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Italian austerity in the polls

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After four years since the beginning of the world Great Recession, and one year of the Monti-Merkel "austerity" therapy, Italy goes to the general elections. Here is an account of what happened, what has been done and with what results.

GDP and growth: where do we stand?

Table 1 offers summary statistics of the main euro-countries *vis-à-vis* the EMU12 aggregate, the United Kingdom and the United States.

Table 1. Annual growth rates of GDP

	Average 2000-08	2008	2009	2010	2011	2012	2013	Average 2010-12	Difference with average 2000-08
France	1.8	-0.1	-2.7	1.5	1.7	0.0	0.4	1.1	-0.7
Germany	1.6	1.1	-5.1	3.7	3.0	1.3	0.8	2.7	1.1
Italy	1.3	-1.2	-5.5	1.8	0.4	-2.3	-0.5	0.0	-1.3
Spain	3.3	0.9	-3.7	-0.1	0.7	-2.0	-1.4	-0.5	-3.8
EMU12	2.1	0.3	-4.3	1.9	1.5	-0.5	0.1	1.0	-1.1
UK	2.4	-1.1	-4.4	2.1	0.7	1.0	0.9	1.3	-1.1
US	2.5	0.9	-2.5	3.0	1.6	1.9	2.3	2.2	-0.3

Source: Eurostat database AMECO

The Great Recession hit everywhere in 2009. The first rebound occurred in 2010, but to different extents across countries. Subsequently, ups and downs followed, and differences widened. UK and US recovered better than euro-countries, except Germany; the bad news is that the EMU is bound to close 2012 with a minus. Forecasts for 2013 are foggy, both because are highly uncertain and because the consensus is that a few euro-countries will fall back into recession while Germany will slow down. All in all, there is no much ground either for electoral optimism or for declaring the end of the Recession war in Europe.

In a medium-term retrospective, it is also important to assess the state of macroeconomic indicators with respect to their *pre-crisis* values as of end 2008. Let us begin with the level of real GDP (table 2). At the end of 2012, only France, Germany and US had caught up, or overtaken, their pre-crisis GDP. The EMU as a whole still showed a gap of 1.5%, but UK apparently did not benefited that much from staying out. Italy and Spain are the worst cases.

Table 2. Real GDP recovery, 2012

	Gap 2012-08 (%)	Gap 2012 from trend (%)
France	0.3	-5.0
Germany	2.5	-2.4
Italy	-5.6	-9.1
Spain	-5.0	-13.9
EMU12	-1.5	-7.4
UK	-1.2	-7.6
US	3.1	-4.2

Source: Eurostat database AMECO

It should also be taken into account that, without the crisis, GDP would have probably grown. The simplest working hypothesis is that growth would have followed the post-euro 2000-08 trend. The 2012 gap from trend, or the loss of potential output, is reported in the second column of the table. These figures are largely negative for all, stressing once more that the damage has been vast and persistent. Italy's -9.1% is the second worst gap. Italians' real disposable income, owing to unprecedented taxation, has fallen to the level of a decade ago.

These orders of magnitude of loss of national wealth are hardly recoverable on the time scale of politicians. The catching-up time depends on the annual growth rate. Hence, we may now see whether the current growth rates have at least regained the pre-crisis trend (last column, table 1). Again, figures are still negative for all countries except Germany, as a result of its amazing rebound in 2010-11 but also its relatively poor pre-crisis trend (and Germany's growth is petering out too). Looking forward at 2003, the overall picture does not improve. These negative signals accruing quarter after quarter raise the legitimate fear that we are not facing a temporay swing around the pre-crisis trend, but a permanent shift in the trend. If this is so, all countries will soon or later regain their previous GDP level, but they will never catch up with the GDP level thay would have reached with the pre-crisis trend.

Fiscal policy dilemmas

The Great Recession has brought fiscal policy to the forefront after years of "monetary dominance", with large packages of "fiscal stimulus", that is, injections of deficit spending in all countries. As regards EMU, contrary to the German narrative it will never repeated enough that the dramatic worsening of public finances was not due to an epidemic of profligacy. Data clearly show that from 2000 to 2008 the EMU witnessed a (slow) process of fiscal retrenchment and convergence towards the Maastricht benchmarks of deficit and debt GDP ratios. In 2008 7 euro-countries (including Spain, Portugal and Ireland) out of 12 had their debt/GDP ratio below Germany and close to, or below, 60%. The fiscal consequences of the crisis, summarized in table 3, are the compound effect of discretionary interventions, mostly aimed at bank bailouts, and automatic stabilizares.

Table 3. Fiscal stimulus as % of GDP

	2008	2009	2010	2011	2012	Cumulated 2009-12
France	0.4	5.1	4.7	2.6	1.9	14.7
Germany	-2.7	0.5	1.8	-1.6	-1.7	-3.7
Italy	-2.5	0.8	0.0	-1.0	-3.4	-6.0
Spain	2.9	9.4	7.4	6.1	3.3	29.8
EMU12	-0.9	3.5	3.4	1.0	0.0	7.0
UK	2.7	9.5	7.3	5.1	3.3	27.9
US	3.7	9.0	8.0	6.8	5.5	33.0

(+) = government's primary deficit
Source: Eurostat database AMECO

First, fiscal stimuli (measured by the ratio of the government's primary deficit to GDP) were activated swiftly in 2008 in non-EMU countries, notably UK and US. By that year, the euro-countries as a whole, in particular Italy and Germany (!), were still engaged in fiscal consolidation. All countries recorded primary deficits in 2009, with again UK and US ranking top with more than 9% of GDP. Deficits persisted in the subsequent years in almost all countries, though with decreasing intensity. Second, in Italy as well as in the EMU at large, except few cases like Spain and Ireland, the fiscal stimulus has been delayed and less intense. This was in fact the (unsuccessful) strategy pursued by Italy's Minister of the Economy Giulio Tremonti. As a result, the overall fiscal impulses have been quite different across our sample of countries. They range from the impressive two-digit *net stimulus* in UK, US, Spain and France to the sizeable *net restriction* in Italy (-6%) and Germany (-3.7%). It is also remarkable the tiny 7% net stimulus reached by the EMU as a whole *vis-à-vis* UK and US. Granted that high-debt countries like Italy could not afford large fiscal deficits, it remains puzzling why the EMU extended the same principle to other low-debt countries marking such a large gap relative to UK and US.

These blatant differences in fiscal behaviour between EMU and the other countries (but also within the EMU) relate to the so-called "austerity" plans urged by the European Commission, the European Central Bank and the euro-nordic club. A simple measurement of austerity is the pace at which the fiscal stimulus is reduced or reversed. This information is reported in table 4 showing the year change in the government's primary budget (fiscal restriction is denoted by a positive sign). It is interesting to see that measures to reverse fiscal stimuli have been taken everywhere as early as

2010, except Germany. The idea of "front-loading" fiscal consolidation was not confined in the EMU. Probably, this timing was due to the 2010 recovery, which generated the presumption that the crisis was over and the time of fiscal retrenchment was come. EMU was the austerity leader in 2011, while Italy and Spain peaked in 2012. The country less engaged in austerity is the US. On the other hand, these figures should be read in relation to the underlying growth rate of the economy: fiscal consolidation may be easier and faster if supported by brisk growth whereas it may be self-defeating if associated with a recession.

Table 4. Year change in the government's primary budget, 2008-12

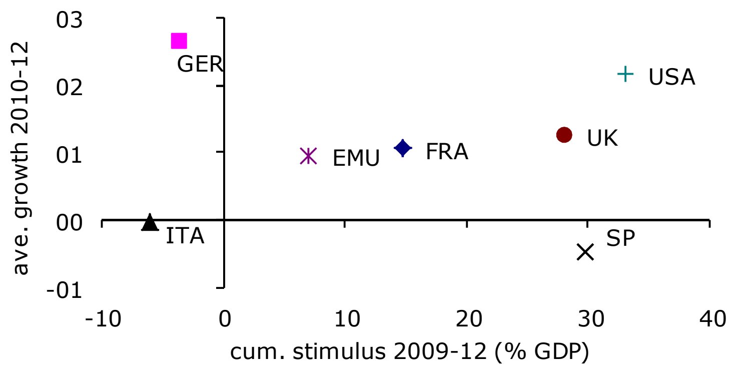
	2008	2009	2010	2011	2012
France	-0.4	-4.7	0.5	2.1	0.7
Germany	-0.3	-3.2	-1.3	3.4	0.0
Italy	-0.9	-3.2	0.8	1.0	2.4
Spain	-6.4	-6.5	2.0	1.3	2.9
EMU	-1.4	-4.4	0.1	2.4	1.1
UK	-2.2	-6.8	2.2	2.2	1.8
US	-3.8	-5.4	1.0	1.3	1.3

Source: Eurostat database AMECO

Austerity: myth and reality

These data raise questions and doubts that the readers of RGE know very well. Was such a quick and severe reversal from fiscal stimulus to austerity necessary for *all* euro-countries? Is this policy fostering, or hampering, fiscal consolidation, financial stability and economic recovery as promised by the EMU institutions? These are key questions, not only for economists, but for the public opinions at large, and hence for politicians, in the countries more severely hurted by the crisis like Greece, Spain and Italy. Answers to these questions are highly controversial both theoretically and empirically, and we cannot provide solutions here. However, the followig graph offers a snapshot of the average year growth performance of our sample countries after the 2009 recession *vis-à-vis* the cumulated fiscal stimulus since 2009.

Graph 1. Average year growth rate 2010-12 *vis-à-vis* cumulated fiscal stimulus 2009-12.



Source: Tables 2 and 3

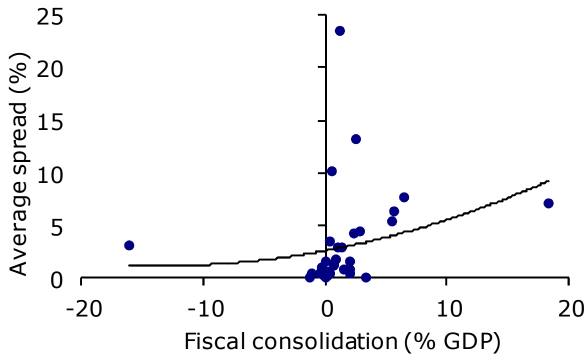
As a matter of fact, the only successful austere country has been Germany. Italy's austerity therapy has been accompanied by zero growth on average (and the 2012 deep recession). All other non-austere countries, except Spain, have enjoyed positive growth rates on average. Mr. Monti, in his new clothes as political leader, has recently said that it was foolish to expect no recession effects from austerity. But that was not his view in November 2011, when he took office heralding "rigour, growth and equity". Indeed, the Brussels-Frankfurt consensus, that Monti endorsed, was that "credible" - i.e. hard and fast - fiscal consolidation was the safest way to minimize recession and foster recovery.

Spokesmen of the Brussels-Frankurt consensus - some of whom come from Monti's alma mater - now argue that his government cooked up the wrong austerity recipe, with too much taxation and too little cuts on spending (in spite of the monster pension reform). It is well known that not all austerities are equal. Yet it is also well known that the tale of so-called "Non-Keynesian effects" of fiscal restrictions has materialized in very few cases blessed by the happy combination of favourable conditions - i.e. small open economies, with easy monetary policy and exchange-rate devaluation (e.g. Perotti (2011), Favero et al. (2011)) - that are hardly applicable to large euro-economies. The German austerity has also been based on taxation, but it has been less severe and compensated by a boom of extra-european exports. Recent IMF studies (e.g. Blanchard and Leigh (2013)) turn the Brussels-Frankfurt consensus on its head showing that the "Keynesian effects" of fiscal restrictions are most likely, but taxation may have less severe effects than cuts on spending.

Be as it may, the most disappointing result in the austerity therapy, especially in Italy, has been on the financial front. Public debt growth has not been stopped, both nominally and relative to GDP. All major euro-countries ended 2012 with a larger debt/GDP ratio than in 2009, 14.7 GDP points for the EMU as a whole. The well-known problem with the debt/GDP ratio is that, by mere accounting mechanisms, it may rise owing to poor growth in spite of fiscal restrictions. As shown by a study of the European Commission (2011), this was the case in 7 countries (Austria, Belgium, Finland, France, Greece, Italy, Portugal). If Keynesian effects of fiscal restrictions prevail, this perverse mechanism steps in quite likely.

Spreads have not been tamed until investors have agreed to believe that the new ECB programme of Outright Market Transasctions launched in the summer of 2012 is in fact a shield against debt runs. Graph 2 plots fiscal consolidation (as in table 4) against spreads for all EMU12 countries in the three years 2010-11-12. The nonlinear fit of the second order suggests that country spreads are poorly, and wrongly, related with fiscal consolidation: larger fiscal adjustments have not been rewarded with smaller spreads.

Graph 2. Fiscal consolidation and year average of monthly spreads over 10-year German bonds, EMU12 countries, 2010-12



Source: Eurostat databes AMECO; ECB, Interest-rate statistics, online database.

These data identify a major flaw in the austerity therapy, because if there is any chance that fiscal restrictions do not trigger a recession, this depends on the fast and sharp fall of the interest rate. It may be argued that this did not happen mostly because fiscal adjustments were not credible - i.e. they were *too small*. On the other hand, along with more formal tests such as those of De Grauwe and Ji (2012), these data may also highlight a scenario of "consolidation fatigue", that is one where adjustments were deemed *too large* by investors (e.g. Tamborini (2012)). Indeed, the credibility doctrine underpinning the austerity plans has turned out to be too optimistic and simplistic. First, Keynesian effects of fiscal restrictions may be self-defeating thus raising the debt/GDP ratio, depressing prospective growth and investors' confidence. Second, investors' flight pushes spreads up and makes fiscal consolidation harder in a vicious circle that may self-sustain debt runs. These are the perverse mechanisms that are now studied in the so-called "self-fulfilling prophecies" models of debt crises (e.g. De Grauwe (2011), Tamborini (2012)), and that have also been endorsed by President Draghi in his presentation of the OMT programme

(…) we are in a situation now where you have large parts of the euro area in what we call a "bad equilibrium", namely an equilibrium in which you may have self-fulfilling expectations that feed upon themselves and generate very adverse scenarios. So, there is a case for intervening, in a sense, to "break" these expectations (…) (Draghi (2012, p. 4))

President Monti candidates himself for a second, "political" mandate with a shadowed picture of his "technical" government. As many people think, we have seen a lot of "rigour", but very little "growth and equity". Perhaps, this was the only feasible recipe to avoid Italy's bankruptcy, and I would credit Monti's government with the important results of regaining Italy's international status and backing

Draghi's conquest of the only significant, and fruitful, reshaping of EMU institutions we have seen to date. Indeed, Italy's halving of its spread in the late 2012 is mostly due to the credibility of the OMT programme, which is however not yet tested in the market. Hence we are living in a precarious equilibrium hanging on "good" self-fulfilling expectations that may easily be reversed. On the other hand, it seems quite clear that Monti started as a believer in the austerity therapy - I think that nobody ever heard him to use the word "aggregate demand" - but he lost his bet on a short recession and fast recovery. Has Professor Monti understood where the faults are, and, more importantly, has he another strategy in mind for Italy and Europe? The answer, three weeks before the elections, is still unclear.