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 level below but 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 range of 100-140 points. Post-election tension, the threat to break with Europe and the prospect of an exit from the euro, together with an economic program that breaks with the past, have led to a successive increase in the spread to a value that fluctuates around 280 points.

Starting in March 2015 the ECB activated a program to buy bonds (known as Quantitative Easing) which, as of today (September 2018), amounted to 2,510 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 announcements, one at the end of 2017 regarding the reduction in monthly bond purchases, and one in June 2018, regarding the termination of the Asset Purchase Program (APP), have 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 May 2018, Italian debt was 2,327 billion euros, of which approximately 85% (1,973 billion euros) was government bonds. The maturity on the debt was 82.44 months in June 2018 and the average interest rate at the time of issuing was at an all-time low (0.75% average interest rate in June 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;
- "Shock external to growth" Scenario: simulates a recession in 2020 that does not impact on the spread;
- "Spread" Scenario: simulates a recession in 2020 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** (82.5 months in June 2018, vs. 75.7 months in July 2014) is **an important element that allows debt management, in the short to medium term, in the absence of further upward shocks of interest rates**.
- The main driver of debt sustainability seems to be **economic growth** and all the elements characterized by potentially recessive effects have impacts that could challenge the sustainability of Italian debt. **Primary surplus and deficit-to-GDP ratio** are elements aimed at creating a **buffer of resources that is indispensable to face potential slowdowns or reversals of the economic cycle**.
- The only really critical event for the sustainability of Italian public debt is **a possible and next global recession that also involves Italy**.

- In the presence of external macroeconomic shocks, **the role of the ECB and of the extraordinary monetary policy maneuvers is essential to limit the impact** on debt sustainability.
- **A spread shock would have no short-term impact on the debt-to-GDP ratio**. The current exposure of the **Italian banking system** to sovereign bonds, however, represents a **channel of transmission to the real economy** of the negative consequences of such a shock. **Increases in the spread, in fact, could cause possible credit crunch risks towards companies**.

Considering 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.