// NO.1 | MARCH 2018

ZEW policy brief

Prof. Dr. Friedrich Heinemann, Centre for European Economic Research (ZEW)
and Heidelberg University

Elections in Italy: Ten Facts and Ten Conclusions on Italy's Debt Situation

The key points in brief

With the exception of Greece, Italy is the Eurozone country with the highest debt-to-GDP ratio (132 per cent). In absolute terms, the country accounts for almost one quarter of all government debt in the Eurozone. This situation is compounded by Italy's anaemic potential growth, its adverse debt trend, and Italian banks' strong dependency on exposures to their own government. Among the country's financial strengths are its fairly reasonable level of private debt, its position as a net creditor internationally and its almost total lack of implicit debt. Nonetheless, Italy is at risk of insolvency over the next few years.

The Eurogroup does not have a viable strategy for dealing with an uncooperative Italian government. It is already the case that key criteria of the Stability and Growth Pact (SGP) are, in effect, not being applied to Italy. Italy is regarded as being 'too big to fail', which means that Europe cannot afford to allow the country to undergo a disorderly insolvency. Italian voters' decision to support populist economic policies is therefore to a certain degree rational: by doing so they can justifiably hope to force the ESM and ECB to grant fresh loans, thereby providing a transfer solution to Italy's impending insolvency. The euro area's consistent refusal to discuss reforms around insolvency procedures is now coming home to roost. New stabilisation mechanisms currently being widely discussed as part of the Eurozone reform debate would not do much to help Italy today because the country currently finds itself in a normal cyclical situation. If, after the election, Italy has installed a government which – similar to the Greek government in early 2015 – retracts its consensus with the Eurogroup, this would create a highly risky political and economic scenario that would herald a new phase of considerable political and economic uncertainty and, ultimately, could pose an existential threat to the Eurozone and the EU.

Ten facts about Italy's debt situation

Election campaign based on promises of largesse

Italy votes for a new parliament on 4 March. One feature of the election campaign has been the extent to which the various parties have competed with each other as to who can promise the greatest largesse. On the other hand, substantive reforms of labour markets, the education system and public administration have hardly been discussed. In order to assess the potential risks posed by a populist new government, it is instructive to examine the facts about the country's debt situation.

1. **Level of government debt:** Italy is the Eurozone country with the highest level of national debt in absolute terms (ahead of France and Germany), having amassed public debt of EUR 2,266 billion as of the end of 2017. Italy therefore accounts for 22.8 per cent of total government debt in the euro area, while generating only 15.4 per cent of Eurozone GDP. With the exception of Greece, Italy has the highest debt-to-GDP ratio, which, at 132.1 per cent, is well above the Eurozone average of 89.3 per cent (all figures: AMECO 2018).
2. **Budgetary position:** Italy's budget deficit has not exceeded the Stability and Growth Pact's (SGP) limit of 3 per cent of GDP since 2012, and amounted to 2.1 per cent in 2017. In structural terms too (i.e. excluding one-off effects and the impact of the economic cycle) the deficit came to 2.1 per cent in 2017 and was therefore well above the medium-term budgetary objective (MTO) of zero per cent. The preventive arm of the SGP has set Italy this MTO as a target. The country's primary balance (i.e. the difference between revenues and expenditures, excluding interest payments) has been positive every year since 2011, with this adjusted surplus amounting to 1.7 per cent of GDP in 2017 (all figures: AMECO 2018). Italy's sizeable deficit is therefore largely due to the interest payments on its substantial stock of debt.
3. **Debt trend:** Whereas the debt-to-GDP ratio for the Eurozone as a whole has been falling since 2014, Italy's debt ratio has risen every year between 2007 (when it stood at 99.8 per cent) and 2017 (with the sole exception of 2015), amounting to 132.1 per cent at the end of 2017. This adverse debt trend is largely a result of Italy's low growth rate. The country has suffered a lost decade in terms of economic growth. Its real GDP in 2017 was still almost 5 per cent below its level in 2008. Italy is currently the only EU country in which the 'snowball effect' is causing its debt levels to rise. This effect denotes the combined impact of economic growth and interest payments on the debt-to-GDP ratio. Across the Eurozone this effect had, on average, a favourable impact last year, reducing the debt ratio by 1 percentage point. In Italy, by contrast, this effect continued to increase the country's debt ratio, which rose by 1.2 percentage points in 2017 (all figures: AMECO 2018).
4. **Extent of the ECB's bond purchases:** With the exception of Spain, Italy is the country that has benefited the most – in relation to its GDP – from the ECB's ongoing purchases of government bonds since March 2015. The central banks of the Eurosystem had Italian government bonds worth EUR 326.7 billion on their balance sheets at the end of 2017. This constituted 19.1 per cent of Italy's GDP and 14.4 per cent of the country's total government debt. Every year since 2015, the central banks' purchases of Italian government bonds have exceeded the country's net borrowing requirements relating to its current deficits (Heinemann 2017, 2018).
5. **TARGET balances:** Banca d'Italia is the largest debtor in the TARGET payment system, with liabilities of EUR 439 billion in December 2017 (ECB 2018a). At the height of the Eurozone debt crisis in August 2012 these liabilities had amounted to only EUR 289.3 billion, and by 2014 they had fallen to EUR 130.3 billion. Thereafter, and especially once the Eurosystem started to purchase government bonds in the spring of 2015, the TARGET liabilities of the Italian central bank repeatedly hit new record levels month after month. The largest creditor in the TARGET system is Germany's Bundesbank, which currently (December 2017) has exposures worth EUR 906.9 billion.
6. **Implicit debt:** The sustainability of a country's public finances can also be jeopardised by 'implicit' debt. Implicit debt provides information on the extent to which the government has undertaken to provide future benefits that are not fully funded by taxes and social security contributions. High levels of implicit public debt are usually the result of governments making generous pension commitments without taking demographic trends into account. Italy performs well on this criterion compared with other European countries. According to the latest calculations, the country currently has no implicit debt at all. The EU Sustainability

Ranking for 2017 published by Stiftung Marktwirtschaft (Stiftung Marktwirtschaft 2017) states that Italy has implicit debt of minus 2 per cent of GDP. By contrast, the average implicit debt among the EU-28 is 132 per cent of GDP, which exceeds the level of explicit debt.

7. **Balance on current account and external position:** The Italian economy's current account has been in surplus since 2013. This surplus amounted to 2.3 per cent of GDP in 2017 (AMECO 2018). Italy is also a net creditor internationally (Gros 2018). The country's high level of government debt is therefore not accompanied by a high level of external debt.
8. **Private debt:** Private-sector debt in Italy amounted to 85.7 per cent of GDP in 2016. This is a fairly reasonable figure compared with other countries and is just below the Eurozone average of 88.8 per cent (all figures: World Bank 2018).
9. **Close ties between banks and government:** Italian banks' exposure to the state is well above the EU average. The Italian banking system's total exposure to the Italian government amounted to 171 per cent of their equity (Tier-1 capital) in June 2016. Meanwhile, the Eurozone average for banks' exposure of this kind to their own governments is 119 per cent (Véron 2017).
10. **Non-performing loans:** In Italy, 15.2 per cent of all bank loans outstanding at the end of 2016 were classified as non-performing (i.e. loan repayments were at least three months overdue), while the Eurozone average was 6.2 per cent (all figures: ECB 2018b).

Ten conclusions on fiscal policy and the importance of the Italian elections for Europe

1. **Italy faces a significant risk of insolvency:** With its combination of high and still rising government debt coupled with anaemic potential growth, Italy is now probably the Eurozone country most at risk of suffering the Greek fate of de facto insolvency over the next few years. A renewed economic downturn or a sharp rise in interest rates (for example once the ECB discontinues its bond purchases) could accelerate the increase in Italy's debt-to-GDP ratio.
2. **The debt criterion of the SGP is being ignored:** Italy is already the main reason for the lack of consistency in the application of key elements of the SGP. The corrective arm of the SGP stipulates that Eurozone countries with debt-to-GDP ratios of more than 60 per cent should reduce the difference between their debt ratios and the 60 per cent benchmark by one-twentieth per year. This imposes on Italy the obligation to reduce its debt-to-GDP ratio by more than 3 percentage points each year. Italy is nowhere near meeting this criterion, as its debt continues to rise despite the country's economic recovery. Nonetheless, and in spite of the fact that Italy's current deficit has made hardly any measurable progress towards achieving its medium-term budgetary objective (MTO), the European Commission has, for political reasons, so far decided against initiating proceedings against the country. If a new Italian government were to loosen fiscal policy further without any sanctions being swiftly imposed by the European Commission, the SGP would lose all credibility.
3. **Legacy non-performing assets on banks' balance sheets are preventing completion of the European banking union:** The issue of high levels of legacy non-performing assets on Italian banks' balance sheets is one of the main obstacles on the path to the completion of the European banking union through the establishment of a European deposit insurance scheme. Such a scheme would socialise large amounts of legacy non-performing assets in national banking systems, which would not command a consensus within Europe.
4. **Eurozone reforms currently being discussed will be of little help:** The current reform debate on the future of the euro area is largely focused on the possibility of establishing new stabi-

lisation mechanisms that could mitigate symmetric and asymmetric shocks. These mechanisms would not help Italy at present. The European Commission has calculated that Italy's output gap (i.e. the difference between its actual growth and potential growth) amounted to just 0.6 percentage points in 2017 (AMECO 2018) and will have closed entirely by 2018. Italy's main problem today is not that it is in a cyclical downturn – it is that it has a low potential growth rate of less than 0.5 per cent.

5. **A comprehensive policy of reforms could mitigate the risks:** The next Italian government could reduce the country's risk of insolvency. To achieve this, it could take three courses of action. Firstly, implement sweeping reforms of the country's labour markets, education system and public administration in order to raise the potential growth rate and halt the adverse debt trend by generating stronger growth; secondly, adopt a rigorous approach to imposing higher taxes on the substantial amounts of private wealth in the country; and, thirdly, introduce further spending cuts in order to boost the country's primary surpluses. Such reforms would be aided by the fact that Italy is not burdened with high levels of implicit debt and is not indebted abroad either. However, the election manifestos put forward by the Italian political parties have largely ignored such policies and, on the contrary, have promised significantly higher spending.
6. **Europe is vulnerable to blackmail:** Populist fiscal and economic policies adopted by a new Italian government could – with some prospect of success – seek to extract further financial aid and ensure that rules are watered down. Unlike Greece, Italy is unquestionably too big to fail. Its government debt amounts to seven times that of Greece. A further potential hazard is the very close ties between the country's public finances and its banks and the central bank's TARGET liabilities. Given the huge importance of Italian government bonds on the balance sheets of the country's banks, any loss of access to capital markets on the part of the Italian government would trigger the immediate collapse of Italy's banking system, which is already weakened by high levels of legacy non-performing assets. The consequences for the Eurozone would be incalculable.
7. **The ESM alone would not be sufficient to stabilise Italy:** The European Stability Mechanism (ESM) currently has a lending capacity of only EUR 380 billion (once the loans already granted have been deducted from its EUR 500 billion credit limit). The activation of this credit line would be nowhere near enough to contain any panic on Italy's bond markets. Such a panic scenario would therefore require either an expansion of the ESM's lending capacity, an extension of the ECB's bond purchases as part of the public sector purchase programme (PSPP) – an option that would be inappropriate in terms of monetary policy – or an activation of the ECB's OMT crisis facility.
8. **The Eurozone lacks formal insolvency procedures:** The fact that efforts to reform the euro area's organisational structures have so far failed to address the issue of insolvency procedures for highly indebted countries is now coming home to roost. Because there is no orderly solution to the insolvency of a Eurozone country, it is impossible to predict the consequences of a potential insolvency on the part of Italy.
9. **Voting for populist parties is a rational strategy:** Italian voters thus have totally rational reasons for deciding to support populist economic policies. By doing so they can, with some justification, hope to force the ESM and ECB to grant fresh loans, thereby providing a transfer-based solution to Italy's impending insolvency. For many Italians this is, for understandable reasons, a more appealing option than tax increases, spending cuts and sweeping reforms together with the various uncertainties involved.
10. **A populist government in Italy would pose a considerable risk to the Eurozone:** The conclusion to be drawn from all of the above is clear. If, after the election, Italy has installed a govern-

ment which – similar to the Greek government in early 2015 – retracts its consensus with the Eurogroup and turns its back on the path of consolidation and reform, this would create a highly risky political and economic scenario that would herald a new phase of political and economic uncertainty and, ultimately, could pose an existential threat to the Eurozone and the EU.

References

AMECO (2018): European Commission, Economic and Financial Affairs, AMECO Database.

EZB (2018a): European Central Bank, Statistical Data Warehouse, Target Balances.

EZB (2018b): European Central Bank, Non-performing loans, ECB website.

Gros, Daniel (2018): The eurozone as an island of stability, CEPS Commentary, 19 February 2017.

Heinemann, Friedrich (2017): Die Bedeutung der EZB-Anleihekäufe für die Schuldenfinanzierung der Euro-Staaten, ZEW Mannheim.

Heinemann, Friedrich (2018): Zur Aufteilung der PSPP-Anleihekäufe auf die Euro-Mitgliedstaaten, ZEW Mannheim.

Stiftung Marktwirtschaft (2018): EU-Nachhaltigkeitsranking 2017, Press Release on 12 December 2017.

Véron, Nicolas (2017): Sovereign Concentration Charges: A New Regime for Banks' Sovereign Exposures,

Study for the European Parliament, November 2017, PE 602.111.

World Bank (2018): The World Bank Data: International Monetary Fund, Global Financial Stability Report.

Further Information

Contact

Prof. Dr. Friedrich Heinemann

Head of the ZEW Research Department “Corporate Taxation and Public Finance“

Phone 0621/1235-149, E-mail friedrich.heinemann@zew.de

ZEW

Zentrum für Europäische Wirtschaftsforschung GmbH

Centre for European Economic Research

ZEW policy brief series

Publisher: Centre for European Economic Research (ZEW), Mannheim

L 7, 1 · 68161 Mannheim · P.O. Box 10 34 43 · 68034 Mannheim · Germany · Internet: www.zew.de · www.zew.eu

President: Prof. Achim Wambach, PhD · Director of Business and Administration: Thomas Kohl

Editorial responsibility: Prof. Achim Wambach, PhD