Are Italian Public Debt Forecasts Too Optimistic?

blogs.lse.ac.uk/eurocrisispress/2015/05/22/are-italian-public-debt-forecasts-too-optimistic/

Italy, a history of large public debt

Italy has the third largest stock of public debt in the world, the second in the euro zone next to Greece and the highest debt service ratio in the G7.

The last point is particularly important to understand the difficulties of managing Italian public debt. Japan holds roughly twice of the Italian public debt, but it spends less than one percent of GDP to service its public debt while Italy spends 5.4 percent of GDP.

The burden of interest payments and slow growth have heavily contributed to enhancing the weight of debt, developing a dangerous vicious circle.

However, there are several optimistic forecasts on debt dynamics (IMF, European Commission, OECD). This is the result of the deep efforts which have occurred in recent years, in particular since 2012.

The objective of this post is to discuss the projections of Italian debt under scenarios simulated by the OECD, IMF and others.

To do this, it is required to understand debt sustainability, analyzing short concepts about it.

By Maryb60 [CC BY-SA 3.0], via Wikimedia Commons

Debt sustainability: a short review

Above is the standard equation which describes changing debt-to-GDP ratio (see Blanchard (2010) or Farmer(1998), *Macroeconomics*). This equation states that debt changing is the sum of two terms.

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = (r - g)\frac{D_{t-1}}{Y_{t-1}} + \frac{G_t - T_t}{Y_t}$$

The first represents the difference between real interest rate (alternatively) and rate of growth multiplied for the outstanding debt. So if the real interest is higher than growth the debt level will increase and vice-versa.

The second term is the primary balance. When public spending is greater than revenue the debt level will rise.

Summarizing, if the rate of growth is lower than the real interest rate, to avoid increasing the debt-to-GDP ratio, governments need to make the relevant primary balance. Instead, when "g" exceeds "r", even with public deficit, debt dynamics will be sustainable.
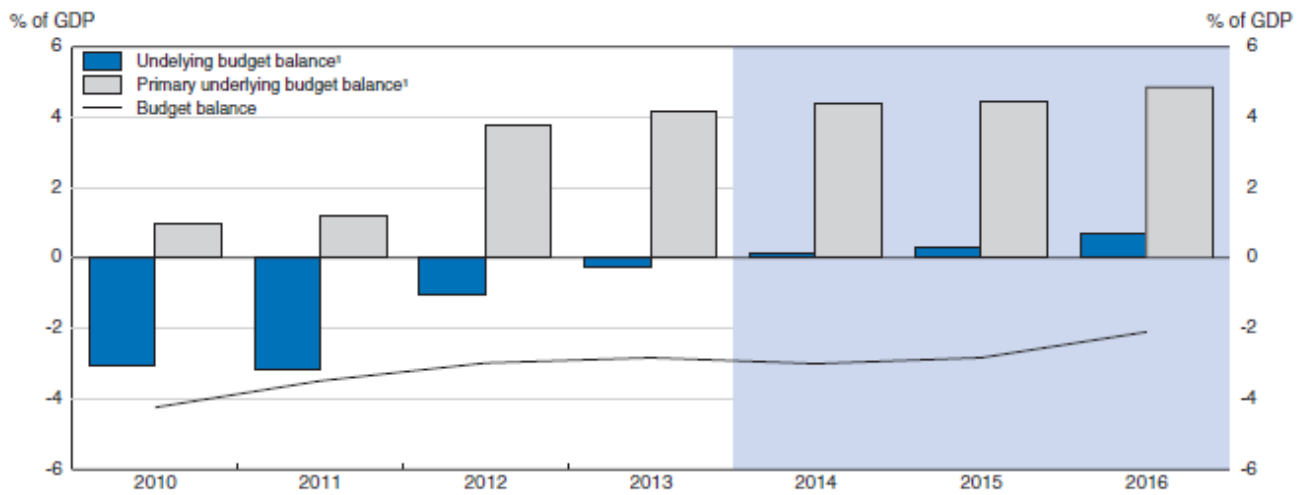
As it will be fairly easy to understand, the last instance does not concern the Italian case. Unfortunately the high level of interest expenditure and the low growth forces it to obtain positive primary balance.

Figure 1

(The underlying primary budget surplus is now large)

1. As a percentage of potential GDP.
Source: OECD Economic Outlook 96 (database).

StatLink http://dx.doi.org/10.1787/888933184721

Since 2012 Italy has improved its fiscal situation (Figure 1), setting the condition to reverse the debt-to-GDP path when growth returns (OECD survey, 2015). The budget balance, without interest payments and adjusted for the cycle, has improved by 4-5% since 2009.

Table 1

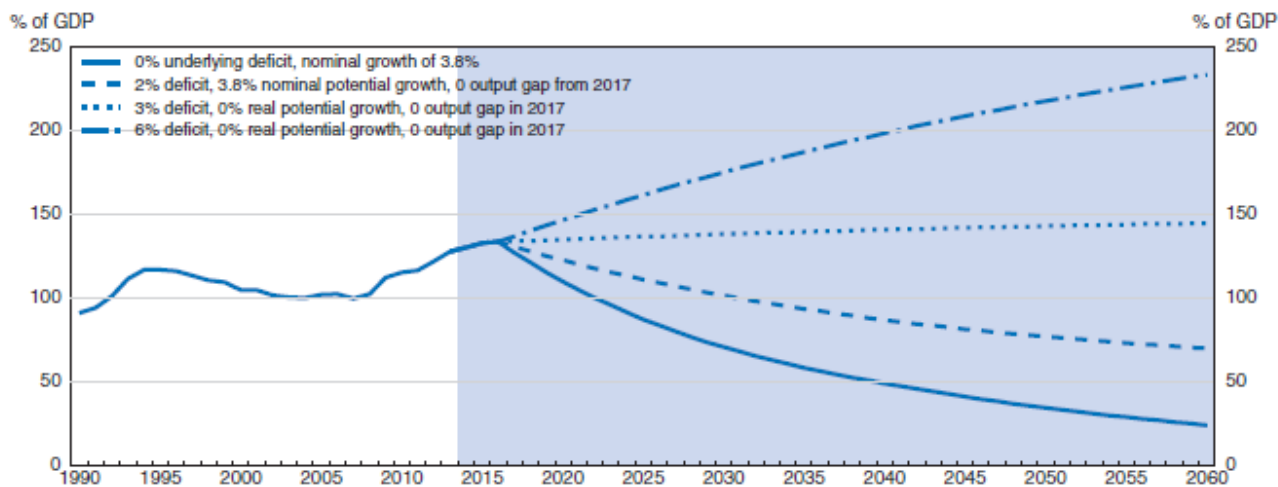|	Structural budget balance (structural primary balance), % GDP							
	2011	2012	2013	2014	2015	2016	2017	Level of debt predicted for 2017, % GDP[1,2]
2012	-3.6 (1.3)	-0.9 (4.6)	0.0 (5.9)	-0.2 (5.7)	-0.4 (5.7)			105
2013	-3.6 (1.4)	-1.3 (4.3)	-0.4 (5.0)	-0.3 (5.1)	0.0 (5.3)	0.0 (5.3)	0.0 (5.2)	115
2014		-1.5 (3.7)	-0.7 (4.2)	-0.9 (3.8)	-0.6 (4.0)	-0.4 (4.1)	0.0 (4.2)	125

1. Debt due to financing the EFSF and ESM, about 3.6% of GDP, is excluded. Debt projections in the original budgetary documentation have been adjusted to take account of the revised system of national accounts.
2. The 2012 budget did not project debt beyond 2015; the table shows an estimate for 2017 based on the projected figure for 2015.
Source: Ministry of Finance, "DEF Update" for successive years.

The Ministry of Economic and Finance estimates that structural budget will reach balance in 2017. If that occurs, Italy should obtain about 4.2% of the primary structural balance in the same year.

Sustaining this strong fiscal position will depend to a large extent on Italy's ability to keep the confidence of financial markets and to secure low risk spreads (see OECD report). The massive program of assets purchased by the ECB (quantitative easing) follows this way, boosting upward asset prices and cutting interest. Nevertheless extraordinary events (Greek insolvency) would lead to "uncharted waters" as warned by Mario Draghi. It could frustrate QE inducing interest rate volatility.

Following the OECD, the forecast output gap would close in 2017, so that debt would fall steadily, reaching 60% of GDP soon after 2030 (Figure 2).

Figure 2

% of GDP

Legend:
- 0% underlying deficit, nominal growth of 3.8%
- 2% deficit, 3.8% nominal potential growth, 0 output gap from 2017
- 3% deficit, 0% real potential growth, 0 output gap in 2017
- 6% deficit, 0% real potential growth, 0 output gap in 2017

Note: Simulations assume the output gap closes by 2017. With a balanced budget and nominal growth at 3.8% of GDP (as in OECD@100) the debt-to-GDP ratio declines to 60% within 20 years, in line with EU rules.
Source: Ministry of Finance and OECD calculations and estimates.

StatLink ᵃᵍᵐ http://dx.doi.org/10.1787/888933184736

Also, the IMF (see World Economic Outlook, 2015) assumes a decreasing debt-to-GDP ratio by 2016 (Table 2) arising from a lower expenditure matched to a growth return.

Table 2

Subject Descriptor	Units	2013	2014	2015	2016	2017	2018	2019	2020
General government revenue	Percent of GDP	47,938	48,651	48,306	48,417	48,617	48,74	48,761	48,832
General government total expenditure	Percent of GDP	50,794	51,686	50,917	50,094	49,732	49,306	48,807	48,49
General government net lending/borrowing	Percent of GDP	-2,856	-3,035	-2,611	-1,677	-1,115	-0,566	-0,046	0,342
General government primary net lending/borrow	Percent of GDP	1,804	1,498	1,405	2,004	2,312	2,663	3,049	3,343
General government structural balance	Percent of potential GDP	-0,339	-0,881	0,307	0,199	0,383	0,577	0,728	0,863
General government gross debt	Percent of GDP	128,605	132,109	133,76	132,867	131,107	128,709	125,734	122,38

Note: Shaded cells indicate IMF staff estimates. Source: IMF(report for selected countries)

Are forecasts too optimistic?

Two questions undermine these results: Italian ability to improve the efficiency of public spending and the threat of interest rate volatility (see W.R. Cline Sovereign Debt Sustainability in Italy and Spain: a probabilistic approach or a summary on VOX).
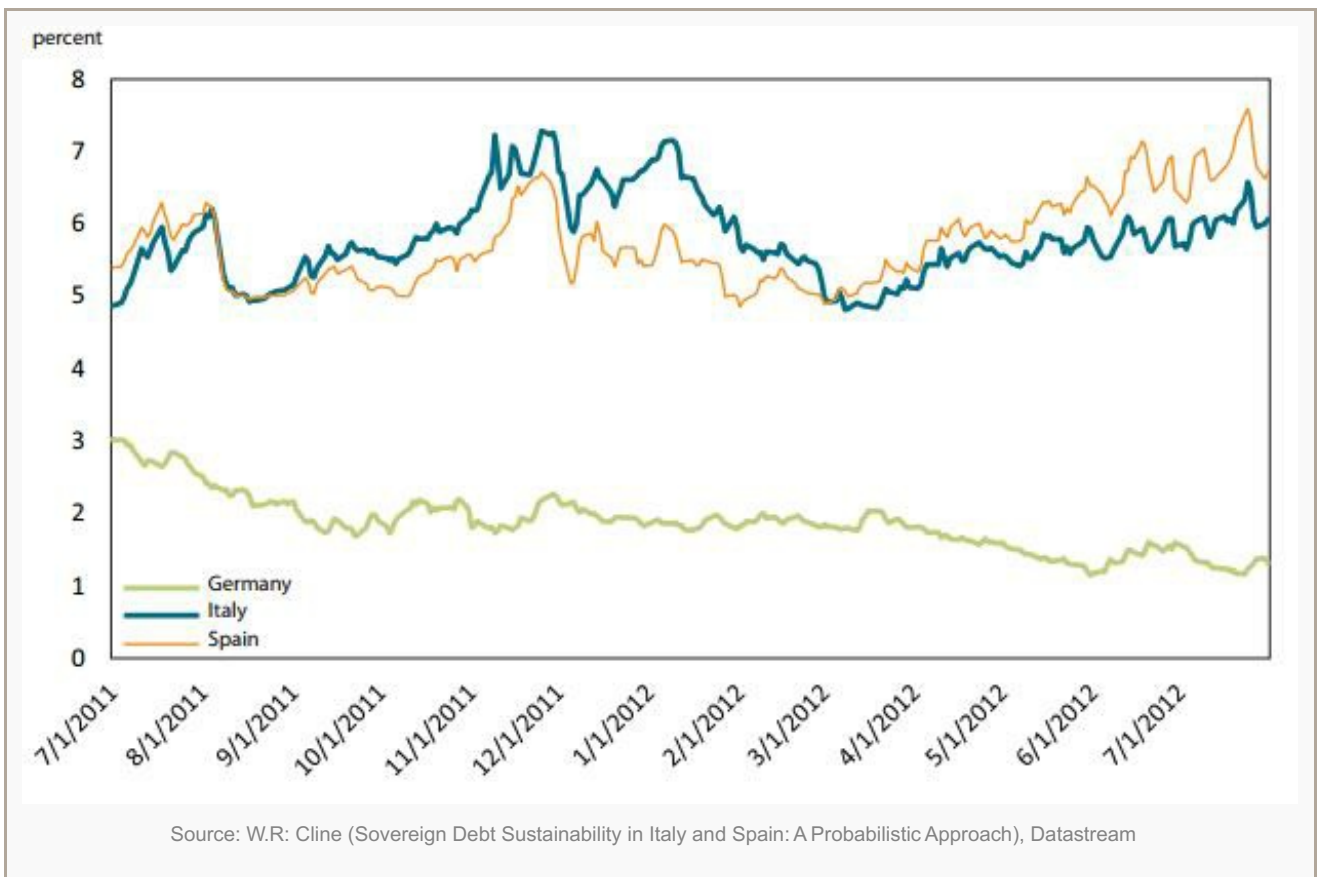
The spending review estimated (on what it described as conservative assumptions) that the ratio of primary spending to GDP could be reduced by as much as 2 percentage points by 2016 (Commissario straordinario, 2014). These are large savings.

Unfortunately the delay to implement reforms (e.g. public administration's reform) reduces the amount of savings estimated. Furthermore the persistent phenomenon of tax evasion (180 billion, 27% of GDP) is not helpful. If growth turns out to be weaker than expected, the risks of revenue shortfalls and spending overruns will rise.

The second item concerns interest rates' randomness. It is worthy to note the vulnerability shown in 2011 by the Italian government (Figure 3).

Figure 3

(10-year government bond yields in Germany, Italy, and Spain)

Source: W.R: Cline (Sovereign Debt Sustainability in Italy and Spain: A Probabilistic Approach), Datastream

The fear of "Grexit" (Italy have invested 40 billion in Greek debt) could revive the same situation. If Greece misses the payment, it will be the first developed nation to default to the IMF. After that European periphery spreads could widen. A Goldman Sachs analyst guesses around 3.5 and 4 per cent on ten year government bonds of Spain and Italy respectively (WSJ).

In conclusion, the current stillness does not mean the storm is ended. QE's effectiveness strongly depends on upcoming events (above all principal payments due from Greece, Table 3). Unforeseen choices by Athens would upset any scenario considered up to now.

Table 3

Date	Event	Payment due
01-May	IMF loans interest payment due	€0.20bn
06-May	Governing council of the ECB non-monetary policy meeting in Frankfurt	
06-May	Greece to sell €1.4bn of 26-week T-bills to refinance maturing GTBs	
08-May	Greek T-Bill (GTB) redemption	€1.40bn
11-May	Eurogroup meeting	
12-May	European Union finance ministers meeting	
12-May	IMF loan repayment due	€0.77bn
13-May	Greece to sell €1.4bn of 13-week T-bills to refinance maturing GTBs	
15-May	Greek T-Bill (GTB) redemption	€1.40bn
20-May	Governing council of the ECB non-monetary policy meeting in Frankfurt	
03-Jun	Governing council of the ECB non-monetary policy meeting in Frankfurt	
03-Jun	Greece to sell 26-week T-bills to refinance maturing GTBs	
05-Jun	IMF loan repayment due	€0.31bn
10-Jun	Greece to sell €1.6bn of 13-week T-bills refinance maturing GTBs	
12-Jun	IMF loan repayment due	€0.35bn
12-Jun	Greek T-Bill (GTB) redemption	€2.00bn
12-Jun	Greek T-Bill (GTB) redemption	€1.60bn
16-Jun	IMF loan repayment due	€0.58mn
17-Jun	Governing council of the ECB non-monetary policy meeting in Frankfurt	
18-Jun	General council meeting of the ECB in Frankfurt	
18-Jun	Eurogroup meeting	
19-Jun	IMF loan repayment due	€0.35bn
19-Jun	Greek T-Bill (GTB) redemption	€1.60bn
19-Jun	European Union finance ministers meeting	
25-Jun to 26-Jun	European Union leaders summit in Brussels	
30-Jun	Bailout expires	
10-Jul	Greek T-Bill (GTB) redemption	€2.00bn
13-Jul	IMF loan repayment due	€0.46bn
14-Jul	International bond redemption (JPY)	€0.09bn
16-Jul to 20-Jul	Greece needs to service interest payments on government bonds	€0.63bn
17-Jul	Greek T-Bill (GTB) redemption	€1.00bn
20-Jul	Greek government bond redemption and interest payment due	€3.62bn
25-Jul	International bond redemption	€0.02bn

Source: J.P. Morgan Asset Management. Bloomberg, International Monetary Fund, European Commission, ING.

Giuseppe Bianchimani is an Italian student of Economics at Guido Carli Free International University for Social Studies (LUISS) in Rome. He is a blogger for "Il Fatto Quotidiano" (personal page). His work concerns politics and economics, focusing on the Italian case and the Eurozone, and specifically concentrating on sovereign debt crises and debt sustainability. He tweets @pinoblanco93.

Note: This article gives the views of the author, and not the position of the Euro Crisis in the Press blog, nor of the London School of Economics.

Related articles on LSE Euro Crisis in the Press:

The election of Italy's new president has strengthened Matteo Renzi's grip over Italian politics

The 1000 Day Agenda: Can Renzi Deliver?

Why Italy Will Not Make It