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Italy: Stumbling Block for the Monetary Union?

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Italy has experienced an unprecedented level of price stability with the Euro. In addition, growth has increased recently. Thus central promises of the European Monetary Union could be implemented. If the economic and financial policy measures laid down by the new Italian government in its coalition agreement are actually implemented, the chief economists of the Savings Banks Finance Group see a risk that Italy's sluggish growth and debt burden will deteriorate further:

- The large number of demand-side elements and the almost complete absence of supply-improving elements give rise to concerns that they will not have much of an impact, aside from an "economic flash in the pan", and that they will not create sustainable growth, but increase the debt burden. As a result, the Monetary Union might be subject to severe strain once again.
- What is needed at least – in addition to demand-side stimuli – is a large number of improvements in Italy's economic environment to counteract sluggish growth.
- The other EU Member States can show solidarity with Italy, in particular within the framework of European Community tasks. In this context, it will be important to make progress at EU level by pursuing common policies in the fields of security and defence.

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New italian coalition – quo vadis Europe?

As of this year, Italy has a government based on a coalition of non-traditional parties. The government is made up of the Lega on the right fringe of the political spectrum, which has evolved into a party covering all of Italy and the Five Star Movement (M5S) on the left fringe of the spectrum. What the two parties have in common is their fight against the political establishment and their extremely critical attitude towards the European institutions. The coalition agreement, which was concluded in May, is likely to give rise to considerable opposition from European partners because it is challenging many of the European Union's decisions and agreements. Earlier than expected by some, the first disputes within the government emerged in early August during preliminary discussions about the draft budget for 2019, which will probably be presented in September (deadline for submission to the EU Commission: 15 October). Rising yields for Italian government bonds in response to rumours that Italy's independent Minister of Finance Giovanni Tria – who pursues a rather conservative fiscal policy and is considered to be pro-European – might resign, show that the financial markets are closely monitoring the developments in Italy's financial and European policies.

Italy's financial plans

What are the Italian government's specific plans? According to the coalition agreement, the VAT increase planned before the election will not be implemented. In line with the current global trend towards reducing corporate tax rates, the Italian government – at the Lega's insistence – is planning to reduce the relevant rate to 15 percent. For private households, the income tax will be reduced to two levels, with rates of 15 and 20 percent, respectively, and the mineral oil tax will be lowered. These plans – if they are implemented – will lead to huge revenue shortfalls in Italy's national budget.

On the expenditure side, M5S has prevailed and would like to keep its election promise of a basic pension and a basic income, initially limited to a period of two years. In addition, public funds are to be made available for investments, for more police and prison officers, for employment services and for families.

In the labour market, the Italian government is planning to introduce a minimum wage. Furthermore, what is referred to as the “Fornero pension reform” – which would have raised the retirement age to 67 years – is to be abolished and replaced by a new system. Under the new system, the sum total of the retirement age and the number of contribution years must add up to 100. Someone who has paid contributions for 41 years, for instance, can retire at the age of 59 years.

It is also interesting to note what measures are not included in the coalition agreement, such as increasing labour market flexibility, deregulating the markets, improving administrative and judicial efficiency, and much more. All of these measures have been recommended by international institutions for many years, with the aim of increasing Italy’s potential growth, which is far too low. From an economic perspective, these measures could actually free Italy from decades of economic weakness – unlike many of the measures listed in the coalition agreement which would only further exacerbate Italy‘s sluggish growth and debt burden. Apart from plans to reduce corporate taxes, hardly any of the measures cited above can be found in the coalition agreement.

Expentiture plans threaten to increase public debt

Spending more money although revenues are lower will ultimately result in higher public debt, unless the additional expenditure is self-financed by an economic upswing, which has never had a sustainable effect in the past, whether in Italy or in other countries. If all the spending plans were implemented, Italy would have to generate growth of 3.5 percent p.a. in the next few years to keep its debt-to-GDP ratio constant (average over the past five years: 0.4 percent).

The budget-related plans specified in the coalition agreement – broken down by permanent, i.e. long-lasting deficit-increasing effects and temporary, i.e. one-off effects (excluding an equally envisaged corporate tax reform and non-recurring revenues from a tax amnesty) – would lead to alarming results. The measures with permanent deficit-increasing effects would add up to approx. 6 percent of the gross domestic product (GDP) per year.

Fiscal costs of key measures planned by the new Italian government
Deficit-increasing measures

	Bn. €	% of GDP
Income tax reduction	50	2.9 %
No VAT increase	12.5	0.7 %
Mineral oil tax reduction	6	0.3 %
Basic income	17	1.0 %
Expenditure on employment agencies	2	0.1 %
Early retirement*	5	0.3 %
Pension reform	8.1	0.5 %
Family policy measures (up to …)	17	1.0 %
Investments*	6	0.3 %
Recruitment of prison officers*	0.2	0.0 %
Recruitment of police officers*	0.2	0.0 %
Disability pensions*	1.8	0.1 %
Total, up to	**125.7**	**7.3 %**
of which permanent	112.6	6.6 %

* temporary

Deficit-reducing measures

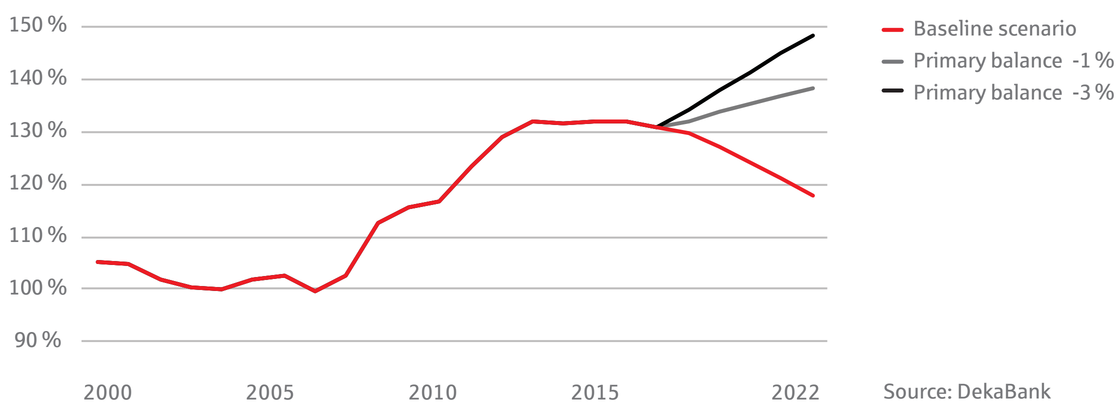
	Bn. €	% of GDP
Reduction of size of Parliament	0.1	0.01 %
Reduction of high pensions	0.1	0.01 %
Reduction of life-long pensions of politicians	0.1	0.01 %
Reduction of development assistance	0.2	0.01 %
Total, up to	**0.5**	**0.03 %**
of which permanent	0.5	0.03 %

Source: CPI Observatory

However, even if only some of the plans are translated into legislation, the primary budget balance (i.e. government net borrowing or net lending, excluding interest payments on consolidated government liabilities), which is so important for the sustainability of public finances, would probably deteriorate significantly. In the past, Italy has consistently had a primary surplus since the establishment of the Monetary Union (with only one exception during the financial crisis in 2010), and according to the budget planned to date, Italy would continue to pursue this fiscal policy stance. This is the only way to slowly reduce the high debt ratio in the coming years. Strong growth in real terms would additionally help. However, this would require new priorities in fiscal policy. Alternatively, high inflation would theoretically also help to reduce debt ratios.

Depending on how much of the Italian government's coalition agreement is included in the draft budget, the primary budget balance will become significantly negative. Even if the interest rate remained at its current low level, the debt ratio would increase – quite apart from much wider yield spreads in the capital markets in response to the Italian government's decisions, so that, with each new bond issue, the wider spreads would then eat away at the debt-to-GDP ratio. The effect of a reduction of the primary balance from its current level of +1.5 percent to -1 percent would be that the debt-to-GDP ratio, which is already high as it is, would shoot upwards by over 10 percentage points in 2023. In the event of a primary deficit of 3 percent, the debt-to-GDP ratio would increase by more than 20 percent to 150 percent, relative to GDP (Fig. 2).

Simulation of Italy's debt-to-GDP ratio



Source: DekaBank

Debt releif is no solution

Contrary to rumours, the coalition agreement did not include the election campaign pledge that government bonds held in the ECB's portfolios would be written off in order to give assistance to heavily indebted countries. However, the support often expressed by M5S for debt relief reflects the philosophy that monetary policy should be subordinated to fiscal policy. The same applies to the idea of using short-term government debt securities (referred to as mini-BOTs) – instead of money – to meet liabilities. If mini-BOTs are recognised as legal tender along with the euro, the accusation of monetary public financing – not by the ECB, but by the Italian government – could no longer simply be dismissed.

Such discussions illustrate just how far the approach of Italian policymakers has deviated from the original idea of the Monetary Union. The guardians of the European currency cannot accept that bonds held in their portfolios are virtually disqualified as second-class government debt because thoughts are publicly expressed about writing off this debt or at least subtracting it from a country's official debt level. In addition, the use of what is referred to as "mini-BOTs" as a kind of parallel

currency would be an attack on the integrity of the euro as the single common currency in the euro area.

Scenarios for the budget

According to the Monetary Union's more stringent budgetary rules which were introduced by the Fiscal Pact, Italy would have to make additional efforts in the next three years to curb its deficit and debt. In light of election pledges and the coalition agreement, the current government is refusing to do so for political reasons.

From the Italian perspective, maintaining the status quo in terms of the deficit would already be an enormous goodwill package vis-à-vis the European Union. Such a budget would also dispel concerns in the financial markets. This moderate scenario includes all the budget figures above a primary surplus of +1.7 percent relative to GDP (corresponding to a total deficit of 2.5 percent relative to GDP).

However, a draft budget as described above is very likely. Even if Italy respected the "three-percent deficit limit" in terms of the total deficit, the country would clearly fail to comply with consolidation rules in view of the debt level it has reached because the deficit would lead to a further increase in the debt-to-GDP ratio. The financial markets would note this development with concern and respond by only accepting Italian government bonds at higher interest rates to cover the growing risks. If rating agencies downgraded Italy's credit rating, this might trigger major market turmoil, especially since – according to the rules of European banking regulation – Italian banks would have limited scope for buying government bonds from their own country in view of their own fragility.

Italy and the euro

The new Italian government's approach is tantamount to a reversion to old Southern European economic policy patterns, which consisted of resolving problems in the real economy one-sidedly by applying the macroeconomic instruments of monetary and fiscal policies. The financial resources required for this purpose were debt-financed, where possible at the low interest rates of a lax monetary policy. Since the envisaged growth and self-financing effects did not materialise, the

country's financial soundness deteriorated. High inflation rates brought about by central-bank financing of government deficits helped to reduce public debt at the expense of domestic depositors. Economic recovery was facilitated by significant currency depreciation. All of these episodes of seemingly powerful stimulation of demand distracted attention from the actual demand-side causes of the economic crisis, so that the performance of the national economies – in terms of real per-capita income – improved only marginally.

What needs to be criticised about this economic policy formula is not so much the fact that a cleverly dosed debt-financed demand policy in combination with growth-oriented reforms cannot create positive effects. However, such effects can only be achieved if the supply-side conditions of a national economy also provide growth prospects. According to studies conducted by international organisations, what is needed in Italy is progress, in particular in the field of public administration, the labour market and the judiciary, in order to create better conditions for growth. However, since the Italian government intends to implement plans that focus almost exclusively on the demand side of the national economy, while at the same time rolling back supply-side reforms of previous governments, the new government's measures are not expected to create sustainable growth, but only a "flash in the pan". Even if such an economic policy, which has failed so often in the past, is pursued in only one Member State, it will potentially also have significant effects in other Member States in the Monetary Union because of the common financial market. For this reason, the rules on fiscal policy were introduced at the beginning of the Monetary Union, and for the same reason, monetary policy should be free of national, governmental influence.

Promotion of supply-side structural reforms

These rules have already been watered down by some developments within the Monetary Union – such as repeated breaches of the deficit limits tolerated by the European Commission, or the generous collateral policy pursued by the European System of Central Banks within the framework of the ELA facilities provided by individual central banks. However, the Italian government's current plan would break a taboo – providing that the approach of credit-financed demand stimulation without supply-side reforms as announced in the election campaign is also reflected in the budget. This would not be acceptable for the European Commission and the other Member States. All the political and institutional instruments available should be used to ensure compliance with the rules, which Italy, as a founding member, has also undertaken to abide by.

It is true that, because of its economic and political importance, Italy's withdrawal from the Monetary Union would pose a much greater potential threat to the Community than Greece's withdrawal, for example. However,

this potential threat should not be overestimated, either. Withdrawal from the Monetary Union, which would have unforeseeable consequences for the future of the European Union, cannot be implemented against the will of the Italian people. Despite – or perhaps because of – the experience with Brexit, winning a referendum on this issue (which is not admissible under the current Italian constitution) would be anything but a foregone conclusion, especially since European Monetary Union will also provide long-term benefits for Italy, such as the low inflation rate in the euro era and the shift from a current account deficit to a current account surplus.

Overcome threats

Notwithstanding the above, such a potential threat must not lead to a situation where political recipes (which have proven to be inadequate in the past) rear their head again in European economic policy – and serve as a role model for other Member States. However, in the Italian government's view, it is precisely these economic policy rules of the Monetary Union which run counter to the country's welfare. This dispute about economic policy concepts may be put into the general context of the diverse economic cultures in Europe. In our view, however, it is wrong to conclude that the Monetary Union is doomed to fail because of these diverse cultures. The economic policies pursued by Member States should be as independent as possible to allow sufficient room for national peculiarities – in keeping with the principle of subsidiarity within the Union. In certain fields such as banking and fiscal policies, however, this independence was limited through the establishment of Monetary Union because of the significant external effects on other countries of the Union. These fields have become Community responsibilities.

Along with other regions in Europe, Italy has often called for financial solidarity from the allegedly stronger economic regions. Apart from the institutional barriers to be overcome when introducing European compensation schemes, it is often forgotten that solidarity is not a one-way street. Systems of financial or social compensation would always be associated with a loss of a country's own decision-making authority. The burden shouldered by Italy and other countries as a result of the protection of the EU's external borders, for instance, could be distributed more evenly among all the Member States. However, this would require common security and immigration policies. Within the framework of such common policies, it is possible to show European solidarity. However, solidarity cannot be expected within the framework of unconditional European budgets and mandatory liability for public debt accumulated in breach of the rules.

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks or the DSGV.

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