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THE PROBLEM IS NOT EU'S FISCAL RULES, BUT ITALY'S ECONOMIC STRATEGY

Carlo Bastasin

The argument that the Italian government is using to change the fiscal policy strategy is captivating. It is basically saying: "Let us try something new because in the past we followed austerity recipes and Italy's public debt greatly increased." Matteo Salvini and Luigi Di Maio used similar words to forward this argument. Both believe it is valid (they were probably pushed by their economic advisors) because it is in line with the very popular criticism directed towards past political leaders who were accused of having bowed to Europe.

The problem is that this interpretation, that is, austerity's responsibility in increasing public debt by about 33 points between 2008 and 2016, is not a result of an in-depth analysis. Just a few calculations are needed to understand that the debt increase is largely the effect of an increase in spending for servicing the debt itself. Other, more technical, factors (among which are the nearly 4 points of Italy's GDP in help to European countries in difficulty) may have also contributed, but it was the tension around the interest rates, caused above all by the uncertainty of whether Italy would remain in the euro, that increased the debt. The weak nominal growth of the economy helped reduce the debt by 5 points; otherwise it would have been close to 140% and without a careful budgetary policy by 2012 it would have been almost 150%.

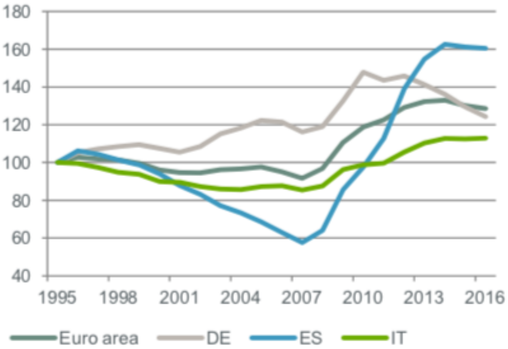
Gross debt accumulation is driven by three main factors: first, the government primary budget balance**,** which is defined as the overall budget balance net of interest expenditure and which in the case of Italy, being in surplus, helped contain the level of the debt. Secondly, the stock-flow adjustment, which is related to elements not included in the government budget balance and mostly derived from privatization revenues, financial transactions related to government support to European newly-established financial institutions, and changes in the size of foreign currency-denominated debt associated with a variation in the exchange rate. Finally, the "snowball effect", which captures the joint impact of interest payments on the outstanding stock of debt and of real GDP growth and inflation rates on the debt ratio. An independent calculation by the Parliamentary Budget Office maintains that the sole effect of the interest rate increase, during the last decade, amounted to 41% of Italy's GDP.

We can say that a more expansive policy in 2012-2013 would have theoretically resulted in more economic growth, triggering a virtuous circle. But during the crisis, the high level of Italian debt prevented the government from taking fiscal expansion measures because they would have been financed only with interest rates that would have been even higher than those that had so quickly increased the debt. Although other countries managed to overcome the same problem, this highlights Italy's original sin: joining the monetary union with an exceedingly high public debt that prevents it from using fiscal space in case of need.

In the graph below, economists at KfW insightfully represented Italy's moderate debt expansion since 1995 compared to those of the other euro-area countries. Italy has regularly made little use of fiscal leverages since it decided to join the euro. Once the crisis erupted in 2008, it was not possible for the Italian government to support the economy, which plunged into a recession, or recapitalize banks. After Lehman went bust, a major mistake was made assuming that the crisis would not last long because it was an "American problem". Thus, Italian banks filled their portfolios with sovereign bonds. Unfortunately, the longer the crisis went on, the higher were the interest rates and the deeper were the banks' losses. Between January 2010 and October 2012 Italian banks' primary capital declined by 22%. The consequence was a credit draught that anticipated and aggravated the necessary fiscal restriction in 2012 when the risk of a public debt default was barely averted.

Italy's real economy still bears the scars of the crisis. One in every four firms has vanished. The rest may have grown stronger. However, in a context of weak growth, the survivors did not fare well enough to absorb the unutilized resources. In particular, workers were laid off by those weaker firms that had suddenly found themselves out of their depth. Consequently, part of the country staged a decent recovery, while the other part was still stuck in the crisis. The divergent performance of the economy has served as a *raison d'être for* diverse political sentiments that are now embodied by two allied, but very distinct, populist parties.

Public debt levels since 1995

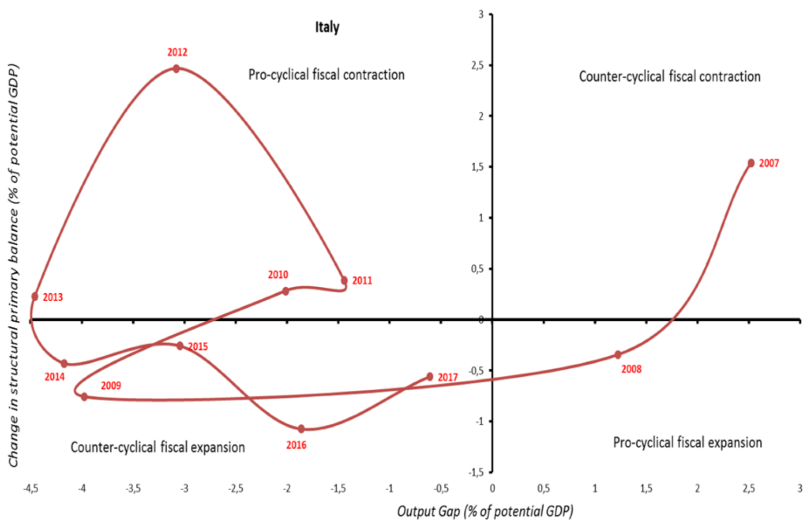


Highlighting Italy's specific weakness does not mean that the aggregate policy of the euro area should be spared from criticism. The euro-area fiscal policy was clearly too restrictive during the recession phase. However, the reason why a restrictive fiscal policy was adopted is the same reason why interest rates increased in Italy: for a long initial phase of the crisis there was no confidence among the euro partners. The eventuality of a euro-area breakup was not ruled out and fiscal cooperation was not seriously taken into consideration. In order to reassure the markets and savers of its permanence in the euro, Italy had to wait for the development of economic coordination and the banking union, which the European Council launched in June 2012, and, above all, the ECB's intervention in July 2012 with Mario Draghi's historical commitment to do "whatever it takes" to keep the euro together.

This is a crucial argument because if the increase of the debt depends primarily on the increase of interest rates and the latter is conditioned by the degree of collaboration or non-collaboration among countries, the Italian government's strategy urgently needs to be corrected. Instead of seeking a clash with its partners, Italy should build with them foundations that are strong enough to make the euro area more homogenous and united. In December the euro-area reform will be examined by the Eurogroup and by Ecofin, which will simultaneously hold a discussion on Italy's fiscal position. This would be a good occasion to undertake constructive negotiations.

However, the Italian government's argument is perhaps too politically captivating to be abandoned. It says that by spending more public money "for the citizens' happiness" it is possible to reduce the debt even in a cyclical phase in which Italy is already growing at a rate that is close to its potential.

A chart from the Parliamentary Budget Office gives us a better idea of the government's choice. The chart shows, year after year, Italy's fiscal position (more structural deficit at the bottom, more surplus at the top), placing it in relation to the strength or the weakness of the economy (on the left the economy grows less than the potential level and at the right it grows more). Good fiscal policy tries to be anticyclical, that is, create fiscal surplus if the economy grows (above on the right) and create fiscal deficit if the economy is suffering (below on the left). For most of the recent years Italy has done reasonable things, although the debt did not decrease (regardless of the ECB's low interest rates). Looking at things superficially, it is as if Italy was not able to implement a reasonable budgetary policy because its debt is so high that it requires severe fiscal policies that would prevent it from going any higher.



From G. Pisauro: *Fiscal Policy in Italy and the European Union*

So, are people who say that Italy should leave the euro right? The answer is that if Italy was able to increase by "just" one point its potential growth rate (if the vertical axis in the chart were to move left), for example by having a proportion of the active population on total population similar to other European countries, the debt would decrease without much effort and without any austerity (the horizontal axis would also be lowered by about half a point as fiscal revenues would increase due to higher employment). This means carrying out reforms that make working more advantageous for more Italian citizens. Had it been done in the past, Italy would have been able to cut the public debt even in the middle of the worst crisis in human memory. Between 2008 and 2016 only for one year fiscal policy expansion would have caused an increase in the debt, which instead of having swollen by a third, would have drastically and almost effortlessly decreased.

Unfortunately, the current government's strategy seems to be the opposite: set an early retirement age for those who work and give aid, instead of work, to the unemployed. It is as if in the chart the vertical axis moved right and the horizontal one moved upward. At this point no budgetary policy would be able to avoid a great increase of public debt. The consequences are obvious.

Italy's fiscal instability would grow not only because it deviated from the budget rules, but primarily because of a wrong economic policy strategy. The European Commission would be obliged to impose a sanction on

Italy. In fact, not even a compromise, that is, a slight correction in the budgetary balance, would change the fundamental error of not having incentivized work and private investments but having only done the opposite. A sanction would make less intrusive EU institutional instruments for saving the economy, such as an ECB intervention, inapplicable. The remaining choices would be too painful, especially for those who assign significant value to national sovereignty.