Sclerotic productivity hobbles Italy

Much-needed economic reform unlikely after election

by Desmond Lachman in Washington

Wed 14 Mar 2018

Anyone who thought the euro area debt crisis was resolved has not been paying attention to economic and political developments in Italy, the bloc's third-largest member.

In the last 10 years, Italy experienced a triple-dip recession that has left its economy around 5% below its pre-2008 financial crisis peak. The country's unemployment level is about double that of its northern neighbours, and youth unemployment still exceeds 25%.

Italy's sclerotic productivity performance has contributed to the persistence of significant economic vulnerabilities. These could be exposed once the European Central Bank exits from its bond-buying programme, which has been especially supportive of the Italian bond market.

Italy's public debt to GDP ratio continued to rise to 133%, making it the most indebted country in the euro area after Greece. The Italian banking system is clogged with non-performing loans that amount to around 15% of its balance sheet and starve the economy of much-needed credit.

Italy cannot afford a prolonged period of political instability and policy experimentation. It needs fundamental economic reforms that would close the productivity gap with its northern neighbours and put the country on a faster growth path. Only then will Italy have a chance to grow out of its public debt and banking system problems.

Unfortunately, the result of the 4 March election does not hold out the prospect of a stable government committed to reform. The strong showing of the eurosceptic Five Star Movement and the League, whose combined vote exceeded 50%, means at least one radical populist party is likely to be a coalition partner in any future Italian government.

Italy could not have chosen a worse time to enter a prolonged period of political instability. In the US, the Trump administration's shift to a more protectionist trade policy and to a reckless budget policy have put the global economic recovery in doubt. At the same time, there is every indication that the favourable global liquidity conditions that have buoyed the Italian government bond market are now ending. The Federal Reserve is firmly on a path of raising interest rates, while the ECB is intimating that it plans to exit its quantitative easing programme later this year.

A prospective Italian economic crisis will be of the utmost importance for both the euro area and the global economy. At around 10 times the size of the Greek economy, the Italian economy is far too large to fail if the euro is to survive in anything like its present form. Yet having the world's third-largest government bond market after Japan and the US, with around $2.5tn in bonds outstanding, Italy is simply too large a country for even Germany to save.

For this reason, one must hope that somehow, out of the wreckage of the parliamentary election, a stable and reform-minded government is formed that can forcefully address Italy's acute economic problems. However, global policy-makers would be ill advised to count on such a fortuitous outcome. Instead it would seem it is not too early for them to start making contingency plans for an Italian economic crisis.

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This is the fourth article in a series on the results of the Italian election. The first, from Antonio Armellini, former Italian ambassador to India and Nepal, was published on Friday 9 March . The second, from Erik Jones, director of European and Eurasian Studies at Johns Hopkins University, was published on Monday 12 March . The third, from Elliot Hentov, head of policy and research for the official institutions group at State Street Global Advisors, was published on Tuesday 13 March .