread around the world. A company that physically started its existence in the United States can, because of the nature of digital technologies, benefit consumers anywhere.

The consumption benefits from technological innovation can be increased in Europe with carefully designed rules that protect citizens from the harms experienced in the US, and indeed the European Union has been quick to regulate the safety of new technology, through the General Data Protection Regulation, the Digital Services Act and other rules.

By controlling the environment so that individual and public health are protected by rules on product design and mis-information, businesses are protected from exploitation by platform conduct rules, and democracy is protected from degradation, Europeans can obtain a greater net benefit from consumption of digital innovation.

Policy implications

European politicians who want Europe to have its own digital platforms are missing a great deal of nuance. The costs of the US model seem inconsistent with European values as revealed through norms and regulations. This suggests that any attempt to copy the US in Europe will not work.

This leaves Europe with two basic options. The first is to outsource high-tech innovation to the US while benefiting from consumption, investment and access to the US labour market for talented Europeans.

Europeans can gain from allowing American society to shoulder the significant negative externalities of growing these tech firms, while European savers take advantage of the investment opportunities and European consumers take advantage of the innovations. Europe would not be free-riding because the US does not perceive itself as sacrificing for the common good when it innovates.

The better analogy is the gain from enjoying the view of your neighbour's garden when they are keen gardeners: they do not want your help, and yet you benefit.

The second option is to develop European policies that will solve specific problems faced by innovative firms that are trying to start up and grow quickly. Policies that acknowledge and manage the riskiness of innovative firms would be helpful. If a young firm fails (even in a case when there has been no misbehaviour of management) it is efficient to shut down the firm.

Moreover, investors will be less inclined to invest if they are required to pay workers after the firm no longer has a reason to exist. If labour- market regulations in Europe remove all flexibility, Europe will not be a good location to build a risky venture that requires human capital.

Policymakers who want innovation but dislike it when employment costs are borne by workers should consider whether there is an incentive-compatible policy that allows society to bear some of these costs in return for the benefits of hosting the innovative company.

Policies that permit immigration of talented entrepreneurs are another area to consider. The leadership of many American digital platforms is often in the hands of immigrants. A 2018 study found that 55 percent of America's startups valued at or above $1 billion had at least one immigrant co-founder, and that immigrants were key members of management or product development teams in 80 percent of those startups (Anderson, 2018). For every Jeff Bezos and Mark Zuckerberg, there is a Pierre Omidyar, Sergey Brin, Sundar Pichai or Elon Musk[16].

Regulations that protect incumbents from market entry by disruptive startups can slow growth or block it entirely. Rent-seeking incumbents often lobby hard to create and then maintain such barriers to entry (Mukoyama and Popov, 2014).

US regulators generally did not block Uber from entering to compete with taxis while many cities in Europe did[17]. The nuanced middle ground that would have benefited consumers in both jurisdictions would harmonise regulatory requirements of the two business models, enable part-time work, protect workers and ensure sufficient capacity to meet consumer demand.

Europeans would benefit greatly if Europe's politicians developed their own distinctive model of growing innovative firms. European policymakers who want innovation at home could improve the innovative capacity of the single market in ways consistent with European social norms and laws.

Options include improvements to education, creation of straightforward paths to citizenship for talented entrepreneurs, reform of labour markets to allow for the practical needs of risky startups, progress towards a more unified capital market and, perhaps most importantly, reductions in regulatory barriers to entry. These types of reforms would significantly improve the innovative climate in Europe and likely lead to more home-grown tech companies.

However, jurisdictions that are willing to accept more harms are likely to attract more harm-creating startups. This may be a very effective strategy for generating innovation in those countries, and it may lead to them out-innovate Europe or any other jurisdiction that better protects workers and citizens.

But if a difference in innovation production reflects a conscious choice on the part of European society in terms of the way it implements its values, then there is no problem to solve. Europe will not have 'lost' against the US or China, despite what politicians may say. Carefully crafting policies that promote homegrown innovation while reflecting European values is the best that can be done. ■

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Endnotes

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Outlook for the euro area economy and financial stability

Luis de Guindos provides an overview of the euro area economy, and argues that it is vital to reform the EU's economic governance framework in order to anchor expectations and support fiscal discipline

I will begin by providing an overview of the euro area economic outlook that underpinned the Governing Council's deliberations and the monetary policy decisions we took in October. I will then discuss how we see the risks to financial stability and related macroprudential policy issues.

Euro area economic outlook

Last year inflation was at historically high levels, both in the euro area and around the world, and growth was slowing following the post-pandemic rebound. Today, inflation is significantly lower, but it is still expected to stay too high for too long.

At the same time, the growth outlook for the euro area economy has deteriorated further, as global growth momentum slows and tighter financing conditions are increasingly weighing on investment and consumer spending.

In the third quarter of this year real GDP declined by 0.1% quarter on quarter. There are signs that manufacturing output remains firmly in contractionary territory, while the services sector has weakened further. Weaker industrial activity is spilling over to services, the impetus from reopening effects is fading and the impact of higher interest rates is broadening.

It is likely that the euro area economy will remain subdued in the near term. However, it looks set to strengthen again over the medium term, as inflation falls further, household real incomes recover and the demand for euro area exports picks up.

Inflation, which has been on a downward trajectory over the last 12 months, dropped markedly in both September and October. It now stands at 2.9%, according to Eurostat's flash estimate. The decline, which was in part due to strong base effects, was broad-based, reflecting a drop in energy prices and falling food, goods and services inflation.

We expect a temporary rebound in inflation in the coming months as the base effects from the sharp increase in energy and food prices in autumn 2022 drop out of the year-on-year calculation. But we see the general disinflationary process continuing over the medium term.

Further tightening is still in the pipeline from the current policy stance, and it is set to further dampen demand and help push down inflation

Energy prices remain a major source of uncertainty amid heightened geopolitical tensions and the impact of fiscal measures. The same is true for food prices, which may also come under upward pressure owing to adverse weather events and the unfolding climate crisis more broadly.

Most measures of underlying inflation continue to decline. The Eurostat's flash estimate for inflation excluding energy and food points to a further decline to 4.2 % in October, supported by improving supply conditions, the pass-through of previous declines in energy prices, as well as the impact of tighter monetary policy on demand and corporate pricing power.

At the same time, domestic price pressures are still strong and are being increasingly driven by wage pressures and the evolution of profit margins. While most measures of longer-term inflation expectations stand around 2 %, some indicators remain elevated and need to be monitored closely.

The resilience of the labour market has been a bright spot for the euro area economy, but there are signs that the labour market is beginning to weaken. Fewer new jobs are being created and, according to the latest flash estimate, employment expectations have continued to decline in October for both services and manufacturing.

Monetary policy

Based on our assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, the Governing Council decided to keep the three key ECB interest rates unchanged at its October meeting.

The incoming information has broadly confirmed our previous assessment of the medium-term inflation outlook. Our past interest rate increases continue to be transmitted forcefully into financial and monetary conditions. Banks' funding costs have continued to rise and are being passed on to businesses and households.

The combination of higher borrowing rates and weakening activity led to a further sharp drop in credit demand in the third quarter of this year. And credit standards have tightened again. We are also seeing increasing signs of the impact of our policy decisions on the real economy.

Further tightening is still in the pipeline from the current policy stance, and it is set to further dampen demand and help push down inflation.

We are determined to ensure that inflation returns to our 2% medium-term target in a timely manner. Based on our current assessment, we consider that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

Financial stability

Let me now turn to financial stability. In our upcoming Financial Stability Review, we highlight that the financial stability outlook remains fragile as the gradual effects of tighter financial conditions on both the financial and non-financial sectors take hold.

These concerns are heightened by the recent upward shift in bond yields owing to the global 'higher-for-longer' narrative and the flare-up of tensions in the Middle East, which have added to the uncertainty surrounding the outlook.

After a period of lower market volatility until August, the rising prospect of higher-for-longer rates has started to weigh on riskier asset valuations in recent months. Risk sentiment in markets remains highly sensitive to further surprises in inflation and economic growth. Higher than expected inflation or lower growth could trigger a rise in market volatility and risk premia, increasing the likelihood of credit events materialising.

This brings me to the vulnerabilities in the non-bank financial sector. As regards credit risk, some non-banks remain heavily exposed to interest rate-sensitive sectors, such as highly indebted corporates and real estate. Deteriorating corporate fundamentals and the ongoing correction in real estate markets could expose non-banks that have invested in these sectors to revaluation losses and investor outflows.

Furthermore, low levels of liquidity could expose investment funds to the potential risk of forced asset sales if macro-financial outcomes deteriorate.

Corporate profitability in the euro area has held up well, but higher interest rates are weighing on the debt servicing capacity of more vulnerable firms. A weakening economy could prove challenging for firms with high debt levels, subdued earnings and low interest coverage ratios.

Real estate firms are particularly vulnerable to losses stemming from the ongoing downturn in euro area commercial real estate markets. In an environment of tighter financing conditions and elevated uncertainty, real estate prices have declined markedly.

The effects of higher interest rates have been compounded by structurally lower demand for some real estate assets following the pandemic. Although banks' exposure to these markets is comparatively low, losses in this segment could act as an amplifying factor in the event of a wider shock.

Euro area households, especially those with lower incomes and in countries with mainly floating-rate mortgages, are being increasingly squeezed by the higher interest rates. Tighter financing conditions have reduced the demand for housing, putting downward pressure on prices. On a more positive note, robust labour markets have so far supported household balance sheets, thereby mitigating the credit risk to banks.

Spreads in government bond markets have remained contained as many governments managed to secure cheap financing at longer maturities during the period of low interest rates. However, higher funding costs and less prudent fiscal policies could reignite concerns around sovereign debt sustainability, particularly in countries where debt levels are already high.

The euro area banking system has been a source of resilience in this turbulent year. Banks' capital and liquidity buffers remain strong, and profitability has further improved in recent quarters on the back of higher interest rates.

Despite these strong fundamentals, it is striking just how compressed bank valuations remain. This seems to reflect lingering concerns about the long-term sustainability of bank earnings, as they face increased downside risks from the prospect of deteriorating asset quality, lower lending volumes and higher funding costs.

While asset quality indicators have been robust over the last year, early signs of deterioration are becoming visible – particularly in smaller firms and some sectors like commercial real estate.

Conclusion

Since the start of our hiking cycle, we have increased our policy rates by a cumulative 450 basis points. Our restrictive policy stance continues to be transmitted forcefully into financing conditions and is increasingly affecting the real economy. Inflation has come down markedly but is still expected to stay too high for too long, and domestic price pressures remain strong. We will therefore ensure that our policy rates will be set at sufficiently restrictive levels for as long as necessary.

In view of the prevailing elevated uncertainty, our future decisions on policy rates will continue to be data dependent and taken on a meeting-by-meeting basis. At our December meeting, we will have a new set of macroeconomic projections and more data on actual and underlying inflation, economic activity and the state of transmission, so we will be in a better position to reassess the inflation outlook and required policy action.

A resilient and well-functioning financial system is essential for the smooth transmission of monetary policy that is required to achieve our goal. To this end, macroprudential authorities should preserve releasable capital buffers to ensure that they are available in the event that conditions in the banking sector deteriorate.

Furthermore, the lessons learnt from the turmoil this spring underline the need to implement outstanding Basel III reforms and complete the banking union, while previous market shocks confirm the need to boost the resilience of the non-bank financial sector by strengthening the policy framework for non-banks in an internationally coordinated manner.

Prudent and investment-oriented fiscal policies are also very supportive of our price stability goal. Fiscal policy should be geared towards making the euro area economy more productive and gradually bringing down high public debt.

Structural reforms to enhance the euro area's supply capacity can help reduce price pressures in the medium term. It is therefore vital that the reform of the EU's economic governance framework is concluded, in order to anchor expectations and support fiscal discipline. ■

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The European economic outlook and policymaking

Laura Papi argues that seeing off inflation and pivoting to longer-term reforms have important implications for the trajectory of inflation, competitiveness, and growth in the future

I will discuss the outlook for Europe and how we see the risks. Inflation, implications of the geoeconomic fragmentation, and the green transition will be particular areas of focus. I will discuss key policies for securing low inflation and forging a path of higher long-term growth.

Progress has been made in taming inflation and the likelihood of a soft landing has increased, both globally and in Europe. But downside risks are significant. Policymakers face the risk of persistent and more volatile inflation. We now live in a more shock prone world.

And the longstanding slowdown in productivity growth, the geoeconomic fragmentation and the challenges of the green transition cast doubt on whether European economies can return to the pre-pandemic growth trajectory.

These competing challenges and a highly uncertain outlook will test policymakers in Europe. Let me start with the European outlook.

Outlook and near-term challenges

At first glance, the European economy seems to be approaching a relatively benign moment. The IMF's baseline forecast anticipates a continued moderation of inflation in Europe and—contrary to initial expectations of recession—modest growth in 2023 and a slight recovery in 2024.

We expect that for Europe as a whole 2023 growth will be 1.3% (2,7 in 2022), picking up to 1.5% next year. Advanced economies are expected to go from 0.7% to 1.2%, while Emerging European Economies are expected to have a sharper recovery from about 1 to about 3%.

Aided by easing commodity prices and supply constraints, monetary tightening has cooled headline inflation, providing support to real wages. In most EU countries, the tightening cycle has peaked, with the prospect of an approaching soft landing as growth this year slows but remains in positive territory.

It is critical not to loosen policies prematurely in response to what may be temporary declines in inflation

However, there are divergencies across European countries: energy-intensive and manufacturing-oriented economies, such as Germany and Hungary, are performing less well. And downside risks continue to prevail everywhere.

Headline inflation is falling, but is not expected to return to target until 2025 in many countries, for some even 2026. Core inflation has been persistently high in many European economies, especially in services. Nominal wages are growing rapidly, outpacing inflation in some economies, especially in Eastern Europe.

As the pandemic and Russia's war in Ukraine hit European economies, in only 2 years prices increased by 25 percent, as much as over the 5 years following the global financial crisis. In Hungary, inflation reached 25 percent at end-2022, and prices have increased by 41 percent cumulatively from end-2020 to August 2023. This rapid and massive price shock eroded workers' purchasing power and left a large real wage gap.

Hence, some wage catch up is reasonable and to be expected. However, we have some concerns. We have decomposed wage growth into inflation expectations and wage catch up in green, the unemployment gap in red, productivity growth in yellow, and in grey other, that is wage growth in excess of what is to be expected from the factors I just mentioned, which as you can see is growing especially in Central, Eastern, and South-Eastern Europe, CESEE.

The risk is that wage pressures could translate into additional inflation pressures, especially where wage setting is backward-looking, as is the case in many European emerging markets, and hence harm competitiveness.

New IMF research, in our recent *World Economic Outlook*, also shows that near-term inflation may play a greater role in setting long-term inflation expectations than previously thought. Near-term expectations, in turn, are influenced to a large extent by backward-looking agents, particularly in emerging market economies where such agents are more prevalent. There is also evidence that the pass-through from inflation expectations to inflation tends to be higher when inflation is high.

The strength of the labour market is fundamentally good news. Vacancy to unemployment ratios stand at record highs and unemployment rates at record lows in most of Europe. But all of this means additional upward nominal wage pressures are likely and the possibility of a wage-price spiral exists.

Let me be clear: we don't see wage-price spirals likely in advanced European economies, but the risk in Eastern Europe is not negligible.

Another driver of high inflation has been firms' profits. In many countries, in the last couple of years, firms have passed on more than the increase in input prices to consumers. In CESEE too we saw an increase in profits, which have started to fall.

Going forward, this is positive in the sense that firms could absorb some wage increases by lower profits. But there is no guarantee that this will continue. In sum, all of these forces put together suggest that we may be experiencing a period of especially sticky price and wage pressures.

Besides the more cyclical factors that I have just discussed, there are some additional risk factors for inflation, which are more structural in nature.

Take geoeconomic fragmentation. We have already experienced big shocks from fragmentation, especially Russia's war in Ukraine. We could see additional commodity price spikes that feed through to core inflation. More generally greater fragmentation brings more trade restrictions and disruptions of supply chains, continuing to generate negative supply shocks, which will be inflationary.

The pre-pandemic view was that central banks could generally ignore supply shocks as these were believed to be mostly transient. But the pandemic and war in Ukraine have highlighted how supply shocks can have broad and persistent inflation effects.

Medium-term challenges

Let me turn to the medium- and long-term challenges. Europe's medium-term growth prospects have been declining for some time. Since the 2008 global financial crisis, per capita growth has fallen and we expect growth to remain weak over the medium term.

The pandemic and the energy crisis have resulted in significant scarring to the level of output. And this comes at a time when countries also grapple with the structural shifts from fragmentation, climate and technological change, and demographic pressures.

Fragmentation is a particularly potent economic challenge. The increasing trade restrictions and reconfiguration of supply chains, besides raising production costs, can further dampen Europe's weak productivity growth.

The economic costs of fragmentation are likely to be substantial. While estimates vary, greater international trade restrictions could reduce global economic output by up to 7 percent over the long term, or some $7 trillion in today's dollars—equivalent to the combined size of the French and German economies.

If technological decoupling is added to the mix, some countries could see losses of up to 12 percent of GDP. And looking just at commodities trade, the IMF estimates that segmentation in the trade of these critical inputs could erase 2 percent from global GDP and up to 3.5 percent from that of emerging Europe.

While reshoring or near-shoring some aspects of production may also present some opportunities to some countries, these are only available if cost competitiveness is preserved, especially on wages.

But let me be clear: economic fragmentation is a negative sum game for the world as a whole.

Climate change is another major challenge. European countries, like other parts of the globe, are experiencing rapid temperature rises and greater frequency of natural disasters, underscoring the urgency of transitioning to a greener and more climate resilient economy.

The green transition holds the promise of being an engine of growth accompanied by greater sustainability and resilience and is one of the key imperatives of our times.

In the short term, though, this may entail significant adjustment costs and benefits spread unevenly across countries, firms, and people. The effects on prices and growth could be uncertain in the short to medium term, depending on how well managed and orderly the adjustment.

Take the auto sector, so important for several countries in Europe including Hungary. IMF research shows that the transition to electric vehicles is already negatively affecting employment in sectors and regions focused on internal combustion engine vehicle production.

We are likely to see disruptions in the extensive regional value chains that have been built around supplying the auto industry, which employs 7 percent of the European workforce. This highlights the need to facilitate the relocation of factors of production across sectors. This transition will have implications for employment, investment, and public policy as countries have to reorient worker training and investment, including in new infrastructure.

Finally, Europe confronts labour supply constraints due to demographics, and capital stocks in emerging Europe are still low.

Policies

I realize that I have laid out a sobering list of near- and long-term challenges. So, what to do about all this? First, it is critical not to loosen policies prematurely in response to what may be temporary declines in inflation.

In a recent IMF paper, we have looked at 100 inflation shocks and we have seen that in many cases, policies were eased too soon, and inflation reaccelerated: here are some examples of premature celebrations, but there are many more. Fund research also shows that countries that resolved inflation episodes experienced lower growth in the short term, but not over the medium term.

Naturally, the level and duration of tightness in the monetary policy stance should be calibrated to country specific conditions. This may mean that some central banks keep rates at current levels for some time while others may have to raise them further.

While many emerging economies started raising policy rates already in 2021 and by substantial amounts, real rates have remained below the neutral level in some countries. Hungary has now one of the highest real policy rate in Europe.

Given the high cost of erring on the side of monetary policy being too loose, the empirical case for a less contractionary stance should be compelling. Monetary policy should remain restrictive until there is clear evidence of a substantial improvement in the core inflation forecast; a reduction of upward inflation risks which hinges mainly on labour market developments; and the absence of upward movements in inflation expectations. These conditions have not been met in most countries.

The key message is that fighting inflation is difficult in the short-term but pays off later, while delaying the day of reckoning ultimately requires a higher sacrifice in future growth and employment.

In emerging markets, in particular, bringing down inflation once it gets sticky can be very costly and high inflation creates competitiveness problems that EMs can ill afford. Short-term pain for long-term gain.

Second and turning to fiscal policy, our strong recommendation is that all countries step up their efforts to rebuild fiscal buffers while protecting the vulnerable. This means consolidation, starting now and especially in high-debt and high deficit countries. By reducing deficits, fiscal consolidation will complement monetary policy in the fight against inflation. Importantly, it will re-build fiscal space for future shocks and for productivity-enhancing investments, including in green infrastructure, and to face the critical transitions that we are experiencing.

In many emerging economies, there is significant room to mobilize resources and to achieve greater expenditure efficiency through better targeting and better spending prioritization. In many countries, there are opportunities to eliminate tax leakages, exemptions, and inefficiencies.

IMF research shows that the potential for revenue mobilization by increasing tax efficiency in emerging European economies is as high as 2 percent of GDP, on average. Many countries still have costly and counter-productive energy subsidies, which run counter to the green transition and reduce energy security, which need to be eliminated.

Support can be given in a targeted way at a fraction of the current cost. And with high yields globally, governments should be even more rigorous in their prioritization of public spending and not leave money on the table on the tax front.

Third, structural policies remain crucial for achieving strong, sustainable, and more evenly distributed growth. With greater prevalence of supply shocks, constrained policy space, and big transitions under way requiring large reallocation of factors of production, policies that can stimulate the supply side and facilitate the necessary adjustments have to take centre stage.

Country needs vary and reforms need to be tailored to the specific institutions and initial conditions, but there are some common priorities.

- Removing barriers that stand in the way of economic innovation and business dynamism. A strengthened business environment with policies that encourage investment and R&D spending will enhance productivity and competitiveness.

- Measures to improve worker training and skills, as well as active labor market policies, will be particularly important to facilitate the green and digital transitions without generating employment losses and to meet the needs of the new economy.

- Boosting labour participation will help counter demographic trends and can relieve the tightness in labour markets and help ease inflation pressures.

In emerging European economies, the need to get structural policies right is particularly important given the urgency of reaccelerating income convergence. To attract inward investment countries should ensure business-friendly environments by strengthening public governance, enhancing skills and infrastructure.

In addition, investing in human capital to align education, health, and social protection outcomes with those of advanced economies can help stem the excess flow of emigration.

To address geoeconomic fragmentation, some countries have introduced industrial policies to encourage the establishment of critical industries or to produce key inputs at home citing national security or just reshoring.

Industrial policies have a role to play in addressing market failures and externalities, such as in the provision of critical infrastructure or in supporting basic research, an under-provisioned public good by the private sector.

But they need to be deployed only narrowly and with care. Costly subsidy races and the use of distortionary tariffs must be avoided, and policies should be coordinated at the multilateral level to avoid beggar-thy-neighbour outcomes.

For the EU, focusing on completing the single market—completing the single services market, the banking union, and the capital markets union—is absolutely vital. Green subsidies should maintain the integrity of the EU's Single Market and follow a common EU approach. Together with the implementation of the Recovery and Resilience Plans, there reforms are critical to boost the EU's productivity and competitiveness.

Energy importers should continue to seek to diversify suppliers to avoid the consequences of overdependence on a single source.

International collaboration on climate change, including a global carbon price floor, will reduce emissions and complement domestic policies. The recently published IMF fiscal monitor proposes a practical mix of policies that are feasible and would achieve the climate goals, including also feebates, green subsidies, and regulation standards, combined with transfers to vulnerable workers.

Conclusion

I realize that these challenges, and the proposed solutions, seem daunting. But every journey starts with a single step. The policies that governments put in place today have important implications for the trajectory of inflation, competitiveness, and growth in the future.

The good news is that tackling inflation now will strengthen resilience and help to buttress competitiveness in the long term. As inflation is brought under control and fiscal space is rebuilt, European policymakers will be able to seize the opportunities posed by big transitions rather than being a casualty of these structural shifts.

Structural policies that help boost supply, including those at the EU level, ultimately will be the only way of boosting growth and will also alleviate some of the structural inflation pressures.

And all this in turn will play an important role in raising regional growth and in helping emerging economies like Hungary to converge with Europe's advanced economies.

The IMF remains deeply committed to the region and will continue to support our member countries to foster macroeconomic stability and higher living standards. ■

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EU-wide investment conditional on adherence to fiscal-structural plans

Age Bakker and Roel Beetsma provide concrete suggestions for the financial design and enforcement of an EU-wide investment fund

In April 2023 the European Commission issued a concrete legislative proposal for the much-needed revision of the Stability and Growth Pact (SGP)[1, 2]. The fiscal rules have effectively been inoperative since the Commission announced in March 2020 (in the wake of the pandemic) the activation of the severe economic downturn clause – in the public debate commonly called the 'general escape clause'[3].

The key objectives of the Commission proposals are a strengthened debt sustainability framework and the promotion of sustainable and inclusive growth through reforms and investments. These objectives should be achieved by focusing on medium-term fiscal performance, gradual and credible debt reduction, more national ownership, better enforcement, and simplification of the rules.

Based on a debt sustainability analysis, the Commission will provide 'technical trajectories' for member states that violate one or both reference values of 3% and 60% for the deficit and debt ratio, respectively.

With the technical trajectory as a starting point, countries may negotiate a four-year fiscal adjustment plan with the Commission. The adjustment period may be extended to seven years based on adequate reform and investment plans, provided the public debt ratio remains on a 'plausibly downward' path, or stays at a prudent level, and the deficit remains below the 3% reference value.

A number of safeguards are added, such as an annual minimum adjustment of 0.5% of GDP when the deficit exceeds 3% and a debt ratio below the initial one at the end of the adjustment period. A major innovation is that the adjustment path stipulates a path for net primary expenditure[4]. There will be no technical trajectories for countries with debt below 60% and a deficit of less than 3%.

Finally, enforcement of the SGP, which has been weak so far, is supposed to be strengthened by reducing the financial penalty associated with violation of the rules, so the relevant actors should have less reason to shy back from imposing sanctions. A larger degree of national ownership by governments for their own plans and a strengthened supervisory role for the national independent fiscal institutions (IFIs), would raise the reputational damage of not meeting the criteria.

The described fund, which is kept outside the regular multiannual financial framework, would be a follow-up to NextGenerationEU, but with a much stronger focus on European public goods

We agree that the new proposal, in particular by requiring a gradual reduction of debt over the medium term, stands a higher chance of achieving debt sustainability than the SGP rule book. In particular, the 1/20th rule, which would demand historically unprecedented primary surpluses from a number of countries, has been unrealistic, which has undermined the credibility of the SGP[5].

Still, the question remains whether the Commission is not unduly optimistic about improved enforcement, especially as adjustment periods longer than four years exceed the customary political cycle. In 2016, it proved impossible to impose even symbolic non-pecuniary sanctions on Spain and Portugal.

Governments are loath to assign a greater role to the national independent fiscal institutions. The role of these institutions is to be critical about policies and, hence, they are often seen as a nuisance by governments. Ministries of finance, in particular, see them as questioning their assumptions or redoing their work.

In view of a long history of transgressions of the rules followed by non-enforcement, enforcement through financial punishment cannot be taken for granted under the revised rules. Therefore, some countries, such as Germany, want stronger safeguards, such as a guarantee that debt at the end of the adjustment period is below the initial debt and an annual minimum debt reduction requirement.

Indeed, only recently, supposedly well-aware of the fact that the escape clause will expire by the end of this year and Excessive Deficit Procedures may be opened again, the Italian government proposed a stimulus package of €24 billion for 2024, on top of a projected deficit of over 4%[6].

If financial sanctions are uncertain to work, what else would? We propose to introduce positive incentives for improved compliance and enforcement[7]. The experience with the Recovery and Resilience Facility of NextGenerationEU may provide guidance.

Countries have designed reform and investment plans and receive funding conditional on achieving certain milestones. Although the process does not work perfectly (plans are too piecemeal and funding is disbursed despite imperfect adherence), the overall experience is considered as reasonably satisfactory.

It may be worthwhile to expand and improve on the experiences so far of NextGenerationEU and provide for a mechanism in which countries, instead of being penalised for non-adherence, are rewarded for good behaviour.

Therefore, we propose to set up an EU fund for European public goods, ie. public investments that benefit more than one country or even the entire EU, and from which (groups of) countries can get funding if they adhere to the agreed fiscal-structural plans. The purpose of EU public goods would have to be well-defined and may encompass, for example, climate and digital transitions as well as EU-wide infrastructure.

The fund serves two purposes: providing an incentive to improve debt sustainability and stimulating investments that are much needed (eg. Beetsma *et al* 2020, Larch *et al* 2022), but that otherwise would not come about, because they are too large for individual countries and insufficiently worthwhile at the individual country level, because the benefits accrue to other countries as well.

Examples of such investments are high-speed railways, increases in the capacity of electricity grids, hydrogen infrastructure, and water management. In particular, the investments fulfil the requirements underlying the extended adjustment path from four to seven years: growth enhancing, supporting fiscal sustainability (by raising potential growth and incentivising fiscal discipline), and addressing common EU priorities, such as the Green Deal.

How could this exactly work? Having committed to their fiscal-structural trajectory (combinations of) countries submit sufficiently detailed plans for investments with a 'public good character'. The Commission itself may also propose EU-wide investment projects which would be subordinate to the same requirements for national disbursement.

The investment plans may also form part of the bid to extend the adjustment period to seven years. They contain a set of concrete milestones with associated funding needs for each next stage. At each milestone, those partners that have stuck to their fiscal-structural plan and to the investment plan itself, get the financing (or part of it) of the previous stage reimbursed from the fund. Hence, financing from the fund takes place afterwards, in order to strengthen the incentives for good behaviour.

A crucial role in the process will be for an independent assessor of the investment plans and their execution. This would need to be done by an EU-IFI, which looks in detail at the investment case itself: can a sufficiently large positive net present value be demonstrated for the project? Can sufficiently large international spill-over benefits be demonstrated? Does each country have sufficient skin in the game, ie. is there sufficient co-financing at each stage?

Finally, after each milestone the EU-IFI assesses whether the project has been executed according to plan and whether partners have adhered to their fiscal-structural plan. In line with standard governance rules, the EU-IFI draws up a publicly available report at the start and at each stage of the project with its assessment and recommendation for the European Commission. The Commission then formulates its own recommendation to the ECOFIN, which then takes a decision.

The financial design of the fund could be as follows. Countries have envelopes within the fund based on the size of their economy and draw at a maximum the size of their envelope (eg. European Fiscal Board 2022). The financial resources of the fund would need to be sizeable in order to provide sufficient incentives for good behaviour.

The design of the fund sees to it that disbursement would only come about when fiscal-structural plans are adhered to. This helps avoid that European expenditures are simply piled upon national expenditures. If they do not use the financial resources within a prespecified period of time, because they have no eligible plans or because they have not fulfilled the EU budgetary criteria, the remainder of their envelope will be re-allocated to the other envelopes.

The resources withdrawn from the fund can be financed by issuance of EU debt, similar to the financing of NextGenerationEU's Recovery and Resilience Plans. Debt only needs to be issued at the moment resources are withdrawn. Obviously, countries need to commit to their share of the debt-servicing costs[8].

That share is based on a fixed repayment key, independent of the extent to which a country has made use of its envelope. Hence, the fixed key incentivises each country to come up with suitable investment proposals. The incentive is strengthened further by the reallocation of any unused funds over the other envelopes.

In this column, we have described a fund for investments with multinational spillovers to which countries have access if they adhere to their budgetary plans. We also believe this is politically feasible.

The described fund, which is kept outside the regular multiannual financial framework, would be a follow-up to NextGenerationEU, but with a much stronger focus on European public goods.

Admittedly, NextGenerationEU was meant to be temporary, but in the meantime the urgency to formulate a European response to the changed global economic power structures has increased significantly. An EU-wide investment fund, financed by borrowing as was NextGenerationEU, would serve this purpose as national public finances, strained by rising interest rates, are not up the task.

The fund would have as additional advantage that investments would be safeguarded from the need of fiscal adjustment, because needed expenditure cuts to stay on the trajectory would not affect investments financed under the EU investment plan. In this way these investments are protected against political opportunism.

This construction simultaneously serves two possible objectives: promote debt sustainability and promote growth-enhancing and climate-benefitting investments that would not materialise, otherwise. It would have a stabilising effect due to the positive effect on potential growth and the budgetary discipline that is enforced at the same time.

Therefore, moving towards fulfilling both objectives will help to alleviate the burden on the ECB as fiscal restraint and higher growth both promote debt sustainability, thereby reducing the chance that the ECB will be confronted with a trade-off between achieving its monetary policy objectives and averting a financial crisis. ■

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Endnotes

1. The full package consists of a new regulation for the preventive arm of the Stability and Growth Pact (repealing EC No1466/97), an amended Regulation EC No 1467/97 of the corrective arm and an amended Council Directive 2011/185/EU. See European Commission (2022, 2023a, 2023b).

2. The proposal for a legislative reform was preceded by a communication by the European Commission (2022) with broad orientations for a possible reform. It was received with mixed approval. Blanchard et al (2022), Micossi (2023), and Wyplosz (2022) voiced some criticism, while Buti et al (2023) defended the proposals.

3. The clause has been extended in light of the conflict in Ukraine but will be deactivated in 2024.

4. Nationally financed primary expenditure is defined as expenditure net of discretionary revenue measures and excluding interest expenditure as well as cyclical unemployment expenditure. Deviations from this path will flow into a control account, of which the parameters have not been specified so far.

5. European Fiscal Board (2020, Chapter 5) pictures the required primary surpluses to bring debt down from 150% to 60% according to the 1/20th rule under different macroeconomic assumptions. Such high primary surpluses have historically been rarely achieved, let alone over a sufficiently long period, as shown by Eichengreen and Panizza (2014).

6. Italy's most fundamental problem is its low potential growth. The envisaged measures, such as tax reductions, reductions in pension contributions, increases in public salaries, and indexation in pensions, may help to stimulate consumption, but will do little to solve the low potential growth problem.

7. The Council of State of the Netherlands (2017) has suggested to introduce positive incentives by linking compliance with fiscal rules to financial support for structural reforms and access to structural and cohesion funds and a stability fund.

8. It is crucial that the additional debt-servicing burden associated with the fund does not endanger a country's debt sustainability. For this reason, the conditional disbursement should discourage fiscal profligacy. It is reasonable to argue, though, that much of the investment financed from the fund would have to be made in any case, for example for successful green and digital transitions.

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Talking about competitiveness in Europe: productivity not protection

The European Commission put EU competitiveness at the top of the agenda. Filippo di Mauro and Marco Matani argue that productivity, financial soundness, and quality orientation are the most important factors

Ursula von der Leyen has put competitiveness in Europe at the top of the economic agenda with her latest State of the Union address. And rightly so. Gaining competitiveness means making better use of the resources and ultimately increasing the productivity of the overall economic system.

On this, the record for Europe is dismal and action is urgently needed. Latest CompNet data show that total factor productivity (TFP) in Europe has been stagnant over the last two decades with negative blips both during the 2009 global financial crisis (GFC) and most recently during COVID in 2020.

Why was it so? Out of the many reasons, in this column we focus on the external factors to conclude that China was not the problem, but more likely some other, very internal ones, including the strong negative impact during crises times of within-EU global value chain (GVC) operations, amid an overall productivity sluggishness. Among the overall competitiveness drivers, we identify productivity and innovation content as key.

The role of EU global value chains

To do so, we examine how the TFP of European firms is affected by their external environment, particularly via the conduit of the GVCs to which they are connected.

Drawing from Bertelsman *et al* (2008) as well as Chiacchio *et al* (2018), we disentangle productivity transmission inside GVCs stretching within EU borders, within two phases. In a first phase, an external productivity shock (eg. an invention on the positive side or a sudden supply disruption on the negative side) has an immediate impact on the frontier (ie. most productive) firms, which are directly connected via trade flows to the respective GVC.

In a second phase, after a learning process, productivity gains trickle down from the national frontier to other national firms through domestic production networks.

To measure such impacts, we link CompNet data on firms' productivity with their respective trade linkages as reported by the OECD Inter-Country Input-Output (ICIO) tables. The productivity of each country and macro-sector is the employment-weighted average of laggard, frontier, and average firms (firms in the bottom 20%, top 20%, and intermediate deciles, respectively, of the productivity distribution of each country and macro-sector).

There are critical factors internal to the EU which could be better activated to enhance firms' productivity and ultimately foster their global competitiveness

Hence, we aim to capture the following contributions to the TFP growth rates of each country and macro-sector each year:

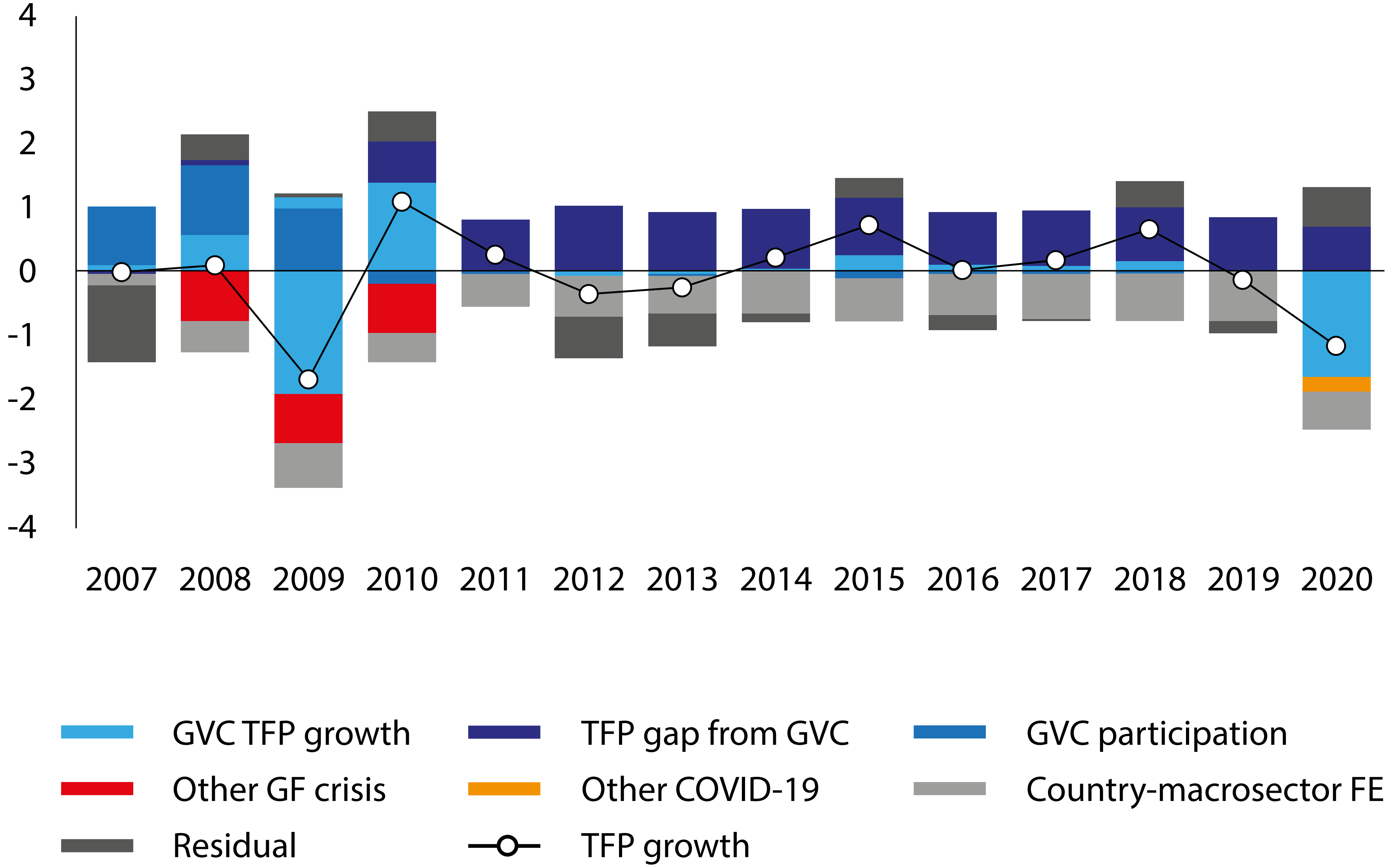
- The transmission of TFP rates of change from the respective GVC frontier (ie. from the average TFP growth rate across foreign countries and macro-sectors that import from the given country and macro-sector).
- The 'catch-up' effect – whether being more distant from the GVC frontier (in terms of a labour productivity gap) benefits TFP growth of national firms.
- Overall GVC participation (increases in percentage points of exports over output from one year to the other).
- Separately, other COVID and GFC shocks.
- Time-invariant features of each country and macro sector.
- Time-varying unexplained factors affecting TFP growth (on top of systemic COVID and GFC shocks).

The results (see Figure 1) are as follows[1].

1. As expected, the TFP growth of the EU GVC counterparts (the dashed blue histogram) has a rather strong impact on the TFP of the economy as it directly affects the frontiers firms connected to them.

2. What is notable is that such impacts become very strongly negative at the time of crisis (see the large negative histogram in 2009 and 2020)[2]. This is reminiscent of evidence of an additional burden from COVID on European

Figure 1. Contributions to EU TFP growth rates within EU global value chains



Note: Figures are yearly averages across countries and macro-sectors weighted by real value added. Results for export linkages between BE, CH, CZ, DE, DK, ES, FI, FR, HR, HU, IT, LT, LV, MT, NL, PL, PT, RO, SI, SK, and SE. Unbalanced sample over 2005-2020. The latest available year is 2018 for DE, and 2019 for LV and NL.
Source: CompNet 9th Vintage (jd_inp_prod_industry2d_20e_weighted) and OECD ICIO.

firms in GVCs (Lebastard *et al* 2023), and its sources – which may trace back to elements such as inventory management (Lafrogne-Joussier *et al* 2022), prevalence of arm's-length rather than intra-group transactions (Altomonte *et al* 2012), or risk misperception (Baldwin and Freeman 2022) – deserve further investigation.

3. The most positive contribution to aggregate TFP growth, however, comes from the productivity gap of the various countries and macro-sectors with respect to their respective within-EU GVC counterparts. The intuition is that when this gap is large, there is possibly a Balassa-Samuelson kind of 'catching-up effect,' which could be activated.

4. On the other hand, and paradoxically given the current debate, the residual, which would include the China effect together with the remaining time-varying omitted factors, has a small and often actually positive contribution to the TFP growth.

Overall, it would seem therefore that the shock that is internal to EU GVCs (ie. European firms trading with other European firms) may be more relevant in explaining TFP growth fragility amidst crises and generalised sluggishness (the always negative 'country-macro-sector FE') than any residual Chinese one.

Drivers of external competitiveness

The 2023 State of the Union speech neatly advocated for true and fair competition. It also stated that European companies recognise global competition being good for business and a pivot to create and protect good jobs in Europe.

In this context, 'predatory' practices benefitting competitors and marginalising European firms on foreign markets have been stigmatised. An anti-subsidy investigation into electric vehicles coming from China was also announced.

Nurturing a vibrant competitive environment requires policymakers to identify those aspects that are most relevant for sound firm performance (di Mauro and Forster 2008, Karadeloglou *et al* 2015). Building on previous work by Amador *et al* (2022) and Lourenço *et al* (2022), and in collaboration with a team at the Portuguese Gabinete de Estratégia e Estudos (GEE), we built a novel micro-aggregated composite indicator using CompNet data.

Our version of the Enterprise Competitiveness Indicator (ECI) considers five dimensions of performance – returns, costs, productivity, risks, and quality orientation (CompNet 2023: 29-34) – for the average firm in each country. When putting it to work, the ECI seems to offer insights into the drivers of EU firms' demeanour on global markets (Figure 2).

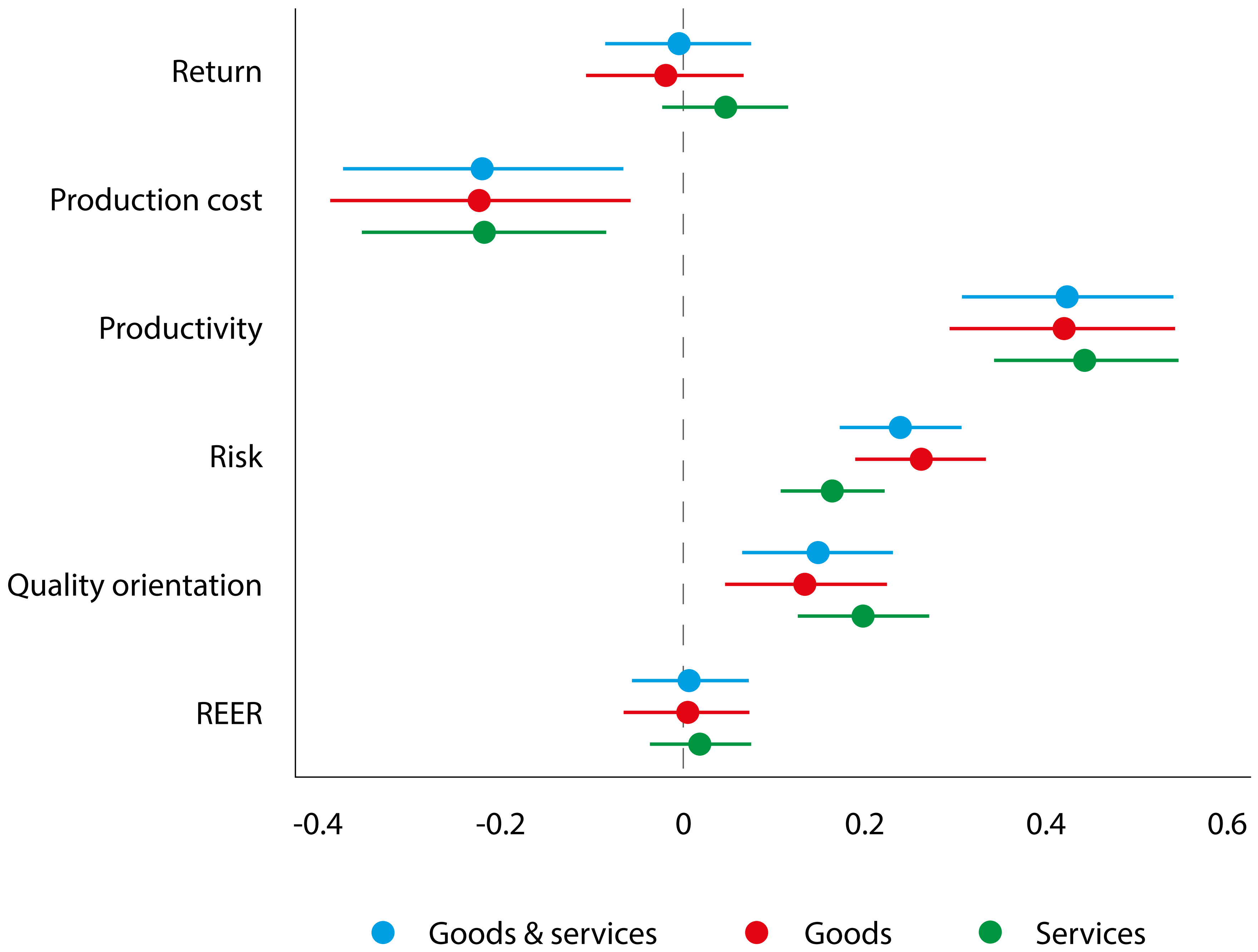
Our results suggest that productivity, financial soundness (risk), and quality orientation correlate with higher EU countries' export market shares more often than profitability (return) and, even more strongly, production costs. Also exchanges rates appear scarcely related to trade developments (see Grazioli *et al* 2016 for further on this).

Intuitively, this correlational evidence may point to European exporters being specialised in more downstream, higher value-added stages of value chains (eg. Bontadini *et al* 2021). If so, curbing artificial low prices would speak only less directly to the competitiveness of EU firms, while other factors appear more in tune with navigating international competition on those markets where the EU comparative advantages are stronger.

Conclusions

That competitiveness is now at the top of the EU economic agenda is welcome. But it is important to choose appropriately the channels one needs to tackle to improve it.

Figure 2. ECI by dimension, REER, and export market shares



Note: Coefficients from regressing market shares on ECI dimensions (pooled, each computed like in CompNet, 2023 pages 29-34) and Eurostat real effective exchange rates (REERs) with year fixed effects. REERs are the nominal effective exchange rates (NEERs) for 42 trading partners deflated by consumer price indices (CPIs). Results for BE, CZ, DE, DK, ES, FI, FR, HR, HU, IT, LT, LV, MT, NL, PL, PT, RO, SI, SK, and SE. The latest available years are 2019 for LV and NL, and 2018 for DE.
Source: CompNet 9th Vintage (unconditional_mac_sector_20e_weighted) and Eurostat

In this column, we have provided evidence that there are critical factors internal to the EU which could be better activated to enhance firms' productivity and ultimately foster their global competitiveness.

First, the GVCs operating within Europe itself have a rather strong impact on the aggregate productivity of Europe, as they directly affect the frontier firms connected to them. The robustness and resilience of these GVCs should be enhanced[3].

The still rather large gaps existing between frontier and laggard firms maintain a strong momentum for 'catching-up' forces, which is also positive for the aggregate productivity of Europe.

In comparison, the impact on the latter of GVCs outside of Europe (including therefore China) is shown to be somewhat limited and at any rate mostly positive.

When we look at the determinants of export market shares of EU firms, we show that productivity, financial soundness (risk), and quality orientation are the most important factors. Rather than, for instance, imposing across-the-board controls on imports, those are the things to concentrate on and most likely what it will take to maintain and enhance the EU's competitive edge. ■

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Endnotes

1. Results are robust to utilising import linkages and to controlling for growth rates of exports toward major non-European partners (CN, IN, JP, KR, MX, RU, TR, US). These results are available upon request to the authors.

2. Note that 2021 OECD ICIO data are available only up to 2018. We assume that the structure of EU GVCs did not change between 2018 and 2020. Since COVID reasonably twisted firms away from their ideal portfolio of trade partners, we may underestimate the magnitude of the GVC TFP shock in 2020.

3. See Miroudot (2020) for a discussion of the distinction between resilience and robustness in GVCs.

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Is it time for a prosperity update?

The digital transformation will continue. Joachim Nagel discusses productivity, competition and stable money in the digital age

1 Introduction

You may have wondered before leaving home whether it would rain today. Perhaps you needed a ticket to travel here by public transport. Maybe you cycled or walked and didn't know the way here. If so, I would be surprised if you hadn't used your smartphone in some way.

When Ludwig Erhard published his book *Prosperity for All*, things weren't that simple: to buy a train ticket, you generally had to go to the station and queue up at the counter. To find your way around town, you needed a map of the city, which you would unfold in order to look for a route. You started by asking: where am I and where do I need to go? And if you wanted to know what weather to expect, you checked the newspaper or listened out for the weather report on the radio.

Nowadays, all it takes is a finger swipe or a voice command to obtain such information. That's thanks to digitalisation. It's made our daily lives easier in many ways. Or when was the last time you pored over a street map, studied a timetable or flipped through a phonebook? And it has opened up new ways for us to communicate, to network and to share in the world's knowledge.

Technological progress is also bringing the economy further into the digital age. Networked machines and cloud-based services have long since become part of day-to-day business operations. Many firms are currently testing the potential uses of artificial intelligence. And in the medium term, quantum computing could cross the threshold to broad applicability.

We all feel the effects of the wave of new technologies: they affect how we work, shop and pay; and they are transforming products, production processes, business models and markets. Fundamental changes of this kind always entail both opportunities and risks. Most experts believe that digital transformation harbours considerable further potential for providing impetus to growth and prosperity. That's the first thing I want to talk about.

But whether this potential is actually tapped remains to be seen. If we want to turn digital progress into prosperity for all, we need an economic model whose framework creates the basis for this.

The digital transformation offers us a wealth of new opportunities for productivity, growth and prosperity

Ludwig Erhard's fundamental principles for the social market economy include strong innovation, competitive markets and stable money. They were important then and still are today. However, they have to be implemented in a way that is consistent with the prevailing circumstances so that the drivers of our prosperity can take full effect even in a changed environment.

That's why it is important to reassess conditions from time to time – and make updates where necessary. I'd like to discuss next.

2 Productivity and growth stimuli from digitalisation

2.1 Surging technological progress and ebbing productivity

Can you remember which mobile apps were most popular at the time of the 2006 FIFA World Cup in Germany? No? It's no wonder, seeing as today's widely successful smartphones did not even exist yet, and the major providers didn't even launch their app stores until 2008.

Smartphones and apps have long since become ubiquitous. With PCs, it took several decades after they had been launched on the market for them to become a fixture in the majority of households. The time it takes for digital innovations to gain a foothold in the market is becoming shorter and shorter. It took ChatGPT all of two months to crack the threshold of 100 million users.

A high pace of innovation actually also promises to boost productivity and thus increase prosperity. In the past, innovations such as the steam engine and electrification brought about radical changes in production. This was followed by major advances in labour productivity – and higher standards of living.

The hoped-for productivity boost from digitalisation is not borne out by the statistics, at least at first glance. On the contrary, productivity growth has been declining in the advanced economies for some time now. In the 2010s, it averaged only around 1% per year. And that was despite the proliferation of digital platforms and clouds which had enabled new production processes.

How do the wave of technological advancements and the slump in productivity fit together? Does digitalisation lead to a more productive economy? Or does it simply make our lives more convenient, while barely making the economy as a whole more efficient?

These questions are crucial factors for our future prosperity. The productivity trend also provides important indications of an economy's growth potential. Paul Krugman encapsulated this notion with the words: Productivity isn't everything, but in the long run it is almost everything[1].

This is especially true in the context of demographic change. The ageing of the population will mean that fewer people are available to the labour market. At the same time, more older people will be drawing a pension. On the one hand, the ageing population will therefore dampen economic activity and thus the basis for government revenue. On the other hand, it will cause government spending to rise more rapidly.

This is making it all the more important to become more efficient and make the best possible use of scarce resources. So let's take a closer look at whether digitalisation can deliver on its promise when it comes to productivity gains.

2.2 Digital transformation crucial for higher productivity

Our Bundesbank experts examined productivity growth between 1997 and 2018[2]. What they found is that the sectors of the economy that are the main producers of digital goods recorded far larger productivity gains than the rest of the economy.

At the aggregate level, however, the positive developments in these sectors were overshadowed by the weak performance of the other sectors. In other words, producers of digital goods were a key driver of aggregate productivity growth. Without their efficiency gains, productivity growth would have been significantly lower, even stagnating in some cases.

To be sure, digital goods are produced by a relatively small subsegment of the economy. However, they transform products and processes in other sectors as well: microprocessors enable us to control almost all electronic products, from cars to washing machines, whilst online reservation and appointment scheduling software eases the administrative burden on doctors' offices, restaurants and hair salons. Digital inputs play a major role in increasing aggregate productivity through digitalisation. This, too, has been shown by our analyses.

But the impetus provided by digitalisation diminished over the period under review up to 2018[3]. While the pandemic did subsequently boost the use of digital technologies, it is not yet possible to say precisely whether this will lead to marked and sustained efficiency gains. Surveys of firms on this topic find that they are optimistic, though.

2.3 General-purpose technologies take time

New digital applications can quickly capture the market, as was the case recently with ChatGPT. But it takes more time for new technologies to fundamentally change the economy. This is true even of ground-breaking inventions, as history shows. Let me give two examples:

James Watt had his steam engine patented in 1769. Despite this, it was not until the 1830s that steam overtook water as the dominant power source in industry. And it took another two decades for the steam engine and steamboat to prevail over sailboats and horse-drawn carriages. Steam's contribution to productivity growth did not peak until after 1850[4].

Or think of the sweeping progress made in IT in the 1970s and 1980s: the first email, the internet protocol, the first programmable pocket calculator, the first PCs that I previously mentioned. At that time, productivity growth was on the decline in many advanced economies. It was not until the mid-1990s that the effects were reflected in productivity statistics.

In other words, we should not be too quick to write off digitalisation as a driver of productivity and growth.

This is very much the case when it comes to the potential of artificial intelligence (AI). For example, Gina Gopinath, First Deputy Managing Director of the International Monetary Fund, said in a speech that AI could be as disruptive as the Industrial Revolution was in Adam Smith's time[5].

I am amazed by the wide variety of AI use cases that we now see in almost all sectors. We will wait with bated breath to see what impact they have and what ideas will be thought up in the future.

The initial findings of a study on the use of AI assistants in customer service were promising: employee productivity rose by almost 14%. Novice and low-skilled workers benefited, in particular, raising their productivity by 35%[6].

The Bundesbank also uses AI. It already has more than 30 applications – performing functions such as predicting financial stress, automating message evaluation and data cleansing. And we see even more potential, for example with regard to language models and generative AI. Our aim is to further enhance our analytical capabilities with the help of AI.

General-purpose technologies such as AI require additional innovation and investment to ensure their practical application by enterprises and public authorities[7]. It is not enough to buy software. Legal issues have to be cleared up, business processes have to be restructured, employees have to be trained. Productivity gains cannot be harvested until later, once these investments have borne fruit. Digitalisation could therefore still provide a considerable boost to growth and prosperity in the future.

3 Framework for competition and innovation

These are opportunities that are there for the taking. Digital transformation must become an engine of prosperity!

This can be achieved if digital transformation is approached with openness to new ideas and room for innovative solutions. For this to happen, two things need to come together: first, innovative entrepreneurs; and second, a state that provides them with the right framework.

For the Nobel Prize-winning economist Edmund Phelps, an innovative mindset is also a matter of values and motivations. In his view, people should seize upon problems with renewed vigour and flourish with their ideas. That, he says, is how people and their economies grow[8].

There are a number of parameters that could be adjusted to make the environment more attractive.

They include well-developed digital infrastructure and innovation-friendly regulation. Clear rules on the use of data and AI systems are important, as is improved access to data for research purposes. I welcome efforts to make the European Union a leader in trustworthy AI.

However, we need to think of ourselves not just as a community of regulators, but also one of innovators. And on this front, too, we should be aspiring to lead the way. I would now like to take a closer look at three further parameters.

3.1 Ensuring competition despite new challenges

Let's start with the core of the social market economy: dynamic competition. On the one hand, it spurs enterprises on to be more innovative and more productive. As consumers, we all benefit from this: we enjoy greater choice and lower prices. On the other hand, competition is also intended to ensure that welfare gains do not accumulate in the hands of the few.

Ludwig Erhard put it succinctly: *"Prosperity for all' and 'prosperity through competition' are inseparable; the first postulate indicates the objective, the second the way to this objective."*[9]

However, the economy does not pursue this path on its own. Governments need to set the right parameters. For competition to work properly, an appropriate regulatory framework needs to be in place. This framework needs to limit economic power and prevent the abuse of market power so that better or cheaper offers can prevail.

Intelligent competition law and strong anti-trust authorities have played a key role in making the social market economy a success story. And they are no less important today.

However, the digital economy is presenting new challenges. On the one hand, there are countless small start-ups and fierce competition, and on the other hand, there are the large platforms of bigtech firms. These differ in some respects from other markets: For example, the benefits of a particular car model hardly depend on whether ten vehicles of this model are sold or 10 million. For platforms, this is different: The more users they have, the more attractive they become.

This network effect strengthens the 'top dogs' – and makes it difficult for newcomers to gain a foothold. This is because customers generally see little benefit in switching from a large platform to a small platform. As a result, this can mean that only a few or even just one single platform operator dominates its respective market.

This strong position can be exploited: for example, by interlinking the main offering of the platform with new additional services and thus expanding the network to other markets. In this way, platforms can grow into self-contained ecosystems that users leave less and less often.

Today, no company is immune from being overtaken by technological progress and its pioneers – not even the market leaders. History provides many such examples of this happening. Kodak and BlackBerry are two that spring to mind.

Could AI perhaps be the stone in David's slingshot that today's tech Goliaths will come to fear? This is conceivable, but there are strong counterarguments[10].

AI opens up fresh possibilities for processing data and linking these data in novel ways. The incumbents have the necessary computing power, which is considerable and expensive. And they are sitting on large volumes of data. This enables them to train AI models and tailor them to their customer groups. And that gives them a head start over new providers who do not have proprietary data to draw on. AI could therefore even increase the market power of the big players.

Politicians and competition watchdogs need to be particularly vigilant here. And lawmakers have already responded: The Federal Cartel Office recently gained greater powers, partly with the aim of promoting competition in digital markets[11].

With this objective in mind, the following aspects are particularly important: As data have a major bearing on competition, data protection and competition law should be closely coordinated. When assessing mergers and acquisitions, it is important to focus to a greater degree on whether they would further enhance individual firms' data advantage[12].

Time also plays an important role: Authorities need to act faster and more proactively than before in order to effectively safeguard competition. At the same time, incentives for innovation need to be maintained. The main thing is to keep barriers to entry low, for example by enabling users to take their data from large platforms to different providers with little or no hassle.

3.2 Promote people's digital skills

New digital technologies are also changing the world of work. In the past, it was mainly physical activities such as agriculture, the manufacture of textiles or automotive production that became fully or partially automated as a result of technological progress. More recently, automation has also been used for simpler cognitive tasks that are routine, such as accounting.

AI could initiate a paradigm shift here[13], as it can also be used to carry out more complex tasks that are not routine, such as programming software or summarising and checking texts.

A study by the International Labour Organization suggests that the latest wave of Generative AI is not a job killer. However, it is likely to change many job descriptions[14], as individual tasks can now be automated in many lines of work.

Job profiles are therefore changing, and with them the requirements of employees. At the same time, AI can be a tool that eases the burden on employees and supports them in their work.

This support could also reduce barriers to entering certain lines of work, such as the need for in-depth knowledge of foreign or programming languages. This would be of great benefit, especially in times of increasing shortages of skilled workers. And employees could take on higher-grade tasks than before.

What is clear is that digitalisation is redrawing the division of labour between man and machine. This is breaking up existing structures and, in some cases, also triggering uncertainty.

Education and openness to new things are key factors in ensuring that this transition is seen primarily as an opportunity and not as a threat. Both factors will allow people to keep pace with the rapid advancements being made.

It is therefore important to be open to the new possibilities offered by technology, but also to be able to assess technology's limits and risks. These skills can be used to make better use of the opportunities arising from the transition.

It is all the more worrying that education and training opportunities in Germany are used less frequently by people aged between 25 and 64 than on average in the EU. In addition, participation rates in training measures in Germany fall significantly with advancing age[15].

Education should not be misconstrued as a phenomenon that is confined to the first third of our lives and is then over and done with. If this has ever been the case, these times are over. People never stop learning – after school, their training, or their studies. Learning needs to be a firm fixture throughout our professional lives.

This is where the state comes into play. The education system should provide people with key qualifications to ensure that they can also survive in the working world of tomorrow. These include skills for dealing with new technologies, for example. Furthermore, the government can help to mitigate particular hardships stemming from structural change through its social safety net.

3.3 Making public administration more efficient

The government sector should also use digitalisation to become more efficient and effective itself. Rigorous digitalisation of administrative processes could pay off twice.

Simpler communication and better networks connecting public authorities could reduce the burden on both administrations and enterprises. This would make it easier to submit applications. And it would cut down on the need to send information twice or in different formats. As a result, it could also help to speed up planning and approval procedures.

In addition, standardised digital interfaces to administrative bodies throughout Germany could make digitalisation easier for enterprises. The OECD pointed to these positive spillover effects in its most recent economic survey for Germany[16].

As a central bank, we are playing our part in this regard and are committed to making use of the opportunities offered by digitalisation in the field of payments. For instance, we enable real-time payments. Payment service providers can use SEPA instant payments as a basis for developing innovative and practical solutions with a pan-European reach.

Another example would be conditional payments, which are settled automatically once the conditions of an agreement are met. Not only is this more efficient, it also reduces the risk of the other counterparty failing to uphold its end of the agreement.

If machines can initiate payments to each other directly and completely automatically, other applications might also be possible. For example, conditional payments could pave the way for innovative business processes.

4 Stable currency in the digital age

4.1 Digital euro belongs to an increasingly digital world

Digitalisation is also changing how people pay. Digital payments are becoming more and more popular – be it via card, smartphone or smartwatch.

Today, around two-thirds of payments made in Germany are already cashless. Amongst younger people, this share is as high as around three-quarters. By way of comparison, six years ago, just under half of payments were made using banknotes and coins[17].

Given these circumstances, I consider the digital euro to be an important and logical step. It would be the (digital) counterpart to the (analogue) euro banknotes, which will also continue to exist in the digital age.

The digital euro would give people the ability to pay electronically as well using central bank-issued money – securely, cost effectively and with guaranteed privacy. And this would be in real time, throughout the euro area and in any everyday payment scenario, be it at the point of sale, between friends or when shopping online.

The digital euro could also result in greater competition in crossborder payments. Today, crossborder payments can often only be made using one of a handful of large, international card schemes.

First, the digital euro could provide an additional option here in and of itself. Second, it could help private European payment solutions to gain acceptance throughout the whole of Europe.

The Governing Council of the ECB has now decided to start preparatory work for a digital euro. This is something I welcome very much.

It is not a decision on whether a digital euro will actually be introduced. That is something the Governing Council will decide at a later date. A stable legal framework must be established first. The European Commission published a legislative proposal on this at the end of June. Even if everything goes smoothly, it will be another four to five years before the digital euro arrives in our wallets.

4.2 Price stability remains key

By then, the wave of inflation that we have been experiencing since the middle of 2021 will hopefully be history. For as much as we should encourage dynamic innovation in the economy, it is just as important to ensure it is firmly underpinned by stable prices.

Fortunately, the euro area inflation rate is now significantly lower than its peak a year ago. But it is still too high. In October, according to preliminary estimates, the headline rate was 2.9% and the core rate was 4.2%.

For consumers, inflation means a loss of purchasing power. This tends to hit people on lower incomes harder, putting it at odds with Ludwig Erhard's pursuit of *"prosperity for all"*. Or, as he put it himself: *"the social market economy is unthinkable without a consistent policy of price stability."*[18]

This also shows that price stability makes an important contribution to economic inclusion and thus to our social cohesion.

The Governing Council of the ECB is determined to bring euro area inflation back to its medium-term target of 2%. And we have taken action, reducing key interest rates ten times in a row by a total of 450 basis points. This has brought the benchmark rate for monetary policy to 4.0%.

In October, we left interest rates unchanged for the first time since July 2022. Given the current inflation outlook and the degree of monetary policy tightening that has already been achieved, I believe this is right.

Our tight monetary policy is yielding results, but we must not ease up too soon. On the contrary: key interest rates need to remain at a sufficiently high level for a sufficiently long duration.

It is not yet possible to say whether interest rates have already reached their peak. This will remain strictly dependent on the data.

There are various upside risks to inflation. Geopolitical tensions in the Middle East, for example, have the potential to push up energy prices and make the medium-term outlook more uncertain.

Our monetary policy stance must ensure that inflation returns to 2%. Inflation has proven persistent and has not yet been tamed.

The people of the euro area rightly expect us to do our job and maintain price stability. That is my top priority.

5 Conclusion

15 years ago, smartphones began to take over. Will we still have smartphones in 15 years' time? Perhaps smart glasses will have captured the market by then – or something completely different that we haven't even heard of yet.

What we do know, however, is that the digital transformation will continue. It offers us a wealth of new opportunities for productivity, growth and prosperity. We can take advantage of these opportunities – in the spirit of entrepreneurship, with a desire for innovation and with the courage to forge ahead.

It is up to policymakers to create the appropriate framework for this. They must implement Ludwig Erhard's fundamental principles for the social market economy in a way that is appropriate to the times.

As the President of the Deutsche Bundesbank, my focus is clear: I will do my utmost to ensure that this period of high inflation is soon behind us. Ensuring monetary stability is the best contribution monetary policy can make to prosperity for all. ■

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