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Merkel versus Renzi for the future of the eurozone

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Behind the big battle for the presidency of the European Commission lies an important debate that has not yet caught much attention – at least not outside Italy and Germany. It is Rome's demand for a fundamental rethink of the fiscal rules in the eurozone. The immovable object of Angela Merkel's fiscal orthodoxy is about to meet the irresistible force of Matteo Renzi's restlessness. Sit back and enjoy.

On July 1 the Italian prime minister will take over the six-month presidency of the EU. He has big plans. The bloc's rotating presidency is no longer what it used to be since the European Council, composed of heads of government, appointed its own permanent president five years ago. But this detail has not deterred Mr Renzi from launching what is essentially a unilateral agenda. The German chancellor has already said Nein – but the tone is still civilised.

Mr Renzi proposes three specific changes. The first is a weakening of the official fiscal rules. The second is a change to the fiscal compact – a multilateral treaty signed by all EU members except the UK, Croatia and the Czech Republic. The offending item is a binding debt-reduction rule. The third demand is a jointly funded investment programme.

He will almost certainly not see his first wish fulfilled. But he may still get what he needs, an agreement by the next commission to interpret the fiscal rules more flexibly. As long as Jean-Claude Juncker, the former prime minister of Luxembourg, promises a fiscal blind eye, he will be able to count on Mr Renzi's support in his bid for the commission presidency job. Mr Renzi may be the swing vote. This puts the Italian prime minister in a good position to extract concessions from any future commission president.

Assuming Mr Juncker gets the job, what could he do to help Italy? For a start, he could give countries more time for deficit reduction. He could introduce a subversive accounting change by subtracting investment spending from deficit calculations. Mr Renzi badly needs concessions such as these. He would otherwise face the dreaded "excessive deficit procedure", which the commission slaps on countries that fail to meet their fiscal targets. With his eccentric 2014 budget – consisting of tax cuts funded by uncertain revenue measures – Mr Renzi has taken a big fiscal risk. He clearly wants the commission off his lawn.

On the fiscal compact, however, I see less leeway. There was never much of an economic rationale for a rule that restricts the amount of debt to an arbitrary 60 per cent of gross domestic product. The sole purpose of the fiscal compact was to give the German public peace of mind during the euro crisis. It contains the message – or rather the lie – that the eurozone member states are happily committed to debt reduction. But there is no way the Italians will reduce their country's debt-to-GDP ratio by 75 percentage points in 20 years as the debt rule demands. Nor should they. They should instead focus on the broader concept of debt sustainability, the one goal that really matters. Even this would be unattainable with present growth and inflation rates.

The fiscal compact had no economic rationale – its purpose was to give the German public peace of mind during the crisis

To generate more growth, Italy and everyone else in the eurozone need more investment. On this point, Mr Renzi might get lucky. Ms Merkel may be open to an EU-wide investment programme. Her Social Democrat coalition partner is demanding one. Sigmar Gabriel, SPD chairman and economics minister, surprised everyone by saying that countries should get more time for deficit reduction if they commit to reforms. He is also in favour of excluding investments from the deficit calculations. German conservative economic commentators had a collective panic attack. Mr Gabriel was accused of favouring a change in the rules – which technically is not true – and of undermining Ms Merkel's negotiating position. The latter is both true and, I presume, intended.

The impact of an EU-wide investment programme will depend almost entirely on its size and the speed of its introduction, more than on what the money is spent on. Austerity has led to a dramatic fall in public and private investment everywhere in the eurozone. Germany needs to invest just as Italy does – in infrastructure, education, energy networks, and research and development.

With interest rates close to zero, such a programme would be essentially self-financing. It could also help raise potential growth if the investments were to lead to an increase in productive capacity. It could be funded through five or 10-year bonds issued by the European Investment Bank. The European Central Bank could then buy most of these bonds as part of a future programme of asset purchases, which I expect to happen later this year.

The history of the eurozone suggests that change takes time and always falls short. But this is the kind of debate the eurozone needs. Its outcome will help us understand whether Italy and other indebted member states can coexist in a monetary union with Germany. I still have my doubts. But Mr Renzi's determination constitutes an important development nevertheless.

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