A coordinated macroeconomic framework for Europe

Policy briefing | Theo Harris, Sebastian Mang and Dominic Caddick | May 2025

Summary

The EU's macroeconomic policy framework should be designed to achieve the long-term goals of the EU. In this briefing we investigate how it could help deliver three key tenets laid out in the Treaty on European Union: sustainable economic and social progress; peace and security; and democracy and the rule of law.

The EU's current macroeconomic policy is unable to rise to four challenges to these goals that have all intensified at the same moment - environmental breakdown, disruptions to global trade, threats to military security, and the rise of authoritarianism. What is needed is a rapid, large-scale, coordinated and long-termist approach. The current approach is incremental, uncoordinated and short-termist.

Deficit rules must be relaxed to allow for greater member state investment in green and social infrastructure. At the same time, the European Central Bank (ECB) must adopt a more flexible approach to inflation targeting to deal with an oncoming era of persistent supply-side shocks. Otherwise, consistently high interest rates will stunt the economy and delay investment, driving down living standards and delaying climate action. To allow for this flexibility, fiscal policymakers must take more responsibility for preventing and mitigating the impacts of inflation.

The ECB must also do more to fulfil its secondary mandate to support the EU's general economic objectives. In particular, it must align its policies to support the decarbonisation goals laid out in the European Green Deal, which will also help secure long-term price stability. In the long run, the establishment of an Economic Coordination Council would provide the institutional framework and democratic legitimacy to achieve better-coordinated monetary and fiscal policies.

The EU's current macroeconomic framework is not fit for purpose

Long-term EU goals

Long-term societal goals should guide the underlying intentions of all macroeconomic policymaking. Yet in the last several decades, policymakers and political leaders have begun to stick faithfully to metrics and rules while forgetting the societal goals they were originally designed to promote. To re-focus attention on these underlying aims, we highlight three long-term goals – drawing from the Treaty on European Union – that can guide thinking on the macroeconomic framework in the current context:

- Promote sustainable economic and social progress
- Provide peace and security
- Consolidate and support democracy and the rule of law

A confluence of generational challenges

Against the context of these underlying goals, four challenges, each of a generational scale, have intensified at the same moment:

- Climate change and environmental breakdown
- The re-balancing of global trade and finance
- Challenges to EU security
- The rise of populist authoritarianism

Opportunities for a more prosperous, secure, and democratic future

If the EU acts quickly and decisively, it can forge a path to a better future by successfully addressing these interlinked challenges. Here we highlight three priorities which are at the crux of multiple challenges:

- **Take the lead in global trade, finance, and diplomacy:** This can support industrial strategy goals and generate prosperity while demonstrating geopolitical leadership.
- **Deliver a fast and fair energy transition:** A domestic supply of renewable electricity will enhance energy security, price stability, industrial competitiveness, and create green jobs in formerly de-industrialised areas.
- **Build a fairer economy by investing in high-quality public services and thriving local economies:** This is the only way to provide sustainable, resilient, and inclusive prosperity for European citizens, and undermine the populist resentment that fuels authoritarianism.

Characteristics of a successful policy response

Firstly, some observations on the characteristics of a macroeconomic policy approach capable of meeting these challenges. The policy response must be:

- **Rapid and large scale**: The challenges are urgent and structural, with a narrow window of opportunity to secure a safe and prosperous future.
- **Coordinated:** A misaligned and piecemeal approach across policy areas will result in self-defeating outcomes.
- **Long-termist:** The structural nature of the challenges demands a consistent approach with a long time-horizon.

Failures of the EU's current macroeconomic framework

In contrast to what is required of a successful policy response, the EU's macroeconomic approach so far could be characterised as incremental, uncoordinated, and short-termist.

Fiscal rules target short-term reductions in debt-to-GDP ratios, prioritising immediate savings over long-term fiscal sustainability. Current forecasting techniques can underestimate the fiscal benefits of green and social spending, which can improve debt-to-GDP ratios via increased growth and avoided future costs[1]. Conversely, they underestimate the long-term economic damage caused by austerity policies. Underinvestment in the green transition is likely to result in future fiscal deterioration owing to extreme weather disasters. Likewise, failing to invest in essential infrastructure—such as Germany's railways or bridges—will only lead to significantly higher costs down the line. Too much hope is placed on the ability of the capital markets union to deliver on the EU's investment gap, while it is clear that this will at best give incremental results, not the step-change in investment that is needed.

Meanwhile, monetary policy is tied to short-term (technically "medium" term) inflation targets which result in overly punitive interest rates hikes which do little to address the underlying causes of supply-side inflation. High, undifferentiated interest rates have damaged private and public investment in the green transition at the very moment when investment needs to ramp up, and when government borrowing is high in the wake of the pandemic and cost-of-living crisis. At the same time, the ECB's collateral framework has an inherent carbon-bias that supports fossil fuel investment, in contradiction to the Commission's Green Deal goals[2].

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[1] Caddick, D., & Kumar, C. (2025). *Forecasting a better future: The case for a 'bucket approach' to fiscal multipliers and more.* New Economics Foundation. https://neweconomics.org/uploads/files/NEF_Forecasting-a-Better-Future-FINAL-Jan-25.pdf

[2] Dafermos, Y., Gabor, D., Nikolaidi, M., van Lerven, F. (2022). *Greening Collateral Frameworks.* INSPIRE sustainable central banking toolbox. www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/08/INSPIRE-Sustainable-Central-Banking-Toolbox-Policy-Briefing-Paper-7.pdf

Background on monetary-fiscal coordination

In the decades following the second world war, it was common in western European countries for governments and central banks to coordinate policies proactively. Central banks supported low government borrowing costs for the build-out of the welfare state and implemented "credit guidance" policies that encouraged private banks to lend to economically beneficial sectors[3].

However, after the period of "stagflation" in the 1970s, a new consensus began to arise around strictly independent central banks setting interest rates to tightly control inflation, regardless of fiscal policy goals and needs. This is known as "monetary dominance", and has resulted in severely uncoordinated macroeconomic policymaking, particularly since the 2008 financial crisis.

The limits of interest rates

Interest rates are a blunt instrument. In theory, they work by raising the cost of borrowing, thereby slowing demand. But when inflation is driven by supply shocks—as it has been recently across Europe—raising rates does little to fix the underlying problem. Interest rates rises cannot increase gas storage capacity, unclog ports and supply chains, prevent corporate price-gouging or accelerate home insulation and renewables deployment. Instead, interest rates work by raising borrowing costs and weakening the labour market. This concentrates economic pain on mortgage payers, workers and the unemployed. While perhaps effective in preventing runaway price increases, this is an inequitable, imprecise and undemocratic solution to supply-driven inflation. Failure to update this approach will undermine the EU's long-term goals.

NEF's recommendation: a coordinated policy response

Fiscal expansion to fund green and social infrastructure

- Reform the fiscal rules to allow for greater investment in green and social infrastructure.
- Facilitate additional borrowing at the EU-level to create a special fund for green and social infrastructure.
- Introduce measures to raise EU own resources, such as via an EU-wide digital services tax, wealth tax, or a frequent flyer levy.

In aggregate, the EU needs a major expansion of public spending to invest in green infrastructure, public services and security (though the cost of better security could be

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[3] Prieg, L., Mang, S., Caddick, D., Jourdan, S., & Harris, T. (2025). *How do you solve a problem like inflation? The case for monetary-fiscal coordination.* https://neweconomics.org/uploads/files/how-do-you-solve-a-problem-like-inflation.pdf

minimised via better inter-state coordination[4]). The EU's fiscal rules, as defined in the stability and growth pact, must be revised to allow for this increase. An increase in debt levels can be democratically justified as the investment needed to provide a secure, sustainable and prosperous Europe for future generations.

Increasing aggregate demand in the EU will increase business investment, attract foreign capital and raise living standards. Ever since the financial crisis, suppressed aggregate demand has placed a structural drag on the desirability of innovating and investing in the EU[5]. The buoyant stock-market reaction to the reform of the German debt-brake is evidence that international investors will reward strategic and responsible fiscal expansion, leading to capital inflows which support the value of the euro[6]. While other member states are not in the same position as Germany, there is nevertheless - on aggregate – sufficient fiscal space for a major fiscal expansion.

In the short run, the deficit escape clause that applies to military spending must be expanded to apply to green and social infrastructure. Otherwise, it is only a partial solution that addresses the challenge of military security, but fails to deal with insecurity from climate damages or the insecurity of democracy from authoritarian populism[7]. As the rise of the Alternative für Deutschland (AfD) in Germany and Reform UK show, the erosion of public services under austerity is fuel to the fire of populist resentment. Furthermore, without this change, the recent reform to the German debt brake will most likely come into conflict with the EU fiscal rules and create a crisis in credibility[8].

As a next step, additional EU-level borrowing should be facilitated, with a special fund for green and social infrastructure. The advantages of EU-level borrowing were demonstrated by the NextGenerationEU fund, initiated during the pandemic, which provided emergency fiscal support, counteracted economic divergences between members states, and fostered

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[4] European Commission. (2025). *White paper for European defence – readiness 2030.* https://commission.europa.eu/document/download/e6d5db69-e0ab-4bec-9dc0-3867b4373019_en?filename=White%20paper%20for%20European%20defence%20%E2%80%93%20Readiness%202030.pdf

[5] European Commission. (2020). *Investment in the EU Member States: An Analysis of Drivers and Barriers*. European Economy Institutional Paper 145. https://economy-finance.ec.europa.eu/document/download/c357a195-1c3d-4bcc-ab73-b41b895fcfa5_en?filename=ip062_en.pdf

[6] Ponthus, J., Jaisinghani, S., & Ritchie, G. (2025, May 9). *Germany's DAX index hits record high after tariffs round trip.* Bloomberg. www.bloomberg.com/news/articles/2025-05-09/germany-s-dax-index-heads-for-record-erasing-tariff-retreat

[7] Mang, S. (2025). *Why military spending alone can't save Europe.* Green European Journal. www.greeneuropeanjournal.eu/why-military-spending-alone-cant-save-europe/

[8] Steinbach, A., & Zettelmeyer, J. (2025). *Germany's fiscal rules dilemma.* Bruegel. www.bruegel.org/sites/default/files/2025-04/Germany%27s%20fiscal%20rules%20dilemma.pdf

economic stability and real output growth[9,10]. The creation of additional EU safe assets would take advantage of the current trade and financial turmoil as global investors seek geographies outside the US for safe-haven bonds. European safe assets would be a crucial step in deepening the capital markets union, serving as a benchmark to encourage capital into EU-wide corporate debt and bolstering the international role of the euro[11].

To fund additional EU fiscal capacity, options for new EU-wide taxation measures – such as an EU-wide digital services tax, wealth tax, or frequent flyer levy – should be assessed and carried forward. Well-designed taxes will not only raise revenue, but create incentives that guide the shape of the future economy towards reducing emissions and/or inequality.

Policy coordination to control inflation while achieving long-term goals

- The ECB must introduce an adaptive inflation targeting approach, to avoid stunting investment and employment with unnecessarily high interest rates during periods of persistent supply-side shocks.
- Fiscal policy and regulation must correspondingly take more responsibility for preventing and mitigating the effects of inflation, allowing space for interest rates to be lower:
    - In the short term via targeted price controls, supply-chain interventions and cost-of-living support.
    - In the long term via monitoring systemically important prices, building buffer stocks, competition policy reforms to prevent price-gouging, and structural measures to boost price stability, such as investing in domestic renewable energy supply.
- The ECB must do more to fulfil its secondary objective to support the general economic objectives of the EU, particularly the green transition. Necessary measures include:
    - Removing the carbon bias in the collateral framework, which currently disproportionately privileges fossil fuel assets
    - Introducing green targeted longer-term refinancing operations (TLTROs), a lending programme that would reduce interest rates for green investments, leading to a cheaper energy transition and improved industrial competitivity.
- In the longer run, establish an Economic Coordination Council to provide the institutional structure and democratic legitimacy necessary for closer monetary, fiscal and regulatory coordination.

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[9] European Commission. (2024). *Strengthening the EU through ambitious reforms and investments.* https://commission.europa.eu/document/download/f953f881-5a01-4040-804c-16be479ed3c4_en?filename=COM_2024_82_1_EN_ACT_part1_v5.pdf
[10] Bankowski, K., Ferdinandusse, M., Hauptmeier, S., Jacquinoit, P., & Valenta, V. (2021). *The macroeconomic impact of the Next Generation EU instrument on the euro area*. European Central Bank, occasional paper series. https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op255~9391447a99. en.pdf
[11] European Stability Mechanism. (2022). *2021 Annual report.* www.esm.europa.eu/system/files?file=document/2022-06/esm-annual-report-2021.pdf

To cope with persistent supply-side shocks without stunting long-term economic goals, the ECB must adopt an adaptive inflation targeting approach[12]. In this new age of uncertainty, the economy will be impacted by increasingly frequent, severe, and persistent supply-side shocks, driven both by climate and geopolitical impacts. EU policymakers will need to look to a longer time horizon and be prepared to look-through higher short-term inflation where circumstances require. Otherwise, the ECB will have to impose consistent rates hikes which will raise government borrowing costs and undermine private investment while doing little to address the causes of supply-side shocks.

To avoid situations in which the ECB is left to hike interest rates, harming economic activity and green investment, fiscal and regulatory policy will need to take proportionately more responsibility for preventing and mitigating the effects of inflation. During the recent inflationary spike, EU and member state policymakers rapidly improvised a range of sectoral policy measures, a departure from the prevailing orthodoxy of free prices[13]. These included price stabilisation policies for energy, and in some countries – such as Spain and France – included tax-breaks or price interventions in other systemically important prices like food and housing[14]. These policies successfully reduced overall levels of inflation, reduced fossil fuel demand, and supported citizens through the cost-of-living crisis[15]. However, compared to this improvised and piecemeal reaction, a centrally coordinated and forward-looking policy framework will be much more effective at preventing cost shocks from propagating into generalised inflation in the first place[16]. Such a programme would include central monitoring of systemically important prices, buffer stocks of key goods, competition policy to prevent corporate price gouging, targeted price caps when needed, and investment in measures to structurally improve price stability (such as increasing domestic renewable energy supply).

The ECB must do more to fulfil its secondary objective to support the general aims of EU economic policy. Given the enormous impact of central banks on the distribution of money and credit in the economy, it is crucial that they support the long-term economic goals of their societies. The ECB's secondary objective is a legal mandate, but in recent decades central banks have largely not been held responsible for delivering on their secondary objectives, resulting in contradictory policies.

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[12] Barmes, D., Claeys, I., Dikau, S., & Pereira da Silva, L. A. (2024). *The case for adaptive inflation targeting: monetary policy in a hot and volatile world.* LSE CETEX. https://cetex.org/wp-content/uploads/2024/12/The-case-for-adaptive-inflation-targeting.pdf

[13] Van 't Klooster, J., Weber, I. M. (2024). *Closing the EU's inflation governance gap: The limits of monetary policy and the case for a new policy framework for shockflation.* Study requested by the European Parliament's ECON Committee. https://www.europarl.europa.eu/RegData/etudes/STUD/2024/755727/IPOL_STU(2024)755727_EN.pdf

[14] Yunda, P. (2024). *There are other ways to tackle the cost of living crisis – just ask France and Spain*. New Economics Foundation Blog. https://neweconomics.org/2024/01/there-are-other-ways-to-tackle-the-cost-of-living-crisis-just-ask-france-and-spain

[15] Van 't Klooster, J., Weber, I. M., *Closing the EU's inflation governance gap, 2024.*

[16] Van 't Klooster, J., Weber, I. M., *Closing the EU's inflation governance gap, 2024.*

To redress this, the ECB must urgently green its collateral framework, removing the carbon bias that privileges fossil fuel assets[17]. The ECB should also introduce green TLTROs or similar credit guidance mechanisms that would reduce interest rates for clean energy investments, even when the overall monetary policy position is tightening. This would ultimately feed through to lower electricity prices, which in the case of renewables are very sensitive to the cost of capital[18]. Lower electricity prices would speed up the energy transition, as well as making European industry more cost-competitive[19].

The ECB also has a vital role to play in supporting the internationalisation of the euro, particularly in the context of the weakening of the dollar's global reserve status. Increased euro internationalisation would promote the EU's prosperity, financial sovereignty and diplomatic power.

As a technocratic institution, the ECB is understandably concerned about overstepping the bounds of its mandate. Yet price and financial stability are both fundamentally enhanced by a stable climate and reduced dependence on fossil fuel imports – so there is a strong argument that supporting the energy transition falls under the ECB's primary objective. Secondly, as mentioned above, under its secondary objective the ECB is already legally required to support EU economic goals, and decarbonisation has been clearly enshrined as an official EU goal in the European Green Deal.

Notwithstanding this, the ECB will need more explicit support from the commission and the European parliament if it is to proactively take policy measures with distributional implications. To support this, MEPs can make public statements, submit questions to the "monetary dialogues" with the committee on economic and monetary affairs, and place comments on the ECB's yearly annual report.

In the longer run, the establishment of an Economic Coordination Council could provide the institutional structure and democratic legitimacy necessary for closer fiscal-monetary coordination.[20] Comprised of independent experts from across a range of policy areas – not just limited to monetary and fiscal policy but including industrial, competition, environmental and social policy – the Economic Coordination Council would assess the overall monetary-fiscal policy mix and make non-binding recommendations to policymakers. This would ensure that a bird's-eye view is taken of the overall

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[17] Dafermos, Y., Gabor, D., Nikolaidi, M., van Lerven, F., Pawloff, A. (2021). *Greening the Eurosystem Collateral Framework.* New Economics Foundation. https://neweconomics.org/uploads/files/Collateral-Framework.pdf

[18] Harris, T. (2024). *Reducing interest rates for clean energy investments.* New Economics Foundation. https://neweconomics.org/uploads/files/Reducing-interest-rates-for-clean-energy-FINAL-Nov-2024.pdf

[19] European Commission. (2024). *Study on energy prices and costs – evaluating impacts on households and industry's costs – 2024 edition.* https://p.europa.eu/en/publication-detail/-/publication/78756c15-f263-11ef-981b-01aa75ed71a1

[20] Prieg, L. et al., *How do you solve a problem like inflation,* 2025.

macroeconomic framework and provide a pathway of democratic accountability for monetary policy tools with allocative impacts.

Achieving long-term goals in an age of shocks

The EU’s current macroeconomic framework is not fit for purpose. It results in kneejerk reactions to shocks that prioritise short-term targets in arbitrary metrics while undermining long-term societal goals. It is only by implementing a coordinated policy approach with a long time-horizon that Europe will be able to achieve its long-term goals in this new era of uncertainty. Fiscal expansion to fund green and social infrastructure, accompanied by a more flexible and supportive monetary policy, is the only combination that can simultaneously confront environmental, military, industrial and democratic crises. Policymakers and politicians must move rapidly and at scale to take advantage of the narrow window of opportunity to achieve a prosperous, secure and democratic future.