

An Italian budget showdown underlines the need for euro-zone reform

The bloc's greatest weakness is not its spending, but its politics

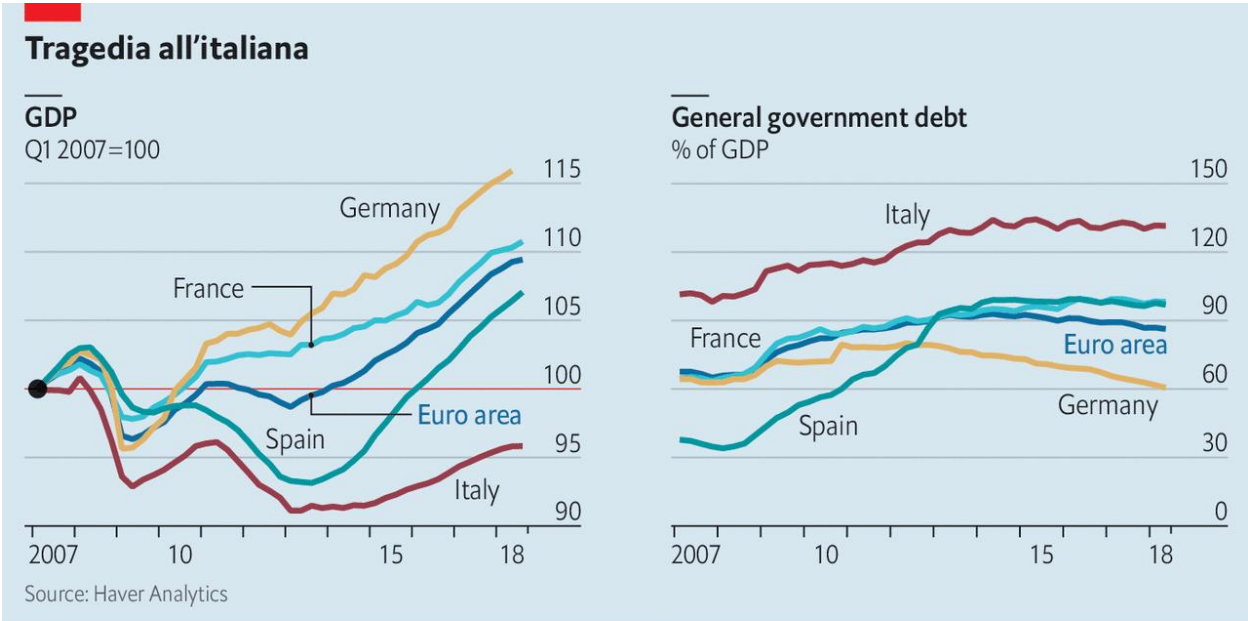
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The fate of the euro was always going to depend on Italy. With annual GDP of more than €1.6trn (\$1.9trn), about 15% of euro-area output and debt of nearly €2.3trn, it poses a challenge to the single currency that Europe seems unable to manage but cannot avoid. Matters are now coming to a head, as Italy's new coalition government instigates a showdown over the European Union's fiscal rules. The disagreement might well become disastrous. But it is also an opportunity for the euro zone to begin building a better, more durable approach to fiscal policy.

Trouble began earlier this year when the populist Five Star movement, led by Luigi Di Maio, formed a government with the right-wing Northern League, led by Matteo Salvini. Both promised budget goodies: Mr Salvini a hefty tax cut and Mr Di Maio a basic minimum income. Such largesse may test the deficit limit of 3% set by the EU's stability and growth pact. And it seems certain to break other fiscal rules set by the bloc: the government's initial budget plan is forecast to raise borrowing to 2.4% of GDP in 2019, above the 0.8% target to which Italy previously committed itself and enough to reverse recent, modest declines in its debt burden.

The EU did not take the news well. On November 5th other countries' finance ministers warned that failure to revise the budget would lead to an "excessive deficit procedure", and possible sanctions. But Italians are unbowed. Mr Di Maio, now deputy prime minister, argued in comments to the *Financial Times* that Italy's fiscal expansion will prove so successful that other European leaders will clamour to follow, citing, somewhat dubiously, faster growth in America after a budget-busting Republican tax cut.

Both sides have their points. Italians are frustrated. Real incomes in Italy have fallen since joining the euro area; inequality and poverty have risen. Economic growth briefly rose to almost 2% in mid-2017 but has since slipped back to close to zero. At 10.1%, the unemployment rate is well above the pre-crisis low of 5.8%. Economic weakness is re-emerging even as the European Central Bank reduces its stimulative asset purchases and prepares for eventual interest-rate rises. Recent indicators of service-sector and manufacturing activity suggest that the economy is at risk of falling back into contraction. A return to recession would prove disastrous for Italy’s politics and its long-run budget position. And a bit more spending now would probably not spark a bond-market panic, since the government’s debt has an average maturity of nearly seven years and most is held domestically. A little forbearance on the part of the EU might therefore enable a dangerous political moment to be defused at little economic cost.



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Yet it is hard to fault the EU for its wariness. Italy’s slow growth reflects serious structural problems. The European Commission estimates that the country’s natural unemployment rate has risen from about 8% in

2007 to 10% now, suggesting that boosting employment is a matter more of reform than stimulus. The OECD estimates that Italy's output gap, the shortfall between an economy's actual and potential output, will have closed by next year. Potential output—i.e., what an economy can sustain without inflation accelerating—is easy to underestimate. But some variables suggest that labour-market slack is disappearing. For example, after a long period of decline year-on-year wage growth roughly doubled over the summer, to 2%. Nor have Italians been deeply mired in austerity in recent years. Italy's structural budget deficit has nearly doubled since 2015. Its pensions remain among the euro area's most generous, a perversity gave the disproportionate economic pain borne by young Italians over the past decade.

Tight budget rules were, moreover, the price of the extraordinary measures that saw the euro area through its crisis earlier this decade. A bail-out programme for Italy could well prove fatal to the currency bloc; a showdown might be worth provoking to keep Italy's debt manageable and the euro area viable. Each side has its reasons for fighting all the way.

Ciao time

There is a path through this impasse. The euro zone shares a monetary policy but lacks a correspondingly coherent fiscal approach. The Italian dispute offers a timely opportunity to address that. Across the euro area as a whole, fiscal policy is arguably too tight. The ratio of debt to GDP is a relatively modest 86.3% and falling fast, by three percentage points in the past year alone. In countries with big budget surpluses, such as Germany and the Netherlands, higher spending on growth-boosting investments would slow the shrinking of debt burdens, but not stop it altogether. Some of the resulting fiscal boost would spill over into Italy through increased tourism and consumption of its exports, boosting demand without straining the Italian public purse. In exchange, the EU could ask Italy to moderate its fiscal plans.

Though it would be anathema to northern Europeans, a further sweetener, in the form of limited debt mutualisation, should also be

considered. Italy's debt is an old problem. It reached 100% of GDP almost three decades ago; but the country has run a primary surplus every year for the past quarter-century, except for the two years immediately after the financial crisis. Taking a hard line with Italy today does nothing to discipline the governments of the 1980s but adds to the bitterness felt by young people, who have fared worst under the euro and must accept towering budget surpluses in perpetuity or face ejection from the single currency. A plan to swap some national bonds for Eurobonds backed by all euro-area governments might be pie-in-the-sky, politically. Yet that policy would acknowledge that euro-area countries share a fiscal fate, relieve young Italians of doing penance for their forebears' sins and make fiscal probity for Italy a less Sisyphean task—and, perhaps, more politically tolerable.

European integration is meant to build a whole greater than the sum of its parts. The euro area could wield its combined fiscal capacity to deal with the Italian threat while building a sense of shared fiscal responsibility. Instead, Europe and Italy are heading towards confrontation. The euro zone's greatest weakness is not its spending, but its politics.

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