



Debt brakes for Euroland

Strengthening the stability pact with national debt rules

July 12, 2010



The economic crisis has weighed heavily on the budgets of euro-area countries. In the coming years new ways will have to be found to cut deficits and boost growth in order to achieve a long-term reduction in public debt.

Good budgeting rules manage the expectations of economic agents, ensure that fiscal policy outcomes are sustainable over the long term and thereby prove to be convincing measures for investors in the capital markets. There is a great deal of room for improvement for the Stability and Growth Pact (SGP) especially with regard to the fiscal policy outcomes and how they are perceived by the capital markets.

Euro-area countries have a wide range of national budget rules. Successful consolidation has been achieved in countries that posted high growth rates and whose deficits were cut by expenditure rules.

Germany's debt brake is an intelligent and promising concept for achieving a long-term reduction in public debt. Its fiscal policy control mechanism addresses both the structural and the cyclical deficit components. Its fiscal targets are dynamic and are calculated on the basis of criteria laid down in the SGP. The debt brake could therefore easily be extended to other countries.

The debt brake represents Germany's first step towards growth-oriented consolidation. Since Germany is seen as a benchmark by the capital markets, other euro-area countries could soon decide to take similar steps. The preventive arm of the stability pact would then be extended to the "domain" of national policy.

The introduction of national debt brakes in the eurozone is technically straightforward, but politically complicated. Legally possible, but politically unrealistic is obligatory transposition in all euro-area states with a debt ratio exceeding 60% of GDP.

The outcome-oriented coordination of national fiscal policies via national debt brakes is effective and therefore desirable. With the medium-term objectives of the stability pact operating as fiscal guidelines they provide the eurozone countries with the commensurate scope to meet their budget goals using their own economic policy strategies.

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Introduction

Economic crisis leaves scars on budgets

The economic and financial crisis has left its mark on the budgets of the member states of the European Monetary Union (EMU). Since the initiation of excessive deficit procedures against Cyprus, Finland and Luxembourg on May 12, all EMU countries are currently the subject of excessive deficit procedures, while Greece has recently called on its eurozone partners and the IMF for financial assistance.

A look at the statistics reveals the depth of the scars left by the crisis: whereas in 2007, the year before the crisis, general government debt was 66% of GDP and thus already significantly higher than the reference value set by the SGP, in 2010 it will rise to no less than 84.7% of GDP.

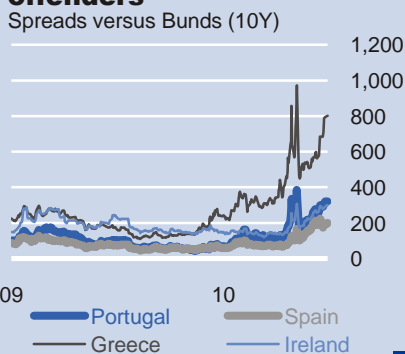
The crisis not only drove up government expenditure to fund comprehensive stimulus and bailout packages for the financial sector. In numerous countries the crisis is also reducing the revenues flowing into government coffers due to lower receipts from taxes and duties. The crisis is hindering extensive consolidation.

Additional burdens due to lack of reform efforts

There are differences nevertheless: in several countries the crisis was not the only reason for large deficits. The unwillingness of national governments to undertake reforms is responsible for the persistently large structural components of the deficit. Budgets have come under additional pressure because of the failure to implement structural reforms, for instance of tax systems or social security systems. On the capital markets this has led to speculation about the solvency of a number of countries. That is why some eurozone countries are grappling with the high risk premia on their government securities – in Greece’s case this development aggravated the already precarious situation and ultimately led to its request to activate the EU support mechanism on April 23.

The widening of sovereign yield spreads shows that the budget policies of eurozone countries are not rated equally – despite a single monetary policy and joint coordination of fiscal policy via the SGP. National fiscal solidity and reform efforts are becoming increasingly important for the valuation of government bonds. Those who assess the pact as a means of coordinating budget policy on the basis of these developments will come to the conclusion that the fiscal coordination is insufficient.

Markets isolate budget offenders



The recently agreed measures to bail out Greece and the EUR 750 bn rescue package for countries in financial difficulties have unleashed a debate about closer coordination of economic policy within the eurozone. The current debate shows that policymakers are increasingly considering supplementing the SGP. The proposed measures differ – for instance with regard to their institutional structure, their binding character, their anchoring in European legislation, the planned sanctions, and the time horizon for implementation.

The solutions currently under discussion range from a reform of the SGP to include a stricter sanction regime right through to complete surveillance of national budgeting processes.¹ Closer coordination of national economic policies² or establishment of a European Monetary Fund³ are also highly topical issues.

¹ See Conclusions of the European Council. June 17, 2010. Brussels.

² See Commission (2010). Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance. Communication

Strengthen national budget rules

The subject of rather less debate at present is the tightening of national budget rules – in the manner stipulated by the German debt brake. This report aims to make a contribution to the current debate and take a closer look at this last option: national budget rules modelled on the German debt brake operating as a complementary instrument to the SGP.

In this connection the following questions arise:

1. Which requirements must budget rules fulfil in order to be effective?
2. Can the stability pact guarantee sufficient budgetary discipline at the national level?
3. Which types of budget rules already exist in Europe, and how do they help the member states to achieve their budgetary objectives?
4. What would be the consequences for the eurozone if the German debt brake were to be adopted as the model for other countries?

This report seeks to explore these four issues and discusses to what degree the German debt brake can serve as a guide for European budget policy.

1. Necessary criteria for effective budget rules

The effectiveness of budget rules is reliant on three factors: the expectations of participants in the political process, the long-term outcomes of budget policy and the reactions of the capital markets.

Three factors to make budget rules effective

The **expectations of economic agents** play a key role over time. Budget rules provide a framework for expectations. Transparent budget rules can provide *ex ante* clarification for voters and policymakers that fiscal policy must have a long-term focus. This can boost public awareness that expansionary fiscal policy without an investment purpose becomes a long-term burden on the budget. The *deficit bias*, politicians' tendency to pile up deficits in the present, will thereby be reduced.

Expectations also influence the **long-term outcomes** of budget policy and thus the measurable influence of a budget rule. What counts at the outcome level apart from allocative and operative efficiency is budget discipline: fiscal rules prescribe a reduction in deficits and a stabilisation of debt levels – as a rule via quantitative targets and process specifications. In order to achieve this objective, however, the incentives provided by these rules must not conflict with other policy objectives. Potential conflicts between objectives can arise, for example, from general political preferences, the normative anchoring of a budget rule in the constitution and the resulting obligation. After all, it certainly does make a difference to the perception of a budget rule's binding character whether it is anchored in the constitution or only normatively in a political arrangement.

Austerity measures are not appropriate in every phase of the economic cycle: good budget rules therefore adapt to the business cycle and provide a cyclical component that gives the automatic stabilisers scope to operate. This subsequently ensures that the economy remains on a growth path over the long term.

Supplementing the necessary recognition and binding character, the

COM (2010) 367/2. European Commission. Brussels. ECB (2010). Reinforcing economic governance in the euro area. European Central Bank. Frankfurt.

³ See Gros, D. and T. Mayer (2009). Towards a (Euro)pean Monetary Fund. CEPS Policy Brief 202. Brussels.

flexibility of a budget rule is therefore an additional factor in delivering sustainably sound budgetary outcomes.

The expectations of market participants and the outcomes delivered by good fiscal rules influence the **capital markets**. A low debt level can thus convince investors that public-sector budgets are sustainable. The direct consequence is lower sovereign risk premia. Budget rules thus relieve the pressure on the public purse not only directly but also indirectly. The decisive aspect, however, is to what degree economic policy communication is able to use budget rules to convey a signal to the markets.

In the EU the instrument for fiscal policy coordination is the SGP. In the next section we aim to review its record and examine to what extent the pact has helped countries to keep on track to meet their budget objectives.

2. Supplement the stability pact with national budget rules

The SGP came into force in 1999. Its purpose is to ensure the coordination of fiscal policies in the EU via binding targets for government deficits. Within the eurozone this coordination is underpinned by sanctions. Since the pact came into force, however, it has been unable to stop public debt from increasing. For a number of countries this was also the case prior to the economic crisis. That is why we start by examining to what extent the pact has served its purpose and to what degree it can be sensibly augmented.

The **expectations** of the participants in the political process are certainly addressed by the pact. The **preventive arm** of the pact provides for medium-term budget planning in agreement with the Commission about the *Medium-Term Objectives* (or MTOs). If this *ex ante* medium-term fiscal target has not yet been achieved, countries are required to reduce their structural deficits by at least 0.5% of GDP per year during economically good times. Depending on the debt level and potential growth the MTOs range between a required structural budget surplus or deficit of 1% of GDP. One shortcoming is that the preventive arm of the pact is not underpinned by sanctions. This reduces the incentive for member states to comply with the requirements to reduce their structural deficits.

The **dissuasive arm** also raises expectations. In the past, sanctions in the case of a lasting infringement of the deficit ceiling of 3% of GDP were regarded as unrealistic. At the latest since onerous controls were imposed on Greece by the Commission and the Council in January the role of the excessive deficit procedure (EDP) has changed. There is no longer any doubt that countries with excessive deficits will have to expect a strict interpretation of the scope provided by the stability pact in future. An overview of the conditions for the eurozone countries currently involved in a deficit procedure are listed in the following table.

A credible and binding sanctions framework influences the **long-term outcomes** of a country's fiscal budget policy. The required effectiveness of the budget rules is, however, only partially satisfied by the pact: the case of Greece demonstrates that although the dissuasive arm of the SGP can work effectively, the corresponding pressure on countries to take action can only be generated at a very late stage of the deficit procedure. In Greece's case this very latest stage proved to be too late. Long timeframes and waiting periods in the EDP result in misdemeanours not being punished in a timely

The SGP: Rules-based self-commitment

The SGP is an instrument for coordinating the fiscal policies of EU member states. The aim of this coordination is compliance with the monetary union's fiscal convergence criteria – an annual deficit ratio of 3% of GDP and a maximum debt to GDP ratio of 60%. If eurozone countries exceed these thresholds, primarily for the deficit, they are punished with a deficit procedure whose final stage entails sanctions. This dissuasive arm of the pact is supplemented by the preventive arm. In the framework of stability programmes it defines a target level for the permitted medium-term structural deficit. This Medium Term Objective – depending on the debt level and potential growth – ranges between a deficit and a surplus of 1% of GDP. Countries that have not yet achieved the structural target are obliged to make an annual improvement in their structural deficits of 0.5% of GDP. If structural reforms are being implemented, a temporary departure from this consolidation path can be made. The preventive arm of the SGP, which was made more flexible as part of the reform of the pact in 2005, does not include sanctions.



manner – but as a rule not until several years after the fact because of the extensive requirements for agreement between the Commission and Council and the numerous opportunities for corrective action.

Strict conditions for budget offenders

	Government budget balance 2009 (% GDP)	Start of consolidation process	Deadline for correction	Recommended average structural adjustment p.a. (% GDP)	Medium-term objective (MTO)
BE	-6.0	2010	2012	0.75	0.5
DE	-3.3	2011	2013	≥ 0.5	-0.5
IE	-14.3	2010	2014	2.0	-0.5
GR	-13.6	2010	2012	2010/11: ≥ 3.5% 2012: ≥ 2.5%	0.0
ES	-11.2	2010	2013	> 1.5%	0.0
FR	-7.5	2010	2013	> 1.0%	0.0
IT	-5.3	2010	2012	≥ 0.5	0.0
CY	-6.1	2010	2012	n.a.*	0.0
LU	-0.7	2010	n.a.*	n.a.*	0.5
MT	-3.8	2010	2011	0.75	0.0
NL	-5.3	2011	2013	0.75	-0.5
AT	-3.4	2011	2013	0.75	0.0
PT	-9.4	2010	2013	1.25	-0.5
SI	-5.5	2010	2013	0.75	-1.0
SK	-6.8	2010	2013	1.0	0.0
FI	-2.2	2010	2011	n.a.*	0.5

*Not yet determined.

Sources: ECB Monthly Bulletin March 2010, European Commission

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Medium-term budget objectives

The preventive arm of the pact includes medium-term objectives (MTOs) for structural new debt. These MTOs are proposed by the member states in their annual stability programmes and are confirmed by the Commission. They pursue three aims:

1. Maintaining a buffer to the cap on annual borrowing of 3% of GDP. This buffer varies depending on the volatility of the economy and the degree to which the budget reacts to this.
2. Rapid reduction in government debt taking into account demographic change.
3. Budget policymaking scope, as long as objectives 1 and 2 are fulfilled.

The MTOs are reviewed every 4 years. If a country is implementing structural reforms, the required adjustment to the MTO can be suspended.

Source: European Commission 2005. *SGP – Code of Conduct*. Brussels.

Close the gap between the pact and national budget rules

The sanctions of the dissuasive arm, which in accordance with Article 126 XI of the Treaty on the Functioning of the European Union (TFEU) are non-interest-bearing deposits or stricter disclosure obligations when issuing government securities, have not yet been imposed. This is reflected in the outcomes: during the eleven years of the pact's existence most countries have been unable to reduce their debt levels – and where they have done so it has been accompanied as a rule by increased macroeconomic growth and a higher inflation level (see p. 10).⁴ The pact has therefore hardly proved effective with regard to delivering sound long-term budget outcomes.

The reaction of the **capital markets** also shows that there is still considerable room for improving fiscal coordination: the widening of several countries' yield spreads to German government bonds is an indication that the capital markets do not consider fiscal policy coordination in EMU to be as effective as the pact envisages.

The gap between the expectations of the participants in the pact and those of the capital markets with regard to sound long-term budgets could be closed by introducing national budget rules.

This complementarity becomes particularly clear with regard to the **expectations** of the participants. Supplementary national budget

⁴ Nonetheless, the latest action taken against Greece by the Commission and the Council, namely the threat of sanctions with conditions to be fulfilled, has indeed brought about a refocusing of national budget policies. One response is for instance more ambitious targets in the stability programmes of other budget offenders who have to submit them to the Commission each year in order to gain approval for their budget policies.

rules could make fiscal objectives more palatable to the general public. Budget objectives would then no longer be dictated “from Brussels”, the bearers of political responsibility would then have a stronger obligation to justify their actions and would have to let their policies be judged against nationally set objectives. National budget rules that anchor the stability pact criteria in the national legislation would fulfil these requirements even better.⁵

This would of course influence the **long-term outcomes** of national budget policy, as voters would identify compliance with national budget rules more closely with those who bear the political responsibility.⁶ At the same time, however, national budget rules need to be compatible with the criteria of the pact so that there is no conflict between incentive structures and expectations. National budget rules could thus defuse potential sources of conflict at the European level before they arise.

Contest between systems to build confidence

Where national budget rules lead to improved national fiscal policy outcomes and this is perceived in the **capital markets**, this is likely to reduce the refinancing costs of individual states. Against the background of the latest widening of yield spreads over German government bonds several countries could be interested in introducing national fiscal rules as a complement to the pact or to bolster existing rules. Ideally, this process could give rise to international momentum – for instance in the form of a competition to gain the confidence of the capital markets by formulating better national budget rules.

National budget rules can thus be an ideal complement to the pact – especially with regard to budget policy outcomes and the reaction of the capital markets. The major challenge for EU member states now is to devise appropriate budget rules and/or optimise existing budget rules.

3. Budget rules in EMU

Budget rules can be divided into two categories: the first is **numerical budget rules**, which set quantitative budget targets. One advantage of numerical targets, which can for instance be based on expenditure, debt levels or deficits, is their measurability. This enables their usage and the comparison of their success over an extended period. Numerical budget rules can take different forms (see box page 7).

Particularly when only numerical targets are used the danger increases of recourse being made to creative accounting practices, like for instance a temporal and structural reallocation of individual budget items to achieve a desired target figure. This can be combatted via **procedural rules** that stipulate the procedures to be used in the four stages of the budget process (drafting, voting, execution and auditing). No further distinction between budget rules can be drawn at this stage. Linking numerical and procedural budget

⁵ However, it is not only a matter of formulating a rule but also of gaining political support for it. The stability pact provides the perfect illustration of this. At the very latest since the toughening of sanctions imposed on Greece it has become clear to all concerned that the political will which now exists will boost the effectiveness of the EDP – although no material legal change has occurred.

⁶ See also IMF (2009). Fiscal Rules – Anchoring Expectations for Sustainable Public Finances. Working Paper. Washington.

Numerical budget rules – a summary

- **Static numerical deficit rules** (balance rules) cap the annual budget deficit at a level which remains constant regardless of the cyclical development. The deficit limit of the dissuasive arm of the SGP is a good example of this. A special type of static numerical deficit rules is a so-called **zero-deficit rule**, which only allows balanced budgets or budgets with surpluses. One disadvantage of these rules is that they have a procyclical effect and due to cyclical fluctuations either have to be broken very often or have to be appended with extensive exemptions.
- There are still **cyclically adjusted numerical deficit rules** (cyclical balance rules). They adjust the permitted deficit to the cyclical situation and allow a higher deficit during a downturn than when the economy is doing well. Time lags and often unclear forecasts, however, also make cyclically adjusted deficit rules slightly procyclical. This problem can be mitigated using an adjustment account which allows exceptional developments to be offset between individual budget periods.
- Another approach is taken by **debt rules** that do not focus on controlling the annual deficit but instead the aggregate public-sector debt level of the economy. This is a longer-term outcome of reliable budget policy and thus enables greater flexibility in the annual deficits as the variable. The SGP combines deficit rules with debt rules.
- Another special type of numerical budget rule is an **expenditure rule**. Expenditure rules do not focus on the deficit as the budget policy outcome, but place a cap on spending as a proportion of the overall budget. One advantage of expenditure rules is that they are easy to administer, transparent and comprehensible since expenditure is usually fixed ex ante. Here, too, static or cyclical rules are conceivable.

Budget rules vary throughout EMU

rules does, however, promise the best results.⁷ The SGP brings together procedural elements within the framework of the multilateral surveillance of the preventive arm⁸ with numerical targets in the framework of the dissuasive arm.

In the EMU there are numerous national budget rules that can be differentiated according to the categories stated above. The summary below provides a comparison of the national budget rules in the eurozone. Besides the type of budget rule and its normative anchoring at the administrative levels the table also details additional institutional factors that influence the binding character of budget rules. These include possible sanctions, the monitoring of the rules (ideally via an independent institution), the share of budget funds covered by the rule (coverage) and whether there are exemptions.

Balanced-budget rules that stipulate the level of annual borrowing are also common, as are **debt rules** which focus on capping the public debt burden. These rules are found at all administrative levels. A cyclical balanced-budget rule has hitherto only been introduced in Spain – and only since 2006.

These rules are supplemented by **expenditure rules** for central governments – in countries such as Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands and Slovakia. Another category of rules is only applied to **welfare systems** – we find them in Belgium, Finland, France and Luxembourg for example. These countries are using spending rules control social security expenditure as the biggest cost item in the public sector budget.⁹

The table shows among other things the development of debt levels within EMU. Countries that managed to reduce their debt ratios (as a percentage of GDP) in the year preceding the crisis are Austria, Belgium, Spain, Finland, Ireland, Italy, the Netherlands, Slovenia and Slovakia. With the exception of Spain these countries have spending rules for central government or their social security systems. Expenditure limits are regarded as particularly effective because they allow *ex ante* monitoring and because of their transparency. Spain, however, has benefited from high growth rates.¹⁰ The debt reduction in Belgium is particularly striking. In preparation for eurozone entry in the 1990s a raft of budget regulations were passed – including a spending rule for social security systems. The development of the debt ratio between 2007 and 2010 is illustrated for the sake of completeness. The sharp increase in most member states is due to increased spending and lower revenues resulting from the economic crisis. No implications can be drawn concerning the effectiveness of institutional arrangements.

The overview does not allow any further conclusions to be drawn about the impact of the normative anchoring of the rules on budget outcomes. It also appears to make no difference whether an independent institution monitors budget compliance.

⁷ A good overview is provided by Milesi-Ferretti, G.M. (1997). Fiscal Rules and the Budget Process. *Giornale degli Economisti e Annali di Economia*, 56 (1,2).

⁸ The preventive arm of the SGP already requires EU member states to justify their medium-term budget planning within the framework of the stability and convergence programmes.

⁹ In Germany the obligation to operate a balanced budget within the social security systems only applies to the health insurers.

¹⁰ In contrast to the other countries that managed to reduce their debt ratios Spain has relied solely on debt caps in the form of debt rules. However, there are strong indications that high growth rates posted during the boom years following the entry into the eurozone helped to generate a good debt ratio and that this trend was reinforced by huge inflows from the structural funds.

Eurozone budget rules in comparison

	Administrative level	Type of rule	Since	Binding character	Sanctions	Monitoring	Coverage	Exceptions?	Change in debt ratio (% GDP) '99-'07	Change in debt ratio (% GDP) '07-'10
BE	PR	Zero deficit rule (from 2010)	<1990	PA	Y	II	13%	No	-29.50	14.80
	MUN	Zero deficit rule	<1990	LA	Y	II	30%	No		
	SI	Zero deficit rule	1992	CA	N	MF	35%	No		
DE	SI	Expenditure rule	1995	LA	Y	MF and II	13%	No		
	FED	Cyclical balanced-budget rule (% GDP)	2009	LA (const.)	N	II	30%	Yes	4.71	13.80
	PR	Zero deficit rule	2009	LA (const.)	N	II	55%	Yes		
IE	MUN	Balanced-budget rule	<1990	LA	Y	II of the states	13%	No		
	FED	Expenditure rule	2004	LA	Y	MF	18%	No	-23.40	52.30
	MUN	Balanced-budget rule	2004	PA	Y	MF	20%	No		
ES	FED, PR, MUN	Cyclical balanced-budget rule (% GDP)	2006	LA	Y	MF and P	100%	No	-26.20	28.70
	PR	Debt rule	1980	RA, PA	Y	MF	70%	No		
	MUN	Zero deficit rule	1988	LA	Y	MF	13%	No		
FR	FED	Revenue rule, expenditure rule	2006	LA	N	II and P	73%	No	4.90	19.80
	SI	Balanced-budget rule (Golden Rule)	1983	LA	Y	II	23%	No		
	SI	Debt rule	2008	LA	Y	P	13%	No		
	SI	Expenditure rule	2006	PA	Y	II	18%	No		
IT	FED	Expenditure rule	2008	LA	Y	II and MF	5%	No	-10.20	14.70
	PR	Expenditure rule, balanced-budget rule	2007	LA	Y	II and MF	60%	In parts		
	MUN	Balanced-budget rule	2001	LA	Y	II	20%	No		
LU	FED	Debt rule, expenditure rule	1990	CA	N	None	90%	Yes	0.20	4.00
	SI	Balanced-budget rule	1999	PA, LA	N	Social Affairs Ministry	28%	No		
NL	FED, PR, MUN	Expenditure rule, revenue rule	1994	CA	N	MF	100%	No	-15.60	20.80
AT	FED, PR, MUN	Balanced-budget rule (% GDP), expenditure rule	2005	LA	Y	Govt.	75%	Yes	-7.70	10.70
PT	FED	Zero deficit rule for individual public bodies	2002	LA	Y	MF	13%	No	12.20	22.20
	PR	Balanced-budget rule	2007	LA	Y	MF and II	13%	No		
	MUN	Balanced-budget rule	2007	LA	Y	MF	5%	No		
SI	FED, PR	Debt rule	2000	CA	Y	MF	100%	No	-3.50	18.20
	MUN	Debt rule	1990	LA	Y	MF and II	8%	No		
SK	FED	Expenditure rule	2002	PA	N	II, govt. and P	45%	No	-18.60	11.50
	PR, MUN	Debt rule	2002	LA	Y	II, MF	13%	No		
	FED	Balanced-budget rule (% GDP), expenditure rule	2003, 2007	PA	Y	MF and P	40%	No	-10.30	15.30
FI	MUN	Balanced-budget rule	2001	LA	N	MF	35%	Yes		
	SI	Revenue rule	1999	LA	Y	II and Social Affairs Ministry	40%	No		

Does not include Malta or Cyprus. No information available about budget rules for Greece. Germany introduced debt brake in 2009. See p.12 regarding previous rules.

Legend:

FED: Federal level MUN: Municipal level CA: Coalition agreement PR: Provincial level MF: Ministry of Finance
 P: Parliament PA: Political agreement LA: Legal act SI: Social insurance II: Indep. institution

Sources: IMF, European Commission, Eurostat, DB Research

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Institutional environment and growth are important

There is no correlation between specific control mechanisms and the trend in the debt level – the binding character appears not to be a factor. Also with regard to sanctions or the type of monitoring of budget policy no pattern can be established about the trends in the debt levels of euro area countries. The same applies to the share of the budget which the rule covers and whether there are exceptions.

This provides further proof that the current institutional framework conditions alone cannot be the sole explanation for the success of budget policy. Rather, it is a matter of the political will to achieve consolidation and the accompanying growth conditions. In order to identify those countries that managed to “grow out of” their debts thanks to favourable growth conditions, we shall now examine primary balances¹¹, real economic growth and inflation trends¹² of the countries.

Table 4 shows that between 1999 and 2007 primarily countries with high primary surpluses and above-average real growth managed to reduce their debt levels. High growth presumably made it easier for these countries to reduce their debt ratios. The table shows a correlation, but not a causal relationship. More detailed investigation is required to establish whether debt reduction is attributable to high growth or whether it is debt reduction first of all that then allows faster growth.¹³

1999-2007: Decisive years for government finances

a) Countries that managed to reduce their debt

	Primary balance p.a.	Real growth p.a.	Inflation p.a.	Change in debt ratio (% GDP)
BE	4.53	2.40	1.97	-29.50
ES	2.54	3.81	2.99	-26.20
IE	3.32	6.79	2.93	-23.40
IT	2.73	1.44	2.21	-10.20
NL	2.53	2.77	2.10	-15.60
AT	1.48	2.66	1.67	-7.70
SI	-0.13	4.73	5.08	-18.60
SK	-2.37	5.69	5.60	-10.30
FI	5.42	3.82	1.41	-10.30

b) Countries whose debt increased

	Primary balance p.a.	Real growth p.a.	Inflation p.a.	Change in debt ratio (% GDP)
DE	0.84	1.76	1.60	4.1
GR	1.14	3.88	3.46	1.6
FR	0.17	2.28	1.70	4.9
LU	2.52	5.44	2.66	0.2
PT	-0.90	1.97	2.70	12.2

Does not include Malta and Cyprus.

Sources: European Commission, Eurostat, DB Research

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¹¹ The primary balance represents the difference between government receipts and expenditure excluding interest expenditure and net borrowing.

¹² Despite the ECB's single monetary policy inflation rates do differ between euro-area countries. The reasons for this are differing growth rates due to catch-up processes or country-specific business cycles and differing wage settlements.

¹³ The opportunities for states to grow their way out of debt is generally viewed with scepticism by academics – such as Reinhart, C. and K.S. Rogoff (2009). This Time is Different. Princeton University Press: p. 84.

Supplement national budget rules in accordance with European regulations

The forerunner of the debt brake

The existing budget rule stipulates that in accordance with Article 115 of the German Constitution (Basic Law) the level of net borrowing must remain in step with public net investment. The thinking behind this golden rule is that public-sector investment can serve future generations by boosting per-capita income and that they can therefore bear the debt burden. There are several problems associated with this:

1. The term "investment" has never been clearly defined.
2. Exceptions are only possible if the macroeconomic equilibrium is disturbed. These exceptional circumstances have, however, never been defined more precisely. Since the budget rule was introduced in 1969 there were only 24 years diagnosed as having no macroeconomic imbalance. Since 1969 public debt has risen from 18.6% of GDP to 73.1% of GDP in 2009.
3. The problem that remains is that the rule acts asymmetrically through the economic cycle. Net borrowing is not limited while there is a macroeconomic imbalance, but there is no obligation to consolidate during an economic upturn.
4. The adjustments that need to be made for demographic change are also not taken into account.
5. At the same time Article 115 of the Basic Law was incompatible with the stability pact. With its medium-term objectives (in Germany's case: a structural deficit of 0.5% of GDP) it does not comply with the concept of the golden rule and sets a cap on borrowing.

Then there is Italy which despite below-average real growth managed to reduce its debt ratio – a pleasing development that was mainly the result of strict spending cuts. At the same time inflation was also at a high level – except in Belgium, Austria and Finland. By contrast, real growth was low in countries whose debt levels increased – with the exception of Greece.¹⁴

Successful budget consolidation to date can thus be attributed more to political will and growth momentum and less to institutional factors: numerous national budget rules coexist with a stability pact whose effectiveness can certainly be enhanced. This tension can definitely be eased by coordinating national budget rules with a minimum of European rules. This raises the question of how much national budget rules can be sensibly complemented so that they become compatible with the management of budget policies via the pact – just like Germany does.

4. Debt brakes for Euroland?

The debt brake has been an issue in German politics for a number of years. The ineffectiveness of the budget rule that has been anchored in Germany's Basic Law since 1969 resulted in a renegotiation of the long-term guidelines for German budget policy produced by the Federalism Commission II in March 2007. This action was taken particularly with an eye on the future burdens facing Germany associated with demographic change on account of its still predominantly pay-as-you-go social security systems. The debt brake has been anchored in Germany's Basic Law since June 12, 2009. After the accompanying legislation has come into force the debt brake will have its first impact on the budget in 2011.¹⁵

The debt brake is intended to ensure debt reduction and at the same time provide the automatic stabilisers with commensurate scope to operate. This will be effected via a structural component and a cyclical new borrowing component.

The structural component allows a structural deficit of 0.35% of GDP.¹⁶ A central role is played by the *Medium-Term Objective* (MTO) for the structural budget balance, which the Commission stipulates for the euro-area countries in their stability programmes. The MTOs differ from one member state to the next. The MTO for Germany permits a structural deficit of 0.5% of GDP.

Besides this rigid structural debt component there is a flexible cyclical component of the deficit. The permitted size of the cyclical deficit component is the product of the output gap and the budget elasticity. According to projections by the Federal Ministry of Finance, public debt could fall to less than 50% of GDP by 2030, if nominal growth can be maintained at 3% per year.¹⁷

Since Germany is the benchmark for other countries on the capital markets it is to be expected that in the coming years numerous other eurozone countries will enact similar rules. Other countries will have to adopt similar measures in order to retain the confidence of

¹⁴ Greece is a special case: despite high nominal growth and a high inflation rate the debt ratio rose slightly.

¹⁵ On June 7, the German government has presented an austerity package with a cumulated consolidation of EUR 82 m from 2011 until 2014 which already reflects a part of the consolidation efforts required by the debt brake.

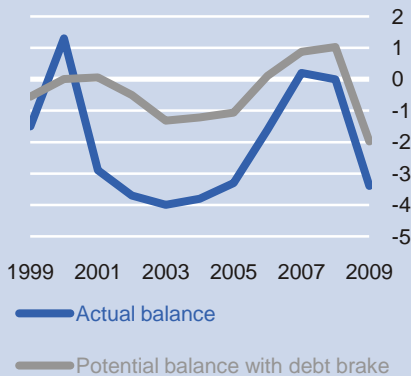
¹⁶ Originally a structural debt figure of 0.15% was envisaged for the *Länder*. In the course of deliberations by the Federalism Commission, however, this plan was abandoned.

¹⁷ A precise summary is provided by the Federal Ministry of Finance (2009). Monatsbericht März 2009. Berlin.



Debt brake exerts discipline

German budget balances of recent years with and without debt brake (% GDP)



Sources: European Commission, DB Research

5

investors and prevent a widening of the gap between the institutional quality of their budget policy and Germany's.

Budget rules modelled on the German debt brake and thus the requirements of the SGP would be easy to adapt technically to other EMU states: the target figure for the structural balance would be geared towards the MTOs from the preventive arm of the stability pact. The cyclical balance target would be the product of the country's budget sensitivity and its output gap.

As in Germany, the permitted structural deficits of the administrative levels of the public sector could be divided up according to the potential burden in the case of fines being imposed during the excessive deficit procedure. Differences between the burdens placed on the respective levels will of course depend on the governmental structure of the country concerned. Euro-area countries with federal structures would presumably prefer greater burden-sharing between their administrative levels than countries that are centrally governed.

There is no question that the economic crisis is an exceptional situation in which the German debt brake would also deviate from its strict rules applied during a normal cycle. In table 7 we therefore project how the debt brake would have operated in other countries in the pre-crisis year of 2006. It shows the levels that the structural and cyclical components of national debt brakes would have assumed.

The large gap between the balanced budget prescribed by the debt brake and the actual budget balance shows the strong consolidation imperative that a German-style debt brake would already have exerted during cyclically more favourable phases.

The debt brake: German idea, European blueprint

The German debt brake is a cyclical balance rule. It is not the public sector debt itself that is addressed, but the deficits. Where structural debt is low the aim is to allow the automatic stabilisers to work throughout the cycle and thereby achieve a long-term reduction in public debt. This is to be achieved via five control elements:

1. A structural debt component specifies that non-cyclical structural borrowing at the federal level from 2016 is to amount to only 0.35% per year – and thus be lower than the medium-term objective (MTO) of the stability pact of 0.5% of GDP. The Länder are not allowed to take on any new debt from 2020. It is generally regarded as positive that permitted borrowing is thus divorced from the otherwise difficult-to-define "investment" concept: no distinction is drawn between investment and consumption expenditure. In this way the risk of individual budget items being reallocated can be averted. Exceptions are only to be allowed in the event of natural disasters and extraordinary emergency situations beyond the control of the state. However this requires an absolute majority in the Bundestag (the so-called "chancellor's majority").
2. A cyclical component adjusts the borrowing cap to the economic situation, increases potential borrowing during a downturn and requires a surplus during good economic times. The cyclical component is calculated as the product of the output gap and budget sensitivity¹, which is determined via the EU cyclical adjustment method.
3. Financial transactions will continue to be stripped out. Financial transactions (e.g. privatisation receipts) can thus no longer be set off against other expenditure in order to help the budget to comply with the borrowing limits. One important motivation for privatisation of enhancing the budget situation thus no longer applies.
4. A fourth element is the control account, which brings together budget formulation and execution. In the event that a debt-rule-compliant budget subsequently requires additional expenditure to be made (for example due to an inaccurate projection of tax receipts), the control account covers the difference. If the control account exceeds a balance of 1.0% of GDP, the possibility of structural new borrowing is reduced by the excess amount – a structural surplus is however not necessary. The absolute maximum is 1.5% of GDP. However, the account can only be reduced if the output gap narrows – this is the way that procyclicality is intended to be avoided. The control account, however, only functions ex post – it is not possible to post items ex ante.
5. A fiscal policy early warning system in the form of a stability council (comprising the federal economics minister and the finance ministers from the federal and Länder levels) is to ensure compliance with the debt brake. The stability council is intended to monitor the budgets of the federal and Länder governments and the efforts of those countries that receive transfers for consolidation until 2020. If a perilous budget situation is identified at the federal level or in a particular state, the stability council and the administrative authority concerned will agree a restructuring programme. As a rule such a programme will last for five years. Länder submit reports to the stability council every sixth months and coordinate further measures with the stability council. One problem that remains is that the stability council cannot impose sanctions on a Land. Legislation concerning the federal states can be passed with the votes of the federal government and a two-thirds majority of the individual states. For legislation relating to the federal government a two-thirds majority is sufficient.

¹For a calculation of budget sensitivity see European Commission (2005). New and updated budget sensitivities for the EU budgetary surveillance. Brussels.

Medium-term objectives vary

Commission's medium-term budget targets for EMU countries (budget balance % GDP)

	MTO	Debt ratio 2009
BE	0.5	97.2
DE	-0.5	73.1
IE	-0.5	65.8
GR	0	112.6
ES	0	54.3
FR	0	76.1
IT	0	114.6
CY	0	53.2
LU	-0.5	15.0
MTO	0	68.5
NL	-0.5	59.8
AT	0	69.1
PT	-0.5	77.4
SI	-1.0	35.1
SK	0	34.6
FI	0.5	41.3

Source: European Commission

6

Most countries would have found it impossible to comply with the rules in the crisis year of 2009. The poor cyclical situation and the heavy budget burden due to the stimulus and bank bailout packages would in this case, however, have fulfilled the exceptional circumstances provision of the debt brake.

Debt brake scenario: Estimated new debt in 2006

	Output gap (% GDP)	Budget elasticities	Required cyclical balance	Required structural balance	Permitted budget balance	Actual budget balance
BE	1.30	0.54	0.70	0.50	1.20	0.30
DE	1.20	0.51	0.61	-0.35	0.26	-1.60
IE	2.20	0.40	0.88	-0.50	0.38	3.00
GR	2.60	0.43	1.12	0.00	1.12	-2.90
ES	1.00	0.43	0.43	0.00	0.43	2.00
FR	1.40	0.49	0.69	0.00	0.69	-2.30
IT	2.10	0.50	1.05	0.00	1.05	-3.30
CY	0.20	0.39	0.08	0.00	0.08	-1.20
LU	2.50	0.49	1.23	0.50	1.73	1.30
MT	-0.20	0.37	-0.07	0.00	-0.07	-2.60
NL	0.40	0.55	0.22	-0.50	-0.28	0.50
AT	0.90	0.47	0.42	0.00	0.42	-1.60
PT	-0.40	0.45	-0.18	-0.50	-0.68	-3.90
SI	2.70	0.44	1.19	-1.00	0.19	-1.30
SK	1.50	0.29	0.44	0.00	0.44	-3.50
FI	2.30	0.50	1.15	0.50	1.65	4.00

Sources: Eurostat, European Commission, DB Research

7

Scenario: Debt brake applies across eurozone

	Debt level 2016 (% GDP)	Trend growth	MTO	Debt ratio of 60% (GDP) achieved in year
BE	104.1	1.8	0.5	2030
ES	92.8	1.9	0	2027
FR	111.3	1.8	0	2034
DE	95.6	1.2	-0.5	2037
GR	160.5	1.8	0	2042
IE	116.4	2.4	-0.5	2034
IT	134.6	1.4	0	2041
PT	119.4	1.8	-0.5	2038
SK	62.8	2	0	2018

Debt in 2016 is calculated using the DBR model "Public Debt in 2020"

The projection is based on DBR inflation forecasts

Sources: DB Research, European Commission

8

What form might the long-term impact take if national budget rules modelled on the debt brake were to be introduced? Projections can certainly be made for the development of national debt if national budget rules modelled on the debt brake were to be established.

Table 8 depicts the scenario of a debt brake for all EMU states from 2016. The year 2016 was chosen because the German debt brake will be binding on the federal and *Länder* governments from 2016. The MTOs and assumptions for long-term trend growth were taken from European Commission data. The projected inflation rate comes from DB Research estimates. We assume that such a debt brake comes into effect in each country from 2016 – the projected debt level for 2016 is taken from the DB Research scenario *Public debt in 2020*.¹⁸ We take a long-term view and calculate when the debt level of the EMU countries reverts to the reference value for the debt ratio prescribed by the stability pact (60% of GDP), if national debt brakes modelled on the German example are established in accordance with our assumptions. Our scenario assumes a symmetrical business cycle and rules out major macroeconomic imbalances for the coming years. If major macroeconomic dislocation should occur, exemption clauses would apply as in the German model. A temporary suspension of the consolidation targets would prolong the consolidation path, but at the same time it would not jeopardise long-term growth fundamentals. Our findings are that many

¹⁸ Becker, S. and G. Deuber (2010). Public Debt in 2020. Current Issues. DB Research. Frankfurt. The data on which it is based ignores a potential phasing out of stimulus packages and an additional reduction in the deficits via the automatic stabilisers.

MTOs generate incentives for structural reforms

The preventive arm of the SGP stipulates that a country's structural deficit has to be reduced by 0.5% of GDP per year until the MTO is attained. This adjustment period can, however, be extended if the country implements structural reforms. These must have a sustainably and verifiably positive impact on the public purse, generating savings and/or boosting trend growth. Examples cited by ECOFIN¹ include reforms in the healthcare sector, old-age provision and labour markets.

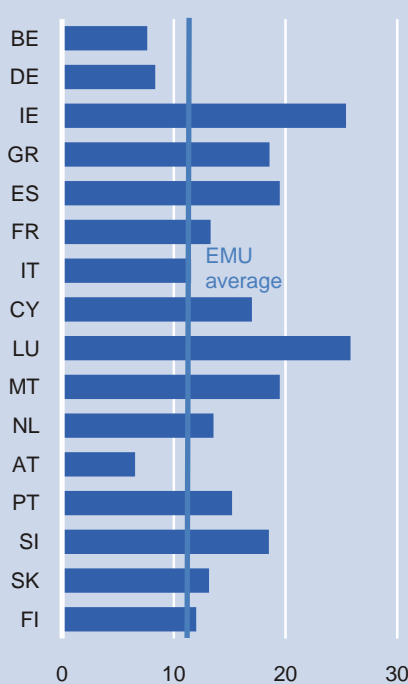
Special support is given to reforms of pension systems that establish a multi-pillar structure in which the state subsidises the establishment of a pension fund for instance. In this case payments made into the fund are no longer regarded as government revenue. In turn, subsequent spending by the fund is no longer deemed to be government expenditure.

Deviation from the MTO should, however, reflect the costs of reform and be accounted for in detail in the stability programmes. Even if the consolidation path towards the MTO is adjusted for a number of years attention will continue to be paid to keeping the deficits within range of the pact's deficit threshold (3% of GDP). Germany's debt brake does not allow the offsetting of structural reforms.

¹See European Commission (2005). Stability and Growth Pact – Code of Conduct. Brussels.

Investment/consumption

Government investment as % of consumption 1999-2009



countries would require several decades of consolidation before the 60% criterion is reached.

It is clear that such scenarios cannot predict the precise development of public debt. Nevertheless, such calculations are a highly appropriate means of showing that budget rules – if they are adhered to – can help to achieve a sustainable reduction in public debt.

National debt rules would be geared towards the MTOs for the individual member states. The structural debt components would be adjusted to the long-term trend growth paths of the member states. In concrete terms this would mean that countries with lower debt levels and high trend growth would be allowed to carry higher structural debt than countries having to contend with high new borrowing. National debt brakes could anchor the preventive arm of the pact at the national level. They would become more effective if they were anchored in constitutional law and strengthened by political preferences.

Implicit **government debt** – for instance the future payment obligations of the social security systems – will remain an issue. While the preventive arm of the stability pact certainly allows temporary non-compliance with the MTO (see box), within the framework of structural reforms – of retirement provision systems for instance – this is not envisaged by the German debt brake. Such a provision would, however, certainly be worth considering.

If the concept of the debt brake were to be **copied** within the eurozone, a positive momentum of its own could develop, as already suggested above. For as soon as the capital markets gain confidence in the new solution of a “copycat” country, the risk premia on its government paper relative to the German benchmark would probably narrow appreciably and other euro-area countries might attempt to offset the resulting competitive disadvantage by adopting similar concepts. This competition to garner confidence would benefit the entire eurozone.

5. Debt brakes being debated

The debt brake has triggered debate among academics and politicians. The criticisms generated by this debate could also become issues in other countries, if they are considering adopting similar rules.

An initial argument often voiced is that debt brakes **inhibit growth**¹⁹, as they do not make an explicit distinction between consumption and investment expenditure. In marginal cases this could result in investment expenditure being sacrificed for consumption expenditure as the latter is more popular in the short term. This would have to be the outcome, because the desired reduction in the debt level would require too much consolidation and thus undermine long-term growth potential. However understandable this train of thought may be, it has very little to back it up. After all, the tendency of politicians to spend excessively on current consumption is a problem that cannot be solved by committing correct definitions to paper. A new artificial separation between consumption and investment expenditure would be circumvented by reattributing budget items. Figure 9 shows the share of public-sector investment relative to public-sector consumption. The figures differ from country to country.

¹⁹ See for instance Truger, A., H. Will and J. Köhrsen (2009). Die Schuldenbremse: Eine schwere Bürde für die Finanzpolitik. IMK Policy Brief. Dusseldorf.

Whereas the above-mentioned criticism concerns the long-term impact of a decline in investment, there is a second, substantively similar argument regarding the lack of scope for the automatic stabilisers – namely that the planned fluctuation bands for the cyclical components are too narrow. The counterargument is that the calculations of production gaps and budget sensitivity are subject to constant surveillance by the Commission and are adjusted. It is still the case that the German-style debt brake can temporarily be suspended in exceptional cyclical situations.

Not completely rigid

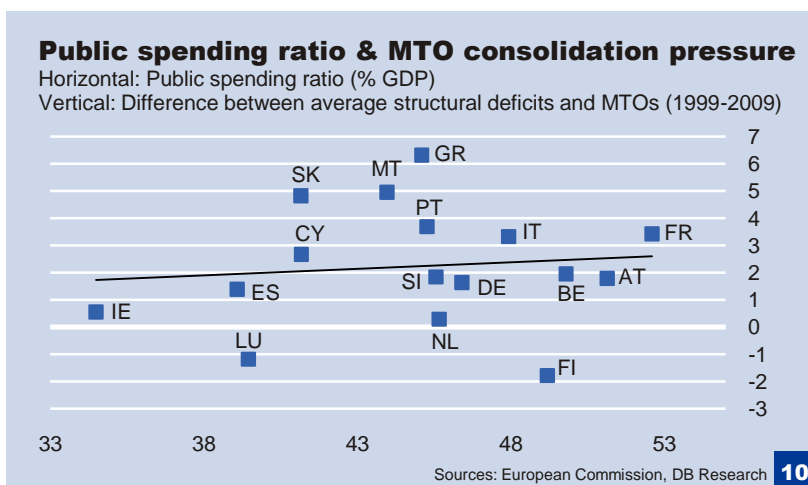
Both the above-mentioned criticisms can also be countered by arguing that consolidation efforts and the resulting lower debt level lead to more investment and thus faster growth in the future. After all, a low debt level promotes certainty among the general public and investors of a lower tax burden in future and motivates them to invest their resources in the present.

Adjustment processes cannot, however, be avoided in the short term: countries with particularly high government debt ratios and MTOs that require a balanced structural budget or a budget surplus have a particularly heavy adjustment burden to bear. In these countries the adjustment pressure is likely to be especially high because the required convergence with the MTO will probably force policymakers to limit public-sector activities.

Heavy pressure to consolidate

Chart 10 illustrates the consolidation pressure and its potential impact on public-sector activity. The debt ratio is plotted along the horizontal axis. The vertical axis plots the average difference between the structural deficits of the member states and their MTOs between 1999 and 2009. This indicates the respective consolidation requirement. We see that countries like France, Greece, Italy and Portugal have above-average debt ratios and consolidation potential.

In these countries serious cutbacks that would be made in the case of strict adherence to the MTOs would have a major impact on the economy as a whole. This adjustment would be simpler for countries with lower debt ratios and a smaller gap between their current budget position and the MTOs – such as Ireland, Spain and Luxembourg.



Debt brakes for Euroland: Implementation methods

There are basically 3 options for introducing new national debt brakes in EMU. They differ from one another with regard to their legal character and their political feasibility.

- One realistic option is the voluntary introduction of national debt brakes. What applies in this case is the competition argument which we have already detailed above: in the contest to gain the trust of investors the reference point for countries will be Germany as a benchmark debtor. Several eurozone countries, such as France, Belgium and the Netherlands, are already using the German model to stimulate their deliberations about overhauling their national budget policies. There are similar debates being conducted in other countries (e.g. Portugal and Italy). A completely voluntary transposition in individual member states would not require any further coordination at the European level. If common core elements are to be laid down, the EU could fall back on Article 136 of the TFEU, which enables close coordination of economic policy within EMU.
- Another option would be an agreement between all eurozone countries to introduce constitutionally anchored debt brakes modelled on the German example. Transposition would be conceivable solely at the intergovernmental level. Nevertheless, incorporation into the European treaties is to be recommended, so that if the rule is broken, pressure can be applied with respect to the infringement not only at the national level, but also at the European level. Since this would require unanimity among the EU states this option is currently regarded as unrealistic.
- A third option is to oblige countries that exceed the 60% debt-to-GDP ratio over the long term to introduce a national debt brake after an assigned period. Since such a step would represent a huge intervention in the financial constitution of countries, the TFEU would need to be amended. This option is also unrealistic at present as it would require the unanimity of all EU countries.

Another criticism levelled particularly at the concept of the German debt brake is that it assumes **symmetrical business cycles** and that – in the case of asymmetrical business cycles – the problem would be one of procyclical fiscal policy. Given the control account and the requirement that the account has to be balanced only if the output gap narrows, this criticism appears exaggerated.

Another objection raised specifically against Germany's debt brake is that it only addresses current deficits but does not, however, sufficiently take into account the **implicit public debt** in the form of the obligations of the pay-as-you-go social security systems.²⁰ This criticism certainly is justified as the German debt brake does not provide for such incentives. This German peculiarity should not, however, be used as an argument against similar rules in other eurozone countries, especially as these could be geared towards the criteria laid down by the MTOs with regard to structural reforms.

However, it must not be overlooked that the indirect spending restrictions resulting from the debt brake will lead sooner or later to a discussion about the prioritisation of expenditure – and probably make comprehensive structural reforms unavoidable.

A fifth criticism is that the EU cyclical adjustment method only relates to past events and the actual response of public budgets (revenues/expenditures) certainly can deviate from the projections for the procedure and the assumed budget sensitivities.²¹ This is definitely an aspect that the control account cannot absorb in every conceivable cyclical situation. However, budget elasticities are constantly monitored by the Commission and adjusted where necessary. It is also foreseeable that over time the MTOs will be adjusted according to the success of reforms and the need for reform of the respective country – they are assessed at least every four years by the Commission.

One final argument against the debt brake is that lower public borrowing would not enable capital market participants to invest in the safer risk class of government paper.²² There are several reasons why this argument does not hold water. Firstly, investors do also have the opportunity to acquire other countries' government securities. Government paper issued by countries currently labouring under large deficits would continue to benefit from a constitutionally anchored budget rule: their risk rating would be better. Last but not least, a debt brake modelled on the German example would at best pursue a gradual reduction in public-sector debt over several decades. Timewise, there would thus be scope for adjusting market structures and investor preferences.

6. Conclusion

A look at the SGP shows that its international fiscal policy coordination has at best conditioned expectations – sustainable long-term budget policy outcomes have not, however, been achieved yet. The latest developments on European bond markets reflect that investors are also not convinced that there is effective coordination. The national budget rules in the eurozone cannot currently compensate for this shortcoming.

²⁰ See for example Hausner, K.H. and S. Simon. Deutsche Schuldenregel als Alleskönner? Working Paper für die Herbsttagung des Arbeitskreises Politische Ökonomie und der Keynes Gesellschaft. October 2009. Karlsruhe.

²¹ See for instance in this respect Kastrop, C. and M. Snelting. Das Modell des Bundesfinanzministeriums für eine neue Schuldenregel. In: Wirtschaftsdienst, 2008 (6).

²² See Peter Bofinger in discussion with *Der Spiegel* published on February 11, 2009.

The German debt brake is a convincing concept that – transferred to other countries – would imbue budget policy in EMU with greater institutional quality. A blanket application of the debt brake across the eurozone could help countries to achieve long-term consolidation of their budgets without foregoing the effect of the automatic stabilisers.

If other euro-area countries were to incorporate a debt brake with a similar structure to that of the German model into their constitutions, the MTOs and the calculation of the cyclical components would provide the European Commission with effective instruments for controlling the budget of every single country – because they would be anchored in the national constitutions.

The financial markets will give individual countries different credit ratings in future as well. The decisive aspect is, however, that commonly designed, transparent and understandable budget rules with a strong binding character could help precisely those countries with budgets in a precarious state to regain the confidence of the markets. National debt brakes should help risk premiums to narrow again.

Since the Lisbon treaty has created the legal basis it will simply be a matter of time before the economic policies of the euro countries are coordinated more closely. If national debt brakes were to be the fiscal limits anchoring the medium-term objectives of the stability pact in the constitutions of the eurozone countries, they would have the maximum binding force. The cyclical component would provide the eurozone countries with the necessary scope to take growth-oriented and independent action to achieve their budget targets using appropriate economic policy strategies. That is why national debt brakes – in contrast to the often asserted ideas for a central European economic government – are appropriate and desirable instruments for executing the outcome-oriented control of national economic policies in EMU.

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