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European fiscal rules should not be bent

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Particularly in times of heightened uncertainty, it is more important than ever to bolster market confidence in the willingness of the EMU crisis countries to implement consolidation and reform measures and in the credibility of the fiscal policy rules and regulations that were overhauled during the crisis. As a result, the European Commission cannot afford to back down in the incipient power struggle with Italy and France, but must insist on strict adherence to the deficit targets. Although the flexibility that the fiscal regulations provide should be exploited in full, we would explicitly caution against relaxing the fiscal rules if a renewed flare-up of the eurozone debt crisis is to be avoided. The looming budget row between the European Commission and the deficit-ridden countries France and Italy risks setting a precedent that would have major implications for the future of the European currency union.

The moment of truth is nigh. On October 29, the European Commission, the body responsible for monitoring the fiscal rules, will make the last - and perhaps most important - move in its term of office when it announces its recommendations on the draft budgets of the EMU member states for 2015. If budgets deviate from the track set out in the EU's consolidation plans, then, based on the more stringent European fiscal rules passed in 2013, the Commission is authorized, if not indeed legally obliged, to reject the draft budgets of the member states in question and demand that they be revised.

France and Italy, in particular, should be bracing themselves for the Commission's criticism. France, for example, plans not to fall into line with the 3% deficit threshold set out in the European stability pact until 2017 - four years later than originally agreed. To justify its breach of the EU's targets, France cites a variety of reasons including an ailing economy, the recent broad revision of the national accounts, updated estimates regarding potential growth along with low inflation. Although Italy is likely to meet the 3% Maastricht criterion, the Commission is likely to accuse the country of dragging its heels on the consolidation front. In particular, Italy is coming under fire for financing the tax cuts it has announced, which come as a welcome development from a growth perspective, by taking out new debt because spending cuts have been far less rigorous than planned.

Attempts on the part of the European Commission to urge France and Italy to polish up their plans before submitting their draft budgets in order to avoid them being rejected - for the first time ever in the history of the eurozone - have been to no avail. Instead, the French government accused the Commission of interfering in matters of national budget policy. But the EMU member states are obliged by treaty to comply with the EU's deficit targets.

The budget dispute between the European Commission on the one hand, and France and Italy on the other, risks setting a precedent that would have major implications for the future of the European currency union. The Commission's recommendation will be the yardstick used by the financial markets to measure the credibility of European fiscal rules, which were extended at the start of last year to grant the Commission additional powers in the monitoring of national budgets to prevent future debt crises. Other eurozone governments will also draw their own conclusions on how any deficit offenders are treated and adjust their fiscal discipline accordingly. As a result, the Commission must adopt a resolute stance if it wants to maintain confidence in the sustainability of state finances and prove that its budgetary controls are effective.

Savings do not mean choking off growth if the measures are taken in the right areas, are embedded in a medium-term concept and go hand-in-hand with pro-growth structural reforms. The combination of a medium-term consolidation strategy and pro-growth reforms has repeatedly proven itself to be effective and necessary in years gone by. Examples of how this strategy can work are available in abundance: the Scandinavian countries in the 1980s, Canada in the 1990s and, only recently, the Baltic states and Ireland (see the attached excerpt from "Emerging from the Euro Debt Crisis: Making the Single Currency Work"). References to a negative spiral caused by deficit consolidation are often politically expedient, but are ultimately not convincing. Besides, the fiscal rules already combine medium to long-term budgetary discipline with economic policy flexibility. Countries can be forgiven for falling a few tenths short of their consolidation targets if they are still making the necessary structural reforms. We strongly caution against being too lax in the application of the flexibility principle, as this could pave the way for a general lapse in fiscal discipline in the euro area, pushing risk premiums up. In this sort of environment, a return of the eurozone confidence crisis could not be ruled out.

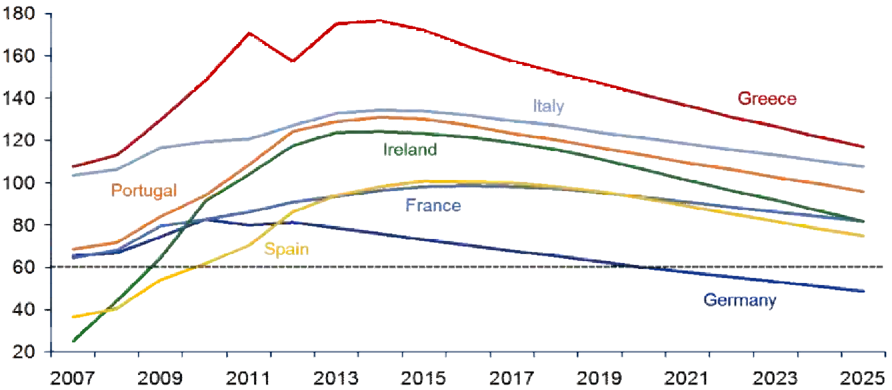
Rather, consolidation measures and reforms are essential to ensure that the current favorable government refinancing conditions can be upheld over the long run. The fact that the progress made in reducing the structural deficit has been moderate at best - both in France and in Italy - is not due primarily to weak economic development, but rather flags up that these countries have to step up their reform and savings efforts substantially. As a result, France and Italy should be asked to revise their draft budgets.

Nobody should be fooled into thinking that there is any way to confront the mountains of debt other than pursuing a disciplined and resolute approach in the longer term. Our Working Paper entitled "*Szenarien zur Staatsverschuldung im Euroraum*" (Government debt scenarios in the eurozone) shows that, even given relatively favorable conditions, whittling down the (in some cases considerable) mountain of debt will be a very tough battle.

The outlook for France and Italy, in particular, is sobering: in our base scenario ("modest growth, moderate fiscal discipline"), both countries only manage to reduce their debt ratio by 13% between 2013 and 2025, compared to a reduction in the government debt to GDP ratio of 36% in Germany and 33% in both Ireland and Greece. At the same time, however, these figures show that the reforms required of the program countries as part of the stringent bailout packages are bearing fruit. Our positive scenario, while looking rather unlikely at present, lends further backing to pro-growth structural reforms by illustrating in figures how countries can grow out of their debt. This applies all the more so in the current low interest rate environment, which offers an ideal opportunity to curb the interest burden on sovereign debt.

EMU debt scenario until 2025: Tough battle even if rules are adhered to

Debt as % of GDP



Sources: Eurostat, own calculations.

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