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Draghi's resignation and a new – more clever - Fiscal Compact

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Italy's political instability resurfaced on July 14 when Prime Minister Mario Draghi presented his resignation to the President of the Republic of Italy Sergio Mattarella after the Five Star Movement, one of the main components of the government coalition, abstained on a confidence vote.

In 2021, Draghi accepted the mandate to form a government comprising the largest possible majority of political forces, with only the far-right Brothers of Italy staying out of the coalition. On July 14, although Draghi secured the support of the parliamentary majority, he saw that the original political majority that underpinned his mandate as Prime Minister was no longer in place.

The outcome of the current turbulent phase is still uncertain. Draghi's resignation, offered to President Mattarella, was a necessary formal step. The President of the Republic, however, rejected Draghi's resignation and, as a result, Draghi will return to Parliament as PM on July 20 to verify whether a majority is still possible and, eventually, reliable. In practice, there will be a new confidence vote which will determine whether Draghi will continue to serve as Prime Minister with solid political support. A lack of support cannot be entirely ruled out and the eventuality of new elections, though not the most likely, is far from marginal.

Whatever the outcome from the negotiations underway, Italy's political situation seems to be precipitating into troubled waters. The fact that even the most reputed of Italy's public servants wound up mired in petty negotiations with single political parties shows that the endemic entropy of Italy's political system relentlessly corrodes even the best endeavors.

The events have significant implications for the ongoing debate on the future governance of the Economic and Monetary Union as well as on the design of new tools to prevent fragmentation of the euro area. Rules and new instruments must reckon with the political responsibility of the participating countries. Excessive political instability can be detrimental to intertemporal responsibility and thus to solidarity.

The relevance of the July 2022 events is determined by the fact that the conditions under which Draghi's government acted were ideal if compared to those that other public servants before him had to manage.

a) Since 2020 the EU Commission has adopted a general escape clause that spared Italy from enforcing "austere" fiscal policy.
b) The special challenges that accompanied and followed the health crisis created convergence among political parties in backing the former head of the ECB as a common leader under emergency conditions.

c) The EU Recovery and Resilience Facility granted Italy a huge amount of loans and transfers from the EU, linked to a program of reforms and investments accepted by Italy's Parliament and forming the backbone of the Draghi government's program.
d) Russia's invasion of Ukraine created a sense of emergency that kept political opposition at bay in most European democracies.
e) Finally, Draghi's stellar global reputation has given Italy a leading role in the current geopolitical turmoil.

Even in this unusually favorable political constellation, Italy has emerged as an ungovernable country in the eyes of its European partners. In fact, similar predicaments emerged in the past months and years in other countries. Since 2007, British governments have had an average duration similar to the Italian ones. In June 2022 France elected a parliamentary majority that weakened the political support backing the President of the Republic. Uncertain political prospects characterize the U.S. and other western democracies. However, only in Italy does its political stability directly reverberate on its financial stability.

Fig. 1 shows the increase in the 10-year interest rate differential (BTp-Bund) in the week around Draghi's resignation.

Figure 1

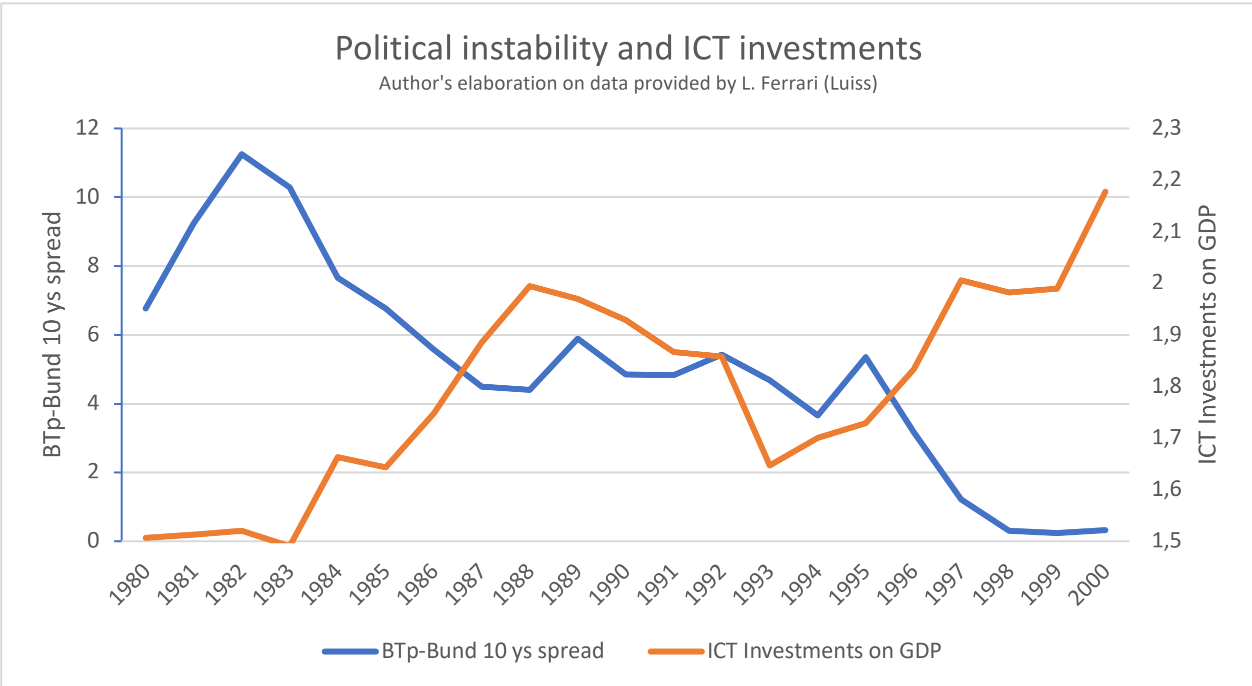
With interest rates expected to rise in the coming months, because of high inflation, Italy's fiscal stability could be tested by investors. In July, expected growth for the next year has been lowered by the EU Commission and the ECB announced an increase in interest rates. The combination of higher interest rates and lower growth can produce a rising debt-to-GDP ratio. Even in these conditions, Italy's fiscal sustainability depends on the political resolve of its government. Draghi represented a guarantee that no "exit" option for Italy would ever have been considered under his government. Moreover, investors were convinced that under Draghi fiscal stability would become a priority in the case that public debt sustainability was in doubt. Finally, Draghi was also identified with the completion of the National Recovery and Resilience Plan, which represents a precondition for the resources transferred by the European Union, positively affecting growth.

Political uncertainty and growth

Assuming that the level of interest rates is exogenous, the two factors that have most significance are growth and the government's commitment to Europe. The two factors are interconnected: the level of uncertainty concerning Italy's commitment to Europe reverberated on the level of the interest rate differential (spread), which is correlated to the level of investments.

Fig. 2 shows a correlation between the spread and the level of investments in Information and Communication Technology in the 1990s. This is probably the core reason why Italy's productivity started declining and brought potential growth to zero.

Figure 2



The factors behind Italy's stability can thus be reduced to the level of the spread – as a proxy for growth - and the political commitment to comply with the European rules.

The inverse correlation between economic growth (via investments) and the spread serves as a reason for two countervailing policy proposals: the first prescribes that Italy's discretionary margins in political economy are reduced to ensure that growth-enhancing reforms are enacted; while the second demands for the spread to be contained – through a self-fulfilling guarantee that no exit from the euro area will be allowed by the European institutions ("whatever it takes") – as a guarantee for private investors.

- In the first case, an ESM program must first be approved and later accompanied by the Outright Monetary Transactions.
- While in the second an "anti-fragmentation tool" enforced by the ECB would be sufficient to stabilize the horizon for investors.

The question raised by the current political turbulence is which of the two proposals fits Italy's innate political instability.

- On the one hand, one of the reasons for an ESM program is to reduce the volatility of Italy's political commitment. However, Draghi's experience in the most favorable external condition demonstrates that the European constraints – even those associated with generous resources - are not held in high regard by Italy's political system. An ESM "punitive" program – prescribing reforms that are not the fruit of parliamentary proposals – would elicit even stronger populist protest.
- On the other hand, under the pressure of populist competition, the anti-fragmentation tool would give rein to fiscal profligacy. Maintaining the level of Italy's interest rates on the same par as the German one would give room for maneuvering in public expenditure without differentiating between a spending spree intended to buy consensus and the virtuous build-up of public investment.

Replacing the Fiscal Compact

After the Draghi government's recent experience, no solution seems possible without limiting political discretionary margins. Contractual agreements – as a friendly alternative to the ESM programs that had been used during the euro crisis - have been evoked in the past as a possible solution. In that case, neither through coercion nor under duress, a detailed political program would be agreed to by the Italian Parliament and the European Institutions together. The contract would ensure per se political consensus and legitimate the interventions of the ECB, keeping the spread in check. But what will happen if elections in 2023 (or even earlier) change the majority in the Parliament?

In 2012, three days before Draghi's famous statement about saving the euro "whatever it takes", Italy ratified the Fiscal Compact. The Treaty prescribed that the rules on the reduction of the debt-to-GDP ratio and a balanced budget be adopted by the Member States as national norms at a constitutional level. That precedent was unsuccessful: the debt rule was de facto never applied and the constitutional norm about the balanced budget was largely disregarded on the grounds of regularly exceptional circumstances.

Ten years later, an opportunity has emerged to redesign the mutual commitment between the EU and the Member States starting from the NG-EU program, which was adopted as an intertemporal agreement, crossing over the legislature.

1) The NG-EU is the policy platform aimed at increasing the structural growth rate of the Member States and needs to be considered – as in the original text of the RRF – as a tool aimed to achieve a higher degree of convergence in the long term in the EU.

2) The NG-EU procedures need to become the basis of the European semester and the national reform plans approved by the national Parliament and the EU Council.
3) The expected rate of growth of the Member State's economy, estimated twice per year by the EU Commission in the context of the impact of the NG-EU, represents the term of reference for setting the target of the national budget policy, taking into account the monetary policy targets as autonomously determined by the ECB, and aimed at the gradual reduction of the fiscal imbalances.
4) The Member State's political commitment to respect the fiscal target – as determined above by the EU Commission - and the other rules to the best of its possibility, must acquire constitutional status, replacing the "debt rule".
5) Given these premises, the ECB may commit itself to keeping the spread at a level that makes the nominal level of interest rates not inconsistent with the level of growth expected by the EU and the fiscal target constitutionally protected.