Fiscal developments in the euro area

General government deficit ratio fell in 2014, but debt ratio continued to rise

At the end of April, Eurostat published data on the general government deficits and debt levels of the EU member states (notification) as part of the European budgetary surveillance procedure. According to these data, the euro-area deficit fell from 2.9% to 2.4% of gross domestic product (GDP) in 2014. This improvement was attributable to subdued interest expenditure, a rebound in economic growth and lower outlays on support for the banking sector. Without these factors, the fiscal stance would have resulted in a slight rise in the deficit ratio. Thus, the euro area's fiscal policy cannot be deemed to have been austere in 2014. The debt ratio continued to rise, from 93.2% to 94.2%.[1]

Debt ratio likewise expected to decrease from 2015

The European Commission's spring forecast expects the euro-area deficit to decrease to 2.0% of GDP in 2015, based on a broadly neutral fiscal policy course. This is attributable to an increasingly positive cyclical impact and a further fall in the interest expenditure ratio. These positive factors are set to continue in 2016, too, with a deficit ratio of 1.7% forecast despite fiscal easing. Not all measures envisaged in the national stability programmes from 2016 onwards, in particular, are taken into account as some of them have not yet been concretely specified. The debt ratio is expected to decline in 2015 – albeit slightly – for the first time since 2007 to 94.0%. This is primarily due to stronger GDP growth. A more significant fall in the debt ratio to 92.5% is on the cards for 2016.

The Greek exception

The situation in Greece still gives cause for concern, and it is virtually impossible to make a reliable forecast at present.[2] The country's outlook had brightened perceptibly up until the end of 2014, as, following a tough adjustment phase, growth had gained a foothold again. The public finance situation could probably have been stabilised without excessive additional fiscal measures. Furthermore, thanks to the extremely favourable interest rate terms granted under the assistance programmes, Greece's general government financing costs are by no means unreasonable despite its very high debt ratio. Thus the country's ratio of interest expenditure to GDP in 2014 was below the figures for Portugal, Italy and Ireland. However, the abrupt change of course embarked on by the new Greek government halted and, in some instances, reversed the reform and stabilisation course. The uncertainty which this created is burdening public finances both indirectly through the setback in economic activity and directly owing to an apparently diminishing willingness to pay taxes. Furthermore, additional expenditures have been approved. The risk premiums on Greek sovereign bonds have consequently increased sharply, and the incipient progress made last year towards regaining access to the capital market has been lost again.

1 Unlike the data reported in the Eurostat notification, the European Commission figures on the debt level in the euro area as a whole cited in this box also include lending between euro-area countries. Excluding these inter-governmental loans, the debt ratio rose by a similar amount to 91.9% in 2014.
2 The European Commission's forecast for Greece cannot be compared with those made for the other euro-area countries. The politically induced uncertainty means that the macroeconomic basis and the fiscal estimate are subject to huge uncertainty.

However, as the assistance programme for Greece – which has since been extended until the end of June – cannot be continued under the current conditions, meaning that no more assistance loans and transfers can be paid, there is an acute danger of Greece becoming insolvent.

Those European countries that have provided assistance up to now and the International Monetary Fund already stopped further payments some time ago as the Greek government has not honoured the existing agreements and has also made no new proposals that could form the basis for a compromise. At present, Greece is managing to stay solvent solely by mobilising the remaining liquidity in its government sector and because Greek banks – which have themselves forfeited access to the capital market – keep rolling over maturing government bonds (T-bills). The latter is only possible as the Greek central bank is granting emergency liquidity, and is moreover continuously extending the amount provided in view of the ongoing outflows of deposits, thereby ensuring the solvency of both the Greek banks and the Greek government in the short term. However, this will probably only be possible for both sectors beyond the immediate horizon if further fiscal assistance payments are made, at least on a temporary basis, and Greece creates a basis for sustainable public finances by implementing economic and fiscal reforms. The decision about providing further funds – which not least involves redistributing considerable risks and hinges on political agreements – should clearly rest with those responsible for fiscal policy and thus with the national governments and parliaments.

A sustainable solution will not be possible without substantial reforms and measures being taken in Greece, which previous Greek governments had committed to. Only this path will ensure that Greece can regain independent access to the capital market in the foreseeable future and that the financial assistance merely amounts to bridging payments, which can be repaid at a later date. This is another reason why the granting of financial assistance should be coupled to corresponding conditionality. It is up to the current Greek government to present suitable proposals, implement the agreements made and thus make its contribution to preventing a sovereign insolvency, which would result in severe dislocations in Greece. Any future agreements should take on board that an easing of the conditions for the fiscal targets would probably delay a return to the capital market and mean that the additional assistance for government financing would have to be higher. A debt waiver by the European Financial Stability Facility (EFSF) and in respect of bilateral loans would currently not help to provide a solution to the Greek government's liquidity problems as the European assistance loans will not mature in the coming years and the associated interest costs are particularly low and, for the most part, deferred for 10 years. By cutting interest rates, granting deferrals and extending maturities, the other countries providing assistance have already granted substantial debt relief, even if these concessions have not been labelled as debt forgiveness.[3]

Consolidation efforts likely to stall in euro-area countries with significant budgetary problems

According to the European Commission's forecast, the deficit ratio will fall up until 2016 not only in the euro area as a whole but also in most of the member countries.

3 In 2012, private creditors agreed to a haircut on their claims together with maturity extensions and low interest rate charges.

However, seven euro-area countries (in addition to Greece[4]) are still subject to an excessive deficit procedure (EDP). For Ireland, Slovenia and Portugal, the deadline for correcting the excessive deficit will expire this year. While the European Commission's forecast expects both Ireland and Slovenia to achieve a deficit ratio of just under 3% by the deadline, Portugal could just miss this target. Cyprus is set to correct its excessive deficit on time in 2016, while Spain – which also has a 2016 deadline – is expected to miss the target by a substantial margin. However, there is still scope for additional consolidation measures, particularly for 2016, and the Spanish government plans to meet the deadline. France's deadline for correcting its excessive deficit is 2017 and thus beyond the European Commission's forecast horizon.[5] On an average of the years 2015 and 2016, none of the countries subject to an EDP is expected to record a suitably ambitious improvement in its general government fiscal balance in structural terms, ie net of cyclical effects and one-off measures. In fact, the European Commission even forecasts a structural deterioration for Cyprus, Portugal, Spain and Slovenia if no additional measures are taken. Overall, the forecast reduction in the deficit ratios of the countries subject to EDPs is in all cases largely attributable to the improving macroeconomic situation and lower interest rates. This is not consistent with the objective of the excessive deficit procedure, which is namely to make tangible progress towards achieving sound public finances.

For those countries that are not subject to an excessive deficit procedure, the consolidation process has generally also not yet been completed. Only three of these countries (Germany, Luxembourg and the Netherlands) met the minimum requirement of a structurally (close-to-) balance budget in 2014 and will also comply with the requirement up to the end of the forecast horizon. The other countries should, in principle, reduce their structural deficit by 0.5% of GDP each year (although, in individual cases, a higher or lower amount of improvement can be requested on account of the economic situation, for example). None of the countries concerned is expected to fulfil the fundamental requirement on an average of the years 2015 and 2016, and in four of the countries the structural deficit is actually set to worsen (Austria, Estonia, Finland[6] and Latvia). In countries with very high debt ratios – as is the case in Italy and Belgium, for example – the delay in moving towards the medium-term budgetary objective is particularly problematic.

Since the beginning of the financial and economic crisis, almost all countries have recorded sustained and considerable rises in their debt ratios over many years. A reversal of this trend is envisaged from 2016 at the latest. Only in Finland, Spain and France are the debt ratios expected to continue to climb thereafter in the absence of additional measures. Despite a forecast decline, the second highest debt ratio for 2016 (after Greece) is recorded for Italy (over 130%). Furthermore, debt levels are also expected to exceed GDP in Portugal, Cyprus,

4 Greece is disregarded in the following analysis regarding the key indicators of the Stability and Growth Pact.
5 In addition to complying with the deficit criterion, member states with a debt ratio of more than 60% must rapidly bring it down to this threshold. Malta is subject to an excessive deficit procedure because it failed to comply with the debt criterion. The deadline for correcting this expired in 2014. The European Commission has recommended that the European Council close the procedure.
6 On 13 May 2015, the European Commission published a report pursuant to Article 126.3 of the Treaty on the Functioning of the European Union, which concludes that neither the deficit criterion nor the debt criterion can be deemed to be fulfilled. It is likely to recommend that the European Council open an excessive deficit procedure against Finland.

Forecast for the public finances of the euro-area countries

Country	European Commission spring forecast, May 2015						Deadline for correcting excessive deficit
	Budget balance as a percentage of GDP			Government debt as a percentage of GDP			
	2014	2015	2016	2014	2015	2016	
Austria	− 2.4	− 2.0	− 2.0	84.5	87.0	85.9	–
Belgium	− 3.3	− 2.6	− 2.4	106.5	106.5	106.4	–
Cyprus	− 8.8	− 1.1	− 0.2	107.5	106.7	108.4	2016
Estonia	0.6	− 0.2	− 0.1	10.6	10.3	9.8	–
Finland	− 3.2	− 3.3	− 3.2	59.3	62.6	64.8	–
France	− 4.0	− 3.8	− 3.5	95.0	96.4	97.0	2017
Germany	0.7	0.6	0.5	74.7	71.5	68.2	–
Greece	− 3.6	− 2.1	− 2.2	177.1	180.2	173.5	2016
Ireland	− 4.1	− 2.8	− 2.9	109.7	107.1	103.8	2015
Italy	− 3.0	− 2.6	− 2.0	132.1	133.1	130.6	–
Latvia	− 1.4	− 1.4	− 1.6	40.0	37.3	40.4	–
Lithuania	− 0.7	− 1.5	− 0.9	40.9	41.7	37.4	–
Luxembourg	0.6	0.0	0.3	23.6	24.9	25.3	–
Malta	− 2.1	− 1.8	− 1.5	68.1	67.2	65.4	2014
Netherlands	− 2.3	− 1.7	− 1.2	68.8	69.9	68.9	–
Portugal	− 4.5	− 3.1	− 2.8	130.2	124.4	123.0	2015
Slovakia	− 2.9	− 2.7	− 2.5	53.6	53.4	53.5	–
Slovenia	− 4.9	− 2.9	− 2.8	80.9	81.5	81.7	2015
Spain	− 5.8	− 4.5	− 3.5	97.7	100.4	101.4	2016
Euro area	− 2.4	− 2.0	− 1.7	94.2	94.0	92.5	–

Source: European Commission.
Deutsche Bundesbank

Belgium, Ireland and Spain. Only Estonia, Luxembourg, Lithuania, Latvia and Slovakia are set to comply with the 60% reference value in 2016. The Finnish debt ratio is expected to exceed the reference value from 2015.

European Commission further weakens binding force of fiscal rules

In the coming weeks, on the basis of guidelines provided by the European Commission, the European Council will have to assess whether the requirements of the Stability and Growth Pact have been complied with. In a departure from the normal procedure, decisions for France, Italy and Belgium were already made in March. For France it was evident that it would fall well short of meeting the 2015 deadline initially set for correcting its deficit. Nevertheless, various mitigating circumstances for missing the target were acknowledged. This justified a renewed extension of the deadline, without the procedure being stepped up or sanctions being considered. France now has until 2017 to bring its deficit ratio back down below 3%. The granting of a two-year extension, instead of the one year "generally" envisaged by the regulations, was grounded, *inter alia,* on the structural reforms that the French government has committed to. Overall, this gives the impression that the recommendations are increasingly being adapted to government plans, rather than *vice versa*. For Italy and Belgium, the need to initiate a procedure was considered as these countries fall far short of the agreed quantitative requirements for compliance with the debt criterion (sufficiently diminishing debt ratio). But in this case, too, various mitigating circumstances were taken into account. In particular, it was argued that the goals are too ambitious and compliance therewith would have undesirable economic repercussions. In view of this, it was decided that expected future convergence with the medium-term budgetary objective of the preventive arm (improvement of the structural balance)

would be taken as the gauge for assessing compliance with the debt criterion. The Commission ruled that the targets of the preventive arm are not being missed to a significant extent and that the debt criterion as a whole is therefore deemed to have been broadly complied with. In Italy's case, this was chiefly facilitated by the fact that the European Commission had significantly lowered the requirement regarding the preventive arm shortly beforehand. Furthermore, in the case of both Belgium and Italy, the Commission took account *inter alia* of planned structural reforms as relevant factors, thereby ensuring that a procedure does not need to be opened. The reform of the Stability and Growth Pact was actually intended to reinforce the debt criterion in order to encourage rapid debt reduction. However, the European Commission's interpretation looks set to largely counteract that intention.

The recent decisions and decision-making processes once again demonstrate that the fiscal framework has in many respects been shaped and interpreted so elastically that a reliable and transparent binding force is achieved in neither the preventive nor the corrective arm of the Stability and Growth Pact. Owing to the growing complexity of the budgetary rules, frequent changes and numerous, open-ended exceptions, it is now barely possible to apply it in a transparent manner. Determining whether or not targets have been missed and procedures need to be stepped up, and thus whether sanctions might have to be imposed, is often no longer rule-based in the strict sense but is above all the result of *ad hoc* considerations and negotiations. It remains to be seen whether the recently announced assessment of the European Council's Legal Service has an impact. This assessment finds that several aspects of the "flexibility" in the Stability and Growth Pact presented by the European Commission are not backed up by the regulations. This could result in the decision-makers being less generous, at least in terms of their liberal consideration of investment spending and structural reforms that are only at the planning stage. However, irrespective of this, there remains large scope for *ad hoc* decisions, with the European Commission's assessments playing a key role. There are increasing signs of a changeover from a rule-based to an institution-based approach in which the fiscal framework is not defined by rules but instead by the European Commission on a discretionary basis. With regard to reliably ensuring sound public finances in the euro area as a key prerequisite for pursuing a stability-oriented monetary policy, the recent developments in connection with the fiscal rules give cause for concern.