The End of Quantitative Easing in Europe and the Impact on Italy

April 2018
Executive Summary
Monetary policy in Europe in recent years has been characterized by exceptional measures taken by the ECB which, as part of its mandate, has implemented initiatives to support the Eurozone and with the goal of returning the Euro Area Inflation Rate to a lower level, but in any case close to 2%.

The first initiatives, including announcements, date back to late-2011 and mid-2012 with the Long Term Refinancing Operation and the now-famous statement, “The ECB is ready to do whatever it takes to preserve the Euro”, by ECB governor Mario Draghi in July 2012.

Since then, the spread, i.e., the risk premium requested by markets to buy Italian government bonds as opposed to German bonds, has gradually returned to normal, decreasing from 575 points for 10-year bonds on November 9, 2011, to the current range of 100-140 points.

Starting in March 2015 the ECB activated a program to buy bonds (known as quantitative easing) which, as of April 2018, amounted to 2,400 billion euros. This program, together with other operations undertaken from 2011 to-date, has caused ECB assets to expand to over 4,500 billion euros which, for comparison purposes, represent over 40% of Eurozone GDP.

The action undertaken by the ECB has been prolonged, deep-seated and incisive because it has not only involved direct purchase of bonds, but has brought interest rates on primary operations to zero and the interest rates applied to overdrafts to -0.4%.

The announcement at the end of 2017 of the reduction in monthly bond purchases, which presages an end to the Asset Purchase Program (APP), has sparked discussion over what the impacts could be on the Eurozone economy of ending this exceptional monetary policy.

The purpose of this study is, therefore, to examine if and to what extent the end of the Asset Purchase Program (APP) and, in particular the Public Sector Purchase Program (PSPP) will have an impact on the sustainability of Italian public debt.
The first stage of our study was to analyze Italy’s current debt situation. From 1980 to 2017 the debt/GDP ratio rose from 54.0% in 1980 to a peak of 117.2% in 1994, falling to 99.8% in 2007 and then back up to 132.1% in December 2017—the highest level in the last 30 years according to Bank of Italy data. The reasons behind these variations are many, as are the factors that influence the trends in the debt/GDP ratio.

The upsurge seen in the 1980s was caused, in fact, by the high cost of interest and the presence of primary deficits, while the causes of the recent explosion are to be found in the virtual absence of growth.

As of December 2017, Italian debt was 2,256 billion euros, of which approximately 84% (1,911 billion euros) was government bonds. The maturity on the debt is 82.81 months and the average interest rate at the time of issuing was at an all-time low (0.68% average interest rate in 2017). This interest rate level was confirmed, or even further reduced, in the auctions during the first three months of 2018. 16% of current debt stock will fall due after 2030 and pay yields that are destined to decline in the short- and medium-term, barring any particularly major shock to interest rates.

Starting from the current situation, we constructed a simulation model which, on the basis of a number of external and exogenous macroeconomic inputs (GDP growth rate, inflation rate, yield curve and primary surplus), simulates potential trajectories in how the debt picture could evolve.

The model does not provide forecasts because the external inputs were merely taken as givens and not analyzed in advance. For this reason, our model is intended to illustrate what would happen if the economic situation were to develop according to given scenarios which were simulated as follows:

- “Ambrosetti Club Consensus” Scenario: based on inputs gathered by the Ambrosetti Club community on the GDP growth rate, inflation rate, yield curve and primary surplus;
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- “Meeting of DEF, ECB goals and interest rate trends like those in the US” Scenario: based on the forecasts in the Documento di Economia e Finanza (DEF) [Economy and Finance Document] and of the ECB (2% inflation target), with a rate curve whose trend is similar to that seen in the United States following the announcement of tapering (beginning of the end of Quantitative Easing);

- “Shock external to growth” Scenario: simulates a recession in 2019 that does not impact on the spread;

- “Spread” Scenario: simulates a recession in 2019 that impacts on the spread, i.e., fears return about Italy remaining within the Eurozone and this produces a rise in the risk premium on Italian debt securities;

- “Meeting of DEF and ECB targets with recession in 2021” Scenario: simulates a recession in 2021 following a three-year period in which macroeconomic values were in line with the DEF and ECB forecasts (2% inflation target).

As mentioned above, the simulated scenarios are not forecasts and no probability level has been assigned to them, but they do offer much information and points on which to reflect.

- The current maturity of Italian debt represents a major factor that allows for the management of this debt over the short- to medium-term, including in the presence of upward shocks in interest rates.
- In the absence of external shocks, until 2020-2021, the average interest rate at time of issuing would be less than the current average cost of issued bonds.
- In the absence of external shocks, the cost of interest rates to GDP would decrease for the coming 2-3 years.
- In the presence of external shocks, the role of the ECB and exceptional monetary policy measures is indispensable to limit the impacts on the sustainability of debt.
- The primary driver for sustainability of debt would seem to be economic growth.
• Primary surplus and the deficit/GDP ratio are elements designed to create a buffer of resources that is indispensable for facing potential slowdowns or reversals in the economic cycle.
• Although important, inflation plays a lesser role compared with other variables in influencing the evolution of trends in the debit/GDP ratio.
• The interest rate variable does not seem to be that critical over the coming 2-3 years.
• For all these reasons, putting aside external shocks, over the next 2-3 years, public debt would seem to be relatively sustainable and relatively resilient.
• The only event that is actually critical to the sustainability of Italian public debt would be a potential, imminent global recession that also involves Italy.
• On the basis of our simulations, if for every percentage point increase in rates (base = 100) an equivalent increase were to be produced in the average financing cost for companies and the public, every year there would be an additional cost of 1.8-2.8 billion euros in the form of an increase in passive interest rates.

In light of our findings, to improve the sustainability of Italian public debt, policies that support economic growth must be promoted. From this standpoint, all aspects with potentially recessionary effects have impacts that could call into question the sustainability of Italy’s public debt. Secondarily, a larger primary surplus corresponds to a greater possibility to successfully take on any external recessionary shocks that could hit Italy in the coming years, thus reducing its growth and putting at risk the sustainability of its debt.