ZAIS Insights

The Euro's Italian Heel

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The Euro’s Italian Heel

- A debt crisis in Italy is a major risk for the stability of the Euro
- The Corona crisis makes Italy’s debt sustainability problem worse
- Structural reforms are needed but “muddling through” seems more likely for now, leaving the Euro vulnerable

Italy has been hit hard by the Corona crisis. The IMF expects the Italian economy to contract by more than 9% this year and government debt to rise by 21% of GDP to 155% of GDP.[1] The outcome could be worse given still high uncertainty.

The ECB has so far stabilized the situation with its Pandemic Emergency Purchase Program,[2] but an Italian debt crisis that threatens the Euro remains a clear and present danger.

In our view, Italy's debt situation was already unsustainable before the Corona crisis.

Furthermore, we think fiscal support from the EU and its members or the issuance of common bonds are not a permanent solution. Instead, we believe only structural and fiscal reforms can solve the problem.

However, radical change seems to us unlikely to come quickly, if at all. More likely, given the complex political situation, is a "muddling through" approach, with emergency measures each time the situation escalates.

The Euro may not fail, because too much is at stake, but it would remain vulnerable.

Italy's debt sustainability problem

Debt is viewed as unsustainable if it continuously increases as a share of GDP.

Italy's debt rose 22% of GDP over the last ten years following the financial crisis to 134% of GDP in 2019 – in the Euro-area excluding Italy, debt rose less than 3% of GDP over the same period to just 75% of GDP in 2019.[3]

The growth of the debt to GDP ratio is a function of the real effective interest rate on government debt, real GDP growth, the primary fiscal balance and the level of the debt to GDP ratio itself (see box Debt Sustainability Arithmetic). In the case of Italy (see table):

- real effective interest rates on government debt are too high;
- real GDP growth is too low; and
- the primary surplus is insufficient to fill the gap between real interest rates and real growth, also because of the high and rising level of the debt to GDP ratio itself.

Debt Sustainability Arithmetic

The change of government debt (ΔD) equals interest payments (I) minus the primary budget balance (P).

(1) $\Delta D = I - P$

Dividing both sides by the level of debt (D) and subtracting from both sides nominal GDP growth (y) results in the % change of the debt/GDP ratio where $d=\Delta D/D$ is the % change of the debt and $i=I/D$ is the effective interest rate paid on the debt.

(2) $d - y = (i - y) - P/D$

Equation (2) can be rewritten by expanding P/D with nominal GDP (Y) where $x=P/Y$ is the primary budget balance in % of GDP and $z=D/Y$ is the debt/GDP ratio. Adding and subtracting the inflation rate (p) converts to the real effective interest rate ($r=i-p$) and real GDP growth ($g=y-p$).

(3) $d - y = (r - g) - x/z$

If the debt/GDP ratio is to be stabilized ($d-y=0$) then the following must hold:

(4) $p = (i - y)*z$

The components of debt: GDP changes

	Period	Italy	Euro-area ex-Italy
Real interest rate on gov. debt, % p.a. (r)	2010-19	2.3	1.2
	2019	1.6	-0.1
Real GDP growth, % p.a. (g)	2010-19	0.2	1.6
	2019	0.3	1.4
Primary fiscal balance, % GDP (x)	2010-19	1.0	-1.0
	2019	1.6	0.6

Source: IMF and own calculations[4]

As can be seen above, the situation has improved a bit in recent years, yet because of its higher debt to GDP ratio, Italy needs a much larger primary surplus to offset the gap between real interest rates and real growth.

Although not identical across all other members, the rest of the Euro-area has much better debt dynamics. As shown above, compared to Italy, real interest rates have been more than a percentage point lower and real growth more than a percentage point higher, producing powerful downward pressure on the debt to GDP ratio. In addition, the region has turned a primary deficit into a surplus.

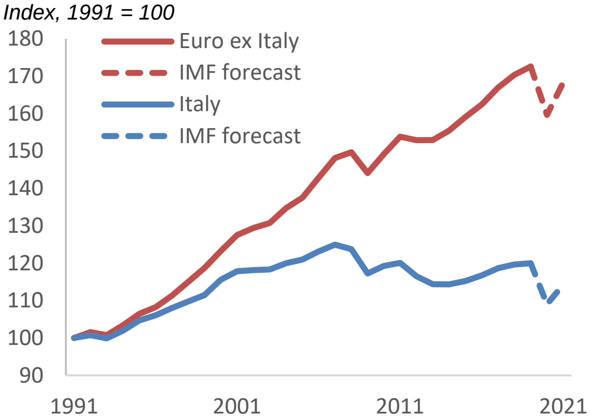
Corona makes it worse

The Corona crisis has worsened Italy's debt sustainability problem. As noted earlier, the IMF predicts a big jump in the debt to GDP ratio and the outcome may well be worse, making it even harder to stabilize the debt dynamic.

Italy would need lower interest rates and much better growth and fiscal conditions than over the previous ten years to stabilize or even reduce the debt to GDP ratio after the Corona crisis. To us, this seems unlikely without significant structural change.

Real GDP developments

Index, 1991 = 100



Source: IMF and own calculations[5]

The Italian economy is shrinking

The root cause of Italy's debt sustainability problem is, in our view, its ailing economy.

Since the financial crisis, the Italian economy essentially has been on a shrinking trend, while the rest of the Euro-area has recovered (see chart). Even before the financial crisis, Italy underperformed the rest of the Euro-area.

As the IMF wrote in its latest country report: "Productivity growth has been weak for over two decades, as Italy's policies and institutions have adapted insufficiently to an evolving global technological and trade landscape. Sustained high unit labor costs, barriers to competition, elevated tax rates on labor, and an inefficient public sector and judicial system, among others, have weighed on employment and growth."[6]

Insufficient fiscal consolidation efforts

The IMF writes further: "Italy's governments over the years have taken necessary actions when faced with episodic market strains. [...] However, policies have not sufficed to durably lower debt and secure stability, particularly during normal times."[7]

The combination of poor growth, rising debt and insufficient structural and fiscal reform efforts have undermined Italy's credibility in the capital market and resulted in higher risk premia on government debt, compounding its debt sustainability problem.

In our view, the ECB's massive liquidity injections and bond purchase programs since 2011 have probably prevented Italian interest rates from going even higher, or a complete closure of Italy's bond market access.

The best solutions ...

The ECB's current emergency measures provide critical support but are likely to end once the Corona crisis is over. That would leave Italy vulnerable as the ECB has limited room to support any country individually and continuously in normal times.

In our view, Italy needs structural and fiscal reforms to raise its growth potential and reduce debt funding vulnerabilities. The IMF recommends in its latest country report.[8]

"Structural reforms: further liberalize product and service markets; decentralize wage bargaining to realign wages with labor productivity at the firm level; enhance public sector efficiency; and deploy the new insolvency code.

Fiscal policy: implement a credible medium-term consolidation that targets a small overall surplus and puts debt on a firmly declining path. Establish credibility by legislating upfront pro-growth and inclusive measures, such as reforming the tax system to broaden the base, lower statutory rates and help fight evasion, cutting current primary spending, and improving the design of the social safety net."

Structural and fiscal reforms as outlined by the IMF would allow Italy to apply for support from the *European Stability Mechanism* and enable the ECB to buy Italian government bonds under its *OMT* program, which would lower the interest burden and ease the pain of the reform process.[9]

Debt restructuring could also be part of the solution if Italy could credibly commit to reforms and secure ECB and other EU institutions' support for its reform process.

… are not necessarily the most likely

Unfortunately, embracing reforms seems to be less popular than blaming the Eurozone and its northern members for Italy's problems. Also, rising nationalism makes it more difficult to find common solutions.

The current EU economic support measures and the planned recovery fund will probably help Italy reduce some of the fiscal cost of the Corona crisis, but these measures will not solve Italy's structural growth and accumulated debt problems.

The often-demanded issuance of common bonds (Euro or Corona bonds) would only help lowering Italy's funding costs if of an amount that would refinance all or at least a large share of Italy's government debt.

Yet Germany and other northern Euro-members are unlikely to agree to such debt mutualization because of moral hazard generally and, in the case of Italy specifically, the risk of removing or diminishing the incentive for reform efforts.

On the other hand, it is not our impression that Italy and its Euro partners would let the situation escalate so far that it results in a debt-crisis that would threaten the overall survival of the Euro. Too much is at stake for all. A disorderly default and/or Euro exit would most likely devastate the Italian banking and financial system, which still holds most of the government debt,[10] and likely cause a financial crisis in the rest of the Euro area.

More likely, in our view, is a continuation of the current approach with stop-gap measures that prevent a further escalation.

The Euro-system may well survive under these conditions but would remain vulnerable to repeated shocks.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

[1] IMF World Economic Outlook – April 2020; https://www.imf.org/en/Publications/WEO.

[2] ECB announces Pandemic Emergency Purchase Program (PEPP); March 18, 2020; https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html.

[3] IMF Fiscal Monitor – April 2020; https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020. Figures for the Euro-area ex Italy have been calculated by ZAIS based on the IMF data for the Euro area and Italy.

[4] Calculations are based on IMF data from the World Economic Outlook and the Fiscal Monitor (see notes 1 and 3).

[5] Calculations are based on IMF data from the World Economic Outlook April 2020 (see note 1)

[6] IMF Staff Country Reports; Italy: Staff Report for the 2020 Article IV Consultation; February 28, 2020; Page 5, #2; https://www.imf.org/en/Publications/CR/Issues/2020/03/19/Italy-2020-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-Executive-49277.

[7] Same as note 6; Page 5, #3.

[8] Same as note 6; Page 1, Recommendations.

[9] ECB Press Release: Technical features of Outright Monetary Transactions (OMT); September 6, 2012; https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

[10] Financial Accounts of Italy; Bank of Italy; https://www.bancaditalia.it/pubblicazioni/conti-finanziari/index.html.

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