Investors set to remain unforgiving on Italian populists' debt diagnosis

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Markets Insight

It used to be said of Italy back in the 1980s that it was a good economy shackled to an unworkable state. Today, the eurozone's third-largest economy is weak and shackled to a monetary union whose impact is substantially malign.

The rise of the populist politics represented by the anti-establishment Five Star Movement and the far-right League is an all-too-comprehensible consequence of gross economic mismanagement both in Italy and in a very imperfect monetary union.

Ten years after the financial crisis, real disposable incomes per capita languish below their level when Italy joined the eurozone. The Italian political establishment has played along with Brussels-imposed fiscal austerity, running primary budget surpluses (before interest) for much of the past 18 years.

Eurozone policy delivers a painfully inappropriate exchange rate. The International Monetary Fund estimated last year that the real effective exchange rate for Italy is overvalued by close to 10 per cent. The overvaluation has been particularly acute in manufacturing, where a gap in unit labour costs vis-à-vis Germany and the eurozone of around 30 per cent was built up before the crisis and has been sustained since, reflecting high wages relative to productivity.

In the monetary union, Italy cannot address this competitiveness issue through devaluation. The only remedy is internal devaluation via wage deflation. Yet despite unemployment of 11 per cent and youth unemployment at a devastating 35 per cent, unit labour costs have not come anywhere near delivering that internal devaluation.

In the meantime, the economy is enjoying a very moderate cyclical recovery relative to France and Germany. Its banking system is poorly capitalised, with one of the highest levels of non-performing loans in Europe. And it is saddled with a stubbornly high level of public sector debt at 132 per cent of GDP.

This is where the market chaos following Sunday's presidential veto of Paolo Savona, the 81-year old economist favoured by the victors of the March election for the post of finance minister, becomes seriously problematic. With enfeebled growth, it does not take long for panicky investors to inflict real rates of interest in excess of the growth rate of output. The debt ratio thus rises automatically unless there is an offsetting non-interest surplus.

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Being part of the monetary union does not help here, as Italy's pre-euro experience demonstrates. In the 1960s, a fairly small budget deficit was largely paid for by seigniorage — the profit governments make on the difference between the value of interest-free notes and coins and their production costs. Even in the 1970s, the debt-income ratio held stable for a while because seigniorage increased much more than the primary deficit. With the abolition of the lira, that salve is no longer available.

The risk is that concern about debt sustainability becomes self-feeding because of the fear President Sergio Mattarella's veto will have stirred up more anti-establishment, anti-Brussels feeling. Five Star and the League might now enjoy greater electoral support.

Of course, if the leaders of the two parties form a government, their bark on matters European may turn out to be worse than their bite. In recent weeks, their anti-European rhetoric has become less strident. And on taking office, they might seek to reassure markets on the debt overhang by promising fiscal consolidation.

Yet the lessons of history are that very high levels of government debt have rarely been reduced to manageable levels without resort to either formal repudiation or informal default via inflation. Italy after the first world war ran a balanced budget under Mussolini but resorted to formal defaults by way of mandatory debt conversions in 1926 and 1934. It then inflated its way out of trouble after the second world war.

The best way to reduce a debt-to-GDP ratio is by increasing the GDP number. That is how the British shrank debt of an estimated 260 per cent of GDP after the Napoleonic wars. Even then, it took 98 years to get the number down to 24 per cent of GDP and the compound annual growth rate over the period was just over two per cent.

There lies the rub for Italy. It has not used the opportunity presented by ultra-loose eurozone monetary policy and global economic recovery to raise its underlying growth potential through sufficient supply-side reforms to turn today's 1.5 per cent or so cyclical growth into a structurally feasible rate.

There is much in the populists' diagnosis of Italy's plight that is right. But the markets are unlikely to give them the benefit of the doubt on policy, especially in relation to debt. In today's uncertain climate, expect them to remain unforgiving.

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