



*Ministero dell'Economia e delle Finanze*  
*Dipartimento del Tesoro*

# **Fiscal Risks in Italy**

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# Agenda – Fiscal Risks (FR)

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- Some comments on the IMF paper.
- Fiscal Risks in Italy – some issues.
- Some considerations on contingent macroeconomic shocks and long-term sustainability of Italy's public finances.

## The IMF methodology: pros

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- A simple framework to assess and disclose worst-case scenarios consistently with past experience of budgetary planning in different countries.
- Tracking past projection errors helps to identify sources of FR and to improve projection methods used by governments.
- Transparency in official budgetary planning, open discussion about baseline projections and underlying assumptions, and design of preventive measures and fiscal rules.

## The IMF methodology: cons

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- Using cross-country data to construct the frequency distribution and percentiles of historical projection errors might be misleading as high-risk and low-risk countries have been mixed; country-specific time series data should be considered. Problem of short series. (US CBO 2007 uses 25 years).
- One-period-ahead projection errors might be insufficient since budgetary planning extends 3-5 years into the future. Horizon up to three periods ahead would be needed. Again, problem of short series. (US CBO 2007 extends to 5 years ahead).

## Fiscal risk mitigation

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- Is it worthwhile?
- In practice, most of the times the government is the economic agent that have the best ability and incentive to manage risk and is best placed to bear risk.
- ... but there may be exceptions.
- Topical issue given recent sharp increase in contingent liabilities: need for risk mitigation in the future once the financial crisis is over.

## Financial hedging and insurance instruments

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- Self-insurance is the default option most of the times.
- Catastrophe bonds or insurance may be considered, especially when first order problems have been solved (try selling earthquake insurance to policymakers struggling to prepare the budget!).
- Main sources of fiscal risk are difficult to insure away (e.g. sub-prime, banking and exchange rate crisis).

## Contingent reserves: risks of pro-cyclical effects

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- Contingencies appropriation vs. contingency reserves.
- Reserves are reduced in bad times making for replenishment and thus calling for tightening policy when tightening is not desirable.
- Conversely, reserves tend to be abundant in good times calling for pro-cyclical use of the excess reserves.
- Conclusion: no binding rules to avoid pro-cyclical effects.

## Transparency vs. moral hazard / endangering negotiations

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- Striking a good balance between transparency and full disclosure on the one hand and risks of endangering future negotiations or triggering moral hazard on the other is a difficult exercise.
- Clearly fiscal policy should be set taking into consideration all fiscal risks, including those that are not disclosed or explicitly quantified, although ... can a democratic debate accept undisclosed items as a basis for policy decisions?
- No clear-cut solution.



## Fiscal Risks – Italy's experience

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- Analysis of sources of FR to Italy's public debt projections: emphasis on unexpected permanent macroeconomic shocks to growth and interest rates rather than contingent liabilities.
- How do we integrate methodologies addressing FR and long-term fiscal sustainability?
- Risks of full disclosure: an example.

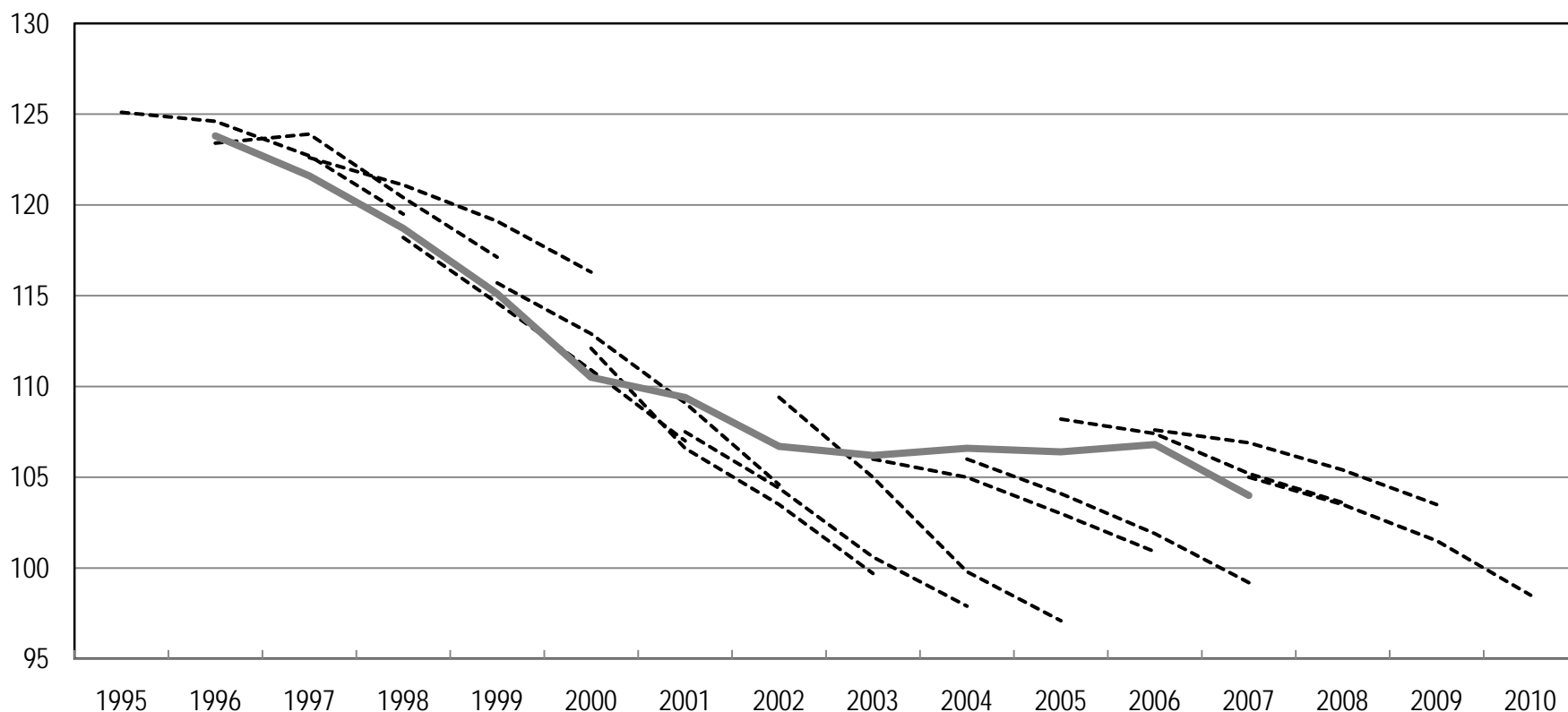
# Mixed feelings on experimental disclosure of contingent risks

Classification of possible expenditure (in Euro Mn)	2008	2009	2010
<b>SIGNED COMMITMENTS *</b>			
Resources allocated to social security and labour <sup>(1)</sup>	1,000	1,000	1,000
Contracts for public sector employees (including school system)	2,354	561	561
Cooperation on development - AIDS Fund and IDA XIV	750	150	150
<i>Total Category 1</i>	<i>4,104</i>	<i>1,711</i>	<i>1,711</i>
<b>CUSTOMARY OBLIGATIONS *</b>			
National Railways (FF.SS.)	4,000	3,500	3,500
National Road Board (ANAS)	1,000	1,500	1,500
ENAV	30	30	30
Post Office	130	130	130
Reserve to offset commitment's overruns	800	1,000	1,000
Resources for next round of collective bargaining with public sector employees	To be established		
Extension of fiscal benefits	1,200	1,500	1,500
<i>Total Category 2</i>	<i>7,160</i>	<i>7,660</i>	<i>7,660</i>
<b>Total (Categories 1 and 2)</b>	<b>11,264</b>	<b>9,371</b>	<b>9,371</b>
<i>Estimates for new initiatives (Category 3)*</i>	<i>10,000</i>	<i>10,000</i>	<i>10,000</i>
<b>Total (Categories 1, 2 and 3)</b>	<b>21,264</b>	<b>19,371</b>	<b>19,371</b>

In the Economic and Financial Planning Document for 2008-2011 a table was introduced for the first time with some contingent liabilities (versus projections “based on unchanged legislation”).

## FR in Italy's debt projections

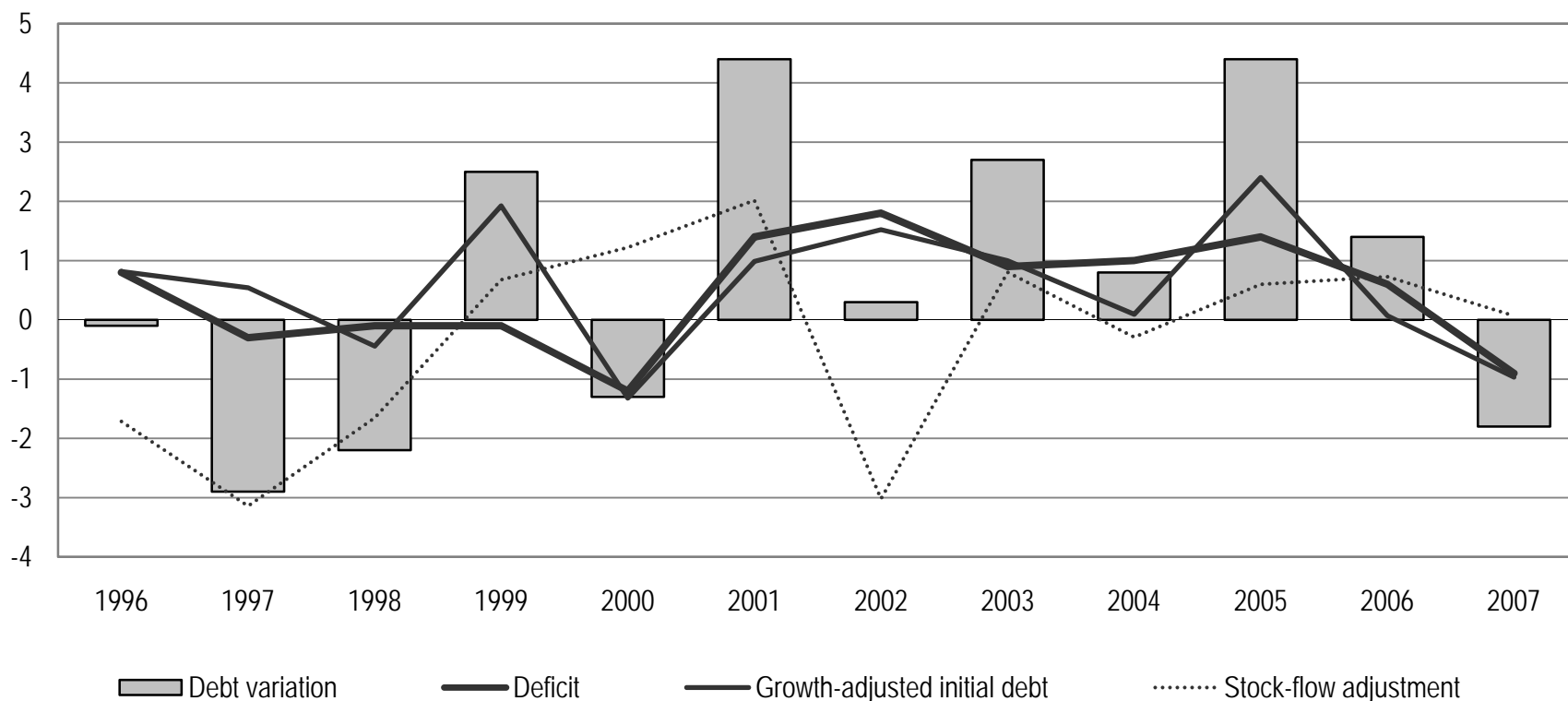
Public Debt Projections (% of GDP)



Unexpected events (e.g. lower-than-expected interest rates) led to overestimation of public debt in 1996-2000, while debt was underestimated in 2001-2007 (e.g. lower-than-expected growth).

# The breakdown of projection errors

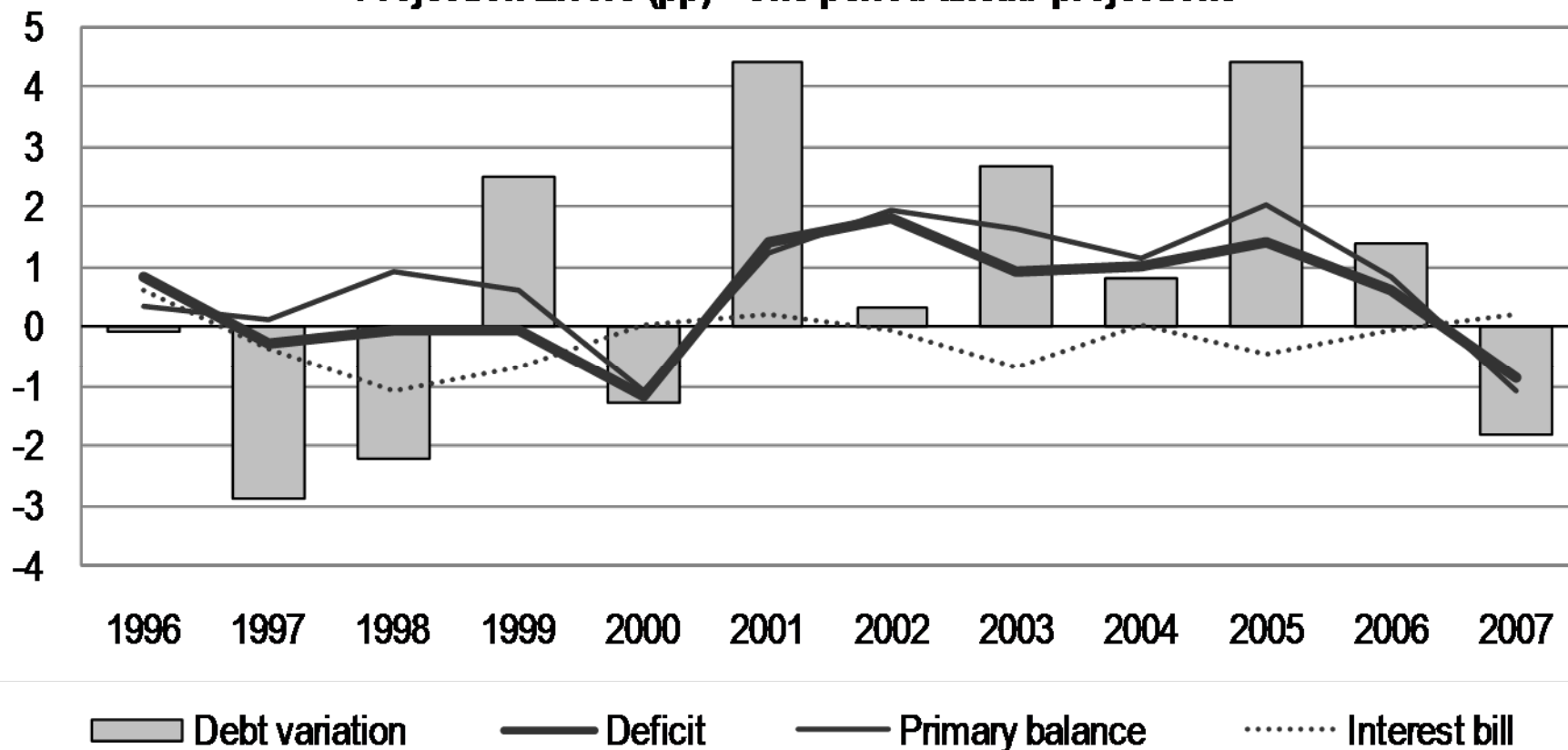
Projection Errors (pp) - One-period-ahead projections



Fiscal risks associated mainly to macroeconomic shocks affecting debt dynamics through deficit and growth-adjusted initial debt (both components are highly correlated because of growth shocks). Stock-flow adjustment with large impact in 1997 and 2002.

## A further breakdown of deficits

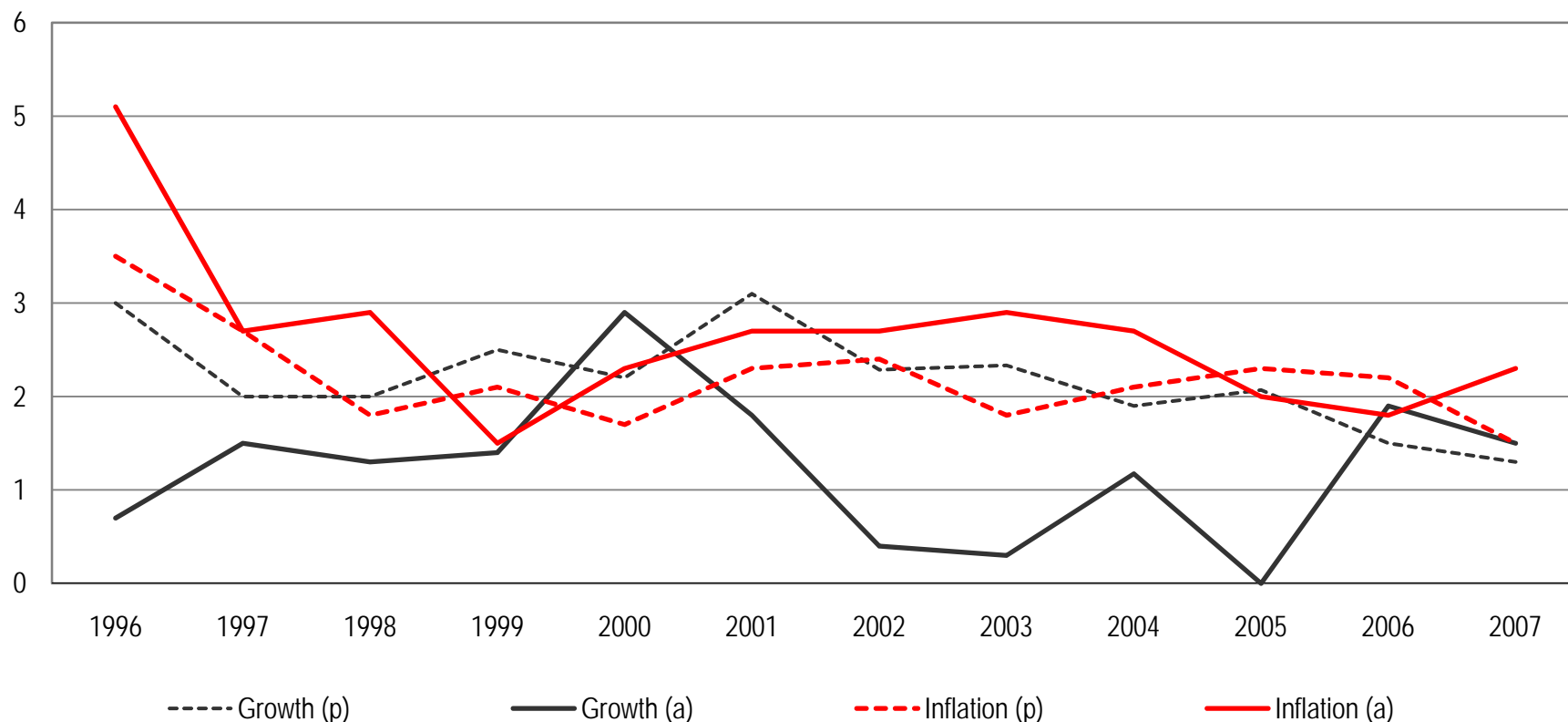
Projection Errors (pp) - One-period-ahead projections



Deficit should be broken down into primary balance and interest bill to disentangle effects on current budgetary items (growth shocks) and on debt servicing (interest rate shocks), especially in high debt countries such as Italy.

## FR and macroeconomic shocks – growth and inflation

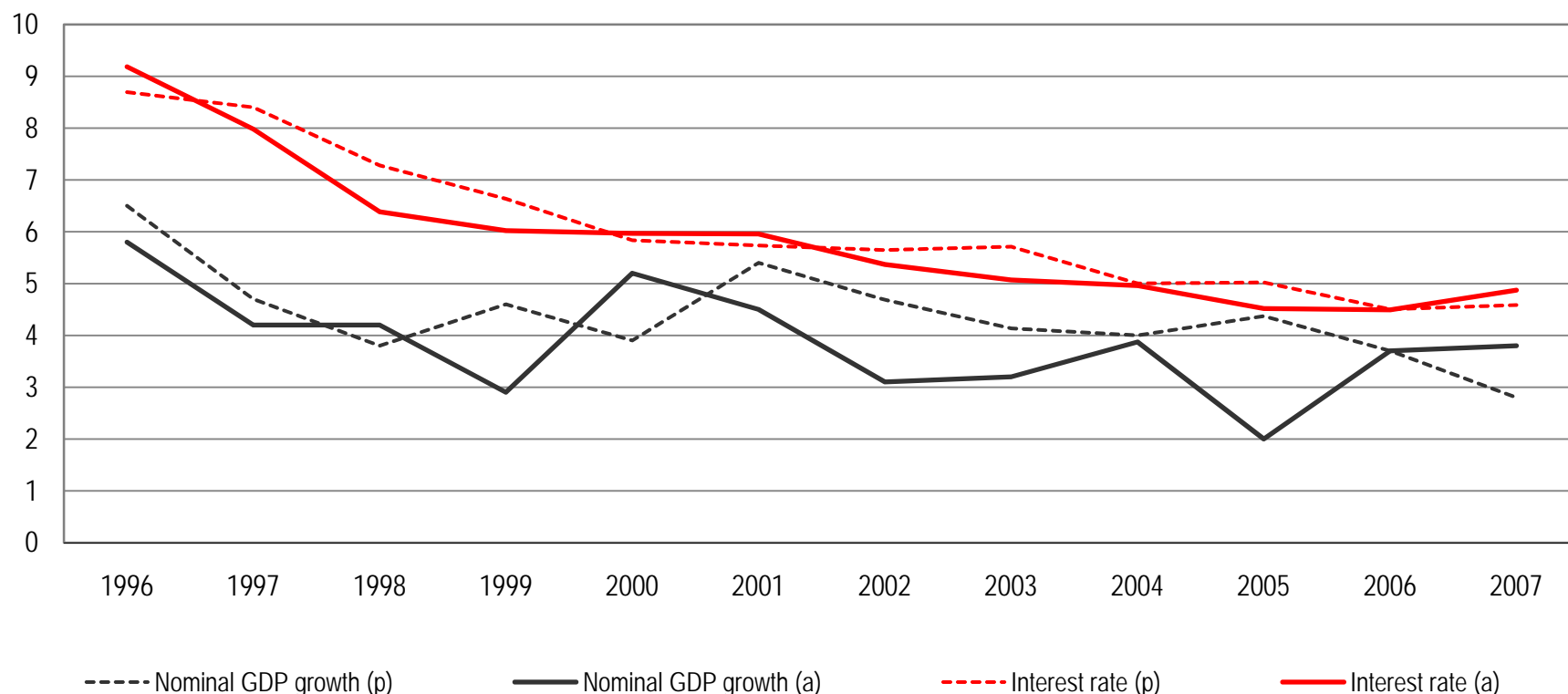
Macroeconomic shocks - Projected (p) and Actual (a)



Negative shocks to growth led to underestimation of deficits and growth-adjusted initial debt.  
Revenues highly elastic to growth, but current expenditure fairly inelastic.  
Good performance in projecting inflation since EMU.

## FR and macroeconomic shocks – interest rates

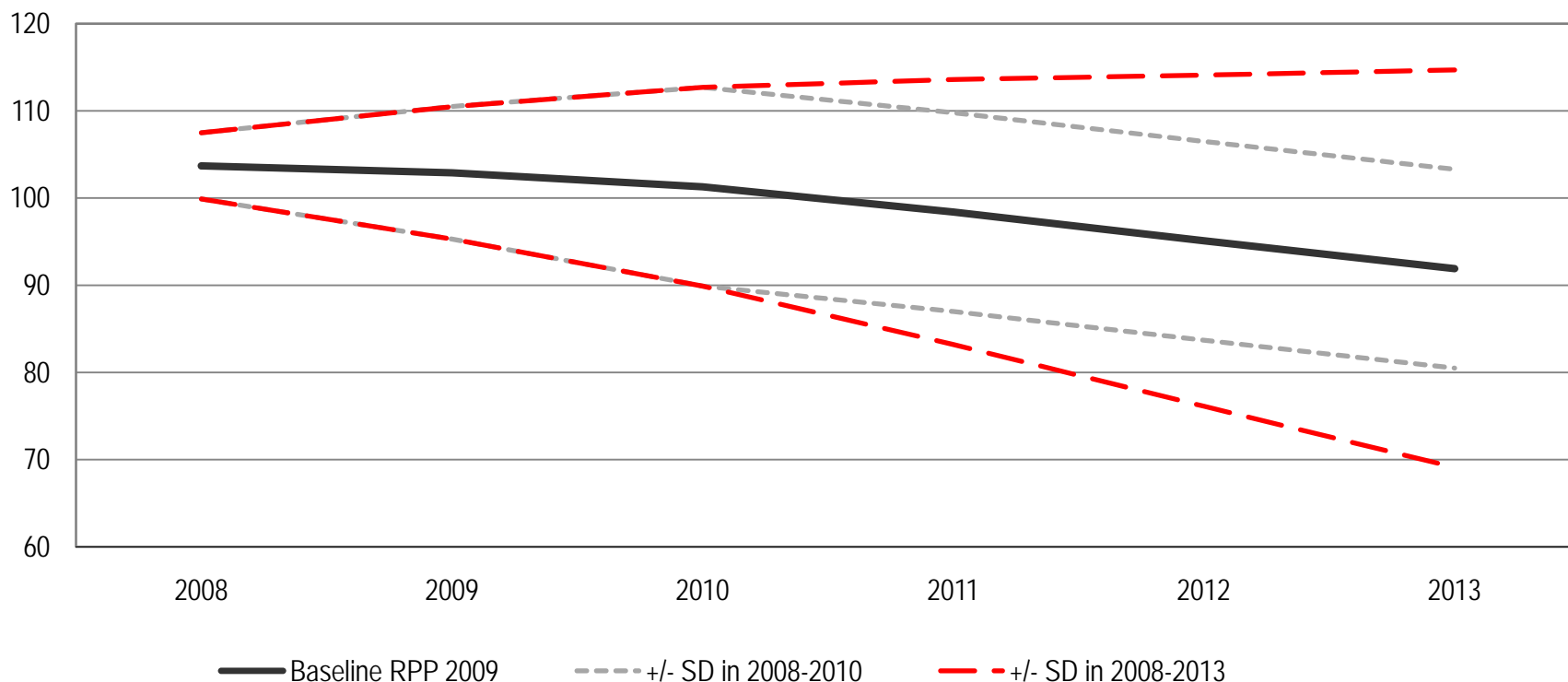
Macroeconomic shocks - Projected (p) and Actual (a)



Favorable interest rate shocks have been observed in 1996-2007. Current financial turmoil might imply downside risk.

## Debt projections adjusted by FR – ‘worst-case scenario’

Public Debt Projections (% of GDP)



Fiscal risks introduced into debt projection by simulating dynamics with one-SD shocks to deficit (1.0 pp of GDP), growth-adjusted initial debt (1.1 pp), and stock-flow adjustment (1.7 pp).

Worst-case scenario: should Italy suffer debt variations of 3.8 pp above the baseline case all over 2008-2013, the 2013 debt would be 115% of GDP.



## FR and long-term fiscal sustainability (LTFS)

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- Focus on macroeconomic shocks instead of contingent liabilities, with shocks affecting LTFS in a lasting manner.
- The IMF methodology: historical projection errors give an order of magnitude of possible shocks in the future; FR-adjusted debt projections.

## FR and long-term fiscal sustainability (LTFS) (cont'd)

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- LTFS challenges (e.g. demographics and productivity growth) are perceived to be more important when the debt-to-GDP ratio is still high.
- The EPC-AWG methodology: indicators S1 and S2 to measure permanent fiscal adjustment needed to achieve solvency, e.g. Maastricht 60% debt ratio or intertemporal budget constraint (IBC).

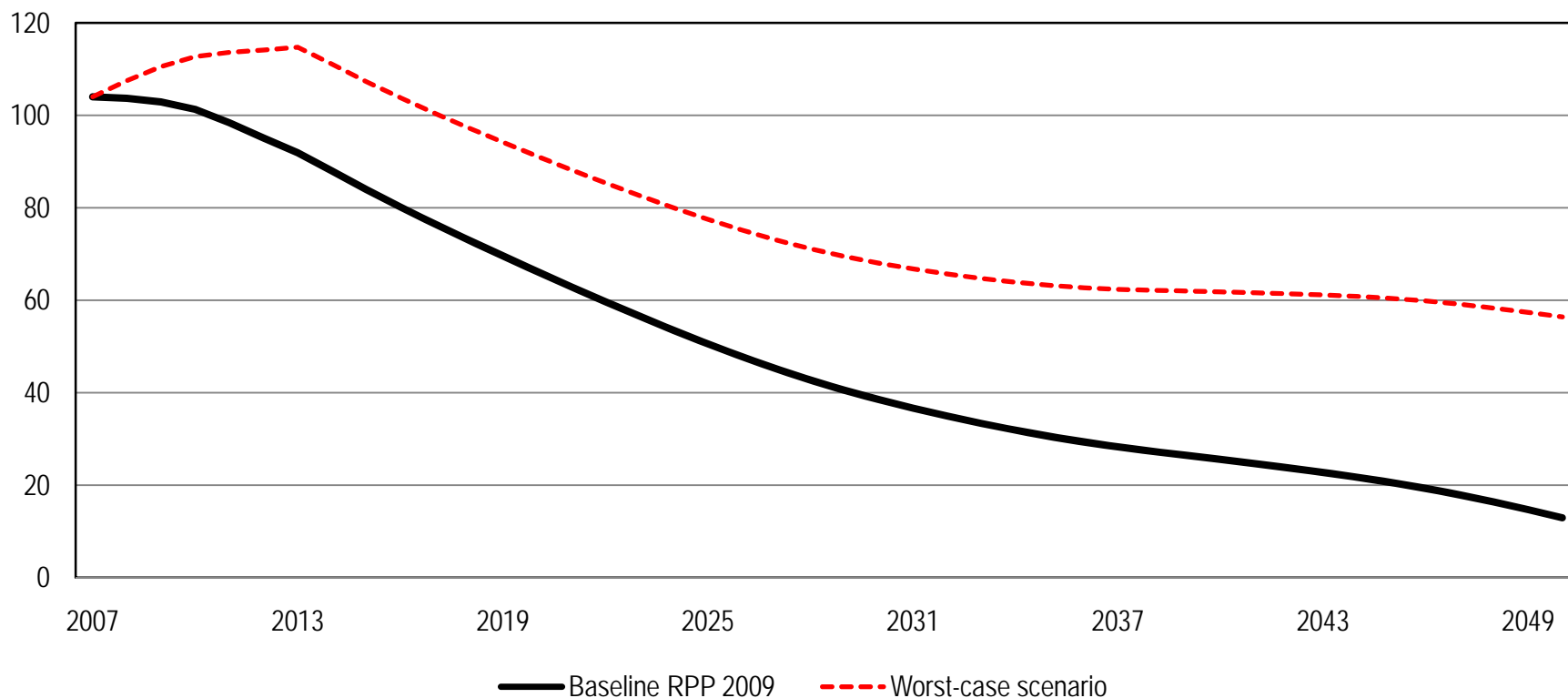
## FR and long-term fiscal sustainability (LTFS) (cont'd)

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- For Italy, the EPC-AWG indicators reveal a substantial margin of safety (due to past pension reforms), giving an order of magnitude of shocks that can be absorbed without threatening LTFS.
- Italy can absorb shocks equivalent to a permanent 0.9pp reduction in the primary balance-to-GDP ratio and still achieve solvency. At 2013, the PV of estimated future primary surpluses is 145% of GDP, hence this would be the maximum level of debt consistent with meeting IBC.

# LTFS - Debt projections in baseline and worst-case scenarios

Public Debt Projections (% of GDP)

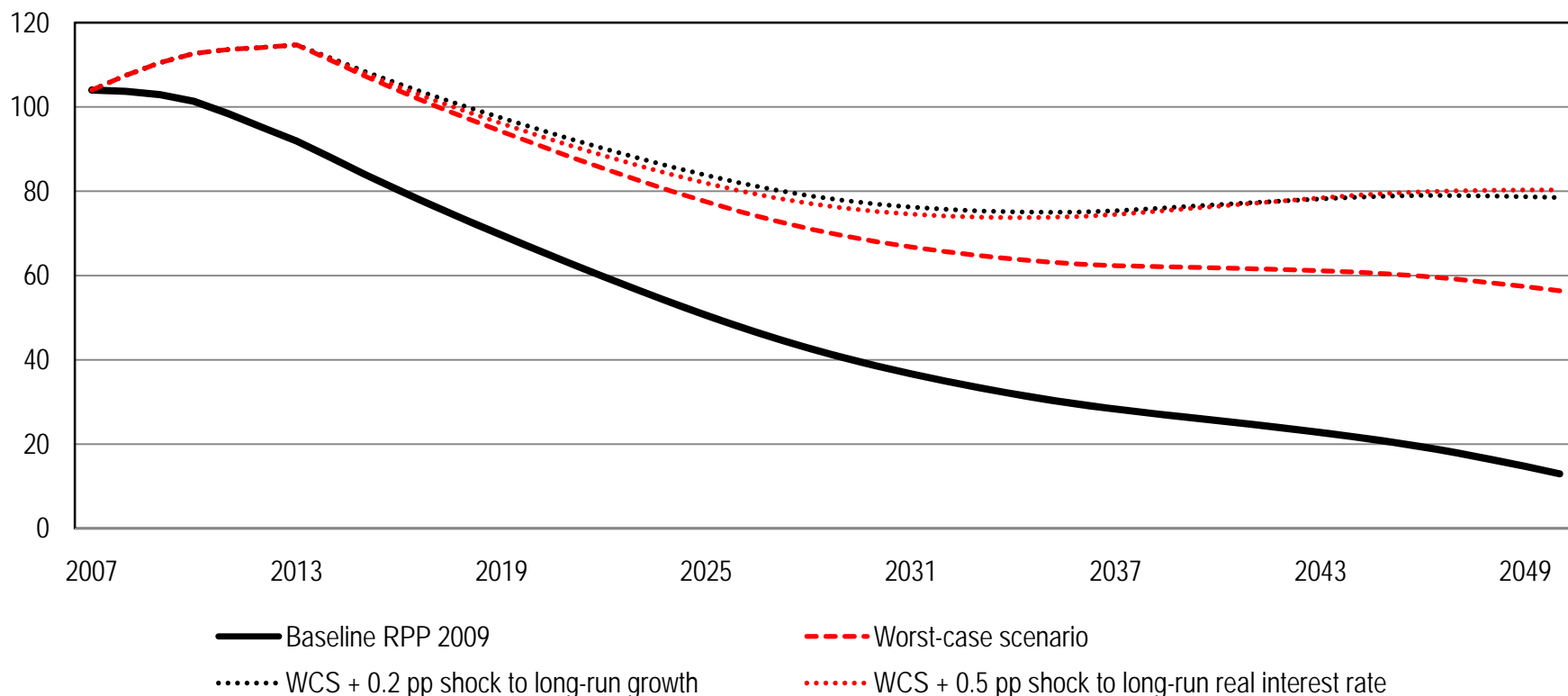


Baseline scenario: debt reaches 13% of GDP in 2050.

Worst-case scenario: debt reaches Maastricht 60% of GDP in 2050 and meets IBC.

## 'worst-case +': low growth + high interest rate in the long run

Public Debt Projections (% of GDP)



Financial turmoil might have long-run effects on growth and real interest rates, thus compounding medium-run effects on budget and debt.

Even in 'worst-case + scenarios', Italy's debt would decrease over time and meet IBC.

## Conclusions (I)

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- FR analysis should be incorporated to regular budget planning. Still, the focus should be baseline projections since they capture events likely to happen according to consensus and expert opinions. Interaction between FR in medium-term and LTFS must be addressed as well.
- A methodology must be shared by countries to ensure data comparability and transparency. Commonly-agreed approach to assess LTFS in EPC-AWG is an encouraging example.

## Conclusions (II)

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- Contingent liabilities might be associated with dramatic events, and so an excessive emphasis in discussing them might trigger self-fulfilling fears (e.g. in good times, making provisions to support banks 'just in case' could fuel unwarranted fears).
- Moral hazard problems compounded by political economy constraints (obstacles to commit current and future governments to honour guarantees signed in the past).

## Conclusions (III)

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- Fiscal consolidation in good times is key because dramatic events are eventually 'insured ex post' by governments (e.g. bailouts) and so they should be prepared to intervene having already achieved a strong budget position.
- Devices for the government to 'share risk ex ante' with the private sector must be used strategically, providing incentives to take actions that eventually reduce the overall exposure facing both parties.
- Increasing the coverage of fiscal risk disclosed by means of a Statement of Financial Risks is worth considering.