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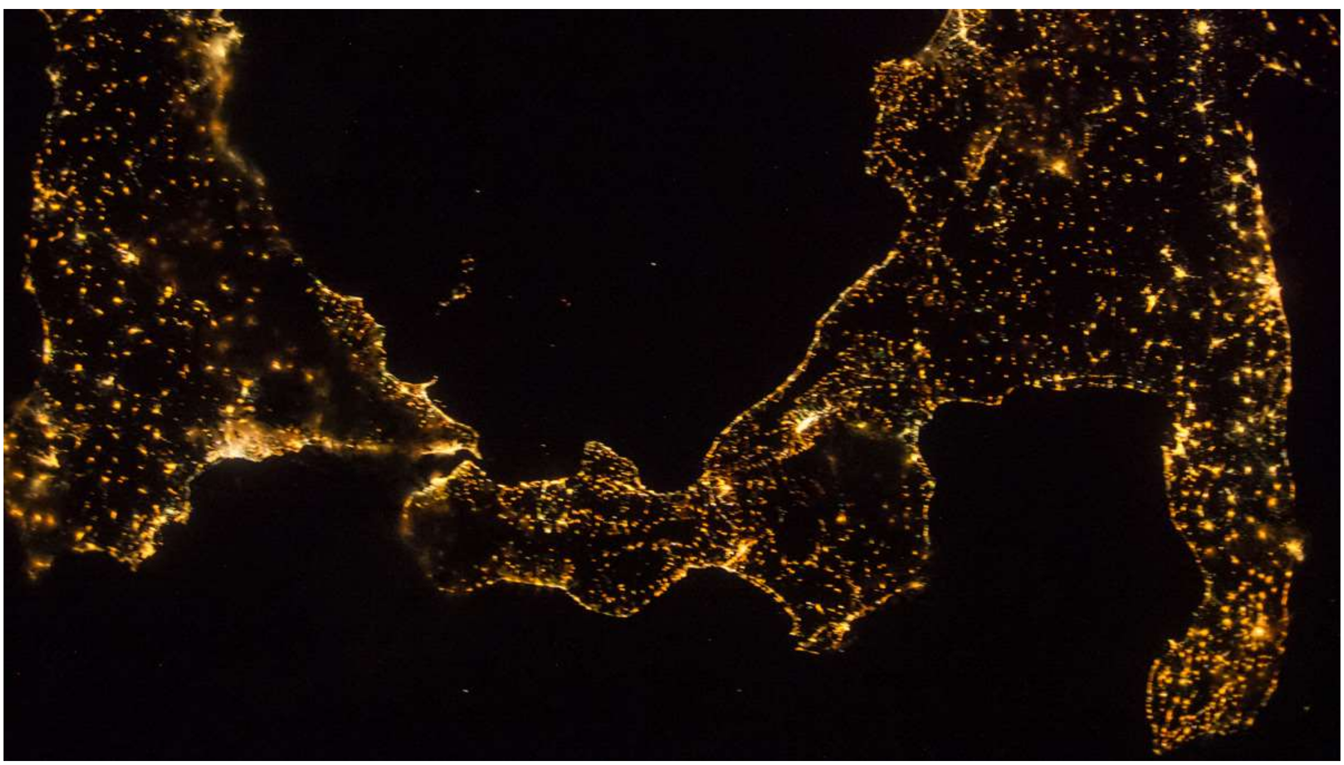
The Italian Job

Draghi has put the Italian economy back on track, but challenges remain.

By Vaibhav Tandon



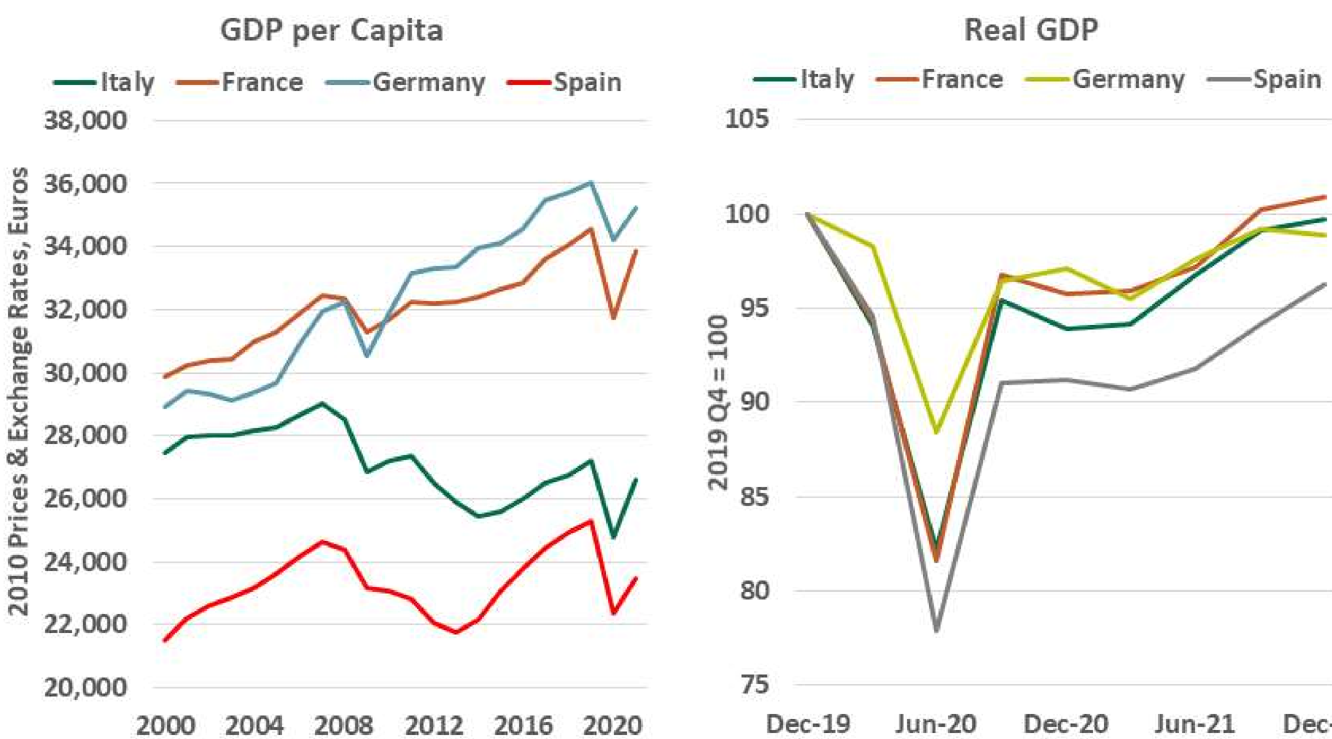
Italy has always been known for its rich heritage. From the Roman Empire through the Renaissance to the modern day, Italy has set high standards in the worlds of art, music, architecture, cuisine and fashion. Unfortunately, there are things that Italy is infamous for, like an unstable economy and a dysfunctional political system. In the past decade, Italy was often referred to as the "sick man of Europe."

Italy's economic wellness has improved quite a bit since the pandemic first struck, thanks to a rare interval of strong leadership. But new maladies are threatening. How Italy copes with these ailments will set an example for the rest of the continent.

In the two decades before COVID-19, Italy's economy barely grew. Its unemployment rate reached double digits in 2012 and stayed there for the next seven years. Italians were poorer in 2019 than they had been in 2000. Their government is among the most indebted in Europe.

Some of this woeful experience is the result of political instability. Since the end of World War II, Rome has had 66 governments lasting for an average of just over one year. Bureaucrats often choke business activity: it takes an average of 500 days to resolve a civil legal dispute in Italy, versus about 200 days in Germany. These kinds of structural frictions have severely limited foreign investment in Italy.

The pandemic inflicted further pain, leading to Italy's worst economic crisis in decades. When Mario Draghi was sworn in as prime minister of Italy in February of last year, his task was clear: provide stability and restore confidence in the Italian economy. And on those fronts, he has made important progress.



Source: Haver Analytics

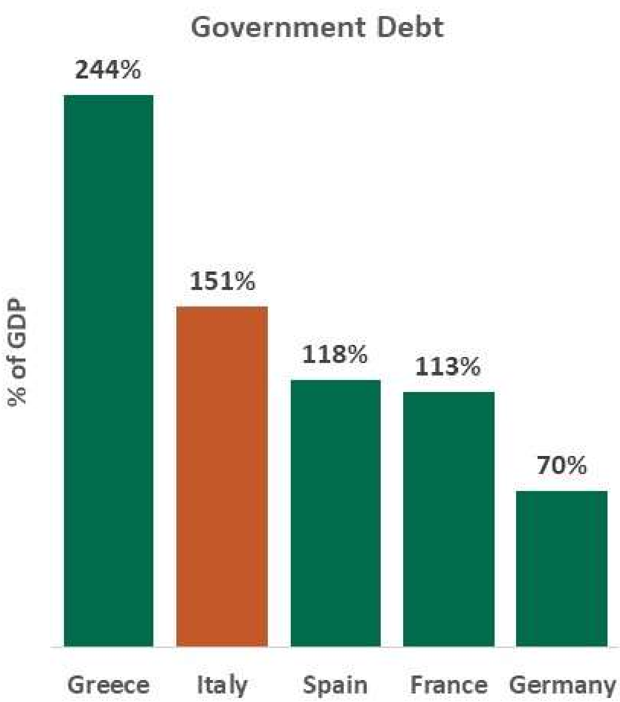
The Draghi government, an alliance of political forces, has proven more durable than most of its recent predecessors. This stability has allowed Italy to make good progress on reforms. Additional resources for the court system will help clear the backlog of commercial cases, freeing businesses to proceed. Accelerated progress on public works, including the construction of high-speed rail and upgrading the telecoms infrastructure, will enhance efficiency. A renewed focus on preventing fraud and conflicts of interest are likely to boost investor confidence.

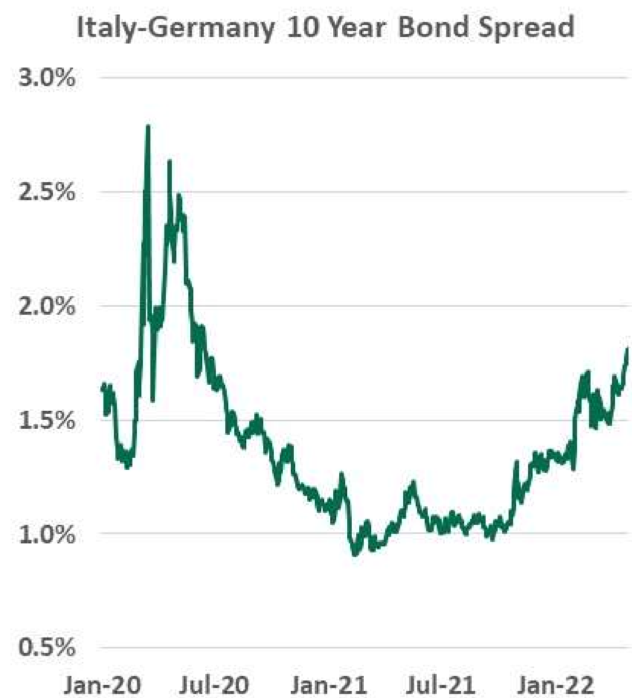
Rome and Brussels have for several years been at loggerheads over the former's state of public finances. Draghi, given his standing as the former President of the European Central Bank (ECB), managed to change the equation. He secured the European Commission's approval for a plan to invest €200 billion in grants and loans, making Italy the biggest beneficiary of Europe's €750 billion recovery fund. In exchange, Italy promised structural reforms. The funds are to be used to modernize inefficient bureaucracy, boost environmental protection, and liberalize the services sector and labor market. All these measures are aimed to boost the country's long-term growth prospects.

Commitment to reforms will boost Italy's long-term growth prospects.

Italy's recent economic performance has topped expectations. Activity rebounded strongly from the pandemic, underpinned by a vaccination rate that was among the highest in Europe. In Draghi's first year in office, real gross domestic product (GDP) grew 6.6%, the fastest rate in three decades. The economy returned to its pre-COVID level of output in the fourth quarter of 2021, ahead of member states like Germany and Spain. Impressed by the trajectory, The Economist named Italy 2021's "Country of the Year."

Though on a better track, challenges remain for the Italian economy. As in other places, higher inflation is starting to weigh on consumer incomes and sentiment. Italy is highly dependent on energy imports, with much of the country's needs supplied by Moscow. An embargo on Russian supplies would hit Italy especially hard.





Sources: Haver Analytics, Bloomberg

The energy shock threatens to push Italy's economy closer to stagflation. The government's latest economic report estimates a Russian energy embargo would reduce growth to just 0.6% in 2022 and 0.4% next year, versus 3.1% and 2.4% respectively under a baseline scenario. Italy's vulnerability extends beyond energy needs: its top two banks have sizeable exposures to Russia.

With inflation becoming a real threat, the ECB has started applying the monetary policy brakes. Rate hike expectations are leading to higher borrowing costs for member states. Stress in the eurozone bond market can be gauged by the spread between Italian and German 10-year bonds, which increased in recent weeks to its highest level since June 2020. And with government debt equal to 151% of its GDP, Italy is facing higher borrowing costs and renewed questions about its debt sustainability.

While certainly a risk, a debt crisis is not imminent. Italy is set to receive billions of euros in the coming years from the European Union's recovery fund, which should help keep a lid on borrowing needs. Strong nominal GDP growth amid high inflation will help **lower the debt**.

Italy's debt is uncomfortably high, but a crisis isn't imminent.

As stated by the ECB president earlier this month, quantitative tightening (QT) or balance sheet reduction is unlikely to commence anytime soon. This implies the central bank will maintain its stock of assets by reinvesting the proceeds of maturing bonds, thereby maintaining demand for Italian debt. Alternatively, under a QT scenario, the ECB could start by reducing its holdings of German bonds, providing Rome with a window of opportunity to lower its debt.

From Leonardo da Vinci to Enzo Ferrari, Rome has a proud history of innovative design. Mario Draghi is trying to design a stable and bright economic future for Italy, and his initial sketches have been encouraging. But broader brush strokes will be needed.

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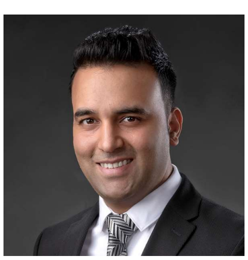

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Vaibhav Tandon is an Economist within the Global Risk Management division of Northern Trust. In this role, Vaibhav briefs clients and colleagues on the economy and business conditions, supports internal stress testing and capital allocation processes, and publishes the bank's formal economic viewpoint. He publishes weekly economic commentaries and monthly global outlooks.