Luiss
School of European Political Economy

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Carlo Bastasin

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*A more dynamic banking system and private equity actors are indispensable to prevent the high private debt from disrupting Italy's public debt sustainability.**

Most advanced economies will emerge from this year with a substantially higher level of public and private debt. The pandemic's recent resurgence throughout the world has affected the outlook for growth and increased the risks of financial instability. So far, questions on the sustainability of historically high levels of public debts have been muted by the exceptionally low level of interest rates. With sovereign bond yields close to zero, doubts on public debt sustainability have been postponed to the time when central banks will decide to change the course of monetary policy.

The Covid-19 pandemic hit an Italy with a high level of public debt and a weak economy. The low level of interest rates in the eurozone made it possible for Italy to contain the consequences of the sudden increase of its debt-to-GDP ratio. The European Commission 2020 Autumn Forecast[1] expects the Italian economy to contract by 9.9% in 2020 and grow by 4.1% in 2021. The Commission projects the government headline deficit in 2021 to decline to 7% of GDP and the public debt-to-GDP ratio to remain slightly below the level of 160%. The main criticism coming from Brussels concerns the fact that some of the government's measures to counter the current crisis do not appear to be temporary or matched by offsetting measures, and this could potentially jeopardize the medium-term sustainability of Italy's public debt. Overall, the reasons for Italy's debt sustainability rest on the expectation of a future level of growth that is higher than the current very low level of interest rates.

This short policy brief raises the question of whether the economic consequences of the pandemic imply a different source of risk that is not fully taken into account while judging public finance sustainability, namely the fact that private actors will emerge from the current recession overburdened by debt as well, and this in turn will influence the level of equilibrium of interest rates as well as the economy's growth rate. This eventuality can become significant if some consequences of the pandemic's shock are to persist, creating a backlog of sectoral disruptions, private firms failures, increase in banks' bad loans and higher unemployment.

* I am greatly indebted to Sergio De Nardis, Marcello Messori and Gianni Toniolo for their suggestions.
[1] https://ec.europa.eu/info/sites/info/files/economy-finance/opinion_on_dbp_italy.pdf

Most of these problems would need to be addressed by public interventions and would be likely to morph into new burdens for public finances. Consequently, any appraisal of public debt sustainability needs to take stock of the unprecedented shock generated by the pandemic and consider that public finances may be called to bear the burden of a number of private actors.

The case I am presenting may be characterized as a "worst-case scenario". However, this scenario should not be dismissed out of hand. Differently from the crisis that broke out in 2008, the current debt escalation has not been caused by excesses in the behaviors of states or banks. In fact, private and public debts are still growing due to exogenous factors generated by the waves of the pandemic. Once the health crisis is overcome, most reasons for debt accumulations should disappear with the virus. In particular, households and firms have been accumulating savings, either voluntarily or involuntarily, during the discontinuation of economic activity. This amount of pent-up money, which the ECB estimates on average for the euro area to reach almost 5% of GDP, could be a springboard for the recovery and inertially contribute to the absorption of private debt. However, the crisis is causing a number of sectoral disruptions that may leave behind deep structural scars and prevent a fully-fledged recovery. In the 1930s, the Great Depression imprinted an entire generation with the tendency to be thrifty and averse to risk. Nobody knows what the lasting economic consequences of the pandemic will be today. Tourism, transportation, live events, retailers and many other sectors may not return to the old "normal". A substantial amount of total private debt might never be repaid. A transformative process would not be linear. Financial actors should act as a bridge to the new normal.

Banks will have a crucial role in the transition to normality, potentially intermediating between the accumulated savings and the economy, but they too must now deal with an unprecedented amount of bad loans in their portfolios. More interestingly, a special role could be construed by private-equity institutions that would be able to funnel private savings to real investments with the potential for higher productivity increases. This could be the most important step for Italy's structural problems, which are rooted in the lame productivity of large swathes of its economy.

Italy is directly affected by the unusual and sudden increase of private debts, not only the public ones. Given the different starting fiscal position of single countries, it is possible that governments that cannot use wide fiscal margins will find it more difficult to stave off the risk of private failures. A similar occurrence took place after the global financial shock of 2008, which opened the door to a dramatic fiscal crisis. Differently from the 2008 global financial crisis, when private debt was extremely high but public finances and firms were in comparably better shape, the Covid-19 pandemic has generated a shock for all three economic actors: states, firms and banks. Thus, the interaction of those vulnerabilities needs to be taken into closer consideration today. The heavier impact of intertwined vulnerabilities on weaker countries should be a matter of great concern for Italy.

Public debt sustainability, the private influence on interest rates and growth

So far, in the course of this year, the policy responses of the political-economic authorities have been much prompter and more adequate than in 2009-2011. In the recent IMF Global Financial Stability Report a general estimate indicates that most advanced economies will recover around 60% of the lost income within five years from now. Currently, for some economies one should even consider the prospect of a swift and robust recovery, compensating within the next 18 months all the economic damages caused by this year's recession. For weaker countries, however, one should reckon with the risk of intertwined vulnerabilities enfeebling the positions of those countries, deepening their economic slack, and consequently pushing the level of real interest rates beyond the level that the standard assumptions of public debt sustainability would consider appropriate.

The relation between growth and interest rates has become the most salient and conventional indicator of the sustainability of public debts. In fact, economic theory has not defined a unique benchmark against which to assess debt sustainability. As a consequence, most of the proposed definitions are based on partial equilibrium models. The classic Domar equation on the dynamics of the debt-to-GDP ratio, as a function of tax levels, interest rate and primary budget ratios, and of its effects on the interest and growth rates, does not include the effects of a parallel buildup in private debts. Formal definitions of debt dynamics tend to consider growth and the level of interest rates as de facto exogenous from the public finance sustainability equation. The absolute level for a debt to be sustainable is not univocally identified. More generally, one might say that the level of debt sustainability depends on a level of taxation consistent – in a dynamic relation - with the necessary level of economic growth, given the level of interest rates.

According to the standard representation of the Domar equation, a constant overall deficit-to-GDP ratio ensures convergence of both the debt-to-GDP ratio and the interest-to-GDP ratio to finite values. Consequently, also taxes needed to service interest payments converge to a finite value as a share of GDP. In Domar's model the primary balance will have to adjust to compensate for growing interest payments. Whether the levels to which the debt and the tax rate converge are sustainable depends on their effects on the level of economic activity and on the level of interest rates.

The base case can be expressed in the system below, where d is the debt-to-GDP ratio, b the deficit-to-GDP ratio, the tax-to-GDP ratio (t) is set equal to the ratio of interest payments-to-GDP, g is the rate of growth of GDP and r the rate of interest. g and r are used here also to express the parameter q:

$$q = (g-r)/(1+r)$$

$$1+q = (1+g)/(1+r)$$

$$d_t = [1/(1+q)]d_{t-1} + b$$

$$d_t = d_0 (1+q)^{-t} + \sum_i (1+q)^{-(t-i)}$$

if $q > 0$ $d_t = \lim_{t\to\infty} b\,[(1+q)/q]$; and if $\lim_{t\to\infty} t_t = \lim_{t\to\infty} r[d_{t-1}/(1+q)] = b(r/q) = b[r/(g-r)]$

In other terms, reducing it to the relation between r and g, the expression of debt variation is:

$\Delta d_t = (r_t - g_t)\, d_{t-1} + b_t$ which assumes[2] that a debt is sustainable in case the nominal level of growth is higher than the nominal level of the interest rate and either the primary surplus is balanced or the increase in the level of taxation is tending to a finite value which is not impinging on growth.

Given the strong support to political economy provided by central banks and the presumed partial transformation of inflation into a non-monetary phenomenon (which gives the monetary authorities more room for supporting the economy), it is generally assumed that the current levels of public debts – and even higher levels - are sustainable only if growth is higher than the current "close to zero" levels of interest rates.

In the context of an exogenous shock such the current pandemic, one should consider an overlooked factor that in the current exceptional circumstances is determining the level of debts, namely the increase of private debt, which is also a possible major factor determining the level of r and g. Normally, the transfer of private debts into the public debt should provide for a stabilization of the economy with potentially positive second-round retroactions for the level of the public debt. However, from an analytical point of view, the coincidental rapid growth of both public and private debts implies that the level of interest rates on the safe asset (typically the government bond) differs from the marginal rates (i.e. cost of loans for SME or marginal borrowers) by a wider margin than it is generally assumed. Under the current extreme strains, if private debts are transferred into the public debt, there will be the risk that the level of the safe-asset interest rate could rise towards the marginal level rather than the opposite. This can significantly alter the results of the Domar equation, affecting r-g. Given the same starting fiscal position, in case of a sudden increase in private debt, the equation would have to reckon with a higher r and a lower g. Even if growth is higher than the safe asset rate, this would not be sufficient to ensure that the debt-to-GDP level will remain stable.

Reasons for special concern in the interaction of private and public debt

The current conditions raise some concerns that should be addressed.

1) The first question regards the size and the quality of the outstanding private debt. According to the IMF's Fiscal Monitor (October 2020), "private sector debt vulnerabilities were elevated before the coronavirus disease pandemic". The increase in nonfinancial corporate and household debt has accelerated for the last two decades, reaching almost 150 percent of GDP in 2019 and exceeding public debt by a large margin in most G20 countries. Italy's position on aggregate – private plus public debt – is much less unbalanced than it is usually assumed to be. However, the quality of corporate debt had been deteriorating in many countries even before the pandemic. Corporate speculative-grade debt as a share of total corporate debt — a leading indicator of corporate sector distress — was nearly 50 percent in China and the United States and even higher in Italy and the United Kingdom.

2) The second issue regards the interaction between the quality of sovereign bonds and that of corporate debt, whose quantity has dramatically increased due to the ECB intervention on the credit supply and its costs. Sovereign bond yields are central for determining the funding conditions of banks, corporates

[2] https://www.piie.com/publications/working-papers/public-debt-and-low-interest-rates

and households in the same country. The low rating of Italy's government bonds is likely to have had repercussions on the average low quality of Italy's corporate debt. The intertwined vulnerability between public and private debtors has been aggravated by the economic consequences of the crisis generated by the Coronavirus. The pandemic has caused serious concerns about the stability of a large number of non-financial firms in several sectors. In parallel, banks have seen a dramatic increase in the amount of non-performing loans in their portfolios. In part, these sources of instability had been addressed by the ECB via its PEPP program, which facilitated the purchase volumes of assets in a flexible manner over time, across asset classes and countries. The threat of a credit tightening similar to the one that followed the global financial crisis in 2008 has induced monetary policy authorities around the globe to promptly support the financial system with huge provisions of liquidity. In the eurozone, the easing of the conditions governing the TLTRO (Targeted long-term refinancing operations) has been helpful in warding off the risks of a credit crunch. In fact, one of the consequences of the monetary policy response to the pandemic, and namely of the "lower for longer" policy orientation of interest rates, is the sustained incentive for the issuance of an unprecedented amount of corporate debt. According to the IMF, the first half of 2020 saw the most intense burst of capital-raising in history, with $5.4 trillion secured by companies across the globe, including $3.9 trillion since the start of March.

3) The third issue concerns the signals of strains in the interaction between banks and firms. The financial adjustment to the problems of the real economy is not a free-for-all, unlimited process that can last forever. According to the IMF's Global Financial Stability Report, "signs of corporate liquidity pressures and growing corporate solvency risk are mounting": the US high-yield bond market has already surpassed leverage levels seen during the 2008 financial crisis in terms of the ratio of companies' gross debt to their EBITDA (earnings before interest, tax, depreciation, and amortization). Since the start of the Covid-19 pandemic, some banks have already started to provision more for the expected losses on their loans. The October euro-area bank lending survey reports a broad-based tightening of credit standards that banks attribute primarily to the risks underlying the macroeconomic environment and a deterioration in borrower creditworthiness. According to the ECB,[3] one disturbing cause of the decline in credit demand is the scaling back of investment plans. It is possible that an adverse interaction is developing between banks receiving weaker than expected signals from the economy and firms that are concerned with a tightening of borrowing conditions.

4) The fourth issue regards the size of the burden for fiscal policy. The latter might be unable to support banks and firms. Fiscal policy could wind up in a position where it cannot sufficiently respond to the tightening of funding conditions caused by the banks-firms loop. Another "sovereign-banks-firms" doom loop would then set in, leading to dangerous increases in sovereign risk premia. Should banks be the first to feel the pain of the loop, the amount of public resources that could become necessary to support the financial system is hard to fathom: cumulative gross support to financial institutions in 37 countries following the global financial crisis reached a staggering amount of $3.5 trillion. In response to the pandemic, governments have announced guarantee programs equivalent to $3.8 trillion that could be put into effect. Public aid is not directed to supporting the financial systems only. For strategic

[3] https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp201126~c5c1036327.en.html

or systemic firms with unsustainable debt, it may be in the public interest for governments to absorb some of the debt. It is reasonable to take into account a number of positive retroactions in which saving banks and firms could return resources to the public revenues and ultimately the public budget. What we don't know is how to deal with a loop simultaneously affecting large swathes of the financial and corporate system while the fiscal margins are proving to be tight.

5) The last point concerns the effects of the much expected roll-out of a vaccine for Covid-19. It is possible that the positive signals of a launch of vaccine treatments in the coming months would be highly welcome by financial markets. In fact, this is part of the problem: the positive news about an imminent and swift recovery will be more rapidly absorbed by financial markets than by households and firms. In a Tobin-world this should translate into easier financial conditions and an incentive in investing the accumulated savings. In fact, financial markets might anticipate the time of an increase in interest rates derailing the macroeconomic recovery. Any source of increase in interest rates is more dangerous for indebted countries recovering slowly. A two-pronged source of divergence might prevail: on the one hand, indebted countries would be penalized by higher risk premia, on the other, a slow recovery would become even slower.

Conclusions

In conclusion, the standard reliance on (r-g) as an indicator of public debt sustainability should be reconsidered in the current circumstances. The coincidence between extreme increases in public and private debt is unprecedented in peacetime. We all know that excessive private debt can suppress growth and migrate to the public sector balance sheet through three channels: (1) direct public support to the corporations or their creditors, (2) calls on public guarantees on private debts, or (3) countercyclical fiscal responses to corporate deleveraging episodes. All of these channels are bound to influence both the level of interest rates and the rate of growth. If the economic damage caused by the pandemic persists, the pressure of private debt will move growth lower and interest rates higher, bringing public debt to the edge of instability even if the static assessment of public debt sustainability is favorable.

In such a context a preventive public policy is required. The mechanism of monetary transmission to the economy must be accelerated through the engagement of banks and of private equity funds. The transformation of firms' debt into equity should be generously encouraged via tax incentives and accompanied by industrial aid consistent with the EU guidelines and the resources provided by the Recovery and Resilience Facility: the digital and automation upgrading of the Italian economy should be a priority in this plan. Rather than musing over how to tax the pent-up private savings to finance the public debt, household resources should be funneled into the real economy to ensure a faster and more equitable recovery of the Italian economy.