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When Politics Dim the Lights of Recovery

By Alessandro Leipold 29 September 2013

The title of the latest IMF report on Italy puts it clearly: "Beyond Austerity, Priorities for Reviving Growth." It is unusual for these reports, typically subdued in tone, to come out with topical headings of this sort. Here, however, it is not merely a case of the Fund trying its hand at catchy communications: the growth theme effectively runs through the entire report. And unsurprisingly so: aside from the dismal short-term prospects, the IMF estimates that – "in the absence of deeper structural reforms" – Italy's potential growth, while rising, would reach only a meager 0.5% by 2018.

The IMF is known for its obsession with fiscal stability (hence the sardonic moniker "IMF: It's Mainly Fiscal"). But, in its Italy report, not only do the fiscal prescriptions come after those on structural reforms, but are driven by the dominant concern of sustaining growth. The report's treatment of public finances accordingly focuses on the structural balance (projected to be near zero this year, as targeted) and on the primary surplus (at an estimated 2.2% of GDP in 2013, "one of the highest in the euro area"). Anyone searching for even the slightest hint of concern for the overshoot of the celebrated 3% of GDP deficit limit will be disappointed – even though an overrun is indeed forecast (with the nominal deficit projected at 3.2% of GDP in 2013). Nor, consequently, is there any call for corrective measures this year. On the contrary, the report notes that the projected achievement of the structural balance target this year "appropriately provides automatic flexibility to the economic cycle." A more ambitious structural target is advised only once the recovery is firmly underway.

Unsurprisingly, Executive Directors (presumably from over-represented Europe) then stepped in to restore orthodoxy. The Board's conclusions thus emphasize the importance of "a continued commitment to meeting the nominal deficit target, in line with EU procedures," and call for measures to compensate for the repeal of the property tax on primary residences (IMU). A repeal that the staff had advised against at the time of its July mission, provoking a political storm. The staff nonetheless reiterates its criticism, noting that the repeal "could erode an important tax base, compromise the fiscal targets, and does little to support medium-term growth." Compensatory measures will be needed in 2014, including an extension of the new services tax to also cover primary residences, "for equity and efficiency reasons." That said, the report reaffirms the importance of rebalancing the fiscal adjustment toward expenditure cuts, so as to reduce tax rates on labor and capital. It illustrates a package along these lines which, by shifting resources to higher multiplier areas, could lift the level of GDP by around ½ percent over two years.

Italy's catalog of needed structural reforms is by now all too familiar, having been an unfinished agenda for years. The report goes through the list patiently: a single contract for new hires, a greater role for firm-level bargaining, the removal of regulatory hurdles in many services, a more efficient judicial system, enhanced competition in the electricity sector, privatizations (including of local public services), etc. In brief, the long litany of unrealized reforms. To which on this occasion the IMF also adds a call for stepped-up efforts to combat corruption, a singular recommendation for an advanced country.

It may be noted, finally, that a full working week lapsed between the discussion of the Italy report by the IMF's Executive Board last Monday and its release on Friday 27. Leaving aside any fanciful conspiracy theory, it is reasonable to suppose that the delay was partly prompted by a concern not to further perturb a situation already much frayed by politics. Preferable to publish on a Friday, after markets had closed in Europe, than risk adding fuel to the fire.

The report itself should not have caused such concerns since, some criticisms notwithstanding, it provides an overall positive assessment of government action since the dark days of November 2011. Nor does it offer any surprise as regards growth projections: the GDP forecast (-0.8 % this year and 0.7 % in 2014) is unchanged and not significantly different from that of the government. Nor, as noted, does the report sound any short-term alarms for the public finances. There was nothing, therefore, to startle the markets. Except for one thing: in its detailed risk assessment matrix, the IMF places one risk ahead of others, that of "an unstable coalition," leading to a possibly significant loss of market confidence, pushing Italy into a "bad equilibrium" and a protracted period of even slower growth. It is said that hope is the last to die. Italy's political class is however doing all it can to kill it. One cannot but yearn for a return to reason, a step away from the abyss.

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