In Italy and Elsewhere, Expansionary Public Spending is Key to Recovery from Covid-19

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Austerity policies will slow recovery and should be rejected

Recent weeks in Italy and Europe have witnessed the economic crisis related to the current pandemic becoming as central as the health emergency. Meanwhile, proposals on how to tackle it proliferate.[1]

While the situation is constantly evolving, I will try to lay out the problems and instruments available, both in principle and in practice, in the hope of clarifying the issues under discussion.

1. The economic context

It is becoming increasingly clear that the pandemic and the contagion control measures adopted worldwide will cause a deep recession as a result of the lock-down of important parts of production and the resulting disappearance of incomes generated by those activities. Many forecasts agree that gross domestic product (GDP) reductions will be greater than those caused by the global financial crisis in 2008, and that they will not all be transitory.

In all countries, the combination of the significant fall in GDP and increases in public spending and tax cuts to deal with the emergency will increase deficit-to-GDP and public debt to GDP ratios.

However, one element of extreme importance has so far often been underestimated or even ignored — in a totally anti-scientific way — in the political debate on these issues: the GDP number, which represents the sum of a country's total production, *is not independent of public budget policy*, i.e. changes in public expenditure (including transfers) or taxes. In other words, more public expenditure means less of a GDP fall. Moreover, the effects of changes in public expenditure on GDP in times of recession or economic stagnation are particularly strong. This means that in an already struggling economy, austerity policies (expenditure reduction) increase the debt-to-GDP ratio. This is not (only) the speculative conclusion of a particular economic theory or model that might not be shared, but a well-documented phenomenon.[2] This is abundantly clear today - unlike 10 years ago – because of what happened in Eurozone countries that carried out severe austerity policies before having fully recovered by the effects of the global financial crisis.

In Italy, for example, the debt-to-GDP ratio increased by more than 10 percentage points between 2011 and 2013, i.e. right in the middle of the implementation of austerity policies and reforms suggested by the European Commission (Paternesi Meloni, and Stirati, 2018). This increase in the debt-to-GDP ratio, *caused by austerity policies*, has made Italy more exposed to difficulties in placing its public debt securities on the financial markets, with a consequent increase in related interest rates.

This means that expansionary fiscal policies (more public spending, less taxes) will reduce the fall in GDP in the present context. Consequently, decidedly expansionary fiscal policies, if well designed and effective, could actually reduce the increase in the deficit/GDP and debt-to-GDP ratios by comparison with more cautious spending policies that are inspired by precisely by the fear of increasing those ratios. Italy has been following a line of extreme prudence until very recently (barely a week ago it was the European country set to spend the least as a percentage of GDP to face the crisis),[3] likely with predictably 'perverse' effects. Now, with a decree made public on the 6th of April, the government is possibly marking a change, with an important package of public guarantees of bank loans up to a total of 400 billion Euros, half of which aimed at supporting exports.

Expansionary fiscal policies are essential:

(a) to sustain health expenditure, income and aggregate demand, in order to ensure the fight against the virus, standards of living and production in the still active sectors;

(b) to lighten the tax burden on businesses and ensure that they have enough liquidity, including through the banking system, to survive the storm, hoping that it will end soon. [4] The risk is that otherwise, when there is a global recovery, companies will no longer be there to respond.

2. Three instruments to expand public spending

The instruments that can be deployed to pursue the above objectives can be divided into three broad categories, listed below in increasing order of 'expansive potential.' In the present situation all three classes of instruments must be used, and all of them, including the third one, appear to be indispensable.

1) *Provision of public guarantees of bank credit to businesses.* Interventions can go in the direction of favoring bank credit to the private sector and businesses at low interest rates and with a reduced demand for (collateral) guarantees. *This in turn requires the banking system to be guaranteed by the state against such loans* – possibly with some conditions concerning restarting production and preserving employment levels. Easier and cheaper access to credit is most important for businesses and should certainly be pursued. In the euro area, the measures that go in this direction are the ECB's policies aimed at maintaining a high level of liquidity in the banking system and the easing of the banking system's precautionary rules that should favor the granting of credit. However, with regard to public guarantees on loans provided by the banking system, there are so far only measures taken at national level, with the strongest countries until recently doing more in terms of funds set-up for guarantees as a proportion of their GDP (according to data published in the *Financial Times*, see note 1 above).[5] While the availability of credit to the private sector is important, it is clearly an insufficient instrument in view of the severity of the crisis. In a situation of falling incomes and demand, great uncertainty about the future even after the end of the health emergency, and with the entire world economy at a standstill, many firms may not want or may not be able to take the risk of taking out loans to restart business.

2) *Public spending and tax reductions financed by issuance of public debt securities by individual national governments.* Issuance of public bonds is the normal means to finance emergency expenditure and tax revenue reduction. They can be purchased on the financial market by private entities, mainly banks and other financial institutions. Subsequently, at least in part, they may be sold by banks to the central bank - to the European Central Bank (ECB) in the Eurozone.[6] They are loans made to governments. This debt will have to be repaid to the subscribers, but, unlike private debts, they do not have to be 'zeroed out' because a government can always

roll-over the debt, i.e. place on the market an amount of debt equal in value to that which has to be repaid. In the current situation however, all countries will be issuing additional debt and markets risk being flooded worldwide. In such context, economically weaker or high-debt countries might find themselves in trouble in placing their sovereign bonds on the financial market and might have to pay exceedingly high interest rates to do so.

Normally, national central banks take care of these difficulties, acting *de facto* as a 'buyer of last resort' and reassuring the markets.[7] This is what happens with government bonds in any 'normal country,' but not in the Eurozone, where the original institutional design was that financial markets should price government bonds, and that it is not up to the ECB to stabilize their value and interest rate. This view was reaffirmed by Christine Lagarde's alleged 'gaffe' that it is not her institution's job to close bond spreads) – an attitude which reflects influential views in Germany and other European countries. In the wake of the global financial turmoil caused by that gaffe, the ECB not only had to intervene promptly, but began to actively move in the opposite direction to the one initially outlined by Lagarde. The indicted phrase, however, suggests that things could change afterwards, leading to uncertainty about the ECB's attitude when the health emergency is over.

3) *The monetary financing of public expenditure is a third instrument.* It is different from the previously listed instruments because *de facto* it does not cause a debt to arise. With the policies adopted so far, the ECB provides liquidity to the banks in exchange for public or private securities, but without a guarantee that it will renew the purchase when they come to maturity. However, with the monetary financing of public expenditure the central bank finances expenditures of the treasury without there actually being an obligation to repay. This can concretely take many forms, more or less explicit, and historically it has often been done by central banks. A clear commitment to stabilize the price and keep at very low levels the interest rates on public bonds, as is currently the case in the U.S., is a form of relatively 'soft' *de facto* monetization; another, more resolute, form would be the transformation in perpetuity of (a significant fraction of) public bonds already in the in the hands of the central bank. In conditions of severe recession and zero or negative inflation, this has no contraindications and is indeed rightly urged by many quarters as absolutely necessary to give a real expansive boost to the economy.[8] In the past few years, the monetary financing of public spending has been an absolute taboo, but today this taboo seems to be breaking down with many influential economists.

Unconditional support from the central bank seems particularly desirable for the financing of health care expenditure and the compensation of incomes lost by households and businesses due to the lock-down. Once the emergency is over, some form of monetization would be highly appropriate to finance large public investment plans that foster recovery and support the ability to cope with any upsurge in health problems.

3. What is happening in Europe

Let us turn to what has happened in the eurozone in the face of the emergency, even though the picture is continuously evolving. As the virus spreads to all countries, the illusion epidemic would be limited and confined to just a few regions or countries has been shattered. For the time being, the ECB, after the first serious hesitations that have led to uncertainty in the financial markets, seems determined to stabilize the values of government bonds and interest rates of all eurozone countries through purchase.

However, the 750 billion increase in purchases already planned is not sufficient. There remains uncertainty about the willingness to maintain a policy of stabilizing the securities market soon *after* the end of the health emergency — although it seems unthinkable that for the time being the ECB will not roll-over the securities already purchased. Even if a commitment to continue in a policy of stabilization prevails, maintenance of "capital key" rule in the medium and long run, according to which the ECB must buy securities from all countries in a pre-determined proportion – at least on average over a certain period of time – guarantees an unpleasant asymmetry in interest rates costs, both for the public and private sectors, among eurozone economies.

The requirements for banks to facilitate the granting of loans to companies have been relaxed. The European Commission has also suspended the public finance parameters relating to the budget deficit in order to deal with the emergency.

The picture up to now is thus of a makeshift and provisional nature, leaving governments, particularly those of countries with higher debt such as Italy, fearing that once the emergency is over they will be asked to 'fall back' to within the parameters of austerity policies which, if adopted, would condemn their countries to deep and irreversible crisis, accompanied by a further deterioration in the situation of public finances, in a perfect vicious circle.

Thus, there are budget and ECB rules: in the short run, the constraints are suspended, but all medium and long term constraints remain in force.

The request to create 'eurobonds' is tantamount to asking for the creation of an instrument to finance public spending in the eurozone under the same conditions as in a 'normal country' where governments can finance public spending by issuing at low interest rates debt securities that are seen by financial operators as risk-free and not subject to speculation, as they are ultimately guaranteed by the central bank as described above. A further step would be some form of monetization, for example combining a clear commitment by the ECB to their purchase with an extremely long-term maturity of the bonds, which would fulfil the conditions set out above. It is extremely important that such bonds should be designed so as *not* to represent an addition to national debt burdens. Their purpose might be the provision of essential medical devices, but even more than that, of a large part of the massive expenditures and public investments that are needed to permit economic recovery.

Initially, the Eurobonds have encountered the 'immovable' no of some countries, such Germany, the Netherlands, Austria and Finland, despite the pressure exerted by nine, and later fourteen, countries, with the significant presence of France and Belgium. The European Council meeting of March 26 did not even consider the idea of Eurobonds issued to finance the additional expenditure caused by the crisis (the so-called coronavirus bonds), while Italy refused to fall back on the European Stability Mechanism (ESM), which has so far always been subject to oppressive conditionality.

The ESM can provide emergency loans to national states by issuing bonds which can be placed on the financial markets or also be purchased by the ECB. Even if these loans were now issued with 'lighter' conditionality, as it seems currently to be under discussion, they still represent a debt on the part of the national state that must be repaid, albeit hopefully on a very long term basis.

This raises two issues related to the support capacity that the ESM can provide. One is the possibility of imposing fiscal conditionalities 'Greek-style' (with the option of involving the International Monetary Fund (IMF) to complete the infamous Troika). Even if not imposed now (if existing rules are temporarily relaxed) they could be imposed at a later stage since EMS regulations allow, with a majority decision of its council, for demanding revisions of macroeconomic policies to the debtor country at any time in the future (Cerniglia e Saraceno, 2020).

The second issue is that the ESM's firepower (just over 400 billion Euros) is in any case limited. For this reason, if Italy and other countries resort to it, it would not constitute enough support to the necessary expansive policy. One argument in favour of the ESM is that it would pave the way for unlimited intervention by the ECB in support of the government bonds of the country that has used it (the famous Outright Market Transactions program launched by Draghi in 2012, never used until now). If this is the aim, however, the country would hardly escape fiscal conditionality. The use of the ESM is therefore an insidious scenario for Italy and other eurozone countries without being an effective measure, and the Italian government has done well to look for other ways.

The outlines of other proposals for recourse to loans from the European Investment Bank, or from the recently proposed Support to mitigate Unemployment Risks in an Emergency (SURE) temporary fund for unemployment subsidies, are still to be fully clarified. In any case, these would still be loans to be repaid to the financial institution providing them, hopefully in the long term, but adding to national debt load. In addition, from what is currently known, each country would be required to provide liquid guarantees *before* the institution can issue its bonds and obtain the liquidity that can be used by each country. Concerning the proposed 100 billion-euro SURE fund, in addition, limitations on the share of resources that can be used within a year time-period appear to be involved, which further scale down its economic impact and effectiveness. Thus, the same considerations advanced for the ESM apply, particularly concerning the too limited firepower of such measures, and in addition to this, a likely very laborious design and implementation, in conflict with the urgency to intervene to prevent a major economic crisis.

Even on the assumption that some form of Eurobonds will be accepted, it is likely that the instrument will not be adopted with the breadth and absence of fiscal conditionality that would be desirable.

It appears that at least part of the ruling class in Germany and other 'strong' countries in the eurozone believe they have 'fiscal space,' i.e. the possibility to spend without excessively widening their public deficits and debts. It is also possible that countries where the epidemic arrived later, and with health systems that have not suffered the cuts resulting from austerity measures in other Eurozone countries, are better prepared to contain the contagion, thus limiting the damage compared to countries where it occurred earlier, such as Italy. At the moment, the facts and figures do not give clear comfort to this eventuality. However, these countries might be betting on their ability to 'go it alone' and to emerge further strengthened, in relative terms, by comparison with the rest of Europe.

This behaviour is often justified to the public on the moral grounds that fiscal space has been gained by Germany through its virtues and past sacrifices. But if there are virtues behind German economic strength — and certainly there are — these do not necessarily have to do with greater 'austerity'; on the contrary, the data suggests the opposite, particularly in the case of Italy. Italy has had primary surpluses in its public accounts for thirty years, is the Eurozone country that has respected the deficit rules the most, and as a result has an overall per capita public spending *much lower* than Germany or France. Indeed, it has been argued that precisely such faithfulness to deficit rules is at the origin of its economic weaknesses, including slow growth and the high debt-to-GDP ratio.[9] Moreover, as mentioned at the beginning, the strong increase in the debt-to-GDP ratio after 2008, following a long period of laboriously conquered reductions, is largely due to *the implementation of the policies demanded by the European Commission*.

By contrast, the interest rate asymmetry within the eurozone mentioned above, and the negative interest rates enjoyed by Germany, thanks to ECB policy since 2012, has allowed Germany to save hundreds of billions of interest rate payments on public debt. [10] This has been a major contribution to sound public finances in Germany.

Indeed, Italy's public finance problems are rooted in the interest payments on public debt. Hence it is essential for the ability of the country to overcome such problems that monetary policy ensures low and stable interest rates. The same will hold for most, perhaps all eurozone countries as the economic consequence of the lockdown accumulate over time. It is a very well-known economic result that interest rates lower than GDP growth are the sustainability condition for public debt. The low interest rate is in the hands of ECB policy, while Eurozone policies should aim at boosting growth performance and public investments, avoiding at all costs contractionary fiscal policies that – as is undeniable after the experiences of the last decade – are a major cause of *persistent GDP loss*es.

4. What Italy can do in this context

Acceptance of any form of conditionality requiring austerity policies now or in the near future would be fatal for Italy and must be absolutely avoided. Far from representing a consolidation effort, such policies would have enormous costs in terms of unemployment and loss of productive capacity, while the state of public finances would worsen further, as explained at the beginning. This disaster may, however, appear to large foreign financial and industrial companies as an excellent opportunity to acquire the country's valuable assets at a low price: banks, businesses, infrastructure, and possibly also part of households' wealth, for example by acquiring property pledged as collateral of non-performing loans, taxing assets, demanding savers and investors to bail-in banks. Fears of precisely this is what has led the Italian government, with its decree of April 6, to allow government intervention aimed at preventing foreign (including intra-European) takeovers in broadly defined strategic sectors of the economy, including finance, transports and high-tech.

In the absence of significant European measures, the alternative for the Italian government and other troubled countries may be to take note of the emergency situation and immediately make all the expenditure needed to meet health and economic sustainability, *without hesitation and without very dangerous delays*. It could finance this expenditure by issuing public bonds, relying on the fact that at this stage the ECB cannot realistically run the risk of failing in support, which could start a global financial storm. Italy should in this way attempt, as explained at the beginning, to effectively contain the fall in GDP and therefore also the extent of the increase in the debt/GDP ratio.

Europe is likely to come out of this crisis politically in tatters. Despite the enormous difficulties that await it, Italy should therefore equip itself in every possible way (international alliances, trade relations, economic and institutional instruments of intervention in the economy) to face the probable political and economic showdown in the eurozone once the health emergency is over. As mentioned, the greatest risk for Italy is the high interest burden on public debt, which may be averted or aggravated by the ECB's choices.

The coronavirus emergency has highlighted for the public the importance of the national public health service and the ongoing damages caused by austerity policies. In view of these issues and the income losses that await them, Italian citizens will not and should not accept further harmful austerity measures.

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[1] See for example: "European Renaissance Bonds To Face Europe's Health And Economic Emergency," accessed 4/7/2: https://europeanrenaissance.altervista.org/; "With or without Europe, Italian economists for an antivirus plan," *Financial Times*, 13 marzo 2020, accessed 4/7/20: https://www.emilianobrancaccio.it/2020/03/13/brancaccio-e-altri-sul-financial-times-with-or-without-europe-italian-economists-for-an-anti-virus-plan/; "UE, BCE, non è così che si supera la crisi", *Micromega* 22 Marzo 2020, accessed 4/7/20: http://temi.repubblica.it/micromega-online/ue-e-bce-non-e-cosi-che-si-supera-la-crisi-appello-di-67-economisti/.

[2] See Fatás e Summers 2018, among others.

[3] According to data published in Gavin Davies, Can the world afford stimulus on this scale? *Financial Times*, 29 March 2020, accessed 4/7/20: https://www.ft.com/content/0f289d20-6e97-11ea-89df-41bea055720b. This scenario of counterproductive caution is unfortunately what is happening in Italy and other European countries, which are spending much less, to face the emergency, than the U.S., Japan, or the U.K.

[4] As pointed out by Draghi (2020).

[5] There have been discussions about the European Investment Bank providing some of the guarantees required to backstop loans to the private sector, but no clearly defined proposal is on the table as yet.

[6] Note that national 'central banks', such as the Bank of Italy or Bundesbank are now part of the European Central Bank System – even though the purchase of public bonds is highly segmented within the Eurozone, with each national 'central bank' purchasing their national public bonds, the operations are authorized by and ultimately conducted by ECB.

[7] Note that I refer to national public debt; clearly if a country has a large foreign debt, no Central Bank intervention can solve the problem.

[8] Many proposals of this kind are currently being advanced by economists with very different backgrounds. In Italy, such measures have been suggested among others by Fassina (2020) – a left-wing MP and an economist always opposed to austerity measures, and Giavazzi and Tabellini (2020) – two neo-liberal economists, the former until very recently publicly supporting austerity policies. Looking back, it can be recalled that until 1980, the Bank of Italy had the obligation to finance directly the Treasury for 14% of the expenses in the public budget. In essence, a behaviour of the central bank systematically aimed at keeping the interest rates on public debt securities low and stable, albeit with purchases on the secondary market, approaches a *de facto* monetization.

[9] Paternesi Meloni e Stirati (2018); Storm (2018).

[10] Schnabel, I. (2020); Halle Institute for Economic Research (2015).

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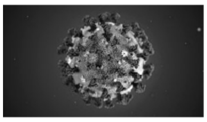

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