The Italian Budget: A Case of Contractionary Fiscal Expansion?

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Italy's government is in a standoff with the European Commission over its first budget proposal. Rather than reducing the public deficit, as the previous government had promised, the new government plans to increase it significantly. Because Italy's debt is very high—over 130 percent of GDP—the proposed budget violates EU fiscal rules. The European Commission has announced that the proposal is not acceptable, while the government has in turn stood firm. Pundits and markets are now focused on how this confrontation might evolve.

But there is an equally important question, namely, whether the proposed budget would in fact boost Italian output, as the government hopes and counts on. We fear not. In fact, the proposed policies are more likely to achieve the opposite.

To explain why, it is useful to recall one of the most controversial debates during the euro area crisis: What is the effect of fiscal policy in countries with high debt? Are there circumstances in which fiscal contractions expand output? Conversely, could fiscal expansions ever contract output?

At the height of the debt crisis, many politicians and economists argued that sharp fiscal adjustment was necessary and likely to stabilize output. By increasing confidence that countries would repay their debt, the argument went, public borrowing costs would fall, making credit cheaper. Increased confidence and cheaper credit would offset the contractionary impact of fiscal tightening. Prodded by the European Central Bank (ECB) and its European partners, the Italian government tightened its fiscal policy by over 3 percentage points of GDP in 2012. The opposing view was that deficits should be allowed to increase during the recession, until the economy started to recover. Borrowing costs, if they increased, should instead be limited through other means, including intervention by the ECB or the European Stability Mechanism (ESM).

We see the evidence as supporting the second position. Output in Italy fell by almost 2 percent in 2013, even though borrowing spreads in Italy did in fact start to fall in 2012, helped by Mario Draghi's "Whatever it takes" speech, and the subsequent announcement of the ECB's Outright Monetary Transactions (OMT) program. And although economists still disagree on whether austerity depressed output more during the euro crisis than in previous settings, they no longer disagree on the direction of the effect. While "expansionary fiscal contractions" and "contractionary fiscal expansions" are theoretically possible, fiscal expansions generally expand output, and contractions contract it—including in high-debt countries.

There could be exceptions, however. And what is happening in Italy could well be one of those exceptions. The reason is that the rise in interest rates on government borrowing in response to the government's expansionary policies has been very strong. Several factors may be at work, including not only the larger deficit but also the resulting defiance of EU rules and the composition of the proposed budget, which does not help long-run growth. Perhaps markets are being unfair, but for the purposes of assessing the impact of the budget on output, this is irrelevant. The question is then whether the direct effects of the fiscal expansion might be offset, or even more than offset, by the increase in interest rates.

It is thus useful to put some numbers on the potential magnitude of the two effects. We do this in the rest of this blog.

Start with fiscal. The government's plans imply an increase in the cyclically adjusted deficit by 0.8 percent of GDP; 0.1 percent of this is an increase in the interest bill, which one would normally subtract as it is not the kind of spending that stimulates the economy. But in Italy much of the debt is domestically held. So, take 0.8 percent of GDP to be the relevant measure of expansion. There is significant uncertainty about the "multipliers" that need to be applied to estimate how this expansion might impact output. We read the available empirical evidence as suggesting that, for given interest rates, and for a country in which there is still a substantial output gap, the multiplier is likely to be around 1, and perhaps a little higher. To give the government the benefit of the doubt, take a multiplier of 1.5. Then, one would expect an increase in output of 1.5 * 0.8 = 1.2 percent on account of the fiscal stimulus.

Turn to the other half of the story, the increase in interest rates. Since mid-April, Italian bond yields have risen by about 160 basis points. This has happened in two phases: in May, as the composition and program of the government coalition was becoming clear, and since late July, as news about the proposed budget began to trickle. The government's budgetary plan acknowledges this increase but treats it as exogenous—implying that Italy would face higher interest rates even if the government had stayed on the fiscal consolidation path announced by its predecessors. This is nonsense: The increase in interest rates is a reaction to the policies described in the proposed budget. To be fair, the rise in yields has reflected a broader set of concerns, including speculation about whether the new government wanted to remain in the eurozone. By October, however, coalition leaders in Rome had repeatedly stated their desire to remain, and tensions between Italy and the European Union are now largely driven by the proposed budget.

How will the increase in government bond rates affect the Italian economy? It depends on whether and how higher government borrowing rates affect consumers and firms. The evidence, both from Italy today and from the past, is that government bond rates, bank funding rates, and bank lending rates move together. Lending rates on new loans in Italy have been rising since May. The ECB's October bank lending survey shows that Italian banks have tightened lending, more so than banks in other eurozone countries. Italy has suffered a ratings downgrade and may suffer more, and the Italian stock market has lost 25 percent of its value. Credit default swap (CDS) spreads for banks have also substantially increased, reflecting losses on government bonds, and more generally, uncertainty about the future. This suggests tighter credit in the future. News-based economic uncertainty measures have also increased; this may well decrease investment beyond the increase in the cost of capital.

One should thus expect the increase in government borrowing rates to have a substantial effect on Italian GDP, for the same reasons that the sharp increase in government rates in 2011 contributed to the 2012–13 recession and for the same reasons why OMT contributed to the Italian recovery. But how much? The effect of interest rates on economic activity is one of the most studied issues in macroeconomics. The literature suggests that the average effect of an increase in long rates on output is roughly 1 for 1—a 100-basis-point increase in the long rate leads to a 1 percent decrease in demand and output—although, again, with large variations depending on the circumstances. Recent estimates of the effects of the OMT suggest slightly lower numbers for Italy, in the region of a 0.8 percent output contraction for a 100-basis-point increase in bond rates.

Putting fiscal multiplier effects and contractionary interest rate effects together—and being generous about the size of the multiplier and conservative about the effect of the interest rate increase—arithmetic suggests that the total effect on growth will be $0.8 * 1.5 - 0.8 * 1.6 \approx -0.1$. While this number comes with a large uncertainty band, the risks are skewed to the downside. This means that the planned fiscal expansion will probably fail to increase growth—and may even reduce it. The deficit will come in larger than predicted. Supporters of the government will be disappointed. The government may double down, and investors may flee, leading to a serious crisis.

It is possible that Italy will suffer a debt run before it even gets a chance to implement its expansionary budget. But if spreads remain high but stable in the next few months, the next challenge awaits: the challenge of weathering a growth slowdown whose seeds were planted in large part by this year's expansionary budget. This, more than the prospect of a protracted standoff with the European Commission, is the real risk threatening Italy over the next two years.