COMMENTS ON SESSION 2
MACROECONOMIC DEVELOPMENTS
UNDERLYING THE CRISIS OF THE EURO AREA

MACROECONOMIC AND FISCAL IMBALANCES IN ITALY: A VIEW FROM ESTONIA

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Comments on "Macroeconomic Imbalances and Fiscal Policy in Italy Since the EMU" by Antonio Bassanetti, Matteo Bugamelli, Sandro Momigliano, Roberto Sabbatini and Francesco Zollino

I enjoyed very much reading the paper "The Policy Response to Macroeconomic and Fiscal Imbalances in Italy in the Last Fifteen Years", which is written jointly by Antonio Bassanetti, Matteo Bugamelli, Sandro Momigliano, Roberto Sabbatini and Francesco Zollino. The paper has been revised and has received a new title since it was presented at the workshop in Perugia in April 2013. It is a long and very comprehensive paper seeking to link the fiscal performance in Italy with macroeconomic developments before and after the outbreak of the global financial crisis in 2007-08. The paper is an excellent starting point for a discussion of the different factors that have influenced fiscal policy in Italy and, by extension, in many other European countries since the mid-1990s.

Italy faced serious problems financing its government debt after the outbreak of the global financial crisis and the spreading of the crisis to government debt markets in the periphery of Europe. The spreading of the financing problems to Italy may be attributed to its very large government debt, which must be rolled over continually, but it may also reflect the rather bleak medium-term growth outlook. The prospect of a serious government debt crisis in Italy is particularly disquieting given the size of the Italian economy and the very large government debt. After the relative stabilisation of European government debt markets from the second half of 2012 the pressure on Italy seems to have abated as the interest spread over the German Bund has fallen to a manageable level. At the time of writing in October 2013, Italy seems to have weathered the storm and does not need financial support from the IMF and/or the EU.

The main message of the paper is clearly spelled out. Policymakers abstained in the decade before the global financial crisis from structural reforms that could have stimulated economic growth and from fiscal reforms that could have improved the structural balance and reduced the debt stock. This complacency meant that Italy was ill prepared for the shocks associated with the global financial crisis and the nervousness of government debt markets.

This policy complacency is, convincingly, explained in two stages. The paper refers to the literature on political polarisation, which typically finds that policymaking is less efficient when it takes place in a highly polarised environment. In this case reforms may be postponed in a *war of attrition* due to a conflict over the distribution of the short-term costs of the reforms. The paper continues by arguing that the policy complacency was facilitated or helped along by events in the macroeconomic environment. The creation of the Economic and Monetary Union (EMU) and Italy's subsequent membership of the euro area provided positive impulses to the economy in the form of renewed confidence and lower interest rates on government debt. These developments

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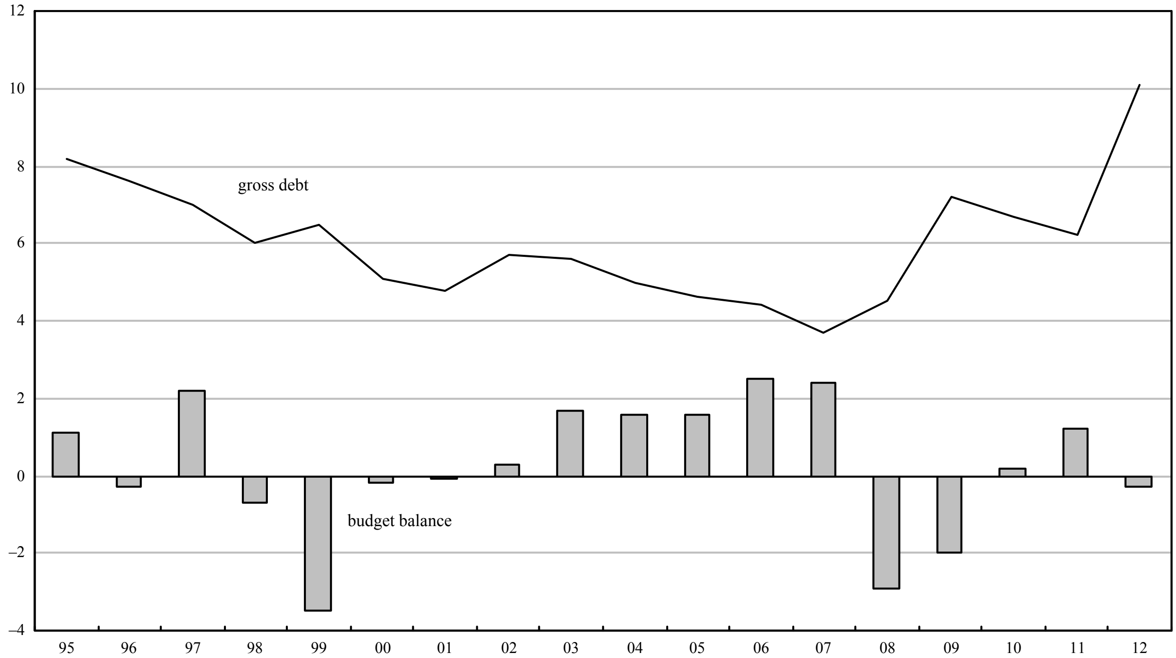
Figure 1

General Government Budget Balance and Gross Debt in Estonia

(percent of GDP)



Source: Eurostat (code: gov_dd_edpt1).

eased the pressure for reform as lower interest rates improved the fiscal position and access to foreign borrowing allowed an expansion of domestic demand. In other words, policymakers in Italy wasted the opportunities afforded by the euro and abstained from the structural reforms that might have stimulated economic growth and the fiscal reforms that could have improved the structural balance and reduced the debt stock. The authors aptly label the years 1998-2007 the "lost decade".

The explanations for the policy complacency in the paper are important, but are hardly the whole story. Many countries in Europe are more polarised than Italy and have large ethnic minorities, multiple languages and a very unequal income distribution. This applies for instance to my own country, Estonia, to which history in many ways has dealt an unfavourable hand of cards. Not only Italy, but also many other countries in Europe benefited from the benign macroeconomic environment during the *Great Moderation*. Most countries in the European periphery experienced large or increasing capital inflows and lower long-term interest rates in the pre-crisis period. This also applies to Estonia where lower capital inflows and lower interest rates brought about an unprecedented boom from 2000 to 2007.

Although polarised and greatly affected by external economic developments, Estonia has managed to retain an essentially balanced budget each year since the mid-1990s and has consequently accumulated a very modest gross debt (Figure 1). The prudent stance was also retained in 2009 when Estonia experienced an output decline of more than 14 per cent. Deep spending cuts, tax increases and additional revenue sources ensured that the deficit remained below the limit set in the Maastricht Treaty, and this helped Estonia gain membership of the euro area from January 2011. The fiscal prudence of Estonia might be related to its past as a transition country, but other former transition countries faced financing problems in 2008-09.

It is striking how the global financial crisis affected countries across Europe in different ways. The paper by Bassanetti *et al.* brings up important factors that apply for Italy, but the comparison with Estonia suggests that other factors could also play a role. Studies comparing fiscal policy and economic performance across different European countries would be likely to provide additional insights. It might be particularly useful to estimate fiscal reaction functions in order to ascertain the effect on the fiscal stance of different developments in the economy. Fiscal reaction functions have for instance been used to assess the response of the primary balance to interest payments or the debt stock. Positive feedback from the debt stock to the primary balance is often seen as a precondition for fiscal sustainability (Bohn 1998).

Some studies suggest that the fiscal stance generally exhibits more persistence in western Europe than in eastern Europe (Staehr 2008, Cuestas and Staehr 2013). This seems consistent with experiences in Italy and Estonia; policymakers in Italy have been reluctant to undertake reforms that would fundamentally change the fiscal course, while policymakers in Estonia have been more assertive. A recent study estimating the reaction of the primary balance finds that there was little feedback from the debt stock and interest payments in countries across Europe before the crisis, but a strong feedback from the debt stock after the crisis, in particular for the countries experiencing debt financing problems (Baldi and Staehr 2013).

Capital inflows and low interest rates facilitated fiscal complacency but may also have led to complacency in other respects. One example is the perception of what can be considered a "reasonable" interest rate on long-term government debt and which interest rate is incompatible with fiscal sustainability. From 2009 it became virtually "perceived wisdom" that an increase in the long-term interest rate to 6-7 per cent was a signal of emerging financing problems, suggesting that a bailout was needed. Given the ECB inflation target of close to 2 per cent, a nominal interest rate of 6-7 per cent entails a real (expected) interest rate of 4-5 per cent. This is not far from what is frequently seen as a good proxy of the steady-rate long-term interest rate. It is for instance close to the steady-rate outcome in many intertemporal optimisation models in which the quarterly discount rate is 0.99. It is also the level of the real interest rate observed in many OECD countries over extended periods of time (Orr *et al.* 1995).

It is striking that nominal interest rates of 6-7 per cent and hence (expected) nominal interest rates of 4-5 per cent had become to be seen as unendurable at the time of the outbreak of the global financial crisis. The interest rate would only apply to new debt or to debt that is rolled over; much of the government debt was after all financed at much lower interest rates due to the collapse of the spread between the interest rates of most euro area countries and the German Bund rate. It is worrying if fiscal policy in Italy and elsewhere in Europe has relied on the assumption that the real interest rate would remain substantially below a level that traditionally has been seen as a steady-state level. The *Great Moderation* in the pre-crisis period may thus have caused a form of "expectational complacency" that have led to a fiscal stance that is only sustainable if the real interest rate is substantially below its long-term level.

The authors make a strong argument for a link between the overall macroeconomic performance and the fiscal stance and argue that structural reforms in the pre-crisis period could have raised trend growth and thus strengthened the fiscal situation before the outbreak of the global financial crisis. There is a lot to support this view; given the fiscal *policy* stance, faster economic growth and a higher income level would be likely to improve the fiscal balance. This argument, however, rests on two assumptions. The first assumption is that there is a clear link between structural reforms and economic growth, even though things might be more complicated in practice. The reforms might entail costs in the short term or produce unanticipated effects, so that it is difficult establish a direct link between reforms and growth (Blanchard, 2004; Aiginger, 2005).

The second assumption is that the fiscal *policy* would not react to the improved macroeconomic outlook. This might be the case, but the experience in Italy in the period before the global financial crisis was exactly that the policy stance changed in reaction to changed fundamentals, in this case lower interest payments. Higher income or stronger trend growth may have led to a similar relaxation of the policy stance and thus had a very limited impact on the fiscal stance. At a more general level it is worth noting that countries across the world have very different income levels and trend growth and it would be unfortunate if only the countries with fortuitous developments exhibited a prudent fiscal stance.

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