The Italian Fault Line

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In its April 2014 *World Economic Outlook*, the International Monetary Fund has concluded that the crisis is history. The ECB has similarly declared victory and refuses to be troubled by deflationary risks. If only that were so. Italy could come back to haunt, even though the interest rates paid by its government have declined.

Like past crises, the recent one advanced by opening cracks in fault lines. On March 28, 2007, Ben Bernanke, then Chairman of the U.S. Federal Reserve, predicted: "At this juncture … the problems in the subprime market seems likely to be contained." However, the apparently inconsequential subprime collapse almost triggered a meltdown of the global financial system.

In the eurozone, the near-run on the Irish banking system in 2008 revealed years of untamed lending, often corrupt, lending and a regulator asleep at the wheel. European banks were tainted. In late-2009, the deception in Greek fiscal accounts was revealed. European sovereigns and their banks were joined at the hips, dragging each other down.

We ignore Italy at our peril. At a 135 percent of GDP, Italy's projected public debt-to-GDP ratio for 2014 has been revised up from the October 2013 forecast, and growth prospects and inflation have been revised downwards. The changes are small but they are relentlessly adding up. In April 2010, the Italian public debt ratio was expected to stabilize around 124 percent in 2014.

The *WEO* once again projects that Italian debt ratios will start declining in 2015. The presumption is that Italians will undertake extraordinary fiscal belt-tightening. They will ramp up primary budget surpluses (the budget balance not counting interest payments) to over 5 percent through to 2019.

So extraordinary is this ramp up that in a recent, but largely forgotten pamphlet, "Fiscal Space," IMF research staff pronounced it to be infeasible. Written just about when the *WEO* was projecting an Italian debt ratio of 124 percent in 2014, the research concluded that, given its past history of primary budget surpluses, Italian debt ratios could no longer be contained. This was not just the outcome of an unforeseen global crisis, but—in IMF euphemism—the stark warning was that Italian debt was not on a "convergent path even prior to the crisis."

Only once since World War II has Italy achieved the primary surpluses it is being called on generate. Between 1997 and 2000, primary surpluses were above 5 percent of GDP.

Those years were special. Global trade growth was at its most buoyant in decades, growing at 8 percent a year. First the lira and then, after January 1, 1999, the euro cumulatively depreciated over 25 percent against the dollar, stimulating growth and inflation. Italian GDP grew in nominal terms (including price inflation) at over 4 percent a year.

In contrast, although last year's anemic world trade growth will revive, the World Trade Organization's Robert Azevedo warns that the recovery will be weak. The euro/dollar exchange rate is about where it was in late 2007. If the near-zero inflation persists, Italian nominal GDP could grow below an annual 2 percent rate for the next few years.

There may be help. Mateo Renzi, the young Italian Prime Minister, may break the country's political gridlock and reverse its decades' long economic decline. The consequences of rising debt may be suspended for Italy, like for Japan. Or Mario Draghi, the President of the European Central Bank, may deliver on his "whatever it takes" promise.

Italy desperately needs growth and inflation—and it cannot achieve them on its own. Rather than doing whatever it takes after the fact, the ECB can act now. By coyly debating the definition and likelihood of deflation, while hoping for a renewal of inflation, the ECB is ignoring the growing cracks in the Italian fault line. With every passing day, the Italian debt burden becomes more onerous.

Harvard University Professor, Jeffery Frankel, says that the ECB should stop fretting about its limited options and start buying American securities to achieve a substantial depreciation of the euro. In a world of slow international trade growth, the only way for Italy—and the rest of the European periphery—to jump start growth is through a much weaker euro. A depreciated euro will also help raise inflation. The United States and Japan have actively engaged in so-called Quantitative Easing, which has kept their currencies weak. The eurozone, with the weakest of the three advanced economies, also has the strongest currency.

The ECB may already have waited too late. If called on to do "whatever it takes," the market may ruthlessly test the ECB's resolve, not least because of the legal and political uncertainties underpinning that promise. So, are the Italian authorities consulting smart sovereign debt attorneys to ensure orderly restructuring? The world has a stake.

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