# Italy's debt burden

*Concern over Italy's public debt is deterring the government from introducing a large fiscal stimulus*

Feb 11th 2009 |

The minister of the economy, Giulio Tremonti, appears determined to keep Italy's public finances under control, fearing that a severe deterioration would lead to a further sharp widening of interest rate spreads on Italy's government debt and a hike in borrowing costs. Major tax cuts promised in the 2008 election campaign have been put on hold and we do not expect the government to provide any major fiscal stimulus, despite the severity of the economic downturn.

Italy's large public debt (an estimated 105% of GDP in 2008 and rising) is deterring the government from introducing a major fiscal stimulus package to alleviate the impact of the current global financial and economic crisis. The minister of the economy, Giulio Tremonti, has insisted that although some other governments might be able to increase their deficit and debt levels to boost their economies, Italy cannot.

As the economy plunges into the worst recession since 1975, Mr Tremonti appears far from convinced that additional public spending would work anyway. In marked contrast to the strategy adopted in both the US and UK of piling public debt on top of mountains of private debt, he has argued that the current problems arose as a result of excessive leverage, and therefore further ratcheting up of the public debt should not be considered a solution.

Mr Tremonti is clearly concerned that a major fiscal stimulus would backfire, leading to higher government bond yields and higher borrowing costs. The interest rate spread between Italian ten-year government bonds and their benchmark German equivalent has widened sharply compared with one year ago. From just 25 basis points at end-2007, it widened to a recent peak of 170 basis points in mid-January. Since then the spread has narrowed (as it has for most euro area countries, most likely in response to the recent lack of any particularly bad economic data), but remains high at around 120 basis points.

**A stable base?**

Mr Tremonti's main concern seems to be to get the country's banks lending again to households and businesses. This will be far from easy, given that the crisis of confidence arising from the global financial meltdown is now weighing heavily on the demand for credit and boosting desired savings (as elsewhere in the world). However, the minister remains confident that although Italy may be entering a sharp recession, it is in better financial shape than some of its EU partners.

This rests mainly on two factors. First, the Italian banking system appears to be reasonably sound. The country's banks were far less prolific in their use of complex credit-risk products than those in the US or UK, for instance, relying more heavily on retail deposits and bonds for their funding. Last month the cabinet formalised its provisions to boost the capital base of Italian banks, should the need arise. The government would buy bonds that would be convertible into non-voting shares in the banks to support their balance sheets. In exchange, the banks would be required to pay a 7.5% coupon on the bonds, promise to lend adequately to households and businesses and adhere to a "code of ethics", including a commitment to report the salaries and bonuses of top managers. So far, no banks have requested government support, seemingly confident that they can overcome their problems on their own. Furthermore, the interest to be paid is high and they rightly feel that a request for support would open the door to unwelcome political interference.

Second, levels of private-sector debt in Italy are among the lowest in Europe. Household debt was about 49% of disposable income in the third quarter of 2008, compared with about 100% in the euro area and about 150% in other major developed economies such as the US and the UK. Credit growth to businesses has accelerated in recent years, but the gross financial debt of the corporate sector was about 75% of GDP in 2008, about 10 percentage points below the euro area average.

**Under pressure**

Reflecting the cautious stance adopted by Mr Tremonti, the major tax cuts promised during the 2008 election campaign have been put on hold indefinitely. Some fiscal stimulus measures have been taken by the government, with parliament recently approving a modest package including income relief for poor households and a boost to Italy's weak unemployment benefit system, worth a total of about €5bn (or 0.5% of GDP). However, net of some revenue-raising measures and savings, the overall package is estimated to be worth less than €1bn. This is far less than measures taken by many other European countries and the 1% of GDP recommended by the EU.

Back in November, in an effort to talk up consumer and business confidence that has languished at historically low levels, the prime minister, Silvio Berlusconi, after a meeting of the G20 group of industrialised nations, announced plans to introduce an €80bn fiscal stimulus package. Under closer examination, however, critics rightly argued that most of the proposed €80bn was in fact a repackaging of old money, more than one-half of which comprised spending of EU funds for the environment, research and development and infrastructure. Such funds can often take years to be authorised. A further €10bn was expected from investment by toll-road operators, albeit in exchange for higher toll charges.

Despite the modest nature of the government's stimulus plans, the fiscal deficit is still expected to rise from an estimated 2.9% of GDP in 2008 to 4-4.5% in 2009-10, rather than fall as predicted by the government in its medium-term economic plan. This reflects high interest payments on public debt of around 5-5.5% of GDP and our expectation of a prolonged recession. The government debt/GDP ratio is also expected to increase from an estimated 105% in 2008 to 110-115% in 2009-10. Thus, in spite of the best efforts of Mr Tremonti, fiscal pressures seem likely to continue to rise. With markets now repricing the risk of lending to governments, a move to austerity beckons.

Feb 11th 2009 |