Italy's Lost Decade

Is Italy the world's new Greece?

By Desmond Lachman

Judging by the still relatively buoyant Italian sovereign bond market, one could be forgiven for thinking that all is well with the Italian economy. Similarly, one could be excused for believing that Italy poses little threat to the world economic outlook. After all, despite its major defeat in the recent constitutional reform referendum, the Italian government can still readily borrow long-term from the markets at a rate of a mere 2 percent, or at a significantly lower rate than can the U.S. government. More striking yet, in October 2016 the Italian government took full advantage of the market's seemingly relaxed attitude towards the country's moribund economy and its political disarray by placing a fifty-year sovereign bond at a less than 3 percent yield.

Before allowing very favorable market pricing to lull one into a false sense of security about the possible risks that Italy might pose to the world economy in the year immediately ahead, one might want to recall Greece's recent experience. In 2009, on the very eve of the European sovereign debt crisis, the Greek government could raise long-term funding at practically the same very low rate as could the German government. It could do so even though the country was on the brink of the largest sovereign debt default in history as well as of an implosion of its economy that bears a

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striking resemblance to the U.S. economic depression of the 1930s.

Sadly, today there would seem to be as many reasons for worrying about the Italian economy as there were for worrying about the Greek economy back in 2009. Like Greece then, Italy today checks all too many of the boxes for the making of a full-blown economic and financial crisis within the next year or two. Now adding to that concern is the likelihood of a prolonged period of Italian political instability following the recent referendum, which threatens to cause capital to leave Italy at an even faster pace than it did in the run-up to that referendum.

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Among the more basic reasons for deep concern about Italy is its demonstrated inability to deliver meaningful economic growth over the past two decades. Indeed, the Italian economy today is barely above its level in 1999 when the country adopted the euro as its currency. Worse still, since the Great Global Economic Recession in 2008–2009, Italy has experienced a triple-dip recession that has left its economy today some 7 percent below its pre-2008 crisis peak level and its unemployment rate stuck at over 11 percent. This performance has been considerably worse than that of most of Italy's peers. It has also prompted the IMF to forecast that the Italian economy will only regain its 2008 peak level by 2025.

Beyond Italy's lost economic decade, it is troublesome that over the past eighteen months the Italian economic recovery has been so weak and that its recent brief economic recovery is already showing the clearest of signs of having running out of steam. This is especially the case considering that Italy's recovery has remained anemic despite the fact that the external conditions facing the country could not have been more favorable. Not only did the European Central Bank's very easy monetary policy produce both very low European interest rates and a weak euro. The collapse in international oil prices also provided Italy with very cheap oil. All of this has to make one wonder what will happen to the Italian economy should external conditions no longer remain quite as favorable as they have recently been and should the country indeed face another period of domestic political instability.

Yet another reason to be worried about Italy's long-run economic prospects is its inability to remain internationally competitive. Stuck within a euro straitjacket, the country can no longer resort to exchange rate depreciation to make up for the deficiencies of its ossified labor market that contributes so importantly to the country's very poor productivity performance. As a result, since adopting the euro in 1999, Italy's unit labor costs have increased by around 15 percentage points more than have those in Germany. Absent major structural reform, there is every prospect that Italy will continue to lose competitiveness to its Northern European partners.

Not surprisingly, years of economic recession have blown a massive hole in the Italian banking system's balance sheet. It is estimated that Italian banks now have around €360 billion in non-performing loans, which amounts to a staggering 18 percent of their loan portfolio. If that were not bad enough, the Italian banks also hold unhealthily large amounts of Italian government debt, which now total more than 10 percent of their overall assets. Should Italy's economy continue to languish, the country's banks will only go from very bad to worse.

In the absence of a serious restructuring of its banking system, Italy's economic growth prospects would appear to be grim. Saddled with non-performing loans and obliged to keep zombie companies afloat, the Italian banks would have little credit available to support the

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Debt Bomb?

With a sovereign bond market that now exceeds US$2.5 trillion, making it the third-largest sovereign market in the world, it is inconceivable that a default in Italy's sovereign bond market would not have major reverberations throughout the global financial system in much the same way as did the Lehman bankruptcy in 2008. This would especially be the case if an Italian economic and financial crisis spread to the rest of the European economic periphery.

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more dynamic parts of the economy. Yet, by requiring that the Italian government first bail in junior bank creditors before it engages in any bank bailout, European regulations very much cloud the prospects for an early restructuring of the Italian banking system.

Yet another box that Italy checks for the making of an economic crisis is the very high level of its public debt.

The Italian economy today is barely above its level in 1999 when the country adopted the euro.

Despite years of fiscal restraint, the country's public debt level has risen from 100 percent of GDP in 2008 to 133 percent of GDP at present. This makes it to the highest government debt level in the eurozone after Greece. With a highly sclerotic economy and with the threat of deflation, it is difficult to see how Italy might bring down this ratio through economic growth. In addition, with political limits having been reached to tolerating more fiscal pain, the country would be understandably reluctant to subject itself to yet more years of budget austerity. This is particularly the case within a euro straitjacket that might only heighten the chances that more austerity brings on a renewed economic recession. While this might not matter much at a time of ample global liquidity, there is every reason to fear that this could become a major issue for the country when global liquidity conditions begin to tighten.

Sadly, Italy also checks the political box for an economic and financial crisis. Years of dismal economic performance has contributed to the fragmentation of Italy's politics and to the rise of the populist Five-Star Party that is intent on taking the country out of the euro. The risk that the Five-Star Party poses to Italian political stability was all too evident in the crushing defeat that Matteo Renzi's Democratic Party suffered in the December 4 referendum that led to Renzi's resignation as prime minister. Equally troubling is the rise of anti-European sentiment in the country that has been fueled by both economic discontent and by anti-immigrant sentiment.

Stuck within a euro straitjacket, the country can no longer resort to exchange rate depreciation.

While markets might be sanguine about the risks that Italy might pose to the global economy, there are a variety of reasons why global economic policymakers would be making a big mistake to share that complacency. Among the more important of those reasons is that, unlike was the case in Greece, Ireland, and Portugal, Italy is simply too big a country for its European partners to save. This has to heighten the risk that an Italian economic crisis could lead to contagion in other troubled countries in the European periphery that could lead to the eventual unraveling of the euro.

An equally important source of concern for global economic policymakers should be that the Italy is very integrated in the global financial system. With a sovereign bond market that now exceeds US$2.5 trillion, making it the third-largest sovereign market in the world, it is inconceivable that a default in Italy's sovereign bond market would not have major reverberations throughout the global financial system in much the same way as did the Lehman bankruptcy in 2008. This would especially be the case if an Italian economic and financial crisis spread to the rest of the European economic periphery.

An Italian economic crisis could lead to contagion in other troubled countries.

Global policymakers can of course hope that the markets are right in thinking that Italy is not headed for major economic and financial crisis that would have global ramifications. They could also choose to turn a blind eye to German political developments that, in the run up to Germany's scheduled parliamentary elections in September 2017, are seeing an erosion in Chancellor Angela Merkel's authority to continue providing the eurozone with the bold leadership that she has offered to date. However, looking at Italy's acute economic and political vulnerabilities and the very size of its economy, doing that would hardly seem to be a responsible way to formulate global economic policy. ◆