Balancing fiscal adjustment and internal devaluation in Italy

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Workshop on „Italy's challenges in the midst of the euro-crisis"

Session 1. Italy - short/medium run issues: fiscal adjustment and internal devaluation

Bruegel and Dipartimento del Tesoro workshop, 8 May 2013, Rome

26 April 2013: Italy Credit Analysis by Moody's

- **Italy's Baa2 long-term government bond ratings with the negative outlook affirmed, because:**

- **Growth problem:** "Italy's subdued economic outlook as a result of weak domestic and external demand and a slow pace of improvement in unit labour costs relative to other peripheral countries;"
- **Banking problem:** " the negative outlook on Italy's banking system;"
- **Sovereign debt problem:** "the elevated risk that the Italian sovereign might lose investor confidence and, ultimately, access to private debt markets as a result of the uncertainty over future policy direction, as well as contagion risk from events in other peripheral countries."

Where do we stand?

		1998-2007	2008	2009	2010	2011	2012	2013	2014
GDP growth	real potential	1.3	0.3	-0.3	-0.2	0.2	-0.8	-0.4	-0.2
	real actual	1.5	-1.2	-5.5	1.7	0.4	-2.4	-1.3	0.7
	nominal	4.0	1.3	-3.5	2.1	1.7	-0.8	0.2	2.3
Output gap		1.5	1.7	-3.6	-1.8	-1.6	-3.1	-4.0	-3.2
Primary balance	actual	2.8	2.5	-0.8	0.1	1.2	2.5	2.4	3.1
	structural	n.a.	1.3	0.5	0.9	1.4	4.1	4.8	4.9
Balance	actual	-2.8	-2.7	-5.5	-4.5	-3.8	-3.0	-2.9	-2.5
	structural	n.a.	-3.8	-4.2	-3.7	-3.6	-1.4	-0.5	-0.7
Gross debt		107.2	106.1	116.4	119.3	120.8	127.0	131.4	132.2

Based on 2 May 2013 ECFIN forecasts.

GDP growth: % change from previous year; all others: % of GDP

Where do we stand?

Weak pre-crisis growth; negative potential growth now

		1998-2007	2008	2009	2010	2011	2012	2013	2014
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Current nominal growth is close to zero

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Where do we stand?

Large negative output gap

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Where do we stand?

Major fiscal adjustment in 2012; current structural prim.surplus is 4.8%

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Where do we stand?

Current overall structural deficit is only half percent

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Where do we stand?

Debt over 130% of GDP

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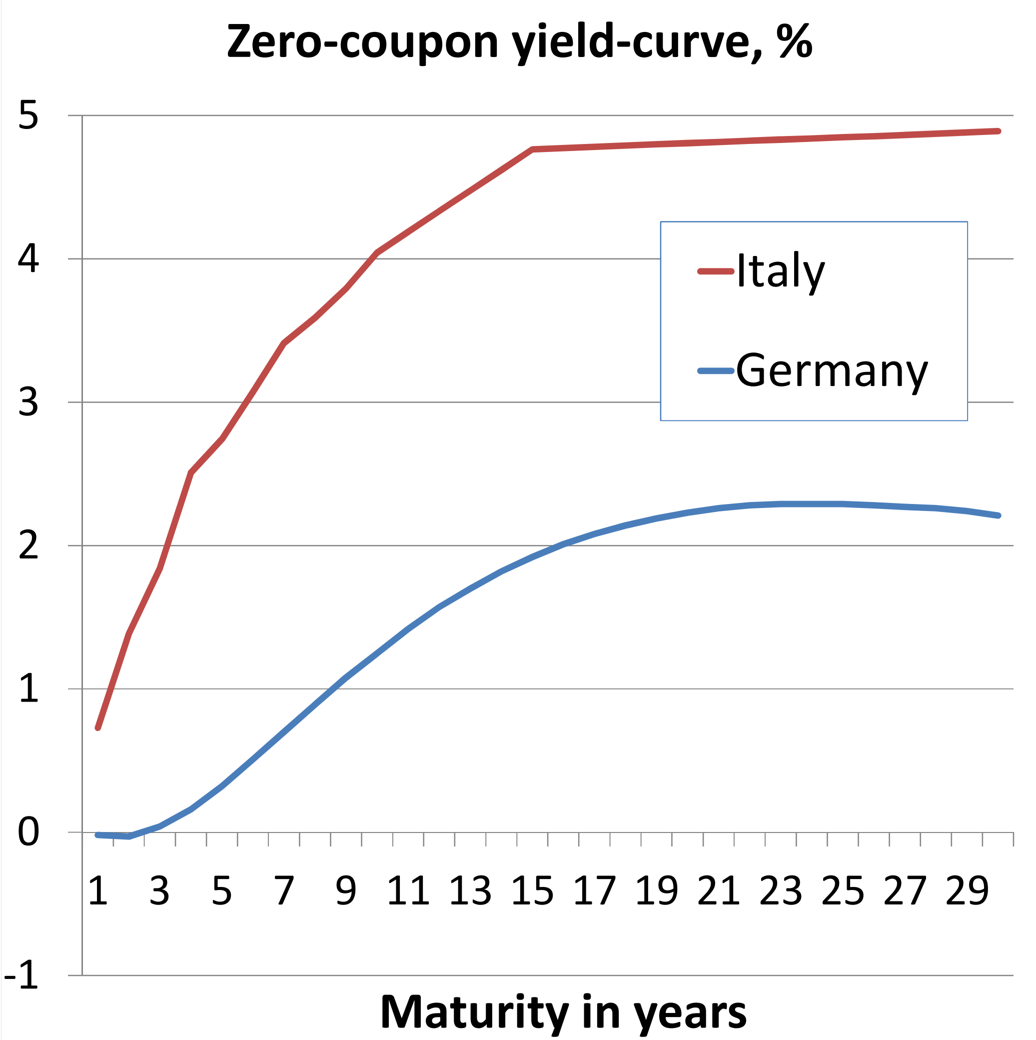
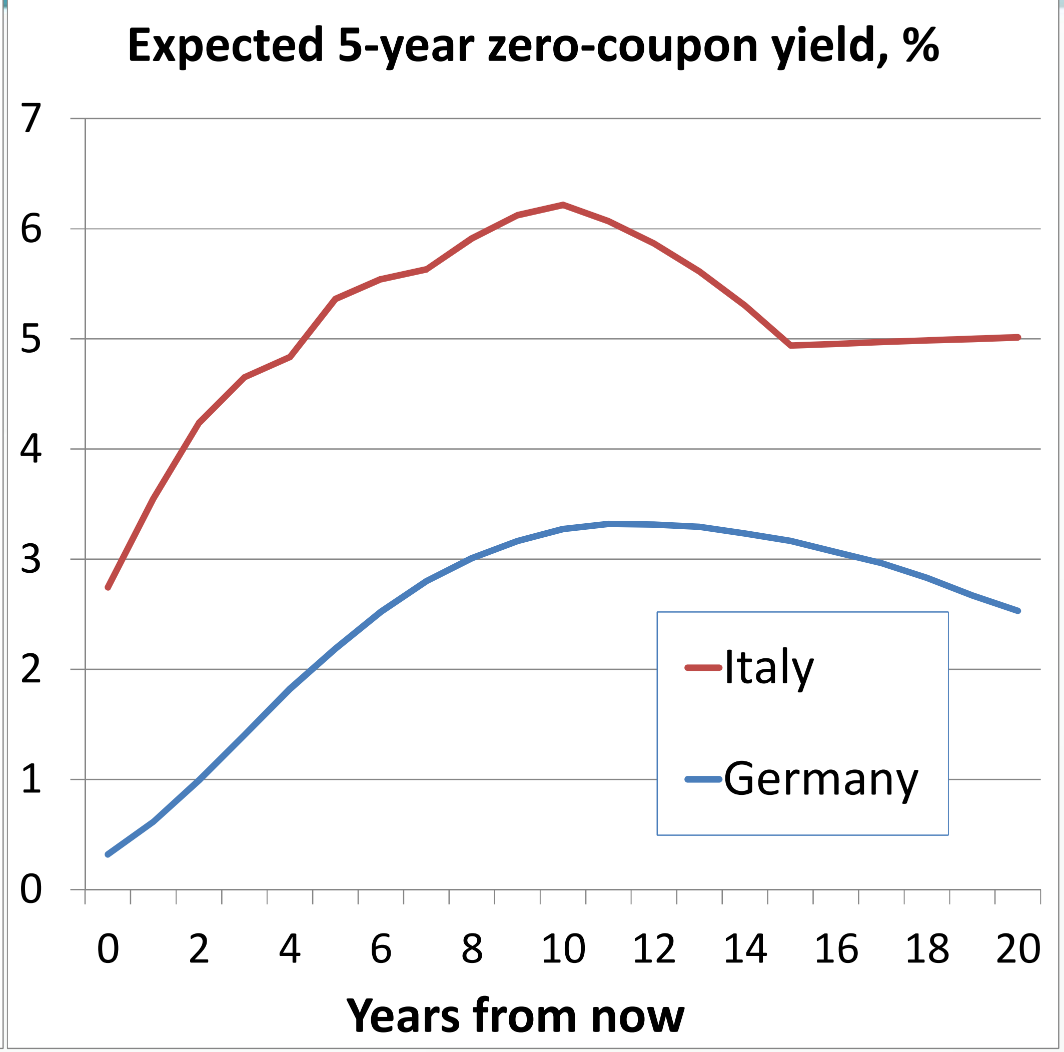
Where do we stand?

Current 10-year yield is below 4%, but yields are expected to increase



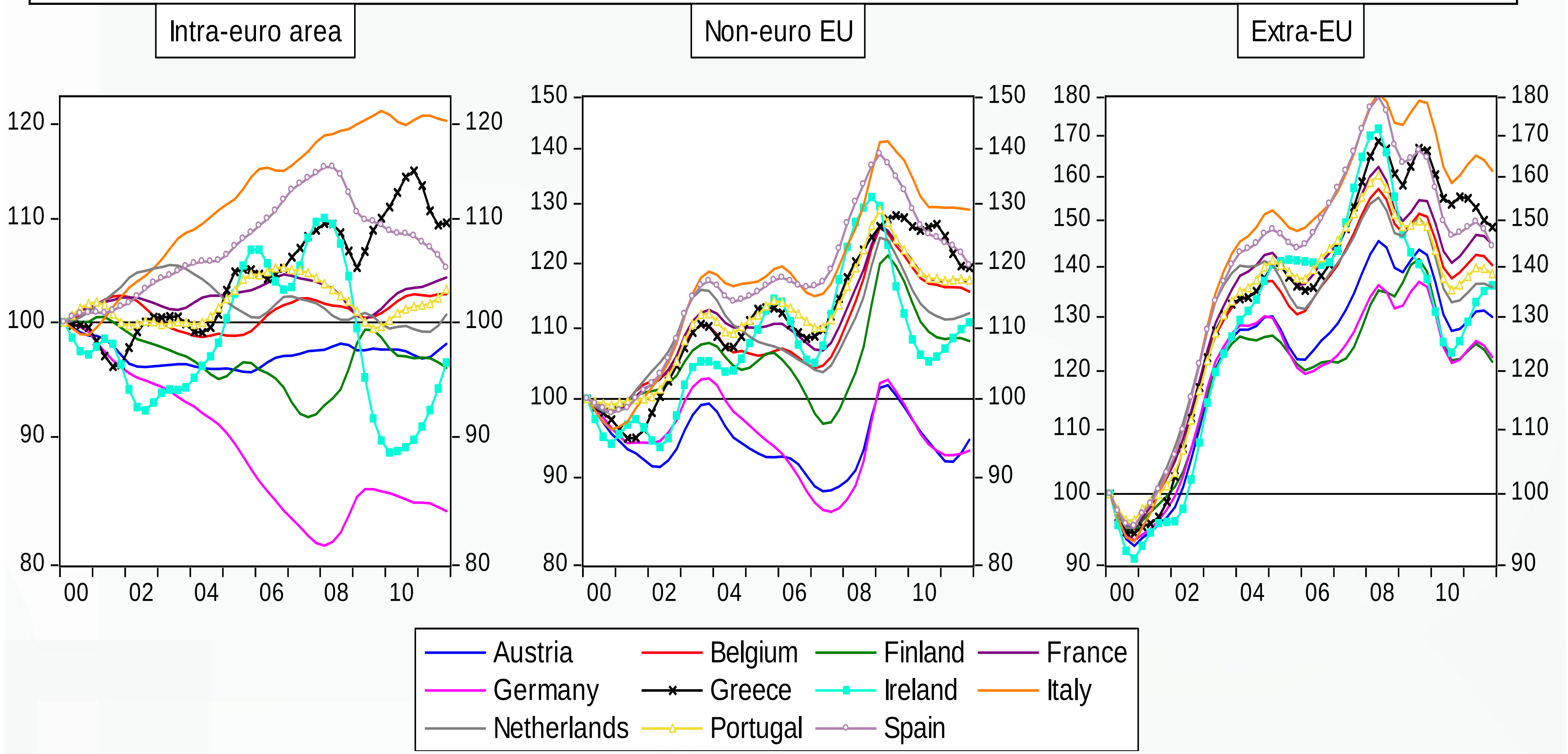


For Italy, maturities up to 10 years, plus 15/20/25/30 years were available, the rest is our approximation. Expected yield: calculated on the basis of the expectation hypothesis of the term structure (EHTS). Based on 6 May 2013 data.

Where do we stand?

Italy's pre-crisis unit labour cost (ULC) divergence has not corrected

ULC-REER against different trading partners, 2000-2011

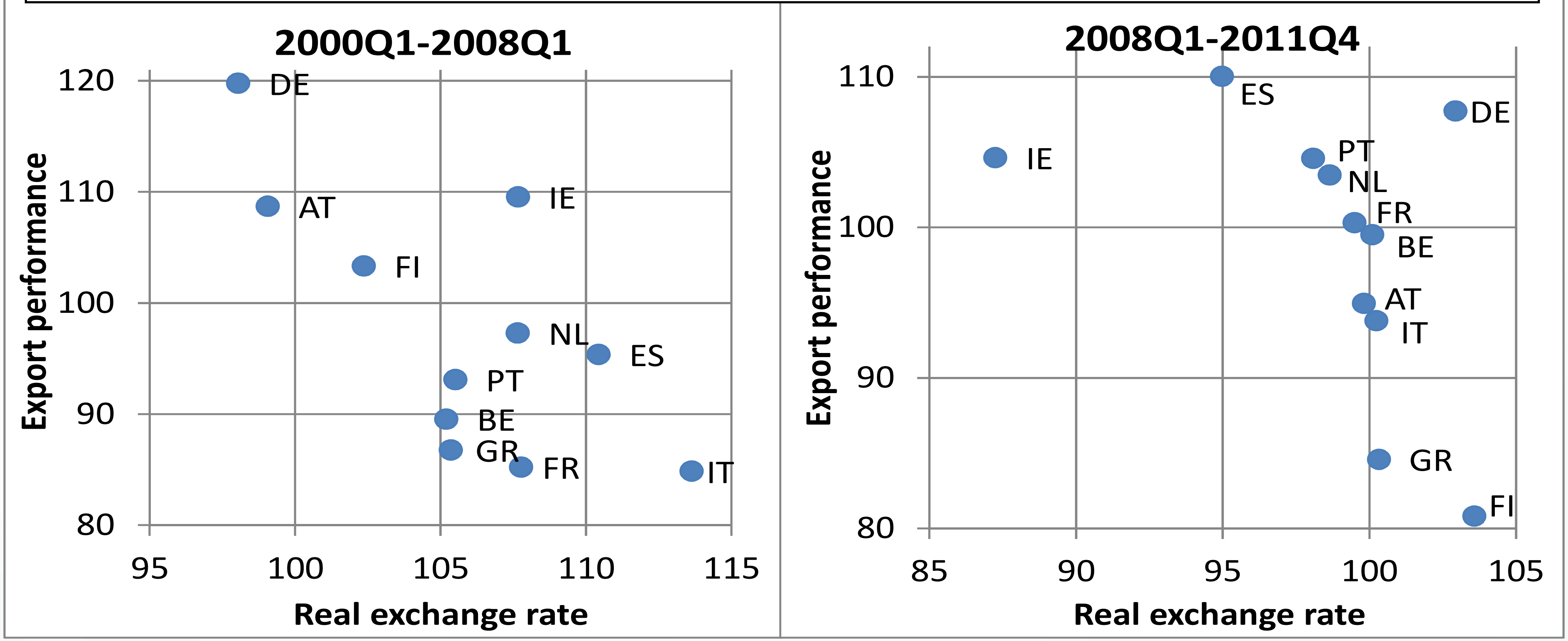


The ULC-REER refers to the business sector excluding agriculture, construction & real state; constant sectoral weights

ULC divergences: do they matter?

Strong correlation between pre-crisis export performance and ULC

ULC-based real exchange rate vs. export performance – before and after 2008Q1



REER ULC for the business sector excluding construction, real estate services and agriculture, calculated with constant sectoral compositions

How to foster ULC REER adjustment?

Fiscal consolidation and internal devaluation are related

- Domestic ULC decline: production ⇧, employment ⇩, wages ⇩
- ULC increases of the ‘northern’ euro-area trading partners
- Absent wage/price increases in the North, South needs deflation, which is difficult to achieve and worsens debt sustainability
- The relative fiscal position between „North” and „South” matters (Merler and Pisani-Ferry 2012)
- Weaker euro

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The questions

- Beyond the vitally important structural reform agenda, the ULC-REER needs to depreciate
- With a structural primary surplus of 4.8% of GDP and very weak economic performance, the case for further fiscal consolidation to depress prices is not strong
- Questions:
  - What to expect in terms of debt dynamics from an unchanged fiscal stance?
  - What if German inflation remains low and Italy needs to reach zero inflation?
  - What if the interest rate spread to Germany is reduced?

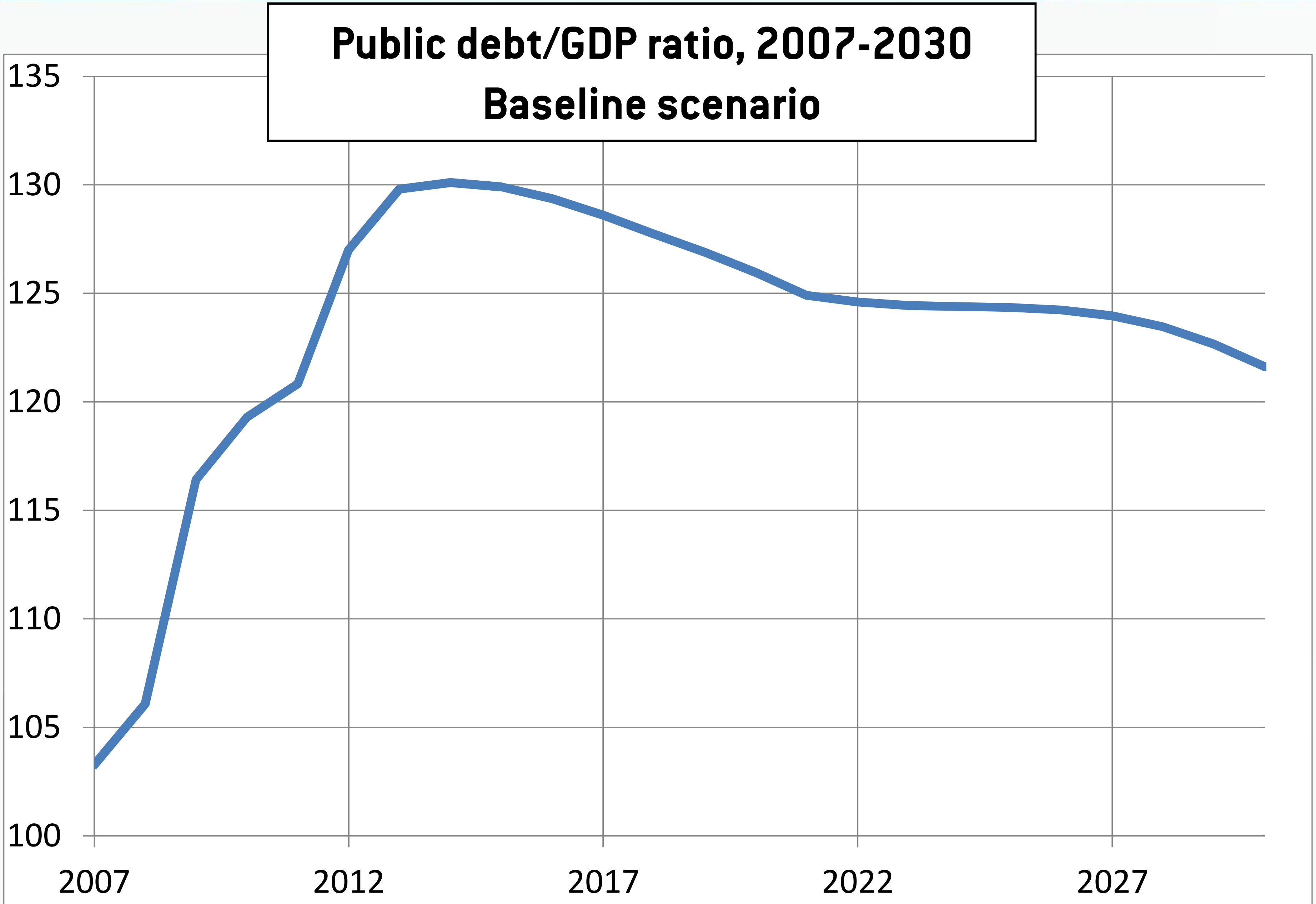
Public debt simulations

Baseline

- Baseline assumptions:
  - Potential growth gradually accelerates from zero to 1% per year in 10 years
  - The current 4% output gap is eliminated in 8 years
  - GDP deflator changes 1% per year
  - No change in the structural primary surplus as % of GDP
  - Interest rates as implied by the term structure
  - Duration of public debt is 6 years

Public debt simulations

Baseline scenario: too slow decline in the debt ratio



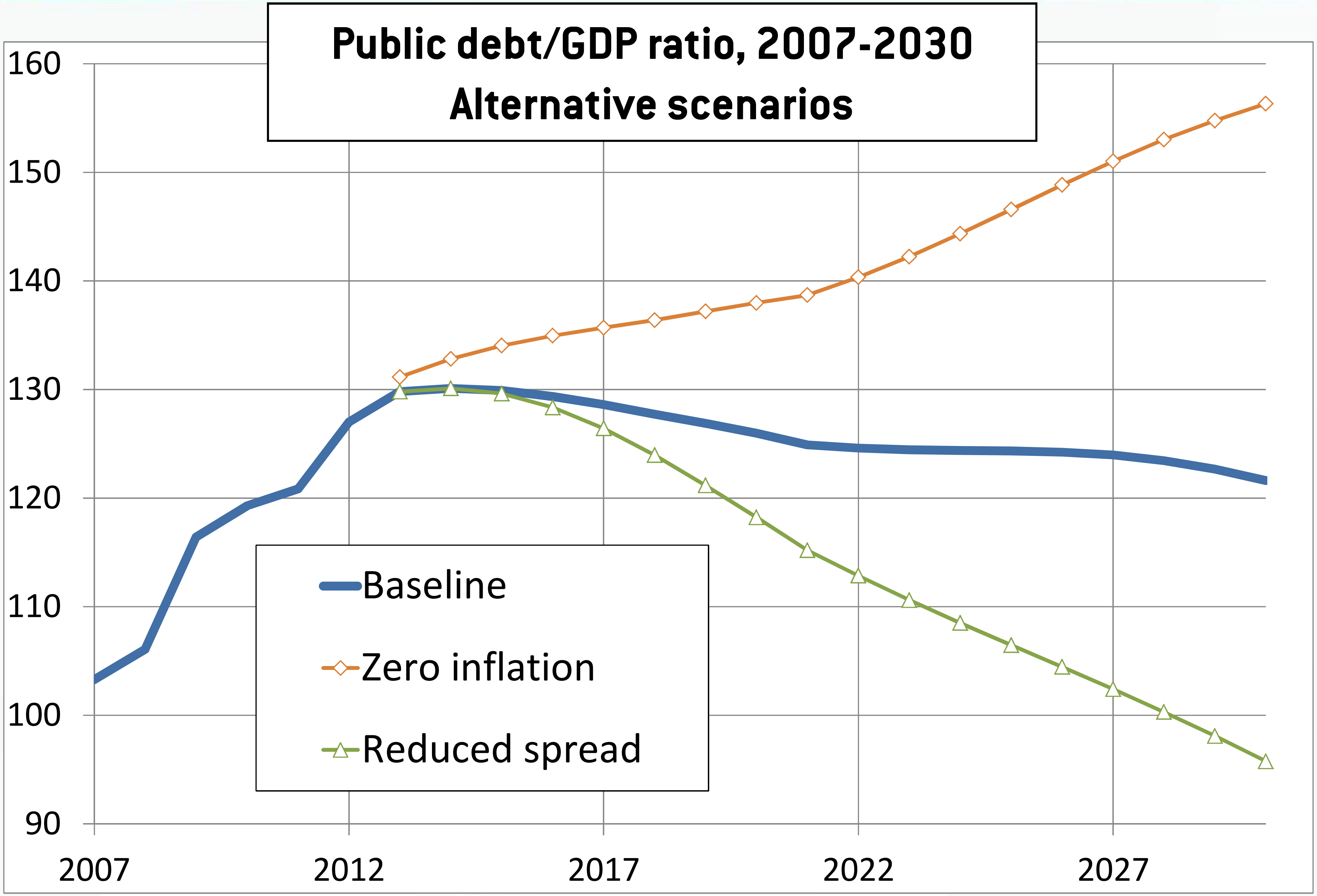
Public debt simulations

Alternatives

- Alternative scenarios:
  1. No change in GDP deflator (instead of the 1% annual inflation)
  2. Interest rate spread to Germany is reduced from the current 260bps to 150bps by 2015 and stays there (instead of market implied yields)

Public debt simulations

Alternative scenarios: rather sensitive



Trade-offs

- Assume alternative scenario 1:

  1. No change in GDP deflator (instead of the 1% annual inflation)

⇨Then a permanently 1.3% of GDP higher structural primary surplus leads to the same debt dynamics

- Assume alternative scenario 2:

  2. Interest rate spread to Germany is reduced from the current 260bps to 150bps by 2015 and stays there (instead of market implied yields)

⇨ Then a permanently 1.2% of GDP lower structural primary surplus leads to the same debt dynamics

Conclusions

Balancing fiscal adjustment and internal devaluation in Italy

- Current state: depressed economy (-4% output gap), large structural primary surplus (4.8%), some but insufficient market confidence
- ULC has not yet adjusted
- The pace of baseline debt reduction is too slow
- Maybe I was too conservative. But if not?
- What to do (beyond reforms, fighting tax evasion, etc)?
  - Consolidate further? Can be self-defeating
  - Fiscal devaluation (higher consumption&property taxes, lower labour taxes)? New government wants to reduce consumption&property taxes
  - Beg a low interest rate? Won't come
  - Ask for precautionary programme to enhance credibility and activate OMT? Politicians are too pride
  - Argue for more symmetric intra-euro adjustment
  - Hope for a weaker euro
- Is Moody's risk perception right?

Thank you for your attention

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