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THE MELONI GOVERNMENT'S BUDGETARY POLICY AND THE REFORM OF EUROPEAN ECONOMIC GOVERNANCE

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Introduction

The Meloni Government's Draft Budgetary Law – based on the Update of the Economic and Finance Document (Nadef) - indicates economic policy objectives and programs whose credibility is burdened by severe constraints. The complex conditions of the international economy and the intrinsic weakness of Italian public finances may call into question the commitments made by the government, create disquiet among investors and jeopardize Italy's financial stability.

Moreover, the presentation of the Draft Budgetary Law (DBL) is taking place during the final phase of negotiations between the EU countries on the reform of the European Stability and Growth Pact, which will return into force starting from January 1, 2024. The policy orientations expressed by the Italian government with the Nadef and the DBL may prove detrimental to Italy's position during the negotiations and influence the conclusions of the debate underway in the European Council.

In this analysis document, I try to highlight some of the consequences of the lack of realism observed in the government's economic policies, policies that derive from the developments emerging from the economic situation and from the monetary policy framework. The choices adopted by the budgetary policies written in the government documents will be analyzed also considering the internal and external political positioning choices of the Italian government. The aim of this paper is to identify the consequences of Italy's fiscal choices in the context of the European negotiations on the reform of the economic governance rules. It is not possible to know the final outcome of those negotiations, consequently I will consider only the impact of Italy's fiscal position, as it results from the new government's documents, on the negotiation itself. I will however consider the possibility that financial instability, which may affect Italy's public debt, may erupt during the negotiations. In that case, Italy might be forced to swiftly raise all its possible defensive barriers: ratifying the ESM Treaty and revising the fiscal commitments of the Draft Budgetary Law. The conclusions of the paper suggest that these extreme defense mechanisms should be raised before a crisis erupts.

[1] I am grateful to Lorenzo Bini Smaghi, Sergio De Nardis, Marcello Messori and Stefano Micossi for their substantial contributions that made this paper possible. Mistakes and opinions must be ascribed to the author only.

The macroeconomic framework

The Update of the Economic and Finance Document (Nadef) estimates an increase in real GDP of 0.8% this year and plans growth objectives of 1.2% in 2024, 1.5% in 2025 and 1% in 2026. These objectives are lower than those published last April in the "DEF" (Documento di Economia e Finanza), reflecting a worsening of the global and domestic economic situation. They also indicate, however, that the government expects growth to exceed its potential level in the considered time horizon.

When growth exceeds its potential, governments are expected to adopt a restrictive fiscal stance and use the opportunity to reduce the public debt-to-GDP ratio. On the contrary, the Meloni government chose to accompany its optimistic growth scenario with an (albeit moderate) expansionary fiscal policy, equivalent to 0.7% of GDP. Only in 2026 will the growth target be 0.2 points lower than the trend forecast due to a restrictive measure aimed at bringing the Public Administration's deficit below 3%.

I highlight here the relevance of this fiscal slippage in consideration of the current negotiations on the future rules of European economic governance. In terms of political economy, not setting the reduction of public debt as a priority can make Italy's European partners more inclined to design more stringent fiscal rules.

An aggravating factor, in the partners' perception, derives from the past experience of setting overly optimistic estimates for Italy's economic growth. This practice was abused at the beginning of the 2000s with governments setting unrealistically high growth targets each year that led to profound revisions when the actual growth data became available. The lower actual growth was used to stress the unexpected worsening of economic conditions, which is one of the formal justifications for higher than planned fiscal deficits.

Table 1. The macroeconomic framework in the April Def and the September Nadef

	2022	*2023*	*2024*	*2025*	*2026*
Real GDP					
- Def, programmatic scenario	3,7	*1,0*	*1,5*	*1,3*	*1,1*
- Nadef, trend scenario	3,7	*0,8*	*1,0*	*1,3*	*1,2*
- Nadef, programmatic scenario	3,7	*0,8*	*1,2*	*1,4*	*1,0*
GDP Deflator					
- Def, programmatic scenario	3,0	*4,8*	*2,7*	*2,0*	*2,0*
- Nadef, trend scenario	3,0	*4,5*	*2,9*	*2,1*	*2,0*
- Nadef, programmatic scenario	3,0	*4,5*	*2,9*	*2,1*	*2,1*
Nominal GDP					
- Def, programmatic scenario	6,8	*5,8*	*4,3*	*3,4*	*3,1*
- Nadef, trend scenario	6,8	*5,3*	*3,9*	*3,4*	*3,2*
- Nadef, programmatic scenario	6,8	*5,3*	*4,1*	*3,6*	*3,1*
Private consumption deflator					
- Def, programmatic scenario	*7,4*	*5,7*	*2,7*	*2,0*	*2,0*
- Nadef, trend scenario	*7,2*	*5,6*	*2,4*	*2,0*	*2,0*
- Nadef, programmatic scenario	*7,2*	*5,6*	*2,3*	*2,0*	*2,1*

In light of the available information, the Nadef's macroeconomic picture indeed appears too optimistic. The government forecast regarding real GDP growth in 2023-24 is based on the assumption that the Italian economy, after the decline in the second quarter of the current year, will have returned to a growth path since July-September (of approximately 0.3%). It also assumes that the newfound pace of moderate increase in GDP is maintained in the subsequent period, when the investments of the remodulated National Recovery and Resilience Plan (NRRP) should also make a contribution. In this last regard, the challenge is twofold: it is taken for granted that these investments are made effectively and that they produce positive short-term effects, even if the new deadlines established by the government are characterized by the postponement of many projects to 2025 and 2026.

Even regardless of the last aspect, the European economy and the Italian economy are not going in the direction supposed by the Nadef. As the most recent international forecasts show (for example, that of the International Monetary Fund), the euro area is entering a phase of stagflation with persistent inflationary excesses and stagnating growth. The distance from the Commission's official estimates is particularly relevant in the EEG procedures. There is consolidated experience leading the national governments to adopt the Commission's estimates, as expressed in the Annual Growth Survey, or not to diverge too markedly from them. In case of excessive differences, the Commission can ask for an immediate revision of the macroeconomic framework. Although this practice can happen in the

backrooms of the bilateral negotiations in Brussels, the eventual visibility of the change in the official figures would foster uncertainty among investors.

There is excessive optimism in the Italian growth estimate also considering that industrial activity still appears weak due to its dependence on foreign demand and the decline in world trade, although it is reasonable to assume that China and Germany's recovery next year will be stronger than currently expected. Also, as seen from the negative dynamics in bank credit flows, the severe monetary and credit tightening of the European Central Bank (ECB) is having increasing impacts. Combining with the reduction of incentives, the monetary tightening is causing a contraction in construction, a sector that is particularly sensitive to changes in credit availability. The volume of the new mortgages is almost 30% lower than last year. In services, the positive performance of some traditional sectors (tourism-catering-entertainment) was favored by the disinvestment of excess savings accumulated by families (Italian and foreign) during the lockdown periods. The peak may, however, have been reached: the sector's confidence indicators, although not collapsing, have entered negative territory.

A weaker second half of 2023 than assumed in government estimates would compromise the macroeconomic framework for 2024, even regardless of the possibility that NRRP investments suffer setbacks compared to what was assumed in the Nadef. In this regard, the recent forecast of the International Monetary Fund (GDP increasing by 0.7% in both 2023 and 2024) assumes that the weak Italian growth rate extends to both the second part of 2023 and the first part of 2024, also due to the effects of monetary policy and the moderate performance of the world economy.

The Nadef's forecasts regarding inflation also appear optimistic since they overestimate the fall of the price level, especially with regard to the internal components of price dynamics. A greater dynamic in domestic prices would have positive effects on the ratio between public debt and GDP, partially offsetting the overestimation of real GDP growth. At the same time, the government's forecasts imply a stronger slowdown in consumer prices than analysts expect for the euro-area average. Nadef does not provide indications to justify this trend. Therefore, if in 2024 there was confirmation that the Italian inflation rate is higher or, at least in line, with the dynamics of consumer prices in the euro area, families would suffer a greater erosion of their incomes in real terms with a consequent reduction in consumption and slowdown in growth. A lower level of domestic prices automatically increases the level of real interest rates, further undermining the expected dynamics of domestic investments.

Inflation and monetary policy

For a country with high public debt and the associated heavy financial burdens on this debt such as Italy, the evolution of interest rates represents a fundamental variable in terms of the sustainability of public finances. The assessment of debt sustainability requires growth rates to be considered together with the level of interest rates and, related to the latter, with the estimate of future inflation. Moreover, the relation between growth and interest rates is the cornerstone of the debt sustainability analysis that the Commission intends to adopt in its proposed reform of economic governance. The Commission

intends that the debt sustainability analysis will contribute to the identification of the "technical trajectory" and, according to the trajectory, orientate national fiscal policies.

Providing a realistic estimate of future inflation is thus of great importance. After the robust and unexpected increase recorded since the beginning of 2021, the inflation rate in the euro area began to decline from the peak of 10.6% in October 2022 to 4.3% last September. Net of the more volatile components such as energy and food products, the inflationary decline was more limited (from the peak of 5.6% in March 2023 to the recent 4.3%) (see Figs. 1 and 2).

Figure 1

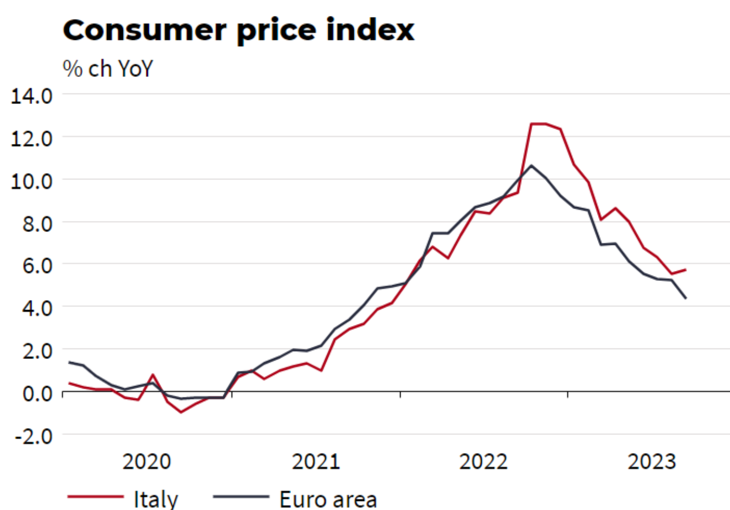
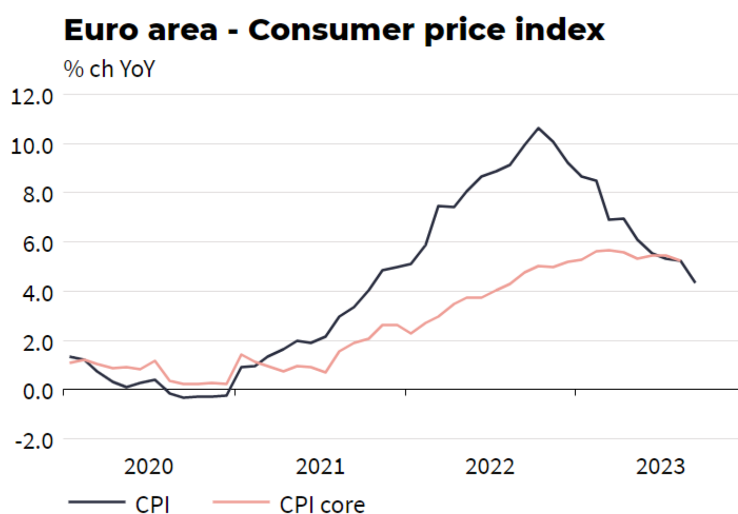


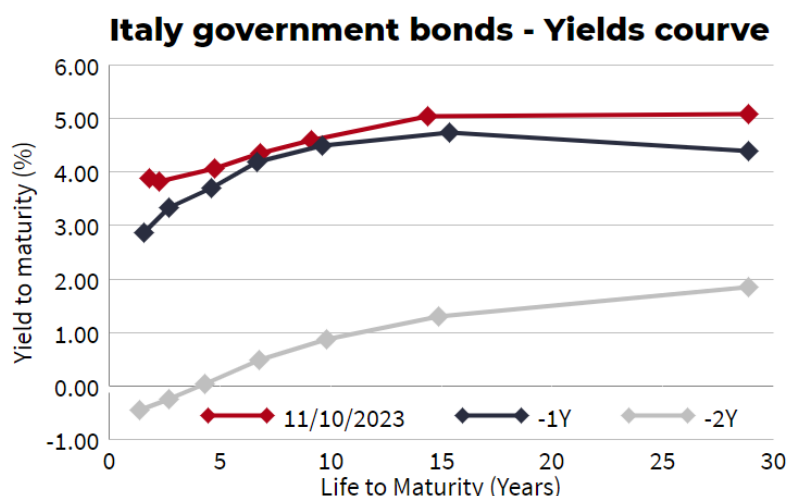
Figure 2



The long series of interest rate increases (including the last 25-point increase in September 2023) implemented by the ECB aims to bring the inflation rate back to the quantitative target of 2% by 2025. At the same time, the ECB has started to reduce the size of its balance sheet, not renewing the securities purchased in the past when they expired and reducing the refinancing of the banking system.

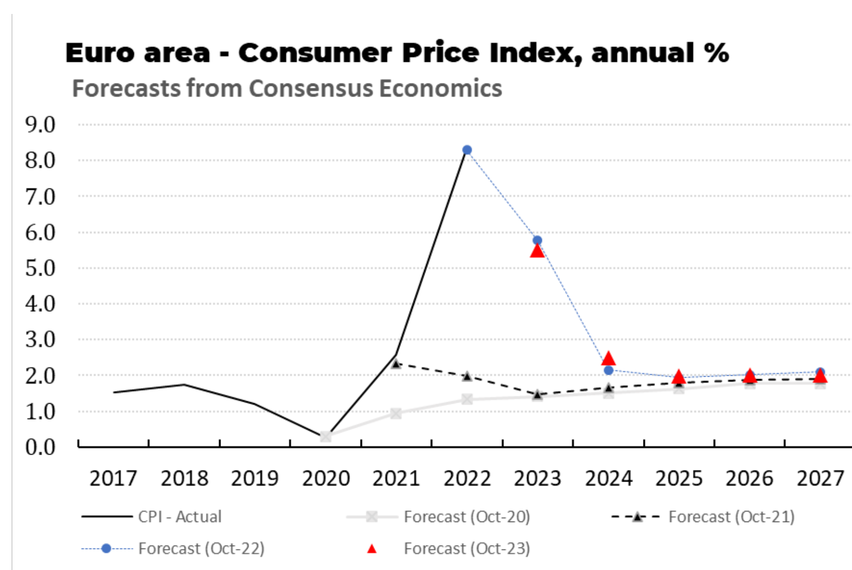
The increase in official interest rates has changed the time structure of market rates. The yield on German government bonds rose to 2.82% in early October 2023, up from -0.13% two years earlier. In the same period, the rate on Italian BTPs went from 1.3% to 4.85% (Fig. 3). The future evolution of market interest rates will crucially depend on the trend of the inflation rate, in particular on the speed of its convergence towards the 2% objective. The debate on the possible revision of the inflation target was short-lived. There are no conditions for central banks in economically advanced areas to revise this target upwards: it would mean admitting an inability to pursue price stability, with a consequent loss of credibility in the financial markets.

Figure 3



In this context, the ECB is reluctant to cut interest rates until it is able to verify that the inflation rate in the euro area has fallen, in a lasting and credible manner, towards the target level. Based on analysts' consensus forecasts, the inflation rate in the euro area is expected to fall below 2.5% in autumn 2024; this implies a persistence of policy interest rates at current levels for at least one year. Furthermore, this is a very uncertain forecast because it is influenced by multiple factors: the prices of energy raw materials, which have remained high (for example, gas and oil), the effects of climate change on the prices of agricultural products, and so on. There is also wide uncertainty about the rigidity of the price adjustment mechanisms, even in the face of inflationary expectations that appear to be anchored at 2%.

Figure 4



Based on assumptions regarding interest rates, GDP growth and public budget balances, Nadef forecasts an increase in interest expense on debt from 3.8% of GDP in 2023 to 4.2% in 2024 and to 4.6% in 2026. The calculation is based on an estimate of interest rates relating to the yield curve on Italian government bonds in force in the weeks preceding the preparation of the Nadef. This is, however, an overly optimistic estimate. Suffice it to consider that between the beginning of September and the middle of October 2023 rates on 10-year BTPs increased by approximately 80 basis points. If such an increase were structural and lasted or worsened over time, the financial costs on public debt in relation to GDP would increase proportionally.

Budgetary policy and political framework

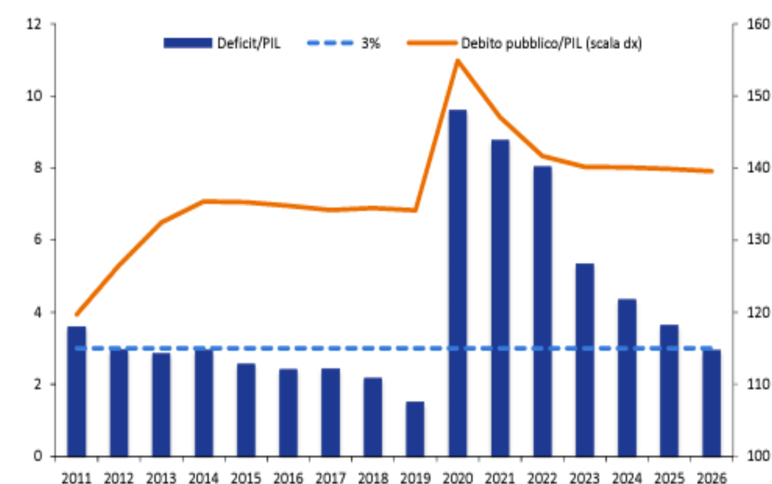
The evaluation of public budget imbalances reinforces the risk that the government's macroeconomic framework will prove to be unrealistic. From the perspective of the EU negotiations on the new fiscal rules, the most striking aspect is the deliberate choice made by the Italian government not to credibly reduce the debt-to-GDP trajectory.

The trend estimate of the public deficit for the current year was raised by 0.7% of GDP also as a consequence of the upward revision of the tax credits relating to the Superbonus and the Facade Bonus, which ISTAT recently estimated at 2.8% of GDP. As already mentioned, it is necessary to consider both the increases in interest rates linked to the ECB's monetary restriction and the slowdown of the European economy. In light of these factors (and others disregarded here), the Italian government has obtained from Parliament the authorization to define a new programmatic path for the public deficit/GDP ratio: from 5.3% this year , to 4.3% in 2024, 3.6% in 2025 and 2.9% in 2026.

This programmatic framework envisages an increase in the deficit compared to the trend of 0.7 percentage points of GDP for next year and of 0.2 percentage points of GDP in 2025; vice versa, in 2026, the deficit should fall by 0.2 percentage points compared to trend. The data presented so far are summarized in Fig. 5. The scenario described in that Figure requires the Italian public deficit to remain above 3% in the next two years and only fall below this threshold in 2026. It also implies that, in the years 2024-26, the ratio between public debt and GDP will drop imperceptibly: from 140.2% at the end of 2023 to 139.6% in 2026. There is therefore a high probability that, next year – the end of the suspension of the Stability Pact – the European Commission will open an excessive deficit procedure against Italy.

This would have a negative impact on international investors' assessments of the sustainability of Italian public debt. Proof of this is the widening of the spread on Italian government bonds compared to the corresponding German bonds. This spread now stands above 200 basis points. It would be important for Italy to present itself at the negotiations on the revision of the fiscal rules with a debt reduction path that is not only well defined and credible, but also more ambitious than the one outlined in the Nadef.

Figure 5: Programmatic trend of the deficit and public debt



Source: September 2023 NADEF

The problem is that the deficit path forecast by the Nadef cannot relaunch Italian growth and at the same time it does not appear achievable because it is based on overly optimistic macroeconomic expectations. The government estimates that the widening of the public deficit could raise Italian GDP growth by 0.2 percentage points in 2024 and 0.1 percentage points in 2025. This kind of fiscal intervention, evidently, does not trigger high multipliers.

Moreover, other factors could further depress the trend dynamics of Italy's GDP with negative effects on the dynamics of the public deficit/GDP and public debt/GDP ratios: the obstacles that stand in the way of the full and efficient use of the funds made available by the Recovery and Resilience Facility program in the 2024-26 three-year period and the announced privatizations. As for the first aspect, it

has already been underlined that the profound revision of the Italian NRRP, approved by the government in August 2023, concentrates the implementation of the projects in the last two years and therefore weakens possible positive impacts in 2024. This intention risks causing bottlenecks on the supply side. As for the second aspect, the government has announced the objective of selling public assets equal to one percentage point of GDP (i.e. around 20 billion euro). These revenues from privatizations, which should compensate for the increase in public debt resulting from the tax credits for the Superbonus and the Facade Bonus, appear to be problematic to achieve at the very least.

All in all, the lower growth and revenues might leave a hole in Italy's budget. It may be urgent to cover this hole but the feasibility of such an endeavor would require taking into consideration the political conditions in the coming year.

The political framework

The political framework in which the parliamentary majority that supports the government led by Giorgia Meloni finds itself operating is strongly conditioned by the prospect of the European elections in June 2024. For the government forces this is an opportunity to consolidate the internal political prevalence of right-wing and center-right parties, but also a challenge for competition within the coalition itself. This includes the choice made by the Prime Minister whether to adopt a cooperative position towards the European Union and partner countries, allowing any successes in Italian influence to prevail over common decisions, or an antagonistic one, instead allowing the nationalist character to emerge. of the Italian government.

The intersection of these multiple factors must be carefully observed. In 2022, the current majority prevailed in the general elections, obtaining 43.6% of the votes, having confronted an approximately equivalent left-wing, center-left bloc. The victory of the coalition led by Giorgia Meloni was facilitated by two factors: on the one hand, the unity between the parties that compose it (Brothers of Italy, League, Forza Italia and Us Moderates) if compared to the division of the parties of the opposite camp and, on the other hand, the personality of the young female leader, who was perceived as "consistent" because she had not taken part in any of the government coalitions that rotated in the previous 16 years.

During the electoral campaign for the European vote, Meloni will still be able to leverage her personal approval among voters, which is still solid according to the polls, but she will not be able to rely on the compactness of the coalition. The proportional nature of the voting system of the European elections will in fact accentuate the competition between the individual parties of the majority.

This friction in the government coalition manifests itself in the daily pressure exerted by League secretary Matteo Salvini through more radical or extreme positions than those of Meloni. The distance between the coalition parties is also expressed in mutually incompatible alliance programs in the European Parliament. The leader of the League in fact envisages an alliance with extremist forces in the major countries of the European Union, first and foremost with the German "Alternative für Deutschland" and the French "Rassemblement Nationale". These radical right-wing formations are not

openly recognized as interlocutors by Meloni, who seems to be awaiting the outcome of the vote before binding her alliance plan, perhaps foreshadowing the possibility of conferring on the probable re-edition of the traditional parliamentary alliance (European People's Party and European Social Democrat) the votes needed to ensure a majority in Strasbourg. This plan could guarantee Meloni an important role in future European parliamentary balances.

For Meloni the competition "from the right" of Brothers of Italy can represent an existential threat, demonstrated by the experiences of 1996 and 2006 when the left-wing coalitions managed to prevail in the general elections also thanks to the lack of participation in the center-right front of two Italian Social Movement exponents (Tremaglia and Rauti), who took away decisive votes from the right-wing coalition. If the objective is mainly to obtain an electoral result that will consolidate her leadership of the coalition in the short term, Meloni will have an incentive to accentuate the non-"centrist" characteristics of her electoral campaign and to strengthen the nationalist rhetoric in contrast with Europe.

In theory, and absent any acute crisis concerning the Italian debt, the ongoing negotiations on the revision of the rules of European economic governance could contribute to accentuating her antagonistic tones. The state of the negotiations is based on the contrast between the European Commission's proposal characterized by margins of discretion in the context of bilateral negotiations with individual countries on the basis of a technical trajectory and the recent proposal coordinated by the Spanish and Dutch governments which introduces "safeguard clauses” valid for all countries and intended to limit any margin for evaluation by the Commission. In particular, the negotiating position of the German government appears to weigh heavily, as it opposes entrusting the Commission with ample margins of flexibility in tax compliance assessments, and, based on the most recent information, it intends to impose a homogeneous debt reduction obligation on each country’s public debt/GDP ratio equal to one percentage point per year for a horizon of 17 years. The distance between the parties could stoke uncertainty in the financial markets, which will also consider the possibility of failure in reaching an agreement or an application of the – currently suspended - past rules of the Stability Pact.

Considering the risks of possible severe pressure from the financial markets in the coming months and the inevitable difficulties in reaching agreement on the major issues at the European negotiating table (new rules of economic governance; immigration; divisions between the interests of individual countries in view of enlargement of the European Union), Meloni will certainly have a game plan favorable to the exercise of nationalist rhetoric. Such an antagonistic approach towards the European Union may perhaps have stabilizing effects on domestic political competition in the short term, but it risks being harmful from the perspective of the country's financial stability because the lack of a European agreement on the rules could, as already said, trigger excessive uncertainty among investors. In the past, Italian democracy has had to regularly verify that policies that conflict with financial stability end up being at odds also with political stability.

What if financial instability emerges during the negotiations?

Since September 2023, interest rates have grown more than proportionally in Italy compared to the other euro-area countries. Given the negative reactions elicited among investors by the government's fiscal plans, a bout of financial instability cannot be ruled out even in a short-term horizon. The probability of market instability, however, can be contained if the European Central Bank intervenes. The monetary institution could intervene and prevent Italy's interest rate differential from spiraling out of control. However, there are severe constraints to the ECB's discretional choice of stepping into the market and buying government bonds.

In order to assess the consequences of Italy's recent fiscal decisions one should analyze their impact on the constraints for the ECB's possible interventions. The ECB has three instruments with which it could help alleviate the pressure on Italian bond yields:

1) The tool of the Outright Monetary Transactions has remained idle since its announcement in 2012 and it is unlikely to be rolled over because it requires the interested Member State to underwrite strong conditionalities in a program with the European Stability Mechanism. In order to benefit from the OMTs, the state needs to have received financial sovereign support from the eurozone's bailout funds, either in the form of direct macroeconomic support or precautionary conditioned credit lines. The signed conditioned Memorandum of Understanding attached to the sovereign support program shall be complied with at the time of OMT purchases. If under review, no OMT purchases will happen until the review has been concluded with the finding of program compliance. Consequently, in order to be supported through OMTs, a government must relinquish a substantial part of its sovereignty in economic policy matters.

2) Given the political barriers that have kept both the OMTs and the ESM impractical, more recently the ECB has launched a new instrument, the Transmission Protection Instrument (TPI) that imposes no conditionality. However, the ECB set three conditions for TPI: compliance with the EU's fiscal framework; absence of severe macroeconomic imbalances; and fiscal sustainability. Unfortunately, given the high deficit planned by the government, Italy is not compliant with EU deficit rules. Italy's fiscal position could also be deemed unsustainable, given the negative relation between the low level of potential growth and (a realistic estimate of) the future level of interest rates. If the ECB were to use the TPI in these circumstances, it would risk being seen as engaging in monetary financing, a practice that is specifically forbidden by the EU treaties.

3) Finally, the ECB might direct to Italy a relevant part of the re-investment of the maturing bonds purchased under the pandemic emergency purchasing program (PEPP). In fact, the ECB is due to discuss a timetable to phase out those re-investments. The problem is that Italy is the only country that might end up in trouble, and it would be difficult to ascribe the financial pressure to exogenous problems rather than to specific Italian conditions. In the latter case, the ECB would have problems in legitimating its strategy in favor of one single country.

Given the uncertain macroeconomic framework described in its recent fiscal documents, Italy cannot fully count on the ECB intervention countering bouts of financial instability. In order to contain the investors' fear of not finding buyers for Italian bonds, the Italian Parliament should swiftly proceed to the ratification of the ESM Treaty, leaving the eventuality of an ECB intervention open. However, in Italy's Parliamentary debates, the ESM symbolizes subjection to Brussels and a loss of national sovereignty, and its ratification is strongly resisted by a large majority of political forces. The Italian government has floated the eventuality of ratifying the ESM Treaty only as a counterpart of a favorable version of the revised stability pact. The government intends the ratification to be a "compensation" for more fiscal space. The other European partners see it instead as an unbalanced bargain because the ESM's activation is also intended to favor Italy.

Conclusion

This analysis indicates that the budgetary documents presented by the Italian government are based on overly optimistic forecasts regarding the expected growth of GDP, the dynamics of financial charges on public debt, the revenues connected to privatizations and, therefore , the decline in the public debt/GDP ratio. The lack of realism in the commitments undertaken by the Italian government in terms of increasing the primary surplus in the public budgets in the coming years increases the uncertainty in the international markets regarding the ability to place on the market, under adequate conditions, the enormous issuances of Italian public securities implicit in the expected trend of the deficit.

If this framework paves the way to bouts of financial instability, Italy will also find itself cornered during the negotiations on the revision of European fiscal rules. A swift ratification of the ESM might become inescapable to contain financial instability. At that juncture, the best option would be to embrace the proposal presented by the European Commission based on bilateral agreements between Brussels and each country. This agreement can be tailored to Italy's specific needs and – provided that the government's fiscal commitments are revised and made more realistic – facilitate the assessment of Italy's compliance with the rules. In such a case, the ECB might be legitimated to intervene, purchasing Italy's government bonds and preventing a market crisis.