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*European constraints and macroeconomic evaluation  
of Italian fiscal policy in 2015*

*Summary and conclusions*

In 2015, the Italian general government deficit fell below 3 per cent of GDP for the first time since the start of the crisis after a three-year period in which it had stabilised at around that threshold.

Compared to the negative peak recorded in 2009, the Italian fiscal policy has therefore succeeded in accomplishing an extensive correction, resulting in a drop of public deficit by almost 3 percentage points of GDP in 6 years. Despite such efforts, the consequences of the crisis, sluggish growth and high interest rates, prevented Italy's debt-to-GDP ratio from decreasing, so that in 2015 it had risen to 132 per cent. Hence, it is not surprising that the European Commission affirms in its assessment of the Italian public debt in the 2015 Country Report: «High public debt is a major source of vulnerability for the Italian economy and, given its large size, it is considered of primary importance for world markets».

The objective of stabilising and possibly reducing public debt represents for Italian fiscal policy a difficult trade-off: restrictive policies aimed at further reducing the deficit risk to jeopardise the already low nominal and real GDP growth, further delaying the decrease in the debt-to-GDP ratio.

Despite the difficult compliance with the debt rule, in our view the consideration that Italy's economic conditions are not compatible with greater fiscal discipline remains crucial.

Structural reforms to promote long-term growth and boost investment are correctly considered as priorities, combined with a use of the flexibilities recognised by the Stability and Growth Pact (SGP) in order to

keep public finance prospects on a sustainable track. However, despite the reforms implemented in recent years, the prospects of the Italian economy remain uncertain.

Uncertain growth prospects are the main factor affecting future fiscal sustainability. Over the last few years, Italian public debt's financing conditions have clearly improved, but a decisive role in the reduction of sovereign interest rates was played by the ECB monetary policy. However, financial markets confidence could deteriorate again in the coming years. The low-GDP-growth and low-inflation scenario that is expected for the near future makes it challenging to bring public debt back to the pre-crisis level.

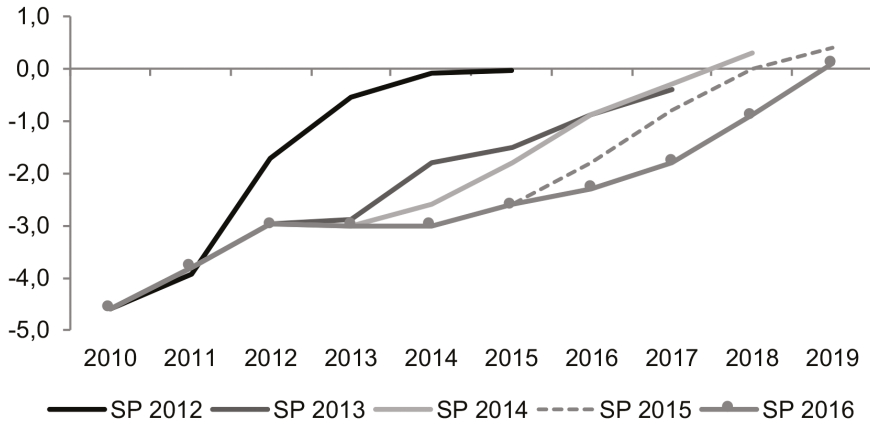
Therefore, the main risk for Italy's economic outlook is that of an extended period of stagnation. This means that, despite the consolidation efforts made in the last years, fiscal policy in Italy has to remain very cautious and will have to skate on thin ice, trying to support growth, keeping, at the same time, fiscal consolidation on track.

In this work we aim to retrace the main features of the Italian fiscal policy over the past few years (paragraphs 1-2) and then to conduct an in-depth analysis of the structural characteristics of public debt that could affect its sustainability (paragraph 3).

### *1. European fiscal rules and flexibility: downward revision of policy objectives*

Since 2011, the main goal of Italian fiscal policy has been to reduce public deficit. In 2015, for the first time since the beginning of the crisis, public deficit in terms of GDP fell below the 3 per cent Maastricht target. Despite the improvements in the past few years though, its level is still relatively far from attaining a balanced budget, that is the ultimate objective according to official documents.

The revision of the objectives in Italy's Stability Programmes of the last few years indicates that the deficit achieved in 2015 derives from a progressive postponement of the balanced budget objective which, according to the 2012 Stability Programme, was to be attained precisely in 2015 (see [Figure 1](#)).

Fig. 1 – *The revision of public finance objectives in Italy: policy scenario public deficit in % of GDP*


(Source: authors' own calculations on Stability Programmes (SP), various years)

The postponement of the balanced budget objective and the stabilisation of public deficit below 3 per cent of GDP have led the Italian government to face up to the restrictions stemming from European regulations.

The Fiscal Compact rules define for each country an annual fiscal adjustment path leading to their budgetary target, known as Medium-Term Budgetary Objective (MTO), that is set in structural terms to ensure a sound fiscal position. Every year the objective is defined in terms of improvement of the structural balance compared to the previous year. The entity of the adjustment (that can range from zero to more than one percentage point of GDP) is defined according to the macroeconomic situation of the country and its level of public debt: the better the economic situation and the higher the debt-to-GDP ratio, the greater the correction required.

In these past few years, postponing the balanced budget objective has caused deviations from the path defined by the Fiscal Compact and, in order to allow for the endorsement of this possibility by European authorities without incurring in an Excessive Deficit Procedure (EDP), the Italian government has called upon a variety of exceptions contained in European treaties, under which temporary deviations from the adjustment path are permitted in special cases. A note by the European Commission dated January 2015 provided a guideline on how to apply possible exceptions to the requirement of pursuing the objectives stated by the Fiscal Compact, defining them more clearly and therefore emphasising the subject of flexibility within the rules.

The recent history of the relations between the Italian government and

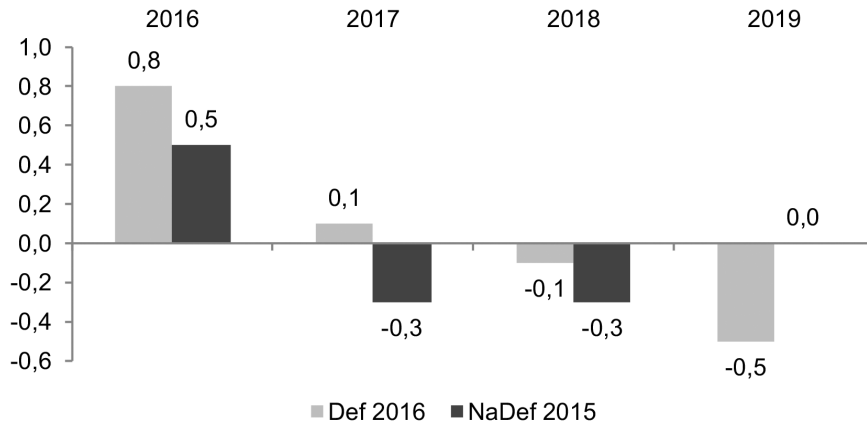
the European Commission has therefore experienced long negotiations, correlated to the attempt to use all possible margins to loosen the path for containing the deficit.

Specifically, in 2015, the European Commission granted to Italy a deviation, with respect to the objective of amending its structural balance equal to 0.4 GDP percentage points, owing to the exceptional circumstances of Italian economy (enduring recession and risk of further downward revisions of growth for 2015, high negative output gap). Additional flexibility was allowed for 2016, driven by Italy's commitment to the implementation of a set of structural reforms, provided that the latter (i) were relevant, (ii) had a positive long-term impact on public finances, and (iii) would be fully accomplished within the forecast period. These structural reforms address several aspects, such as administrative simplification, justice system reform, competitiveness, labour market, fiscal reform and public spending review. According to official estimates their impact on growth should be significant, so that Italy has been allowed to correct the structural balance by only 0.1 GDP percentage point, instead of the required 0.5 points of GDP.

A further deviation will most probably be granted also for the adjustment path in 2017, but to which extent it remains uncertain, depending on the Commission's assessment of Italy's 2017 Stability programme and of the measures included in the 2017 Budgetary Law.

In any case, as it has happened in the past, the fiscal policy scenario of the Italian government plans to postpone a reversal of the fiscal stance for one more year.

Therefore, should the Commission provide a positive appraisal of the envisaged fiscal policy scenario over the coming years, the overall fiscal policy for 2015-2019 will eventually be only mildly expansionary, even though it is the result of the gradual postponement of more ambitious objectives. If no other changes occur, the fiscal stimulus will be positive for the economy only in the 2016-2017 period, whereas it will reverse in the following years, as shown in [Figure 2](#).

Fig. 2 – *Planned fiscal stimulus - annual change in structural primary balance, as a % of GDP*


(Source: authors' own calculations on the 2016 Economic and Financial Document (DEF) and 2015 Update of the Economic and Financial Document (NaDEF))

Nevertheless, the strategy of delaying fiscal targets defines a turnaround compared to the fiscal policy restrictive trends followed by the Italian government in recent years, although it is not the first European country that has experienced a loosening of its fiscal convergence plans in the past few years. In the second half of the 2000s various countries deviated from their fiscal targets, with Germany being the only one with a structural balanced budget at the beginning of the recession. In 2011, this evidence called for the introduction of a set of more restrictive rules, via the 'Six Pack' reforms, which led to the negotiation of the European Fiscal Compact. Up until now, the Fiscal Compact rules have remained formally binding, and the relaxation of constraints has been accomplished via the introduction of scope for derogations. As a result, the overlapping of different rules and exceptions to the rule itself has generated a substantial opacity of the entire system of regulations, with a concrete risk of undermining its credibility (Pisani-Ferry, 2016)<sup>1</sup>.

In other words, the benefit expected from a system of strict rules mainly lies in the gains in terms of credibility of the commitment to the targets, at the cost of a loss of margins for discretionary policies. Actually, the main risk now is a decrease in credibility with little degrees of freedom in adopting discretionary policies, if not within the flexibility margins permitted by the regulations.

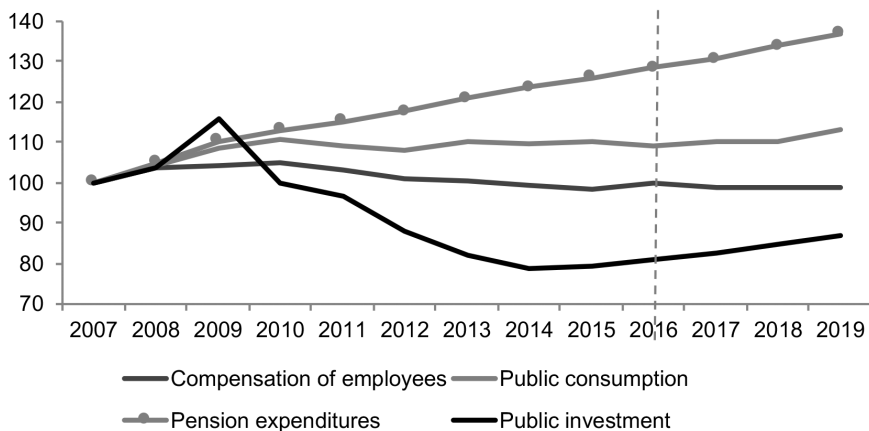
<sup>1</sup> J. PISANI-FERRY, *The Eurozone's Zeno paradox – and how to solve it*, in VOX, <[voxeu.org](http://voxeu.org)> (last access 05.12.2016), 2016.

## 2. Fiscal policy recent trends: decrease in fiscal pressure and spending review

Besides trying to mitigate fiscal targets, Italian fiscal policy has also tried to modify its budget composition and, specifically, to change the levels of revenues and expenditures, with the purpose of reducing their weight on GDP.

Some of the measures for reducing primary expenditure were particularly effective. However, the various interventions had different degrees of effectiveness depending on the inherent features of each public expenditure item (see [Figure 3](#)).

Fig. 3 – Public expenditure: evolution of main items - Index: 2007=100



(Source: authors' own calculations, Istat, 2016 Economic and Financial Document)

The 'Fornero reform', which aimed at controlling pension expenditures via the gradual increase of the required age for retirement, was not enough to curb the lively spending dynamics (based on unchanged legislation), so that the expenditure levels have kept rising, on average, at a rate above 2 per cent per year.

On the other hand, given the relative low rigidity of capital expenditure compared to current expenditure, investment spending was cut and showed an unprecedented decline. This choice entails extremely negative repercussions on the country's infrastructure, and thus on the level of potential GDP.

As in the case of public investments, compensation of employees has also shown an extensive downturn, as a result of the rather stringent measures to

curb the public wage bill during the crisis years, via freezing of public wages and limitations to the turnover of public employees (only a small share of the retired personnel was allowed to be replaced every year).

Despite the increasing emphasis placed on spending review policies and on containment measures, public consumption expenditure kept on raising. Nevertheless, growth rates of intermediate consumption slowed down significantly in nominal terms and fell considerably in real terms, which is an unprecedented event in the last twenty years.

Last, total public expenditure trends have been affected significantly by the major reduction in interest expenditure, that is benefiting from the ECB expansionary monetary policy. This component is especially relevant for Italian public expenditure, given the higher public debt as compared to other countries.

The decrease of total public expenditure as a share of GDP should continue in coming years, according to the government's forecast scenario (based on unchanged legislation), as published in 2016 Economic and Financial Document (DEF)<sup>2</sup> and as confirmed in the Update to the 2016 DEF<sup>3</sup>, that also consider the effects of the 2016 Stability Law.

Measures on the expenditure side have been coupled with a gradual, yet significant, reduction of the tax burden, which started already in 2014 and should be completed over the coming years.

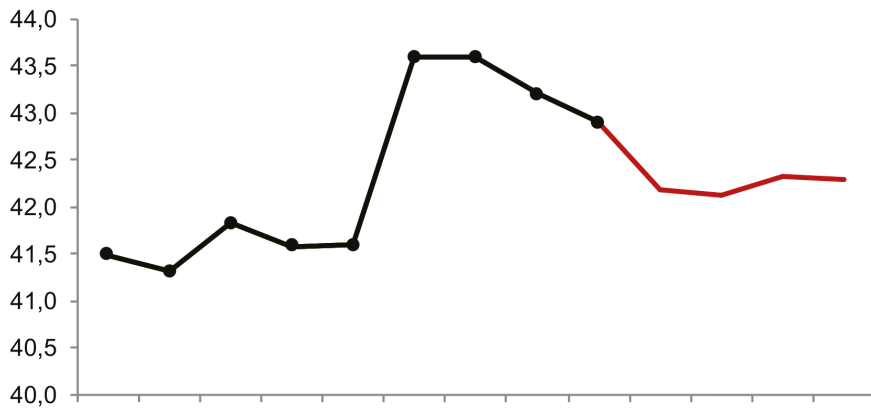
Starting with the 80 euros monthly bonus, i.e. the labour income tax reduction aimed at sustaining the income of worse off employees in a critical stage of the economic cycle, a wide set of measures has been implemented with the purpose of reducing the tax burden both on households and firms. Over the five-year forecast horizon (up to 2019) tax-burden-reducing measures will amount to more than 30 billion euros (based on the *ex-ante* government quantification). The overall tax burden as a percentage of GDP has partly been reduced in the last two years. It remains in any case high, not much lower than the peak reached in 2012, if compared to the levels experienced in the first half of the 2000s. A further decline is expected in coming years, also because a substantial part of the impact of past interventions on revenues has still to emerge between 2016 and 2017 (see [Figure 4](#)).

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<sup>2</sup> Documento di Economia e Finanza 2016.

<sup>3</sup> Nota di Aggiornamento del Documento di Economia e Finanza 2016.

Fig. 4 – Tax burden before and after the crisis – including the 80 EUR bonus



(Source: authors' own calculations, ISTAT, and 2016 Economic and Financial Document)

Given their heterogeneity, the set of adopted and planned tax-reducing measures may seem partly uncoordinated or, as criticisms often addressed to government choices say, mainly inspired by the 'political' objective of reaching a large portion of the population in order to gain broader consent. Nevertheless, the set of interventions actually appears to be mostly inspired by a common rationale, which is closely linked to the one behind the adopted job-market policies. In fact, several government measures insist upon reducing the tax wedge, i.e. the gap between the cost of labour sustained by the employer and the net salary received by the employee. In 2017, more than 70 per cent of the overall (*ex-ante*) impact of legislated measures is aimed at shifting the tax burden away from labour, of which the most relevant are the Irpef (labour income tax) reduction for low income earners (the 80 euros bonus), the cut in Irap (regional corporate income tax) through the full deduction of the labour component from the tax base (limited to the cost of permanent employees) and the social security exemption for new permanent employees in 2015. A second tranche was introduced for new permanent employees hired in 2016, lower in terms of duration and amount.

Such measures have been adopted in parallel with the change in labour market legislation brought about by the so-called 'Jobs Act', which introduced the progressive entitlement employment contracts. All these elements aimed to promote the hiring of new, permanent employees, by reducing their cost and making the firing cost certain.



The amount of resources allocated for the reduction of the tax wedge and the changes in job market regulations should, according to the intentions of the government, activate the creation of new jobs and increase the share of permanent positions. In 2015 and 2016 the creation of new jobs has been significant; even if, after the expiration of the first tranche of the incentives on social contributions, the creation of new jobs has slowed down, the demand for labour increased more than GDP, resulting in a reduction of productivity growth.

As to the impact of the mentioned tax reductions on domestic demand, the expansionary impulse has been partially compensated by other measures, a mix of expenditure cuts and increase in other taxes, that amount to almost one third of the tax reductions (based on the *ex-ante* government quantification).

Moreover, in the unchanged-legislation scenario, the planned deficit targets have been guaranteed by resorting to the stratagem of foreseeing a 'safeguard clause', defined for 2017 by a 0,9 per cent of GDP VAT hike. By their very nature such safeguard clauses should not be considered as an actual tax increase, since they only represent formal coverage to achieve fiscal targets, while the government is committed to gradually repeal them. The 2016 Economic and Financial Document announced its intention to sterilise the safeguard clauses, as it had done already for the clauses that insisted on 2015-2016, by partially replacing them with a mix of other measures, such as fight against tax evasion, spending review and the revision of tax expenditures. With its 2017 Draft Budgetary Plan the government confirmed its intention of repealing the clause for 2017 and therefore the 2017 deficit objective was revised downwards. At the moment, the negotiation with the European authorities and the parliamentary discussion on the 2017 Budgetary law are still ongoing, so it is not yet clear what the actual composition of the fiscal manoeuvre will be.

It is anyway certain that, should spending review policies prove to be less effective than expected, or should further downward revisions of the deficit targets be denied by European authorities, the described tax reductions will have to be almost entirely financed via the increase of other taxes.

### *3. Deficit vs. Debt: the good and the bad. The position of Italian debt in the EMU and the rules of the Fiscal Compact*

The Italian fiscal policy, based on the postponement of the balanced budget target and on keeping the deficit close but below 3 per cent of GDP, makes it clear that the government medium-term strategy relies on (i) relative soundness of Italian public accounts, (ii) interruption of the fiscal consolidation and (iii) some relief to aggregate demand.

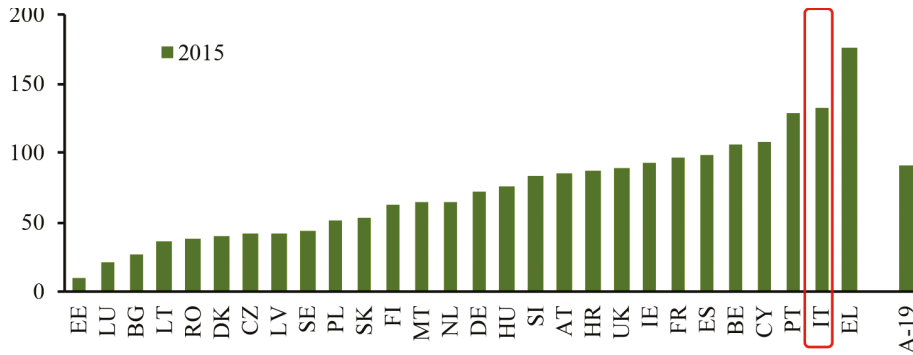
Besides, an important contribution to the consolidation of Italian public finances in the past few years has derived from the drop in interest rates, related to the zero rate policy embraced by the ECB and to the decrease in the BTP-Bund spread resulting from the Quantitative easing. Because of high debt-to-GDP ratio, Italian public finances are more sensitive to the level of interest rates than other countries.

However, the fall in interest rates also reflects the weak inflation dynamics, close to zero for three years. If the net effect of falling inflation and dropping interest rates is apparently favourable for the deficit, it is also true that what matters for debt stabilisation is the level of interest rates in real terms, that could become much less favourable if a situation of persistently very low inflation or even deflation should materialise.

It is no coincidence that Italy is experiencing serious difficulties in complying with European regulations, especially with reference to the debt rule. In 2015, debt-to-GDP ratio was at 132 percent, second only to Greece out of the 28 Member States of the European Union ([Figure 5](#)).

In the recent past Italy experienced an Excessive Deficit Procedure, which was initiated in 2009 and withdrawn in 2013. From 2016 onwards the debt rule defined in the Fiscal Compact will become fully operational, after the 2013-2015 transition period in which full respect of the Minimum Linear Structural Adjustment (MLSA) to the debt benchmark was required.

Fig. 5 – General Government debt-to-GDP ratio in the EU Member States (%)



(Source: Eurostat)

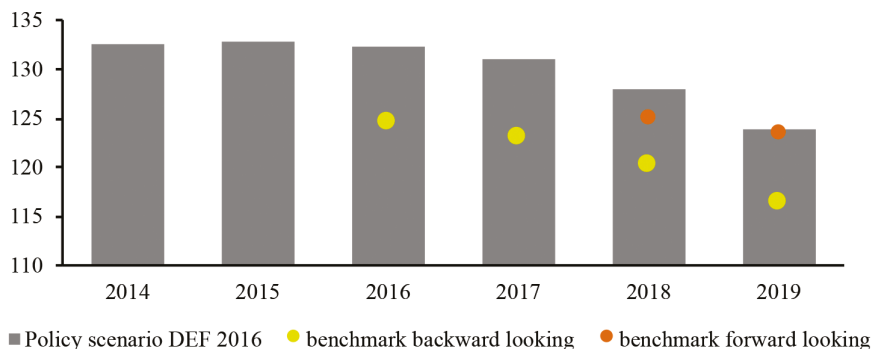
The MLSA would have required an annual improvement in the structural balance by 0.9 per cent of GDP, a rule which has never been fully complied with (Table 1); the further adjustment that should have been attained is estimated at approximately 2 percentage points of GDP. As in the case of deficit, both in 2014 and in 2015 the deviation from the convergence path was justified by the government in the light of the so-called ‘relevant factors’, i.e. continuing adverse macroeconomic conditions and risks of deflation. In this context, and given the implementation of structural reforms able to increase potential growth on one side, and the respect for the preventive arm of the SGP in terms of deficit restriction on the other, the European Commission deemed fit to consider as not significant the deviation from the debt rule and did not proceed to initiate an excessive deficit procedure.

 Table 1 – *MLSA and structural variation required for full compliance with the debt rule (Policy scenario, 2016 Economic and Financial Document)*

	2013	2014	2015
Minimum linear structural adjustment (a)	0.9	0.9	0.9
Variation inherited from the previous year (b)		0.5	1.5
Planned variation of the structural balance (c)	0.4	-0.1	0.2
Further necessary variation (d)=(a+b-c)	0.5	1.5	2.1

Starting from 2016, the convergence of Italian debt towards the target value will be assessed on the basis of rules of compliance with the benchmark. Figure 6 indicates the value of the debt-to-GDP ratio predicted by the 2016 Economic and Financial Document as compared with the benchmarks in both its formulations, namely ‘backward looking’ and ‘forward looking’.

Fig. 6 – *General Government debt/GDP (%) - forecasts vs benchmark*



(Source: authors' own calculations, MEF)

In 2016, the debt reduction rule was not satisfied. The gap is expected to be relevant both with respect to the ‘backward looking’ criterion and in relation to the ‘forward looking’ benchmark, since the forecast for nominal GDP growth remains modest until 2018. Also in this case, the government’s position is that relevant factors justify the deviation of debt from the decrease required by the rule. The first relevant factor is the risk of stagnation and deflation, to which are added, inter alia, the insufficient coordination of fiscal consolidation in the Euro Area, the effects of restrictive fiscal policies on growth, immigration costs, the consideration that primary surplus is in any case high, also as compared to other countries, and Italy’s good position in relation to the S2 long-term sustainability indicator (see paragraph 3.3 below).

In order to appraise the feasibility of the Fiscal Compact required path, as well as the sustainability of Italian public debt, it is useful to take into account all the relevant aspects of debt dynamics. Therefore, an outlook on the factors determining the evolution of the debt-to-GDP ratio will be provided, according to standard indicators in debt analysis;

also debt composition (in terms of maturity, creditor base and currency of denomination) will be analysed, in order to provide further information about its riskiness/vulnerability<sup>4</sup>; last, the sustainability indicators used in the Debt Sustainability Analysis framework of the European Commission will be described.

It must be pointed out that in general it is not possible to define an upper limit above which public debt is no longer sustainable<sup>5</sup>, since the sustainability of a high level of debt depends on several factors, including the level of development of financial markets, the government's credibility to implement structural reforms, the degree of risk aversion and the attractiveness of investments alternative to government bonds.

However, it is clear that high levels of debt are associated with greater risks in that they generate vulnerability<sup>6</sup>; the greater exposure to market turmoil and to changes in interest rates may result in confidence crises and can increase the financial costs for the government via interest expenditure. These greater costs are also transferred to the borrowing conditions for households and businesses, affecting consumption and investment. Recent history has proven it.

### 3.1 *Dynamics of debt and sustainability: an analysis of the evolution of the debt-to-GDP ratio*

Although the levels of debt recorded in recent years are not new in the history of our country (Figure 7), it is also true that the current conditions represent an exceptional situation in many ways. In the past, only during war times Italy experienced such levels of debt-to-GDP ratio coupled with such a speed of its increase.

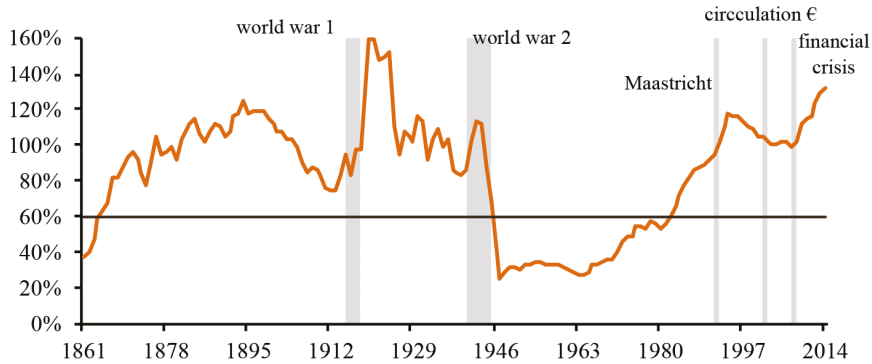
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<sup>4</sup> Three variables of debt structure are considered in DG ECFIN's DSA: i) the share of short-term debt in total public debt (y-o-y change, at original maturity); ii) the share of debt held by non-residents in total public debt, and iii) the share of debt denominated in a foreign currency in total public debt.

<sup>5</sup> As the Japanese case clearly shows, with a public debt at 240 per cent of GDP in 2015, and over 140 per cent since 2000.

<sup>6</sup> G. EGGERTSSON, P. KRUGMAN, *Debt, Deleveraging, and the Liquidity Trap*, in «The Quarterly Journal of Economics», vol. 127, 3, 2012.

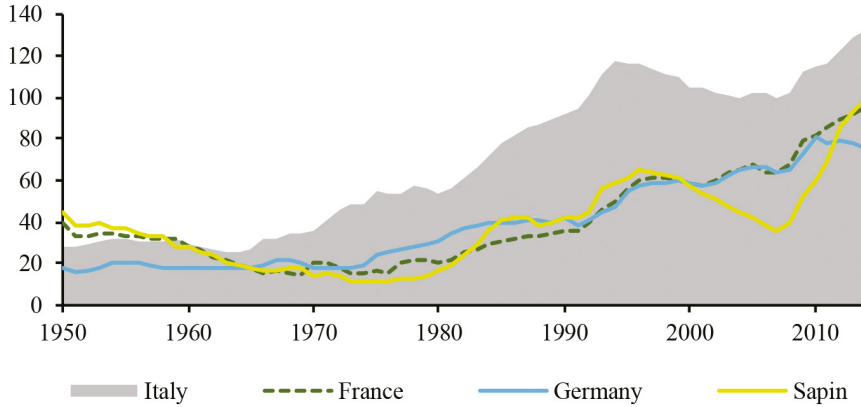
Fig. 7 – General Government debt/GDP (%)



(Source: Banca d'Italia and ISTAT)

Italian public debt has been relatively high for the best part of its history, also compared to other main European countries, as it is shown in [Figure 8](#). However, the comparison with other countries' debt evolution from the 90s to the present day shows how the overall debt increase in Italy has been relatively slower. The crisis that started in 2007 played a key role in this increase and in the different intensity experienced by the countries. The recession, the sovereign debt crisis and the resulting increase in the cost of debt, the bank bail-outs, the public resources allocated both to counter-cyclical policies and to the stability of the euro area, were reflected in a rise in public debt of 28 percentage points of GDP for the entire EMU. The increase registered by Italian debt is only slightly above this value.

Fig. 8 – Debt/GDP (%), comparison across European countries



(Source: authors' own calculations, IMF and Eurostat)

Debt-to-GDP evolution can also be examined with reference to its dynamic equation<sup>7</sup>, that quantifies the impact on debt dynamics that stems from three underlying factors: economic growth, average cost of debt, primary balance.

Table 2 illustrates the contribution of the different determinants since 1951. It clearly shows how the accumulation of the debt-to-GDP ratio was particularly relevant in the 80s, due to the persistence of primary deficits in the presence of favourable growth conditions, that allowed to more than neutralise the cost of debt financing.

<sup>7</sup> The change in the government gross debt-to-GDP ratio can be decomposed as follows:  
 $\Delta bt = -pbt + [(rt-gt)/(1+gt)*bt-1] + sft.$

In each period (t) it is expressed as the sum of: the current primary balance (-pb); the snowball effect (second term on the right-hand side), which captures the joint impact of interest payments on the accumulated stock of debt and of real GDP growth and inflation on the debt ratio; the stock-flow adjustments (sf) relates to that part of the change in the debt-to-GDP ratio which is not reflected in the deficit (government financial transactions or privatisation receipts for example).

Table 2 – *Debt-to-GDP ratio changes and its drivers (percentage points; cumulative values for each period)*

				Italy				Euro area
	1951 1959	1960 1969	1970 1979	1980 1989	1990 1999	2000 2006	2007 2014	2007 2014
Change in debt	2.7	2.1	20.1	33.7	19.8	-7.1	29.8	28.8
Primary balance	15.9	7.5	45.9	44.4	-26.2	-13.7	-11.6	7.6
Snow ball effect	-22.7	-25.2	-51.5	-12.4	42.8	7.8	33.5	13.1
Stock-flow adjustment	9.5	19.8	25.7	1.7	3.2	-1.3	7.9	8.1

(Source: authors' own calculations, Banca d'Italia, ISTAT, and Eurostat-Ameco)

The 90s marked a break in the underlying dynamics of Italian public debt. Fiscal consolidation measures in the first half, and the interest rates convergence to low levels, due to the introduction of the common currency (the so-called Euro-dividend) in the second half of the 90s, were responsible for the deceleration in the debt-to-GDP ratio growth. The contributions of the determinants were therefore reversed with respect to the previous decade: the return to surplus of the primary balance was associated with a less favourable gap between the average cost of debt and the GDP growth.

Even during the recession, the contribution of primary balance to the decrease in the debt-to-GDP ratio was significant (-11.6 pp), an especially virtuous result if compared to the other European countries. In fact, while the total increase of Italian debt was similar to the one registered in the euro area as a whole, the relative weight of the determinants proved to be very different. In our country the snow ball effect was decisive, reflecting the greater depth of the recession, the low rate of inflation and the greater cost of public debt; conversely, the primary balance component, that reduced the debt in the case of Italy, contributed to increase the debt of the area.

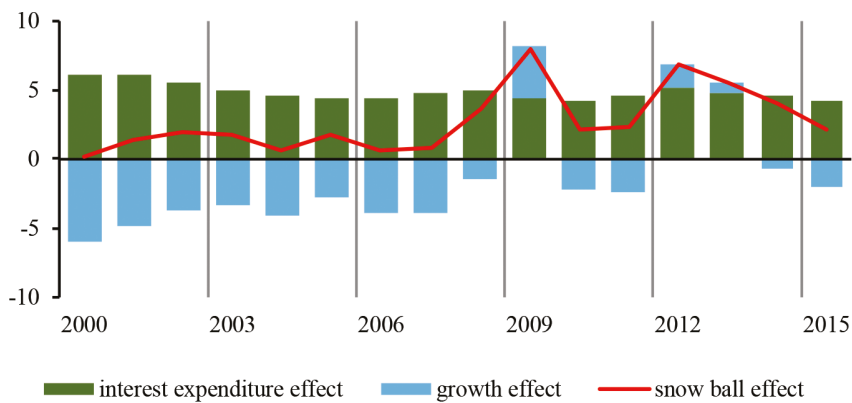
Further investigation (Figure 9) breaks down the impact of the snow ball effect into its two determining factors: effect of expenditure in relation to the burden of pre-existing debt and effect of GDP growth. In the last eight years the accumulation of debt is clearly resulting from the lack of GDP



growth, given that the impact of the cost of pre-existing debt is similar to the one experienced in previous years. As recalled by the Bank of Italy,

«If real GDP had grown, since the beginning of the crisis, at a similar rate to the previous ten years and the deflator had risen in line with the euro area's inflation target, by a purely mechanical effect the debt would now be just 3 points, not 33 points, higher than in 2007»<sup>8</sup>.

Fig. 9 – Snow ball effect broken down into: interest expenditure effect and growth effect (%)



(Source: authors' own calculations, Banca d'Italia and ISTAT)

### 3.2 The structure of public debt

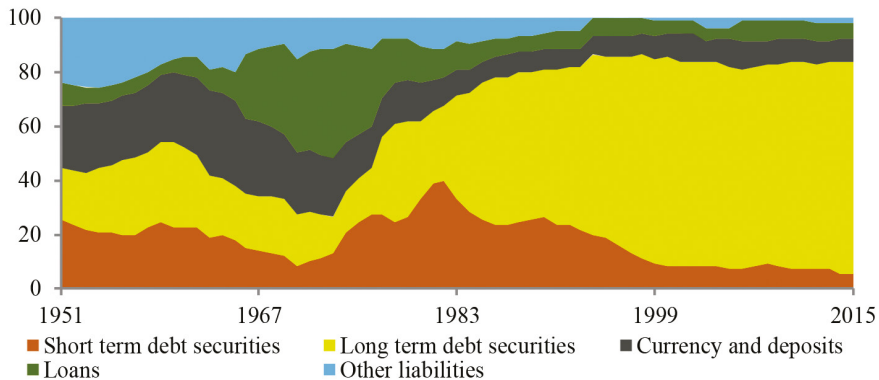
A different composition of public debt according to instruments and holding sectors implies different levels of vulnerability. Large increases in the share of short-term public debt provide an indication of higher rollover risk at any given debt level in terms of a government's reliance on temporary market financing. A large share of public debt held by non-residents may capture vulnerabilities in terms of volatility of capital holdings as shown by the literature, though it can also signal strong confidence in a well-performing economy. Finally, a large share of debt denominated in a foreign currency provides an indication of risks related to exchange rate fluctuations<sup>9</sup>.

<sup>8</sup> BANCA D'ITALIA, *Preliminary testimony on the 2016 Document on the Economy and Finance*, Testimony of the deputy Governor of the Bank of Italy, Luigi Federico Signorini.

<sup>9</sup> EUROPEAN COMMISSION, *Fiscal Sustainability Report 2015*, p. 79.

The structure of Italian debt has undergone significant changes in the course of time. In terms of instruments, the share of government bonds has grown and then remained stable between 80 and 85 per cent. Simultaneously, securities issues have gradually shifted to the medium/long term segment that in 2015 represented a near 80 per cent of total debt, a particularly high share within the EMU, the highest among the major countries.

Fig. 10 – Public debt: composition according to instruments (shares in % of the total)



(Source: authors' own calculations, Banca d'Italia and ECB)

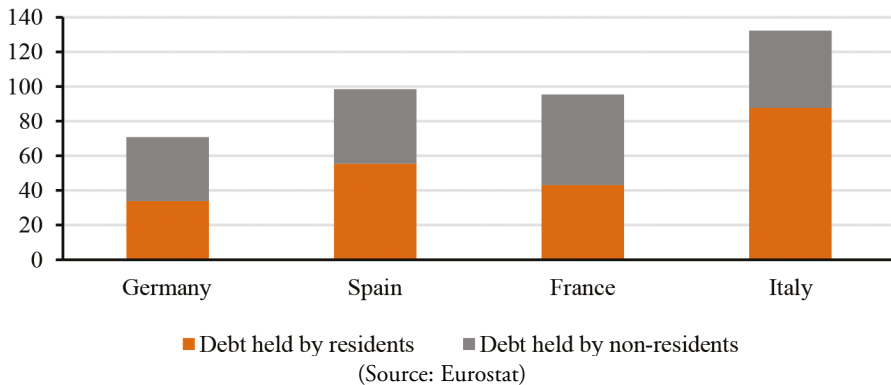
Accordingly, the average life of debt increased to just under eight years at the end of 2010, the maximum level of the time series, and was equal to 7 years at the end of 2015; again, one of the highest levels in an international comparison.

Liabilities other than securities make up of 16 per cent of public debt, and among these, liquid liabilities are especially high, representing a further element of stability in the case of turmoil on financial markets. In fact, during the crisis extensive use of liquidity was made to limit the issues. Nevertheless, at the end of 2014 in Italy the share was still at high levels compared to that of other major European economies.

Last, the share of public debt held by non-residents was 38 per cent at the end of 2015. Over the years, a steadily increasing trend has been observed from 1997 to 2010, bringing debt held by non-residents up to 50 per cent. The confidence crisis of 2011 affected the preferences of foreign investors, that rapidly divested their Italian securities until the share dropped to a minimum of 37 per cent at the end of 2012.

Compared to the rest of Europe, the share of Italian debt held by non-residents is relatively low (Figure 11) and, according to the European Commission evaluations, it is consistent with a relatively low risk level. Similarly, the foreign exchange risk is extremely low, as measured by the debt issued in other currencies, that in Italy represents only 0.2 per cent of the total debt, with 2.2 per cent in France and 3.6 per cent in Germany.

Fig. 11 – Public Debt-to-GDP ratio by holders



### 3.3 Fiscal sustainability indicators

Figure 12 outlines the position of the European countries with reference to the three sustainability and risk indicators processed by the European Commission on the basis of the 2015 Autumn Forecasts<sup>10</sup>. The data are also reported in Table 3. The colours green, yellow and red identify the different risk levels, respectively low, medium and high.

As noted above, for the risk of short-term fiscal stress S0<sup>11</sup> a low level is generally reported; the indicator is below the critical threshold (0.43) for all countries.

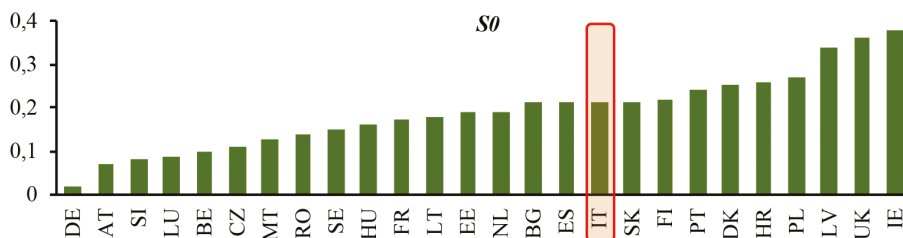
<sup>10</sup> The update of the FSR will be likely available on winter 2016-2017.

<sup>11</sup> S0 measures, for the year following the current year, the likelihood of risks on the sustainability of the debt on the basis of 28 variables broken down into two sub-groups: fiscal and macro-financial; threshold values are identified for the single variables and sub-groups and the entity of the deviation from them is appraised. Whereas indicators S1 and S2 quantify the required fiscal adjustment ('sustainability gaps'), indicator S0 follows the so-called 'signal-approach'.

With reference to the other indicators the situation is more composite. Indicator S1, that identifies medium-term risk, i.e. the gap to be bridged in order to reach the target of the debt-to-GDP ratio equal to 60 per cent by 2030, shows that 40 per cent of the countries shows low risk conditions and, among the others, the countries with high risk conditions are more numerous. With reference to S2, that measures the gap between the current primary surplus and the surplus required for ensuring the inter-temporal balance over an infinite time horizon, most countries occupy medium/high risk positions<sup>12</sup>. As illustrated in Table 3, the overall evaluation on the basis of the three indicators shows that only in a minority of countries the level of risk for sustainability is low; among major countries, Germany is featured in this sub-group.

Despite the high level of debt, the results relative to Italy do not raise relevant concerns in terms of sustainability as compared to the other countries.

Fig. 12 – Sustainability indicators, overall results



(Source: European Commission, *Fiscal Sustainability Report 2015*)

The risk is low when the short-term is considered, with S0 below the threshold and in line with the European average. Risk appears even lower for the long-term indicator, with S2 at the lowest level out of all EU countries. Conversely, the computation of S1 detects a high risk and this is sufficient to obtain an overall negative assessment, as in the case of France, Spain and Belgium, *inter alia*.

<sup>12</sup> Values S2 and S1 are constructed by identifying the two sources of risk associated with the long-term sustainability of public finances: (i) the initial budgetary position (IBP), that calculates the correction of the primary balance required for the stabilisation of the debt-to-GDP ratio and derives, therefore, from the level of the structural primary balance and from the inherited stock of debt; and (ii) the costs of ageing (CoA) that measures the deterioration expected in the primary balance resulting from the increase in age related expenditure. S1 deviates from S2 since it also considers the debt requirement (DR), namely the adjustment required for attaining 60 per cent by 2030.

Unlike what has been calculated for these countries, however, what determines the reversal of the risk assessment for Italy is the consideration in S1 of the adjustment required so that the debt-to-GDP ratio may reach 60 per cent by 2030. Since the starting level is very far from this target, the adjustment is particularly onerous, the most burdensome among all countries. The other components of S1 and S2 quantify as low the risk stemming from other sources: the initial balance position and the expected increase in age-related expenditure. The level of the primary surplus and the reforms already implemented on pension expenditure place Italy among the virtuous countries, with much better results as compared with the average level of the area, thus confirming that what matters is not only the management of the public balance but the cost, in the broadest sense, of the high level of debt attained.

Table 3 – *Fiscal sustainability and overall assessment*

	S0 indicator Overall SHORT- TERM risk category	S1 indicator Overall risk category S1 indicator Overall risk category	S2 indicator LONG- TERM risk category	Debt sustainability analysis - overall risk assessment
BE	0.10	3.8	2.5	HIGH
BG	0.21	-1.2	2.4	LOW
CZ	0.11	-0.6	3.2	LOW
DK	0.25	-3.3	1.2	LOW
DE	0.02	-0.8	1.7	LOW
EE	0.19	-4.0	0.7	LOW
IE	0.38	2.7	1.0	HIGH
ES	0.21	2.5	0.1	HIGH
FR	0.17	4.4	0.6	HIGH
HR	0.26	4.5	-0.8	HIGH
IT	0.21	4.2	-0.9	HIGH
LV	0.34	-2.1	0.9	LOW
LT	0.18	0.5	2.9	LOW
LU	0.09	-4.4	4.2	LOW
HU	0.16	-0.6	1.5	MEDIUM
MT	0.13	-0.2	4.6	LOW
NL	0.19	0.6	4.5	MEDIUM
AT	0.07	1.3	2.7	MEDIUM
PL	0.27	1.0	3.5	MEDIUM
PT	0.24	4.7	0.7	HIGH
RO	0.14	1.4	4.4	HIGH
SI	0.08	3.0	6.8	HIGH
SK	0.21	-0.7	3.5	LOW

(Source: European Commission, *Fiscal Sustainability Report 2015*)