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School of European Political Economy

Notes for the European Council meeting
Some suggestions for the Italian Prime Minister in view of the negotiation of April 23, 2020

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The reflections underlying the Italian position in the European negotiation seem to refer mainly to both financial and political-communication needs of a very short duration. In order for Italy to present itself at the April 23 European Council meeting with a non-emergency strategy, one that is not weak by definition, it is important to keep in mind the conditions in which the country will find itself in the slightly longer horizon.

- To do this, it is necessary to take into account that the current negotiation is not the last of a series, but on the contrary, that the Council meeting tomorrow will be followed by further negotiation steps. Italy's strategy therefore requires its representatives to be constructive, to renounce setting both propaganda goals and unrealistic goals in the context of a negotiation among countries that is in Italy's interest, one that, as we will see, can continue.

- Consequently, it is necessary to renounce the unfounded claim that other countries' taxpayers will have to be responsible for Italy's public debt. Italy must avoid making its partners believe that by "Eurobonds" Italy means financial instruments intended to burden other countries with the Italian debt. It is a mistake that must be avoided in order not to see the door closed to other possibilities. Making a precise distinction among the financial instruments to be used together with others would therefore be a fundamental step forward.

- The third consideration requires Italy to keep in mind that within a few months the country's debt position could be more precarious than it is today. The International Monetary Fund estimates that the Italian debt-to-GDP ratio will reach 155% at the end of 2020. This is a rather conservative estimate. Other analysts believe that the debt level will be significantly higher. Even by adopting consensus forecasts for the fall in Italian GDP of around 10 points in 2020, the debt-to-GDP ratio would exceed 160% by the end of the year.

- In recent weeks, doubts about the sustainability of Italy's financial position have manifested through a significant increase in the interest rate differential with Germany, which has repeatedly come close to

250 basis points. These episodes must not be transformed into a permanent increase in interest rates, that is, from a reflection of fears of instability into their accelerator. Avoiding the idea of "going alone" and deceiving oneself that “the ECB will always be around”, as happened during the last European Council meeting, is very advisable.

- Debt sustainability depends on the relationship between the rates themselves and the rate of economic growth. In 2019, the average issuance costs of Italian government bonds had fallen below 1%, a very low level historically, although still higher than the nominal growth rate. In the case of high debt and in the absence of a convincing plan for relaunching the Italian economy, the difference between the average cost of debt and the nominal growth rate is likely to widen. The country's financial conditions would emerge as unsustainable. This is what financial markets seem to be signaling to Italy at the moment. At that point, recourse to the ESM would take place in conditions of serious difficulty and therefore with the risk of having to resort to an assistance program with full conditionalities. Recourse to the ESM before the debt is unsustainable would perhaps allow Italy to negotiate better conditions that could be extended in the probable event of necessity at the end of the year.

- So far, the Italian government has based part of its approach for the upcoming European Council meeting on the objective of distributing the increase in Italian debt to other countries through common budgets and shared guarantees. It is possible that the "Recovery Fund" may be approved by the European Council and lead to the issuance of common bonds. The fact that the proposal is supported by the French government is not surprising. According to IMF forecasts, the French debt will rise to 115% of GDP this year (that of Spain above 120%) and therefore enter the risk zone: in 2008 the Italian debt-to-GDP ratio was 99% and this was enough to worsen its trajectory almost exclusively because of the increase in financing costs. An alignment of Italy, France and Spain’s negotiating positions is advisable.

- Aiming to reduce debt costs through common debt issuance tools can be useful but not sufficient once the debt-to-GDP ratio reaches 160%. Debt monetization in the United Kingdom and the United States could however make the forecasts of expected inflation and market reactions towards particularly indebted euro countries unstable. A plan that guarantees the sustainability of the public debt in the future must be designed as soon as possible.

- The current crisis could make the capacity of the financial system precarious: losses on securities, compression of interest margins and an increase in non-performing loans are some of the factors that could make Italy request an increase in European guarantees and perhaps also the establishment of a common bad bank.

- Concerning the sustainability of the debt in the future, the Italian government has not been convincing in addressing the other factor that contributes to debt stability, that is, the programs aimed at increasing the growth rate of the Italian economy. In the future, public responsibility for economic growth is bound to increase, also in parallel with the function of supporting private investments. Already today we see in Europe public interventions facilitated by the new temporary state aid framework. Subsequently, the definition of strategic sectors could be extended to relevant sectors such as transport and medical care, which had previously been public competence, often exclusively. Other sectors of public intervention, starting from electronic communication infrastructures, could be considered of strategic interest as a consequence of the distance that has been created between geopolitical players and in particular towards China.

- In realizing public interventions, States with adequate fiscal margins for providing financially demanding operations will be favored. A renewed divergence - which at this point must be defined as "strategic" - can arise in Europe between fiscally strong countries and countries with less space for intervention. To avoid this risk, Italy must be an active part in directing the use of European resources towards its production system.

- Instead of requesting financial assistance for emergency purposes - which may also be necessary if the conditions worsen - Italy should offer itself as a place of development. Not as Europe's patient, but as a potential site of new development. If European trade relations with China, and perhaps also with the United States, slow down, the vacuum of supply and demand could be filled by European countries such as Italy, which currently is underusing its production factors.

- It is essential for Italy to immediately design a recovery plan consistent with the guidelines of the European budget, directing the consensus of its partners towards the achievement of common objectives by using the financial resources of the Recovery Plan and those of the EIB. Digitization, environmental reconversion, development of hospitality-health systems, security and other service infrastructure sectors (telecommunications, energy and others) – these are the areas that offer opportunity for new investments supported by European funds. Decades of economic stagnation have also created resource margins waiting to be used, starting with an underemployed workforce, one with costs that are much lower than the German or French one.