Flash Economics

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It is important to keep in mind that when the public debt becomes domestic and international capital mobility declines, the fiscal multiplier becomes low

The new government coalition in Italy has announced that it will conduct a very expansionary fiscal policy. But international capital mobility between Italy and the rest of the world (and also the rest of the euro zone) has become low; Italy's public debt has, as a result, become very domestic.

In this configuration where an increase in the fiscal deficit must be financed by domestic savings, and not by savings attracted from the rest of the world, the crowding-out effect is significant: the increase in the fiscal deficit leads to a sharp rise in long-term interest rates since the demand for government securities is not fuelled by non-resident purchases.

The fiscal multiplier (effect of the increase in the fiscal deficit on growth) is then low, which the new coalition in Italy should take into account.

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We use the example of Italy

The new government coalition in Italy has announced that it will conduct a very expansionary fiscal policy: tax cuts (for households and small businesses), increase in public spending (on security, pensions, introduction of a universal income). Italy's fiscal deficit (Chart 1) could increase by at least 5 percentage points of GDP.

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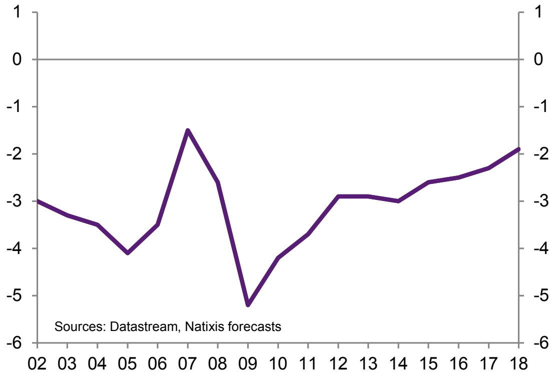
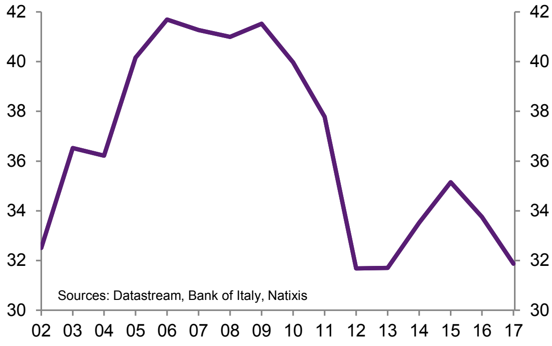
Chart 1
Italy: Fiscal deficit (as % of nominal GDP)



But capital mobility between Italy and the rest of the world has decreased markedly since the 2008-2009 crisis and the 2011-2014 euro zone crisis. We can see, in particular, that the proportion of Italy's public debt held by non-residents has decreased markedly **(Chart 2).**

Chart 2
Italy: Share of government bonds held by non-residents (as % of nominal GDP)



Purchases of Italian bonds by non-residents (Charts 3A and **B)** have become zero on average since 2008.

Chart 3A
Italy: Net purchases of bonds by non-residents
(as % of nominal GDP)

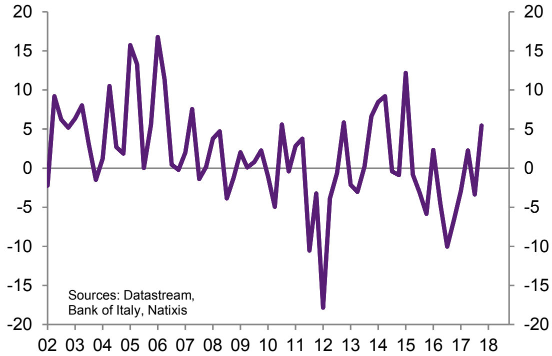
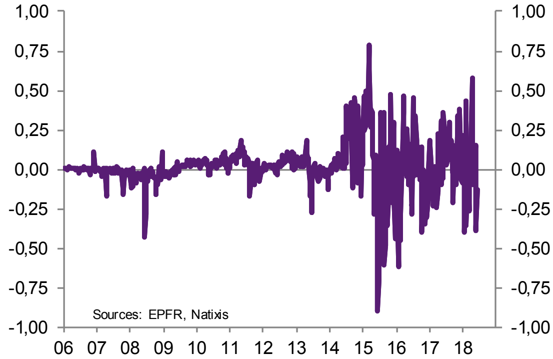


Chart 3B
Italy: Net purchases of bonds by non-residents
(in USD bn)



What effect of the lack of international capital mobility on monetary policy?

Italy is currently characterised by **low capital mobility between Italy and the rest of the world.**

If Italy's fiscal deficit is increased, it cannot be financed by non-resident purchases. As the government bond market is a very domestic market, if the fiscal deficit is increased, it must be balanced by an increase in the purchases of Italian government bonds debt by the Italians, which is more difficult than if global investors buy Italian government bonds.

As a result, there is significant crowding-out: the increase in the fiscal deficit leads to a sharp rise in long-term interest rates since the domestic government bond market must be rebalanced without the help from non-residents' savings.

This is what happened in Italy from 2011 to 2013 and in 2018 (Chart 4).

In the recent period, the announcement of a large fiscal deficit in Italy immediately led to a sharp rise in Italy's yield spread **(Chart 5).**

Chart 4
Italy: Public debt and interest rate on 10-year government bonds

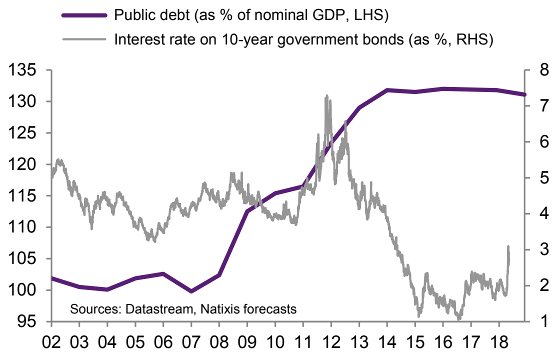
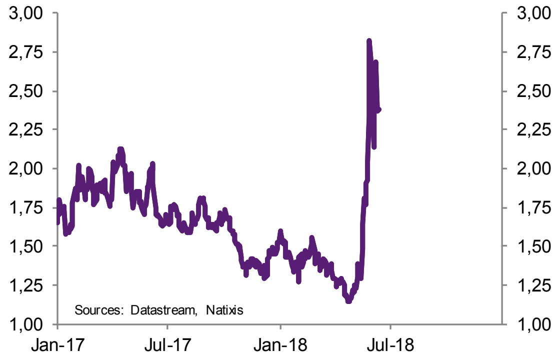


Chart 5
Italy: Yield spread on 10-year government bonds
(as %)



Conclusion: Low fiscal multiplier

The fiscal multiplier is the effect of a 1 percentage point of GDP change in the fiscal deficit on growth. As we have just seen, **if international capital mobility is low, an increase in the fiscal deficit leads to a sharp rise in long-term interest rates.**

This means that in this configuration - in which Italy finds itself currently - the fiscal multiplier is low: the Italian government should normally be discouraged from conducting an expansionary fiscal policy.

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