Italian resilience to hardship

ECB and EU must be flexibile to Rome's crises

Marcello Minenna and Edoardo Reviglio

The good news for Italy is that a systemic solution to the banking crisis may soon be implemented. The bad news is that, despite a relatively good start to 2017 in terms of GDP growth, further clouds will overshadow the economy in the second half of the year.

A substantial recapitalisation of troubled banks is underway, with the burden to be shared by a combination of retail and institutional investors. This is in addition to a government contribution of €20bn of capital injections, plus €80bn of state guarantees.

The state-backed recapitalisation includes help for Monte dei Paschi di Siena, the country's third-largest lender, which was given liquidity guarantees and a capital injection under a cabinet decision just before Christmas. MPS failed to raise enough funds in a last-ditch attempt to bring in private capital. The so-called 'precautionary recapitalisation' will force losses on MPS's junior bondholders under new EU bail-in laws.

Restrictive fiscal stance

The second half of 2017 seems more ominous. GDP grew at a faster than expected rate of 0.3% in the third quarter. But the economy could be compromised by the combination of a restrictive fiscal stance and continued monetary tightening due to the European Central Bank's decision to trim its asset purchase programme to €60bn a month from €80bn.

According to the European 'fiscal compact', the successor to the stability and growth pact, Italy should reach a primary surplus of 3.2% of GDP by 2019, starting from 1.5% in 2016, to comply with the medium-term objective of a zero structural deficit.

These objectives are set every three years for each euro country in line with the public debt level and demographic change in each state. The European Commission will classify Italy as a state undergoing 'very bad times' economically and with high public debt. Accordingly, the structural adjustment will be lowered to 0.25% of GDP.

The October earthquake and immigration emergency add to the reasons for further flexibility. As additional government reforms are set to have a positive impact on the budget, the EU can either set Italy a longer period of compliance with the fiscal compact objectives or authorise a temporary deviation from them.

However, the method for measuring the cyclically adjusted budget balance is seriously flawed, given that the indicator is dependent on the volatile and often biased estimate of the output gap. Such estimates have shown very poor predictive power.

Key international institutions such as the Commission, International Monetary Fund and Organisation for Economic Co-operation and Development often provide diverging estimates of the size of the output gap. Significant changes in the estimated structural balance for the same year therefore can occur between different forecasting periods, leading to confusion.

No radical modification

In 2017 the European parliament will start integrating the fiscal compact into secondary EU law and an overall assessment of its implementation. This should be an important opportunity to discuss and define more flexible rules on debt and deficits.

Public sector investment or spending forced by exceptional events such as natural disasters may benefit from special treatment. However, it is difficult to imagine radical modification of the fiscal compact, in view of the policies on enforcing budgetary discipline by Germany and other core EU countries.

The fiscal stance was reconfigured by the government of former Prime Minister Matteo Renzi through a deactivation of safeguard clauses. This would automatically increase VAT rates and other taxes to comply with fiscal thresholds. Now, stricter consolidation appears unavoidable. These measures will probably begin to be felt in early April 2017 with the need for a budget correction worth at least €2bn. In 2018 fiscal adjustment could reach over €20bn, limited to €4bn in 2019. At the moment the major contribution would come from a VAT increase from 22% to 25%.

Upward pressure on rates

Later in 2017 Italy will face higher interest rates on its public debt. The ECB will begin to reduce the pace of its asset purchases from April until December, when the quantitative easing should stop definitively. ECB demand for Italian government bonds (up to €2bn monthly), which allowed over €20bn of saving on interest expenses between 2014-2016, will end and markets will expect higher yields.

The end of QE will put upward pressure on rates in 2018, increasing the refinancing cost of the Italian debt. This will also weigh on the banking system, which will be forced to transfer higher interest rates to the manufacturing sector through increasing financing costs.

The Italian economy appears to be entering another phase of austerity and hardship. However, observers should not forget that, since 1992, Italy has been the most fiscally virtuous country in the EU, with 14 years of near-constant primary surplus (excluding 2014), despite its exceptionally high public debt. Italy will probably continue to show fiscal resilience. But the country's prime requirement is for higher growth, and it is difficult to see where this will come from. ■

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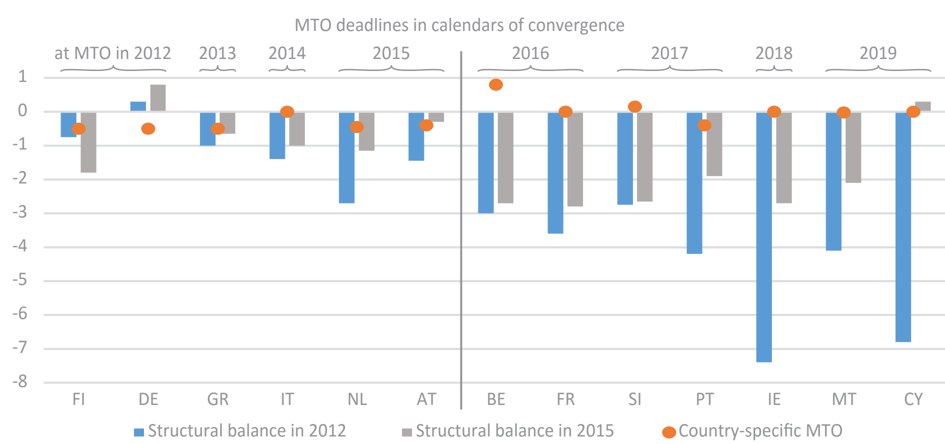
HEADING

Gaps in structural balance relative to 2013 calendars of conversion, % of GDP

Limited convergence towards medium-term objective targets

Structural balance and medium term budgetary objectives, % of GDP, by country



Source: European Commission and European Central Bank calculations

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