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Overview: Slow drift without foreseeable change of course in the short term

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Overview: Slow drift without foreseeable change of course in the short term

After the modest recovery in 2004 not providing any significant help to European public finances, the economic slowdown in the first half of 2005 has made their management all the harder. Several countries have been put under the Excessive Deficit Procedure (EDP). The stabilisation of the deficit for the euro zone as a whole will rely mainly on one-off measures. In 2006, these will drop out of the equation and the arrival at retirement age of the first of the baby-boom generation, coupled with a probably modest pick-up in economic activity, is likely to push the overall deficit beyond 3% of GDP.

2004: It could have been…

■ **Not only was 2004's official improvement in public finances marginal and inadequate…**

According to Eurostat's latest figures, the Euro zone's GDP grew by 1.7% in 2004, from 0.7% in 2003, but this only allowed a very small reduction in the public deficit, from 2.8% to 2.7% of GDP (Chart 1). Public consumption was a significant contributor to growth, with an increase of 2.6% over the year for a total contribution of half a percentage point.

Most importantly, the structural deficits in the euro zone are already fairly wide. In 2004, just as in 2003, the cyclically-adjusted deficit was 2.4% of GDP (Chart 2). This structural deficit reflects primarily a substantial and growing debt. The cyclically-adjusted primary balance was around 1% of GDP (0.9% in 2004, from 1.0% in 2003). Interest payments represented 3.4% of GDP.

Moreover, the stagnation of the cyclically-adjusted primary balance raises questions about the real desire of governments in the euro zone to cut their structural deficits. Indeed, this part of the deficit can be considered as the discretionary element, the one over which governments have effective control. Now, all, the final analysis shows that the slight decline in the euro zone's aggregate public sector deficit in 2004 was due solely to activity, even though it was hardly buoyant. (Chart 3)

■ **… but very far from reality as well**

The diagnosis is grim enough, but should be even worse, as it was founded on the official figures provided by Italy to the European Commission in the Stability and Growth Programmes, up to last winter. Italy has now recognised that its deficit certainly exceeded the 3% limit in 2003 and 2004. Having posted official figures of 2.9% and 3.0% of GDP respectively for these two years, ISTAT finally revealed on 24 May that the real figure was 3.2% in both cases. Eurostat formally recorded it (see the final table).

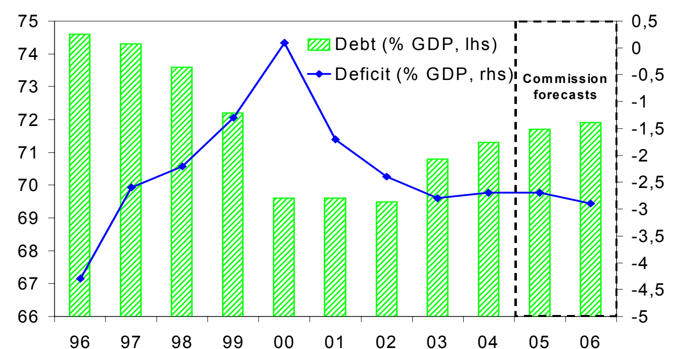
Thus, on July 12th, the Ecofin Council decided to endorse the Commission's recommendation to launch an EDP. The recession in which Italy fell in Q1 2005 and the extent of the adjustment needed have been qualified as "special circumstances" as defined in the reform of the SGP adopted in the spring. Italy will thus have until 2007 to bring its deficit back below 3%, with corrective measures to be introduced as soon as 2005 (see box). Under the first version of the Pact, the time limit would have been set at 2006.

Table 1 Government deficit forecasts (updated: July 2005)

	2005		2006	
	EC	**BNPP**	**EC**	**BNPP**
Austria	-2.0%	-2.1%	-1.7%	-1.8%
Belgium	-0.2%	0.5%	-0.6%	0.8%
Finland	1.7%	2.0%	1.6%	1.8%
France	-3.0%	-3.5%	-3.4%	-3.8%
Germany	-3.3%	-3.7%	-2.8%	-3.5%
Greece*	***-4.5%***	***-4.5***	***-4.4%***	***-4.4%***
Ireland	-0.6%	-0.2%	-0.6%	0.5%
Italy*	***-3.6%***	***-4.3%***	***-4.6%***	***-5.2%***
Luxembourg	-1.5%	-1.0%	-1.9%	-0.9%
Netherlands	-2.0%	-2.2%	-1.6%	-2.0%
Portugal*	***-4.9%***	***-7.0%***	***-4.7%***	***-6.2%***
Spain	0.0%	0.1%	0.1%	0.3%
Euro zone	**-2.6%**	**-2.9%**	**-2.7%**	**-3.1%**

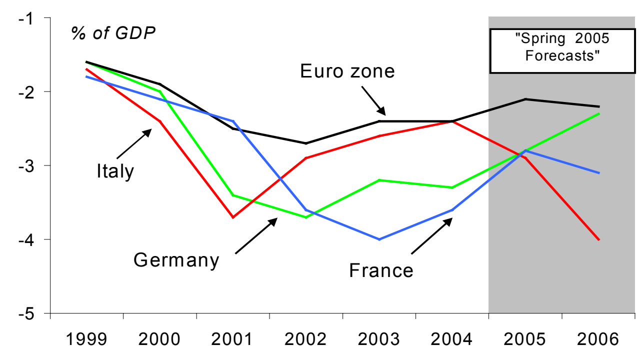
Sources: European Commission (*Economic Forecasts, Spring 2005*), BNP Paribas
** Excessive Deficits Procedures under way*

Chart 1 Growth in 2004 had only a limited impact on deficits…



Source: European Commission

Chart 2 … but, given the overall stagnation in structural balances (% GDP)…



Source: European Commission

No way out in the short term

Thus, Italy joined Greece (which had a deficit of 6.1% in 2004) in the frame of the corrective part of the Pact. However, the former enjoys the flexibility of the reformed version, while Greece has been put under the first version of the procedure. Yet, Greece has been granted a further year to correct its deficit, as an exceptional measure meant to get the conditions in line with the new provisions of the Pact. Finally, Portugal's revised SGP, which forecasts a 6.2% deficit for 2005, has been adopted by the Eurogroup and the Ecofin on 12 July. An EDP is therefore very likely to be started in September. It will be difficult for these countries to cut their deficits to under 3% within the timeframes they have announced (2.9% in 2006 for Greece, 2.8% in 2008 for Portugal and by 2007 for Italy).

For Italy, it looks highly unlikely that corrective measures will be taken in 2005, given current economic conditions (we expect GDP to shrink by 0.3% over the year) and the imminent elections. Moreover, a certain number of exceptional measures (securitisations, tax amnesties) will reach their end in 2005, whilst the tax cuts that took effect at the beginning of the year will eat into revenues. Lastly, Fitch has downgraded the outlook on government debt from "stable" to "negative", which could increase the spread against the Bund and thus increase the cost of servicing debt.

From this point of view, the markets have factored the worsening of public finances in Greece and Italy (Chart 4). So far, spreads have increased by between 10 and 16bp since February. The growing divergence between the euro zone's economies and the slippage in government deficits make the region look to investors as an increasingly less uniform economic entity.

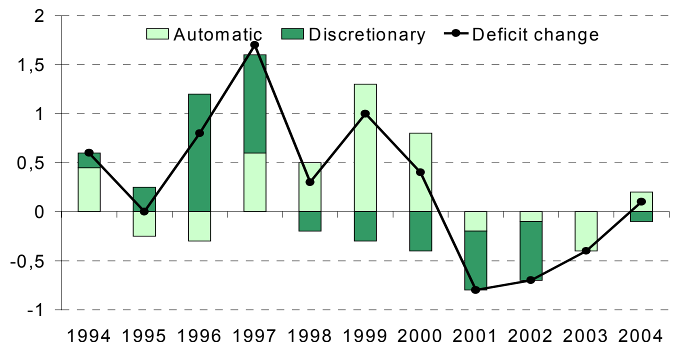
■ "Stabilisation" of deficits in 2005

We do not expect any significant improvement in the situation in 2005 or 2006. Indeed, not only will the countries under surveillance struggle to meet their undertakings to the European Commission, but other countries recently joined them on the list. Germany is likely to post its third consecutive "excessive deficit" in 2005, whilst France is also likely to go beyond the 3% mark according to the latest estimates by the Ministry of Finance which were recently leaked to the press.

With public finances in the euro zone remaining highly dependent on economic conditions, the marked slowdown in the first half, and particularly sluggish domestic demand, is likely to produce a significant fall off in receipts. Meanwhile, the Hartz IV measures in Germany and the health insurance reforms in France won't produce their full benefits this year. The sale of government assets (EDF, GDF, motorway companies) will be badly needed to offset the continued strain in social security accounts.

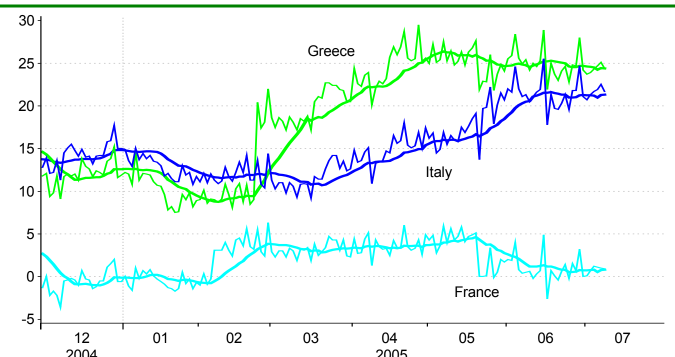
All in all, after taking into account the exceptional measures that certain governments will take to respect the Pact, we expect the euro zone deficit to stay below the 3% ceiling in 2005. Yet, if this call proves to be correct, it will be so only with a very slight margin, given the latest updates in national growth and deficit forecasts.

Chart 3 … was nevertheless the only reason for the marginal cut in deficit



Source: European Commission - The "discretionary" part equals the change in the cyclically-adjusted primary balance (CAPB). The "automatic" part equals the difference between the variations in the total deficit and in the CAPB.

Chart 4 10-year BTP, OAT, GGB *vs.* Bund : spread (bp)



Source: Ecowin, BNP Paribas *bold line: 15-day moving average*

■ 2006: growth to record a limited recovery and first cohort of the baby-boom generation to retire

Public finances in the euro zone are unlikely to improve significantly in 2006, unless there is a substantial upturn in growth accompanied by a noticeable improvement in the labour market. However, such conditions do not look likely to be met: we expect GDP to grow by 1.5% in 2006.

Pushing the other way, the retirement of the first cohort of the baby-boom generation is a certainty that will put considerable pressure on social security budgets. Meanwhile, Italy, Portugal and Greece will certainly continue to post deficits that are well above 3% of GDP.

Thus we expect the deficit, under the Maastricht definition, to increase in the euro zone as a whole. In other terms, it is very likely to break the 3%-ceiling.

Reform of the Stability and Growth Pact

On 22 March 2005 the European Council revised the mode of enforcement of the Stability and Growth Pact. The Council recognised the various abuses of the initial rules – particularly by France and Germany – and their roots. As a consequence, it sought to give greater flexibility to the Pact and strengthen its preventative powers, whilst at the same time retaining its original spirit, with the rules continuing to prevail.

The compromise produced a number of changes. The main reforms in the preventative part were as follows:

1. **Determination of a medium-term objective (MTO) that reflects the specific situations in countries, i.e. their potential growth and debt/GDP ratios.** The budget balance corrected for cyclical effects and exceptional measures must be between -1% (for countries with low borrowings and/or high potential growth) and a surplus (countries with high debt and/or low potential growth).

2. **An agreement in principle on a gradual adjustment to the balance relative to the MTO (at least 0.5% of GDP per year, more in periods of above-potential GDP growth, depending on elasticity of taxes to GDP)**. This will allow countries to anticipate cyclical slowdowns. Their inability to do so prior to 2001 was a major contributory factor to the subsequent crisis for the Pact. However, no enforcement structure has been created for the application of this principle, suggesting that its implementation is likely to be more theoretical than practical.

3. **Recognition of structural reforms enabling a move to more sustainable debt levels** (improving public finances over the long term, increasing potential growth), and in particular the reform of pensions systems, in assessing these adjustments.

The corrective aspects of the Pact and the related procedure were also significantly modified:

1. **The recognition of various factors in the application of the 3% deficit limit.** On the one hand exceeding this limit can now be justified by a period of GDP growth that is merely negative, rather than under -2% under the former conditions. In addition, some spending is excluded from the calculation of the deficit (*"other relevant factors"*), such as that linked to research and education (under the Lisbon Agenda). Development aid, solidarity measures with Eastern Europe (notably the former East Germany) and possibly some defence spending can also be "stripped out" of the assessed deficit. This said, a deficit that is "too far" from the limit or that is not "temporary" will be considered as excessive in all circumstances.

2. **An increase in the time frame for all stages of the procedure, and an extension in the period allowed for the correction of an excessive deficit**, which is increased from one to two years if "relevant factors" can be applied and if the country has already taken steps to reduce its deficit.

Budget balances and growth in the main EMU countries

	2003	2004	2005(f)			2006(f)		
Real GDP (% y/y)			**SGP**	**Commission**	**BNP P**	**SGP**	**Commission**	**BNP P**
Euro zone	**0.5**	**1.7**	**2.3**	**1.6**	**1.2**	**2.4**	**2.1**	**1.5**
Germany[1]	0.0	1.0	1.7	0.8	0.9	1.8	1.6	1.0
France	0.9	0.5	2.5	2.0	1.3	2.5	2.2	1.8
Italy[3]	0.4	1.0	2.1 [3]	1.2	-0.3	2.2 [3]	1.7	1.0
Spain	2.9	3.1	2.9	2.7	3.3	3.0	2.7	3.1
Netherlands	-0.9	1.4	2.5	1.0	0.3	2.5	2.0	1.2
Budget balance (% of GDP)								
Euro zone	**-2.7**	**-2.8**	**-2.3**	**-2.6**	**-2.9**	**-1.8**	**-2.7**	**-3.1**
Germany	-3.8	-3.7	-3.0	-3.3	-3.7	-2.5	-2.8	-3.5
France	-3.6	-3.7	-2.9	-3.0	-3.5	-2.2	-3.4	-3.8
Italy[2, 3]	*-3.2*	*-3.2*	-2.7 [3]	-3.6	-4.3	-2.0 [3]	-4.6	-5.2
Spain	0.3	-0.3	0.1	0.0	0.1	0.2	0.1	0.3
Netherlands	-3.2	-2.5	-2.1	-2.0	-2.2	-1.9	-1.6	-2.0

Sources: Eurostat (2003, 2004), European Commission (*Spring 2005 Economic Forecasts*, April 2005), Stability and Growth Programmes 2005-2008 (SGP), BNP Paribas (2005 and 2006 forecasts, updated in July 2005)

[1] *unadjusted for not-working days*

[2] *Eurostat has revised the figures for the Italian deficit in 2003 and 2004, provisionally setting the revised figure at 3.1% of GDP (decision of 23 May 2005) – On 24 May, ISTAT has released a new estimate (3.2% of GDP), which is the EC's working hypothesis since then.*

[3] *On 15 July, the Italian government released updated forecasts: GDP growth is expected to be 0.0% in 2005 and 1.5% in 2006; deficit-to-GDP ratio to be 4.3% in 2005 and 3.8% in 2006..*

Budgetary indicators (% of GDP)

Public debt	**2003**	**2004**	**2005 (f)**	**Structural balance**	**2003**	**2004**	**2005 (f)**
Euro zone	**70.8**	**71.3**	**71.7**	**Euro zone**	**-2.4**	**-2.4**	**-2.1**
Germany	64.2	66.0	68.0	Germany	-3.2	-3.3	-2.8
France	63.9	65.6	66.2	France	-4.0	-3.6	-2.8
Italy*	*106.5*	*106.6*	105.6	Italy	-2.6	-2.4	-2.9
Spain	51.4	48.9	46.5	Spain	0.2	-0.3	0.0
Netherlands	54.3	55.7	57.6	Netherlands	-2.7	-1.7	-1.0

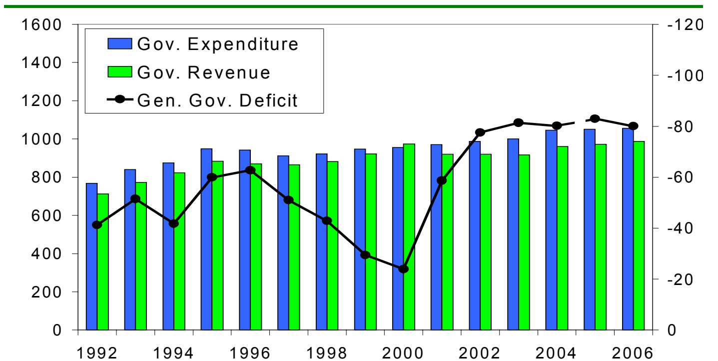
Source: European Commission (*Spring 2005 Economic Forecasts*)

** Eurostat has revised figures for Italy's debt in 2003 and 2004, setting the revised figures provisionally at 106.5% and 106.6% of GDP respectively (decision of 23 May 2005)*

Germany: No significant improvement in 2005

In 2005 Germany will see a combination of two factors that will hinder an improvement in public finances: the final tranche of income tax cuts and an increase in unemployment, linked to the introduction of the final batch of measures under the Hartz labour market modernisation package. Fear of unemployment is causing consumers to save rather than spend additional income, and the German economy is struggling to generate any growth. As a result fiscal receipts are falling and the budget deficit remains well above the 3% of GDP limit set by the Maastricht Treaty. Unless the elections due in September bring a radical change, there is unlikely to be any significant improvement in 2006.

Public spending, receipts and deficit (EUR billions)



Source: Finance Ministry; BNP PARIBAS estimates for 2005-2006

Consolidation inch by inch

The extra costs of Hartz IV

The condition of the public finances did not improve in the early part of 2005. In the first five months of the year, federal spending rose by 2.5% on the same period in 2004, which was more than twice the rate of 1.1% forecast for the whole of the year in the 2005 Budget, finalised on 18 February 2005.

At first sight, the slippage in public spending contrasts with the situation observed at the end of 2004. Last year the government was able to control growth in spending largely through reductions in the public sector wage bill (from EUR168.16bn in 2003 to EUR166.6bn) and in subsidies (from EUR28.94bn in 2003 to EUR27.56bn).

Moreover, this performance came at a time when unemployment had continued to edge upwards (up 0.2% on unadjusted figures in 2004) and whilst the opposition blocked a number of subsidy reductions (including subsidies to first-time buyers and to the mining industry).

However, much of the increase in spending seen so far this year has come from the increase in unemployment linked to the introduction of the Hartz IV Act. It would seem that the budget calculations for 2005 considerably underestimated the number of former recipients of social security who would be willing to declare themselves as looking for work in order to receive the new Type II unemployment payment.

Excluding the 'Hartz IV effect' public spending remained under control. Although some measures, such as the securitisation of future pensions of former Post Office employees[1], will have only a one-off effect, others will have more lasting impacts. For instance, February saw the signature of an agreement on continued moderation in public-sector pay. This will come into effect in October this year and last until December 2007. It will freeze the salaries not only of federal employees but also of municipal employees in the Länder of the former West Germany. Salaries for municipal employees in the Länder of the former East Germany will gradually be increased. Bonuses will be frozen at current levels for all staff and the number of hours worked will be increased slightly. The introduction this year of a "sustainability factor" in pensions[2] also figures among the measures likely to help curb public spending.

No miracles in receipts

There was no surprise in figures for federal receipts. These were down slightly (0.6% y/y) over the first five months of the year, due in part to the cut in income tax[3] in January 2005. The loss of tax income from this reduction in tax rates is estimated at 0.3 points of GDP. According to the 2005 Budget this will be only partly offset by the opening of toll motorways to trucks, which is expected to boost public sector receipts by 0.1 of a point of GDP.

The break in the recovery in private sector consumption in the first quarter has clearly contributed to holding back receipts linked directly to economic activity, particularly as the increase in unemployment is causing consumers to save rather than spend any additional income.

Public deficit at 3.5% of GDP for 2005

The government cut its forecast of GDP growth from 1.6% to 1% in April, thus effectively scuppering any chance of meeting its target of cutting the deficit from 3.6% of GDP in 2004 to 2.9% in 2005.

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[1] This will mean that the federal government is spared having to make a transfer, thus saving it around 0.25 points of GDP in 2005.

[2] This sustainability factor allows for the automatic adjustment of the level of pensions (and thus the level of contributions) to reflect the relative number of pensioners and contributors.

[3] This is the third and last tax cut provided for under the 2000 reform of tax law effective from January 2001. In January 2005, the marginal tax rate on income was cut from 45% to 42%, with the base rate cut from 16% in 2004 to 15%.

Under the original expectation of faster growth, it was forecast that federal fiscal receipts would rise 2% over the course of the year, a figure that now looks seriously compromised by the lack of any improvement in the job market and the weakness of global demand.

Moreover, although the total number of unemployed has fallen since April, it remains above the expected figure and the EUR4bn allocated by the federal government to the Office of Employment for 2005 will probably once again prove to be insufficient.

The marked impact of unemployment on consumer confidence and hence on private sector consumption, coupled with persistent very high oil prices, have led us to cut our GDP growth estimate for 2005, albeit to a much more marginal extent (from 1.0% to 0.9%). Thus the effect of this change on our deficit estimate is minimal; we continue to expect a deficit of around 3½% of GDP in 2005.

A slight improvement in 2006

Despite the targets set out in the Stability Programme and updated in December 2004, Germany's public sector deficit will not be brought below 3% of GDP in 2006. Rather, the Finance Minister recently announced that it would stay around 3½%, in line with our forecast.

The main reason for this is that even with a new government[4], economic conditions are unlikely to show any significant improvement. Although employment seems to be growing (weakly) once more, this is largely due to artificial support measures which are only just managing to offset the soft demand from companies for employees.

The Hartz reforms and, in more general terms, the measures contained in Agenda 2010 aimed at reforming the social security system have clearly increased the incentives to work, but have hardly solved the structural problems of the labour market, which remains too rigid and deters companies from hiring in periods of weak growth. The liberal element of the opposition is calling for a further relaxation of the rules protecting employees and a dismantling of wage negotiation procedures in order to be able to take better account of the situations companies are in.

Further progress is to be expected in the social security system. According to the International Monetary Fund[5], models suggest that due to the demographic effects of an ageing population, public finances and the social protection regime are not sustainable over the long term. Fiscal consolidation will need to be continued in order to ensure the survival of the protection regimes and eliminate the distortions that are hampering growth. In particular, the effort to reduce the share of pension payments financed by contributions from the wages of current employees will need to be continued.

Table 4 : GDP and public sector accounts (EUR billions)

	2002	**2003**	**2004**	**2005[1]**	**2006[1]**
GDP[2]	2148.8	2164.9	2207.2	2260.2	2305.4
GDP Growth (%)	0.2	0.0	1.6	1.0	0.8
Public deficit	77.5	81.4	80.1	83.6	80.7
as % of GDP	3.6	3.8	3.6	3.7	3.5
Public sector borrowing	1,284	1,367	1,453	1531	1600
as % of GDP	60.9	64.2	66.2	68.3	69.2

Sources: Destatis for 2002 and 2003; [1] BNP Paribas estimates for 2004 to 2006
[2] Data not adjusted for working days

For a number of years now, the difficulties in the labour market and the moderate level of earnings growth have tended to erode the financial base of pension protection, resulting in an increase in contribution rates and the non-wage element of labour costs, in turn holding back any upturn in employment and thus reducing still further social security receipts.

It is this vicious circle that the reforms of the health, unemployment and pensions systems have so far failed to break. This is the tricky challenge facing the next government, of whatever political colour it may be.

[4] On 1 July 2005 the Bundestag passed a motion of no confidence in the Chancellor, opening the way to early legislative elections, which will probably take place on 18 September 2005.

[5] IMF: Germany – 2005 Article IV Consultation Concluding Statement of the Mission. June 28, 2005.

France: Deficit unlikely to fall below 3% of GDP

The effective deficit of the government budget was significantly larger than one year before at end-May, so that the annual target now looks hard to achieve. Regarding social security accounts, the reduction in health service deficit is offset by worsening elsewhere (pensions branch, family branch). The task of bringing the overall public deficit back below 3% of GDP this year now looks hard to achieve.

Public finances: key figures

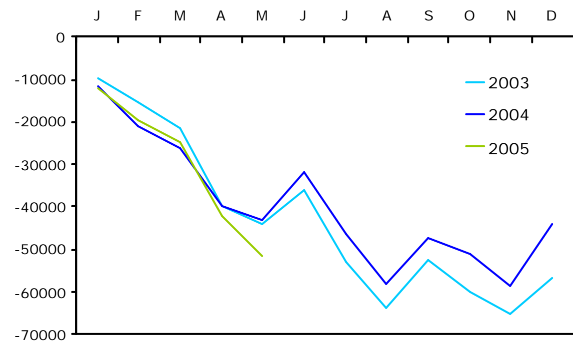
	2003	2004	2005	2006
GDP (%)	0.9	2.1	1.3	1.8
Public deficit (€bn)	-66.3	-59.7	-59.3	-67.0
Of which budget balance	*-56.9*	*-43.9*	*-49.0*	*-49.0*
Public deficit/GDP (%)	-4.2	-3.6	-3.5	-3.8
Of which budget balance	*-3.6*	*-2.7*	*-2.9*	*-2.8*

Source: INSEE, Ministère de l'Economie et des Finances
BNP Paribas forecasts for 2005 and 2006

■ **Government budget: at end-May, the effective deficit was significantly larger than one year before (EUR-8bn). The annual target now looks hard to achieve.**

At the end of May, the effective (central State) budget deficit was EUR51.5bn, i.e. EUR8.2bn greater than at the same point last year (figure 1). Compared with previous years, the gap now looks significant, whilst it had remained moderate until April. Whilst the increase in spending over a year is slightly more dynamic than initially planned (+2.6%), notably due to the rise in civil servants wages from March, receipts are for their part clearly weaker than expected (-3.8% y/y). According to the Finance ministry, this is partly due to calendar effects (in particular concerning non fiscal receipts, which look especially low indeed, and contributions to the European Union). The trend for some types of receipts is also suffering from the dip in the economy (in particular, receipts from the corporate tax are 10.2% lower than in 2004 at end-May).

Figure 1: Government budget execution

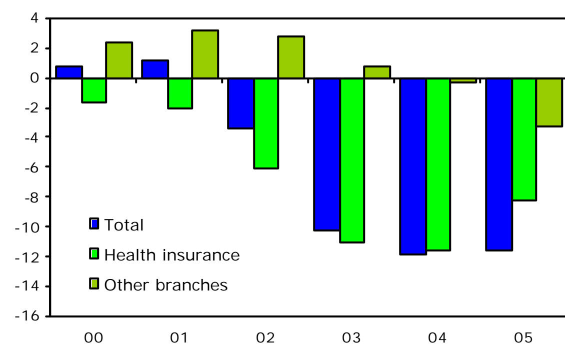


Source: Ministry of finance

■ **Social security: different causes, but the same result. Reduction in health service deficit offset by worsening elsewhere.**

The overall social security figures are little changed, even though the underlying causes are different from one year to the next. According to the social security audit commission, the overall deficit is likely to be EUR11.6bn this year, in line with the EUR11.9bn posted last year and much worse than the figure predicted last September. If one also includes the elderly persons' solidarity fund (Fonds de solidarité vieillesse (FSV)[1]), the total social security deficit could indeed climb to a record EUR13.5bn. The fact that the social security deficit will match its 2004 level is, of course, in part due to the persistent depressed state of the labour market (fall in numbers in work in the first quarter of 2005, increased unemployment at the beginning of the year) as two-thirds of receipts come from social security contributions on wages. However, the lack of control over some areas of spending is also to blame, as emphasised by the detailed figures for the various branches of the social security system.

Figure 2: Social Security: smaller health insurance deficit offset by worsening of situations in other branches (pensions, families)



Source: CNAM

[1] *This fund is not included in the overall regime. Its main responsibilities including pension contributions for the unemployed and the payment of a minimum pension. As a result it is sensitive to unemployment rates and poverty levels.*

The breakdown of the overall deficit will be different in 2005 from in previous years. An improvement in health insurance has been offset by a worsening of the situation in the other branches (family support, pensioners) as shown in figure 2:

- To no great surprise, health insurance accounts will improve in 2005, due to the net increase in compulsory contributions under the August 2004 reforms (EUR4.2bn). On the spending side, there were only fairly modest changes in early 2005, although the national health insurance spending targets are likely to be exceeded over the whole year. The targets set for the next few years – with a return to a balanced budget in 2007 – still look highly ambitious, with the effects of the spending control aspects of the 2004 reforms (focussed in particular on the nomination of a single doctor for primary care and the introduction of a personal medical file, whose implementation may take more time than initially planned) as yet unclear.

- The pensions branch will, however, slip into deficit in 2005. The downward trend in the accounts for this branch is not surprising, given the underlying demographics of the baby-boom generation arriving at retirement from 2006. However, the deterioration this year has been exacerbated by the early retirements of people who began work at a young age, made possible by the 2003 reforms.

- The family branch is also likely to clock up a significant deficit in 2005, having initially been expected to be in balance, as some areas of spending have risen faster than expected (services for young children, housing allowances).

All in all, there will be no improvement in the social security deficit this year, despite a substantial increase in contributions following the major reforms of pensions in 2003 and health insurance in 2004. Whilst by no means all of the planned measures have yet been applied, the targets set look ambitious.

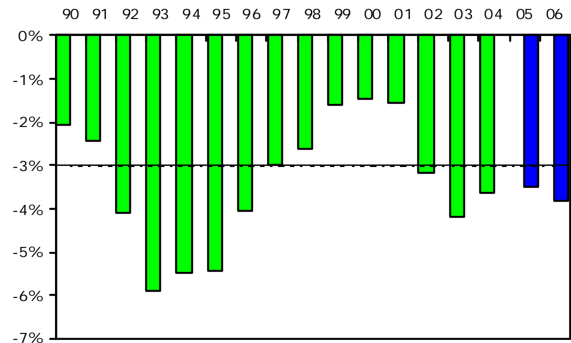
■ **Partial privatisations: GDF, EDF, and motorway operators on the menu.**

In his general policy statement of 8 June, the new Prime Minister set out his privatisation programme. The privatisation process for GDF began on 23 June. The partial privatisation of EDF and the sale of stakes in motorway companies were also confirmed[2] (revenues from the latter are earmarked for financing transport infrastructure projects).

■ **An "economic deficit" above 3% of GDP in 2005 and 2006. A debt-to-GDP ratio stuck above 60%.**

In the final analysis, the task of bringing the government deficit back below 3% of GDP this year now looks hard to achieve. The marked downturn in growth in the first half[3] and sluggish labour market conditions weigh on fiscal and social security receipts in a noticeable way. In addition to this, some kinds of expenditure

Figure 3: Overall public deficit (% GDP)



Source : INSEE – Forecasts: BNP Paribas

are more dynamic than initially planned, among both social accounts (pensions branch, family branch, unemployment insurance) and the central State (civil servants wages). The payment by EDF and GDF of the balance of the sum due to the general pensions regime[4] may in the end only moderate the slippage in public finances, without enabling a return of the deficit-to-GDP ratio below the 3% threshold (-3.5% forecast, figure 3). However, it is still too early to exclude the possibility for the government goal to be achieved, as a positive effect from receipts which are not currently known cannot be ruled out at the current juncture (in particular: a possible additional balancing payment by EDF to complementary pension regimes).

Next year, the deficit-to-GDP figure is likely to be above the 3% limit (-3.8% expected) in the absence of such exceptional receipts, as the government tries to re-launch its employment policy[5] (and despite the fact that rates of income tax will not be reduced as had originally been planned).

Based on these forecasts, the ratio of public borrowing to GDP will inevitably remain above the 60% limit in 2005 and 2006 (from 65.6% in 2004). The accounts commission recently criticised this excess, stressing that this additional borrowing is used too often to finance current spending rather than public sector investment which could eventually serve to boost economic growth.

[2] *In 2002, the government sold half of ASF (Autoroutes du Sud de la France) for EUR1.8bn.*

[3] *The GDP growth projection contained in the budget was 2.5%; our forecast is that GDP will grow by only 1.3%.*

[4] *EUR7.7bn for the time being, or 0.45 points of GDP. Note that additional payments, into complementary pension regimes, are still possible.*

[5] *Taken together the new measures to boost employment to be introduced in 2006 will generate additional costs of EUR4.5bn compared to 2005, equivalent to 0.25 points of GDP. See EcoWeek 05-25 for more details (Focus 3: France: general policy statement: priority to employment).*

Italy: First test for reformed Stability and Growth Pact

At the proposal of the European Commission, the EcoFin council launched an excessive deficit procedure against Italy on 12 July. Nonetheless, the country has two years, i.e. until 2007, to bring its deficit back below 3% of GDP. This flexibility is completely in keeping with the new Stability and Growth Pact rules adopted in March. The recession into which the country has slipped and the scale of the adjustment needed were considered to qualify as "special circumstances" opening the way for Italy to be given an extra year in which to put its public finances in order. However, it is not certain that this will suffice. The fiscal deficit might balloon to 4.3% this year. The Italian government, which expects 1.5% GDP growth in 2006 and 2007, projects the deficit to decline to 3.3% of GDP next year and 2.8% in 2007. Our growth estimates are less optimistic than the government data. We anticipate a further deterioration in public finances. The deficit could exceed 5% of GDP next year.

Second recession in less than two years.

As GDP contracted by 0.5% in Q1 2005, Italy slipped into recession for the second time in less than two years and a rebound in Q2 looks unlikely. The weakness of domestic demand lasting for over a year, and a sharp drop in exports and textile production provide little encouragement for investment. Moreover, most of the growth stimulating measures by the Berlusconi government have been focused on consumers rather than businesses, suggesting that a further decline in private sector investment is likely over the next few quarters. The country's balance of payments is hampered by three main difficulties: a still strong euro despite easing since the beginning of the year, poor labour productivity and competition from China for Italy's key products, most notably textiles. Lastly, consumer confidence was down for the third month running in June, undermined by poor economic conditions, and particularly by the weak labour market. In addition, the fear that the next parliament may introduce less accommodating fiscal policies is inciting consumers to save. Taking all these factors together, we expect GDP to shrink this year, followed by a modest rise of perhaps 1% in 2006.

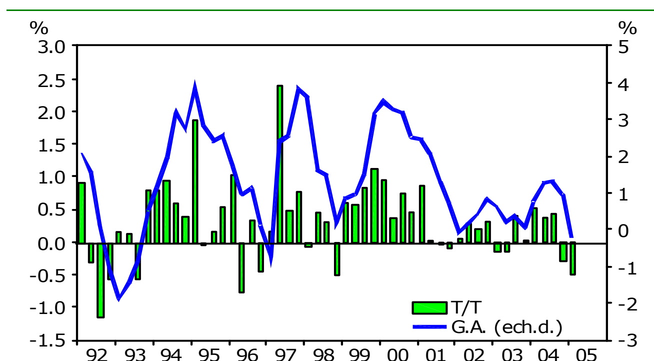
Sharp deterioration in public finances…

Against the backdrop of a floundering economy, the poor state of Italy's public finances is not a surprise.

In response to doubts expressed by Eurostat regarding data on Italian public finances, and its view that the public sector deficit exceeded 3% of GDP in both 2003 and 2004, ISTAT revised upwards its figures for the budget deficit on 24 May. In fact, the government had initially announced a deficit of 2.9%, obtained by one-off measures. This estimate was retained in the Stability Programme, but never validated by Eurostat.

The deficit is now put at 3.2% of GDP in 2001, 2003 and 2004, and has been raised to 2.7% for 2002. The debt-GDP ratio has also been revised upwards, to 110.9% in 2001, 108.3% in 2002 and 106.8% in 2003. The figure for 2004 has been confirmed at 106.6%. Against this backdrop, the Stability Programme presented at the beginning of the year has become obsolete.

Chart 1 : A second recession in less than two years



Source: ISTAT

Economic (%, y/y) and budget (% of GDP) forecasts

	2004	2005	2006	2007	2008	2009
Economic and Financial Planning Document 2005 to 2009 (DPEF) (July 2005)						
GDP	1.0	0.0	1.5	1.5	1.7	1.8
Inflation (HICP)	2.3	2.2	2.1	2.0	2.0	2.1
Unemployment rate	8.1	8.1	8.1	8.0	7.8	7.7
Budget deficit	-3.2	-4.3	-3.8	-2.8	-2.1	-1.5
Trend deficit (*)	na		-4.6	-3.8	-2.7	-2.0
Primary balance	+1.8	+0.6	+0.9	+1.8	+2.5	+3.0
Debt	106.6	108.2	107.4	105.2	103.6	100.9
BNP Paribas (July 2005)	**2004**	**2005**	**2006**			
GDP	1.0	-0.3	1.0			
Inflation (HICP)	2.3	2.1	1.7			
Unemployment rate	8 .1	8.1	8.3			
Budget deficit	-3.2	-4.3	-4.5			
Primary balance	+1.8	+0.9	+0.5			
Commission (March 2005)	**2004**	**2005**	**2006**			
GDP	1.4	1.2	1.7			
Inflation (HICP)	2.3	2.0	1.9			
Unemployment rate	8.0	7.9	7.7			
Budget deficit	-3.1	-3.6	-4.6			
Primary balance	1.9	1.3	0.4			
Debt	106.6	105.6	106.3			
PSC 2004 (February 2005)	**2004**	**2005**	**2006**	**2007**	**2008**	
GDP	1.2	2.1	2.2	2.3	2.3	
Inflation	2.2	1.6	1.5	1.4	1.4	
Unemployment rate	-2.9	-2.7	-2.0	-1.4	-0.9	
Budget deficit	2.4	2.4	3.3	4.0	4.7	
Primary balance	106.0	104.1	101.9	99.2	98.0	

Sources : Italian government, European Commission, BNP Paribas.
(*)Estimate of deficit without corrective measures

The European Commission published, on 7 June, an initial report showing that the treaty's requirements concerning the deficit and debt had not been met, thus opening the door to an excessive deficit procedure. In particular, it considered that the excessively slow reduction in the debt ratio was due to a contraction in the primary surplus (*i.e.* the public balance net of debt-servicing costs), which fell from over 5% in the late 1990s to less than 2% of GDP by 2004. On top of this there were budgetary considerations which prevented a rapid reduction in debt. The low level of potential growth in Italy – estimated by the Commission at around 1.5% for 2005 and 2006 – and the high level of borrowings indicate that the current level of the primary balance is far from sufficient to allow any debt reduction.

The Commission's projections made gloomy reading, with the budget deficit (in the absence of corrective measures) reaching 3.6% of GDP in 2005 and 4.6% in 2006, and debt stuck at around 106% of GDP.

On 30 June, following this assessment and taking account of the specific factors put forward by the Italian government, the European Commission put a proposal before the EU25's Finance Ministers that gave Italy two years, *i.e.* until 2007, to bring its deficit back below 3% of GDP.

The current recession has slipped and the scale of the adjustment needed were considered to qualify as "special circumstances" opening the way for Italy to be given an extra year in which to put its public finances in order. This recommendation was adopted at the meeting EU's finance ministers on 11 and 12 July and will be officially adopted in September. The flexibility granted to Italy is completely in keeping with the new Stability and Growth Pact rules adopted in March.

More precisely, Italy will be required to take measures from 2005 to bring the deficit back to under 4% of GDP, and to less than 3% in 2007, thus requiring a cumulative reduction equivalent to 1.6% of GDP over the period. The Commission has recommended that the measures taken should be sustainable, an allusion to the one-off measures used and abused by the Italian authorities in the recent past.

The government will also very soon bring forward its four-year economic and financial plan or DPEF, covering 2005 to 2009. Having been presented to ministers on Tuesday 12 July, the draft plan was approved by the cabinet on Friday 15 July. The main points that have transpired in the press are: 1/. economic growth of 1.5% in both 2006 and 2007, after zero growth in 2005; 2/. a budget deficit at 4.3% of GDP in 2005, before being brought back to 3.8% next year and 2.8% in 2007 ; 3/. a spike in public sector borrowing at 108.2% of GDP in 2005 (*i.e.* the first rise of the ratio for the past decade), followed by a rapid reduction, taking the figure back to 105.2% by 2007 ; 4/. additional spending cuts amounting to 1.8% of GDP in 2006 and 2007 ; 5/. EUR 15 bn from privatisation proceeds until end-2008.

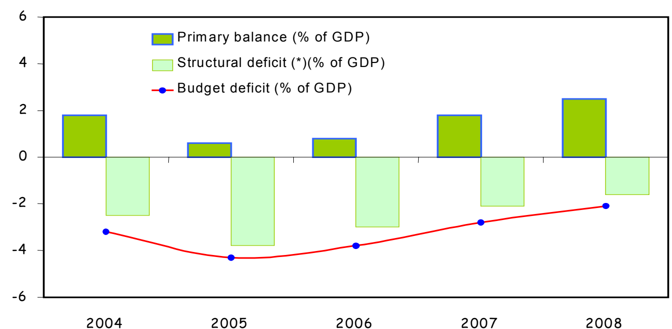
Nonetheless, it is not certain this will suffice to respect the criteria of the Stability and Growth Pact. Our growth estimates are less optimistic than those of the Italian government, and we expect a further deterioration in public finances to more than 5% of GDP next year.

…which will take a long time to improve

In fact, the current recession has its roots in structural weaknesses which successive governments have failed to tackle. Clearly the euro's rise of nearly 50% from its low point in 2000 has hit the key Italian traded goods sectors – textiles, shoes, furniture – which are facing strong competition from China. The introduction of the euro effectively removed from Italy the weapon of competitive devaluation, which it had wielded with abandon in the past. It is also clear that the depreciation of the euro since the beginning of this year, if it were to continue, will give the Italian economy a bit more room to manoeuvre. However, the reasons for the current slump in the Italian economy extend far beyond the issue of exchange rates. In particular, the common currency has allowed the Italian economy to benefit of low levels of nominal, and more particularly, real interest rates at both the short and long end of the spectrum. This is welcome given the scale of the Italian budget deficit. Notably, structural reforms in the product and labour markets are being implemented far more slowly in Italy than in other EU countries.

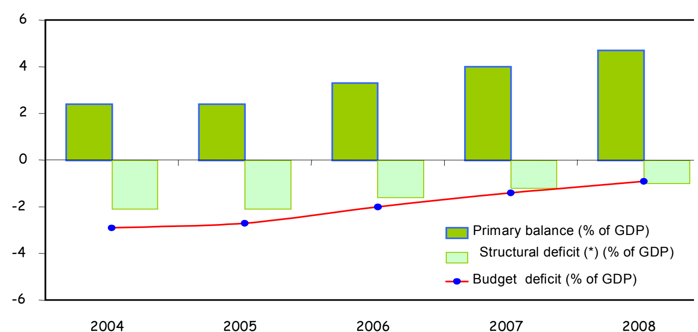
Over a longer horizon, the government has to face the threat entailed by population ageing on the sustainability of public finances. To meet this challenge, a reform of the pension system is being gradually implemented. This reform, which is necessary since otherwise public accounts would not be able to post a surplus over the projection period, is nonetheless not radical enough in our opinion.[1] The macroeconomic scenario in the Stability Programme guarantees the long-term sustainability of the public debt, which is to slip below the 60% of GDP mark in 2018 and to zero in 2042. Since we think this program is flawed by excessive optimism, we confidently bet that further consolidation measures and fiscal discipline will be required to meet these objectives.

Chart 2a: According to the DPEF, most of the adjustment will take place in 2006-2007



Source: DPEF 2005-2009 (*) Adjusted for the effects of the business cycle.

Chart 2b : as it was already in the in the Stability Programme 2004-2008



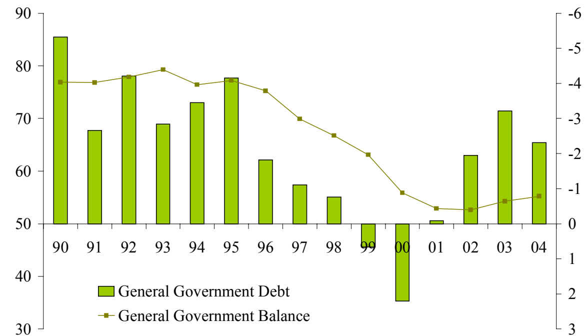
Source: Stability Programme 2004-2008 (*) Adjusted for the effects of the business cycle.

[1] *Cf. EcoWeek 05-04 "Italy: Latest pension reform is too modest*

Netherlands: Staying ahead in the tax competition race

Budget outcomes are better than expected thanks to lower interest costs and the purchase of the gas transportation network. The deficit is projected to come down to 2.3% of GDP in 2005 without additional corrective measures. Three major projects are planned for 2006: the new health care insurance, the new disability law, and the new pension law. The latter has been delayed, which can have consequences for the introduction of the new financial assessment framework. The government envisages to lower the corporate tax rate to only 26.9% by 2007.

Chart 1: Deficit and debt (% GDP)



Source: Statistics Netherlands

Better than expected budget outcomes

Since the presentation of the 2005 Budget last September (EcoWeek 04-34 The Netherlands: The 2005 Budget), the economic climate has substantially deteriorated. Whereas the government had assumed the economy to grow by 1.5%, an outcome closer to 0.5% seems now more likely. One of the reasons for this disappointing growth performance is the substantial increase in oil prices. Last September, the government expected oil prices to be around USD 35 bbl for 2005. This seems much too optimistic. We now expect the barrel price to exceed USD 50 bbl on average this year.

However, the consequences for the government finances seems limited. On the one hand, lower growth should lead to higher expenditure (social transfers) and lower income tax receipts. On the other hand, this is more or less offset by higher government receipts from natural gas sales.

In May, Finance Minister Gerrit Zalm presented the Spring Memorandum, a progress report on the execution of the 2005 Budget. The minister announced some significant shortfalls on the expenditure side. Wages and prices in the government sector have increased more rapidly than the overall GDP deflator (EUR 300 million). Moreover, health care spending will end 200 million higher. However, the shortfalls are to be offset by lower interest payments (EUR 400 million) resulting from lower interest rates and a lower deficit in 2004. Following the budget proposals of the European Commission, the Dutch contribution to the EU budget is now estimated to be EUR 200 million lower than initially assumed. Moreover, unemployment has not increased as fast as expected. At the time of the presentation of the budget, the government had expected unemployment to go up to 7% of the labour force. The most recent government projections show the unemployment rate to reach 6.75%, as many people have "voluntarily" left the labour force.

On the income side, the government announced a one-off windfall of EUR 3.8 billion from the purchase of the gas transportation network[1]. By contrast, profits of De Netherlandsche Bank (DNB) were EUR 200 million lower than estimated, largely because of last year's depreciation of the dollar.

Netherlands: Economic and Fiscal Forecasts

	2002	2003	2004	2005*	2006*
GDP (%)	0.6	-0.9	1.4	0.3	1.2
Consumer Prices (%)	3.2	2.1	1.2	1.5	1.4
Unemployment rate	4.1	5.3	6.4	7.2	7.3
Budget Balance**	-9	-14.6	-11.5	-10.3	-9.6
% GDP	-1.9	-3.2	-2.5	-2.2	-2.0
Funding requirement**	34	36	29	36	36
3-month rate***	2.83	2.12	2.16	2.15	2.25
10-year bond yield***	4.21	4.33	3.63	3.35	4.00
spread over bund, bp	-1	4	-5	-5	0

Source: Netherlands Statistics, DSTA, *forecast BNP Paribas, **billion EUR, ***end of period

In April, the 12-month EMU deficit stood at 2% of GDP. The government estimates that the deficit/GDP ratio for 2005 will reach 2.3%, 0.3 percentage point lower than estimated at the presentation of the 2005 Budget in September 2004. It has also fallen below the 2.5% target of the coalition agreement.

Hence, Mr Zalm concluded that no additional measures are necessary. On the contrary, to stave off a government crisis in March, the government reached agreement on increasing the government expenditure on education (EUR 250 million) and research and development (EUR 500 million). The latter will be funded out of the increase in gas receipts.

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[1] The gas transportation network operator will hence be fully owned by the State, which will consolidate the firm's profits as early as the year they are made from 2005 onwards. Until now, the State has shared the dividends with Shell and ExxonMobil (one year after the profits were made, as with any dividend).

DSTA issues 30-year state loan

In April, the Dutch State Treasury Agency issued a 30-year bond It followed the example of France, Germany , Greece and Spain, who had previously supply the very long end. This development owes to the growing demand for very long bonds, which is stimulated by the new bookkeeping rules. In particular, IAS19 will require a more realistic (market-to-market) valuation of assets and liabilities, and the incorporation of the balance sheet of corporate pension funds in that of the sponsor. To avoid large swings in the value of assets, companies might prefer less volatile assets such as bonds. The new Dutch pension law, which will come into force during 2006, could have a similar effect, as it requires pension funds to establish a safety margin depending on the risk profile of their assets to avoid underfunding. The DSTA collected EUR5.2 billion at an initial yield of 4.073%, *i.e.* 4 points above the German Bund. It is the intention to raise the volume of the issue to at least EUR 10 billion. Pension funds and insurers took each more than 10% the issue.

At the beginning of the year, the DSTA estimated that the borrowing requirement to reach EUR 36 billion. Owing to the favourable budget developments, this is now estimated to come down to EUR 33 billion,

Three projects for 2006

The government has three major projects for 2006 in the pipeline. In June, the proposals for a new general health care insurance were approved by the First Chamber. (cf. EcoWeek 05-16 The Netherlands: Health care insurance should enhance competition and efficiency). In September, the government will announce measures to limit the financial impact for certain groups.

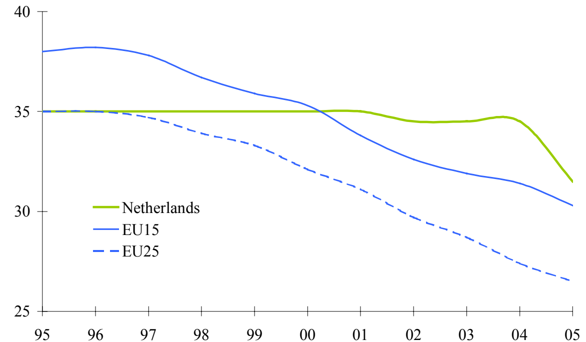
The second major initiative is the new incapacity law, which aims at curbing the inflow into the public disability scheme. From 1 January, only completely disabled people can receive a benefit. The benefit for the partial handicapped will be related to their degree of incapacity. If the scheme will be sufficiently slimmed down, the benefit will be increased to 75% of the last earned salary from 70% at the moment. The law was recently adopted by the Second Chamber and is waiting for approval by the First Chamber.

The third project is the new pension law, which gives the right to every employee to participate in a pension fund. The preparation of the law is delayed, and the government expects to introduce it in the course of 2006. This could also have consequences for the new Financial Assessment Framework (FTK) fund, which determines the valuation rules for assets and liabilities (market-to-market), minimum funding rules and solvency rules (see EcoWeek 04-41 The Netherlands: To a more solid pension system). The Minister argues that the FTK can still be introduced by decree of DNB as supervisor of the pension and life-insurance sector. DNB will take a decision in September if the FTK will be postponed till January 2007.

To a new corporation tax in 2007

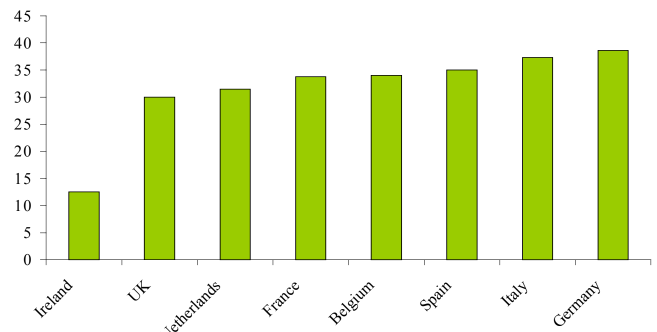
The government is preparing a new corporation tax to be introduced in 2007. Traditionally, the Netherlands has a very attractive tax regime for foreign investors, in particular because of the advance pricing agreement and advance tax ruling practices. These rules provides certainty on the acceptability of transfer pricing between the Dutch group company and a foreign group company. However, they are increasingly copied by other EU member states to attract foreign investment

Chart 2: Corporate tax rates are coming down



Source: Deloitte, European Commission

Chart 3: Corporate tax rates in 2005



Source: Delottie, European Commission

Moreover, corporate tax rates in the EU have steadily come down (cf. chart 2). In 1995, the Dutch corporate tax rate was 35%, three point below the EU average. In 2005, the Dutch rate has come down to 31.5%, which is slightly higher than the EU15 average (30.3) but well above the EU25 average (26.5). This is mainly due to the exceptional low tax rate in Ireland. Compared with surrounding countries, the Dutch rate remains very competitive (cf. chart 3). Moreover, the government has already announced that it will lower the corporate tax rate further, to 30% in 2007.

European rules against harmful tax competition and rulings by the European Court of Justice make it difficult to compete on preferential tax regimes for mobile activities. As a result, European tax competition is shifting to competition on tax rates rather than on the tax base. The new corporate tax law envisages to broaden the tax base and to reduce the corporate tax rate to 26.9%. The corporate tax rate for the SME will be reduce by 5 percentage points to 20%. Moreover the capital tax (0.55% of the value of a share issue) will be abolished. This tax has already been scrapped in Germany, France and the United Kingdom.

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