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The Nexus Between Credibility, Flexibility and Investment

by Alessandro Leipold

In a world of increasingly divided opinions, there seems to be at least one recommendation that garners general support. Namely, that exiting the crisis requires scaling up investment, both public and private (with the emphasis varying according to the proponent's ideology). The call for higher investment was recently echoed by Christine Lagarde, Managing Director of the IMF, at a conference centered on the need to "invest for the future." Re-launching investments is also at the heart of the debate on the flexibility (or lack thereof) of the EU's fiscal rules.

There is in fact little doubt that the global economy – and the advanced economies in particular – suffers from a severe investment shortfall. In Europe, the level of investment is today about 20% below that of 2008. The legacy of this shortfall for future generations is a heavy one, reflected in dilapidated infrastructure, mediocre schools, inadequate health care systems, and an impaired growth potential. The consensus, however, ends here.

There is no agreement on the next key question: which legacy is likely to be more burdensome for future generations? Is it that deriving from the shortfall in investment or, rather, that imposed by high and rising debt levels? As attentive an economic observer as Larry Summers has no doubts: he has declared himself to be "a lot more worried" about bequeathing his own children an economy starved of investment than "about bequeathing them ‘paper debt' which is accumulating interest at less than 1% in real terms" (in the US at least). An opposite view was put forth by the Association of German Industrialists in Il Sole 24 Ore of July 3.

As is often the case when issues are painted in black-or-white, the truth does not lie unequivocally on one side or the other. The trade-off between investment and debt can be resolved only on a case-by- case basis, via a careful analysis of the potential return on investment, its impact on economic growth, its financing, and the related effects on debt sustainability, country by country. The result will vary depending on the case – hence the reference in official Brussels jargon to "differentiated adjustment." The very fact that the answer is not axiomatic, however, provides grist for the mill of controversy.

Almost nobody denies that countries that can afford to should boost public investment ("almost" nobody, given that Germany is not doing so). The differences arise in the assessment of this capacity, which depends on two parameters: a sustainable debt level and a reliable implementation capacity. Both conditions are lamentably absent in Italy. There is no need to dwell much on the high level of debt. The inefficient dispersion of EU funds and the scourge of corruption, for their part, weigh heavily on implementation capacity. The diffidence vis-à-vis Italy's requests for flexibility stems also from here: not only from reforms that remain largely at the announcement stage, but also from concerns about fiscal sustainability and the efficiency and honesty of public administration.

Which suggests three main avenues to regain credibility. First, and self-evidently, implement reforms. The refrain coming from Brussels is clear-cut: to even discuss flexibility, reforms have to be enacted (with all implementing decrees in place), not merely announced. Not surprisingly, Italy's Ecomic Minister, Pier Carlo Padoan, focused the last meeting of the Eurogroup on the reduction of the tax wedge – a reform that, while insufficient, can at least be claimed to have been implemented in Italy. Tito Boeri rightly writes, on lavoce.info: "Let's try to carry at least one reform through to the very end."

Second, credibility requires that increases in investment be compensated with a strengthened privatization effort and a vigorous implementation of the spending review – about which one unfortunately hears less and less and, what is worse, when one does, it is in terms of scaling down the original objectives. The combination of privatizations and spending cuts would also reduce the degree of flexibility required, making it easier to obtain. Third, and certainly not least, credibility requires far greater assurances regarding the efficiency of investment and the fight against corruption. Italy has the dubious privilege of being the only advanced economy for which the IMF has felt the need to include combating corruption among its recommendations, and furthermore for two years running - a sign of the extent to which the phenomenon worries the international community and undermines goodwill towards the country's requests.

In addition to national efforts, there would of course also be a need for more EU investment in trans-European infrastructure. Here, however, it is difficult to be optimistic. As is known, the EU budget for 2014-2020 foresees a reduction of funds for research, innovation and infrastructure. Such self-destructive blindness at Community level requires to be offset by granting a reasonable margin of maneuver for national initiatives, provided it is well-deserved. This should be the thread running through the Italian Presidency of the European Council. The start of the semester allows some - albeit very cautious - optimism.

alessandro.leipold@lisboncouncil.net
Twitter: *@ALeipold*