



# Is debt deflation a risk? The trade-off between fiscal and competitiveness adjustments

Daniel Gros with Cinzia Alcidì  
Centre for European Policy Studies

Draft Briefing Paper submitted in advance of the Economic  
Dialogue with the President of the Eurogroup in ECON  
5 September 2013

## Abstract

Most of the country-specific recommendations (CSRs) of 2012 and 2013 concentrated on the need to reduce budget deficits and to increase competitiveness. This was particularly the case for the euro area periphery. These two policy goals remain appropriate, but the CSRs failed to recognise the trade-off between them, especially concerning countries that have accumulated large external imbalances and now require a significant adjustment in wages and prices. Internal devaluation will improve competitiveness, but lowering nominal GDP growth will also worsen the debt-to-GDP ratio.

Moreover, fiscal adjustment, coupled with falling prices, will weaken the domestic corporate sector and in particular SMEs, which are prevalent in this part of the economy. There is thus a contradiction between these recommendations and the aim of protecting the SME sector from financing difficulties.

The CSRs on structural reforms are often so vague that they have become of limited meaning. They are ignored by strong countries and result in activism in weak countries without tangible results.

## 1. Introduction

The European Semester cycle closes in early July with the endorsement of the country-specific recommendations (CSRs) by the European Council. Member State governments are then expected to implement such recommendations into budgetary decisions, structural reforms and employment policies. The recommendations are formulated on the basis of specific challenges previously identified by the Commission in the framework of the annual growth survey (budget and structural challenges) as well as within the macroeconomic imbalances procedure and after hearings of the European Parliament.

Two stages are therefore crucial in this process: first, the identification of main challenges within the framework of the EU policy instruments, which include fiscal issues (falling under the spectrum of activity of the 'traditional' SGP), macroeconomic imbalances (falling under the new excessive imbalance procedure, EIP) and major overarching economic objectives, including growth and financial stability. Second, the identification of the challenges has then to result in policy recommendations.

There are sets of formal CSRs for each Member State (except the four programme countries Cyprus, Greece, Ireland and Portugal) and for the euro area as a whole, each of which covers a whole array of fiscal and structural measures. The summary document on the implementation furnished by the European Parliament<sup>1</sup> runs to about 50 pages in a schematic format. Any detailed analysis of the CSRs would thus easily run to hundreds of pages.

Hence, this short briefing paper cannot provide a detailed analysis of the CSRs and their implementation, and even less so for each country. Instead, it will concentrate on one core policy challenge, which in our view is not properly recognised in the CSRs. We will also use two examples to illustrate that judging the implementation of broader based recommendations remains highly subjective.

Our key argument reads as follows. First, the external adjustment in the euro area periphery is almost complete as their current accounts are now close to balance and turning into surpluses in some cases. This leaves the fiscal correction, both in terms of flows (deficits) and in terms of stock (i.e. excessive debt ratios), as the most important and difficult challenge.

Secondly, it is widely recognised that over the medium run, restoring competitiveness is a key requirement for ensuring that external debt can be serviced and growth can resume without large external imbalances reappearing. Structural reforms might help to increase productivity, but this will take time. It is thus certain that a significant internal devaluation will be unavoidable in several countries (some countries have already achieved part of this).

What is not recognised in the CSR is that the internal devaluation makes the achievement of the debt reduction target much more difficult. Indeed, a key limit of the

---

<sup>1</sup> See TABLE 1 on Country Specific Recommendations (CSRs) under the European Semester Cycles 2011, 2012 and 2013. European Parliament:  
<http://www.europarl.europa.eu/committees/en/econ/publications.html?id=ECON00012#menuzone>

CSRs is that they fail to acknowledge the trade-off between debt reduction and increasing competitiveness.

When it comes to structural issues, there is little doubt that financial stability is the key structural challenge for the monetary union as whole and only a true banking union can fully address it. However, this challenge falls outside the field of action of the European Semester. Country recommendations can address financial stability challenges related to country-specific problems but would fail to tackle the one at the level of the system.<sup>2</sup>

The rest of this paper is organised as follows. The next section provides some indication of the fiscal challenges and competitiveness divergences and shows how the need to restore competitiveness conflicts with the fiscal challenge and alters the debt-to-GDP ratio. The last part of this section makes a similar point by looking at debt sustainability in terms of flow variables for both the government and the private sector, with special emphasis on SMEs.

Section 3 moves away from fiscal issues and focuses on reforms. It challenges the way implementation is pursued by countries and provides two examples of the reaction of Germany and Italy to recommendations relating to structural policies. The last section concludes.

## **2. Which challenges?**

The country-specific recommendations identify a list of policy recommendations in numerous areas, which include government spending, taxation, sovereign debt, labour market, services market, banking sector, energy market, education and the business environment at large. With the specific recommendations issued in 2013 almost each country of the euro area is being asked to monitor risks, introduce corrective policy measures or provide incentives for the purpose of the good functioning of domestic systems and markets (segments) in each of the areas listed above.

This is the consequence of both the crisis and the attempt to make sure that a coherent system of surveillance is applied to all countries and that the policy stance is consistent across the area.

However, the challenges are uneven, both in economic terms and required policy responses, given that the crisis has hit in a heterogeneous fashion and structural conditions of Member States differ a lot across the Union. Furthermore, from a system perspective, in some cases, country-specific challenges are more relevant than others as the incapacity to face such challenges could have spill-over effects beyond national borders.

For the purpose of this paper we will focus on one challenge that is particularly relevant for peripheral euro area countries; a challenge that is created by trying to restore both external and fiscal balance simultaneously.

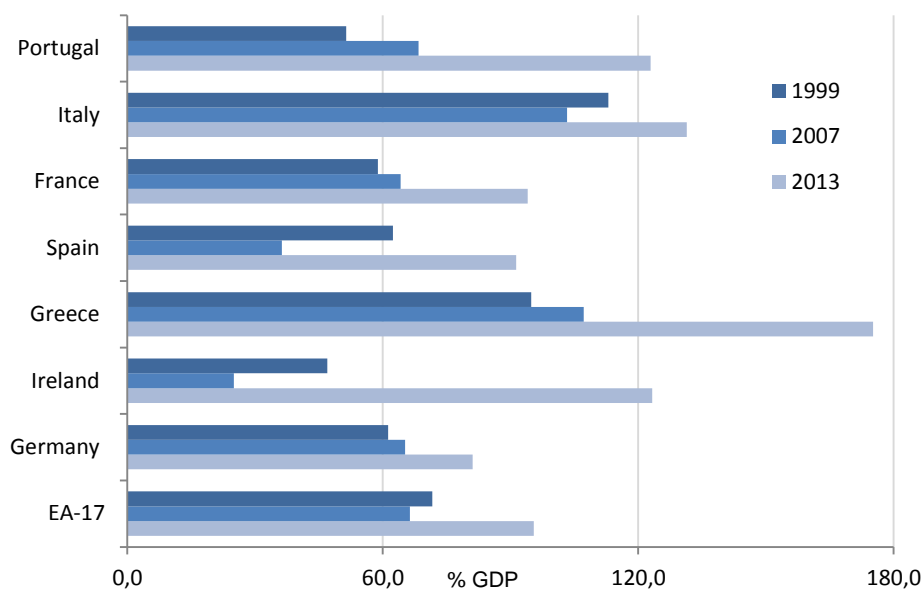
---

<sup>2</sup> In principle the euro area wide recommendations could play a role in this respect and address the issue of financial stability. However, national diverges within the Council around the issue of the Banking Union and the opposition of large countries to certain elements of it make such a kind of recommendation unlikely .

## 2.1 Short-term challenge: Fiscal adjustment

Although the fiscal policy stance became restrictive in almost all euro area countries and some implemented drastic public spending cuts after the implementation of the European Recovery Plan at the end of 2008, their budgetary position still remains negative and progress in terms of debt reduction is not yet visible anywhere. The debt-to-GDP ratio remains high on average and in many countries it is not yet under control.

Figure 1. Government debt as % of GDP: Sovereign debt ratios not yet under control.



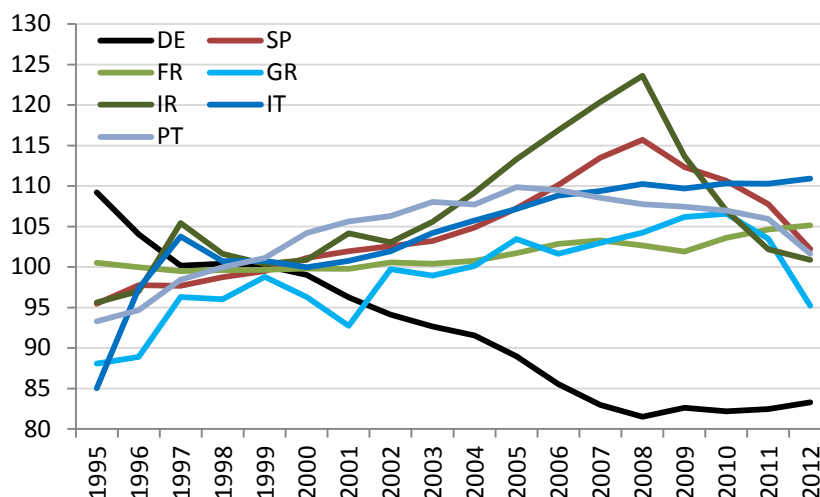
Source: European Commission services (AMECO).

This situation makes fiscal adjustment the main short-term challenge for several countries, in particular for those who have been hit most severely by the crisis. In those countries the fundamental issue is how to make sure that debt can be serviced, given that the debt is very high relative to GDP and the growth rate, current and expected, remains low. Higher growth rates of (nominal) GDP would of course help to reduce the debt/GDP ratios, but in some countries there is little prospect of this happening.

## 2.2 Long-term challenge: Restore competitiveness

There is no need to review, at length, the divergences in competitiveness that have arisen within the euro area over the last decade. Figure 2 below provides a standard illustration for this.

**Figure 2. ECB competitiveness indicator, unit labour cost, index, 1999Q1=100**



Source: ECB Statistical Warehouse.

The figure displays the large gap in unit labour costs that arose between Germany and other euro area countries up to 2008, but also how this trend is now reverting and some convergence is materialising, notably in Ireland, Spain and Greece. Several countries still have a long way to close the gap with Germany, however. This suggests that for some time yet prices will have to fall or productivity would need to increase in the euro area periphery relative to Germany.

### 2.3 Is debt deflation a risk?

According to what we argued in the two previous sub-sections, countries in the euro area periphery are struggling to achieve two goals, which should be pursued simultaneously: they have to engage in austerity to reduce fiscal deficits and, at the same time, regain competitiveness. Restoring competitiveness, in a monetary union, requires an internal devaluation. This means that domestic prices and wages in countries such as Greece, Portugal and Spain have to be reduced close to German levels, although not necessarily on a par with the German levels. Such fall in domestic prices will inevitably have a negative impact on nominal GDP, which at best will stagnate, maybe even fall. This lack of growth in nominal GDP in turn makes debt service more difficult.

In this section we propose a measure of the effect of the necessary price realignment on debt. For this purpose, we concentrate on the GDP deflator and not on unit labour costs because government revenues are usually proportional to (nominal) GDP, and do not depend directly on the evolution of labour costs.

The phenomenon whereby lower GDP growth makes debt service more difficult is often referred to as 'debt deflation', a concept introduced by the economist Irving Fisher<sup>3</sup> in the 1930s. At that time he identified a self-reinforcing feedback loop that was operating between falling prices and the economy. Falling prices made it more difficult for debtors to service their debt, but debt servicing difficulties in turn meant weaker demand, which then led to more deflation. In fact Fisher's argument goes beyond this evidence and emphasises the role played by the tight link between the credit cycle and the real economy, both during boom and bust (which in extreme cases can lead to depression). His argument starts from the observation that in a situation of over-indebtedness, deflation raises the real interest rate and the debt burden and induces distressed selling; this potentially increases bankruptcies and lowers profits. This then feeds back into the real economy as lower demand and output, which leads to lower prices. This sequence is quite comparable to the situation of the US in the late 1920s and the depression of the 1930s is an extreme example of debt deflation. Indeed, by 1933, prices had fallen by close to 40% relative to the level of 1929 and nominal GDP went down to about half of its level in 1929.

The situation in the euro area today is very different from back then, prices are still increasing and nominal GDP is also increasing in most Member States, albeit at low rates. Nevertheless, a milder form of debt deflation is operating in some countries where a large adjustment in relative prices is required and not yet completed. This difficulty has not been recognised in the country-specific recommendations addressed to any of the Member States.

Debt deflation can be looked at both from a stock and flow perspective. From the point of view of the stocks, debt sustainability is usually assessed on the basis of the debt-to-GDP ratio. This static approach neglects the ability to generate economic growth, which depends on the competitiveness of a country. Competitiveness is a relative concept which is particularly relevant within a monetary union. In order to measure the sustainability of the sovereign debt of a country accounting for its competitiveness, one should not look merely at nominal debt stock divided by GDP evaluated at today's prices, but at debt relative to GDP evaluated at the price level that would make the country competitive, and hence able to repay the debt.

This stock aspect of the debt deflation can be operationalised by simply evaluating today's GDP with the GDP deflator that would make the country competitive again, i.e. under the hypothesis that prices have realigned to the competitiveness level of the other Member States.<sup>4</sup>

---

<sup>3</sup> See Fisher (1933).

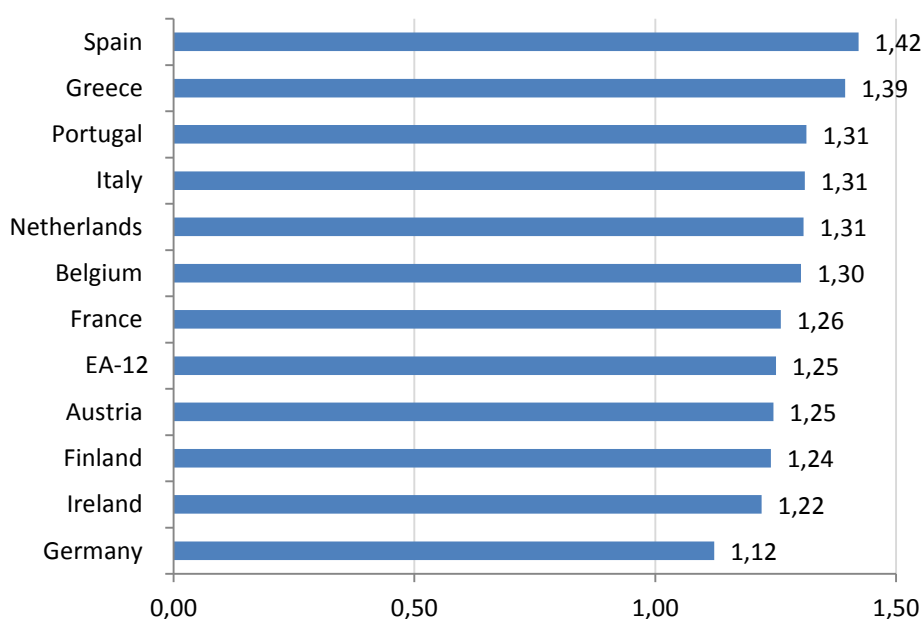
<sup>4</sup> This can be expressed as follows:

$$\left(\frac{D_t}{Y_t}\right)_i^a \equiv \frac{D_t}{P^*Y} \cdot \frac{P_t Y_t}{P_t Y_t} = \frac{D_t}{PY} \cdot \frac{P_t}{P^*} = \frac{D_t}{Y_t} \cdot \frac{P_t}{P^*}$$

The formula above simply says that the competitiveness-adjusted debt-to-GDP ratio of a country  $i$ ,  $\left(\frac{D_t}{Y_t}\right)_i^a$ , is given by its standard debt-to-GDP ratio,  $\frac{D_t}{Y_t}$ , corrected for the competitiveness of the country relative to the euro area,  $\frac{P_t}{P^*}$ . In practice, the benchmark for evaluating the loss/gain of competitiveness of a euro area country relative to the other Member States is the ratio of their GDP deflator today compared to that at the start of EMU, i.e. in 1999. This starting point also seems appropriate in light of the fact that at that time Germany was running a (small)

Figure 3 below shows the evolution of the GDP deflator and the average for the euro area countries, between 1999 and 2012, and suggests that all peripheral countries under financial stress and with highest debt today have experienced the largest increase in the indicator. Ireland is an exception since the country already experienced a swift adjustment in prices that absorbed the increases accumulated during the booming years until 2007.

**Figure 3. GDP deflator, change between 1999 and 2012 (price index, 1999Q1=100)**



Source: European Commission services (AMECO), Price deflator GDP at market prices.

Note: 1999 is assumed to be the base year.

Our key argument reads as follows: assuming that all deviations from 1999 have to be corrected one can calculate the price adjustment needed for each country, relative to the euro area average. The second row in Table 2 shows that, for example, the GDP deflator of Italy would have to fall by 5% (relative to the euro area average), whereas that of Germany should increase by 10% to be in line with the average. These values can be used to calculate a ‘competiveness adjusted’ debt-to-GDP ratio. The result of this thought experiment is contained in the last row of Table 1, which shows the ‘competiveness adjusted’ debt ratio.

**Table 1. Competitive-adjusted debt-to-GDP ratios (reference year 1999)**

Belgium	Germany	Ireland	Greece	Spain	France	Italy	Netherlands	Austria	Portugal	Finland	EA-12
---------	---------	---------	--------	-------	--------	-------	-------------	---------	----------	---------	-------

---

current account deficit and most of the euro area periphery had small deficits or actually surpluses (Italy).

Debt-to-GDP	100	82	118	157	84	90	127	71	73	124	53	98
Adjustment factor	1.04	0.90	0.98	1.11	1.14	1.01	1.05	1.05	1.00	1.05	0.99	1.00
Adjusted debt ratio relative EA	104	73	115	174	96	91	133	75	73	130	53	101

Source: own calculation based on European Commission services (AMECO).

This implies that the debt ratio in Italy, as well as in Spain, Greece and other countries is in reality even higher than officially measured; whereas that of Germany is lower than the official value. The difference between the standard measure and the 'competitiveness adjusted' debt ratios represents the impact of (relative) debt deflation. The table suggests that Germany is now enjoying 'debt inflation'. It is clear that for some countries, notably Italy and even more so Greece, where the level of debt is already very high debt deflation is important as it makes the achievement of lower debt/GDP ratios even more difficult.

This approach suggests that (relative) debt deflation is an important phenomenon, but mainly for the two countries with the highest level of debt ratio. The situation should be manageable for Italy (where the competitiveness-adjusted debt ratio is 133% of GDP instead of the 127%), while for Greece both ratios ('normal' at 157% of GDP and competitiveness adjusted at 171%) seem so high to denote an unsustainable situation. Since most Greek debt is now owed to official lenders, the IMF and the ESM (which are the main creditors) will have to recognise that the more progress Greece makes in reducing its price level (and thus regain competitiveness) the higher the debt/GDP ratio will be and the more difficult it becomes for the government to service the debt.

The countries that had lost competitiveness in the past often have a debt/ratio above the average today. This implies that in most cases the changes in competitiveness work in the direction of magnifying already existing disparities: as shown in the table, Germany, which already has a relatively low debt ratio, will benefit from debt inflation. By contrast, Italy and Greece, which already have high debt ratios, will suffer from debt deflation.<sup>5</sup>

The values shown above are computed based on the reference year 1999. Other experts and analysts have taken different approaches, resulting in much larger adjustment needs. Below we show an equivalent calculation to that in Table 1 but assuming 1995 as the reference year. This is consistent with the analysis of Sinn (2013) where it is argued that 1995 should be taken as the base year because that is when the irrevocable commitment to the euro was announced. Under this hypothesis the debt deflation phenomenon becomes more extreme, leading to a competitiveness-adjusted measure of the debt-to-GDP ratio that is much more unfavourable to high-debt countries.

---

<sup>5</sup> In statistical terms this can be seen in the standard deviation in the debt ratios: while this is 30 for the 'normal' debt-to-GDP ratios and 35 for the adjusted ratios.



**Table 2. Competitiveness adjusted debt-to-GDP ratios (reference year 1995)**

	Belgium	Germany	Ireland	Greece	Spain	France	Italy	Netherlands	Austria	Portugal	Finland	EA-12
Adjusted debt ratio relative EA	101	71	124	205	101	89	141	76	70	140	53	98

Source: own calculation based on Sinn (2013) and European Commission services (AMECO).

Table 2 illustrates that under this extreme view about the need for the competitiveness adjustment, the divergence in debt ratios is even greater. The adjusted ratio for Greece would go above 200% of GDP and others, such as that of Portugal, would also deteriorate considerably. By contrast, the advantage of Germany is magnified given the much higher estimate of the relative need for inflation in Germany (according to Sinn, 2013).

However, a return to the relative price levels at the start of EMU, 1999, should be enough to re-establish current account equilibrium at full employment in the long run. This means that the approach based on 1995 over estimates the real need for adjustment.

Finally, it is important to emphasise that as long as there is no deflation on average in the euro area, debt deflation remains only a relative concept within the euro area. Moreover, the debt deflation required from some countries in the future represents a reversal of the (relative) debt inflation they have enjoyed in the past. This is little consolation for policy-makers today.

In the next section, we will address the debt deflation issue from a flow perspective, by comparing interest rates to nominal growth rates.

## **2.4 Can debt be serviced in Europe?**

Debt deflation can also be measured by the 'real' interest rate burden, or rather the difference between the interest rates (the rate at which debt grows if there is no repayment of principal) and the growth rate of the revenues of the borrower. But the revenues of most economic agents grow in line with nominal GDP. This is the case for the government (unless it changes tax laws) and also, on average, for the private sector.

It is thus clear that the recession that resulted (partially) from the need to rein in deficits made it more difficult to service debt in the euro area.<sup>6</sup> The difference between the growth rate of nominal GDP and the interest rate has taken a turn for the worst since the start of the crisis in the countries under financial pressure. Table 3 below shows the difference between the growth rate of (nominal) GDP and the (nominal) interest rate actually paid by governments while Table 4 displays the same differential for non-financial corporations.

---

<sup>6</sup> The UK is somewhat different given that nominal income has held up better due to higher inflation.

Table 3 illustrates how even before the crisis began the difference was negative for the euro area average, indicating that interest payments were accumulating at a faster pace than the capacity to service the debt out of income (this implies that ‘Ponzi units’ i.e. actors who depend on additional credit to pay debt service<sup>7</sup> would already have had a difficult life). After the crisis the difference worsened by about one full percentage point (to minus 2.1%).

One first implication is that, under these circumstances, throughout the euro area it has become even more difficult to fulfil the debt reduction target recently introduced (1/20<sup>th</sup> of the excess of the debt ratio above 60% of GDP).

**Table 3. Interest rate-growth rate differential (government debt), selected countries**

	Boom (until 2008)	Bust (since 2008)	Change
EA	-1.1	-2.1	-1.1
DE	-2.7	-1.2	1.5
ES	2.0	-3.3	-5.4
IT	-1.4	-3.7	-2.3

Source: own calculations based on Eurostat data.

Note: interest rate refers to 10-year government bonds

Table 4 displays the same variable (difference interest rate – growth of nominal GDP), but this time for the corporate sector, using the interest paid on medium-term loans to non-financial corporations. The table shows that the area average deteriorated by over two full percentage points during the crisis. This implies that the corporate sector must be under considerable stress.

**Table 4. Interest growth rate differential for the non-financial sector, selected countries**

	Boom (until 2008)	Bust (since 2008)	Change
EA	-0.3	-2.7	-2.4
DE	-2.1	-2.1	0.0
ES	3.6	-3.9	-7.5
IT	-0.7	-3.6	-2.8

Source: own calculations based on ECB Statistical Data Warehouse.

Note: The interest rate used is the one applied on new business (not averages on past loans) of medium-term loans (over 1 year and up to 5 years) to all non-financial corporations.

The debt service capacity of non-financial corporations confirms the broad picture of a generalised boom for the periphery followed by a bust: for the euro area average the interest rate – growth rate differential was actually close to zero during the boom, but worsens after the crisis. When looking at the situation of individual countries again, one finds a stark difference between Germany (no change) and countries like Italy and Spain, where the interest rate now exceeds the growth rate by almost 4 percentage points. The deterioration is particularly stark for Spain (over 7 percentage points) given that during the boom Spanish interest rates had been lower than the euro area average

---

<sup>7</sup> See Minsky, 2008.

and the growth rate (of nominal GDP) had been much higher. Both elements have now turned around.

Here again, the intra-area differences are critical. And a clear conflict between competitiveness adjustment and the strength of the corporate sector emerges: to the extent that domestic prices and wages adjust downwards in the countries under stress the revenues of enterprises in the domestic sector will decline. Fiscal adjustment will of course make the fall in revenues even larger for that part of the corporate sector that mainly sells on the domestic market (this particularly applies to SMEs in the services sector). Lower revenues for these firms mean higher probability of default for them and losses for banks. This is indeed the feedback loop that Fisher observed in the 1930s in the US, on much larger scale. This implies that the CSRs should recognise that the combination of fiscal and competitiveness adjustment must lead to weakness in the banking sector and to financing difficulties for SMEs (which dominate the domestic services sector). As banks anticipate that the probability of payment difficulties will be greatest among SMEs operating in the domestic market, they will naturally increase interest rates and reduce the availability of credit to this sector.

Table 5, below shows that SMEs are particularly prevalent in the services sector and that the average firm size is particularly low in the countries under financial stress, like Italy or Spain. The average firm in the service sector of these two countries has only about 5 employees, compared to 11 in the German services sector (and over 30 in the German manufacturing sector). Given this prevalence of very small firms in the services sector (most of which depends on domestic demand) it is thus unavoidable that 'austerity' will lead to losses among SMEs, which in turn makes banks more reluctant to lend to them.

**Table 5. Average size of firms**

	Average number of persons employed per enterprise	
	Manufacturing	Services
Germany	33.1	11.6
Spain	10.7	5.3
Italy	9.4	4.6

Source: Eurostat

This mechanism represents just another manifestation of debt deflation, as mentioned above: there is a feedback loop between the lack of domestic demand generated both by the fiscal adjustment and the competitiveness adjustment, which has a negative impact on all firms operating in the domestic market and the strength of the domestic banking system.

Again, the same feedback mechanism should operate in reverse in Germany where 'debt inflation' should lead to an improvement in the debt service capacity of the German government and the German corporate sector, including its SMEs. One should keep in mind that (as illustrated in the tables above) Germany had the worst growth – interest rate differential during its slow growth period until 2005, but this improved after the crisis as interest rates fell in Germany while they increased elsewhere in the euro area.

Table 4, above, showed the interest – growth rate differential for the past. Table 6, below, tries to look into the future by assuming that interest rates remain at their

present level, but nominal GDP grows along the path predicted by the IMF; a path that implies a return to competitiveness.

**Table 6. A continuing squeeze on the non financial sector?**

	Actual interest-growth differential (since 2008)	Status quo continues with competitiveness adjustment
EA	-2.7	-0.61
DE	-2.1	-0.31
ES	-3.9	-2.33
IT	-3.6	-1.64

*Source:* own calculations based on ECB Statistical Data Warehouse.

*Note:* The second column contains the difference between the average GDP growth rate (nominal, based on WEO projections) from 2013-2018 and the current interest rate measured by the average interest rate, over the period January-June 2013, applied to new loans to non-financial corporations (ECB, August 2013).

This problem is crucial for future economic developments in terms of the capacity of the private sector to service its debt and banks' ability and availability to extend credit, but it is not recognised in the CSR.

### 3. How to make policy recommendations meaningful?

In reality, the CSR contain two quite different sets of recommendations: the policy recommendations regarding fiscal policy are usually precise and contain numbered targets. However, many other policy recommendations are quite vague and effectively constitute exhortations to the government to adopt a certain general policy direction without giving any precise target to be achieved. This leaves lots of room for disagreement on what the recommendations actually mean and leads to vague suggestions that might be addressed in a superficial and artificial way by any country. Which country would not benefit from a "better coordination of different levels of government" or "a more efficient implementation of planned reforms"?

On the structural reforms front, the key is thus the (old and twofold) issue of interpretation and enforcement. This is unavoidable, given that in some areas targets cannot be quantified and it is not clear how to reach them best. We provide two, admittedly extreme, examples for this.

#### 3.1 Two extreme examples: Germany and Italy

One example of how a government deals with a generic recommendation to "further stimulating competition in the services sector" is provided by the case of Germany.

Germany's national reform plan of 2013<sup>8</sup> (which is supposed to incorporate the CSRs) contains a response to the recommendations of the previous CSRs. Below we consider the parts relative to competition in the services sector:

---

<sup>8</sup> The plan presented in early 2013, refers to reforms implemented over the past year (see [http://ec.europa.eu/europe2020/pdf/nd/nrp2013\\_germany\\_en.pdf](http://ec.europa.eu/europe2020/pdf/nd/nrp2013_germany_en.pdf)).

*“70. The domestic services market harbours great potential for growth, especially in the area of services based on network infrastructure. For this reason, the Federal Government is further considering the elimination of excessive constraints. Essential and appropriate regulations that serve, for example, to safeguard a level of training, actively provide consumer protection or ensure freedom to exercise a profession independently, are to be retained.”*

While this statement seems to claim the obvious: excessive constraints are to be eliminated but ‘useful’ regulation to be retained; implicitly it is saying that Germany has little intention of enacting reform in this sector.

*“71. The internal market for services cannot be strengthened through legal regulations alone. Improving “soft” factors is also important: such as building trust among consumers in services providers from other member states.”*

Similar to the point above, this also states a truism. But the real message is that German consumers will in any case not buy services from other countries because they do not trust them.

The most interesting part of the German government’s response is contained in the following paragraph:

*“72. Competition has become more intense in the services sector over the last few years.....According to the laws on chimney sweeping, regulation of fees is to be limited to the few remaining government tasks performed by authorised district chimney sweeps.”*

It is interesting that in the summary evaluation of the Commission this liberalisation of chimney sweepers is judged as ‘limited progress’ with service sector liberalisation.

All in all it seems that the recommendation to “further stimulate competition” in the German services sector has not had much of an impact on German policy-making.<sup>9</sup>

In Italy the situation is not much better: in 2013 key recommendations contained in the CSR were:

- 1) Keep taxes on wealth: *“shift tax burden away from capital and labour to property ...”*

It is unclear at the moment whether the present coalition government will fully abolish the real estate tax (IMU) introduced by the former Monti government or keep it. At the very least its degree of applicability will be reduced as one key coalition partner wants to see this tax abolished.

---

<sup>9</sup> In defence of Germany, one needs to keep in mind that the CSR are addressed to the national government, but that in Germany services sector liberalisation would require the consent of the lower echelons of government as well.

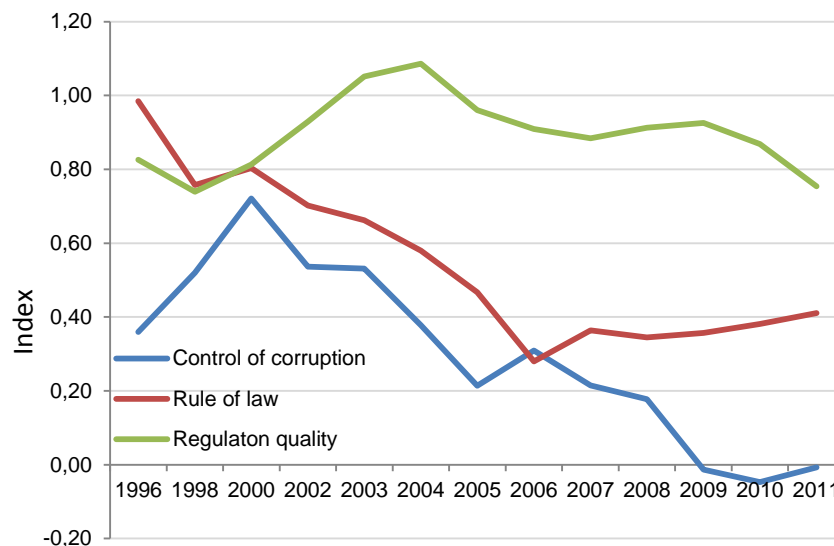
- 2) Improve governance of banks: *“Extend good corporate governance practices to whole banking sector”*.

In concrete terms what was meant was to reduce the influence of the thinly capitalised foundations that dominate the board of the major banks. It seems very unlikely that anything will be done in this direction.

- 3) Improve the judicial system: *“Reduce the duration of case handling and the high level of litigation in civil justice...Strengthen the legal framework for the repression of corruption”*:

This is an evergreen, which every government in the past has promised to address. But the results so far have had the opposite effect: the most widely followed indicators of corruption have actually deteriorated over the last decade (see also Gros (2011) on this issue). Fighting tax evasion constitutes another evergreen which all Italian governments have vowed to address – but on which little progress has been achieved.

**Figure 4. Italy: Selected Governance Indicators**



Source: World Bank, Worldwide Governance indicators,

Note: Indicators range from approximately -2.5 (weak) to 2.5 (strong) governance performance

This simple observation that corruption indicators have deteriorated in Italy despite official government efforts to the contrary raises a key issue for the parts of the CSR that aim at structural reforms: should compliance with the CSR be judged based on the actual outcome (as in the SGP) or on the efforts of the government concerned?

## 4. Conclusion

The recommendations dispensed in the context of the European Semester contain many very useful elements. We have concentrated only on two key shortcomings.

The first problem for the CSRs is that the adjustment after a credit boom is always painful and comprises difficult policy choices and contradictions between different policy goals. One such policy dilemma is the need to reduce debt ratios and at the same time lower domestic prices and wages. Some debt deflation effect is inevitable after the 'debt inflation' experienced by some countries until 2008. Hence, this is not a problem that can be 'solved' easily. We propose that one should not look only at headline debt-to-GDP ratios, but also at the value this ratio would have at the prices that would make the country competitive again.

A second shortcoming of the CSRs is that their structural parts are often too vague to allow one to judge implementation. The politically and financially strong countries tend to ignore them. The politically and financially weaker countries usually respond to recommendations on structural policies by taking many measures, but it is often difficult to say whether these measures will achieve the intended result. One important case where policy activism has gone hand in hand with deteriorating results is that of Italy, where the professed fight against corruption and administrative inefficiencies does not seem to have delivered any results over the last decade.

There have of course been also instances where the CSRs have resulted in identifiable reforms (Belgium, France?), but in many cases the process seems to have become more important than the results. Therefore, more emphasis should be put on assessing the implementation of the annual recommendations.

## References

Alcidi, C. and D. Gros (2011) "[Adjustment Difficulties and Debt Overhangs in the Eurozone Periphery](#)", CEPS Working Documents No. 347, CEPS, Brussels.

Alcidi, C. and D. Gros (2013), "Country adjustment to a 'sudden stop': Does the euro make a difference?", European Economy - Economic Paper No. 492, Directorate General Economic and Monetary Affairs (DG ECFIN), European Commission.

OECD (2013), "Economic Policy Reforms 2012. Going for Growth" ([www.keepeek.com/Digital-Asset-Management/oecd/economics/economic-policy-reforms-2012\\_growth-2012-en](http://www.keepeek.com/Digital-Asset-Management/oecd/economics/economic-policy-reforms-2012_growth-2012-en)).

Fisher, I. (1933), "The Debt-Deflation Theory of Great Depressions", *Econometrica*.

Gros, D. (2011), "What is holding back Italy", Voxeu (<http://www.voxeu.org/article/what-holding-italy-back>).

Minsky, H. (2008), *Stabilizing an Unstable Economy*, McGraw Hill Professional.

Sinn, H.W. (2013), "Austerity, Growth and Inflation. Remarks on the Eurozone's Unresolved Competitiveness Problem", CES-ifo Working paper No. 4086.