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THE ITALIAN BUDGET: ITALIAN CRISIS OR EUROZONE CRISIS?

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- ***"There is a country where joys are manifested, but false, and sorrows are hidden, but real", La Bruyère.*** One immediately thinks of Italy today when reading these few lines! A country which in 2018 has not yet regained its GDP level of 2007, a country which since the year 2000 has seen no growth in its per capita GDP. And yet, this same country is rich, with one of the highest household savings rates in the Eurozone and a wealth/gross disposable income ratio far higher than that of Germany. Its manufacturing sector, as a percentage of GDP, is one of the largest in Europe together with Germany and Sweden, and it has a manufacturing trade surplus. Also, let's not forget, Italy has a primary budget surplus making it one of the rare countries whose public debt/GDP ratio (130%) has hardly dropped since 2008 nor since even the creation of the Eurozone.

- The problem now is populism, the demagogy of leaders who are endeavouring to appeal to a population tired of the stagnation of its income over the past twenty years or so, and irritated at an unemployment rate still at 9.7%. In short, where the country needs a supply-side policy, the team in power is proposing worryingly inappropriate measures. We can further examine this by comparing the dream to the reality.

I. **The dream**: ***"Remember to always be daring", d'Annunzio.***

Between the ultimatums of Luca di Maio and the aggressive posturing of Matteo Salvini to keep his troops happy, Italy intends to pit the democratic legitimacy of the ballot box against the “dictate” of the markets and EU authorities. It is not begging the European Commission for indulgence, but intends to challenge it. It is not seeking an opt-out from complying with the budgetary rules, but is opposing them.

When presenting their budget, Matteo Salvini and Luca di Maio may have remembered the words of d’Annunzio, but they were wrong not to heed the minister of the Economy, Tria. Italy's leaders would like to overlook the fact that capital markets are global and that the foreigners who hold between 35% and 40% of Italian public debt are by no means obliged to believe in the virtues of the proposed programme.

What is the sense in a reduction of the retirement age for 400,000 people in a country whose population is declining by 150,000 each year and which refuses any immigration?

What is the sense in a 15% flat tax, bound to be limited initially, to very small businesses which generate less than €100,000 in revenues? Even if it were to be adopted across the board, it would change nothing. Against a backdrop of political instability and economic uncertainty, attracting foreign capital capable of offsetting the decline in revenues is a pipe dream.

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What is the sense of introducing a universal income of €780 per month which will ultimately cost as much as €30 billion, and even around €10 billion if initially, it were to concern only the 3.5 million people receiving small pensions? Unfortunately, it is not so much consumption that should be encouraged in Italy as investment in production to improve growth potential.

II. **The reality**: ***"Hell is truth seen too late", Hobbes***.

To see the reality is to recognize the lack of trust, to judge that the budget deficit will exceed the forecast percentage and to anticipate that the ECB will not intervene.

- ***Lack of trust***:

It is not possible to ignore the cost of a debt which represents 130% of GDP, one-quarter of the Eurozone's debt when the country accounts for only 15% of the Eurozone's GDP.

Without trust, S&P and Moody’s will downgrade Italy's credit rating at the end of October, and the country will then no longer be able to benefit from certain aid measures from the ECB.

Without trust, investors will turn their backs on Italian debt, and the spreads with Germany (already 290 basis points) and with other countries will worsen.

Without trust, the vulnerable Italian banks, burdened as they are by non-performing loans (€360 billion in 2016, or an amount close to 20% of GDP) and crippled by billions in Italian government bonds (about 20% of the total, and an additional €40 billion for the second quarter alone), will have problems obtaining new funding. In less than one week, their share prices fell by between 17% and 20%. Before the spring 2018 elections, Italy's 10-year bond yield stood at 1.50%, while now it is 3.10% and, if laxness prevails, it will soon reach 3.5%.

- ***A larger budget deficit than forecast***:

It is hard to imagine that the budget deficit will not exceed 2.4% in 2019, because the mere postponement of the VAT hike deprives the country of €12 billion in revenues, or the equivalent of 0.7% of GDP. The introduction of a minimum income will initially cost the equivalent of 0.6% of GDP, the lowering of the retirement age will worsen the budget deficit by 0.5% of GDP, and the initial version of a flat tax will cost 0.2% of GDP, while the rising cost of debt servicing will weigh on this deficit, which could in fact exceed 3%. And all this is on top of the deficit projected by the previous government.

It is hard to validate the projection of 1.6% GDP growth in 2019, because it will be remembered that in a good year of growth for Europe, 2017, Italy's growth did not exceed 1.5% and that in the second quarter of this year, growth was merely 1.2%. Lower growth will mean a worsening budget deficit. We will not discuss the economic

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growth scenario of 1.7% adopted by the government for 2020, because it is more of a prediction than a forecast, and is no longer anything like the 1.1% initially projected.

A country whose interest charges on the €2,300 billion of public debt constitute the largest expense item of the budget, at €65 billion, a country whose BBB credit rating has for the past several months been placed on negative watch, cannot distribute imaginary manna.

- ***A lack of support from the ECB***:

This is not a financial crisis but risky economic policy. So the ECB will not support it. Mario Draghi has announced, on several occasions, that quantitative easing will stop at the end of this year, and he will not change his policy because of Italy. He could not do so even if he wanted to, because the limits to holdings of sovereign bonds, set at one-third of issuance, have already been reached for several countries such as Germany and Portugal, and the ECB already holds €340 billion worth of Italian public debt.

- **Conclusion**: ***"Firstly think whether it is fair and possible to do so, for your promise is a debt", Confucius.***

- To conclude these few lines, this is the advice that should be heeded by the Italian leaders. The demagogy of the governing class is arousing investor mistrust, and Italians will not be richer but poorer due to the rising cost of debt resulting from rising interest rates. Businesses will not invest more, because credit will be more expensive. Economic growth will decline and debt servicing will become more costly. And it is futile to expect €5 billion from an umpteenth tax amnesty.

- Italy needs structural reforms: investing in education, for too long underestimated, in infrastructure, for too long neglected, and in research, for too long forgotten at 1.1% of GDP. Boosting the birth rate, currently one of the lowest in the world at 1.3 children per woman, encouraging a meritocracy and preventing the emigration of numerous graduates (a further 120,000 in 2016, and 1.5 million over ten years) discouraged by the lack of prospects.

- The interest rate situation is not yet as alarming as in 2012 when the 10-year bond yield exceeded 5%, but the 3.39% reached this morning is likely to be exceeded by the time of the official presentation of the budget to the European Commission on 15 October, or if, on 26 October, S&P downgrades the country's credit rating.

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- The Italian crisis will probably persist, but for the time being the Eurozone is apparently spared. Except for the European banks which are exposed to Italy, stock markets have not been greatly affected. Likewise, there has been hardly any pressure on bond yields of the zone's member countries. Of the southern European countries, the 10-year bond yield for Spain, at 1.53%, is hardly any higher than the 1.45% level reached at end-July. Portugal's 10-year bond yield is 1.90% versus 1.76% at end-July, and Greece's 10-year bond yield is 4.15% versus 3.93% at end-July. Nothing alarming. Nothing like the financial crisis of a few years ago, because in these various countries, competitiveness has improved, the trade surplus has been restored, export market share has increased and unemployment has fallen. Also, the euro has depreciated only moderately against the US dollar and the Swiss franc.

- A more negative aspect is the difficulty of envisaging reform or a deepening of the Eurozone itself while there is such a situation of tension with a European Union founding member, the third largest economy in the Eurozone.

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