

The Imaginary Growth

The hidden illness of Italian economic policy

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Since the end of September 2018, the Italian government has been involved in complex negotiations with the European Commission to avoid an infringement procedure for excessive deficit in relation to the debt rule. The talks have led to a radical reflection on the relations between the Italian government and the European Union. After the relationship evolved from one of antagonism to one of cooperation, a compromise was reached (at least for now) and Brussels implemented measures on Rome that are less penalizing than the ones that would have been implemented through a long and harsh procedure.

Nevertheless, in this Policy Brief we raise the question of whether the negotiations are indeed dealing with the real defect in Italy's budgetary policy, which, with small yet significant exceptions, seems to be rooted in the country's political culture. In the following considerations, we will note that ever since Italy joined the Economic and Monetary Union of the European Union (EMU), Italian governments have systematically planned their budgetary policies on unrealistic growth and debt estimates. This defect concerning the "ownership" of the estimates may be related to the problem of the governments' brief duration, but it actually seems to be rooted in a political mentality that manifests irresponsibility for the consequences of one's own choices.

The nature of the procedure launched in October by the European Commission was based on the ascertainment of two problems: the reliability of the growth estimates for the Italian economy and the effects of the specific fiscal policy choices regarding the failed decline of the debt-to-GDP ratio. A large part of the negotiations was concentrated on the estimate of the fiscal impact of the reforms and more generally, of the expenses and revenues proposed by the Italian government in the draft budget. The growth estimate for 2019 and for the following years was considered and calculated in a residual manner with respect to the main negotiations.

This is a continuous defect in the negotiations between Brussels and the Italian governments because the latter are directly responsible for their state budget and only to a lesser degree for the effective growth rate. Nevertheless, in the course of the years, we have seen a systematic manipulation on the part of many Italian governments of the expected growth estimates and of the resulting public debt. This has led to postponing, year after year, the solution of the true problems related to low growth and high debt and which in the mid to long term determine the degree of stability and wellbeing in the country.

Without clarity in the objectives of economic policy, beginning with those related to Italy's economy being in a context of global competition, even the painful process of political maturation that we have seen in the last months risks being insufficient.

1. The persistent problem of the Italian public debt

The Maastricht Treaty, which defines the criteria that must be respected for joining the EMU, envisaged that member countries of the euro area would have a public debt with a level less than 60% of GDP or that it would anyway be diminishing at a satisfactory pace.¹

Two years after the ratification of the Treaty, the Italian public debt reached a peak of 121.8%. Afterwards, it began to diminish significantly. In 1999, when Italy joined the euro, its public debt was about 110% of GDP. Italy was allowed to join provided it was committed to further reducing the public debt. In the following years the debt's decline was less rapid than expected. Only in 2007 it was at a level of 99.5%.

In 2008, the eruption of the global financial crisis and the consequent recession completely changed the public finance scenario. By 2017 Italy's public debt had grown to 131.2%. The debt's initial high level made it difficult for Italy to contrast the recession of 2009, a result of the global financial crisis, and then to recapitalize the most exposed credit institutions. The economy's weakness and the closed circuit between sovereign debt and bank debt fed on each other. In 2011-2012, the European crisis led to a high degree of uncertainty concerning the sustainability of the Italian debt. Only measures carried out by the European Central Bank removed the doubts about Italy's position in the euro area. Since 2014 the Italian debt has basically remained stable and at times was even slightly reduced.

A posteriori it can be said that not having reduced the public administration's indebtedness in the pre-crisis periods is the fundamental error of Italy's recent budgetary policy because the revenue growth level would have allowed for more aggressive budgetary adjustments. The reasons for this situation are also instructive for what happened afterwards.

2. Five different strategies in a period of 20 years

Speaking in a simplified and general manner, there are three factors that influence the course of the debt: on the one hand, the primary balance of the state budget and on the other, the interest rate

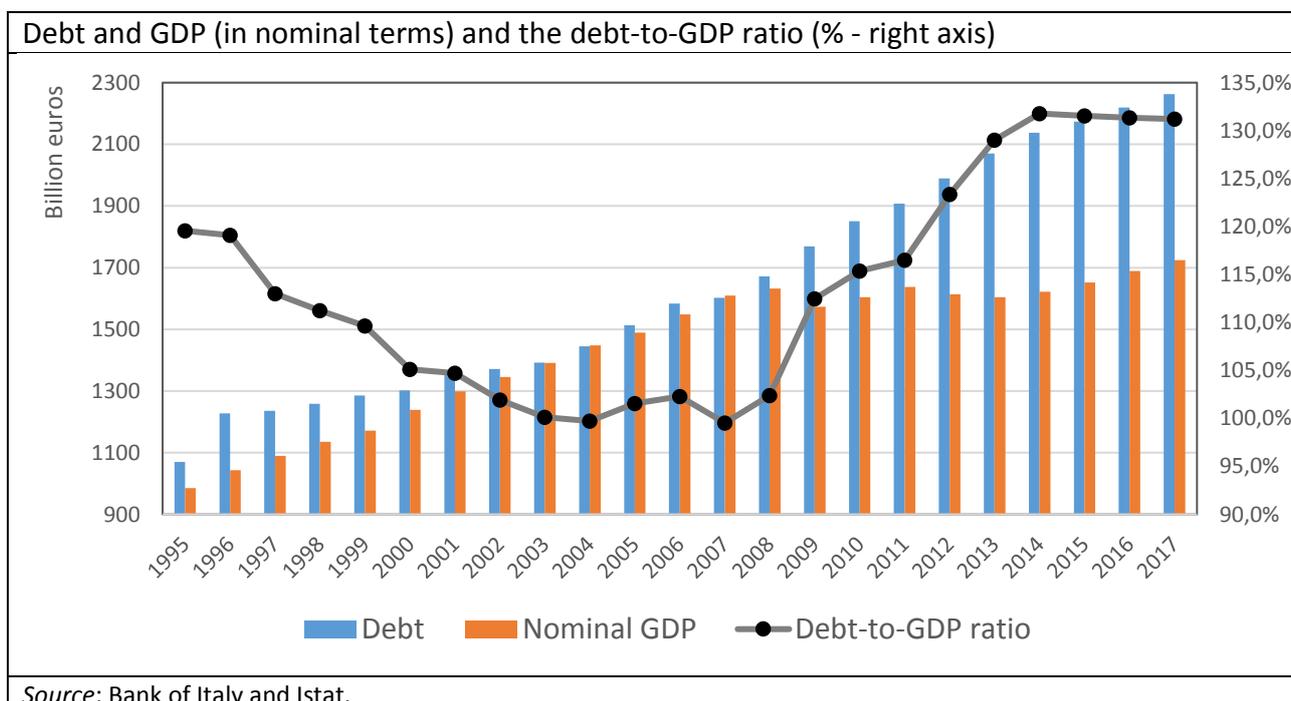
¹ The formulation was "sufficiently diminishing and approaching the reference value at a satisfactory pace."

and the growth rate of the GDP, in real terms.² Therefore, there is an increase in the debt-to-GDP ratio when the primary deficit increases if the other variables remain unchanged, or if the interest rate on the debt is higher than the economy's growth rate and their difference is higher than the primary surplus³.

We must recognize the fact that these variables are not under the government's complete control. The macroeconomic context has a specific impact on inflation, interest rates, investment flows and therefore, on the overall development of a country.

In any case, although the international economic situation may produce critical effects, a farsighted strategy for reducing the debt should be based on a combination of more economic growth and reduction of expenses.

If we look at the trend of the debt-to-GDP ratio in nominal value during the last twenty years, we can distinguish five periods. In the first one, which runs from 1995 to 1999, the budget's primary surplus is very high and it allows for a rapid reduction of the debt-to-GDP ratio. In the second period, from 2000 to 2005, the primary surplus sees a rapid fall, but the debt-to-GDP ratio is also reduced. In the third period, from 2005 to 2007, the surplus increases again and the debt falls below 100% of the GDP. In the fourth period, between 2008 and 2013, however, the ratio largely increases because first the financial crisis and then the debt crisis cause the variables to diverge in opposite directions. Finally, since 2014 there has been a slight upturn of the GDP, which has compensated for the increasing trend of the debt.



² The variation of the debt-to-GDP ratio, in nominal terms, Δb_t , is described by the equation:

$$\Delta b_t = d_t + (r_t - g_t)b_{t-1}$$

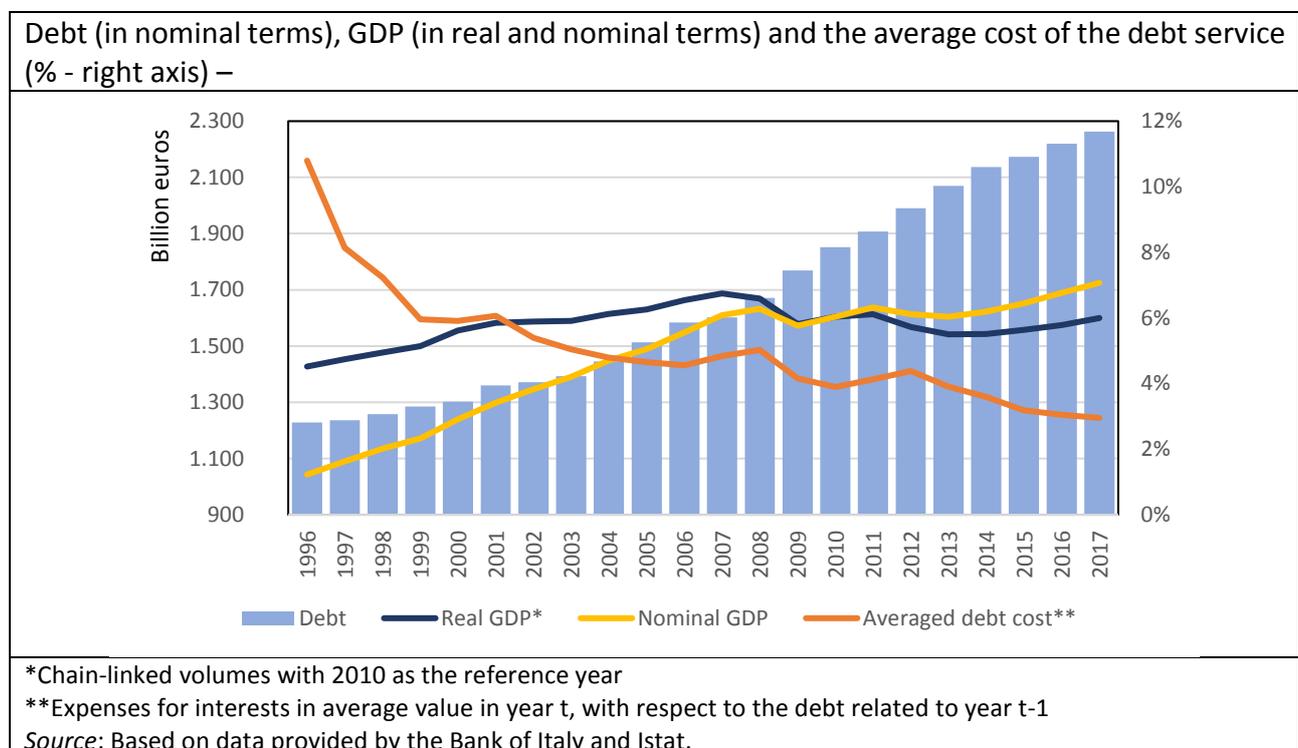
where d_t is the primary deficit, that is, the deficit at net of the costs related to debt service, r_t and g_t , are respectively the interest rate and the growth rate of the GDP, in real terms, and finally, b_{t-1} is the debt-to-GDP ratio in nominal terms in year t-1.

³ We assume here that the level of debt is equal to the GDP

Looking at the debt-to-GDP ratio, we can conclude that in the beginning Italian governments launched a virtuous process that was inevitably cut short later by the world financial crisis and subsequently overwhelmed by the sovereign debt crisis. Unfortunately, the figures tell us a different story.

In fact, between 1999 and 2007 Italy's public debt declined by 10 percentage points. This result, however, was not determined by investment or spending review policies. It was caused by other relevant factors, among which were revenues from privatizations and other stock-flow adjustments.

As the chart below shows, between 1997 and 2007 Italy did not experience a significant growth in real GDP (the effective GDP was +1.5% on the average) that would have accelerated the reduction of the debt and helped the country be less exposed to the impending financial crisis.



And yet, in the same period, Italy was in favorable conditions concerning the contraction of the average cost of the debt. In fact, on the one hand, Italy's joining the EMU helped it significantly reduce the interest rates applied to Italian government bonds and on the other, privatization policies continued collecting large revenues that the government used to repurchase public debt securities.

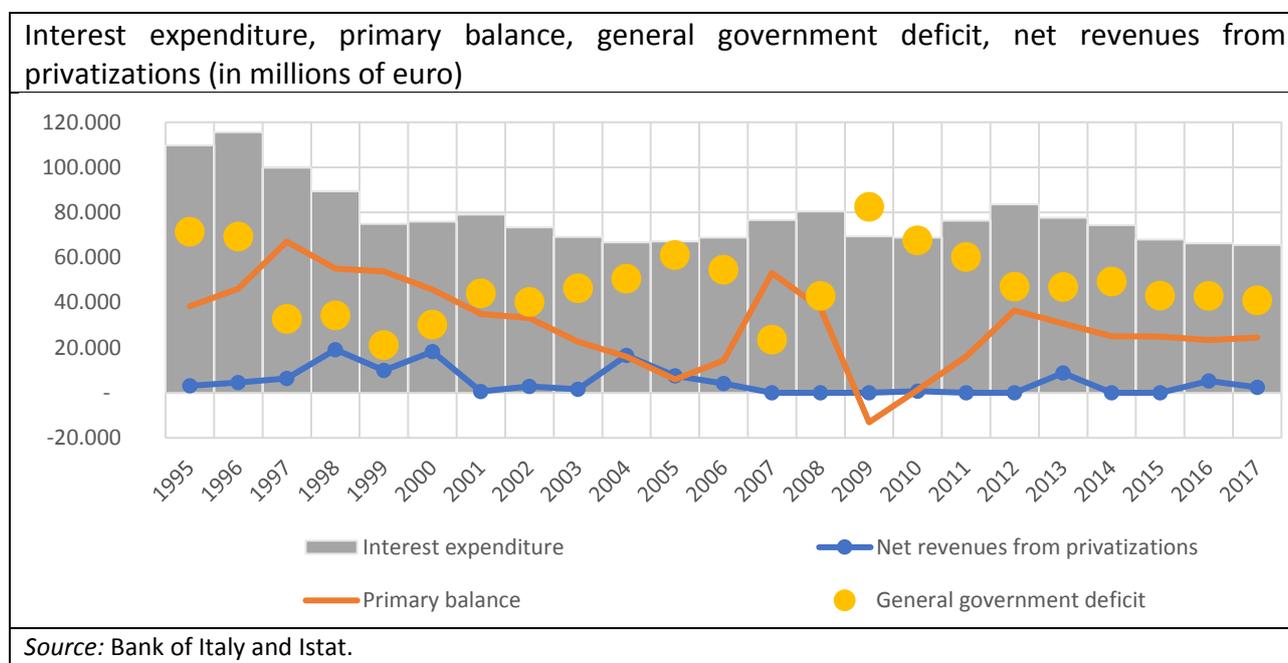
In the draft budgetary plans presented annually by the Italian governments, we see the contribution from privatization and disposal operations during the process of paying off the debt. Furthermore, it is interesting to note that in the economic and financial draft budget plans of 2006 the government reports that among the causes of the increase in the public debt-to-GDP ratio was the smaller volume of privatizations. Throughout the years, in absence of incisive cuts to expenditure, the sale of public assets became almost an indispensable element in the process of paying off public debt, despite the fact that this leads to a reduction of public capital and it is not prudent to use such a

strategy to reduce the debt, since the revenues coming from privatization are, by definition, exhaustible.

Once the privatization program finished and the convergence of interest rates in the euro area was achieved, the government should have concentrated on the primary surplus and on the component of growth.

However, judging by the data, Italy did not conduct a systematic policy of rationalization of expenditure. In fact, between 1999 and 2007 with less interest expenditure - derived also from privatizations that reduced the debt level by about 94.5 billion euro - the net annual indebtedment increased from year to year.

The main factor to determine this course was the progressive reduction of the primary surplus. If we look at the details, we will see that the level of the primary surplus, which in the last five years of the 1990s had been equal to 4.6%, drastically decreased between 2001 and 2007 to an average level of 1.8%.



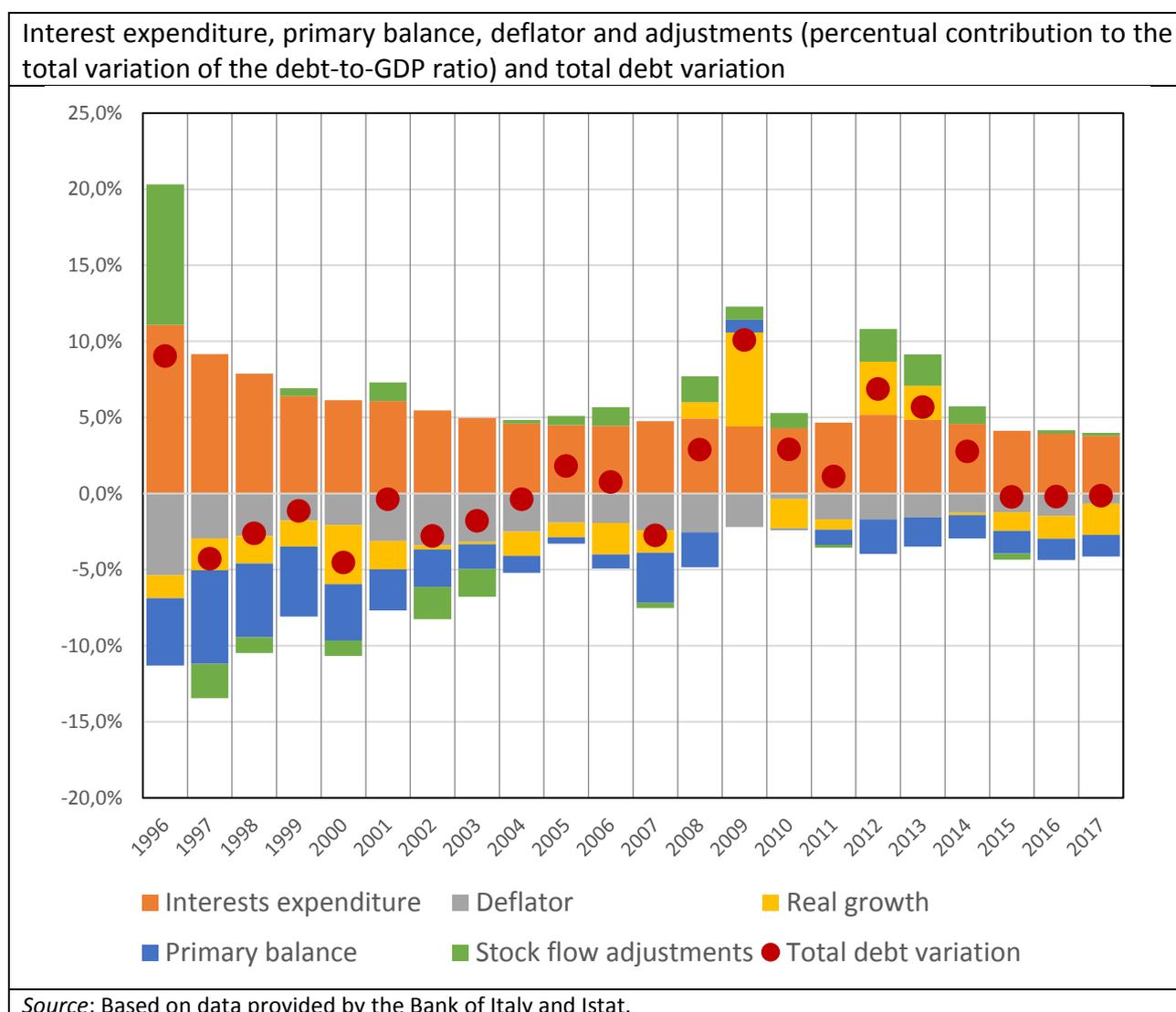
Between 1999 and 2007, the contribution of the primary surplus to the reduction of the debt-to-GDP ratio thins out from year to year (from 4.6% in 1999 to 0.9% in 2006).

If the level of the surplus in the 1995-2005 period had been preserved, Italy would have confronted the European crisis with the same debt-to-GDP level as Germany, the same average growth rate in the previous decade as Germany, a less innovative industrial system but a more solid banking system than the German one. It is useless to say that in these conditions Italy would have been a safe haven throughout both the global and the European crises and it would have benefited from substantial capital flows, as happened in the German economy.

However, in that period, as the following chart clearly shows, although there was no particularly strict budgetary policy, even the growth's contribution to the reduction of the debt proved to be contained and decreasing.

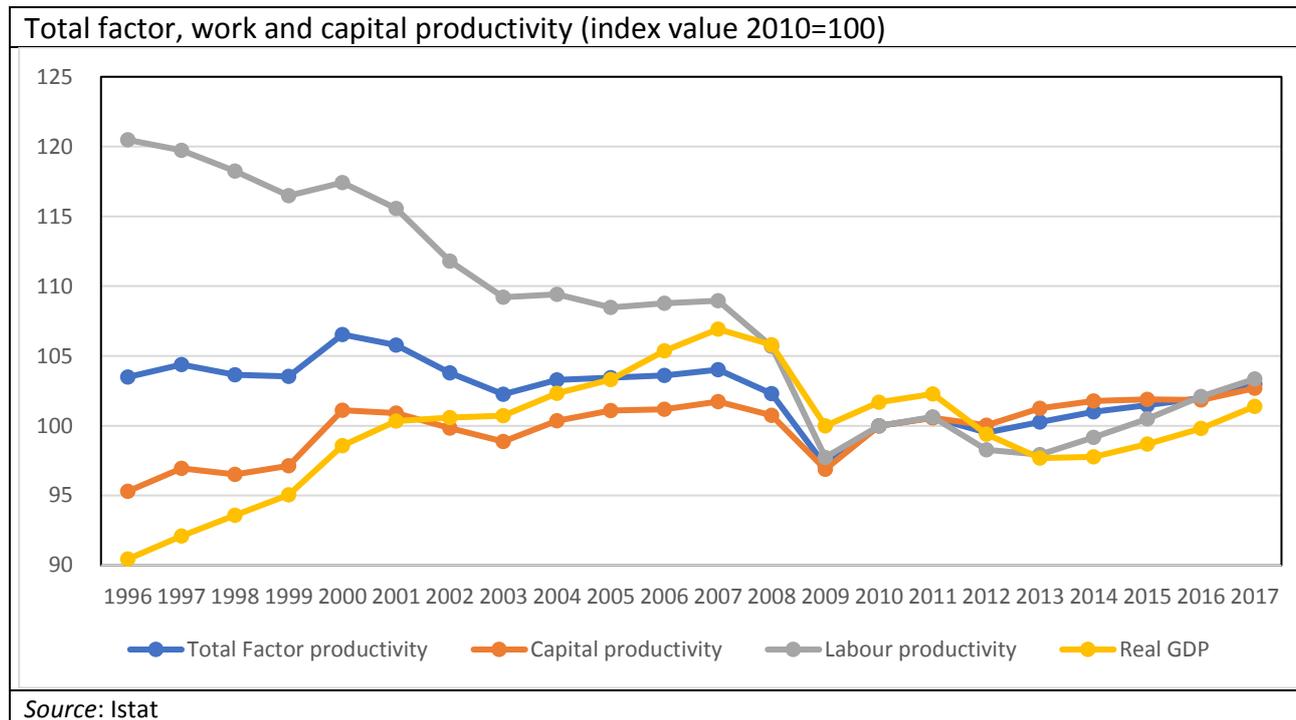
3. The growth that did not occur

Looking at the growth indices, Italy’s performance was greatly below the expectations. In fact, between 1999 and 2007 the average real growth rate was equal to 1.5%, clearly below the real interest rate on the debt (an average of 2.8%). The positive effect of the growth, therefore, was not enough to compensate for the increase of the debt owed at the payment of the interests on the outstanding debt. The most significant contribution to the compensation of the negative impact of interest expenditure on the debt-to-GDP ratio basically comes from the increase of inflation: the effect of the deflator leads to an average reduction of the debt-to-GDP ratio of 2.5%. Less influential, although still important, were the stock-flow adjustments, which contributed to an average annual reduction of the debt equal to 0.2%.



Between 1995 and 2013 the Italian economy experienced a decisive contraction in its production level. In the period considered, the production of capital decreased substantially. This data shows that in the course of the major global industrial and technological transformations, in Italy resources and productive factors were reallocated in an inefficient manner. The credit system favored

conservative investments in construction, while businesses from other sectors reduced their investments.



The low economic growth, which was due to poor productivity, should have become the barycenter of economic policy action. On the contrary, only small structural changes and not very incisive budgetary policies were implemented. The question, therefore, is: what caused the errors of economic and budgetary policy in the period after Italy joined the euro? Usually, this is attributed to the “exhaustion of reforms,” which caused a slowdown in the adjustment of public finance after Italy made the – partial - effort to adhere to the convergence requirements established by the Maastricht Treaty in the second half of the 1990s.

Another possible reason is the low level of growth in the Italian economy, which was due to various factors and which justified the adoption of less strict budgetary policies. Nevertheless, if we analyze the data from the 2002-2007 period, it does not appear that the structural weakness of the Italian economy was taken into consideration when planning the objectives of economic and budgetary policy. On the contrary, what is evident is that budgetary objectives were calibrated systematically towards growth objectives that in reality proved to be extremely unrealistic. It was not the objective of balancing the budget that prevented the substantial reduction of the public debt but an “error” in the estimate of the growth rate of the aggregate income.

At least this is what results from the evaluation of the difference between the growth expected by the government at the moment the Economic and Financial Document (and thus the estimates of the public finance objectives) was defined and the actual results.

In none of the years considered did effective growth come anywhere close to the growth estimated by the government in its economic and financial documents.

Chart: Estimated and Effective GDP Growth rates (in real terms)

		1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Estimates*	July 1998	2,7%									
	July 1999	1,3%	2,2%	2,6%	2,8%	2,9%					
	July 2000		2,8%	2,9%	3,1%	3,1%	3,1%				
	September 2000			2,3%							
	July 2001			2,4%	3,1%	3,2%	3,1%	3,1%			
	July 2002			1,8%	1,3%	2,9%	2,9%	3,0%	3,0%		
	September 2002				0,6%	2,3%	2,9%	3,0%	3,0%		
	July 2003					0,8%	2,0%	2,3%	2,5%	2,6%	
	September 2003				0,4%	0,5%	1,9%	2,2%	2,5%	2,6%	
	July 2004					0,3%	1,2%	1,9%	2,0%	2,1%	2,1%
	July 2005							0,0%	1,5%	1,5%	1,7%
	July 2006							0,0%	1,5%	1,5%	1,2%
	June 2007							0,1%	1,9%	2,0%	1,9%
Actual Data**	Istat (SEC 1995)	1,46 %	3,69 %	1,82 %	0,45 %	- 0,02 %	1,53 %	0,66 %	2,04 %	1,48 %	- 1,32 %
	Istat (SEC 2010)	1,56 %	3,71 %	1,77 %	0,25 %	0,15 %	1,58 %	0,95 %	2,01 %	1,47 %	- 1,05 %

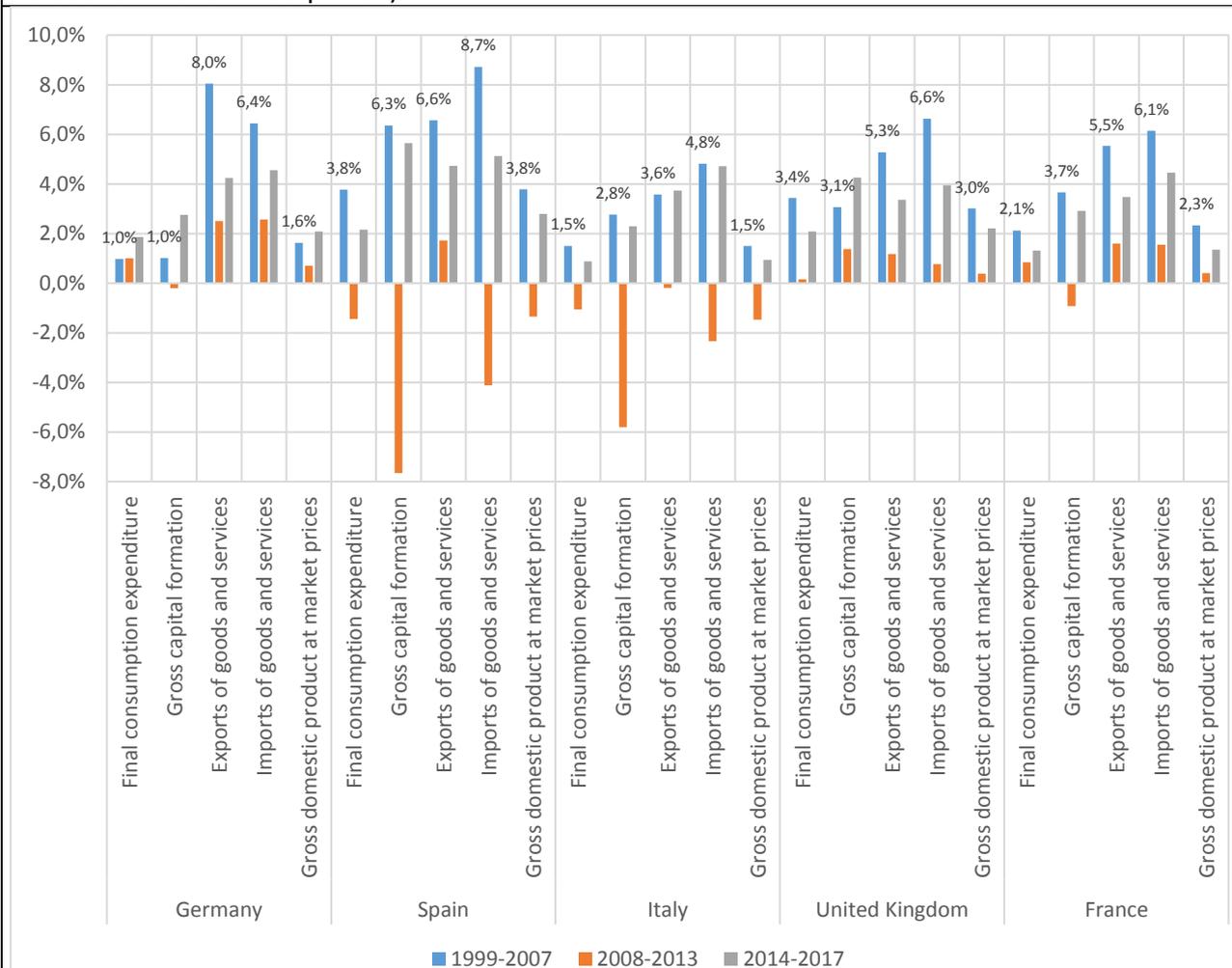
*The name July and June n refers to the data of the Economic and Financial Documents published in the months of June and July of year n; the name September n refers to the data of the Economic and Financial Documents published in autumn of year n.

** With reference to data published by Istat, according to the European system of integrated economic accounts SEC 1995 and SEC 2010.

In general, each draft budgetary plan estimated an increase in the real GDP for the following year of about 3% or 2%. This growth would have primarily been guided by the increase of the domestic demand. Furthermore, great expectations were held for the growth of investments. On the contrary, net foreign demand was not given much consideration: in general, it was estimated that the influence of imports on the commercial balance would have been greater than that of exports.

But the actual Istat figures confirm with precision only the estimates related to a negative foreign demand. On the contrary, the increase in domestic demand, for which great expectations were held and which was considered the greater beneficiary of the direct action coming from the incumbent government, proved to be overestimated year after year. Its total average value (about 1.5%) was far from the levels it had between 1971 and 1980 (+3.9%) or between 1981 and 1990 (about 2.7%).

Annual growth rates of final consumption, investments, exports, imports and total GDP (average values for the referred period)



Source: Based on Eurostat data.

4. The manipulation of the growth estimates

What did Italy lack with respect to its larger European competitors? In the period at hand, Germany experienced a rather moderate increase in its GDP (+1.6), which resulted not so much from the increase of domestic demand, which was as stagnant as in Italy, as much as from an increasing trend of the trade surplus. This surplus was one of the structural and permanent factors of the country's economic growth in the following years. In Spain, on the other hand, the large flow of investments and the increase in domestic demand allowed the country to obtain an average GDP growth rate of 3.8%, something that later proved to be incompatible with an efficient allocation of investments. In France and the UK there was an increase in domestic demand (something very coveted in Italy) which, together with greater investments, allowed the countries to obtain real GDP growth rates of, respectively, 3% and 2.3%.

If we look at Italy, first and foremost we see very little political will to work out reliable estimates of the future, a characteristic that, based on analyses from European institutions, Italy seems to share above all with countries that had to ask for financial assistance from their partners (Chart 2). Furthermore, this lack of realism in planning economic policy coincides with a certain incapability

manifested by the governments. Although they verified the effective growth data, they continued applying the same development recipe to the country. And although the recipe was devoid of any “yeast”, the governments consistently continued basing their actions on unrealistic growth expectations.

One theory says that there was a systematic desire to win time, that is, to procrastinate the fiscal effort that the adoption of a serious debt reduction plan would have required and to attribute the inadequate adjustment to the “unexpected” slowdown of the economy.

The European Central Bank had already indicated certain deviations between actual data and the objectives set by the single governments in the Stability Programs. The data concerning the budget balances with respect to the GDPs of Greece, Portugal and Italy have the greatest deviations from the estimates. Nevertheless, if we look at the chart below in detail, we will see that out of all the countries, Italy has the largest negative deviation in the annual estimate of the GDP’s growth rate and it is second only to Portugal with respect to triennial estimates.

Chart 2: Deviation from the objectives envisaged in the Stability Programs (1999-2007)								
	Deviation from annual estimate				Deviation from triennial estimate			
	Budget balance with respect to the GDP	Real growth rate (A)	Deflator of the GDP (B)	Nominal growth rate (C=A+B)	Budget balance with respect to the GDP	Real growth rate (A)	Deflator of the GDP (B)	Nominal growth rate (C=A+B)
Belgium	-0,1	0,1	0,1	0,2	-0,5	-0,3	0,4	0,1
Germany	-0,2	-0,3	-0,4	-0,7	-1,7	-1	-0,4	-1,4
Ireland	0,7	1,1	0	1,1	0,3	0,6	0,5	1,1
Greece	-3,5	0,3	0,5	0,8	-5,1	0,1	0,6	0,8
Spain	0,1	0,5	1	1,5	0,3	0,4	1,4	1,9
France	-0,3	-0,3	0,1	-0,2	-1,7	-0,5	0,3	-0,2
Italy	-1	-0,7	0,3	-0,3	-2,7	-1,3	0,7	-0,7
Luxembourg	2,1	1,4	0,7	2,1	-0,1	0,6	0,7	1,4
Netherlands	0,1	0	0,2	0,2	-0,4	-0,3	0,7	0,4
Austria	-0,4	0,1	0,1	0,2	-0,6	-0,4	0,2	-0,2
Portugal	-1,1	-0,5	0,4	0	-2,8	-1,4	0,5	-0,9
Finland	1	0,3	0,2	0,5	0,7	0,3	-0,2	0,1
Euro Area	-0,4	-0,2	0,1	-0,1	-1,5	-0,6	0,3	-0,3

Source: The Stability and Growth Pact: crisis and reform - European Central Bank, Monthly Bulletin, October 2008

This demonstrates that the Italian authorities, more than the rest, committed errors in their estimates of future growth.

After the adoption of the Treaty of Lisbon, the European Semester was introduced. In the course of the semester the growth estimates contained in the budget documents presented to the national

authorities are submitted to the European Commission for appropriate verification based on the Winter Forecasts. Since then it has not been possible to approve the draft budgetary plans with completely unrealistic growth estimates.

5. Opportunism or myopia

The macroeconomic conditions during the crisis produced other forms of uncertainty in estimation that have undermined the reliability of the planned public finance objectives. In particular, it was wrong to consider the crisis an “American problem” from which Europe would have quickly exited. At that point a pattern formed in public finance aimed at, on the one hand, a very modest fiscal adjustment in the current year and on the other, a commitment to implement a very ambitious adjustment in the upcoming years, in which a powerful rebound of the economic cycle is expected to take place.

From the analyses of the draft budgetary plans presented each April in the last decade we can see that the reduction of the debt has been the primary objective. However, we can also see that the governments that have succeeded each other in the last decade have had different methods for containing the debt, methods with diverse levels of intensity.

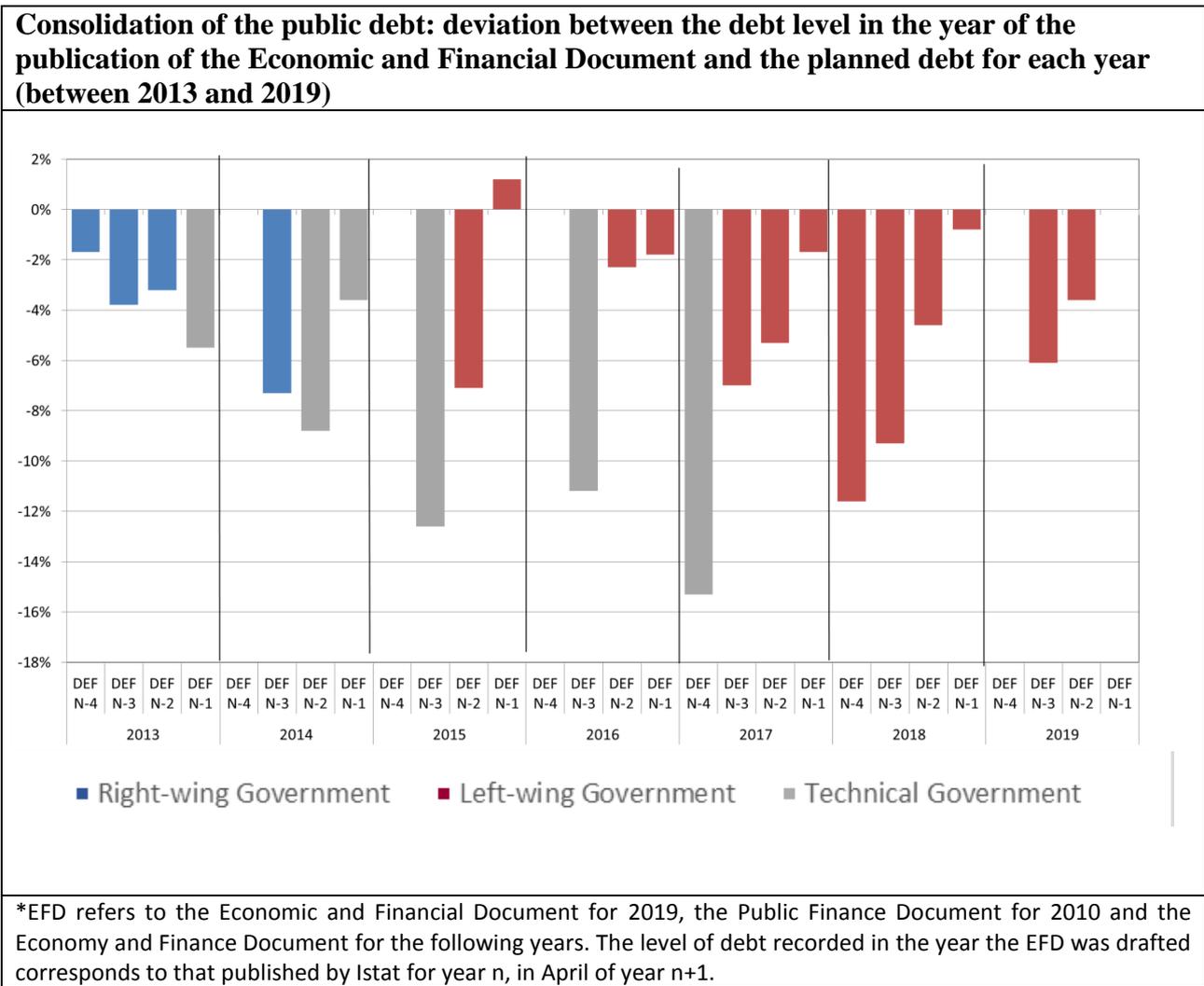
With the aim of illustrating the various methods implemented for reducing the debt by the various governments, the chart below shows the deviation between the debt level announced by the various draft budgetary plans and the debt level recorded each year the documents were drafted.

Even with a simplified analysis we can see what the reduction expected by the government was starting with the current debt: concerning 2013, for example, we see that the Berlusconi government, in 2009 (to year $n-4$), had envisaged a debt level lower by only 1.7 percentage points of the GDP with respect to the current debt level recorded in 2009. This government’s debt reduction program proved to be rather prudent, even though the current debt level is almost twice that envisaged by the Maastricht Treaty.

It is possible that at that time the incumbent government undervalued the real duration of the crisis, which instead of dispersing progressively in the following years, as happened in the United States, on the European continent only extended and was exacerbated. Probably, underestimating the breadth and duration of the crisis, the government believed that growth would return, something that would have guided the reduction of the debt.

On the contrary, the government presided by Mario Monti paved the way for a steeper adjustment of the debt. Once his government was formed, in 2012, it envisaged a reduction of about 5.5 percentage points of the GDP for the following year and about 15.3 points for 2017.

The various center-left governments inherited this approach. In 2018, the first Economic and Financial Document presented by the Renzi government envisaged a reduction of about 11.6 percentage points with respect to the debt level in 2014. On the other hand, with a public debt that had reached 130% of GDP, it was difficult for the government to set less ambitious objectives.



On the whole, what emerges from the analysis of the last years confirms the substantial inability in evaluating the depth and persistence of the impacts of the financial crisis and of the European crisis on the structural fragility of the Italian economy.

But this “error” has been repeating without corrections ever since Italy joined the Economic and Monetary Union. Since then no one has understood the necessity of reforming and modernizing an economic system that by now is exposed to global competition.