The euro area is in an economic and political quandary. The ECB is behind the curve. It has to deliver on its inflation target without worrying about moral hazard. Public debt sustainability needs to be better achieved without the need for self-defeating austerity. Growth prospects need to be bolstered with structural reforms without fear of stoking reform fatigue. We believe the euro area’s new policy coordination framework can help solve this increasingly complex problem by focusing on the underlying causes of the euro area crisis.

The lingering after-effects of the dual sovereign/banking crisis are weak, fragile and uneven growth with increasing risk of low inflation for an unduly protracted period of time. The euro area needs to accept the origins of the crisis were for the most part not fiscal imbalances and credibly refocus its attention on sustainable growth. Countries like France and Italy have no room for manoeuvre with respect to the binding fiscal rules. But within the rules there is room for discretion in exchange for structural reforms. Credibly focusing on growth would minimise the risk that whatever fiscal stimulus is squeezed out of the rules suffers a self-defeating Ricardian fate.

There is a way to credibly refocus attention on growth even without changing the ECB mandate or loosening the fiscal rules. In our view, the most efficient strategy would be to grant the maximum fiscal flexibility to countries such as Italy and France "within the rules" while at the same time pushing for the strictest possible implementation of the new Macro Imbalance Procedure’s (MIP) preventive and corrective arms. Europe can increasingly link fiscal flexibility to verifiable implementation of country-specific, time-bound structural reforms. These reforms need to be designed to maximise potential growth while minimising their short-term political and deflationary costs.

We see four advantages to such a strategy. It would help the ECB to follow a more proactive monetary policy stance by decreasing moral hazard concerns. It would make it easier to grant maximum fiscal flexibility to countries such as Italy and France while credibly arguing that fiscal flexibility will not have to be soon reversed. It would prove that the euro-area architecture is now better designed to address the underlying causes of macro imbalances and is not overly focused on fiscal metrics to the detriment of growth. Finally, if carefully designed and clearly communicated, it would avoid further boosting support for populist parties. The last two elements should be positive for growth over 2015 and 2016 while the first could strengthen government intentions to implement structural reforms boosting growth in the medium term.

For this strategy to emerge, it is not enough for the Commission to be willing. The support of the Eurogroup/Council is necessary. The issue is that so far politicians have failed to deliver a fully coordinated response.
Introduction: A coordinated response to boost growth requires understanding the causes of crisis

We need a simple framework to avoid getting lost in the maze of euro-area fiscal and macro rules. This will allow us to realistically assess prospects about the current debate on the need for a fiscal stimulus and identify an effective strategy.

- First: the origins of the crisis
The euro-crisis is not a simple fiscal crisis. True, mismanagement of public resources led Greece in an unsustainable position and contributed to that in Portugal. But Ireland’s and Spain’s public debt levels and fiscal deficits were in better shape than Germany’s before the crisis (Figure 1). The crisis in these countries was due to excessive leverage in the private sector. Even for Italy, the high and increasing public debt is a symptom of the chronic lack of growth over nearly 15 years.

- Second: a pinch of theory
A fiscal impulse is bound to have a disappointing impact on growth if it is clear that it will have to be soon reversed. This is not an empty tribute to the Ricardian equivalence, but a pragmatic statement for those countries that are domestically and externally perceived as fiscal constrained.

- Third: let’s be realistic
A potential fiscal impulse to euro-area real GDP could come from either the euro-area federal level or the individual country level. We discussed the prospects for the former in a recent Focus Europe and concluded that it is unlikely to be a game-changer (Section 1). At a country level we have a problem: those who could afford it won’t do it, those who want it cannot afford it. Germany is in the first group, Italy and France in the second.

- Fourth: the right kind of reform
The euro area fiscal rules contain discretion that allows a degree of fiscal leniency to be traded for structural reforms. Moreover, Europe now has a more integrated framework to manage reforms: a fiscal and a macro surveillance framework. However, the EC needs to adapt its strategy in two directions to maximize the likelihood of implementation and impact of reforms:

  a. The EC cannot afford to be too generic in its reform recommendations to countries. This means that the reform recipe needs to be adapted to the key underlying causes of macro-imbalances and be spelt out in a clear time-bound timeline. We have seen progress along this dimension in the country-specific recommendations issued to Italy (more below).

  b. Reform fatigue is a key risk. Populist parties are on the rise, even in a ‘recovery’ story like Spain. Reforms have to be designed to boost growth in a growth-friendly and non-deflationary way as soon as possible. Labour market flexibility that raises unemployment before seeing benefits may be economically costly and therefore politically self-defeating in this environment. For example, reforms that reduce the cost of business without imposing the cost on employees, should be implemented as a priority so that tougher reforms find more fertile soil.

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1 See “Economics and fiscal policy coordination in the euro area: a primer”, Focus Europe, 14 November 2014.
A coordinated solution

The euro-area will generate enough speed to exit the crisis only if the causes of the crisis are addressed. This requires structural reforms, but populist parties have increasing chances of benefiting from reform fatigue.

We think the best strategy for the euro area is to move the focus unconditionally onto growth. Importantly, to avoid ending up in a Ricardian world, this shift in focus needs to be seen as sustainable. Since neither the ECB mandate nor the fiscal rules will soften, we believe that the most efficient strategy would be to grant maximum fiscal flexibility to countries such as Italy and France and, at the same time, push the strictest possible implementation of the Macro Imbalance Procedure’s (MIP) preventive and corrective arms. Fiscal flexibility should, and can, be increasingly linked to the implementation and not just the announcement of structural reforms, with input on the assessment of the benefits of the implemented reforms coming from impartial third parties: the ECB and the IMF.

Further coordination may enhance the impact of fiscal policies further. Our strategy would be enhanced if the MIP were used equally forcefully against Germany and the Netherlands, countries with large current account surpluses and large net international investment positions. This could increase policy coordination across all euro member states and address one of the reasons why EMU is not seen as an optimal monetary area.

This is part of what we see as a necessary coordinated effort to avoid returning to crisis mode. Unfortunately, the euro-area crisis has taught us that euro-area politicians are unlikely to take a proactive approach.

In the first two sections below we consider the scope for fiscal stimulus, from a federal perspective (Section 1) and from a national perspective within the context of the euro area’s main fiscal constraints (Section 2). The results of the latter (Section 3) take us into a more detailed look at ‘those who can but won’t’ — Germany (Section 4) — and ‘those who want to but can’t’ — France and Italy. We next develop the policy coordination potential of Europe’s new and improved fiscal and macro policy framework (Section 5). Finally, we use the example of Italy to demonstrate the increasingly prescriptive, detailed and time-bound nature of Europe’s approach to pressuring member states into action on structural reform (Section 6). We conclude by wondering whether politicians will be willing to follow such a strategy.

Section 1, Fiscal stimulus I: Do not expect too much from federal investment initiatives

Some additional federal investment in Europe will come, but it is unlikely that it will be big enough to be a game changer – be it in terms of volume or sentiment.

In Focus Europe on 10 October 2014 we discussed the investment gap that we currently see in the euro area and the scope of potential euro area level initiatives to address this dearth of investment.

Investment remains weak in the euro area, compared to the recovery in countries such as the US. Some of this may reflect correction of past overinvestment, but factors such as financial fragmentation and greater policy uncertainty in the EMU suggest that the fall has been excessive, creating an

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2 It is essential that the euro area minimises the risk that the disappointing recovery becomes the new norm via a coordinated strategy based on four cardinal points: (i) structural reforms along with further coordination, (ii) proactive monetary policy, (iii) efficient use of fiscal room and (iv) fighting banks’ ever-greening via a balanced approach between a credible AQR/stress–test and a not-too punitive regulation.

investment gap. We believe that supply side measures are pre-requisites for closing the investment gap but that these should be complemented by demand side increases in public investment. The most efficient solution would link the disbursement of additional funds to compliance with the recommendations for structural reforms.

Of the measures currently on the table a potential extension of the activities of the European Investment Bank (EIB) is the most fleshed out. There is a general consensus in European politics that there should be an extension of activities of the EIB, which currently disburses EUR 50-70bn annually in the EU. The first option could be to allow more flexible use of EU structural funds for European Structural Investment Fund instruments. The second option would be for the EIB to engage in riskier projects. In the absence of a capital increase this could, however, affect its current AAA rating. Some member states, including Germany, though, have hinted that a further capital increase should not be out of sight.

These two options focus more on better deployment of existing resources and catalyzing private investment than substantial additional contributions of public funds. The multipliers are considered to be large — for instance, the EUR 10bn expansion of EIB capital in 2012, leveraged through EIB’s borrowing and co-financing of projects, was aimed at facilitating EUR 180bn of total investment. Still, there are limits to scale. Spending is reliant on the availability of appropriate projects and the ability to attract private investors – factors which limited the impact of the EUR 120bn of growth measures agreed in 2012. Even when there are suitable projects, they take time so federal investment initiatives cannot be looked at as a short-term boost to growth.

Section 2, Fiscal stimulus II: Euro area fiscal rules — who is bound and who isn’t

We use three of the main euro area fiscal rules to briefly appraise fiscal performance on the basis of our forecasts for fiscal balances in 2014-16. We use this to separate the member states into those who have fiscal room for manoeuvre (e.g., Germany) and those who don’t (e.g., France and Italy).

In a companion article in this week’s Focus Europe, our colleagues Barbara Boettcher and Nicolaus Heinen, present a primer on policy coordination in the euro area, reviewing the annual process of fiscal and non-fiscal policy surveillance in the euro area, the fiscal criteria that are assessed and the various factors taken into account to judge whether countries comply with the rules. Discretion within the rules is discussed; for example, the role that structural reforms can play in creating leeway within the fiscal rules.

### Figure 2: Euro area main fiscal rules

<table>
<thead>
<tr>
<th>Variable of reference</th>
<th>Target Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Headline fiscal deficit threshold</td>
<td>&lt; 3% of GDP</td>
</tr>
<tr>
<td>Structural fiscal balance = Medium Term Objective (MTO)</td>
<td>&gt;-0.5% of GDP</td>
</tr>
<tr>
<td>Expenditure limits - net of interest payments, unemployment benefits, funding of EU programmes</td>
<td>A – if MTO satisfied</td>
</tr>
<tr>
<td></td>
<td>B – if MTO not satisfied</td>
</tr>
<tr>
<td>Public debt (debt brake)</td>
<td>Decrease excess of debt above 60% by about 1/20 per year (see later section for formulae). This rule does not apply to countries that are under an EDP (it should fully apply 3 year after EDP exit)</td>
</tr>
</tbody>
</table>

Source: Deutsche Bank, European Commission
#1. General Government deficit below 3% of GDP
In 2014, among the euro area member states we actively forecast, four (France, Spain, Portugal and Ireland) have “excessive deficits”, defined as deficits above 3% of GDP. Each is already under an Excessive Deficit Procedure (EDP). All four have already had their deficit correction timeframes extended. This demonstrates some of the flexibility within the euro area fiscal rules. With the possible exception of Ireland, more discretion may be required in the next few years if an escalation of EDPs is to be avoided.

![Figure 3: Countries under Excessive Deficit Procedures declining…](image1)

![Figure 4: …but four countries still under excessive deficit procedures in 2014…](image2)

![Figure 5: …and progress will be slow exiting EDPs](image3)

Source: Deutsche Bank, European Commission

#2. Medium-Term Objective (MTO): structural deficit of 0.5% of GDP
Keeping the General Government Balance below 3% of GDP is not sufficient, however. Member states must aim for a Medium-Term Objective (MTO) of a structural deficit of no more than 0.5% of GDP – this would allow for up to 2.5% of GDP of cyclical deficit before breaching rule #1. Broadly speaking, that would accommodate GDP growth 5 percentage points below trend.

![Figure 6: Only Germany and Greece meet the structural budget criterion](image4)

![Figure 7: Greece’s structural budget adjustment has been large…](image5)

![Figure 8: …but France and Italy are set to remain shy of the MTO objective](image6)

Source: Deutsche Bank, European Commission

While the majority of member states comply with the sub-3% deficit criterion, only two countries among our set comply with the consistently in the period 2014-2016: Germany and Greece. The latter reflects the scale of the adjustment that has occurred through the crisis. From an average structural deficit of almost 12% of GDP in 2008-10, Greece recorded a surplus in 2013 of 3.1% of GDP in 2013, the highest of any euro member state (Germany: 0.8%).

Deutsche Bank AG/London
Countries might not be at the MTO. The recommended minimum annual adjustment in the structural balance towards the MTO is +0.5pp per year (recommendations can be larger for those under EDPs or with high public debt-to-GDP ratios). According to our expectations, hardly any country will comply with this minimum requirement in 2014, 2015 or 2016. This means either that the Commission will be broadly criticising fiscal adjustment efforts going forward, with risks of escalating action and recommendations against EDP and non-EDP countries or member states will be under pressure to avail of flexibilities within the rules, for example, adopting structural reforms to obtain leniency.

#3. Debt brake: reducing excess debt (above 60% of GDP) by 1/20th per year

The debt brake consists of a two components: a backward-looking component, aiming to assess whether government debt in excess of 60% of GDP has been falling fast enough (at least one twentieth of the gap), and a forward-looking component, to similarly assess whether debt is expected to continue to fall at a rapid enough pace.

Only one country complies outright with the debt brake: Germany. This is the case even though strictly speaking, it need not comply until 2015.

Five countries are under EDPs or a sovereign funding programme and therefore need not satisfy the debt brake criterion yet: France, Spain, Portugal, Ireland and Greece.

Four countries are out of EDP but are still under the 3-year post-EDP shield from the debt brake: Italy, Netherlands, Belgium and Austria. However, even though the debt brake does not strictly apply in most cases because of ongoing EDPs or the post-EDP shield, the Commission nevertheless still requires a sufficient adjustment in the annual structural deficit in the post-EDP countries such that once the brake does apply, the member state in question is likely to comply with it. There is a transitional requirement. The Commission requires a proportional linear adjustment of the gap between the projected debt level when the post-EDP shield ends and the benchmark level of debt at that time.

The second last column in the table below captures the potential scale of required adjustment. This column shows the gap between the forward looking debt benchmark and the expected debt-to-GDP ratio, adjusting for cyclical effects. This is because only structural slippage has to be addressed. The above-defined transitional requirement relates only to the countries in blue. In 2014, the forward looking debt benchmark says that Italian public debt is likely to be 4.5% of GDP above the required level in 2016, two-thirds of which will be due to structural slippage. This gap needs to be worked off in a linear fashion over 2014-2016. Belgium has a similar sized challenge. Netherlands and Austria are significantly less challenged.

Only one country needs to comply with the debt brake in 2014 (Finland). With debt rising through the 60% of GDP level only in 2015, Finland complies with the backward-looking benchmark. However, based on our calculations the general government debt (GGD) ratio will be 2.6% of GDP above the forward-

<table>
<thead>
<tr>
<th>Change in structural budget balance % of GDP</th>
<th>2014F</th>
<th>2015F</th>
<th>2016F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>France</td>
<td>-0.2</td>
<td>0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Italy</td>
<td>-0.2</td>
<td>0.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>Spain</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.4</td>
<td>-0.3</td>
<td>-0.2</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Austria</td>
<td>-0.2</td>
<td>0.3</td>
<td>0.4</td>
</tr>
<tr>
<td>Finland</td>
<td>-0.4</td>
<td>-0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Portugal</td>
<td>-0.4</td>
<td>0.3</td>
<td>-0.1</td>
</tr>
<tr>
<td>Greece</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.6</td>
<td>0.5</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Source: Deutsche Bank, European Commission
looking benchmark, of which only 1.0pp can be explained by weak cyclical conditions. If this is borne out in the Commission assessment, it could result in recommendations for additional tightening to be made.

![Figure 10: Being under the 3-year post-EDP debt brake shield does not mean countries do not need to reduce their debt ratios: Italy is exposed](image)

<table>
<thead>
<tr>
<th>% of GDP</th>
<th>Benchmark1 deviation 2014</th>
<th>Benchmark2 deviation 2014</th>
<th>Benchmark2 adj deviation 2014</th>
<th>Debt brake applies in:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>2015</td>
</tr>
<tr>
<td>France</td>
<td>-4.6</td>
<td>-4.4</td>
<td>-3.4</td>
<td>2020</td>
</tr>
<tr>
<td>Italy</td>
<td>-6.9</td>
<td>-4.5</td>
<td>-3.0</td>
<td>2016</td>
</tr>
<tr>
<td>Spain</td>
<td>-6.9</td>
<td>-4.3</td>
<td>-3.1</td>
<td>2019</td>
</tr>
<tr>
<td>Netherlands</td>
<td>-2.3</td>
<td>-0.7</td>
<td>0.0</td>
<td>2016</td>
</tr>
<tr>
<td>Belgium</td>
<td>-3.2</td>
<td>-3.4</td>
<td>-2.9</td>
<td>2016</td>
</tr>
<tr>
<td>Austria</td>
<td>-7.5</td>
<td>-1.0</td>
<td>-0.4</td>
<td>2016</td>
</tr>
<tr>
<td>Finland</td>
<td>0.0</td>
<td>-2.6</td>
<td>-1.6</td>
<td>2014</td>
</tr>
<tr>
<td>Portugal</td>
<td>-2.9</td>
<td>-0.8</td>
<td>0.0</td>
<td>2018</td>
</tr>
<tr>
<td>Greece</td>
<td>-4.7</td>
<td>0.0</td>
<td>0.0</td>
<td>2018</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.0</td>
<td>-2.0</td>
<td>-1.9</td>
<td>2018</td>
</tr>
</tbody>
</table>

Countries coloured grey are under EDPs and therefore rules do not currently apply
Countries coloured blue will have to comply from 2016
Countries in red have to comply from 2014
Assumes zero structural adjustment in 2014-2016

Source: Deutsche Bank

### Section 3, Fiscal compliance: Germany good, France/Italy not good

The above is a brief, surface-level assessment of euro member fiscal positions relative to the key fiscal criteria based on our macroeconomic assumptions (our GDP growth assumptions are more pessimistic, for example). More specifics would be taken into account in the formal Commission assessment. Nevertheless, one can appreciate that Germany is more or less the only country in compliance with the main fiscal rules — not only should Germany record a balanced budget in 2014, but it has reached its structural budget MTO and satisfies the debt brake.

The rest of the member states, to greater or lesser degrees, are not compliant and therefore face fiscal constraints. Among the least compliant are France and Italy, both at the forefront of current market thinking and the political debate. Representing c.35% of euro area GDP combined, these countries have the potential to be destabilizing.

Italy may have exited the EDP last year and is within half a percentage point of the MTO, but its challenge is the high public debt and the need to push consolidation further to ensure compliance with the future debt brake. France, on the other hand, has one of the highest structural deficits as well as one of the greatest challenges with public debt.

The other country that ranks poorly across these fiscal metrics is Spain. Unlike the other two, Spain has not put itself in the spotlight by seeking to lengthen its deficit adjustment period. Spain also has the benefit of a GDP growth
record in recent quarters to dampen market concern about sustainability. Nevertheless, there is vulnerability. Disorderly politics in 2015 could turn some of the spotlight onto Spain and some of the pre-election fiscal relaxation in 2015 may have to be reversed.

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**Section 4, ‘Can, but won’t’: Germany has self-imposed constraints**

Germany is currently not subject to an Excessive Deficit Procedure and also does well as regards the preventive component of fiscal surveillance. However, *national* fiscal rules limit the fiscal leeway considerably.

All told, the discretionary fiscal leeway stands at about 1% of GDP. However, using it would face non-negligible legal and political hurdles not least given the still forecast robust GDP growth. The easiest compromise could come via moderately higher infrastructure investment and would also be well in-line with current debate. The IMF, France and many economists have called for this. In practice, this would only have a limited near-term effect on demand, however.

However, while there is some room for fiscal discretion, it is unlikely that much of it will be used. Chancellor Merkel and especially finance minister Schaeuble have invested substantial political capital into achieving a balanced budget. It is often seen as the last eminent CDU/CSU goal for this government. So far also the SPD seems to adhere to the target of a balanced budget. It is often seen as the last eminent CDU/CSU goal for this government. So far also the SPD seems to adhere to the target of a balanced budget. While Vice Chancellor Sigmar Gabriel has on various occasions talked about the need for more public and private infrastructure investment and has even set up a prominent working group, he has so far defended the government’s budget plans against the SPD’s left wing. However, Gabriel would probably like to be (seen) in the driving seat of potential stimulus measures.

If there was a discretionary fiscal push, more investments in infrastructure would probably receive the broadest support (both politically and from the public). Indeed, presenting the updated revenue forecasts finance minister Schaeuble has proposed a EUR 10 bn investment package (a good EUR 3 bn p.a. from 2016 to 2018). Higher investments have limited potential in the short term – probably more limited by planning horizons than by fiscal constraints – and Schaeuble only wants to increase them with the 2016 budget. Also the SPD’s parliamentary spokesman for the budget has reiterated his support for a balanced budget as long as the growth outlook does not deteriorate further. In addition, we see a comparably limited need for the higher public infrastructure investment.

Another moderately sized and often talked about measure could be the elimination of the “cold progression” in the tax system (as German tax breaks are not inflation linked, the real impact of wage increases on people’s disposable income is limited). While this measure would probably receive broad support, the volume would also be very small. When the tax brackets were adjusted in 2012, the finance ministry estimated that adjusting for 4.4% of inflation over two preceding years corresponds to a revenue loss of EUR 6bn. The Council of Economic Advisory estimated that abolishing the cold progression would lower annual tax revenues by about EUR 3 bn. Thus, the macroeconomic impact would be negligible.
Box 1: How much fiscal room Germany really has

With the latest government plans (German draft budgetary plan 2015 submitted to the EU commission in October) seeing instead about a 0.5% structural surplus for the next years, this would in theory leave room for a fiscal stimulus of up to 1% of GDP.

The discussion about the size of the potential fiscal stimulus in Germany should, however, focus on the federal budget and its structural balance. There are several reasons for that: 1) If the government implicitly or explicitly agreed to do fiscal stimulus it can only commit its own resources. For a contribution from the German states and municipalities a separate agreement with them would be necessary. However, given the more restrictive debt brake rules for the Länder and the often precarious financial situation of the municipalities they would be much harder pressed to find room for a meaningful stimulus compared to the federal level. 2) Despite the limited direct responsibilities of the federal level for infrastructure (mostly autobahns) the size of a fiscal push for infrastructure investment would not necessarily be a constraint. Just like during the Great Recession the federal level could use targeted financial support to enable investment in e.g. local infrastructure. This also brings the Länder and municipalities into a good bargaining position vis-à-vis the federal government. 3) The social security system is unlikely to be used for fiscal stimulus (e.g. lowering of contribution rates). It would be politically difficult to sell and the system is better used as an automatic stabilizer.

The German federal government’s budget draft for 2015 foresees a structurally and non-structurally balanced budget. The Bundestag is expected to adopt the final budget by end of November. In addition, the government’s medium-term planning for the general government also anticipates a structurally balanced budget until 2018. Since then, however, the government has lowered its growth forecast from 1.8% to 1.2% for 2014, and from 2.0% to 1.3% for 2015. Obviously, the government’s budget plan was still based on the more optimistic forecasts. The new official revenue forecast which was released 6 November will be incorporated into the final budget. The changes for the federal budget were small as cyclically lower revenues were partly compensated for by lower EU budget contributions. The revenue forecast for the Länder and municipalities was more affected (about -0.1% of GDP p.a. from 2015) likely further limiting their willingness and ability to contribute to any fiscal stimulus measures. Given our own GDP forecasts (2014: 1.3%; 2015: 0.8%) there are modest downside risks to the government’s budget plans in terms of headline deficit. Our own forecast for the general government balance calls for a balanced budget in 2014 and a 0.5% deficit in 2015, while the structural should weaken from 0.5% to 0.2%. We are generally more pessimistic with respect to the structural balance on the back of the government’s spending plans (e.g. the pension package) and the expectation of a stronger negative employment impact of the minimum wage.

The German debt brake imposes a limit for the structural deficit of the federal budget of 0.35% of GDP from 2016 on, with a clearly defined adjustment path. Beginning in 2010 the structural deficit of the federal budget had to shrink from 1.9% of GDP – in equal steps of 0.31% p.a. – until it reaches the 0.35% limit in 2016. For 2015, the reduction path imposes a deficit limit of 0.66% for the federal budget. In light of the current projection of a 0.3% structural surplus (DB: 0.2%), the theoretically legal room for fiscal stimulus from the federal government would be about 1% of GDP in 2015 also in this case.
Section 5, Proactive coordination versus impasse: solving the policy quandary

Above we have shown that, in our view the fiscal side of the equation will not solve the euro-area growth problem. We are skeptical that a significant, positive fiscal impulse could come from the federal level. And at the country level we have a problem: those who could afford a material fiscal boost won’t do it, those who want to do it cannot afford it. Germany is in the first group, Italy and France in second one.

France and Italy are not simply constrained by euro-area fiscal rules. Fiscal relaxation is likely to bring disappointing consequences if it is clear that it will have to be soon reversed due to elevated levels of public debt which are not more than offset by private wealth as is the case for Japan. Without implementing structural reforms we see Italy’s public debt struggling to materially fall below 120% of GDP for the rest of the next decade.

The key culprit of the disappointing Italian debt/GDP trajectory is not elevated fiscal deficits but lack of growth. Similarly France needs to improve its competitiveness to improve its current account balance.

We have been calling for a proactive ECB. Given the unwillingness to take enough credit risk on its balance sheet we have argued that the ECB will have to expand its asset purchase programme to include government bonds (public QE). The usual objection is that public QE will heighten moral hazard and further delay pro-growth policies.

We have been writing since before the sovereign euro-area crisis that structural reforms are the number one priority. Here the objection is that in the current depressed economic conditions the short-term costs of structural reforms would be toxic from a political point of view. These short-term costs could also have deflationary consequences bringing euro-area inflation into negative territory.

Sum the above two objections and you end up in a perilous impasse. The ECB would miss its target for a prolonged period to avoid moral hazard while governments would be even wearier of implementing reforms due to their short-term deflationary impact. The former risks de-anchoring inflation expectations, deepening reform fatigue and heightening governments’ fears. Fears of losing electoral support at the advantage of populist parties leads to postponement of reforms. The postponement of reforms justifies those within the ECB opposing a pro-active monetary policy. And we would be stuck.

But we think the ECB will act according to its price stability mandate and implement public QE by Q1 2015. In our view part of the ECB Governing Council recognizes also that by increasing the average level of inflation in the euro-area towards the 2% target would help countries to cope better with the deflationary impact of structural reforms. Still moral hazard considerations also play an important role in the Governing Council dialectic and they are one of the reasons why the ECB is currently behind the curve.

That said, the ECB cannot solve the crisis. So, as described above, we believe that the most efficient strategy would be to grant maximum fiscal flexibility to countries such as Italy and France and, at the same time, the stricter possible implementation of the macro imbalance procedure preventive and corrective. Hence, while France is already under an excessive deficit procedure (EDP), we think the EC should avoid initiating a new EDP for Italy.

We see four advantages from such a strategy:

1. It would prove that the euro-area architecture is now better designed to address the underlying causes of macro imbalances and it is not
overly focused on fiscal metrics to the detriment of growth. Hence, if carefully designed and clearly communicated, it would avoid further boosting support for populist parties.

2. It would help the ECB to follow a more proactive monetary policy stance by decreasing moral hazard concerns.

3. It would make it easier to grant maximum fiscal flexibility to countries such as Italy and France and at the same time credibly argue that fiscal flexibility will not have to be soon fully offset.

4. Finally, if carefully designed and clearly communicated, it would avoid further boosting support for populist parties.

Note that the last two elements should be positive for growth over 2015 and 2016 while point one could strengthen governments’ intention to implement structural reforms boosting growth in the medium term.

Box 2: The Macroeconomic Imbalance Procedure

The Macroeconomic Imbalance Procedure (MIP) is the EU response to the erosion of competitiveness and other major imbalances developed by several member countries before the Great Recession. This new surveillance and enforcement mechanism was set up in December 2011 as part of the so-called “Six-Pack” legislation which complements the fiscal surveillance. The MIP encompasses three main elements:

1 - An early warning system: The alert system in the report is based on a scoreboard consisting of a set of eleven indicators covering the key potential sources of macroeconomic imbalances. The aim of the scoreboard is to filter countries that warrant in-depth reports (IDRs) to determine whether the potential imbalances identified in the early-warning system are benign or problematic.

2 – The preventive arm: The MIP allows the Commission and the Council to adopt preventive recommendations to member countries. These recommendations are embedded in the package of country-specific recommendations which the Commission puts forward in May/June every year in the context of the European Semester.

3 – The corrective arm: The MIP also has a corrective arm which applies in more severe cases: an Excessive Imbalance Procedure (EIP) may be opened for a Member State if it is found to experience excessive imbalances in the sense of the MIP regulation. The Member State concerned will have to submit a corrective action plan with a clear roadmap and deadlines for implementing corrective action. Surveillance will be stepped up by the Commission on the basis of regular progress reports submitted by the Member State concerned.

For euro-area countries the corrective arm is enhanced by a two-step enforcement regime: (i) an interest-bearing deposit can be imposed after one failure to comply with the recommended corrective action and (ii) after a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1% of GDP). The decision-making process in the new regulations is streamlined by prescribing the use of reverse qualified majority voting to take all the relevant decisions leading up to sanctions.

4 This box is a summary of the MIP as described in the European Commission EU economic governance website.
Section 6, Calling for strict macro conditionality

In March 2013 the European Commission published the results of its in-depth reviews (IDRs). The EC identified macro-imbalances relative to the above scoreboard in several European Union countries: Belgium, Bulgaria, Germany, Ireland, Spain, France, Croatia, Italy, Hungary, Netherlands, Slovenia, Finland, Sweden, and the United Kingdom.

Among these only three member states were found to be experiencing excessive imbalances: Italy, Croatia, and Slovenia. At the time the EC put in place a specific monitoring of the policies recommended by the European Council to the Member States with excessive imbalances (Croatia, Italy and Slovenia), as well as for countries where imbalances require decisive policy action (Ireland, Spain and France).

Section 6.1: Focus on Italy

Increasing Italy’s potential GDP growth is a key issue not only for the country but for the euro-area as a whole. On 11 November 2014, the EC published its preliminary report on Italy’s progress on growth-enhancing reforms since July 2014 following the Council’s country-specific recommendations (CSRs) and the country’s commitments in its National Reform Programme.

According to the EC the positive is that reform momentum at the government level has picked up. We would add that we need to take into account that the reform process had been in a virtual standstill since the end of 2012 if not before. However, the EC recognizes that progress is uneven.

The report is consistent with our view that several reforms – some more promising than others – have been initiated by Renzi’s government, but the overall implementation remains disappointing. The reports states that “Implementation is, indeed, Italy’s historical Achilles’ heel. Several ambitious reform packages that could represent a step-change still await full adoption or further implementing decrees and outcomes thus remain uncertain”

We also share the EC’s concerns over the “Significant uncertainty surrounds the spending review, which is key for financing important measures” such as the growth-enhancing tax cuts on productive factors. The EC criticizes the Italian Government’s decision to not follow the initial plans announced in 2013.5 The EC focused on PM Renzi’s decision that all Ministries will propose short-term spending cuts themselves: “This approach may however negatively affect the quality of the spending cuts and jeopardize the objective of preserving growth-enhancing items and improving economic efficiency.”

The EC also focused on the labour market reform enabling (delegation) law – “which contains promising measures to address segmentation, increase exit flexibility and foster participation”. The enabling law is expected to be approved by the Parliament by end-2014. The enabling/delegation law will delegate to the government the power of writing the detailed labour reform with the ex-ante approval of parliament as long as the government moves within the perimeter established by the delegation law itself. The perimeter defined by the delegation is very wide; hence, uncertainty about the final form and benefits of labour reform will remain until the government approves the legislative decrees.6

However, we do not think that even a deep labour market reform would be enough by itself to turn the Italian economy around, as has happened in Spain.

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5 These were based mainly on the work of previous IMF Fiscal Affairs Department Director Carlo Cottarelli. Cottarelli was appointed by Renzi’s predecessor Enrico Letta in October 2013 and has left his role of head of Italy’s spending review this autumn.

6 See “Italy: the beginning of the labour reform” in Focus Europe on 10 October 2014.
The labour reform needs to be planted in more fertile soil for growth. In our view, this requires an overhaul of the (i) public administration, (ii) the justice system, (iii) and of the tax system in favour of productive factors.

Overall, implementing the above reforms should bring political and economic benefits. Politically increasing the efficiency of the public administration and civil justice system is likely to be less contentious than some parts of the labour reform. Economically the advantages would be material in terms of potential GDP growth.  

In terms of reducing the tax burden on productive factors, the EC highlighted that a “first step in reducing the tax wedge has been made and the implementation of the enabling law to reform the tax system is progressing, but progress in the important areas of tax expenditure revision and environmental taxation is still limited.” In terms of the justice system the EC was more positive than we expected stating that “important efforts have been made to improve the functioning of the judicial system and a further ambitious package has been initiated, but full operationalisation has to be ensured.”

On the public administration front the EC noted the intention of the government to introduce modernizing measures. Overall we would be more critical on the progress on this aspect. We continue to think that a deep reform of the public administration is needed urgently.

The EC defined as ambitious the education system reform expected for early-2015 and was also relatively positive on measures aimed to ease and diversify firms’ access to finance which have been implemented. It recognized that steps have been taken to address energy, transport and telecom infrastructure bottlenecks. But the EC was less complimentary about developments in market opening and simplification for firms, which have been “piecemeal, often owing to institutional barriers”. While the EC recognized that proposed constitutional and institutional reforms are undergoing the legislative process, progress on the institutional side has been slow as we had expected.

The EC concluded that “While reform efforts are ongoing and several CSR deadlines are scheduled for end-2014 and early-2015, progress in the coming months will be crucial to evaluate Italy’s success in implementing measures to address its imbalances. The beneficial effects of structural reforms will be delayed and reduced if the many institutional bottlenecks, implementation barriers and the weak enforcement capacity are not tackled as a matter of priority.”

Section 6.2: Next steps

The EC should deliver the final report on Italy’s progress on structural reforms at the beginning of 2015. If deemed unsatisfactory we think that the EC should ask the European Council to put Italy officially under the corrective arm of the MIP, that is, an excessive imbalance procedure (EIP), described above.

This is not because Italy should be “punished” for old delays. Our view is that while fiscal flexibility should be maximized, the EC should be as strict as possible in evaluating progress on the structural reform side – above all for those policies that would bring significant economic benefits with limited political costs. Indeed, this should be a positive for Italy’s growth prospects.

Our reasoning applies to the overall approach to the euro-area crisis. France is one step behind Italy in terms of the Macro Imbalance Procedure’s (MIP) process, but we think the same principle should apply. If France does not fully address the causes behind the country’s lack of competitiveness, the EC

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7 Back in February, we conservatively estimated that a reduction, relative to France and Germany, of the inefficiency of the Italian civil justice system by one-third or of the gap in Italy’s FDI stock by one-fifth could boost long-term potential GDP by 0.3pp.
should quickly escalate the MIP process to the next step. Indeed, pressure should be put also on current account surplus countries if they do not address excessive current accounts by boosting domestic demand.

We think that this strategy could be enhanced if the MIP were used more forcefully against the imbalances in current account surplus countries like Germany and the Netherlands. The current account surpluses of both have been identified in the Commission in-depth reports (IDRs) as ‘imbalanced’ and a potential threat to euro area economic stability.

The IDR identified that, to the extent that the high surpluses result from large domestic investment gaps, “they also hamper the medium- to long-term economic outlook”. The report discussed the drivers of the German surplus, identifying the rising non-euro area surplus and the declining euro area surplus. The report says the latter is partly an adjustment against other surplus countries but owes more to the decline in demand from Germany’s euro area neighbours than to an increase in German imports per se. “An increase in [German] domestic demand through an acceleration of investment, would reduce the surplus, boost potential growth, and could contribute to the recovery and to the ongoing adjustment in the euro area”.

Under the preventive arm of the MIP, country specific recommendations (CSRs) have been issued, but these remain less prescriptive, less detailed and not time-bound. We expect Germany’s current account surplus to decline in 2015, but the Netherlands’ surplus should rise. An evenhanded application of the MIP should entail an escalation against the Netherlands. The new policy coordination framework would appear all the more powerful if a message was sent to Germany that it too would see an escalation if the current account surplus rises contrary to expectations. This would further increase the policy coordination across countries, partially addressing one of the reasons why EMU is not an optimal monetary area.

**Conclusions: Unpicking the OMT**

In our view the OMT was smartly constructed to address at the same time the moral hazard risk and the risk of spiraling recession.

There are, however, two issues with the OMT. First, the German Constitutional Court’s preliminary judgment seriously dented the OMT’s feasibility. Second, current projections for a very low inflation for an overly long period are not due to idiosyncratic shocks or too-high risk premia hindering economic activity. They are due to a widespread depressed economic recovery.

In this article we propose an alternative to deal with the underlying causes of the euro-area crisis. In the strategy suggested above we extract the conditionality attached to OMT and transfer it to the existing euro-area macroeconomic surveillance mechanism. In other words, we call for a strict implementation of the Macro Imbalance Procedure while allowing maximum fiscal flexibility within the existing rules.

This would leave free the ECB from concerns about moral hazards so that the central bank can optimize its monetary policy response to meet its inflation target. Such a strategy requires proactive coordination from national governments. The European Commission’s willingness is not enough to guarantee the strict application of the Macro Imbalance Procedure principles. The Eurogroup/Council’s support would be necessary. The issue is that so far politicians have failed to deliver a fully coordinated response.

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Appendix 1

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