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STORM? WHICH STORM?: ITALY'S WEAK GOVERNABILITY CAN LEAD TO A NEW CRISIS

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RARELY HAS ITALY'S governability been this complex. Every day, within the political community, people are relentlessly musing over new possible election dates. The main governing party has just split, and its majority faction remains exposed to the credibility crisis surrounding its leader, Matteo Renzi. At the same time, the major opposition party, *Cinque Stelle* (Five Star), does not seem motivated to form a coalition with other parties in order to overcome the threshold for a parliamentary majority as defined by electoral law, which itself remains in question. In the kindest words—these political conditions are not ideal for facing an impending storm.

The political inertia is all the more surprising because other worrying signs are also coming out of Rome. For example, the conventional wisdom is that Italian public debt would become a little more sustainable if inflation would only return to normal levels, close to 2%. This scenario should allow lower taxation relative to public expenditures, i.e., a smaller primary budget surplus should be needed to cover the interest payments on the country's public debt. Lower tax rates should help facilitate the country's economic growth, thus reducing the debt-to-GDP ratio. However, Italy finds itself in an unfavorable situation—Italian inflation is lower than the European average, as it should be for a country that wants to recuperate competitiveness, but the interest rates on Italian debt is higher than the European average. An increase in European inflation, therefore, risks becoming an additional problem instead of a solution.

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It had also been presumed that an increase in inflation would aid the rebalancing of the banking system, one of the Italian economy's other weak points. In theory, this would be the case—inflation's expected recovery would increase long-term interest rates, permitting banks a return to profitability. They could finance themselves at reduced rates in the short run, while lending at higher long-term interest rates. But, this positive effect on bank profitability and, therefore, the solidity of the credit system, is unfortunately counteracted, in Italy more so than elsewhere, by the negative impact of higher interest rates on the value of long-term bonds in the financial portfolios of Italian banks. In particular, this effect on bank balances would be negative if, in the past few years, to slightly defend against low returns, banks chose to sell their more profitable securities—ones that brought higher yields—and substitute them with the purchase, at nominal values, of emissions with lower yields. Relatively, the latter's price would fall more in the case of an interest rate increase, thus tanking profits and the banks' ability to supply the economy with credit.

Those involved in financial professions talk of new tensions in the market for interbank financing, although on a scale far smaller than at the height of the European crises. Italian stock indices, which are weighted heavily toward credit institutions, reflect developments detached from those of more stable European economies. Furthermore, the euro area continues to record capital flows from the periphery toward Germany, despite the fact that German current account surpluses vis-à-vis euro area countries have almost zeroed out. Normally, capital movements finance current account deficits, i.e., disequilibria in the balance of payments, but, in the euro area, they can also create monetary imbalances—notoriously recorded by the Target 2 payment system—that do not depend on trade, but rather the very credibility of the monetary union and, therefore, on the risk, however remote, that the union could fall apart. Even though there are clear signs of strength on the part of a consistent band of Italian exporters who, in fact, allow Italian current accounts to be in the black, the Italian financial imbalance toward Germany, from 2015 onwards, grew more than those of the other countries.

Italy's credibility seems to remain constantly in doubt. The struggle to correct the public deficit by only €3.2 billion, as the European Commission requested, is yet another sign of weakness connected to the political capacity to respond to risks that characterize the country. If, overseas, the Italian capability to respond to problems such as public debt and banking issues is seen against the backdrop of the country's weak governability, then the reasons behind their mistrust is not difficult to comprehend. As opposed to the situation in other euro area countries, foreign debt is not a problem for Italy, i.e., the country's balance of payments is not in disequilibrium. Therefore, its issues would not be solved by a transfer of financial assistance similar to those that had supported other countries in recent years. The main problem is administrative and political management.