LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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THE 2019 BUDGET LAW: THE DANGERS FOR ITALY'S ROLE IN EUROPE

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1. Introduction

The dramatic increase of Turkey's insolvency risk on the international markets and the possible collapse of its national currency (the Turkish lira) are the results of the country's profound economic and financial difficulties and are bringing to ruin its banking sector, its payment system and its institutional setting. The Turkish crisis is an important warning for Italy. Unlike countries such as Argentina, Italy's risk of direct contagion is limited even with respect to the financial aspects.[1] The more significant risk concerns the indirect contagion related to Italy's vulnerability in a market that is extremely volatile.

Italy's industrial and economic importance surely cannot be reduced to that of Turkey or Argentina, and regardless of Italy's current political fragility, the resilience of Italian institutions is much greater than that of Turkish institutions, which have been seriously damaged by Erdoğan's dictatorial regime. And yet, the Turkish crisis is showing that a complex system can be profoundly affected by persistent macroeconomic disequilibria that are not kept under constant control but are improperly attributed to external constraints. If the disequilibria are out of control and the efforts are focused on bypassing or eliminating the supposed constraints, negative exogenous shocks or the mere loss of confidence on the part of international investors (financial or "real") can lead to a sudden collapse, which will have a heavy and negative long-term impact on the economic and institutional organization and the social conditions of the country involved.

[1] Unicredit's position in the Turkish banking sector, although significant, seems manageable.

Italy has various persistent macroeconomic disequilibria, the most serious of which is the abnormal incidence of its government debt on a GDP that has experienced either anemic growth or recessionary trends since the mid-1990s. In the first weeks of the current month of September, the new coalition government, composed of two parties with different economic objectives and related but different priorities in public expenditures, is expected to demonstrate that its economic and social policies are compatible with the task of keeping the country's heaviest macroeconomic imbalances under control. In particular, the "Update to the Economic and Financial Document" must outline the credible modes of adjustment, which in a few years will place Italy's government budget on the convergence curve towards the Medium-Term Objective (MTO). Also, the Budget Law draft must substantiate those modes with an adequate containment of the public deficit/GDP ratio and a suitable reduction of the public debt/GDP ratio in 2019.

Below I would like to raise some doubts concerning the Italian government's will and ability to achieve these goals. Firstly, I emphasize that – today – Italian public debt is sustainable, although it is vulnerable to negative shocks (cf. section 2). I will then show that this vulnerability would risk turning into unsustainability if, by 2019, Italy limited itself to symbolically reducing the incidence of public debt, allowing the share of public deficit on GDP to go significantly beyond 1.6% (cf. section 3). Finally, I maintain that the commitments made by the government coalition in its program (the so-called 'contract'), although gradually implemented, will take the actual 2019 public deficit/GDP ratio significantly beyond 2% (cf. section 4). My conclusion, therefore, is that the Italian government needs to seriously rethink its strategy before it is too late. The warning on possible future downgrades of Italy's rating issued by Fitch a few days ago, as well as Moody's possibly related decisions to be divulged in the upcoming weeks, will condition the reactions of international investors. With possible tensions on the markets looming, it is fundamental that the Italian government shows its concern to adjust the macroeconomic imbalances, meeting the European constraints on the government budget.

2. The current sustainability of the Italian public debt….

According to the forecast of the 'Economic and Financial Document' approved last June, which limits itself to projecting the recent economic trends based on unchanged legislation in the future years, the public deficit/GDP ratio in Italy should settle at 1.6% in 2018 and decrease to 0.8% in 2019. This last figure includes the application of the safeguard clauses (increase of VAT), without which the 2019 deficit would exceed 1.5% of GDP. Given the expectations of a further slowdown in Italy's growth rates and higher increases in the public debt's interest rates (which, by the way, is indicated by the leap from 100 to 280 basis points due to the government's announcements, the new barriers in international trade and the Turkish crisis), it is reasonable to predict that – without further intervention – the public deficit/ GDP ratio will increase to 1.8% in 2018 and 1.3% in 2019 (or to more than 2% if the safeguard clauses are deactivated).

Evaluating these data in structural terms, in 2018 the adjustment would basically be equal to 0 despite of a 0.3%-correction required by the European Commission.[2] On the contrary, for 2019 the required adjustment in structural terms should be 0.6%. The latter commitment was approved by the European Council in June 2018 and formalized by the European Union-ECOFIN Council in July 2018, in both cases with Italy's consent. On the other hand, Minister of Economy and Finance Giovanni Tria committed himself to implementing a correction of 0.1% in 2018, taking advantage of the loopholes in the current government balance. He then asked the European institutions to concede Italy a maximum deviation margin on future commitments (equal to 0.5%) so as to implement a correction of only 0.1% also in 2019 budget.

If the Italian minister's requests were accepted on a European level, the trend values of the public deficit/GDP ratio for 2018 and 2019 would be, respectively, 1.7% and 1.2% (1.9% if the safeguard clauses were deactivated). Such requests, however, may be rejected by the European Commission. Therefore, we cannot take for granted that a commitment made by the Italian government to carry out Tria's objectives would be enough to avoid subjecting Italy next spring to the European Union's procedure for excessive deficit, especially due to the abnormal amount of its public debt. In fact, it should not be forgotten that the Italian public debt/GDP ratio is still very high (about 132% at the end of 2017 and, in the most optimistic estimates, just over 130% at the end of 2018). We should also remember that even with the activation of the safeguard clauses, the abovementioned trend values of public deficit/GDP ratio would lead to a decrease in the public debt/GDP ratio in 2019 that would be less than the ones required by European rules.

Although these problems should not be underestimated, I believe that the public deficit/GDP ratios equal to 1.7% in 2018 and 1.2% in 2019 are compatible with the sustainability of Italy's public debt. In fact, it would be reasonable to predict that the nominal growth rate of Italy's GDP in 2018 and 2019 will be slightly above 2.5% in normal circumstances (in 2018, 1.0% in real terms + 1.6% of the inflation rate; in 2019, 0.9% in real terms + 1.7% of the inflation rate). This nominal growth rate of GDP would guarantee a positive margin with respect to the abovementioned growth rates of the public deficit. Furthermore, at a structural level, the public deficit/GDP ratio could approach the equilibrium interval projected by the Six Pack, which would make Italy's new objective of reaching its MTO by 2021 credible.

This scenario, which is reasonably positive, would be robust even if interest rates were to go up, as is currently feared. Thanks to the time re-composition in the issuance of Italian government bonds, today the average duration of such a bond is slightly over seven years. This implies that each average increase of 100 basis points in interest rates on government bonds would result in an increase in the public deficit/GDP ratio of: 0.11% in the first year (roughly 1.9 billion euro), 0.25% in the second year (about 4.3 billion euro), 0.36% in the

[2] Let me remind you that the 0.3% is a "discount" of 0.3% with respect to the 0.6% required by the European rules of the Stability and Growth Pact.

third year (about 6.3 billion euro) and 0.45% in the fourth year (about 7.8 billion euro). Therefore, even if we predicted an average increase of 200 basis points in interest rates in the period from the end of February 2018 to the beginning of January 2019, the public deficit/GDP ratio in 2019 would go from 1.2% to about 1.5-1.6% and would still be compatible with the conditions set for controlling the public deficit, leading to a sizable reduction of the public debt/GDP ratio and to the possible fulfillment of Italy's MTO by 2021.

3…and the future risks of unsustainability

The conclusions stated in the preceding section are valid provided two interconnected conditions are met. First and foremost, the evolution of the government budget must not worsen the investors' loss of confidence in Italian government bonds.[3] If government announcements and related initiatives triggered the investors' aversion to risk, the result would not only be increases in the rates of return of Italian government bonds but also a fall in their demand or an increased preference for Italian bonds with shorter maturities. These events would consequently spark a vicious circle between the progressive reduction in the average maturity of Italian government bonds and the increased impact of financial charges on the public deficit and debt. Secondly, such a vicious circle must not transform into uncontrolled increases in the Italian spread with respect to the German benchmark, something that would lead to the Italian government losing access to the market. Judging by the current cash reserves and the time distribution of government bond maturities, in the autumn of 2018 a possible no-access to the market would leave Italy only a month of available liquidity before being forced either to declare bankruptcy or to take recourse to the European aid program provided by the ESM.

These considerations underline that the introduction in the 2019 Budget Law of further deviations exceeding the trend values discussed at the end of section 2 would increase the probability of a correction request by the European Commission and would feed national and international investors' doubts about the sustainability of Italy's public debt. To implement this correction and to overcome such fears, relying on the strengthening of future economic growth rates of the Italian economy would not be enough. Therefore, the first result of my previous analysis is that Italy's next Budget Law must guarantee an adequate reduction of the public debt/GDP ratio in 2019 by setting a public deficit/GDP ratio target that does not deviate substantially from 1.5-1.6%. These values are the critical threshold that will allow Italy to achieve sufficient control of its macroeconomic

[3] As shown by several indicators (i.e., the Italian Central Bank's imbalances in Target 2), there has been a significant decrease in the weight of Italian government bonds in international financial portfolios since March 2018. This trend was partly compensated by an increase in purchases made by the Italian banking sector and disguised by the ECB's (and the Eurosystem of central banks') quantitative easing (QE). As is well known, QE will probably end next December; meanwhile, the program of government bond purchases will be reduced starting in the current month of September. Hence, the sentiments of international private investors towards Italian government bonds will become still more important in the following months.

imbalances in 2019 and to reduce the unsustainability risks related to its government budget.

Ministers Di Maio and Salvini, together with other members of the Italian government coalition, announced several times that the actual implementation of the most significant components of the coalition's 'contract' cannot be constrained by European rules and by the threshold of 3% in public deficit/GDP ratio. Minister Tria proposed to mediate in order to avoid the excesses of the two vice presidents of the Council of Ministers. However, his mediation does not offer any credible reassurance about the matter. Besides making a (comprehensible) commitment to not exacerbate the structural imbalances of Italy's government budget, Italy's economy minister insists on the necessity of further diminishing the public debt/GDP ratio in 2019 and in the following years. The problem is that this constraint is not enough to guarantee that the decrease of Italy's public debt will suffice in satisfying the conditions of its sustainability. Only a few observations are needed to illustrate this point.

The decrease of the Italian public debt/GDP ratio, begun only in 2017, was minimal. Moreover, in 2018, there is a high probability that this decrease will not be implemented in the amount budgeted, thus implying that the Italian public debt's incidence on GDP will remain above 131%, that is, it will achieve a minimal adjustment even in 2018 with respect to 2017. Therefore, Minister Tria's commitment to continue the previous trend to diminish the public debt/GDP ratio in 2019 and in the following years could be satisfied, even if the reduction consisted of a few fractions of percentage points. In this perspective, the expectations concerning the nominal growth rate of Italy's economy indicate that, in 2019, a public deficit/GDP ratio of 2.5% with a spread of 300 basis points would still be in line with a fractional reduction of the public debt/GDP ratio. The problem is that such a ratio would be largely incompatible with Italy approaching the convergence curve towards its MTO. This ratio would, in fact, prevent Italy from obtaining a structural equilibrium in the government balance even with a delay of two years, if compared to the term planned by the previous Gentiloni government. Even more so, Italy would not obtain the budget's primary surpluses required to satisfy the Six Pack rule, that is, a reduction of 5% of the gap between the actual public debt/GDP and the threshold of 60%.

By not satisfying any of the European rules on the reduction of public debt, Italy would not find itself on a credible adjustment path and the sustainability of its government budget would be greatly compromised, even if there was a fractional decrease in its public debt/GDP ratio. The second result of my analysis is therefore rather clear: although I appreciate Minister Tria's attempt at mediation, I believe that his objective to continue slowly decreasing the public debt/GDP ratio is not enough to guarantee the sustainability of Italy's government budget. To reach the latter condition, it would be necessary to substantiate the constraint on public debt with a further commitment to not exceed the 1.5-1.6%-limit on the public deficit/GDP ratio in 2019. Unfortunately, I fear that without a drastic change in the current government's fiscal policies, this further commitment will not be attainable. In the following section, I state that it is not by chance that Minister Tria limits himself to insisting on the fractional reduction of the public debt/GDP ratio: having cost so much effort, this reduction is the maximum result that can be reached in order to gradually satisfy the points of the contract signed between the League and the Five Star Movement.

4. The heavy burden on the Italian budget

The Italian economy minister has stated that the next Budget Law will amount to 25 billion euro. Moreover, he called for the relaunch of economic growth by means of a public investment policy that would invert the restrictive trend that the country has experienced for more than ten years. The two vice presidents of the Council of Ministers declared that this Budget Law will not trigger the clauses on the increase of VAT (equal to 12.4 billion euro), will not eliminate the monthly 80 euro for low-medium income earners introduced by the Renzi government and will change the current pension rules by introducing the so-called '100 threshold' (at least 64 years of age and 36 years of contribution). Minister Di Maio then added that in 2019 some pillars of the 'minimum income for citizens' will be implemented, and Minister Salvini reiterated that simultaneously the government will start a new fiscal system with double or single tax rates. Even a minimal assessment of these commitments, based on specific prudential calculation made by various experts in different fields who are close to the government, highlights that launching the 2019 Budget Law with a public deficit/GDP ratio below 2.5% has a next to zero probability.

Let me begin with the list of additional public expenses for 2019. To the 12.4 billion euro required to avoid an increase in VAT, we must add the following items: at least 5 billion euro to replace the current pension system with the selective and thus problematic application of the '100 threshold' system; at least another 6 billion euro to launch the first phase of the 'minimum income for citizens', making the public employment centers operative (about 2.5 billion euro) and increasing the beneficiaries receiving inclusion income and other forms of social support; another 6-7 billion euro to implement the first changes in the fiscal regime, increasing the beneficiaries (small businesses, craftsmen, professionals) of the 15% flat-rate system and applying a new minimum rate to the lowest taxable incomes.

This first list of expenses already amounts to 30 billion euro. Then, to be added are: the sum of public expenses that cannot be put off because they are linked to outstanding commitments (about 4 billion euro); the inevitable, although difficultly quantifiable, public disbursements for the (temporary) solution to ILVA, Alitalia and other companies going through an industrial and financial crisis; the costs due to the comprehensible extension of incentives for the innovative private investments that are now expiring; support for the adequate formation and utilization of human resources advocated above all by the League; and the finances for the desired relaunch of public investments. Assuming that the increase of public investments is little more than symbolic and that the other items' costs are always set at the minimum expected threshold, the total amount of these additional expenditures will not be less than 10 billion euro. The overall sum of public expenditures that must be covered by next year's budget is therefore about 40 billion euro. This figure then has to be increased by adding the charges for the correction required by the European Commission. Consequently, even in the most favorable case for Italy (a correction of 0.1% of GDP rather than 0.6%), the total additional public expenditures for 2019 will be about 42 billion euro.

To be able to cover these expenditures the Italian government proposes to: reduce fiscal benefits, deductions and detractions; set at zero the nominal increase rates of a number of current public expenditures (excluding health, pensions and research); make additional non-linear expense cuts; reduce, permanently or temporarily, the various types of high existing pensions; implement a tax amnesty that will exclude big evaders. Again wishing to be overly optimistic, in 2019 such initiatives could at most cover the costs for not activating a VAT increase (about 12.4 billion euro). Therefore, the other non-covered public expenditures would lead to a deficit/GDP ratio in 2019 of more than 3%.

The Italian economy minister and other reasonable exponents of the government realize that if such a Budget Law was drafted, it would inevitably lead to heavy sanctions from the European institutions and – even before that – from market investors. To avoid Italy's bankruptcy, they are thus proposing to contain the budget expenses, to transform Renzi's monthly 80 euro into income tax detraction and deduction, and to partly increase the VAT by means of a re-composition of the various rates. The economy minister is also proposing to finance half of the annual expenses for citizens' minimum income through the European Social Fund, and to dump a large part of the costs of the probable corporate crises on the *Cassa Depositi and Prestiti* (CDP) and on other state-owned companies which are not included in the government balance. The result should be a Budget Law which amounts to slightly more than 30 billion euro, financed in deficit with more than 17 billion euro. Given that my previous trend calculation implied a public deficit/GDP close to 1.5-1.6%, this would lead to a real deficit/GDP ratio in 2019 of no less than 2.5%.

5. Conclusions

The result obtained confirms the argument advanced at the end of section 3: Italian Minister Tria is aiming to satisfy the constraint of a (fractional) reduction of the public debt/GDP ratio, because this is the maximum goal that he can achieve striving hard within the framework of the contract signed by the two government coalition parties. However, in the previous section, I tried to explain why a public deficit/GDP ratio of about 2.5% in 2019 would have a high probability of leading to either Italy's bankruptcy or its recourse to a European aid program. In other words, a ratio above 2.0% would make the Italian public debt unsustainable.

The scenario described underlines the fact that Italy is in a very difficult situation. However, this situation may also open some positive opportunities. The two leaders would have to be convinced that it is not in their interest to bring the country to the brink of an abyss that resembles those experienced in Greece and Portugal between 2010 and 2013. Italy is the only country among the most fragile EMU member states not to have implemented structural adjustments from the second half of 2011 until today. The Italian government, able to activate these adjustments in socially fair forms, would acquire enormous merit (also electoral) for having secured Italy an active role in the evolution of the European institutional and economic design.

To illustrate the last consideration, let me recall the tragic collapse of the 'Morandi Bridge' in Genoa in mid-August 2018. The dramatic event bears witness to the urgency of infrastructural modernization that involves the whole euro area and that should be financed through a European project. To obtain this result, the most effective strategy is surely not to adopt old and trite prejudices – emblematically expressed with the saying "it's raining, thievish government" – and to polemicize with European institutions. Saying that Italy's infrastructural shortcomings are the consequence of European constraints on national government budgets is false and borders on "bad faith." It suffices to emphasize that, in the past years, Italian governments were able to spend only a fraction of the European financial resources devoted to Italian investments.

The attempt to find the culprit for Italy's infrastructural deficiencies in the European Union has already produced serious damage for Italy's international credibility, as seen in the condemning articles that appeared in the international press. Instead of awkwardly assigning false blame to the European institutions for having imposed overly tight fiscal constraints on the maintenance of national infrastructure, Italy should prove with facts that it has what it takes to play a proactive European role.