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The Stability and Growth Pact, and Balanced Budget Fiscal Stimulus: Evidence from Germany and Italy

This paper assesses the limitations that the Stability and Growth Pact has imposed on Italy's economic recovery and its debt reduction. By evaluating Germany's fiscal policy since 1997, the paper offers recommendations for the Italian authorities. Measures put forward by European Union institutions are hampering Italy's economic recovery, and evidence indicates that fiscal consolidation is ineffective in reducing the debt-to-GDP ratio. A balanced budget fiscal injection seems the only way for Italy to escape from its economic slump without further violations of the SGP. The paper concludes that the Pact either needs to be reformed or replaced by a central fiscal authority.

The collapse of Lehman Brothers in 2008 led to a global financial and economic crisis. The resulting lack of available capital, together with the current account imbalances among the eurozone member countries, led to the eurozone sovereign debt crisis in 2009-10. Whereas the German economy emerged from the economic and financial crisis in better shape than most other eurozone countries, the Italian economy is still struggling to recover.[1] Hence, for this paper, Germany is used as a model for considering Italy's policy options. The paper evaluates the economic performance of the German and Italian economies in the context of the Stability and Growth Pact (SGP) by focusing on their ability to meet the SGP criteria. It argues that in order to reduce its debt-to-GDP ratio, Italy must pursue policies aiming to stimulate growth before undertaking long-term structural reforms. Keynesian economists claim the solution is for the government to use a "fiscal injection" (increase government spending) to hasten recovery. However, many of the recession-hit countries are also deep in debt, due in some cases to having rescued banks and other private-sector organisations, limiting these governments' options. One approach is a "balanced budget" expansion, in which government spending and taxes are raised by the same amount – hence raising national income without increasing government debt. A balanced budget fiscal expansion may be the only policy for a country to achieve growth within the SGP rules.

1 P.R. Lane: The European sovereign debt crisis, in: Journal of Economic Perspectives, Vol. 26, No. 3, 2012.

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Pre-crisis development

The SGP is an EU rule-based framework that attempts to ensure fiscal sustainability through an early warning mechanism and with potential sanctions for eurozone countries only.[2] It stipulates that government deficits should not exceed three per cent of GDP and total government debt should not exceed 60 per cent of GDP. If national debt exceeds 50 per cent of GDP, then governments should necessarily register deficits below three per cent of GDP. The growth in government expenditure must not outpace growth in gross national product and, where member states do not comply with the excessive deficit procedure (EDP), multilateral sanctions up to 0.5 per cent of GDP may be imposed.[3] Since the global financial crisis and the subsequent sovereign debt crisis, only the debt and deficit thresholds remain relevant. The SGP was revised in 2005 to take into account the effects of cyclical fluctuations on budget positions. In 2011 the SGP was reformed again to strengthen its surveillance and enforce-

2 P. De Grauwe: Economics of Monetary Union, 9th ed., Oxford 2012, Oxford University Press; S.C.W. Eijffinger, J. De Haan: European monetary and fiscal policy, Oxford 2008, Oxford University Press.

3 European Union: Treaty on the Functioning of the European Union, Eur-Lex, 1997, Articles 121, 126, 136 and Protocol 12.

ment capabilities in an attempt to instil member states' fiscal discipline.[4] However, neither the debt nor the deficit thresholds were changed, and the SGP remains a sclerotic aspect of the Economic and Monetary Union (EMU).

In the runup to EMU, many potential risks of monetary union surfaced, such as a member state adopting a loose fiscal policy.[5] With access to a much larger capital market and lower interest rates, governments could potentially engage in reckless borrowing and spending. Such policies could cause two negative externalities. First, moral hazard, if creditor states were forced to tighten their fiscal policies in response to overspending by debtor states. Second, spillover effects, if one state faced a debt crisis.[6] Furthermore, unsustainable sovereign debt risked causing price instability, which could hinder the functioning of the European Central Bank (ECB), whose mandate is to maintain EMU-wide inflation at a rate below but close to two per cent.[7] A fiscal and a banking union would complete EMU, but a central fiscal authority remains politically elusive, due to state sovereignty and subsidiarity concerns. The SGP was established to prevent these externalities, but it was designed to leave the member states' fiscal autonomy intact: a balance very difficult to strike.

Despite implementing different economic policies, the German and Italian economies shared similar patterns following the adoption of the single currency on 1 January 1999. The challenges faced by each country during the EMU sovereign debt crisis were different, but Germany's resilience reinforced its role as a model European economy. Thus, despite the differences between the Italian and German economies, European institutions pointed to the German model when proposing solutions to Italy's debt crisis. This paper provides a comparative analysis of the two economies to assess the effectiveness of such proposals. The comparison is made possible by a number of similarities between the two economies. For example, they rank as the first and third-largest economies in the EMU in terms of GDP.[8] They both maintain large global trading sectors, with a substantial share of intra-EU trade and high volumes of bilateral trade. Each country has great regional disparities: in Germany the former Soviet, eastern part of the country still lags considerably in relation to the western regions of the country, whereas Italy is characterised by an underperforming south. Both experienced the lowest average growth rates of all eurozone countries in the first half of the 2000s,[9] and both were in violation of the SGP from 2001 to 2005. However, Germany's debt rarely exceeded 60 per cent of GDP before 2008, whereas Italy's debt-to-GDP ratio has exceeded 100 per cent since the early 1990s, and it has never met the 60 per cent debt-to-GDP criterion.[10] Indeed, Italy, alongside Belgium in 1999 and Greece in 2001, succeeded in joining the eurozone on a "flexible" application of the 60 per cent debt criterion that allowed countries to join as long as they demonstrate sufficient progress towards meeting the 60 per cent target.

Throughout the first half of the 2000s, both Germany's and Italy's competitiveness declined significantly. For Germany, this was partly due to the lingering costs of unification, but also because it joined the euro at an overvalued exchange rate.[11] For Italy, this was largely because it could no longer rely on devaluation to regain competitiveness losses. German authorities engaged in a series of labour market and other structural reforms, which improved competitiveness and arguably allowed its labour force to remain relatively robust during the economic downturn of 2007-09. On the other hand, no such policies were put in place or at least rendered effective in Italy. Furthermore, Germany is one of the world's largest exporters of vehicles, machinery and chemicals,[12] with a relatively price-inelastic product specialisation. Conversely, in the past decade, Italian exports declined as the country's product specialisation came into direct competition with Asian economies.[13]

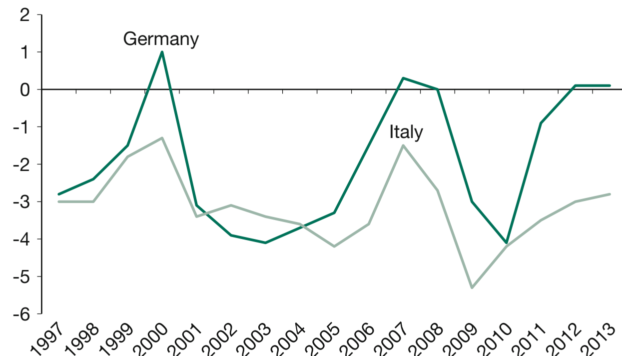
Major obstacles to growth in both countries during the early 2000s were stagnant domestic demand, structural rigidities and low productivity growth. In Germany stagnation was accompanied by a major rise in unemployment. The extended period of low growth led to structural unemployment in Germany and declining growth for both Germany and Italy. Since the 2008 global financial crisis, both economies have rebounded, although Italy's recovery has been much more modest than Germany's.

Germany and the SGP

Germany is often regarded as a fiscally prudent economy, but it was amongst the first states to be subjected to the EDP after violating the three per cent deficit-to-GDP threshold. Germany's deficit exceeded three per cent of GDP

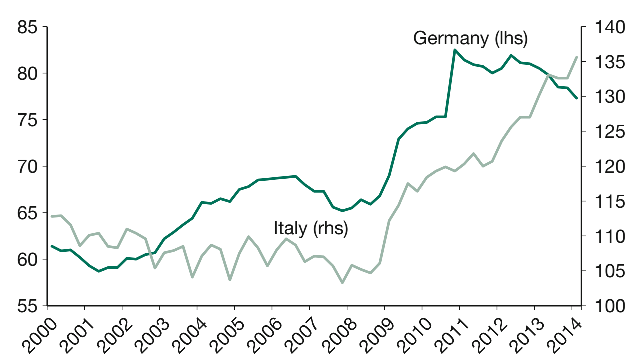
4 P.R. Lane, op. cit., p. 62.
5 S.C.W. Eijffinger, J. De Haan, op. cit.
6 Ibid.; P. De Grauwe, op. cit.
7 S. Collignon: The end of the Stability and Growth Pact?, in: International Economics and Economic Policy, Vol. 1, No. 1, 2004, pp. 15-19.
8 World Bank: World Development Indicators, 1 July 2013.
9 European Commission: The EU economy: 2006 review, European Economy, No. 6, 2006.
10 P.R. Lane, op. cit., p. 51.
11 European Commission, op. cit.
12 Organisation for Economic Co-operation and Development (OECD): Restoring Public Finances, 2011.
13 European Commission: Macroeconomic Imbalances – Italy, European Economy, Occasional Papers 107, July 2012.

Figure 1
Net lending (+) / net borrowing (-)
in % of GDP



Source: Eurostat, 2014.

Figure 2
Government gross consolidated debt
in % of GDP



Source: Eurostat, 2014.

every year between 2001 and 2006, and its debt ratio has remained in excess of the SGP threshold of 60 per cent of GDP since 2002 (see Figures 1 and 2). According to the European Commission,[14] these consecutive deficits were largely due to over-projections of GDP, which remained at just over one per cent during that period. Sluggish growth led to lower tax revenues, making it difficult to reduce deficits. However, as is evident in Figure 3, the expenditure ratio increased between 2000 and 2003, whereas the revenue ratio was reduced or virtually unchanged, even after Germany's economic recovery.

Underscoring Germany's low growth potential in the first half of the 2000s were its sluggish domestic consumption and its high unemployment. Unemployment reached one of its highest post-war levels at 11.5 per cent in 2005 (Figure 4).

14 European Commission: The EU economy: 2006 review … , op. cit.

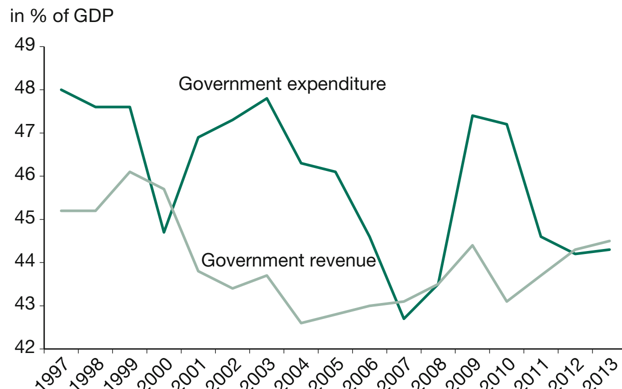
However, following a series of structural reforms between 2003 and 2005, the unemployment rate declined. These reforms, popularly known as the Hartz reforms, attempted to increase labour flexibility and improve productivity and competitiveness.[15] However, the global financial crisis resulted in the deterioration of German public finances and the excessive deficits of 2009 and 2010.

Due to Germany's reliance on trade and its specialisation in investment goods, the downturn in global investment caused one of the sharpest GDP declines there among all the world's industrialised economies.[16] However, well-functioning automatic stabilisers and expansionary fiscal policies helped boost economic growth. In addition, after three

15 M. Burda: German recovery: it's the supply side, voxeu.org, 23 July 2007.

16 European Commission: European Economic Forecast – Autumn 2009, European Economy, October 2009.

Figure 3
Government expenditure and revenue in Germany
in % of GDP



Source: Eurostat, 2014.

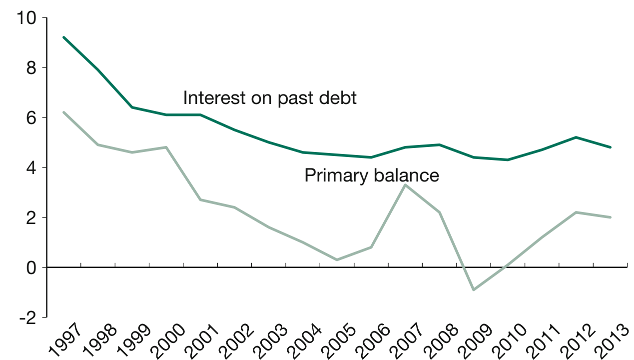
Figure 4
Harmonised unemployment rate
in %

Source: Eurostat, 2014.

Figure 5
GDP growth
Index 2005 Q1 = 100

Source: Eurostat, 2014.

Figure 6
Debt components, Italy
in % of GDP



Source: Eurostat, 2014.

years of budget surpluses prior to 2009, Germany's public finances suffered less than some of its EMU partners.

Prior to the financial crisis, German debt as a percentage of GDP had been declining. With the onset of the crisis, however, it increased dramatically. Largely due to negative cyclical conditions,[17] the German debt-to-GDP ratio increased by 10.6 percentage points between the third quarter of 2008 and the last quarter of 2009. The debt ratio also experienced a sharp increase between the third and fourth quarters of 2010, but this was almost entirely due to the government's purchase of "bad assets" from the banking sector.[18] Germany's budget balance and GDP growth since 2007 (Figure 5) show a striking resilience to the global financial crisis and the subsequent eurozone crisis. German GDP fell sharply in 2009, but growth recovered almost immediately and has since outperformed the eurozone average.

The largest contributing factor to Germany's economic recovery is its export growth. Although its increased reliance on trade to boost GDP growth predisposed Germany to the downturn in global demand, it is also what characterises its current stability and its resilience to the eurozone crisis.

Italy and the SGP

Italy suffers from a chronically high debt-to-GDP ratio, currently at 130 per cent of GDP and likely to continue rising. Efforts to reduce the debt ratio between the second quarter of 2000 and the last quarter of 2004 did not have a lasting effect, and in recent years there have been further sharp increases. Italy has been one of the best performing eurozone economies in terms of its primary balance, maintaining a primary surplus ever since joining the EMU, with the exception of 2009 (Figure 6). Even though the primary balance deteriorated considerably between 2000 and 2005,[19] this was the result of over-projections of GDP rather than loose fiscal policy. Yet despite a prudent fiscal stance, Italy's debt ratio increased by 15 percentage points since the establishment of the SGP.

Figure 1 demonstrates that between 2001 and 2006, Italy's budget deficit consistently exceeded three per cent of GDP. Under the EDP, Italy reduced its deficit to below three per cent in 2007, but following the global financial crisis, it rose in 2009 to 5.4 per cent of GDP, its highest level since 1996. The cause of these deficits, and hence the increase in the debt-to-GDP ratio, was the government's vast interest expenditure on past debt – and not fiscal recklessness. Thus, excessive debt is both the cause and the symptom of Italy's persistent deficits. Figure 6 illustrates that the interest payments each year exceed the primary surpluses (the difference between the two comprises the total budget deficit, which is added to the debt burden). Moreover, with average GDP growth of just 0.7 per cent since joining EMU, it has been nearly impossible for Italy to escape this vicious circle.

Currently, any deficit spending will put Italy in violation of the SGP and may expose it to sanctions, making it even harder to meet the SGP criteria. In 2009 Italy's annual GDP fell by 5.5 per cent. With already poor public finances, Italy's ability to engage in fiscal stimulus was and remains severely restricted by the SGP.[20] Declining nominal GDP and subsequent deficit spending between 2008 and 2009 caused an increase in the Italian debt ratio of almost 14 percentage

17 European Commission: European Economic Forecast – Autumn 2011, European Economy, June 2011.
18 Ibid.
19 European Commission: The EU economy: 2006 review …, op. cit.
20 M. Buti, N. Carnot: Fiscal policy in Europe: Searching for the right balance, voxeu.org, 14 March 2013.

points,[21] and the primary balance went into deficit for the first time since 1990. However, tax reforms led to increased revenue and pushed the primary balance into surplus despite a declining GDP,[22] indicating a notable effort by the Italian authorities. Nevertheless, the debt ratio continues to rise even as the primary balance improves. At its current pace, and based on the current EMU GDP forecasts, fiscal consolidation will most likely remain ineffective in reducing the debt ratio.

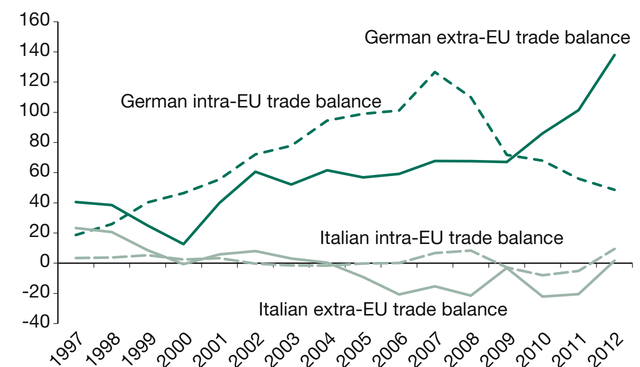
Comparative analysis

German economic policies since 1997 demonstrate considerable sacrifices whilst other EMU members enjoyed protracted periods of growth and prosperity. Although this reflects foresight by German policymakers, it must be emphasised that these reforms were made possible by deviating from the SGP criteria. This leeway allowed Germany to engage in fiscal stimulus and enact a series of reforms, which helped develop a robust economy and enabled a strong recovery from the global financial crisis. After 2005 German GDP began to increase and the country's public finances recovered. The budget deficit of 2004 became a moderate surplus by 2007, and the debt-to-GDP ratio declined.

During the crisis, the German government adopted measures including capital injections and guarantees to stabilise the faltering banking sector.[23] Although this added to deficits in 2009 and 2010, the combined effect of these measures had a positive effect on GDP and resulted in a strong recovery from the crisis. Indeed, German GDP fell more than in most other eurozone economies in 2009, but growth recovered almost immediately and has since outperformed the eurozone average. The 2010 deficit of 4.1 per cent of GDP was reduced to a deficit of 0.8 per cent of GDP a year later, whilst the debt ratio has stabilised. The largest contributing factor to this recovery is Germany's export growth.

Figure 7 helps clarify how the composition of Germany's exports boosted its recovery. Both intra-EU and extra-EU trade in goods followed upward trends until 2007. Between 2002 and 2007 there was little improvement in the balance of Germany's extra-EU trade, but during the same period, the balance of intra-EU trade became the main component of Germany's total trade surplus. At the trough of European economic activity in 2009, the German intra-EU trade balance deteriorated to its pre-2002 level. Yet despite the ensuing eurozone crisis, the German economy was able to recover through an improved external trade balance.[24] With external trade accounting for approximately 74 per cent of Germany's trade surplus, there has been a clear shift. When intra-EU trade waned, Germany was able to access Asian markets to maintain GDP growth; this diversity explains, in part, Germany's ability to remain resilient in the ensuing crisis. Thus, one of the biggest differences between the two countries is the geographical destination of their exports. Germany has covered its loss of intra-EU trade by accessing Asian markets. Italy's exports, on the other hand, suffered from a decade of stagnant demand for imports in the German market (Italy's largest trading partner). Italy's inability to access Asian markets also partly explains the decline in its trade balance.

Figure 7
Trade balance of goods
in billions of euros/ECU



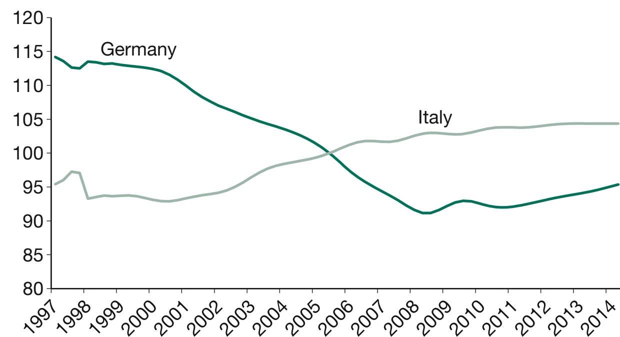
Source: AMECO, 2014.

In addition, the real effective exchange rates illustrated in Figure 8 show that Germany has experienced vast improvements in competitiveness since the first quarter of 1998, whereas Italy's competitiveness has deteriorated. Germany's improvements in cost competitiveness are primarily due to the fact that real disposable incomes were virtually unchanged between 1997 and 2006.[25]

Italy's poor export growth is characterised by the predominance of price-elastic products, which led to the loss of a large part of its market share to price-competitive emerging economies.[26] Italy's current situation is reminiscent of Germany in the first half of the 2000s: Italy would benefit from structural reforms to improve productivity and price competitiveness, as Germany did.[27] However, although such structural reforms have medium- to long-term benefits, they

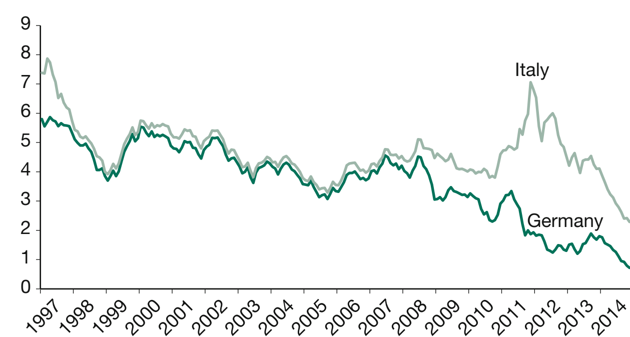
21 European Commission: Fiscal sustainability report 2012, European Economy, August 2012.
22 European Commission: Tax reforms in EU Member States 2012 – Tax policy challenges for economic growth and fiscal sustainability, European Economy, June 2012.
23 European Commission: European Economic Forecast - Autumn 2009, op. cit.; OECD, op. cit.
24 European Commission: Public Finances in EMU – 2010, European Economy, April 2010.
25 M. Burda, op. cit.
26 European Commission: Macroeconomic…, op. cit.
27 M. Burda, op. cit.

Figure 8
Real effective exchange rates
Index 2005 Q1 = 100



Source: Eurostat, 2014.

Figure 9
10-year government bond yields
in %



Source: Eurostat, 2014.

have short-term costs; structural efforts to improve competitiveness must be preceded by efforts to improve growth.

Policy options

A number of arguments have been made in favour of continued fiscal consolidation for indebted countries.[28] Fiscal consolidation may be compatible with GDP growth if uncertainty over the sustainability of public finances depresses consumption and investment – and hence growth.[29] Yet there is little evidence of this being the case in Italy, whose debt is only a medium- to long-run concern.[30] Moreover, with unemployment at almost double the March 2007 rate, domestic uncertainty is unlikely to be centred on government debt.

Another argument in favour of fiscal consolidation is that failure to reduce debt will lead to credibility losses and higher borrowing costs. This can be self-fulfilling, if higher borrowing costs lead to uncertainty over the sustainability of government finances.[31] In response, financial markets add a default risk premium on Italian sovereign bonds, which can raise the debt ratio even higher. However, De Grauwe and Ji[32] found compelling evidence that bond spreads are not correlated with the debt ratio in the eurozone post-2008. Instead, they found that eurozone bond spreads increase as the result of panic-driven collective behaviour rather than poor macroeconomic fundamentals. Their findings highlight the need for a fiscal union, or at least a banking union, rather than improving any country's fundamentals – with the exception of Greece. The ECB's Outright Monetary Transactions (OMT) policy, for all its effectiveness, does not provide a long-term solution.

Although the Italian spread increased considerably towards the end of 2011 (Figure 9), there is little evidence to suggest that this reflects unsustainable macroeconomic fundamentals. The relationship between Italy's debt ratio and borrowing costs is complex; factors such as fear of contagion and political instability must be taken into account. The spreads increased sharply after May 2011 and peaked in November 2011 as the Italian government credit rating was downgraded,[33] spreading fears of a self-fulfilling liquidity crisis. Rates then declined when Mario Monti became Italian Prime Minister. Whilst this decline might be attributed to Monti's commitment to fiscal consolidation, it is more likely that financial markets responded to the newfound political stability.[34] Shortly after the political deadlock of spring 2013, general elections led to a further downgrade of Italy's credit rating,[35] although macroeconomic fundamentals such as

28 A. van Riet et al.: Euro area fiscal policies and the crisis, ECB Occasional Paper No. 109, 2010; C.M. Reinhart, K. Rogoff: Growth in a time of debt, in: American Economic Review, Vol. 100, No. 2, 2010, pp. 573-578; A. Merkel: Addressing global and European challenges, World Economic Forum, Annual Meeting, Davos, 24 January 2013; O. Rehn: Recovery from the crisis – Coherent policies for growth and jobs, ILO European Regional Meeting, European Commission, Speech, Oslo, 9 April 2013.

29 F. Giavazzi, M. Pagano: Can severe fiscal contractions be expansionary? Tales of two small European countries, in: O.J. Blanchard, S. Fischer (eds.): Macroeconomics Annual, Vol. 5, pp. 75-122, Cambridge, MA 1990, MIT Press; A. Afonso: Expansionary fiscal consolidations in Europe: New evidence, ECB Working Paper No. 675, 2006; A. van Riet et al., op. cit.; G. Giudice, A. Turrini, J. in 't Veld: Can fiscal consolidations be expansionary in the EU? Ex-post evidence and ex-ante analysis, European Economy, Economic Paper No. 195, 2003.

30 European Commission: Fiscal ..., op. cit.

31 A. van Riet et al., op. cit.

32 P. De Grauwe, Y. Ji: Self-fulfilling crises in the Eurozone: an empirical test, CEPS Working Document No. 367, June 2012.

33 R. Milne: S&P downgrades Italy's credit rating, Financial Times, 20 September 2011.

34 P. Krugman: Austerity, Italian style, New York Times, 25 February 2013, p. A17.

35 Moody's: Rating Action: Moody's downgrades Italy's government bond rating to Baa2 from A3, maintains negative outlook, Moody's Investors Service, 13 July 2013; F. Landini: Italy's debt cost at 2013 high on downgrade, politics, Reuters, 13 March 2013.

slow growth and rising unemployment were also contributing factors. Increasing Italian bond yields resulted in upward pressure on private borrowing costs and constrained private sector investment, weighing heavily on Italy's future growth potential. Arguably, the only thing that staved off a liquidity crisis before accession of the next prime minister, Enrico Letta, is the ECB's OMT policy.[36] Letta had made no commitments to austerity when he took office,[37] but long-term interest rates continued to decline.

As bond yields continue towards their pre-crisis level, it becomes apparent that they – and consequently the debt ratio – respond less to austerity and more to political and regional stability. Italian political debates prior to the spring 2013 elections were centred on the eurozone crisis and the prospect of fiscal cuts, which highlights an important relationship: fiscal consolidation polarises opinions and leads to political instability. In turn, political instability leads to a higher debt ratio and potential speculative attacks. Italy would benefit from reducing its debt ratio, but, given the current political and economic climate, severe fiscal cuts are highly unlikely to achieve this.

If fiscal consolidation is unlikely to reduce Italy's debt ratio in the short term, an alternative approach is for the Italian government to spend more and to raise taxes by the same amount. This balanced budget approach is a compromise between a Keynesian approach and the austerity currently required in Italy by the SGP. There is considerable evidence that a balanced budget fiscal injection could help Italy recover from recession through the multiplier effect.[38] As argued by Blanchard et al.,[39] only after economic activity has recovered should Italy attempt to reduce its long-term debt. By restoring growth, the Italian government will have more space for the implementation of much-needed structural reforms that will help reduce the debt-to-GDP ratio in the medium term. The ECB's recent engagement in quantitative easing is supporting the existing downward trend of the 10-year Italian bond yield, as this seems capable of preventing the emergence of deflation in the Italian economy. This will allow further leeway for Italy to engage in a balanced budget fiscal stimulus.

The effectiveness of fiscal policy will be determined by the size of the fiscal multiplier. An increasing number of studies indicate that multipliers are higher during recessions;[40] thus, if the Italian government follows a balanced budget fiscal stimulus policy, the effect will be equivalent to a fiscal stimulus. Furthermore, a large multiplier implies that fiscal consolidation is likely to be ineffective or indeed dangerous. Therefore, the EC's current emphasis on fiscal consolidation[41] might cause a deterioration in Italy's debt ratio by further depressing growth. Furthermore, it also risks causing structural unemployment and permanent long-term loss in potential output growth.[42] As Italian unemployment increases, a balanced budget fiscal stimulus may be the only way to reduce the debt-to-GDP ratio. To that extent, the SGP considerably restricts Italy's ability to scale down its debt ratio, it prolongs instability and it endangers the future of the eurozone. Indeed, Germany failed to comply with the EDP in 2005 but was not punished with sanctions. Whilst violating the SGP, Germany had the fiscal flexibility to boost its GDP growth. Italy therefore currently has the following three options:

- The Italian government could implement a balanced budget expansion by raising government spending to increase GDP and raising tax rates to avoid a rise in Italian sovereign debt.
- Italy can do what Germany did during German reunification and increase government spending – either by persuading the EU to relax SGP rules or by breaking SGP rules.
- Italy can try to persuade richer EU countries (such as Germany) to support poorer EU countries or regions (such as southern Italy). This may be the most difficult for the Italian government to achieve.

The first option, the balanced budget expansion, is the easiest to implement, as it does not involve any other European governments or EU institutions, and it is therefore politically viable.

36 M. Buti, N. Carnot, op. cit.; P. De Grauwe, Y. Ji: Panic-driven austerity in the Eurozone and its implications, voxeu.org, 2013.

37 J. Mackenzie: Italy's Letta faces early squeeze over anti-austerity drive, Reuters, 1 March 2013.

38 O. Blanchard, D. Leigh: Forecast errors and fiscal multipliers, International Monetary Fund, Working Paper No. 13/1, 2013; B.J. DeLong, L.H. Summers: Fiscal policy in a depressed economy, Brookings Panel on Economic Activity, Vol. 44, No. 1, 2012, pp. 233-297; S. Griffith-Jones, R. Jolly: Be outraged by austerity, in: Challenge, Vol. 56, No. 1, 2013, pp. 40-60; D. Hatzinikolaou: A simple approach to testing the potency of government purchases to stimulate aggregate demand, in: Journal of Reviews on Global Economics, Vol. 2, 2013, pp. 117-122.

39 O. Blanchard, A. Amighini, F. Giavazzi: Macroeconomics: a European perspective, Harlow 2010, Pearson, p. 54.

40 G. Corsetti, K. Kuester, A. Meier, G.J. Müller: Debt consolidation and fiscal stabilization of deep recessions, in: American Economic Review, Vol. 100, No. 2, 2010, pp. 41-45; A.J. Auerbach, Y. Gorodnichenko: Fiscal multipliers in recession and expansion, National Bureau of Economic Research, Working Paper No. 17447, 2011; O. Blanchard, D. Leigh, op. cit.

41 European Commission: European Economic Forecast – Autumn 2011, op. cit.; European Commission: Fiscal . . . , op. cit.

42 B.J. DeLong, L.H. Summers, op. cit.

The response to the sovereign debt crisis aggravated asymmetries in the eurozone. The gap between the German growth rate and that of Italy, and of the eurozone in general (Figure 5), has widened considerably since 2008. Whereas Italian borrowing costs have risen, German rates have decreased – reflecting the low risk premium on German bonds and indicating capital transfers from Italy to Germany. Having stabilised its debt, Germany can now afford to run a deficit within the SGP threshold and use part of the deficit for eurozone fiscal transfers.[43] Whilst this is likely to be effective, political realities remain major obstacles to solving the crisis. Yet, growing asymmetries in the eurozone require a system of fiscal transfers or a system of debt mutualisation. If the eurozone fails to act decisively, this is likely to lead to fewer options and greater political sacrifices in the future.

Conclusions

The SGP is a mechanism for maintaining fiscal prudence that allows the ECB to focus on maintaining price stability in EMU. In that respect, the SGP could bring the benefits of fiscal union without the associated externalities. Evidence reported in this paper shows that the EMU debt crisis is widening the asymmetries between Italy and Germany, which are likely to be part of a broader pattern between the centre and periphery of the EU. The existing structural rigidities in the euro area (e.g. being prone to different types of shocks) imply that a one-size-fits-all fiscal rule might be harmful in some countries.

This paper focuses on Italy and Germany, especially the slow or non-existent recovery in Italy since the global 2008 crisis. There is no evidence in this paper to suggest that Italy is unique – hence if the SGP has been harmful to Italy, it is likely to be causing problems in other peripheral eurozone countries as well. There is widespread concern among economists that the SGP is preventing recovery in Europe by producing the opposite effects of what it was intended to achieve: it has restricted governments' ability to use fiscal policy without providing the benefits of a fiscal union. Adherence to the SGP is self-defeating for Italy, which (like Germany in the mid-2000s) needs to stimulate growth before engaging in fiscal consolidation. The effects of a future shock on the Italian economy will be severe if the current institutional framework remains in place. If Italy were allowed to follow Germany's example (i.e. to break the SGP rules, in order to adopt appropriate economic policies), then a faster recovery would be expected. To protect EMU against future crises and to deal with current and future asymmetries, evidence in this paper suggests the EU should make radical changes to the SGP – or abandon it in favour of closer fiscal integration.

43 P. De Grauwe, Y. Ji: Panic-driven austerity ..., op. cit.