LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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ECONOMIC GROWTH AND EUROPEAN BARGAINS: WHY ITALY SHOULD DECREASE ITS GOVERNMENT DEBT

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1. The election of Emmanuel Macron as president of the French Republic and the acquisition of a parliamentary majority by his “En Marche” movement has raised the prospects for Franco-German cooperation and reinvigorated the process of institutional and political progress in the European Union, and, in particular, the euro area. If the expected electoral victory of chancellor Angela Merkel in September does in fact occur, for the first time in about fifteen years there will be a coordinated political cycle between the governments of these two major euro area economies. Indeed, this expectation is already reinforcing dialogue between Paris and Berlin. Such coordination could make it possible to implement the path outlined by the European Commission at the end of March (see *Reflection Paper on the Deepening of the Economic and Monetary Union*), based on the resumption and deepening of the many issues evoked by the Five Presidents’ Report (*Completing Europe's Economic and Monetary Union*, June 2015).

It is important that Italy offers its active contribution to this path in order to orient it to the fulfillment of both the general interests of the entire European Economic and Monetary Union (EMU) and the protection of the most fragile member states. President Macron has reiterated the importance of the Italian role, perhaps to reduce the risk that Germany's overwhelming weight could erode the French bargaining space. In addition, chancellor Merkel seems willing to involve Italy and Spain in the new European yard, giving a signal of confidence in the process of further integration of the euro area. However, the strong political and financial uncertainty characterizing Italy since the fall of 2016 is a serious hindrance for any initiative aimed at strengthening a shared responsibility within the EMU.

In this *Policy Brief*, we present a hypothesis of completing the institutional framework of the euro area meeting two conditions. First, in order to be accepted by Italy’s partners, a new framework must safeguard the responsibility and stability requirements of each member state; second, and indispensable for Italy, it must secure growth support through the advancement of European economic cooperation. Such conditions can achieve a balance in the trade-off between stability and growth, reconciling the distinct visions of Germany and France, and, above all, the fundamental divergences between Germany and Italy.

2. Over the last decade, the governance of the euro area has been improved in response to the challenges posed by the financial crisis. The European institutions have decided to strengthen the oversight of Member States' fiscal policy, notably through the Six Packs and Two Packs. In parallel, they have created the European Stability Mechanism (ESM) with the aim of providing financial assistance to those member states that had temporarily lost access to the market for the financing of their government debt. As highlighted in the European aid plans for Ireland, Portugal, Greece and Cyprus, financial assistance is subject to a macroeconomic adjustment program and subordinated to conditionality. Subsequently (2012), ESM had the task of implementing three "facilities". The first facility consists in the possibility of providing direct or indirect loans for the recapitalization of European banks (such as in the Spanish case). The second facility concerned precautionary financial assistance through the opening of credit lines to countries that can meet the main European rules but are unable to finance their debt on the market at non-penalizing terms. The third facility links the precautionary financial assistance to the "Outright Monetary Transactions" program, which allows the European Central Bank (ECB) to purchase in the secondary markets an unlimited amount of the sovereign debt of a member state facing temporary difficulties. The facilities, implemented by ESM, have been modified by the creation of Banking Union, whose architecture is currently comprised of the Single Supervisory Mechanism and the Single Resolution Mechanism, but still has to be completed by a European Deposit Insurance Scheme (EDIS).

These considerations show that the EMU's governance system, as it emerged after years of profound difficulty, has a more stringent surveillance mechanism and is equipped to deal with a liquidity crisis of a member state or some banks. It is not, however, able to prevent or regulate a structural insolvency crisis in a country or a national banking system.

When the ESM is called to provide financial assistance to a member state struggling under the weight of its public debt, it imposes a conditionality so tight and severe that it tends to trigger a recession in the country involved as well as in the neighboring economies. For what concerns bank insolvencies, the possible decision of the Single Resolution Mechanism to start a resolution process by activating the “bail-in” rule encounters strong resistance while another resolution tool (the Single Resolution Fund) is still under construction. Moreover, as already mentioned, an agreement has not been reached to create a European deposit insurance scheme able to avoid, by its very nature, a vicious circle between banking and sovereign debt crises in a member state. Additionally, the operation of ESM is hindered by internal governance issues, as many of its decisions must be taken unanimously and, in some cases, submitted to the approval of national parliaments.

3. These shortcomings stimulated new proposals. In particular, Germany and France have suggested the creation of a new institution that, starting from the current functions of ESM, can address the euro-area fiscal policy problems.[1] However, the positions of France and Germany significantly

[1] We neglect here a detailed analysis of the – by no means - important proposals concerning the evolution of the European financial markets and based on the Capital Markets Union process.

diverge in the definition of the nature and tasks of the new institution and, consequently, in the priorities to be achieved.

Germany proposes that ESM should take the responsibility of supervising the budgetary policies of individual Member States from the European Commission, considered too exposed to political influences. The ESM would thus become a European Monetary Fund (EMF), possibly led by a European Finance Minister, with the objective of protecting the fiscal stability of European governments and the structural stability of European banks. France does not oppose the transformation of ESM into EMF. In keeping with the position of the European Commission, however, it envisages the EMF as the instrument to institute a new European Ministry of Finance. The EMF should, first of all, create the premise for the sovereignty delegation by member states on fiscal policies that is necessary for the progressive establishment of the European Ministry of Finance. Up to speed, the latter would take a more defined responsibility in determining the European fiscal stance and in coordinating the consequent fiscal policies of the various countries. It could thus create a harmonious division of labor with the European Commission, possibly reinforced by the commitment that the new European finance minister would also become president of the Eurogroup and vice-president of the Commission (delegated to the economic affairs). In addition to securing the financing of the traditional European aid plans of Member States in serious difficulties and the three above-mentioned facilities (see point 2), ESM-EMF would also play the fiscal facility role for the European Ministry of Finance.

German and French proposals are not immediately compatible because they have two different objectives: the first aims to centralize the functions of EMU's fiscal stability, the second aims to centralize fiscal policies and make them compatible with the cyclical phases of the euro area. Leaving aside the fact that the EMF itself could be subject to excessive politicization or transformation into a non-democratic authority, Germany aims at a preventive reduction of fiscal risks in the euro area. The establishment of the German EMF model would impose on France, and even more on economically fragile countries, such as Italy, a centrally supervised fiscal consolidation path. The creation of the European Ministry of Finance along the French model would instead require Germany and other 'core' member states (primarily the Netherlands) to increase nominal wages and/or to boost public investment so as to reduce positive imbalances on their current accounts. Possibly overestimating spillover effects on other member states as a result of the expansion of the German and Dutch government expenditure and aggregate demand, France aims to trigger stronger growth in the euro area through gradual adjustments of national government balances and weak forms of fiscal risks sharing.

Beyond their diversity, both the German proposal and the French proposal highlight a crucial point for the economic and institutional evolution of the euro-area: the growing importance of European fiscal policies. European monetary policy is running out of its expansive support for the euro area economic cycle. Many signals indicate that the ECB will initiate, in the short term, a path to normalizing its policy interest rates and to reducing its public securities purchasing program. Strengthened by the increasingly moderate intonation of US monetary policy, such initiatives will lead to a rise in the structure of market interest rates that will mainly hit the European countries with the most serious budgetary imbalances. Therefore, it is easy to foresee that the focus of financial markets on public debt financing will increase from the fall of this year. This does not mean that the EMF or the European Ministry of Finance are called upon to replace the ECB's quantitative easing programs (QEs). It simply means that monetary policy is ceasing to be the "only game in town" and is going to give more room for fiscal policies aimed at preventing and, where appropriate, putting under control the most severe shocks.

4. The foregoing considerations imply that, in order to make the process of strengthening the euro area more effective, the different positions of Germany and France on governance and fiscal policy must not be chained into an irreconcilable contrast. In this regard, these two positions do not have to fall into the old *querelle* between 'risk reduction' and 'risk sharing'. In fact, we need to find a compromise that safeguards the goals of both countries. Sapir and Schoenmaker (see *We Need a European Monetary Fund, but how should it work*, Bruegel, May 2017) make a first step in this direction, finding inspiration from the division of labor between the single supervisory mechanism and the single resolution mechanism within the Banking Union. The two authors suggest that the European Commission should continue to monitor the Member States' fiscal policies in the normal economic phases whereas the ESM-EMF would take up this same task during the crises. The limit of their proposal is that they do not draw a gradual path to attributing the responsibility of the European fiscal stance to the European Ministry of Finance. A simpler and more effective compromise is that the European Ministry of Finance, as outlined by the European Commission and France, is based on reinforced forms of central control of national fiscal budgets to ensure macroeconomic and macro-fiscal structural adjustments (as required by Germany).

This explains why the possible compromise between Germany and France in terms of governance and fiscal policy will bring about a much more substantial divergence between Germany and Italy (together with other fragile member states of EMU). Germany is certainly worried that the French government balance has recorded for many years a deficit of more than 3% of GDP; and it is not certain that, for the current year, that balance will fall below the critical threshold as promised by Macron. Yet the decisive obstacle, which drives Germany to look suspiciously at the process of building a European Ministry of Finance according to the French model, is represented by the huge Italian public debt and the inadequacy of the structural adjustments already implemented. In addition, this nightmare is exacerbated by the radical political-institutional uncertainty that is characterizing our country.

The latest forecasts from the International Monetary Fund and the Bank of Italy show that the Italian economy has hooked, albeit belatedly, the stronger than expected euro-area growth. Although Italy's expected growth rate remains appreciably lower than the average of the euro area, it is based on the dynamics of the aggregate domestic demand and, in particular, on the recovery of private-sector investment. If such data were reproduced in the next quarters, Italy would enjoy a not ephemeral expansive perspective. This opens a window to initiate a credible and balanced path to reducing the government debt/GDP ratio, and to thus reassuring European partners about the sustainability of our public debt.

From a strictly accounting point of view, the sustainability of public debt in a given country is guaranteed by a very simple condition: achieving a primary surplus sufficient to stabilize or reduce the government debt/GDP ratio. It is clear that the level of this surplus depends on several factors, and, in particular, from: the average nominal interest rate paid on government debt, the nominal growth rate of the economy, and the previous public debt stock. If either the 'real' growth rate of the economy and/or the inflation rate are very low or the outstanding debt stock is very high, even non-exorbitant nominal interest rates may render unsustainable a government balance sheet. In those cases, the stabilization of the public debt would in fact require primary surpluses so high to be incompatible with tolerable levels of taxation, social protection, public investment and public services. Since the end of 2015, the structure of nominal interest rates in the euro-area has reached historic lows due to the QEs implemented by the ECB. Yet, also due to the modest growth rates of our economy, in the same years, the Italian debt-to-GDP ratio did not stop growing even if at a slower pace.

5. The gradual affirmation of a French model of European Ministry of Finance, incorporating structural adjustments of seriously unbalanced government budgets, is in the best interest of the Euro-area and Italy. It is, in fact, the necessary condition for consolidating European growth and bringing about convergence in the macroeconomic fundamentals of member states. For this condition to be feasible, there can be no doubt about the present and expected sustainability of the Italian public debt. Consequently, taking advantage of the expected strengthening of the growth rate of our economy, the Italian government should have to initiate progressive, but continuous and systematic reductions in the public debt/GDP ratio.

In this perspective, the Italian repeated use of derogations from the European rules is dangerous, even though they are met with acquiescence by the EU Commission concerned with a worsening of Italy's political and institutional instability. Even worse would be the attempt to reduce the stock of Italian debt by way of accounting expedients, that is, through formal divestiture of part of public activities to companies under the full public control but outside the perimeter of the public administration. Similar expedients would have the effect of accentuating the mistrust of European partners and market lenders towards the Italian public debt, incentivizing dangerous European initiatives to intervene on public debts at risk. Let us not forget in this regard that there is a proposal to create a European Sovereign Debt Restructuring Mechanism, and that Germany has even speculated on an automatic restructuring mechanism for the government debts of member state requiring financial assistance from ESM.

By exploiting the last phase of the QE and low nominal interest rates, Italy must instead step in to reduce its debt-to-GDP ratio, in order to secure adequate growth rates in the medium-term and to allow the Franco-German compromise, without stifling the recent recovery. It is not just about reducing the numerator (amount of debt) or increasing the denominator (GDP) in the short term. Instead, it is about implementing the reforms recommended by the European Commission and endorsed by the EU Council. In this perspective, it is above all necessary to re-allocate public spending and to strengthen the economic growth potential. This implies, among other things, the relaunch of efficient public investment and the activation of redistributive and inclusive policies mainly for the most vulnerable part of the population. It is also about overcoming the persistent fragility of the Italian economy that could have a direct negative impact on the public finance. Following the *blueprint* that the European Commission will shortly publish on the possible creation of bad national banks (as stated in the *Conclusions* of the EU Council on last 11 July), the Italian government must ensure that the banking sector dispenses with the persistent excess of non-performing loans. It is also necessary that this same sector ceases to hold an excessive stock of national debt bonds in its balances before interest rates begin to grow.

The difficulties for a credible implementation of such initiatives are, in themselves, severe. The challenge is made even more difficult by the current political-institutional uncertainty and the expected - albeit not immediate – market rise of the structure of nominal interest rates. Yet there are no alternatives. In order to secure strong growth rates in the medium term and to avoid to be the weakest link in the new European governance, Italy must make its public debt sustainable and correct its greater fragility by using the window of opportunity offered by the temporary continuation of the QE and by the European recovery. Reducing the public debt/GDP ratio could also indirectly relax certain problems in the Italian banking sector. This reduction would allow the European Ministry of Finance to design and manage *European Safe Bonds* (ESBs) along the lines proposed in the aforementioned European Commission's *Reflection Paper* (March 2017), and it would facilitate the exchange between these same ESBs and the excess stock of Italian public debt bonds held in the balance sheets of Italian banks.

6. A part of the Italian ruling class and political-institutional representatives does not seem to share the conclusions just reached. Concerns about the sustainability of Italian public debt tends to be dealt with as unfounded alarms. An emblematic example is offered by the two points proposed by Matteo Renzi, secretary of the largest government party: raising the Italian public deficit, bringing it for five years near the maximum threshold of the old "Stability and Growth Pact" (2.9% of GDP); at the same time, achieving a reduction in the Italian debt-to-GDP ratio. Leaving aside that it is incongruous to support this proposal by threatening Italy's veto to transform the so-called "Fiscal Compact" into a European treaty, two facts remain. First: in a cyclical phase like the current one, characterized by the robust growth of most euro area countries and the positive (albeit modest) growth of Italy itself, the constraints on the *structural* ratios between the public deficit and GDP, imposed by the Six Pack, would be much more binding than the 3% nominal constraint in the public debt-to-GDP ratio. Consequently, the 2,9% deficit policy would be markedly pro-cyclical. Secondly: with the current growth rates, it is inconsistent to assume that a public deficit of 2.9% of GDP is compatible with the reduction of the public debt/ GDP ratio in Italy without extraordinary operations on the public debt stock.

It is worth dwelling on this last fact. A simple calculation shows that, given a public deficit of 2.9% and the current nominal interest rates, Italy would comply with the European rules on public debt reduction only if it had an average yearly nominal growth rate of GDP slightly lower than 5% over the next five years. Given the current Italian inflation rate, the expected real growth rate of our economy would thus be less than half of the figure required. Additionally, in the next five years, it is highly likely that a rise in the interest rate structure will more than compensate for a possible rise in inflation rates. On the other hand, assuming again a government deficit of 2.9% of GDP, the stabilization (not the reduction) of the ratio between the Italian debt and the GDP at the current abnormal level (more than 133% of GDP) would require an annual nominal growth rate of Italian GDP systematically above 2%. Given the low level of expected inflation, even this growth rate seems unrealistic. Consequently, it is implausible to assume that a public deficit at 2.9% could be compatible with a significant reduction in the ratio of public debt to GDP without accounting stratagems or one-off interventions.

In order to make the public debt/GDP ratio compatible with an annual public deficit of 2.9%, extraordinary debt reduction measures would be needed. Let exclude those purely accounting interventions already mentioned, because they are not in line with the objective of making the Italian adjustment process credible in the eyes of both France and Germany as well as the European institutions. It would be necessary to resort to the systematic privatization of companies under (partial) public control and the disposal of parts of public property. If done without a design of industrial policy and environmental sustainability and before starting a persistent decrease of the public debt-to-GDP ratio, these operations would risk producing two adverse effects: weakening the already fragile productive system and environment of the country; and impoverish the residual public wealth without a structural adjustment of the public balance sheet.

Italy's political-institutional uncertainty increases the risk of endangering the medium-term sustainability of our public debt for electoral purposes. This kind of policies would not ensure that Italy achieves robust growth rates in the medium term and would hamper the country from playing a positive role in the negotiations between Germany and France for the institution of a new European Ministry of Finance.

Completing fiscal union in the euro-area is indispensable for the future prosperity of EMU. It is therefore necessary that, by exploiting the window of opportunity opened by the more positive economic situation and by the remaining lifetime of the QE, the Italian government starts a credible process of reducing the public debt-to-GDP ratio. To this end, three basic conditions are required: rationalizing the composition of public spending; setting aside unachievable tax reduction targets, and pursuing instead a tax reform aimed at the reallocation of fiscal charges; increasing the growth potential of the Italian economy through efficient public investment projects funded - as far as possible - by European funds,[2] and through effective incentives to private investment able to support the dynamics of the various forms of productivity.

This is a difficult bet to win, in particular during a long and uncertain election campaign. It is, however, the unavoidable condition for achieving two results: to make the Italian economic growth more robust towards negative exogenous shocks and, therefore, more stable in the medium-term; and to sit at the negotiating table, which France and Germany are setting along the lines suggested by the Five Presidents' *Report* and by the European Commission' *Reflection Paper*. Differently from what a significant part of the Italian ruling class seems to envisage, this time opportunism and rent-seeking will guarantee neither shortcuts for growth nor a free seat around the new European table.

[2] A proposal for the European funding of Italian public investments, based on a "contractual agreement" was published by Bastasin and Messori (see: *"A joint intervention for Italy: A non-punitive plan for investments and reform"*, SEP Policy Brief, February 2017)