Austerity without end – or, how Italy found itself trapped by European rules

By Raul Sampognaro

If the budget submitted by France is out of step with the rules on fiscal governance in the euro area (see the recent posts on this subject by Henri Sterdyniak and Xavier Timbeau), Italy is also in the hot seat. The situations of France and Italy are, however, not directly comparable: the case of Italy could be far more restrictive than that of France, once again reflecting the perverse effects of Europe's new governance. While, unlike France, Italy is no longer subject to an Excessive Deficit Procedure (EDP), with its budget deficit at the 3% threshold since 2012, it is still covered by the Stability and Growth Pact's preventive arm and thus enhanced surveillance with respect to the debt criterion. The country's debt of 127% of GDP is well above the 60% level set by EU rules and, according to its medium-term budgetary objective (MTO), Italy must come close to balancing government spending.

While the French budget deficit for 2015 will be the highest in the entire euro area (excluding countries subject to a programme [1]), since the latest announcements on October 28, Italy has a deficit of 2.6%, which should not trigger a new EDP. However, the Pact's preventive arm puts constraints on changes in the country's structural balance:

– (i) in the name of convergence towards its MTO, Italy must make a structural adjustment of 0.5 percentage point per year for 3 years (i.e. cut its structural deficit by 0.5 point per year),

– (ii) if the structural deficit defined in the MTO is not sufficient to reach a debt level of 60% within 20 years, the country must make an extra effort under the *debt criterion*. According to the latest forecast by the Commission, Italy must provide an average annual structural effort of 0.7 point in 2014 and 2015.

Yet the government is counting on a *deterioration* in the structural balance of 0.3 point in 2014, followed by an *improvement* of 0.4 point in 2015.

Thus, while according to the Commission the treaties require Italy to make a cumulative effort of 1.4 point in 2014 and 2015 (for its part the Italian Government considers that this effort should instead be 0.9 point), Italy is announcing an *improvement* in its structural balance of 0.1 point during the period, a difference of 1.3 points from that demanded by the Commission. From this perspective, Italy is further from European requirements than France, and will have to justify its lack of a structural adjustment. In addition, Italy is not expected to reach its MTO in 2015, even though at the end of the European Semester in July 2014 the Council had recommended it stick to the 2015 target.

Italy is the first country to be constrained by the *debt criterion* and is serving as a laboratory for the application of the rules by showing some of their adverse effects. Indeed, the adjustment required under the *debt criterion* is changing in line with several parameters, some of which were not really anticipated by the legislator. For example, the amount of the adjustment depends on a forecast of the ratio of nominal debt / nominal GDP at the end of the transition phase. However, the fall in prices currently underway in Italy is lowering the nominal GDP forecast for the next three years, without any change in fiscal policy. Thus, the debt criterion is tightening mechanically without any government action, endlessly increasing the need for structural adjustment as the new adjustments induce more deflation. In addition, the procedures used to find deviations from the debt criterion are slower because the controls are carried out essentially *ex* *post*, based on the accumulated deviations observed over two years. However, the magnitude of the deviation announced by the Italian government could spark procedures based on *ex ante* control. Recall, however, that unlike France, Italy is not currently in a procedure. This would have to be opened before any sanctions could be envisaged against Italy. This preliminary and necessary step gives the Italian government time to take suitable measures or to justify its deviation from the MTO.

Furthermore, the EDP's preventive arm provides more opportunities for deviation than the corrective arm. In addition to the clause on exceptional economic circumstances, Italy can argue major structural reforms that will improve the future sustainability of the debt. This argument, which is also raised by the French government, is not set out in the EDP text (the Commission could accept some flexibility). Here, however, the Renzi government is drawing on its reputation as more of a reformer than the French government.

Both governments have requested the application of the exceptional economic circumstances clause in order to break their commitments. The Commission could be more sensitive to the Italian request because its economic situation has deteriorated: Italy has seen 3 years of falling GDP, which is continuing in the first half of 2014. The country's GDP is 9 points below its pre-crisis peak, while in France it is one point higher. The latest survey indicators, for example on industrial production, do not augur well for recovery in the short term. Finally, Italy is suffering deflation.

In summary, while the Italian gap seems larger than that of France, it could benefit from greater indulgence. The procedures applied to each country differ and give Italy more time before any sanctions can be applied. The country's willingness to reform could win it higher marks than France from the Commission. Finally, the most important point in the discussion is that Italy's economic situation is much more serious, with an uninterrupted recession since the summer of 2011 and with prices falling.

But in both cases the reinforced pact, whether it is corrective or preventive, implies endless structural adjustment. Italy demonstrates that getting out of the excessive deficit procedure will demand continuing efforts to meet the debt criterion. If France leaves the EDP in 2017, its debt will be, according to government forecasts, around 100% of GDP. It must then continue with adjustments of more than 0.5%. Confirmation of deflation will make the Pact's rules even more recessive and absurd. Ultimately, the fiscal pact meant to preserve the euro by chasing free-riders or stowaways could lead to blowing it apart through an endless recession.

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[1] Greece, Ireland and Portugal have received European aid and thus have been subject to joint monitoring by the ECB, the IMF and the European Union. Ireland and Portugal are now out of their bailout programme.

Japan's reconstruction: constrained by the deterioration in public finances

By Bruno Ducoudré

Following the earthquake that hit Japan in March 2011, the government estimated the cost of the loss at 16.9 trillion yen (3.6 points of GDP). The response in terms of the structural deficit needed to deal with this exogenous shock conflicts with the government's desire to implement an austerity policy to reduce the deficit. The additional financing requirements are thus coming at the worst possible time, amidst the economic crisis that began in 2008, which has been accompanied by a sharp deterioration in public finances due to the need to prop up the economy.

On the growth front, 2011 was a difficult year for Japan, coming on the heels of a 4.4% rebound in GDP in 2010 following a 5.5% drop in 2009. While the economy saw renewed growth in Q3 of 2011 (1.9% GDP growth quarter-on-quarter), after two quarters of falling GDP, at year end floods in Thailand again disrupted the supply chains of Japanese firms, and the economy faltered (zero growth in Q4 and -0.7% growth for 2011). The period of reconstruction begins in 2012.

In fiscal year 2011, four additional budget bills were passed for a total of 3.9 percentage points of GDP, mainly to cope with emergency expenses (1.3 GDP points) and to prepare for reconstruction (2.3 GDP points). The services of the State have estimated the total bill for reconstruction at 23 trillion yen (4.8 GDP points). The reconstruction will be spread over the next ten years, with the main effort concentrated on the period 2012-2016. The government decided to allocate 0.8 GDP points for reconstruction in fiscal 2012, three-quarters of which is to be funded by debt (Table).

Contrary to expectations, the series of plans passed in 2011 have not resulted in a rapid surge in public spending: public consumption grew by 2.1% in 2011, unchanged from 2010 and less than in 2009, and public investment fell by 3.1% in 2011. Reconstruction costs were partly substituted for other expenses. Also, part of the budget adopted was set aside and so is just beginning to be spent. Public orders for construction work rose by 20% in Q4 of 2011 yoy, and public works in progress rose sharply at year end. Thus, the additional expenses related to the reconstruction costs already approved will be spread in part over the coming quarters, and even beyond fiscal year 2012.

Japan’s fiscal situation is actually precarious. The expenditures needed to rebuild the devastated areas were decided in a context of high levels of deficit and debt related to the crisis. The budget deficit has indeed deteriorated sharply since the beginning of the crisis, rising from 2.2% of GDP in 2008 to 8.1% in 2010, while the debt has risen by 31.2 GDP points since 2007, to reach 199% of GDP in 2010. In 2011, the deficit widened to 9.3% of GDP mainly due to the increased debt burden, higher social security spending and the fall in GDP in 2011. The government announced that some plans would be financed by a combination of restrictions in other areas of expenditure, surplus tax revenues related to the improvement in activity in 2010, and the accumulated reserves from past budgets (for a quarter of the budget dedicated to reconstruction in 2011-2012).

In the short term, the government has nevertheless chosen to favor growth over fiscal consolidation. We expect, for instance, a fiscal stimulus of 0.4 GDP point in 2012 and 0.5 GDP point in 2013, and the Japanese economy should see average annual growth of 1.9% in 2012 and 1.5% in 2013 (see “Japan: reconstruction time”, in our forecast dossier, in French). In these circumstances, the budget deficit will be stable at 9.2% of GDP in 2012, and will worsen to 9.8% of GDP in 2013.

Provisional budgets for 2011-2012 for reconstruction
Central government

In % GDP

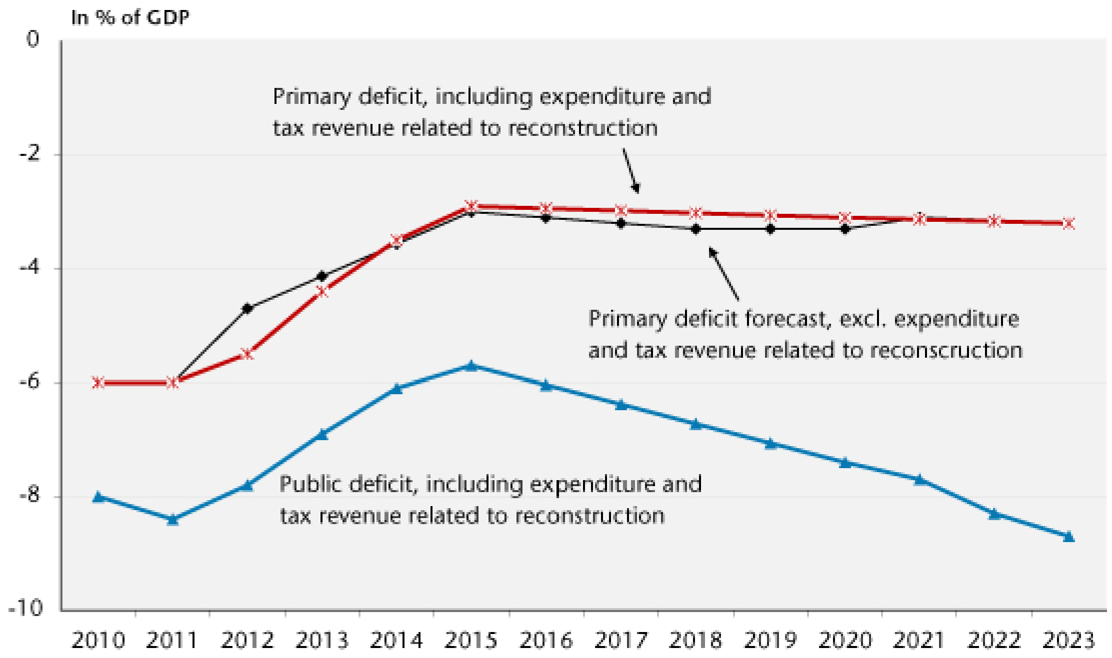
	2011	2012
Revenue and financing	3.9	0.8
Tax revenue	0.3	0.1
Non-tax revenue	0.0	0.1
Bond issues	2.1	0.6
Surplus from previous years	1.1	0.0
Reduction in expenditure	0.4	0.0
Expenditure	3.9	0.8
General expenditure, including:	3.3	0.7
Public works	*1.4*	*0.2*
Other expenditure	*1.9*	*0.6*
Transfers to local government	0.6	0.1

Sources: Cabinet Office, Ministry of Finance, OFCE calculations.

However, beyond 2013, there is still uncertainty about the direction of government economic policy. In the Japanese government's medium-term fiscal strategy, decided in 2010, it aimed to halve the primary deficit of central and local government by 2015 compared to the level in 2010 (6.4% of GDP), and to break even by 2020. According to our calculations, balancing the primary structural deficit would require the implementation of a major fiscal consolidation effort. This would involve a negative fiscal impulse on the order of 1.1 GDP points a year in 2014, which is nevertheless a slower pace than the consolidation policies planned in the euro zone in 2012-2013 (see "He who sows austerity reaps recession" in our forecasting dossier). To this end, an increase of 5 points in the consumption tax is to be considered during the current session of the Diet, Japan's parliament, which will wind up in June. This increase would occur in two stages and yield 2.5 GDP points in tax revenue. According to the latest medium-term forecast of the Japanese government, this will not be sufficient to meet its targets (Figure 1). Moreover, the means to achieve a balance by 2020 have not been clarified, and the government has not indicated how the debt built up to finance reconstruction would be repaid. Finally, given the continuing growth of the public debt, the interest burden, which currently is low (1.8 GDP points in 2011), will place an increasing burden on state finances in the future. This will exacerbate the government's difficulties in implementing any budgetary changes aimed at stabilizing the debt-to-GDP ratio by 2020, and then to bring it down even further.

Despite all this, Japan does not seem to need a brutal fiscal consolidation, as it is currently borrowing at low interest rates (0.86% for the last issue of 10-year government bonds). Furthermore, the share of the debt held by non-residents is still low (6.7% in Q4 of 2011), and the abundant savings of the Japanese population, together with the Japanese Central Bank's programme of share purchases, considerably reduces the risk of a sovereign debt crisis like the one seen in the euro zone.

Government forecasts of the primary deficit over the reconstruction period



Note: These forecasts are based on the hypothesis of a rise in the VAT rate from 2013 and a nominal GDP growth rate of about 2% on average over the period. This includes a rise in tax revenue distributed evenly over 10 years to finance reconstruction-related expenditure. The forecast covers only central and local government.
Source: Cabinet Office.

This text refers to the economic analysis and forecast for 2011-2012, which is available on the OFCE website.