For Italy, all economic and financial trends are going in the wrong direction

Ashoka Mody

Italy needed—and needs—the crutch of a depreciating currency to offset its abysmal productivity growth.

The depreciating lira, 1970-1998
(Number of liras for one D-mark)

Italian productivity fell relative to German
(annual total factor productivity growth)

US Dollar/Euro exchange rate is back where it began, 1999-2018

Italian productivity collapsed while even German fell behind the U.S.
(annual total factor productivity growth)

Young college-educated Italians leave Italy in growing numbers.

*Source: Italian National Institute of Statistics.*

*Italy’s low growth trap: poor opportunities, the educated leave, R&D remains weak, and opportunities remain poor.*
Italy’s immediate growth problem:
Like rest of the euro area, Italian economy beats to the drum of world trade growth—but does even worse when world trade slows.

Predictably, Italian growth is slowing with deceleration of world trade growth.

(Annual growth rates, percent; three-quarter moving averages)

Source: For world-trade growth data World Trade Monitor, https://www.cpb.nl/en/data; for the industrial production of Germany, France and Italy Eurostat, code [sts_inpr_m]. Note: The three-month average of growth over the same three months in the previous year.
Italy’s ECB problem:

The ECB keeps forecasting a rise in inflation, but has lost credibility with its errors, chronic delays, and half-measures

Note: 2018 core inflation is the average of months January to September 2018.
A single monetary policy causes inflation divergence:
Italy’s lowflation causes high real interest rates.
(Annual core inflation, three-month moving average, percent)

Source: Eurostat. Note: Core inflation is the annual percentage change in the Harmonized Index of Consumer Prices excluding energy, food, alcohol and tobacco.

With current 10-year government bond yields near above 2.8 percent, Italian real interest rate is just above 2 percent.

As growth decelerates and lowflation persists, Italian real interest rates will remain too high for a country with such low growth.
With even weaker commitment than the Bank of Japan’s, ECB bond purchases have done little to weaken the euro to boost demand and inflation. Withdrawal of bond purchases, a special problem for Italy.

Note: Exchange rate for JPY/USD equals 100 on January 4, 2013 (date of the announcement of quantitative easing by the Bank of Japan) and exchange rate for EUR/USD equals 100 on January 22, 2015 (date of the announcement of quantitative easing by the ECB).

Italy’s financial problems:
The government-bank “doom loop,” always latent, has remerged.

Sources: FTSE Italia All-Share Financial Index: Global Financial Data, ticker IT8300 Index; FTSE Italia All-Share Index: Global Financial Data, ticker FTSEMIB Index; Italy ten-year bond yield: Datastream International, code S310DT. Notes: The graph presents the relative performance of financial stocks and the Italian 10-year bond yield from 2 January 2015 to 18 September 2012. The relative performance of financial stocks for Italy is the ratio between the FTSE Italia All-Share Financial Index and FTSE Italia All-Share Index.
The future ain’t what it used to be.

- With world trade slowing down, the entire euro area—even the German economy—is slowing, quicker than most realize.
- With QE tapering, the euro can only strengthen and real interests can only rise.
  - Both will further squeeze an anemic Italian economy.
- For Italy, everything is going in the wrong direction:
  - Slower European and world economy.
  - Higher real interest rates
  - Stronger euro
  - **Hence, likely soon q-o-q GDP growth about zero.**
- Italian government debt levels are high; the chaotic banks have large volumes of non-performing loans and thin margins.
- OMTs could crack under political limits.