Luiss
School of European Political Economy

Loans or "gifts"? What the Italian economy needs from Europe

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The following five bullet points offer a summary of the Luiss School of European Political Economy (SEP) webinar that will take place on April 29, 2020.

1. According to the recent Economic and Financial Document (DEF) drafted by the Ministry of Economy and Finance (MEF), in 2020 the Italian economy will undergo a deep recession (around - 8% in 2020), which will only be partially offset by the recovery of 2021. These trends are bringing the public debt/GDP ratio above the 155% threshold.

The consequence is that, if there were no alternative sources of financing for the country, in 2020 the Italian government would have to offer additional government bonds on the primary market (additional to those already provided for the replacement of the bonds maturing on the existing public debt stock) for an amount of approximately 320 billion euro. In that case, the value of the Italian government bonds placed on the market should almost double by December 2020 with respect to what was expected before the pandemic (DEF 2019).

2. Despite this state of affairs, in the short term there are no overwhelming concerns about the absorption of such a large mass of Italian government bonds. There are several reasons that justify such a claim:

- after the pandemic shock, the European Commission has already granted Italy around 30 billion euro in transfers in the form of access to residual funds in the EU's seven-year financial framework and reallocation of structural funds not yet earmarked or, if already earmarked, not yet spent;

- in the past weeks the Eurogroup and the European Council approved, although not yet definitively, financing for euro area countries through the European Stability Mechanism (ESM) for 240 billion euro and through a fund of social safety nets for the temporary unemployed (SURE) for around 100 billion euro; if used by the Italian government, this set of loans could provide Italy with liquid resources of more than 50 billion euro.

ESM and SURE financing is linked to specific fields and, of course, will have to be repaid on maturity. However, thanks to these European initiatives, the additional financing needs of the Italian government in the primary market would no longer amount to 320 billion, but instead to about 240 billion euro. In addition, with the approval of the European Council, the European Investment Bank (EIB) has approved an additional fund of 25 billion euro which will be able to offer guarantees and financing for investments of around 200 billion euro. Italy could obtain a share of the latter amount equal to approximately 30 billion euro. Although more indirectly than the previous transfers and loans, even a part of the EIB's intervention would reduce the additional offer of bonds on the market necessary for Italy to finance its public debt by the end of the year.

3. Adopting a conservative view, it can therefore be said that the Italian government would be able to cover more than 30% (more than 100 billion euro) of its additional financing needs through transfers or loans from European institutions instead of from the market. In other words, at least for the duration of the European loans, a substantial part of the Italian public debt usually allocated in the market will be replaced by debts to the European institutions.

The remaining 220 billion euro of additional financing will be raised through issues of Italian government bonds on the primary market. However, buyers of these bonds will enjoy a de facto reinsurance: they can be certain that, by December 2020, they will be able to resell a large part of the bonds to the European Central Bank (ECB). In fact, thanks to the decisions taken in mid-March, the ECB will absorb in the secondary market by the end of the year more than 1,100 billion euro of bonds issued by governments and firms in the euro area; and around 10% of Italy's public debt (roughly 170-180 billion euro) will thus be purchased by the ECB. In other words, even if a high share of the 'quantitative easing' program pre-existing to the March 2020 decisions is excluded (about 20 billion euro for Italy), more than 70% of the additional financing that the Italian government must find on the market for 2020 will be held not by professional or retail investors but by the ECB.

My tentative conclusion seems reassuring: in spite of the deep recession and the consequent large expansion in its fiscal policy, in 2020, thanks to a set of European interventions, Italy will have to cover on the market ("without a safety net") an effective additional financing of its public debt of around 50 billion euro. This is not a negligible amount (around 3% of GDP at the end of 2020), but neither is it a significant threat to the short-term sustainability of Italy's public debt.

Also, there are three additional European instruments in the background: the ECB's commitment to increase, if necessary, its temporary demand for government bonds of the euro-area countries; a forthcoming possible commitment by the ECB to absorb bonds that lose their investment grade; the creation of the Recovery Fund (RF). I will not go into the details of the first or the second instrument. I will just underline four points concerning the establishment of the RF:

- the RF should reach an amount of just over 300 billion euro, with a leverage ratio capable of providing liquid resources ranging from 1,000 to 1,500 billion euro;

- the RF should be guaranteed by the new European multiannual budget (2021-2027) and, therefore, it will hardly be operational before January 2021;

- since it is based on a specific article of the European Treaty (art. 122), it will be legally bound to give just loans (and not grants) to member states;

- the loans will have a maturity of between three and seven years.

4. However, the reasoning made so far is not reassuring with regard to the medium-long and long term. The crucial question is:

What will happen to the Italian public debt stock when the ECB's monetary policy ceases to be ultra-expansive and Italian debts towards other European institutions expire?

My answer can be summarized in three points:

- if no preventive adjustments are introduced, when the question asked becomes topical and unavoidable (2024?), it will be too late to avoid a serious sovereign debt crisis in Italy;

- there are many ways to design, launch and implement these adjustments, so much so that a set of different tools will have to be used instead of the decisive 'silver bullet' (which is an illusion);

- even before discussing the possible and varied adjustment processes, it would be worth asking whether it is possible to avoid or - at least - limit the explosion of the Italian public debt/GDP ratio from 2020 or 2021, despite the unavoidable need to implement an expansive fiscal policy during the pandemic crisis and the start of the recovery phase.

The rest of my seminar focuses precisely on this last point. The solution I propose is much less innovative than it seems. My suggestion is to replace a significant part of the European financing for Italy and other euro-area member states who request it with irreversible transfers. In the jargon used many decades ago in Italy these would have been called 'lost fund' transfers. In an apparently provocative way, but actually by referring to a well-known anthropological tradition (from Lévi-Strauss to Godelier), I would like to refer to the concept of "gift".

5. "Gifts" to EU member states are nothing new. A typical item, which is an important part of the multiannual European financial framework, is represented - for example - by the 'structural funds' in favor of the economically less developed sub-areas of the European Union. My proposal therefore consists in designing and implementing "gifts" that are, directly or indirectly, connected to the economic impact of the pandemic.

Apparently, the easiest way would be to use the European financial framework by reinforcing the 'expenditure' components of that framework which are comparable to the 'structural' funds; and the aforementioned RF seems to be the appropriate tool to proceed in this direction. As was clear from the first steps outlined in the European Council on April 23, the probable technical configuration of the RF, however, precludes such a solution.

First of all, if it is legally based - as it seems - on Article 122 of the Treaty, the RF will be bound to give loans to member states in difficulty for reasons beyond their control. Secondly, if it is economically based on the issue of a debt bond originated by the European Commission and guaranteed by the European multiannual financial framework, this fund will achieve its unavoidable balance only by recording an equivalent credit amount towards the member states with a maturity in the seven-year period. Therefore, with the same own resources, the limited presence of "gifts" can only result from a re-

composition of the items in this financial framework which are covered by traditional incoming resources (transfers by member states and limited inflows from national taxes). Thirdly, if the attempt to avoid the aforementioned constraints was pursued by increasing the own resources of the European multiannual financial framework (by means of some form of new centralized taxation) to launch European investment projects, the RF implementation time would expand dramatically. Finally, the construction of the RF and the survival of the European Union itself require the approval of the 2021-27 European multiannual financial framework and, therefore, a favorable unanimous vote by all member states; and this constrains the innovations that can be introduced at the moment.

This is why, in a recent SEP Policy Brief (M. Messori, "The current European debate on fiscal policy: Too much and too little", SEP Policy Brief, March, n. 10, pp. 1-5; revised version: "Europe debate on fiscal policy: too much yet too little", CEPS Policy Insights, n. 2020-08, April, pp. 1-8), I have pursued a different path: the use of a "gift" offered by the ESM through the creation of a new "transfer line" which can be activated at the discretion of all the requesting member states. The transfers would be intended to cover only the costs, directly or indirectly, related to the coronavirus pandemic; and the establishment of the related line would require a decision by a qualified majority in the ESM decision-making board.

There is an underlying reason and an instrumental reason that facilitate the achievement of this majority. The underlying reason is rooted in the anthropological tradition to which I referred above: in any society with even rudimentary markets, the "gift" involves reciprocity. In the case in question, reciprocity requires that the beneficiary countries and the ESM cooperate in the utilization of the grants, and that the former countries are therefore ready for a partial transfer of fiscal sovereignty in favor of the ESM. It follows that, through the "gift" and the associated reciprocity, the ESM would acquire a role of co-decision maker in the use of "common goods" during economic crises such as the current one; and this role would strengthen both the function of the institution responsible for the management of European crises and its candidacy as a technical-bureaucratic apparatus for the future European ministry of economy and finance. The instrumental reason is that, to receive the "gifts", Italy would have an interest in removing its veto on the approval of the new ESM statute, defined about a year ago.

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To complete these five bullet points, we should keep in mind two further aspects. Italy would greatly benefit from the transfers (instead of a part of the financing) of the ESM; in fact, if the approval of the ESM's new statute also provided for its recapitalization, Italy (as well as any other beneficiary country receiving the "gifts") could considerably increase that share of public expenditure which does not translate into increases in its public debt. On the other hand, the demonization of the ESM in the current Italian political-institutional discussion and the opposition to a centralization of powers at European level prove that Italy is not ready to take this opportunity. Moreover, even in the pro-European camp there could be objections: the ESM is an intergovernmental institution, founded on international law and with the power to trigger improper ex ante restructuring of national public debts (see M. Messori, "The flexibility game is not worth the new ESM", SEP Working Paper, n. 15, October 25, pp. 1-18; abridged Italian version "Il gioco della flessibilità non vale la candela del nuovo ESM", *Rivista di Politica*

Economica, n.1, pp. 121-34). However, the ESM is also an irreplaceable mechanism for managing European crises that must assume the rank of a European institution even from a legal point of view. The solution is therefore not to limit the ESM's role but to strengthen it by introducing appropriate changes.