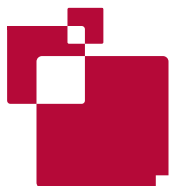# THE EURO AREA'S TIGHTROPE WALK: DEBT AND COMPETITIVENESS IN ITALY AND SPAIN

ZSOLT DARVAS

Highlights

- Competitiveness adjustment in struggling southern euro-area members requires persistently lower inflation than in major trading partners, but low inflation worsens public debt sustainability. When average euro-area inflation undershoots the two percent target, the conflict between intra-euro relative price adjustment and debt sustainability is more severe.

- In our baseline scenario, the projected public debt ratio reduction in Italy and Spain is too slow and does not meet the European fiscal rule. Debt projections are very sensitive to underlying assumptions and even small negative deviations from GDP growth, inflation and budget surplus assumptions can easily result in a runaway debt trajectory.

- The case for a greater than five percent of GDP primary budget surplus is very weak. Beyond vitally important structural reforms, the top priority is to ensure that euro-area inflation does not undershoot the two percent target, which requires national policy actions and more accommodative monetary policy. The latter would weaken

THE EURO AREA'S TIGHTROPE WALK: DEBT AND COMPETITIVENESS IN ITALY AND SPAIN

ZSOLT DARVAS, SEPTEMBER 2013

SOUTHERN EURO-AREA COUNTRIES face a number of challenges, such as achieving sustainable public and private debt positions, sound banking systems and improved competitiveness in the midst of a deep economic contraction and high unemployment, which are also fuelled by major structural weaknesses. The triple crises of balance of payments, banking and sovereign debt, and the consequent growth crisis, are highly interrelated[1]. Notwithstanding these difficult conditions, major adjustments have been achieved – but much more is necessary. For example, Italy's almost 5 percent of GDP structural primary budget surplus suggests that further fiscal consolidation may not be needed. But Italy's real exchange rate has hardly corrected and the country's export performance remains weak, factors that call for a major adjustment. Spain is in almost the opposite situation: there has been a significant fall in unit labour costs (ULC) and Spain's export performance has been outstanding since 2008, yet its large external debt necessitates further improvements in exports, and a major fiscal adjustment is also still ahead. In both countries, the large stock of public debt means the fiscal situation is vulnerable.

There are five major ways in which high debt ratios can be reduced: fiscal consolidation, fast economic growth, high inf
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1. In this Policy Contribution we focus on the balance of payments and sovereign debt crises, but not the banking crisis. Concerning the latter, we only note that banks in these countries now hold even larger amounts of the sovereign debt of their home governments than before the crisis, which makes banks particularly vulnerable to the deterioration of public debt sustainability. Also, banks in southern euro-area members suffer losses on their assets because of the output fall and high unemployment, which limits banks' ability to supply credit to the real economy, which in turn deepens the output contraction and makes it more difficult to achieve a sustainable fiscal position.

2. Financial repression refers to explicit or indirect caps or ceilings on interest rates and various regulations that create and maintain a captive domestic audience (such as pension funds) that facilitate directed credit to the government (Reinhart and Rogoff, 2011).

Both I... nd Spain have recently implemented major ... adjustments, as reflected in their structu... imary balances, which are expected to imp... om a surplus of 0.5 percent of GDP in 2009 ... percent in 2013 in Italy, and from a deficit ... percent of GDP in 2009 to a deficit of 1 perc... 2013 in Spain. Due to the depressed state ... economy, the actual primary budget balanc... orse than the structural balance. The overa... tural balance has also improved, but l... e primary balance, because of ...crea... rest payments[3]. Gross public debt increa... bout 25 percentage points of GDP in Italy a... than 50 percentage points in Spain from 2... 2013, exceeding 130 percent of GDP in Italy ... 90 percent in Spain by 2013[4].

Both c... es have succeeded in improving their

TABLE 1: ITALY ... AIN, ... AIN MACRO... OMIC INDICATORS

A. ITALY		1998-2007		2009	2010	2011	2012	2013
GDP growth	Real potential	1.3		-0.3	-0.2	0.2	-0.8	-0.4
	Real actual	1.5		-5.5	1.7	0.4	-2.4	-1.3
	Nominal	4		-3.5	2.1	1.7	-0.8	0.2
Output gap				-3.6	-1.8	-1.6	-3.1	-4
Unemployment rate		8.7		7.8	8.4	8.4	10.7	11.8
Inflation	Headline	2.3		0.8	1.6	2.9	3.3	1.6
	Constant			0.8	1.6	2.6	2.5	
Primary budget balance	Actual	2.8		-0.8	0.1	1.2	2.5	2.4
	Structural			0.5	0.9	1.4	4.1	4.8
Budget balance	Actual	-2.8		-5.5	-4.5	-3.8	-3	-2.9
	Structural			-4.2	-3.7	-3.6	-1.4	-0.5
Gross public debt		107.2		116.4	119.3	120.8	127	131.4
Current account balance		-2.9	-0.2	-2	-3.5	-3.1	-0.5	1
Net International Investment Position		-13.2		-25.3	-23.9	-20.7	-24.4	
B. SPAIN		**1998-2007**		**2009**	**2010**	**2011**	**2012**	**2013**
GDP growth	Real potential	3.4		0.9	0.3	-0.2	-0.9	-1.4
	Real actual	3.8		-3.7	-0.3	0.4	-1.4	-1.5
	Nominal	7.7		-3.7	0.1	1.4	-1.3	0.1
Output gap		-3.1	1.4	-4.2	-4.7	-4.1	-4.6	-4.6
Unemployment rate		11.1		18	20.1	21.7	25	27
Inflation	Headline	3						

3. The overall actual balance is also influenced by bank bail-outs. In the case of Spain, in 2012 the one-off and other temporary measures (largely comprised of bank-bail outs) increased the deficit by 3 percent of GDP.

4. An approximately 4 percent of GDP increase in the debt ratio is due to euro-area bail-outs (bilateral lending to Greece, EFSF – European Financial Stability Facility, ESM – European Stability Mechanism).

flow external imbalances, ie the current account balance is expected to turn to surplus this year, after reaching a large pre-crisis deficit in Spain (minus 10 percent of GDP), less so in Italy (minus 3 percent of GDP). But the stock problem is still there in Spain: the net international investment position (IIP) shows a negative balance of minus 90 percent of GDP, which is very large (much larger than the 35 percent threshold of the scoreboard of the Macroeconomic Imbalance Procedure – MIP[5]), and largely comprises debt. Its service will require major resources from the economy, while reducing it towards the MIP threshold necessitates sizeable trade surpluses. By contrast, Italy does not have a major stock problem, since its net negative IIP is only about one quarter of GDP.

There is a major difference between Italy and Spain in the drivers of the improvements of the current-account balance. Spain's export performance has been even better than Germany's, but Italian exports have remained much weaker (Figure 1). Import compression has also been a major factor, especially in Spain, where domestic demand fell more significantly than in Italy.

The calculations and literature survey presented in Darvas (2012b) suggest that the ULC-based real effective exchange rate (REER) is strongly related to export performance. Figure 2 shows that the ULC-REER relative to euro-area partners has not yet adjusted in Italy – the euro-area country that faced the highest pre-crisis real appreciation. The REER calculated against non-euro area countries depreciated somewhat, largely because of the nominal depreciation of the euro from its highly overvalued rate in 2007, but the index is still much stronger than the historical average.

Spanish data looks better, and the fall in REER is in line with the excellent export performance. However, ULC improvements were largely achieved through labour shedding (Darvas,

7. See Darvas and Savelin
(2012) for the develop-
ments of the Italian, Span-
ish and German
government bond yields
after ten ECB actions

Figure 5: Public debt/GDP ratio: alternative scenarios
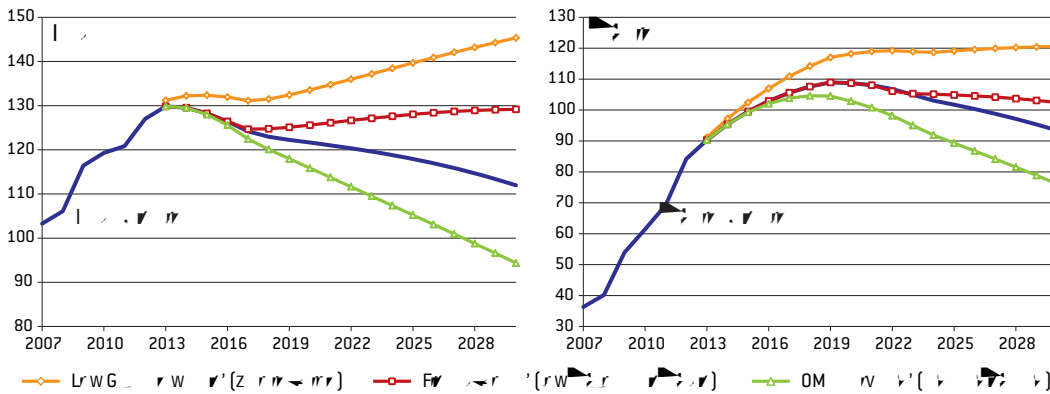
Source: Bruegel.

TRADE-OFFS

Using the model described in the previous section, we can quantify various trade-offs. First, we assess the situation in which inflation has to be 1 percent lower because of low German inflation, in order to support the necessary competitiveness adjustment between southern euro-area members and Germany. If inflation is 1 percentage-point per year lower, to have debt dynamics similar to those in our baseline scenario, then:

- Either the persistent primary surplus has to be higher in Italy by 1.3 percent of GDP and in Spain by 1.0 percent of GDP,
- Or the interest spread to Germany should be reduced to approximately 130 basis points in Italy and 160 basis points in Spain

.
Second, we check the implications of a reduction of the spread to Germany from 227/239 to 150 basis points. In this case, in both Italy and Spain, an approximately 0.8 percent of GDP lower structural primary surplus would produce the same debt dynamics as our baseline scenario. Therefore, spread reduction would bring a major relief for fiscal consolidation.

And thirdly, we check what policy measures would help Italy and Spain to meet the operationalised fiscal rule on public debt ratio reduction. As we have argued, for Spain the issue is that debt reduction starts later. Therefore, for Spain the deadline for exiting the excessive deficit procedure has to be extended by about two or three more years beyond the current deadline of 2016. If we replace our baseline assumption with:

- Either a 0.9 percent of GDP higher primary surplus in Italy and 0.2 percent in Spain,
- Or 0.7 percentage point per year higher inflation in Italy and 0.3 percentage point in Spain,
- Or about 90 basis points lower interest rate spread to Germany in Italy and about 10 basis points lower spread in Spain,

then the debt ratio by 2030 would be the one implied by the operationalised debt rule as depicted in Figure 4. Therefore, meeting the operationalised SGP debt rule would not require a major effort from Spain (if the deadline for exiting the EDP is extended by two or three years), but Italy would need to make more effort. The difference between the two countries is explained by the difference in debt levels: since Italy has a significantly higher debt level, but in our baseline assumption we assume the same growth, inflation and primary balance for the two countries, Italy needs to do more to reduce her debt.

CONCLUSIONS

The Italian and Spanish economies are depressed with large negative output gaps and high unemployment. Italy has a large structural primary surplus (4.8 percent in 2013 according to the May 2013 forecast of the Commission), but Spain is still expected to have a structural primary deficit of 1 percent, necessitating a major fiscal adjustment in the years ahead. Unit labour costs have not yet adjusted in Italy and have adjusted through labour shedding in Spain; further adjustment is needed in both countries. There is some, but insufficient, market confidence, which is reflected in the 227 (Italy) and 239 (Spain) basis points expected 6-

year maturity spread relative to German bunds from 2014-2030. According to our baseline scenario for public debt, the projected pace of debt ratio reduction is too slow in Italy, missing the requirements of the SGP operationalised debt rule by a wide margin. In Spain the debt ratio is even expected to increase until about 2020 before starting to decline gradually afterwards, ie about 2/3 years after the operationalised debt rule applies to Spain, should the country exit the excessive deficit procedure by the current deadline of 2016. And there are major risks because of the high public debt ratios: even small negative deviations from our assumptions, such as a somewhat lower long-term growth, inflation and primary surplus, could easily result in a runaway debt trajectory.

These simulation results paint a bleak picture. Perhaps we were too conservative in making our baseline assumptions. Economic growth might pick-up faster and to a higher level than what we assumed. The tradable sector might improve without further real exchange rate depreciation. Future interest rates might be lower compared to current market expectations. But merely hoping for such benign outcomes would amount to wishful thinking. Instead, forceful policies are needed to pursue the dual goal of debt sustainability and improved price competitiveness, beyond the badly needed structural reforms aimed at fostering labour and product market flexibility, greater public sector efficiency, and banking sector clean-up.

Further fiscal consolidation beyond the 5 percent primary surplus we assumed might be an option. However, the case for further fiscal consolidation is weak in the short and medium terms, when both Italy and Spain have depressed economic conditions, and high and rising unemployment. For the longer term, history teaches us a lesson in caution. Over the last 50 years, no OECD country (except Norway, thanks to oil surpluses) has sustained a primary surplus above 5 percent of GDP. Even sustaining a 5 percent of GDP primary surplus (our assumption) for several decades could

prove to be politically challenging. Moreover, further fiscal consolidation may not do much to help the competitiveness adjustment when the Phillips-curve is quite flat (implying that an even greater negative output gap and even higher unemployment might not do much to reduce prices and wages). Even if the Phillips-curve becomes steeper (ie prices and wages respond more to changes in unemployment) due to structural reforms that enhance the flexibility of labour

the dual goal of debt d improved

month of the previous year). But as Vihriälä (2013) argues, the underlying inflation trends are better reflected in indicators excluding volatile food and energy prices and the impact of tax hikes induced by fiscal consolidation programmes. As Figure 6 shows, the inflation rate excluding energy, food, alcohol and tobacco was 1.1 percent in July 2013 and the constant tax rate inflation rate was 1.2 percent, suggesting that we are head-

12. The constant-tax inflation indicator is not available for the aggregate excluding energy, food, alcohol and tobacco. Since the constant-tax all items inflation is below the headline inflation, the constant tax inflation of the aggregate excluding energy, food, alcohol and tobacco is now likely below 1 percent per year, suggesting that the underlying inflationary trend undershoots the 2 percent target.

13. We note that a weaker euro exchange rate may increase the euro-area current account surplus. The euro area's current account is expected to reach a surplus of about 2 percent of GDP in 2013, after a decade of being almost balanced. The two main surplus countries, Germany and the Netherlands, have slightly larger surpluses, while formerly deficit countries are now moving toward a balanced position. The increased euro-area current account surplus was largely absorbed by smaller surpluses in emerging countries, which was the right way of adjustment (Darvas, 2012b). In the future, euro-area countries with large surpluses should boost their domestic demand, which would reduce their surpluses, and thereby the external surplus of the euro area would not widen too much.

in turn would necessitate Italian and Spanish applications for at least a precautionary financial assistance programme, and an increase in the resources of the ESM[14]. In terms of adjustment requirements, this would not lead to much change, because the two countries are anyway obligated to follow the Council's recommendations because they are under the Macroeconomic Imbalances Procedure. Also, Spain already has a banking programme from the EFSF with condi-tionality for the banking sector. It is quite unlikely that a precautionary programme would make many other demands compared to what the two countries have to do anyway. Yet it may prove to be difficult to agree on financial assistance pro-grammes for Italy and Spain and to increase the resources of the ESM, and the euro area may not easily survive a scenario in which the ECB has to buy large amounts of Italian and Spanish public debt.

ANNEX: NOTES TO BASELINE SCENARIO ASSUMPTIONS (BOX 1)

- We take the end-2012 public debt stock and European Commission's May 2013 forecast for budget balance and GDP growth for 2013 as the starting point.

  By now, the situation with budget deficits, debts and the economic outlook is slightly worse than the May 2013 forecasts. However, there is no up-to-date comprehensive forecast for all of the required macroeconomic indicators and our focus is on the medium- and long-run simulations, which would be only marginally affected by a more up-to-date forecast for 2013.

- Potential GDP growth gradually increases by 0.1 percentage point per year from zero to 1 percent per year in 10 years.

  This assumption is similar but slightly more conservative than the baseline scenario in Italy's stability programme, which assumes that potential growth increases from about zero in 2013 to about one percent by 2018 and stays at this level thereafter. Spain's stability programme assumes a negative potential GDP growth rate at least until 2016 (the table in the stability programme presents yearly data only up to 2016) and an average 1.2 percent per year rate in 2017-21, assumptions that do not differ much from ours.

- The baseline GDP deflator change is 1 percent per year.

  This assumption is more conservative than the assumption in Italy's stability programme, which assumes an average 1.8 percent yearly change in the GDP deflator from 2013-18. Our choice is motivated by what we see as a major need for a price competitiveness adjustment. We note that the baseline inflation is altered when there is a change in the cyclical position of the economy, as described by the Phillips-curve relationship below.

- Phillips-curve is rather flat: a 1 percent lower output gap reduces prices by 0.1 percent.

  There have been major fiscal adjustments in Italy and Spain, yet prices have not declined, suggesting that prices are sticky and the Philips-curve has to be flat[15]. The Phillips-curve may change because of, for example, structural reforms that make prices and wages more responsive to the cyclical position of the economy. However, it takes time for structural reforms to have an effect and in our model the output gap gradually reverts to zero (see the next point) and the Phillips-curve matters only while the gap is non-zero.

- If there are no other shocks and no change in the structural primary balance, then the output gap improves by 1 percent of GDP per year, until zero is reached.

  This assumption is broadly in line with the assumption in Italy's stability programme, which assumes that the current 4.8 percent of GDP output gap corrects by about 1 percent per year in the next four years, and the then remaining approximately one percent gap is corrected by about one-third of a percent per year in the following three years.

  The potential growth rate and the closure of the output gap define the real GDP growth rate[16], and the real GDP growth rate and the change in the GDP deflator determine the nominal GDP growth rate.

- We define the fiscal effort as the change in the structural primary balance.

  There is now an extensive literature arguing that this is not the best measure, partly because the structural balance calculations are imperfect. Yet this is the most widely used indicator and it is very easy to link this indicator to public debt simulations.

- The fiscal multiplier is only instantaneous (within the year) and its value is 1, which implies that a 1 percent of GDP higher structural primary surplus reduces the output gap by 1 percent.

  There is an intense debate about the size of fiscal multipliers, which also depend on the composition of fiscal adjustment and the economic cycle. Some empirical papers argue that fiscal adjustment not only has an instantaneous effect, but an effect spreading across several years. Yet there is a controversy regarding the magnitude of fiscal multipliers and uncertainty about the composition of future fiscal adjustment, which implies that it is not possible to make a sound assumption about the multiplier. Our assumption should not be that far from fortjd4..7.

15. The increase in consumption taxes also contributed to inflation in the midst of the deep crisis, yet the constant-tax consumer price indicator of Eurostat suggests that underlying inflation was relatively high considering the depressed state of the economy, high unemployment and the need for a relative price adjustment between euro-area countries. Also, in Ireland the GDP deflator fell, suggesting that the Irish economy is more flexible than the economies of southern Europe.

16. For example, if potential growth is 0.2 percent per year and 1 percent of GDP output gap is corrected, then real GDP growth is 1.2 percent.