

# Can Germany save Italy?

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Italy's referendum on the constitutional reform, to take place on Sunday, December 4th, is politically highly charged, and its outcome could become a manifest expression of euro-scepticism in one of largest economies of the euro area.

A prevalent line of reasoning<sup>1</sup> argues that the Italians are understandably dissatisfied with falling living standards and high unemployment, for which the euro is held responsible in both cases. This argument continues by insisting that Italy's economy would have performed much better if it had been allowed to devalue its currency and if it were not bound by German-imposed austerity. According to this view, Germany is ultimately responsible for Italy's problems.

Until a few years ago, it was argued that Germany was impeding the recovery of the euro-area periphery by opposing a more expansionary monetary policy and not allowing the ECB to undertake large-scale government bond purchases. This argument proved to have weak foundations when the ECB decided to engage in the purchase of sovereign bonds, but this did not result in higher growth rates across the union.

Today the problem is no longer monetary policy but rather fiscal policy and the 'austerity' imposed by Germany. The argument is twofold. First, it is argued that Germany does not allow the European Commission to bend the euro-area's fiscal rules and allow Italy to run a larger deficit. However, this statement overlooks the reality that it is the Commission, and not Berlin, that takes all the relevant decisions under the Stability and Growth Pact. Moreover, it neglects the fact that fiscal policy

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<sup>1</sup> See for instance "Italy's referendum holds the key to the future of the euro", *Financial Times*, 20 November 2016 (<https://www.ft.com/content/7ea6837a-ad83-11e6-ba7d-76378e4fef24>).

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has recently become expansionary in Italy, as the government has tried to buy popularity by initiating ad-hoc transfers and selective tax reductions.

Second, another often-heard argument is that Germany's large current account surplus could benefit other euro-area countries, if this could lead to higher expenditure in Germany. It is undoubtedly true that its neighbours could increase their exports if demand in Germany were to increase, but the real question is how to induce German consumers to spend more and German enterprises to invest more in Germany. The German government does not have many levers at its disposal to effect these changes.

In fact, consumption is already increasing at a healthy rate, propelled by record-low unemployment and solid wage increases. This has had a small impact on the trade balance surplus, which has fallen slightly, but no impact on the current account surplus, given that the increase in the income on German assets abroad has offset the fall in the trade balance. The introduction of a minimum wage last year apparently has also not had a noticeable impact on this pattern.

This leaves fiscal policy as the main lever by which the German government could stimulate the economy. *A priori*, one would expect that a fiscal expansion in Germany, possibly through an infrastructure investment programme, should have a strong external impact because the German economy is operating at close to full capacity. Under these conditions, any additional demand should thus result in higher imports. Moreover, in the current situation of negative output gaps in most member states and monetary policy operating at the zero bound, such a positive shock could be associated with significant positive spill-over effects into other countries. According to the European Commission's simulations,<sup>2</sup> a two-year increase in government investment in Germany and in other core euro-area countries of 1% of GDP leads to an increase in GDP between 0.2% and 0.3% in Italy (and other peripheral countries) driven by trade linkages. While positive, this is a rather limited effect.

A recent CEPS study (Belke and Osowski, 2016)<sup>3</sup> finds somewhat larger spill-over effects, but these are much smaller than in other countries. In particular, the results suggest that an expansionary fiscal policy in Germany mainly benefits its immediate neighbours, i.e. Belgium, the Netherlands, Switzerland and Denmark, all of which are already doing well and also running large current-account surpluses.

It is thus misleading to believe that Italy's problems could be solved in Berlin.

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<sup>2</sup> See J. in 't Veld (2013), "Fiscal consolidations and spillovers in the euro area periphery and core", European Economic Paper, No. 506, European Commission, October.

<sup>3</sup> See A. Belke and T. Osowski (2016), "Measuring fiscal spillovers in EMU and beyond: A global VAR approach", forthcoming CEPS Working Document, CEPS, Brussels.

The key source of concern in Italy is public debt, which is now close to 140% of GDP and which has attracted the attention of financial markets and much political commentary. The main cause of such a dangerously high ratio of public debt is the low GDP growth of Italy. The country has underperformed vis-à-vis the rest of the euro area for three decades now. This underperformance started long before the introduction of the euro. Even during the 1990s, when the lira depreciated strongly, Italy's growth rate was about half a percentage point lower than that of the euro area (1.7% versus 2.2%). During the decade of the 2000s, the degree of underperformance even increased (the growth differential with respect to the euro area increased to 0.8%) implying that Italy's growth had been disappointing long before 'austerity' (see Figure 1).

*Figure 1. Real GDP growth rates, euro-area average and Italy (year moving average)*



*Source:* Own calculations on European Commission data (AMECO).

In short, the euro, and its 'Teutonic' rules, might provide a convenient scapegoat to politicians, but in reality the fate of the country is ultimately in its own hands.