

## Italian journeys

A lot has changed when it comes to the European government debt market since the Eurozone crises a decade ago – despite the latest political crisis in Italy.



### IN A NUTSHELL

- With Italy's government embroiled in crisis, this summer is likely to revive fears of yet another Eurozone crises.
- Ahead of the ECB's July 21 meeting, we are cautiously optimistic that such an outcome will be avoided.
- Our detailed look at Italy suggests that problems at the Eurozone periphery currently appear manageable overall. Still, there are plenty of other worrisome issues for Europe as a whole.

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This summer, plenty of newspaper readers are likely to experience a sense of déjà vu. Once again, there is political upheaval in Southern Europe, with the survival of the Italian government under prime minister Mario Draghi hanging in the balance and snap elections potentially looming.<sup>1</sup> Meanwhile, financial markets are seeing a revival of fears of yet another Eurozone crisis. Much of this is going to focus on fragmentation risks, a new name for a mostly familiar phenomenon. As Isabel Schnabel, member of the executive board of the European Central Bank (ECB) put it in a recent speech: "Put simply, fragmentation reflects a sudden break in the relationship between sovereign yields and fundamentals, giving rise to non-linear and destabilizing dynamics."<sup>2</sup> In Section 1, we take a quick look at what has and hasn't changed. In our view, recent changes in the terminology used by the ECB partly reflect a better, and increasingly common understanding of how and when it should act. Section 2 explains why we are cautiously optimistic that it will succeed in containing the yields on government bonds in the Eurozone periphery compared to their German equivalents. Despite the growing signs of fracturing of Italy's coalition government, problems at the Eurozone periphery currently appear manageable overall. The note concludes by highlighting some of the current issues that remain worrisome for the Eurozone as a whole.

<sup>1</sup> [Crisi governo: Draghi annuncia le dimissioni, Mattarella le respinge - la Repubblica](#)

<sup>2</sup> [United in diversity – Challenges for monetary policy in a currency union \(europa.eu\); as of 6/14/22](#)

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# 1 / A recap of the basics of Eurozone crisis economics

How and why could Italy – or for that matter any other member of the Eurozone - get into trouble again in sovereign debt markets? If you think you have some firm idea that relates to spreads between German and Italian bonds, say, or levels of government indebtedness, think again. In and of themselves, spreads between different types of bonds just tell you how risky markets may perceive them to be currently. Moreover, spreads are always relative – bonds by different issuers or types are compared to each other. Retrospectively, it might turn out that markets were wrong on both. Indeed - and as even the ECB now acknowledges - part of the underlying cause of the initial Eurozone crises was that for the first few years of the common currency in the new millennium, financial markets did not discriminate enough between good and bad credits when it came to the sovereign government bonds of various members.<sup>3</sup> That, in turn, allowed imbalances to build up.

Of course, there are Eurozone treaty commitments to keep debt or deficits below certain thresholds, such as keeping each nation's public debt to 60% of gross domestic product (GDP). When these are breached, though, as they have been by many of the larger founding members for much of the common currency's existence, this tends to trigger political haggling more often than instant economic crisis.<sup>4</sup> Experience both inside and outside the Eurozone suggests that there is no one neat level of government indebtedness that clearly demarcates the dividing line between safety and danger. For example, before the financial crises that began to shake Eurozone banks and countries during summer 15 years ago, Spanish, and Irish government finances looked quite healthy. It was the private sector that had taken on unsustainable debt, mostly mortgages to buy houses that turned out to be overpriced. Meanwhile, Japan's experience has long illustrated that high levels of public debt compared to GDP doesn't need to be a problem in and of themselves – provided a country can borrow in its own currency and has a central bank, able and willing to buy those sovereign bonds, keeping debt financing costs low.

Which brings us to what really matters for debt sustainability. Namely, how much interest the government of the country in question must pay on its existing debt, compared to how much the nominal GDP is growing. The latter largely determines government tax receipts. A rough rule of thumb is that provided nominal economic growth exceeds nominal interest payments, the debt burden will shrink, all else equal. By contrast, low initial debt can still snowball out of control, if interest rates spike while the economy shrinks or stagnates, swiftly leading interest payments to exceed nominal GDP growth. That dynamic was key to Eurozone crisis economics a decade ago, along with the public sector having to bail out private banks and supporting heavily indebted households.

At least for now, things look rather more reassuring this time around. Yields on 10-year Italian government bonds remain quite low by historical standards. Meanwhile, nominal GDP growth last year and probably this year is likely to be higher than at any point since 2000, at roughly twice the level of nominal interest rates.<sup>5</sup> At least in the short-term, inflation – and the boost it provides for nominal GDP – is improving Italian debt sustainability.

<sup>3</sup> [United in diversity – Challenges for monetary policy in a currency union \(europa.eu\)](#)

<sup>4</sup> [French finance minister says EU debt rules are 'obsolete' | Financial Times \(ft.com\)](#)

<sup>5</sup> [GDP and spending - Nominal GDP forecast - OECD Data](#)

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### Yields on 10-year Italian government bonds



Sources: Refinitiv, DWS Investment GmbH as of 7/14/22

Why then, had serious people starting to worry well before Italy's latest political upheaval? Why is the ECB about to launch a new anti-fragmentation tool, tentatively called Transmission Protection Mechanism (TPM) and rushing to unveil it at its upcoming monetary policy meeting on July 21? There are two parts in answering this question. Start with the more general one, which relates to inflationary pressures and fears of inflation expectations becoming unanchored.<sup>6</sup> To avoid the latter, central banks around the world have started to increase interest rates and cut back on government bond purchases. The ECB has promised to follow suit, with its first interest rate hike in over a decade looming in July.

Think back to Japan to see why this could be a problem for government finances, with or without a common currency. We wrote above that high levels of public debt compared to GDP doesn't need to be a problem – provided a country can borrow in its own currency and that there is a central bank, able and willing to buy those bonds, keeping debt financing costs low. Inflation and a weakening currency are the textbook reason why a central bank might no longer be willing and able to engage in such activities. That does not appear to be an issue yet for the Bank of Japan (BoJ) but could eventually become one.<sup>7</sup>

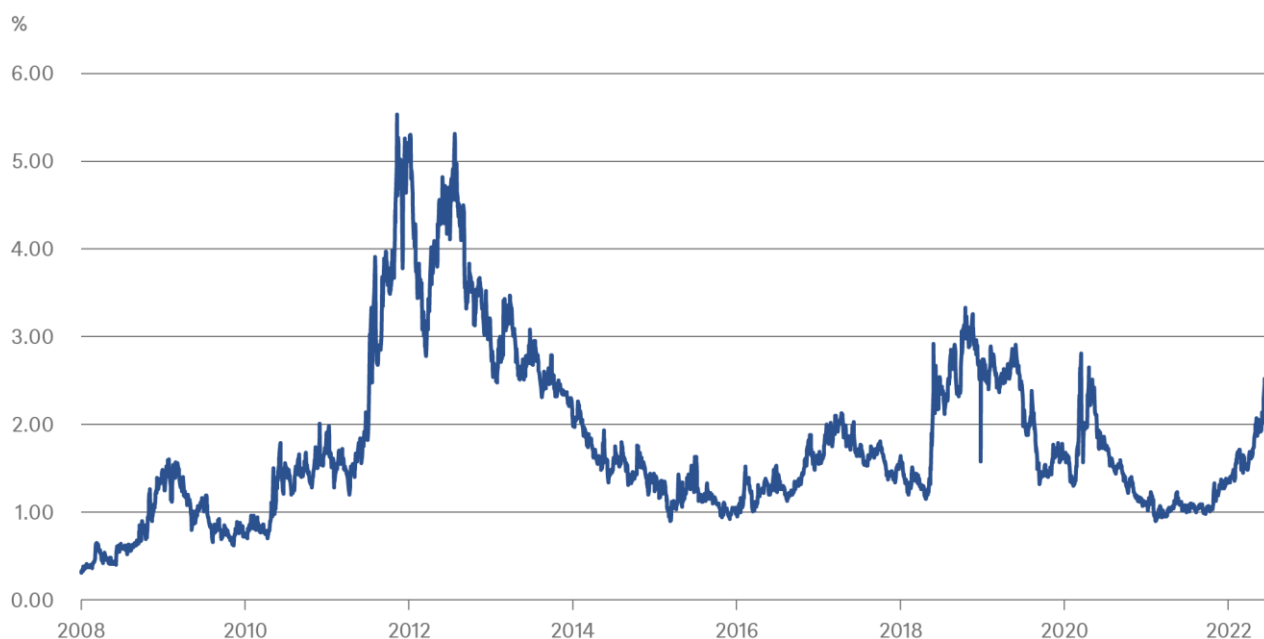
For the ECB, Eurozone inflation is very much a contemporary worry already, which is why it appears keen to tighten monetary policy overall. Its planned TPM is best understood as an attempt to soften the blow of rapid interest rises on more highly indebted member states, the second part of answering the above question. This is where spreads, such as those between the yields of 10-year Italian and German government bonds come in. For now, these remain low by historical standards, but the rapidly opening gap in recent months has caused alarm bells to ring at the ECB.

<sup>6</sup> Soaring inflation sparked ECB calls for more aggressive rate rises, minutes show | Financial Times (ft.com)

<sup>7</sup> After the yen's slide (dws.com)

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### Spreads between 10-year Italian and German government bonds



Sources: Refinitiv, DWS Investment GmbH as of 7/15/22

Why is this worrying for the ECB? Well, remember that it can only influence private sector borrowing costs very indirectly when it changes policy rates. Most Eurozone debt financing is still via bank loans, and the rates bank charge generally move in lockstep with the yield of their countries' longer-term sovereign bonds, not short-term ECB interest rates.

When spreads rise, this does more than just increase the interest financing costs of the Italian government. It also raises borrowing costs of Italian households and companies on their bank loans. A rising spread between Italy and Germany can thus also mean that private sector borrowing costs rise by more than desired south of the Alps, compared to what happens up to the north. Such fragmentation can hinder monetary transmission and is problematic within the single market of the European Union (EU). Worst of all, it can also start to feed on itself. Worries about Italian public sector debt could, for example, spill over to Italian banks, which still tend to hold a lot of that debt – or vice versa. The TPM will be designed to stop such vicious circles – ideally, before they can spin out of control.

## 2 / Why we are cautiously optimistic

Will the ECB'S new antifragementation tool work? Impossible to say, not least given the current political uncertainties in Rome. At the time of writing, it seems likely that Mario Draghi will address parliament next Wednesday, with the new tool to be unveiled on Thursday.<sup>8</sup> Non-linear and destabilizing dynamics have a natural tendency to be hard to predict. Whatever the ECB unveils, markets might also try to test whether the central bank is still willing and able to do "Whatever it takes" to preserve a functioning currency union. That was how Mario Draghi, then president of the ECB famously put it a decade ago.<sup>9</sup> Whether his successors will be similarly successful will be an open question until we know all the details, and maybe even beyond that.

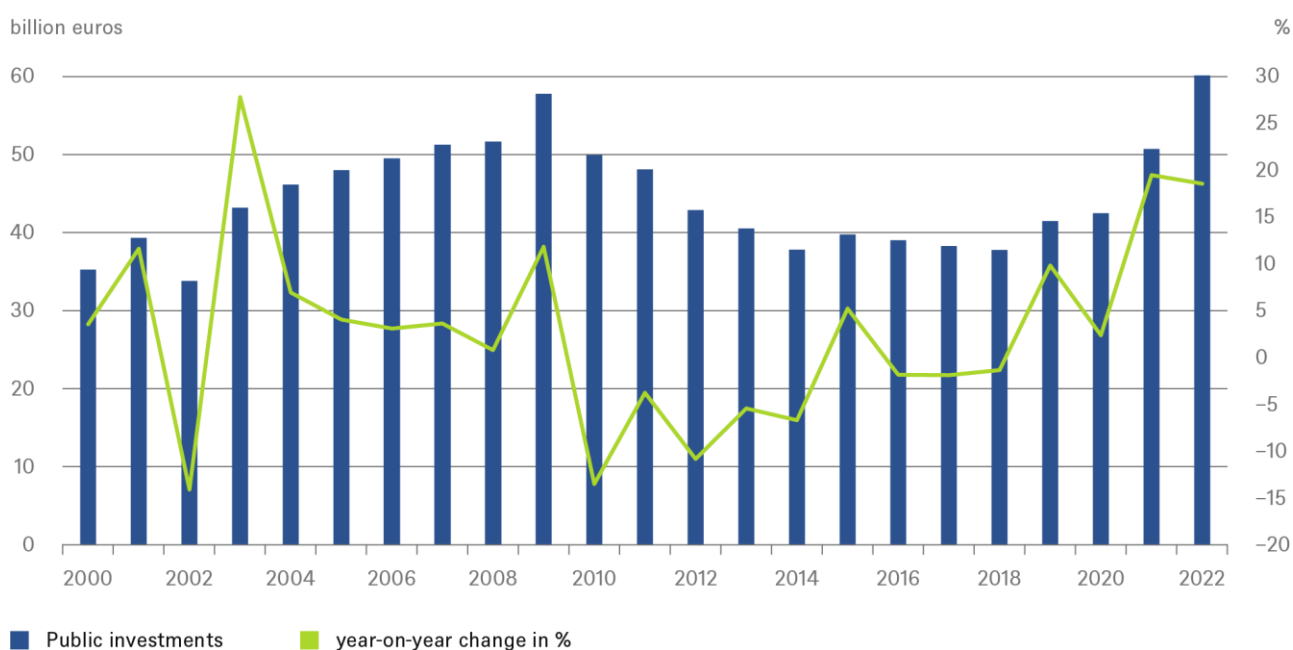
<sup>8</sup> [Mario Draghi offers to stand down as Italy's prime minister | Financial Times \(ft.com\)](#)

<sup>9</sup> [Does Mario Draghi still have 'whatever it takes'? – POLITICO](#)

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Still, we are cautiously optimistic. Over the past decade, a series of Italian governments have addressed plenty of erstwhile weaknesses from the justice system to competition rules. Under Draghi, these have gotten additional impetus. Italy is a primary beneficiary of the EU's pandemic support schemes, partly because it has been able to swiftly respond to the various conditions set by the European Commission. For the first time in many years, this has started to boost public sector investment, which in turn, and along with the reforms, should support its longer term GDP growth prospects.

### Public sector investment in Italy



Sources: Ameco, Haver Analytics, DWS Investment GmbH as of 6/30/22

An added benefit of EU fund disbursements is that they will probably somewhat stabilize Italian politics in coming days, weeks and months in the run-up to next year's parliamentary elections, due to be held no later than May 28.<sup>10</sup> Until then, we are likely to continue to see plenty of politicking, with various groups within and outside the ruling coalition jockeying for position.<sup>11</sup>

In recent days and weeks, the various maneuvers and counter maneuvers lead to Draghi's offer to resign as prime minister. Instead, President Sergio Mattarella has rejected the resignation and presumably hopes that a government of national unity can regain full parliamentary support by next Wednesday.<sup>12</sup> The judgments and misjudgments of various political actors that contributed to this crisis would probably require a book length treatment along the lines of Niccolò Machiavelli's classic political treatise.<sup>13</sup> But to vastly simplify a highly complex and unpredictable political situation, it remains fairly unlikely that these will trigger a snap election, which plainly does not appear to be in the electoral interest of most of the parties concerned.

<sup>10</sup> [Conte warns Draghi over any shift on financial aid to Italian people | Financial Times](#)

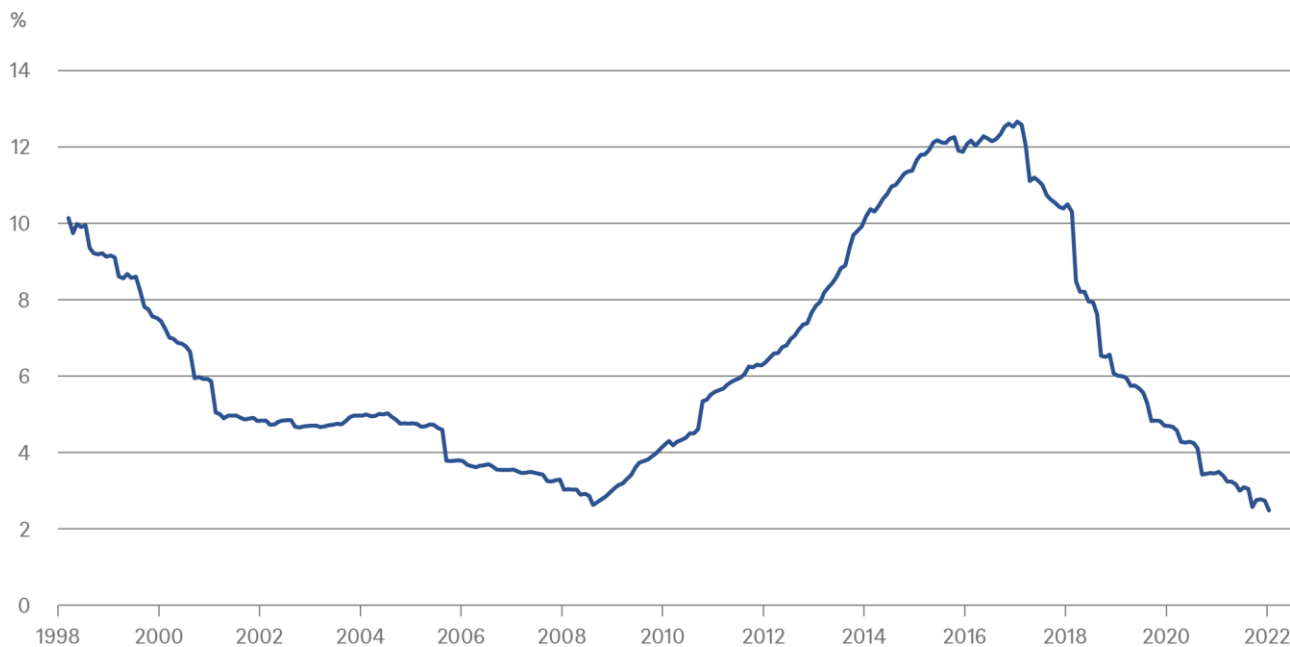
<sup>11</sup> For some recent examples, see: [Draghi leaves NATO summit early to deal with domestic woes – POLITICO](#); [Italy's Draghi to meet 5-Star chief with government's future at risk - EU Reporter](#); [Draghi, Conte start de-escalation talks - English - ANSA.it](#)

<sup>12</sup> [Draghi, dopo le dimissioni, le news sulla crisi di governo - la Repubblica](#)

<sup>13</sup> Machiavelli, Niccolò; Rippel, Philipp (Herausgeber, Übersetzer), (1986) *Il Principe /Der Fürst: Ital. /Dt.*, Reclam Universal-Bibliothek

Compared to other Eurozone economies, moreover, Italy is starting to look quite healthy on several measures. To list and illustrate a few, non-performing loans at its banks have shrunk to manageable proportions since being a perennial problem during previous crisis episodes.

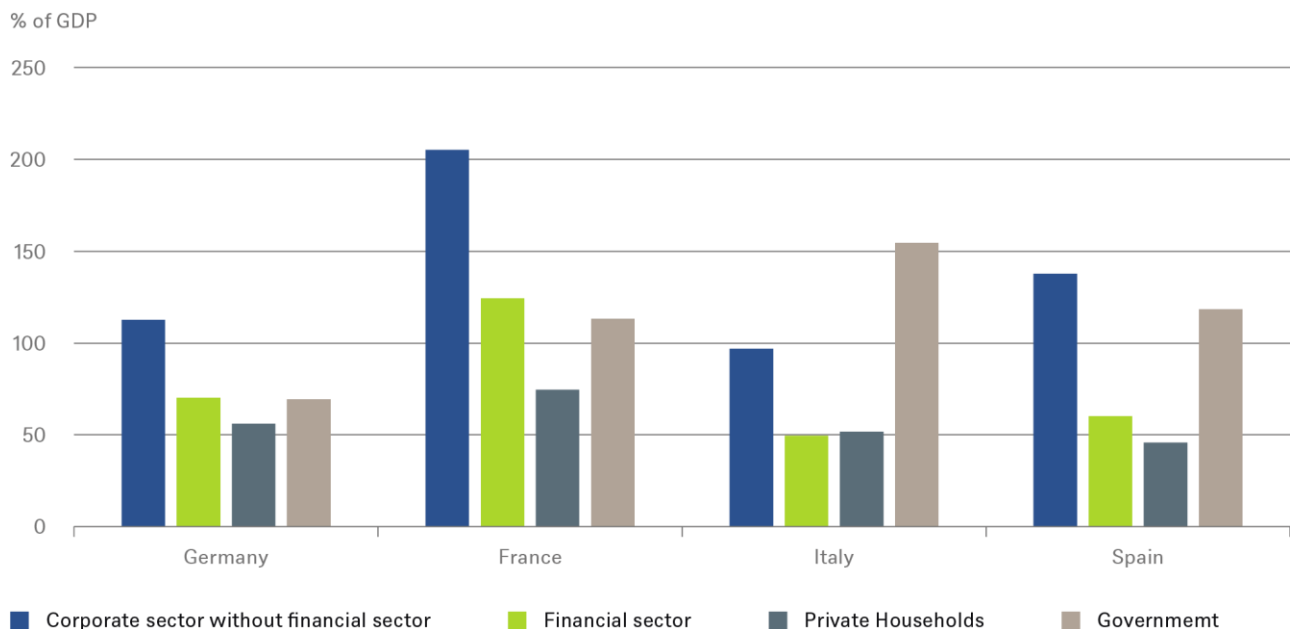
### Italian non-performing loans, ratio to total loans



Sources: Refinitiv, DWS Investment GmbH as of 7/8/22

While public sector indebtedness is indeed higher than among large Eurozone peers, balance sheets of Italian households and both financial and non-financial businesses look comparatively healthy.

### Total debt as % of GDP by various Italian sectors compared to other countries



Sources: Haver Analytics, DWS Investment GmbH as of 6/30/22

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Nor has Italy seen excessive growth in house prices. Most mortgages, moreover, are at fixed, long-term rates, leaving Italian households with comparatively little exposure to rising interest rates.

### House prices in Spain, Germany and Italy



\* Eurostat House Price Index year-on-year change in %; Sources: Haver Analytics, DWS Investment GmbH as of 6/30/22

Like households, the Italian state has also extended maturities on its debt, so it would take a while for higher interest rates to feed through.

## 3/ Conclusion

In this note, we have provided a recap of the basics of Eurozone crisis economics and put Italy's recent political upheaval into context. We also explained why we are cautiously optimistic that the ECB's new anti-fragmentation tool, tentatively called Transmission Protection Mechanism (TPM), is likely to be effective in containing incipient panics in the government debt markets of the Eurozone's periphery. It is quite noteworthy, for example, that there have been few signs of contagion in recent years across various countries that used to be lumped together under this heading.

None of which is to deny that there could be problems. Since the last crisis, the ECB has developed many additional tools and gained flexibility and experience in how to use them. The TPM, though, as its main new defense mechanism, will not necessarily be untested. As with its predecessors, there will no doubt be some initial kinks to be worked out, as well as potential political and legal challenges, both at the EU level and potentially in various member states. Partly as a result of previous such challenges, integrating the Eurozone's financial architecture remains a work in progress.

Europe is still some way off from having a region-wide bank deposit insurance. Its banking system and capital markets remain far from unified. That is a potential problem for Italy, but also for other members whose markets currently are perceived to be stronger. Especially if economic growth were to suddenly weaken, things could certainly get dicey and not just in Italy. Against the background of a broader European energy crises due to Vladimir Putin's latest war on Ukraine, other countries, notably Germany, appear vulnerable. Oddly, that too suggests some scope for cautious optimism. If and when the latest set of challenges were to clarify that European solidarity is not a one-way street, that could finally prompt further progress in integrating the Eurozone's financial architecture and further strengthen the foundations of the common currency. In short, there are still going to be plenty of things to worry about – no matter how events in Rome and at the ECB play out over the next couple of days.

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## Glossary

The **Bank of Japan (BoJ)** is the central bank of Japan.

The **European Central Bank (ECB)** is the central bank for the Eurozone.

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

**Non-performing loans (NPLs)** are loans on which scheduled payments have not been made for (usually) at least 90 days.

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

**Tightening** policy occurs when central banks raise the deposit rate.

**Yield** is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.



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