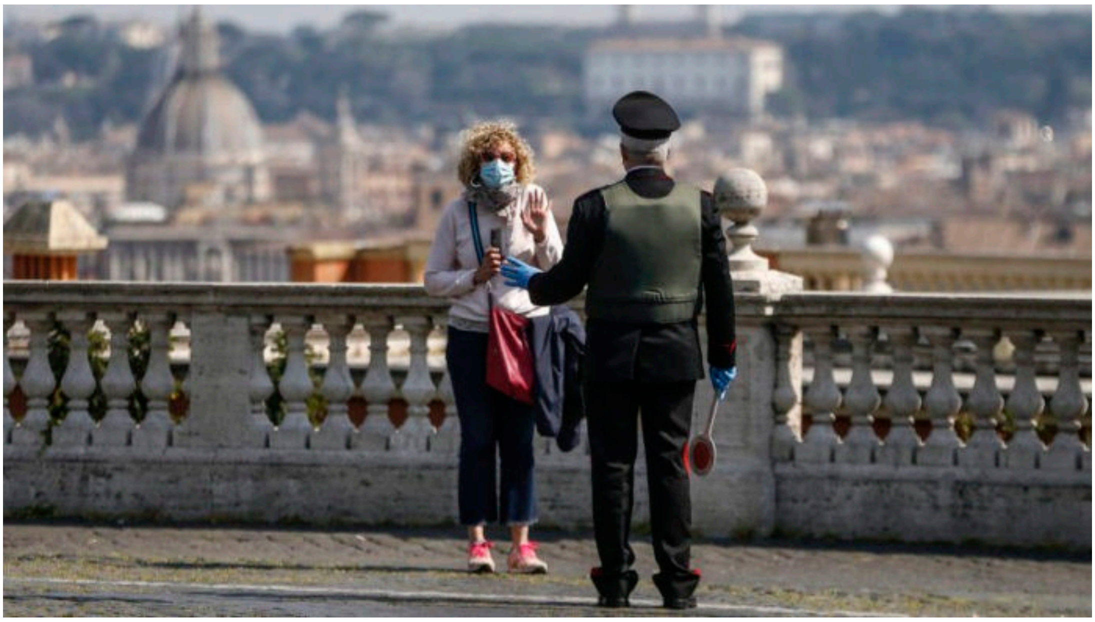
Italy is in more danger than the eurozone knows

By **Martin Joseph** - 19 April 2020



The spread between Italian and German bonds increased last week to around 2 percentage points. Why would this be so? Unlike 2012, there is no imminent threat of a liquidity crisis. The European Central Bank's emergency pandemic buying program will likely guarantee that the Italian government will be able to issue the debt it needs this year. Italy's problems are rather different in nature.

At the end of last year, Italian public sector debt represented 136% of gross domestic product. In the previous decade, it had increased by 30 percentage points. If you assume that what the IMF calls the big lockout leaves Italian GDP 10% lower than in 2019, and if the stock of debt increases by 20%, then its debt / GDP ratio rises to 180%. When debt increases and production decreases at the same time, these ratios increase rapidly.

So what should Italy do? I see three action plans. My expectation for this week's virtual meeting of European leaders is a compromise on a restructuring fund. Once the applause has stopped and people have looked at the details, they will realize that it will have no macroeconomic relevance. This will leave the ECB, once again, as the only EU institution that matters. His pandemic program will do the necessary this year.

But what about next? The only instrument available for the deployment of the ECB is the "direct monetary transactions" of former President Mario Draghi – the never-launched program that will always be associated with his 2012 promise to "do whatever it takes" to save the euro zone. This would allow the ECB to make unlimited purchases of Italian debt, but only if Italy requests the European stability mechanism for a line of credit on improved terms. It's like an overdraft facility with a few light conditionalities. It is not the facility itself that matters, but its link to an ECB program.

However, there does not seem to be a majority in the Italian Parliament to support the MES. It is also not clear that the ECB would agree to trigger the MTO. The argument is that it is not intended to remedy the impending insolvency.

Another solution is for Italy to default or seek debt restructuring. This may be compatible with joining the euro area, but would require the participation of the ECB, failing which the Italian debt would lose its status. National banks are another priority. As they hold a large part of Italy's sovereign debt, the default could lead to bank failures. However, like Irish economist Karl Whelan points out, Italy could "cut" its bonds and gain enough savings to nationalize and save them. Investors would be wiped out but deposits saved.

Finally, there is always the specter of leaving the euro zone. It is not a likely event. But then again, neither is Brexit. As happened in the UK, the Italians are starting to blame the EU for everything that is wrong. I heard the story of a person accusing the Dutch of delay in their unemployment benefits. It is an absurd accusation, of course. But the Five Star Movement, the main partner of the ruling coalition, could see an opportunity to rekindle its declining political support and play on the rise of anti-EU sentiment. It's hard to overstate Italy's dramatic turn towards Euroscepticism. It will not disappear at the end of the lock.

Emmanuel Macron is right to warn against the collapse of the EU. I fear, however, that the French president will avoid a long-awaited confrontation with Germany, which remains skeptical about the idea of eurozone bonds. Unless he wants to establish such a link with a smaller group of Member States, his threat is cheap talk. If Giuseppe Conte, Italian Prime Minister, acts in the spirit of his predecessors, he will accept an unfair compromise and later discover that the costs outweigh the benefits. Once this achievement is established, there won't be many good options left.

When northern Europeans discuss Eurobonds or similar instruments, they frame the debate in terms of solidarity and charity or, in the Dutch case, as a gift. They don't see it as risk insurance. There is no appreciation in Germany, and, I suppose, in the Netherlands too, a potentially catastrophic setback for their financial sectors and their economies if Italy were to default.

However, default becomes more and more likely if politics excludes alternatives. If or when this happens, the eurozone will not be ready.

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