

EURO THEMES

Can Italy save itself?

- **The ongoing debt crisis in Greece is a legitimate concern for policymakers and investors, but growing concerns about Italy pose the real danger to Europe and the world economy. Yields on Italian government debt have reached new highs, and are at levels that we consider clearly unsustainable.**
- **We believe that policy reforms in Italy are necessary to increase confidence in the Italian credit. However, historical experience suggests that the self-reinforcing negative market dynamics that now threaten Italy are very difficult to break. At this point, Italy may be beyond the point of no return. While reform may be necessary, we doubt that Italian economic reforms alone will be sufficient to rehabilitate the Italian credit and eliminate the possibility of a debilitating confidence crisis that could overwhelm the positive effects of a reform agenda, however well conceived and implemented.**
- **While it is a step in the right direction, we believe that the EFSF is not an adequate safety net to insulate countries like Italy from contagion, and short-circuit ‘vicious circle’ market dynamics that could overwhelm countries’ efforts to adjust and reform. Foreign governments and the IMF could provide cash but not credit. We see little practical alternative to a strengthened commitment by the ECB to act as lender of last resort to precariously positioned eurozone governments.**

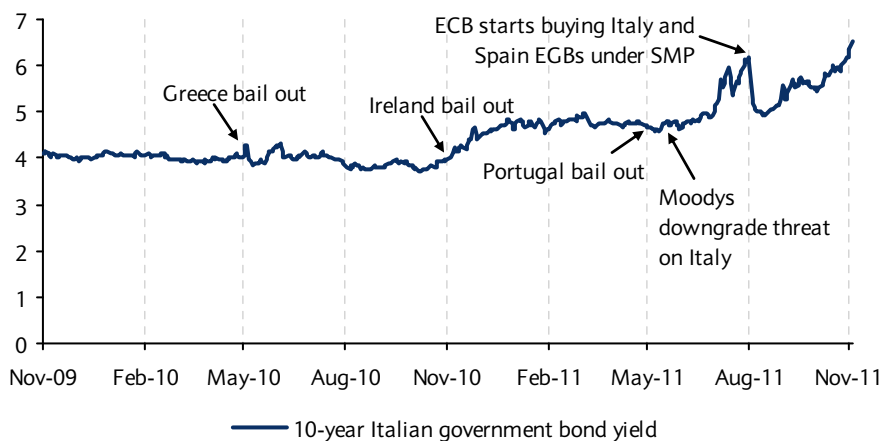
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Figure 1: Italy – Still at risk



Source: Bloomberg

CAN ITALY SAVE ITSELF?

Italy – Approaching a fiscal event horizon?

In the nearly two years that have passed since market anxieties about peripheral European debt began to escalate, it has consistently paid to remain cautious about countries that have become caught up in unfavourable market dynamics, and to position against the view that each country's individual efforts would be enough to stabilize market sentiment and public debt dynamics. First Greece, then Ireland, and then Portugal have been forced reluctantly to accept the fact that they have lost market access, and would not, by their unassisted efforts alone, be able to regain it in time to avoid a credit event. In each case, yields demanded by investors to compensate for perceived credit risk were simply too high to be compatible with sustainable debt dynamics, and fiscal consolidation and economic reform programs held out little hope of breaking the vicious circle.

Since July, the stakes have been raised dramatically as Italy has come into question. With Italy, the magnitudes are much larger, and a potential accident much more disruptive for Europe and the world economic and financial system. Moreover, Italy did not fit the previously-established mould. While Greece was clearly insolvent, Portugal probably insolvent, and Ireland maybe insolvent, Italy is among the large group of sovereigns that, according to our calculations (and assuming a fiscal effort that is modest by international standards), are in a grey area: solvent if investors are highly confident in its fiscal sustainability, but insolvent if this confidence is weak. Italy thus raises in a stark fashion the problem of multiple equilibria created by self-fulfilling expectations, a problem that plays a less central role in Ireland, Portugal, and Greece.

To be sure, investor scepticism of Italy has been amplified in recent months by the country's relatively unambitious reform agenda and lacklustre implementation. But while reforms are necessary, the Italian fiscal position compares reasonably well with other countries that are not now experiencing a debt crisis, such as the UK, the US, and Japan (*What's the difference between Italy and Japan?*, 27 July 2011) To us, this highlights the complications for Italy created by the fact that its government cannot print the money that it has promised to repay to investors who hold its debt. Without this capacity, and in the absence of an effective lender of last resort to tide it through a potentially extended period of market anxiety, Italy is much more vulnerable to vicious circle dynamics than countries that can, *in extremis*, print the money that the government may need to repay debt that bondholders do not want to roll over.

At this point, Italy may be beyond the point of no return

The problem for Italy now is that, once set in motion, these self-reinforcing negative dynamics are very difficult to break. At this point, Italy may be beyond the point of no return. Prompt and effective policy action from Rome may be necessary to remove Italy from the downward spiral that threatens it, but we doubt that it is sufficient.

Can the circle be squared?

With a public debt of 120% of GDP, a plausible non-interest budget surplus no higher than about 3% of GDP, and a slow rate of economic growth, the Italian debt dynamics do not add up unless interest rates are lower than about 5.5% (*Italy: Time to act*, 21 June 2011). Higher interest rates lead to a debt that continues to grow faster than GDP, eventually requiring a debt restructuring.

The problem is that an interest rate of 5.5% only compensates investors for perceived credit risk if investors' assessment of the probability of default is very low. To make this concrete, it may be useful to remember that:

$$\text{Fair yield} = \text{risk free rate} + P \cdot (1 - R) + \text{risk premium}$$

Where P is the yearly default probability and R is the recovery value in the event of default.¹ Suppose that the risk-free rate of interest is 2%, that the recovery value is 35 cents on the euro, and that the risk premium is one-third the default probability. On these assumptions, a 5.5% interest rate would require a yearly default probability no higher than about 3.5%. Even if the recovery value were 50 cents on the euro, which seems optimistically high to us, the default probability would need to be lower than about 4.2% to justify a fair yield of the same 5.5%. For reasons that we will discuss in more detail below, we consider it unlikely that Italian reforms alone will be able promptly to secure a reduction in perceived default probabilities to such low levels.

But before we turn to this, it's important to recognize that, because of its high debt level, Italy is quite likely at a point where higher yields do not make bonds more attractive to investors, at least to those investors with reasonably long investment horizons. This is because the higher yields are not compatible with debt sustainability and therefore require an upward adjustment of perceived default probabilities, which makes the debt less, not more attractive. Higher yields also cast doubt on the economic outlook, which not only intensifies doubts about the debt dynamics but also raises the prospect of political tensions that may undermine the policy framework going forward.²

The danger is that high interest rates may reinforce investors' concerns about sustainability, generating a self-fulfilling credit event

In short, the problem is not only that doubts about sustainability are transformed into correspondingly high interest rates. If that were the end of the story, it may be thought feasible for a country in Italy's position to withstand those high rates until policy adjustments gradually restore market confidence. The danger is that high interest rates may reinforce investors' concerns about sustainability, leading to yet higher rates, deeper conviction that the fiscal arithmetic does not add up, even higher rates and an eventual run from the public debt that can, in the absence of last-resort lending, generate a self-fulfilling credit event. It is not the high rates alone, but the potential instability of the market dynamics that create the real danger for vulnerable sovereigns like Italy.

Salt in the wound

We view the decisions adopted in the recent eurozone summit as a meaningful step forward (*Eurozone summit and EU summit update: A positive surprise at last!*, 27 October 2011). That said, the news was not all good; in our view, Italy's already precarious position was undermined to some extent by these recent policy decisions.

- Even though Greece is widely recognized to be a special case, the very low recovery rates for private owners of Greek public debt may have served as a wake-up call for holders of other peripheral European sovereign bonds. The decision to exempt official-

¹ The risk premium in excess of the term reflecting default risk is compensation for bearing the systematic mark-to-market risk in sovereign credit markets created by the fact that they are so highly correlated with global asset markets. See Longstaff, Pan, Pedersen and Singleton, "How Sovereign is Sovereign Credit Risk", *American Economic Review: Macroeconomics*, April 2011.

² The reason we think Italy is particularly susceptible to these unstable dynamics, as opposed for example to Spain, is because the Italian public debt is so much higher (as a share of GDP). The required adjustment associated with a given increase in interest rates is, therefore, larger in Italy than in Spain, and the probability that the authorities will not be able to make that adjustment is correspondingly higher. This means that the impact of a rise in interest rates on the probability of an eventual credit event is higher in Italy than in Spain, which leads to the possibility of unstable dynamics. See *Debt Sustainability and restructuring: A unified framework*, 17 June 2011 for a more complete discussion of debt sustainability issues.

sector holdings of Greek debt from restructuring may be grounded in inescapable political realities and sound policy principles, but it highlights the reality that official intervention to support a distressed sovereign tends to concentrate credit risk in the gradually declining share of private bondholders, potentially impeding rather than promoting renewed market access.

- The attempt to engineer a very deep restructuring of privately-held debt without triggering CDS contracts that were designed to protect bondholders against exactly this event may succeed, but at the cost of degrading the perceived value of CDS contracts on other sovereign debt. This seems likely to incentivize bondholders who thought that they had protection for their holdings to reduce their cash exposure to sovereign credits, likely including Italy.
- The EFSF is, in our view, a step forward but it is not an adequate mechanism to provide last-resort lending to potentially distressed sovereigns like Italy (*Euro themes: Leveraging the EFSF – Uses and limits*, 25 October 2011). It is strictly circumscribed in size, as it must be given the vulnerable fiscal position of the guarantor countries, and offers substantially less credit support than its headline size may suggest. The offer of what is for all practical purposes officially underwritten sovereign CDS may be discounted to some extent by market participants because of the extreme economic, financial and political stress that guarantor countries would be under in the event of an Italian credit event, and because of the official sector's strenuous attempts to engineer a Greek restructuring without triggering private CDS. Meanwhile, the ECB remains unwilling to play lender of last resort on the scale that would be needed to short-circuit a real attack on the Italian public debt. In his first press conference as President of the ECB, Mario Draghi stressed that the Securities Market Program (SMP) of sovereign bond purchases would remain temporary and limited. Even more recently, the G20 summit appears to have ended without any promise of international financial support to stabilize peripheral European debt markets. This is utterly unsurprising, given the gaps that still remain in the European policy response to the crisis, but it is nevertheless unsettling.

These are necessarily tentative judgements, because the information available on the recently-announced eurozone package is still quite incomplete. But on the basis of what we now know, it seems to us that Italy is fully exposed to market contagion arising from the Greek restructuring, with a policy safety net that offers very little in the way of protection against the unstable market dynamics that it now confronts. The question arises: with the limited international safety net available to it, will Italian reforms be sufficient to turn market tides back in its favour?

Can Italy go it alone?

*Policy reform alone will not
be sufficient*

We agree with the widespread view that Italian policy reform is a necessary condition to stabilize Italian debt markets at sustainable interest rates (*Italy: Time to act*, 21 June 2011). Political resistance to the reforms will not be easy to overcome; otherwise they would already have been done. But the magnitude of the reform effort pales in comparison with the efforts that will eventually be required of countries like Japan and the United States. We feel reasonably confident that political roadblocks will be cleared in the weeks and months to come, and that Italian political actors will be able to set the policy stage for a rehabilitation of the Italian credit.

But the question that confronts us now is not whether such reforms are necessary, but whether they will be sufficient to stabilize market dynamics. The extensive historical record of similarly-situated countries suggests to us that the answer is no.

This is partly because it will take time for the reforms to be implemented, and for their beneficial impact on growth and debt dynamics to become visible. In the meantime, investors will be confronted with mainly unsettling news, as fiscal consolidation tends to be associated with weak economic activity, which dilutes the impact of the fiscal measures on budgetary outcomes, and can create political tension that keeps alive doubts about the sustainability of the fiscal consolidation. Pro-growth economic reforms are unambiguously positive in principle, but policy levers to increase economic growth are easier to recommend in the abstract than to identify in practice, and they generally take even longer to become effective than do fiscal reforms. What's more, there is evidence that some structural reforms that may be necessary to raise productivity and growth in the longer term can have adverse effects on economic activity in the short run. It is worth noting, too, that Italian bondholders may need to weather contagion from unfinished business in the rest of the eurozone including, for example, the possibility of a Portuguese restructuring. Italian fundamentals are not the only thing that is likely to keep Italian bondholders on pins and needles for some considerable time to come. As Italian bondholders wait for the reforms to take effect, the country will be fully exposed to potentially unstable market dynamics, whose adverse economic effect could easily swamp any positive results of Italian policy reform.

The size of the Italian market has systemic implications for global and financial markets

Italy poses an additional complication created by the global and systemic nature of a potential financial event there. It is one thing for investors to take a position that makes a big difference to a small country. But the size of the Italian market means that global investors will need willingly to hold positions that are significant portions of their portfolio. Moreover, because an accident in Italy would likely undermine the world economy and financial markets, acting upon an optimistic view of Italy requires accepting enormous systemic risk, unlike in the case of a much smaller country, where outcomes are likely to be much less correlated with global asset markets.

Confidence lies at the heart of the Italian debt problem, and as a theoretical matter it is impossible to rule out the possibility that Italian policy reforms alone would generate a large enough confidence shock to push Italy back into a high-confidence/no-default equilibrium. But we find this highly unlikely. Confidence is weak not only about policy settings *per se*, but also about the capacity of policy reforms to put Italy back onto a clearly sustainable fiscal trajectory. Investors have seen too many fiscal consolidation and reform programs fail, because the problem was simply too big to be addressed by policy reforms that arrived too late, either because of adverse economic shocks or political upheaval, or because of lacklustre implementation. Much time will be required to demonstrate to justifiably cautious investors that Italian reforms will address the medium-term problem. But in our view, the time that markets will provide has nearly run out.

What will it take?

We repeat; meaningful policy reforms in Italy are a necessary condition for rehabilitation of the sovereign credit, both because market participants understand that the existing policy framework is not fully sustainable, and because international policymakers, no less than investors, need confidence in the Italian policy framework if they are to support it in the way that we think will be necessary.

Besides fully implementing the fiscal consolidation plans announced over the summer, the policy agenda should prioritize pro-growth measures that address the problem of declining productivity and loss of competitiveness, including: 1) a labour market reform that reduces market segmentation and modifies collective bargaining in favour of firm level agreements; 2) a pension reform that increases the retirement age, including for women to be set equal as for men; 3) a reform of the public administration that better aligns wages and

productivity, and enhances labour mobility, with the objective of mitigating North-South productivity and unemployment differences; and 4) full implementation of the service Directive and the opening of closed professions to enhance competition and reduce production costs. Pro-growth measures should also be accompanied by a meaningful privatization plan of state-owned assets in order to help reduce the stock of public sector debt towards 100% of GDP (or below) over the next 2-3 years.

But as we have argued, it seems unlikely that policy efforts in Rome will be sufficient to break the negative market dynamics that have ensnared Italy. Italy is likely to need external support. We have previously outlined elements of a medium-term framework to restore financial stability in Europe (*Euro Themes: A proposal to restore euro area stability*, 18 August 2011). Many of these will require time to implement, and time is running out. More immediately, we think that a rehabilitation of the Italian credit will also require at least two external developments.

First, it is necessary to secure a definitive resolution of the debt overhang in Greece and, perhaps, other fiscally stressed European sovereigns. It is difficult to imagine markets really settling down and focusing on Italian fundamentals while the Greek situation remains unresolved, and the prospect that markets may face further uncertainty down the road if another of the embattled sovereigns finds it necessary to restructure. While these situations will necessarily unfold according to their own timeframe, it would be unhelpful to Italy for mere policy inertia to delay resolution.

In the meantime, Italy, Spain, and perhaps other precariously creditworthy sovereigns will need help managing market contagion and short-circuiting vicious-circle debt dynamics through the creation of a more effective lender of last resort than now exists. This is the purpose of the revised EFSF, and it is an important step in the right direction. But as we have argued, it is by itself not up to the task, if only because it is too limited in size. Expanding it dramatically is not an option, because of limitations in the fiscal capacity of the European guarantors.

Expanding the facility with foreign official support is not likely to be an option. Foreign governments will most likely want to be senior non-defaultable and hence unwilling to provide credit, just cash. Europe does not need cash. What it lacks is enough credit for stressed sovereigns like Italy.

The ECB is the only institution with the balance sheet available to play the required role

This leaves the ECB as the only institution with the balance sheet available to play the required role. So far, the ECB has been unwilling to accept this revision of its institutional mandate, for extremely good reasons that have, unfortunately, been rendered obsolete by the crisis into which the eurozone governments have fallen. It is to be hoped that longer-term institutional reforms to eurozone fiscal structures will allow the ECB eventually to step back from a role as lender-of-last resort to governments. For now, we see no practical alternative that offers the realistic hope of fending off an extremely expensive escalation of the ongoing debt crisis.

As investors contemplate policy announcements along these lines, we suggest that they bear in mind one of the enduring paradoxes of crisis management. The larger the potential financial firepower that is brought to bear on a confidence problem, the smaller and more effective the initiative tends to be. Incremental, grudging, half-hearted interventions tend to be tested by investors, and therefore require far more actual expenditure than credibly open-ended support.

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