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# THE MACRO-ECONOMIC IMPACT OF THE COST CRISIS

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## LESSONS FOR EUROPE

### ABSTRACT

The surge of inflation in 2021-22 has become a major test for macroeconomic policies. Policy response has not always been adequate. This is partially due to insufficient understanding of the causes of inflation, but also rigidities on the part of policymakers, who have stuck to the usual tools of demand management to treat inflation shock, even though it was triggered by supply-side factors. This experience points to the need to revise the ways we are dealing with inflation. One set of proposals is about the techniques of monetary policy itself, including data and modelling issues. The second set is about policy mix and coordination in dealing with inflation, bringing fiscal and other policies on board.

In this policy brief, we summarise the ideas explored in a seminar discussion organised by FEPS in collaboration with the Friedrich-Ebert-Stiftung and the European Institute at the LSE, we introduce the broader policy agenda and look at the data, modelling and policy mix that can instruct policymaking.



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## Introduction

This policy brief summarises and discusses the main takeaways from the seminar “The Macro-Economic Impact of the Cost Crisis: Lessons for Europe” that took place on 11 May 2023 in London, co-organized by FEPS, the LSE European Institute and Friedrich Ebert Stiftung London.

The seminar gathered around 30 participants, among them prominent academics, policymakers and researchers. The variety of views and perspectives made it a deep and lively discussion. In this policy brief, we summarise the arguments brought up in the discussion but also add our reflections, concluding with some policy recommendations.

## 1. The current juncture

The multiple shocks of the last several years have become a major test for macroeconomic policies. The conventional macro models appear to have been insufficiently suited to the scale and size of shocks and the extreme uncertainty experienced across Europe and beyond. The policy response was not always adequate, due in part to insufficient understanding of the causes of inflation, but also rigidities on the part of policy makers, who have stuck to using the usual tools of demand management to treat this inflation shock, even though it was triggered by supply-side factors.

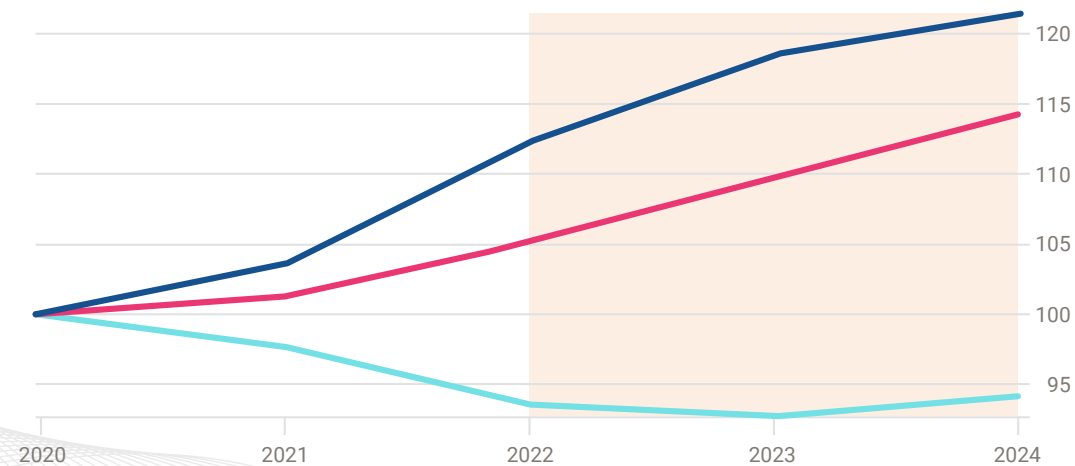
At the same time, the urgency of an adequate policy response is heightened by the magnitude

Figure 1.

Eurozone households will continue to feel much poorer than before the pandemic, despite fall in inflation

Indices (2020 =100)

— CPI — Nominal wages — Real wages



Shaded area indicates forecasts  
Sources: Consensus Economics, Eurostat

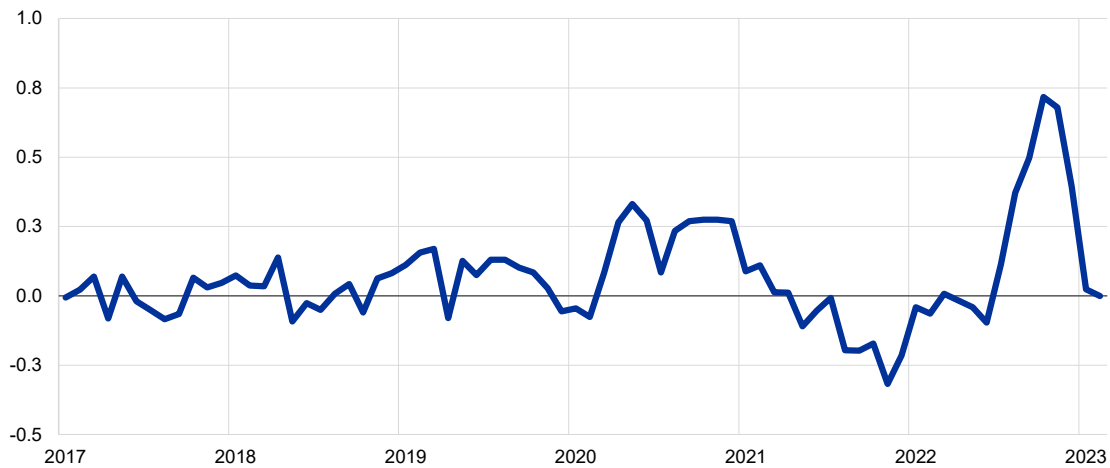
Source: Financial Times<sup>1</sup>

**Figure 2.**

**Difference in annual inflation between the lowest and highest income quintile households and its decomposition**

**a) Inflation difference between the lowest and highest income quintile households in the euro area**

(percentages)



Source: ECB Economic Bulletin, May 2023, p 102<sup>2</sup>

of the effect of inflation on the population, especially the most vulnerable groups. Due to rising prices, especially for food and energy, large parts of the population find it increasingly difficult to pay their bills, leading to the cost-of-living crisis. In the Eurozone, real incomes fell by 6.5% between 2020 and 2022, and by the end of 2024 are expected to remain 6% below 2020 levels, according to a Consensus Economics forecast (see Fig.1).

As poor households spend a larger proportion of their income on necessities (food, energy and housing), they feel the cost-of-living crisis the strongest (see Fig.2).

This strong negative effect on the wellbeing of large parts of society makes the fight against inflation an urgent priority.

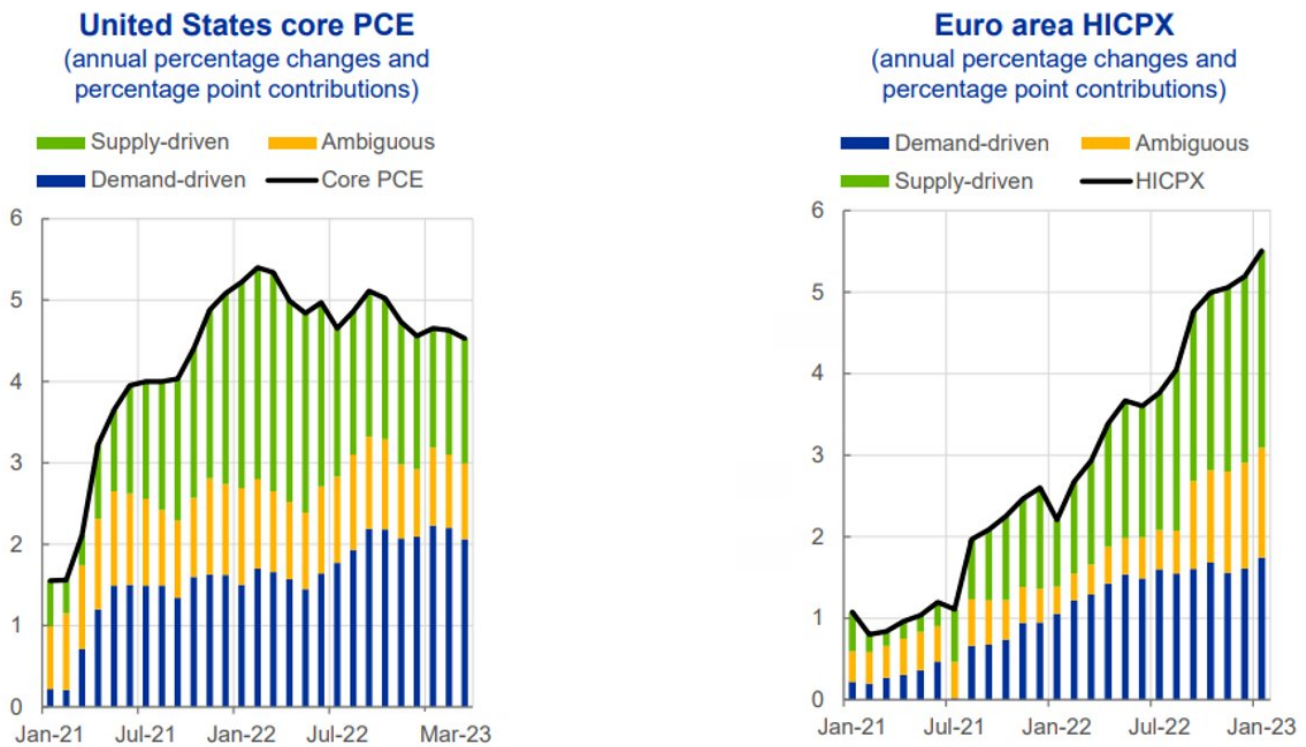
## 2. Causes of inflation

The seminar discussion kicked off with a comparison of inflation dynamics in the US and the Eurozone and its drivers (see Fig.3). In the US, the original impetus for inflation was a combination of supply and demand factors. To be more precise, it was triggered by supply shocks and sectoral demand shifts (but not excess aggregate demand), as Stiglitz & Regmi (2022)<sup>3</sup> show.

In the Euro area, by contrast, inflation was caused predominantly by a supply-side shock in the energy and food sectors.<sup>4</sup> Over time, inflation picked up in other sectors. The demand contribution also grew gradually.

The sectoral breakdown of inflation in the Euro-area shows how the initial spike in energy prices

Figure 3.



Source: ECB

transformed into economy-wide inflation (see Fig.4).

The identification of driving factors is important because it bears consequences for the appropriate policy response. If inflation results from excessive aggregate demand, then monetary policy (monetary tightening to reduce aggregate demand) is appropriate. In the case of supply-driven inflation, a more nuanced and multifaceted response is needed to alleviate the supply constraints. From the evidence above (as well as numerous studies), it is clear that European inflation was triggered by supply-side factors: pandemic-induced supply-side shortages, lack of resilience in supply chains, and disruptions caused by the war in Ukraine. There is not much that monetary policy could do to address these causes. Over time, as wages started to catch up in 2023 and demand factors

grew in significance, the rationale for monetary policy became stronger.

### The role of profit margins

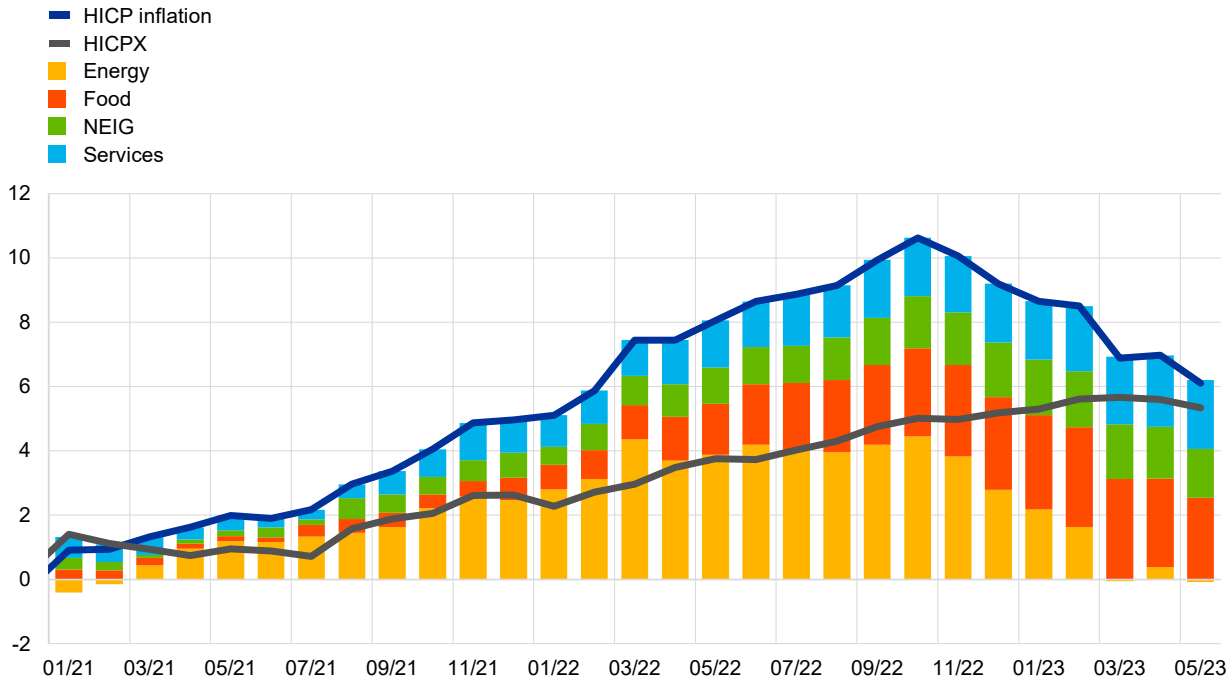
Profit margins have become a hot topic in the media and were also a point of lively discussion at the seminar. The comparison of unit labour costs and unit profits by sector shows that inflation in the energy and food sectors in 2021 was associated with surging profits margins in these sectors (see Fig.5). In 2022 other sectors also increased their margins.

The mechanism of a profit-inflation spiral is described in Isabella Weber and Evan Wasner's (2023)<sup>7</sup> study that shows how higher profit margins are the result of opportunistic behaviour by firms. Weber & Wasner (2023) show that the current round of inflation is

Figure 4.

## Headline inflation and its main components

(annual percentage changes; percentage point contributions)



Source: ECB Economic Bulletin, 4/ 2023<sup>5</sup>

“sellers’ inflation”, that derives from the ability of firms with market power to hike prices. The paper uses transcripts from investor calls of large companies to understand their price strategy. The authors show that the bottlenecks in supply chains in the wake of Covid lockdowns created situations of increased market power in certain segments, and companies used this increased market power to hike prices. The inflation propagation mechanism, as suggested in Weber & Wasner (2023), starts with a price shock in systemically significant upstream sectors, then gets amplified as firms in other sectors compensate (and overcompensate) for cost increases. This dynamic matches well the sectoral development of inflation in Europe, which we have shown above, with the original push for inflation coming from energy market

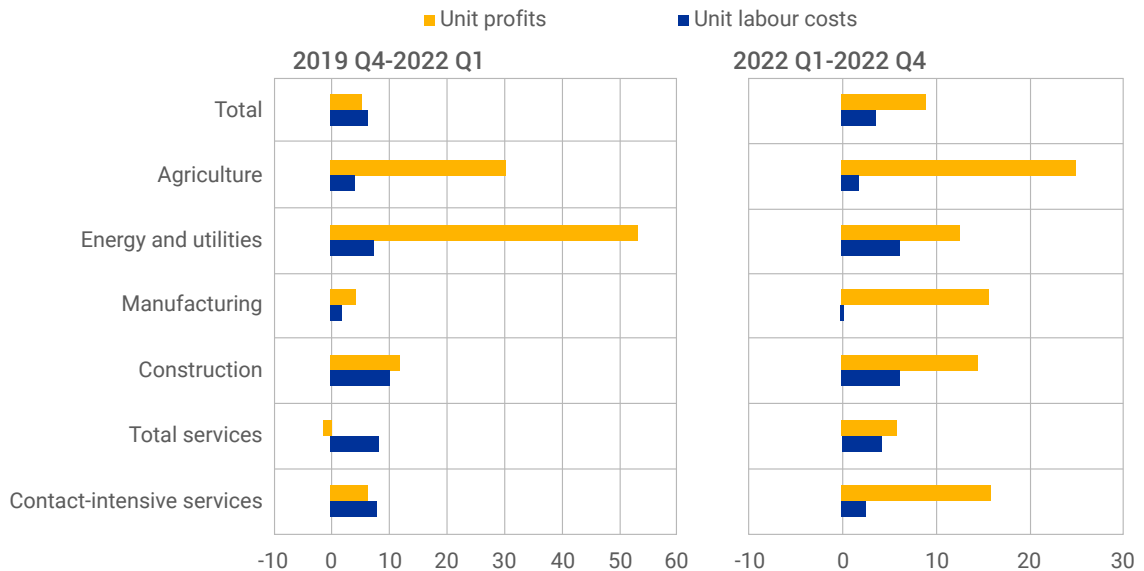
disruptions and then feeding into the broader economy. The evidence in Weber and Wasner (2023) also points to particular features of markets that make them more prone to profit inflation: large companies, whose shares are traded on financial markets, are more likely to increase prices in response to cost increases.

Central banks in the US and Europe have by now acknowledged the strong contribution of profits to inflation. In its March 2023 blog, the ECB said that the effect of profits on inflation in 2021-2022 has been “exceptional from a historical perspective”.<sup>8</sup> While, on average, from 1999 to 2022, unit profits contributed around one-third to the GDP deflator, over 2022 they contributed an average of two-thirds.

**Figure 5.**

## Sectoral wage and profit developments

(percentage changes over the indicated period)



Source: Arce, Hahn, Koester (2023)<sup>6</sup>

In a later article, Hahn (2023)<sup>10</sup> makes the same conclusion: profits made disproportionately large contribution to domestic price pressures in the corporate sector in the second half of 2022. This conclusion was also communicated by ECB top figures in their speeches.<sup>11</sup>

The point on which seminar participants broadly agreed is that profit margins indeed have increased strongly recently. However, there was no agreement about whether we should do something about them.

### Is there a wage-price spiral?

The question of a possible wage-price spiral is the other side of the coin of the profits question. The charts in the previous section make it clear that in 2021-22 wages contributed to European

inflation much less than profits (while in the US, wages had a stronger contribution). Notably, the trend for a declining share of wages in GDP has been continuing for several decades. Ever since the 1970s the share of wages has been declining and the share of profits has been rising (see Fig.7 for the EU).

One reason for such a redistribution is the declining role of collective bargaining. There are also broader forces at play here, notably, globalization: it allowed companies to relocate production to low-wage countries, which reduced costs and increased profits without invoking inflation.

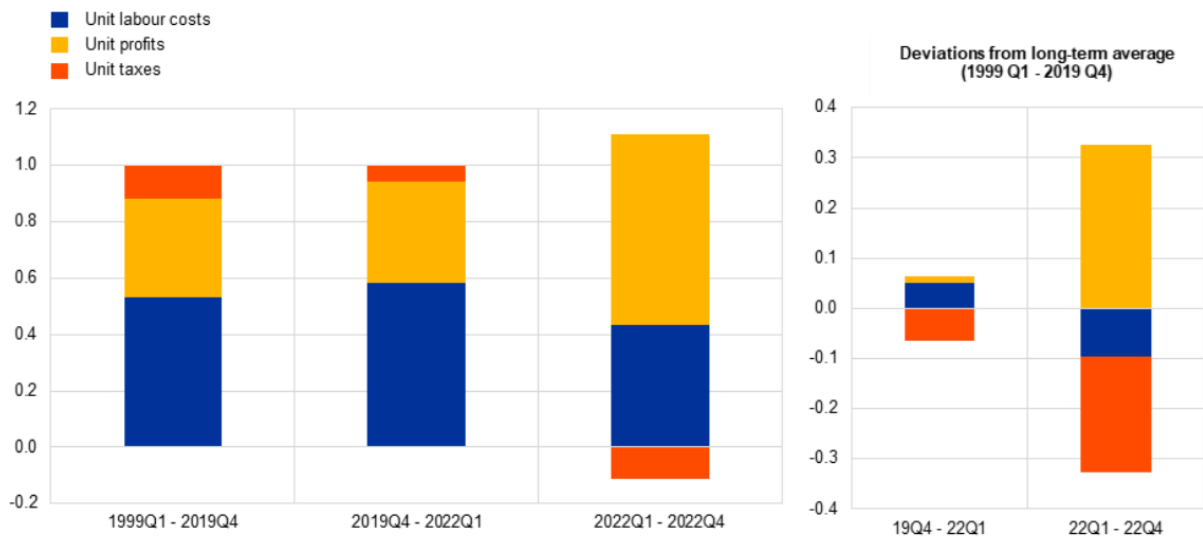
Interestingly, the wage-price spiral did not happen for decades in the United States. At the seminar, Kenneth Kuttner presented the results of his simulations for the US over 1960-2022



**Figure 6.**

## Contributions of unit profits and unit labour costs to domestic price pressures as reflected in the GDP deflator

(relative shares and deviations)



Source: Arce, Hahn, Koester (2023)<sup>9</sup>

which show no evidence of a wage-price spiral. The chart below (Fig.8) shows the results of a test of the “wage spiral”, calculated as an error correction term between nominal wages and prices. The results actually show the opposite causality: it is the prices that moved first and wages then followed. Yet after 2001 even this reverse causality broke down, as wages no longer caught up with prices.

The conclusion at the seminar was that the wage-price spiral is not visible in the EU. It would actually be desirable to have wages catch up, especially in the public sector. This is true especially in the healthcare sector, where unattractive work and pay conditions lead to severe shortages of personnel and threaten to disrupt the healthcare system.

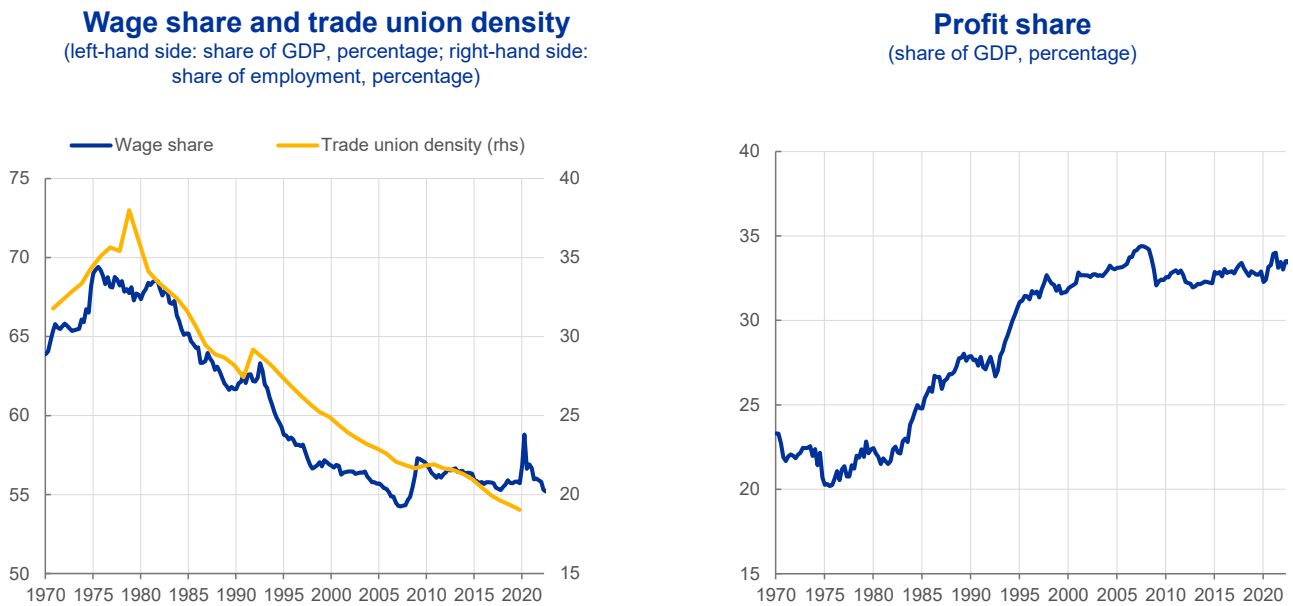
Belgium’s example was brought up as another

confirmation of an absence of wage-price spiral. It has an automatic wage indexation, yet its inflation in 2022 was close to the Eurozone average (10.2% vs 9.2%) and slightly below the EU average (10.4%).

### 3. Policy response

Statements and publications by ECB show the understanding on the part of the central bank of the role that profit margins play in this round of inflation.<sup>13</sup> However, the only tool the ECB uses for dealing with it is curtailing demand. In one 2023 speech Christine Lagarde said: “Since profits are ultimately influenced by the business cycle, it is our responsibility to restrict demand enough to prevent such a spiral.”<sup>14</sup> Interestingly, the article in the ECB Economic Bulletin later that month observed that unit profits in 2022-23 were higher than would be justified by the economic

Figure 7.



Source: Isabel Schnabel presentation “Monetary policy in a cost-of-living crisis”, 30 September 2022<sup>12</sup>

cycle, and demand-supply mismatches in some sectors and opportunistic pricing were behind the string profitability dynamics.<sup>15</sup> It is regrettable that with all the evidence of a supply-side shock, the ECB continues to act as if it were demand driven, and the aggressive tightening may instigate a recession. The Euro area economy in fact had lacklustre performance in 2023, growing by just 0.5% YoY in Q2.<sup>16</sup>

Policy makers have to be careful about the distributional consequences of high interest rates and recession. Banks appear to be the big winners of the high-interest rate environment. By contrast, households and companies face increased financing costs. Also, the rise in unemployment during a recession will disproportionately affect the most vulnerable groups, because unemployment is not equally distributed. While the average unemployment rate in the EU was 6.5% as of September 2023, the youth unemployment rate was 14.2%.<sup>17</sup> A rise in the average total will mean much higher

unemployment for the youth. This example highlights another problem with the macro approach of monetary policy – a lack of attention to distributional consequences.

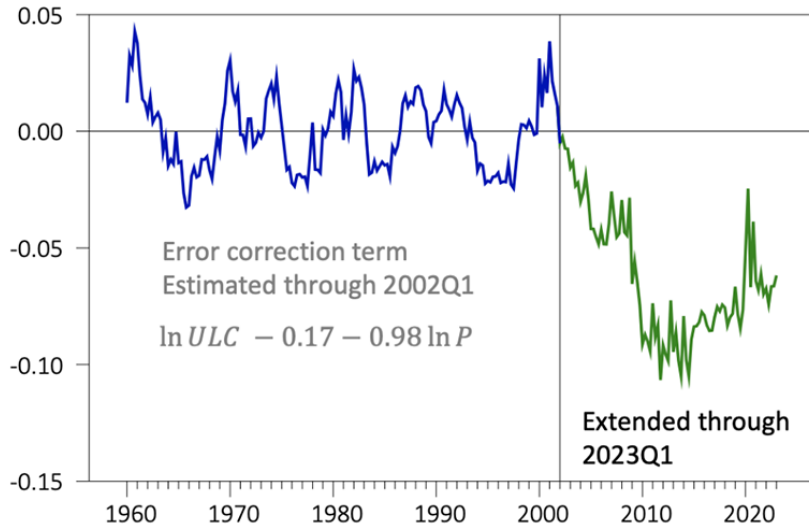
### Data dependency

Another problem that the current inflation spike has exposed is the data dependency of monetary policy. In their monetary policy decisions, central banks tend to rely on models that are built on past data. For example, ECB consistently states in its reports that interest rate decisions are “data dependent”.

Macroeconomic models rely on data, which means that they reflect reality as it has happened, not necessarily as it will happen. In an environment of high uncertainty, however, the past is a very poor predictor of the future. This reliance on past data is therefore problematic and accounts, at least in part, for

**Figure 8.**

Testing the wage-price spiral: error correction term in relationship between wages and prices



**Source:** Presentation by Kenneth Kuttner

the poor forecasts that Central Banks have delivered since the Covid pandemic outbreak. In a presentation at the seminar, Maria Demertzis argued that data dependency of monetary policy has led to delays in ECB policy response.<sup>18</sup> What models can be used for is to estimate the potential impact of diverse scenarios, but not for predicting the future. Demertzis advises: “Do not ask: ‘what is the best policy for the next policy horizon?’ Ask instead: ‘which is the policy that will deliver good outcomes (not necessarily best outcomes) for the widest spectrum of possible contingencies?’”

The argument about a delayed ECB response can be debated, because this round of inflation was initially driven by supply-side factors, so that there is not much that the ECB could do to address them. But there is a general recognition that conventional macro models are not suited for situations of high uncertainty. Macro models that are used by central banks assume stationary

processes, with stable relationships between variables. But in situations of high uncertainty, as is the case today, these relationships do not hold.

### Effect of monetary policy on the financial sector

The collapse of Silicon Valley Bank and several other banks in the US in spring 2023 has raised worries about the effect of monetary tightening on banks’ portfolios and risk exposure. A discussion at the seminar asked whether banks should prioritise their price stability mandate or be more considerate about their mandate to preserve financial stability.

One expert made the point that central banks’ mandate is about preserving stability of the banking system, but not its profitability. De Grauwe and Ji (2023)<sup>19</sup> show how the practice

of remuneration of bank reserves at the central bank results in large transfers of central bank profits to commercial banks, which is effectively a subsidy. Their calculations show that at 2023 interest rates, these transfers amount to 1.01% of GDP in the Eurozone, 0.64% GDP in the US and 1.75% of GDP in the UK. These transfers have grown substantially since the start of the tightening cycle, as the rate on reserves is tied to the policy rate. De Grauwe and Ji point out that there is no genuine economic basis for paying interest on reserves, and for a long time, they were unremunerated.<sup>20</sup> They suggest that central banks should gradually sell bonds from their portfolio and supplement it with

a temporary increase in minimum reserve requirements, on which no interest is paid. Such a move would also improve monetary transmission, as reserves would become more scarce and small manipulations in the supply of reserves could change the money market rate.

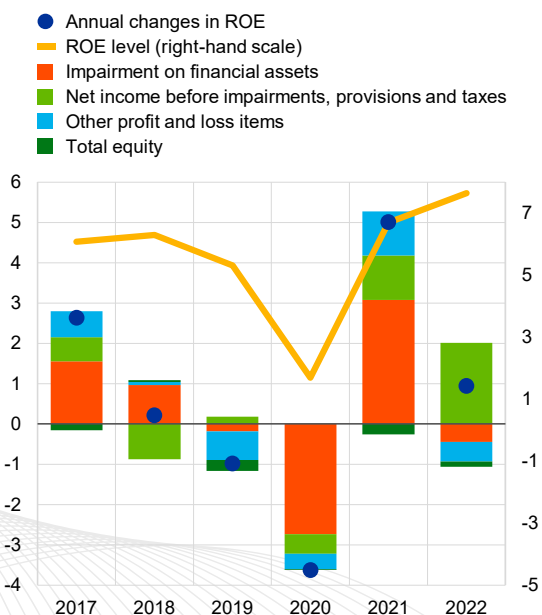
Given the weak growth dynamics of the European economy, the sale of bonds from the ECB portfolio should be rather gradual, as it would lead to additional monetary tightening. The best approach would probably be to combine the sale with the cancellation (or at least reduction) of reserve remuneration or increase in a non-remunerated minimum reserve requirement.

Figure 9.

Bank profitability improved further in 2022 on the back of stronger net interest income driven by higher margins, especially in countries with variable interest rates

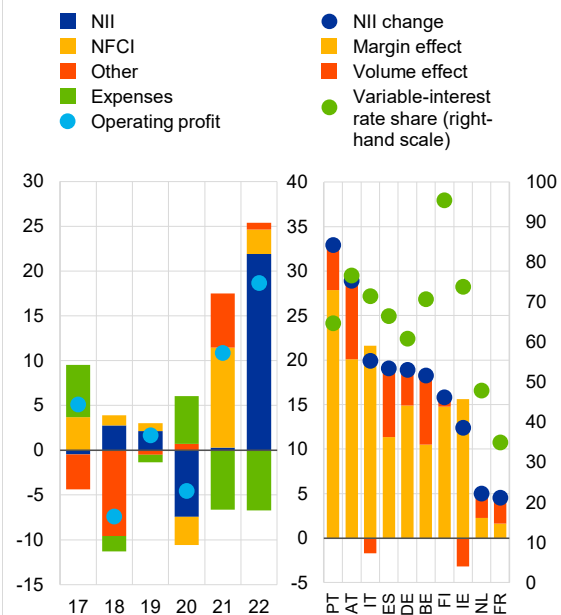
a) ROE of euro area banks and the main drivers of annual changes

(2017-22; percentage points, percentages)



b) Annual changes in operating profits and the main drivers of changes in NII

(left graph: 2017-22, percentage points; right graph: Q4 2022, percentage points, percentages)



Source: ECB Financial Stability Review, May 2023<sup>22</sup>

These measures would balance each other: the sale of assets would mean tightening, while a reduction in remuneration would stimulate banks to put money into the economy - and would stimulate credit. By calibrating the two tools, the ECB can effectively solve the problem of bank subsidisation.<sup>21</sup>

On top of this subsidy from the central bank, banks were also enjoying large margins on lending activities in 2022, as they increased lending rates to follow policy rates, but barely moved their rates on deposits. The figure below shows the contribution of different factors to profitability and Net Interest Income (NII). In 2022, the effect of margin outpaced by far all others (left chart). It is noteworthy that in countries with prevalent fixed-rates loans (for example, France has predominantly fixed-rates mortgages), margins and NII rose much less (the right panel in the chart). Limiting variable-rate mortgages could be an approach to banking sector regulation - since the higher burden of mortgage repayments is clearly adding to the cost-of-living crisis.

By contrast, the profits of central banks declined substantially in 2022. On top of massive transfers to banks as remuneration for their reserves, central banks also suffered from a downward revaluation of the bonds in their portfolios due to the increase in interest rates. As a result, as OECD calculations show, the transfers of central bank profits to the government have decreased substantially in 2022.<sup>23</sup> The fact that central banks transferred less to the governments because of their subsidisation of banks makes the remuneration of bank deposits at central banks even more questionable from the distributional justice point of view: this subsidy directly reduces the income of the government. Why should taxpayers subsidise commercial banks?

## 4. Towards a new macroeconomic toolkit for Europe: takeaways and ideas

The discussion at the seminar points to the need to revise the ways we are dealing with inflation. One set of changes is about the techniques of monetary policy itself, such as data and modelling issues, and balancing economic objectives with financial stability. The second set is about the policy mix and coordination in dealing with inflation, bringing in fiscal and other policies on board. Here we present some ideas based on the seminar discussion, as well as the broader policy agenda.

### Data and modelling

As the discussion on data dependency demonstrated, using macro models to predict reality is backward-looking and too imprecise in conditions of uncertainty. These models can be used as instruments for simulation of diverse outcomes, but policy should not automatically rely on them. Bank of England (BoE), for example, is using some forward-looking indicators, like hiring and firing expectations of companies to monitor labour market conditions. The set of such indicators should be expanded to also monitor risks in supply chains and monopolisation tendencies in industries. This information is not in central banks' domain, so coordination with other policy bodies should be established.

Another problem with macro data is that it is too aggregated. Jonathan Haskel from BoE shows that decomposition of GDP by labour and profit shares has a substantial residual.<sup>24</sup> Moreover, the labour and profits components in national accounts are aggregates of many different things. So, he shows, the 'profit' component includes returns not only on business capital, but also government capital and housing capital

(dwellings). Likewise, 'wages' includes bonuses. Therefore, to understand what exactly drives inflation, Haskel concludes that we need to go to the sectoral and firm level data, looking at behavioural dynamics of price and wage setting. Isabella Weber's study, which we cited earlier, does exactly that. Such approaches should become a regular instrument for monitoring and analysis of inflation.

An accompanying measure would be to increase transparency on corporate profits. Currently, Eurostat collects data on profits once per year. As of June 2023, its most recent data was for 2021, uploaded in November 2022.<sup>25</sup> The ECB does better with its statistics on gross operational surplus,<sup>26</sup> yet it is still far from the level of detail and frequency it has for wages monitoring: as of June, it had data on profits only for December 2022. In her June 5 speech at the European Parliament, ECB President Christine Lagarde acknowledged this problem:

The contribution of profit to inflation had gone a little bit missing for a very simple reason which has to do with the fact that we don't have as much and as good data on profit as we do on wages. I think that if I had the choice, I would like to improve our data on profit on an aggregate basis as well as on a more granular basis to really fully understand and appreciate the transmission of the cost push.

## Policy mix

It is widely understood that monetary policy alone is not enough for dealing with the current round of inflation, given it was originally to a large extent supply-side driven, especially in the EU. For that, other policies need to step in. In the United States, the Inflation Reduction Act (IRA) and related legislation became an answer:

a mix of industrial and fiscal policies to reduce vulnerabilities in supply chains and increase local production capacity in critical sectors. The US also actively uses fiscal policy as a stabilisation tool during economic cycle fluctuations. By contrast, the ECB finds itself more or less alone in fighting inflation, because there is very limited central fiscal capacity in the EU. ECB policy is additionally complicated by the fact that it is a multi-country central bank, having to take into account variable consequences of its policies in different member states. The fiscal stimulus is done at member state level, but the diverse capacity of different states means even greater divergence within the Union.

Throughout 2023, an intense discussion of options to increase the EU's own fiscal resources have been ongoing. One can only hope this will result in some meaningful volume. Another route would be to make Next Generation EU (or some version of it) permanent. The EU needs something similar to the IRA: fiscal and industrial policies combined so that it would use fiscal resources to strengthen the supply side. In the face of uncertainties about supply chains and the associated price spikes for certain imported goods and materials, industrial policy can be a tool to prevent supply-shock-instigated inflation. Notably, the ECB has finally recognized the role of supply-side policies in dealing with inflation in its recent Economic Bulletin:

Policies to enhance the euro area's supply capacity – which would be supported by the full implementation of the Next Generation EU programme – can help reduce price pressures in the medium term, while supporting the green transition.<sup>27</sup>

Competition policy also needs to step up. Indeed, in the EU, this one is the strongest pillar. The existing evidence points to instances of increased market power in certain sectors,

even if temporarily. Firms, logically, used this opportunity to increase their profits, which eventually led to economy-wide inflation. To prevent such experience in the future, competition policy needs to develop safeguards against monopolistic price setting by firms. This is especially needed in the energy and food sectors, because they have a major impact on industry and consumers.

## **Conclusions**

The seminar provided a broad snapshot of challenges for monetary policy in the current environment, characterised by high uncertainty and disruptions. The fact that the current spike of inflation was triggered by supply-side factors and exacerbated by high profit margins put in question the effectiveness of the monetary policy to deal with such causes of inflation.

It is clear that the monetary policy toolbox needs to be updated, in particular with regards to the granularity and scope of data: there is a need to engage more with sectoral and firm-level data, and also incorporate profits explicitly in the analysis. The way that central banks use models also need to be revised, viewing them less as predictive tool and more as a simulation exercise. Furthermore, central banks have to reconsider their focus on boosting private banks' profits. Finally, governments need to take part of the responsibility for price stability as well, as supply-side shocks cannot be dealt with monetary policy alone. A more efficient policy mix is needed, combining investments, industrial, competition, regulatory and fiscal policies.

## Endnotes

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- 6 Arce, Hahn, Koester (2023) “How tit-for-tat inflation can make everyone poorer”. *ECB Blog*, 30 March 2023.
- 7 Weber I., Wasner E. (2023) “Sellers’ Inflation, Profits and Conflict: Why can Large Firms Hike Prices in an Emergency?” *Economics Department Working Paper Series*.
- 8 Arce O, Hahn E, Koester G (2023)
- 9 Arce, Hahn, Koester (2023) “How tit-for-tat inflation can make everyone poorer”.
- 10 Hahn (2023) “How have unit profits contributed to the recent strengthening of euro area domestic price pressures?” *ECB Economic Bulletin*, Issue 4/2023.
- 11 For example, in her June 2023 speech at the European Parliament, Christine Lagarde said that “in 2022 certain sectors of the economy had taken advantage of the mismatch between supply, constrained by bottlenecks, and demand, to increase prices. Those sectors have taken advantage to push cost through entirely, without squeezing on margins, and – for some of them – to push prices higher than just the cost push.” Source: Speech by Christine Lagarde, President of the ECB, at the Hearing of the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 5 June 2023: <https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230605~0aadd43ce7.en.html>
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- 14 Speech by Christine Lagarde, President of the ECB, at “Deutscher Sparkassentag 2023”, Hanover, Frankfurt am Main, 1 June 2023: <https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230601~2740cf2320.en.html>
- 15 Hahn (2023) “How have unit profits contributed to the recent strengthening of euro area domestic price pressures?” *ECB Economic Bulletin*, Issue 4/2023.
- 16 Eurostat GDP main aggregates and employment estimates: <https://ec.europa.eu/eurostat/documents/2995521/17467476/2-07092023-AP-EN.pdf/7e5a0792-7a97-eac1-de9d-6461274a3f56>
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- 18 The same argument is presented in Demertzis M. (2023)
- 19 De Grauwe P. and Y. Ji (eds) (2023) “DP18103 Monetary Policies without Giveaways to Banks”. CEPR Press Discussion Paper No. 18103.)
- 20 The ECB introduced interest payments on excess reserves when it started its operations in 1999, and the US Fed in 2008.
- 21 As of the time of printing of this paper in November 2023, the ECB has started moving in this direction. In addition to the discontinuation of reinvestment of LTRO proceeds, it set the remuneration of minimum reserves at 0% as of July 2023. However, as minimum reserves are a small fraction of the total bank liquidity holdings at the CB, this did not have major effects on P&L, but conceptually this goes in the direction of the De Grauwe proposal.
- 22 ECB Financial Stability Review, May 2023
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## About the author



### ANNA KOLESNICHENKO

Anna Kolesnichenko is Economic Policy Analyst at FEPS. She focuses on European fiscal and monetary policies, but also does multidisciplinary projects at the intersection of economy, democracy and international relations.

She started her career at CASE, a think-tank in Ukraine, specialising in fiscal and monetary policy, as well as European integration. Later she had short-term engagements in several international organisations and banks: NATO Parliamentary Assembly (Brussels), Center for Strategic and International Studies (CSIS, Washington), ING bank and Bear Stearns bank (London). From 2009 to 2020, Anna worked in different roles in the area of banking sector analysis and strategy monitoring at UniCredit bank in Vienna.

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The sanctions on Russia following the invasion of Ukraine show the importance of currency dominance in international financial markets. This policy brief addresses the issues relevant to reinforcing the international dimension of the euro and using it to enhance EU's strategic autonomy.

The euro remains a strong second to the dollar amongst international currencies. The recent renewed motivation for policies to foster a stronger international role for the euro can be linked both to historically high public support for the common currency and to concerns about an increased weaponisation of the dollar by the US.

Strengthening the international role of the euro involves policy action on three fronts:

- 1) filling in the missing elements of the economic and monetary union, completing banking union with a common deposit insurance scheme, creating a capital markets union, a fiscal capacity for macroeconomic stabilisation, and a euro area safe asset by making the instruments of the Next Generation EU initiative permanent;
- 2) improving financial market infrastructure and efficiency in euro transactions, including by extending the use of swap lines to facilitate liquidity in euro;
- 3) policies that expand the use of the euro in key strategic sectors such as energy, commodities, and transport – sectors that are now heavily reliant on the use of the dollar.

These policy actions will significantly strengthen the international position of the euro and thus contribute to EU's strategic autonomy.

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