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WHEN THE EURO was launched in 1999, public debt had been brought down substantially in the two countries, to roughly 110 percent of GDP. At the time Belgium and Italy were also identical in another respect: GDP per capita.

TODAY THE SITUATION is very di erent. e level of public debt is 130 percent of GDP in Italy against only 100 percent in Belgium. Worse, in GDP per capita terms, Italy is now 20 percent poorer than Belgium. No wonder Italians are dissatis ed with their lot.

THIS POLICY CONTRIBUTION looks at the evolution of public debt in Belgium and Italy since 1990 and seeks to explain the contrasting evolution in the two countries in the run-up to the introduction of the euro, during the early years of the euro and since the beginning of the crisis.

IT FINDS THAT, after substantial scal e orts during a relatively brief period before the launch of the euro, Italy's e orts tailed o , while Belgium continued to consolidate its debt at an impressive pace. Italy also did too little to improve its growth performance, which lagged signi cantly behind Belgium's and that of all other euro-area countries.

WHEN THE CRISIS hit the two countries, Italy was therefore much more vulnerable to market sentiment than Belgium, especially when the sovereign debt crisis spread from Greece to other euro-area countries. Italy responded to the onslaught of markets with austerity measures, which made matters worse, sending GDP growth into negative territory and increasing the debt-to-GDP ratio.

POLITICS HAS BEEN central to the contrasting debt dynamics in the two countries. Bad domestic politics prior to Maastricht were responsible for the huge accumulation of public debt in Belgium and Italy up to the early 1990s. Maastricht brought scal discipline to both countries, but the constraint proved more binding on Belgium than on Italy once the two countries joined the euro. During the crisis, Belgium fared better than Italy because its political class

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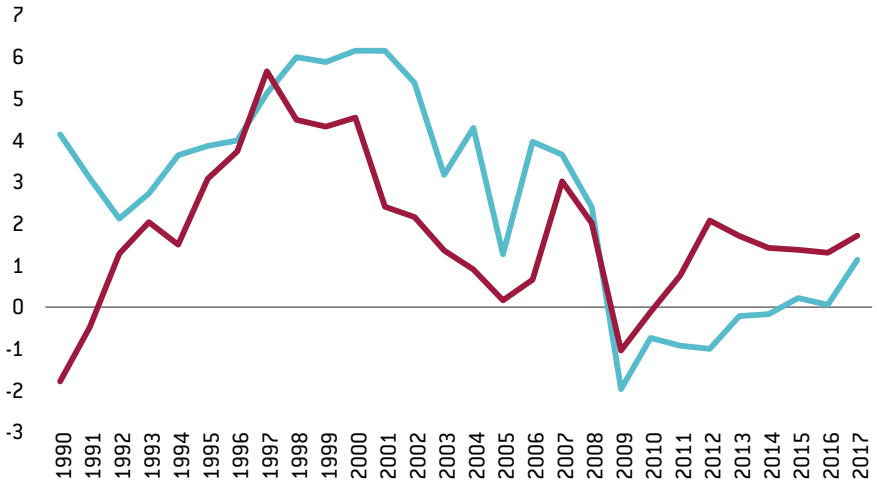
Figure 2: Primary surplus (+)/de□cit (-) as a ratio of GDP (in %), 1990-2017



Source: Bruegel based on IMF WEO database.

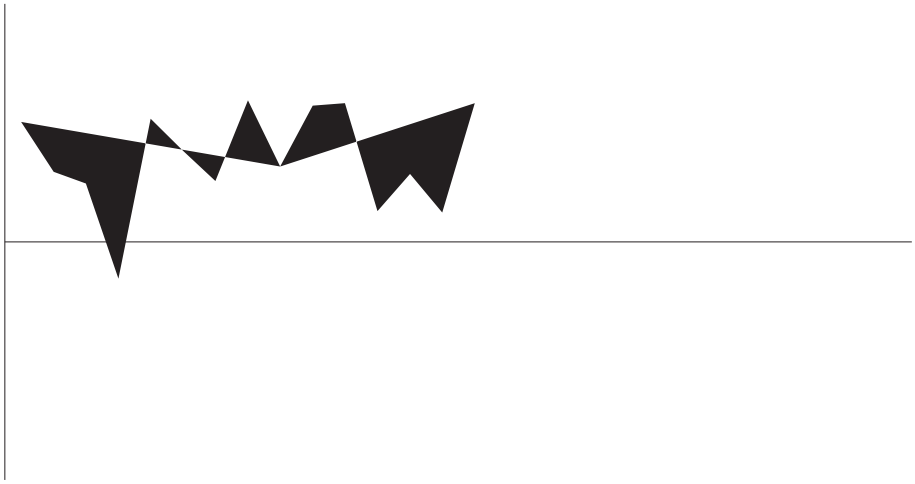
Figure 3: (r-g) (in %), 1996-2017

Source: Bruegel (see Figures 4 and 6).

Figure 4: Implicit real interest rates on government debt (in %), 1996-2017

Source: Bruegel based on AMECO database, European Commission.

Figure 6: Real GDP growth rate (in %), 1990-2017



Source: Bruegel based on IMF WEO database.

4 Explaining debt dynamics in the two countries: from the early 1990s to 2007

In both countries the debt-to-GDP ratio reached a peak soon after the signature of the Maastricht Treaty, and subsequently declined more or less rapidly and more or less steadily until 2007.

In Belgium the debt ratio declined by 51 points of GDP between the peak (of 138 percent) in 1993 and 2007, an average of 3.7 points per year. By contrast, in Italy the debt ratio declined by only 27 points between the peak (of 127 percent) in 1994 and 2007, an average of only 2.1 points per year. ree factors explain the contrasting performances of the two countries.

e rst factor is the government's primary balance. In Belgium, the government ran a primary surplus averaging 4.7 points of GDP per year from 1993 to 2007. e Italian government also succeeded in producing a primary surplus from 1994 to 2007, but it only averaged 2.9 points of GDP per year (Figure 2).

e second factor is the growth rate of GDP, which averaged 2.4 percent per year in Belgium from 1993 to 2007, but only 1.7 percent in Italy from 1994 to 2007. Much has been written about the relatively poor growth performance of the Italian economy during this period (see, for instance, Faini and Sapir, 2005). It is su cient to say here that after a remarkable growth and convergence performance, Italy (or at least a signi cant part of it) seems to have been unable to modernise in response to the economic and social challenges of globalisation and technological change that accelerated during the 1990s.

In particular, total factor productivity (TFP) growth has stagnated or even decreased since the mid-1990s. According to Calligaris *et al* (2016), a large fraction of the Italian productivity slowdown during the past 20 years arises from increased misallocation of resources, with the country being increasingly unable to reallocate resources from low- to high-productivity rms. e authors estimate that if misallocation had remained at its 1995 level, aggregate TFP in 2013 would have been 18 percent higher than it was actually was,

which would have translated into 1 percent higher GDP growth per year between 1995 and 2013.

e third factor is the real interest rate on government debt, which declined substantially in both countries in the run-up to and early days of the euro. In contrast to the previous two factors, on which Belgium performed better than Italy, here Italy did better than Belgium. On average during this period[2], the real interest rate paid on government debt was only 3.7 percent in Italy compared to 4.3 percent in Belgium. is di erence re ected two factors: the lower yields on Italian debt than on Belgian debt because of the bigger size of the Italian government bond market, and the higher in ation rate in Italy compared to Belgium.

Clearly, with rapidly declining interest rates on government debt, and lower levels than in Belgium, Italy missed an easy opportunity to reduce more substantially its public debt ratio between the early 1990s and 2007. Successive Italian governments should have taken more vigorous action to reduce the debt ratio. Two avenues should have been pursued more forcefully.

First, Italy should have implemented more structural reforms to increase the growth rate of the economy. But raising the average annual growth rate by say 0.5rlhe groh8 (tal)1 (y sho)4 (uld h)6.9 (a

of vulnerability to contagion from the eurozone debt crisis…One-o measures such as public spending cuts are all very well. But Italy's chronic underperformance needs a more transformational remedy."

Between May and December 2010, the spread between Italian and Belgian 10-year government bonds stabilised at around 20 basis points in favour of Belgium. During the rst ve months of the following year, it even came down, averaging only 2 basis points. But starting in June 2011, Italy's spread with Belgium climbed rapidly, reaching more than 50 basis points in July, more than 100 points in August and more than 200 points in November (Figure 5B). e country was falling into the very debt trap it had been trying to avoid.

In summer 2011, under growing pressure from markets, the Italian government announced three scal consolidation packages in barely six weeks: on 30 June, in mid-July

rated, was forced to cede his position of prime minister to Mario Monti a week later, on 16 November.

In order to stop a further rise in the yield of Italian debt, which reached more than 650 basis points in November 2011, and to avoid a further downgrade in the country's sovereign

e austerity measures increased Italy's debt-to-GDP ratio from 117 percent of GDP in 2011 to 129 percent in 2013. During the same period, by continuing to run a primary de cit and stimulating economic activity, Belgium managed to keep its debt-to-GDP ratio more or less constant during this period. As a result the debt-to-GDP di erential between Italy and Belgium, which was 14 points of GDP in 2011, increased to 24 points in 2013. Austerity did not

timent than Belgian debt. is is exactly what happened in 2011-13, after the Greek sovereign debt crisis spread to other euro-area countries, sending shockwaves through the Italian sovereign bond market but leaving the market for Belgian bonds relatively calm. What would have been di cult to predict, however, is the magnitude of the impact of the shock on the Italian sovereign bond market.

What happened in Italy between 2011 and 2013 seems to con rm the line of reasoning of De Grauwe and Ji (2012 and 2013) about panic-driven austerity and self-ful lling crises in peripheral euro-area countries. eir main argument is that nancial market sentiment about peripheral euro-area countries turned more negative in 2010 and 2011 than was justi ed by their economic fundamentals; that market sentiment led to panic-driven austerity measures by national governments, in turn worsening economic fundamentals, feeding into worsened market sentiment; and that only the ECB could have stopped this self-ful lling crisis by reassuring markets that it was ready to inject su cient liquidity into the sovereign bond market of peripheral countries.

Although De Grauwe and Ji (2012 and 2013) make a clear distinction between peripheral and core euro-area countries and argue that Italy (like Belgium) belonged to the group of core euro-area countries, their thesis seems to t the Italian case perfectly. In 2011, one year into the euro-area sovereign debt crisis, markets suddenly demanded yields on Italian government bonds far in excess of yields on Belgian bonds. is led to austerity measures by the Italian government in 2011 and 2012 that produced negative growth in 2012 and 2013 and a sharp increase in the debt-to GDP ratio. e fact that Italian spreads reached an all-time high on 24 July 2012, two days before Mario Draghi's London speech promising to do "*whatever it takes*", and declined sharply thereafter, lends support to the view of De Grauwe and Ji (2012 and 2013) that markets had succumbed to self-ful lling prophecies of Italy leaving the euro and that the ECB was capable of guiding them back to calmer sentiment if and when it displayed su cient determination.

Yet, neither the spread between Italian and Belgian government bonds (see Figure 5B) nor the sovereign rating di erential between the two (Figure 5C) have returned to their pre-2011 levels. For a while, after the ECB's announcement during the summer of 2012 and especially after it launched its asset purchase programme in March 2015, buying massive amounts of government bonds from banks to support economic activity and in ation in euro-area countries, it seemed that the situation had calmed. But in November 2016, on the eve of the referendum that Italian prime minister Matteo Renzi lost the next month, and which led to his resignation, spreads between Italian and Belgian 10-year bonds again rose beyond 100 basis points. And in May 2018, during the political crisis that preceded the appointment of Giuseppe Conte as Italian prime minister, these spreads even reached 200 basis points for the rst time since the period of 12 months that started in November 2011, when the Berlusconi government was forced to resign.

e timing of these three recent episodes – November 2011, November 2016 and May 2018 – suggests that domestic politics in Italy bears a heavy responsibility for sending markets into a panic about the country's creditworthiness. e fact that domestic politics played such an important role in these events also suggests that, though clearly useful, ECB intervention was not and could not have been su cient to restore the con dence of markets in the Italian sovereign to its-pre crisis level. is required changes in domestic politics.

7 Conclusions

I draw three conclusions from the comparison between Belgium and Italy during the period from 1990 to 2018.