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Reform denial poses bigger threat to Italy than austerity

An apparently obvious conclusion from last month's Italian elections is that citizens – ie, voters – don't like austerity programmes. The question that voters, especially in Italy, may not yet have reflected upon is what is the alternative in order to reduce the excessive burden of the debt, public or private, which has been accumulated over the past. There are at least three choices.

The first is to inflate away the debt, through the central bank buying large amounts of risky assets, thus socialising the losses, and keeping interest rates low, so as to reduce the real value of the debt. Some central banks around the world are indeed trying to pursue such an avenue, but the success is yet to be proven. In Europe this solution is prevented by the agreement that the member states reached at the launch of the euro that the European Central Bank should be independent and conduct monetary policy with the primary objective of pursuing price stability.

The second is to restructure the debt, with a substantial haircut for creditors, or default. The recent experience with the restructuring of the Greek debt has shown the potential instability of such a solution. Indeed, there is no such a thing as an "orderly debt restructuring", contrary to what some commentators, academics and interested lawyers may suggest. One of the reasons is that the largest share of public debt is generally held by the domestic financial system, which would be severely hurt by such an operation and would have to be recapitalised. A run on the domestic banking system would be hard to avoid. The lack of public funds to increase banks' capital would lead most likely to a nationalisation of the banking system, through an expropriation of shareholders. While this solution may appear attractive to populist politicians, it is hardly a recommendable way to achieve sustained growth.

The third way is to promote economic reforms that increase growth potential, improve the country's attractiveness for investors and ease the burden of the necessary budget adjustment. This is the textbook recipe, ie coupling budgetary adjustment with structural reform. That's what the ECB asked Italy and Spain to accomplish in August 2011, before intervening in the Italian and Spanish secondary government bond market to avoid the spiralling of interest rates. That's also what the European Commission and the International Monetary Fund requested from countries that applied for adjustment programmes.

However, structural reforms are politically difficult to implement, in advanced economies, not only in Europe. They require measures that are generally opposed by lobbies, which defend the interests of insiders, in the labour, capital or goods and service markets. Such lobbies are strongly represented in parliament or in government. Structural reforms thus tend to be delayed as long as possible, at least until the financial markets continue to finance imbalances at sustainable rates.

When markets turn around, and start losing confidence, pressure mounts on the policy makers to implement measures aimed at reducing the excessive budget deficit so as to maintain market access. The longer governments wait, the tougher are the measures required to restore investors' confidence. On the other hand, market pressure makes it easier for governments to convince parliament, and the voters, that the alternative to the tough measures is much worse. Only on the verge of the cliff do policy makers find the energy to adopt unpopular measures.

There are several problems with this strategy. The first is that when market confidence is at stake, quick decisions are needed to restore stability. Under these circumstances, it's politically easier to adopt fiscal measures, in particular on the revenue side. Selective expenditure cuts are more difficult to agree upon. Structural reforms are left for a second stage, as they require more time to be designed and negotiated with the social partners. Such a sequencing has been explicitly devised in Italy at the end of 2011, with the fiscal measures aimed at "saving Italy" being taken first, while the structural measures aimed at "growing Italy" were supposed to be adopted in a second phase.

The second problem is that if the fiscal measures are successful in calming the markets, there is less pressure to implement the second leg of the programme. Structural reforms tend to be further delayed. The opposition of interest groups strengthens. The proposals for changes in the labour and goods markets are diluted.

The result of this strategy is that the adjustment takes place largely through restrictive budgetary measures, whose impact on growth is much more recessionary than expected. No wonder that the fiscal multipliers turn out to be higher than expected, as shown in a recent IMF document. In the autumn of 2011 the European Commission forecast a 0.1 per cent increase in gross domestic product for Italy in 2012, with a budget deficit of 2.3 per cent and a debt/GDP ratio peaking at 120.5 per cent. One year later, growth has been revised down to minus 2.2 per cent, the deficit up to 3 per cent and the debt still rising above 127 per cent of GDP.

No wonder citizens voted against this policy. But this policy is the result of their unwillingness – and that of their elected politicians – to implement a timely and more balanced adjustment package, either independently or through a programme negotiated with international institutions.

Austerity is the result of countries' democratic decisions to wait until the last minute before acting, under the pressure of the markets, mainly by raising taxes rather than implementing long-waited reforms. Denying this, by claiming that austerity has been imposed on countries – rather than self-inflicted – and looking for scapegoats, is the biggest threat to democracies going forward.

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