The Quiet Collapse of the Italian Economy

blogs.lse.ac.uk/eurocrisispress/2013/04/23/the-quiet-collapse-of-the-italian-economy/

Roberto Orsi 4/23/2013

By Roberto Orsi

Please also read the updated analysis of the Italian situation in The Demise of Italy and the Rise of Chaos *and in* *Why Italy Will not Make It* *by the same author.*

While attention on the Euro crisis has been focusing primarily on Greece and Cyprus, it is no mystery that Italy, alongside with Spain, constitutes the real challenge for the future of the common currency, in any direction events will be unfolding. In the relative silence of the international press, Italy's macroeconomic situation has been showing no sign of improvement, and indeed numerous indicators portray a national economy which finds itself in a depression, rather than in a however severe recession. It is no overstatement that the Italian economy is currently collapsing.

Italy is the third largest economy of the Eurozone (after Germany and France), holds the largest public debt (over €2 trillion), which has been growing at an astonishing pace, even in more recent times and particularly as a ratio to GDP (130%), since the latter is contracting fast. How is this sustainable? Well, it is not. But for the moment, thanks to the ECB direct interventions (€102.8 billion of Italian bond purchases in 2011-12) and especially to the LTRO mechanisms, the finances of the Italian state can still be kept afloat. Italian banks have been absorbing €268 billion of liquidity issued by the ECB by means of the LTRO programme. In its essence, the mechanism is the following: because the ECB cannot lend liquidity directly to the states, except in times of absolute emergency and for the stabilisation of financial markets in the short term (as happened in 2011), it lends money to the banks, which in turn purchase government-issued bonds. Interestingly, the LTRO scheme has also become an instrument for the relatively orderly withdrawal of international investors from Italy, especially French and German, whose share of public debt has fallen from 51% to 35%, mirroring the rise of Italian banks purchasing public debt. This is an important signal, which goes in the opposite direction of an increased interdependency as would be expected from a monetary union in preparation for a political union. It is arguable that many investors are actually systematically reducing their exposure in South Europe, possibly hoping that a future breakup of the common curency will have less harmful consequences if their involvement in the financial and economy destiny of those countries is curtailed to the minimum. For Eurosceptics, it is a signal that, once all foreign investor withdraw, Italy will be left to its fate.

The truth is that the Italian state went bankrupt in summer 2011, when interest rates on the national debt went out of control, and as a result Italy lost access to the financial markets. Of course, because of the sheer dimensions of Italy as an economy and as a debtor, the ECB and political authorities in Europe have agreed to create around the country's finances the appearance of a market, which is in fact, as the numbers above show, largely artificial. Ideally, Italy should stay on this artificial support until the economic conditions improve and confidence is restored to such a level that the country will have again access to a "normal" credit market.

However, this is not happening and there is no sign it is going to happen in the years to come. The situation of the Italian economy is simply dramatic. Recently, a study has appeared which reveals how the current crisis (2007-2013) is in many ways much worse than the 1929-1934 contraction. In the present crisis, investments have collapsed by 27.6% in the five year period, against 12.8% in the interwar depression. GDP has declined by 6.9% against 5.1%. Italy, with the second largest manufacturing sector in Europe after Germany, has lost about 24% of its industrial production, going back to the 1980s level. No data is currently showing any sign of recovery. From the beginning of this year, the country has lost over 31,000 companies. Every day 167 retail units are lost, signalling an authentic disintegration of the retail sector. The automotive sector, a crucially important one for the Italian economy, has been constantly contracting: from about 2.5 million cars sold in 2007, sales in 2012 reached only the 1.4 million mark (the 1979 level) and they are still contracting this year. Construction, the other pillar of the national economy, is in rout: the 14% slump in 2012 is only the last in a series of difficult years. Home sales have dropped by 29% in 2012 against the already miserable 2011, to the 1985 level of 444,000 units, about half the number of 2006. Of course, the consequences of this economic disaster in terms of loss of employment are dire: unemployment is now at almost 12% and growing fast. Half a million workers have been put in stand-by and receive a state funded social benefit (*cassa integrazione*): it is projected that this year again the state will pay well over a billion work hours equivalent of this benefit. Needless to say, it is far more likely for all these workers to lose their job, rather than being re-integrated in the production cycle.

The Italian state has so far managed to defend its financial position by means of increased taxation, limited spending cuts and more borrowing. As illustrated above, the borrowing scheme has been engineered with the help of the ECB and the banking sector. Taxation has now reached unprecedented levels, and it is asphyxiating the economy together with the credit crunch. Spending cuts have been implemented to a certain extent, but like taxes they have a depressing effect on the economy, not to mention their unviability in a largely clientelistic, if not openly kleptocratic system.

Under pressure from the European Union, Italy has committed to a rigorous budget and it has even introduced a balanced-budget amendment in its constitution. Absurdly, the Italian state runs a surplus when public debt interest payments are excluded, but this only appears to be because, purely and simply, the state often “forgets” to pay its suppliers (the outstanding debt to private companies is in the €90-€130 billion range, depending on the criteria for calculation).

Now, it is not difficult to imagine that, in a few months, despite the new taxes, the sheer collapse of entire sectors of the economy will cause a rapid contraction of tax revenues. The Italian state cannot possibly accumulate even more debt at a faster pace (at least for Italy, the austerity debate makes little sense). Italy will simply run out of options, and it will require additional measures from the EU. Essentially, some sort of bailout. But because of the sheer size of the economy and the public debt, this is simply impossible. In the absence of any political consensus around a radically different monetary policy of the ECB, i.e. unlimited QE, which will probably never materialise, and which will clearly not solve any of the country’s structural problems, the only realistic scenario will be that of a debt restructuring or renegotiation, as suggested by Nouriel Roubini in a precise analysis published more than 18 months ago. The collapse of the Italian state finances is rapidly approaching. It will have an enormous impact on the Eurozone and the European Union.

Note: This article gives the views of the author, and not the position of the Euro Crisis in the Press blog, nor of the London School of Economics.