

The Gloomy Scenario of Italy's Default

Diego Valiante

What will happen if Italy is not able to implement structural reforms and if international institutions, such as the EFSF and the IMF, do not intervene with sufficient resources to prevent Europe's second-largest economy from defaulting on its debt? The potential costs of such a scenario are, as of today, unquantifiable. But what we can anticipate is that the Italian economic system would certainly embark on a perverse path that would follow three phases: liquidity crisis and insolvency; deflationary pressures; and finally inflationary pressures and economic and political instability.

While Italy is struggling to approve tough structural measures to consolidate its public finances, all solutions put in place so far to contain the costs of debt at European level have been ineffective to get a hold on financial markets. The decisions reached at the December 9th European Council are no exception, even though they set the grounds for a new institutional order among eurozone member states. Does this agreement sufficiently tackle the ongoing liquidity crisis? In other words, what is going to happen from now onwards, until the 'intergovernmental agreement' sets up and enforces a fully coordinated governance of the eurozone's economic policy (through the European Stability Mechanism) and perhaps decides to give a full mandate to the European Central Bank?¹ At first glance, the EU Council decision seems a rather weak response to the short-term market distress and an overhanging eurozone government debt of over € trillion.

¹ It is reasonable to expect member states to modify the Treaty and allow the ECB to become the 'lender of last resort' once the new institutional framework is put in place. A rather different picture emerges on the other side of the Atlantic, where the Federal Reserve enjoys a full mandate and effectively has purchased Treasuries for roughly \$1.7 trillion over a debt of \$7.7 trillion (over 22%) to stabilise yields, and so far with good success.

This 'muddling-through' solution is based on three pillars and the action of the national central banks (individually), the ECB, and the EU Council through the EFSF. First, the securitisation mechanism backed by national guarantees (the European Financial Stability Fund, plus the European Financial Stability Mechanism) has been allowed to raise up to €500 billion,² in competition with national member states' issuances. However, the EFSF may lose its triple A rating if France would lose its triple A rating, which seems quite likely. In addition, if a bigger country like Italy would need external support, the amount that can be raised on secondary markets would be much lower (as Italy's guarantees would step out). Second, an additional direct injection of €200 billion is going from European national central banks (including non-eurozone countries, such as the UK) to a fund managed by the International Monetary Fund (with all the implicit political ramifications), which will provide additional firepower to face the liquidity crisis. Single eurozone countries in trouble would need therefore to ask for a bilateral loan from the IMF. Third, with the recent decision to boost liquidity injections in the banking system, the ECB expects banks to invest more in euro area sovereign debt. The situation in the interbank market is so difficult that the ECB does not consider banks' moral hazard an immediate concern. In a context of no real control over multiple rational agents, this ECB's decision would most likely push banks to adjust their maturities (liabilities), but it will not necessarily put them in a position to buy more sovereign debt, even though they are receiving full support from the ECB. The ECB assumes that they would buy eurozone sovereign bonds to stabilise their funding needs over time, disregarding the likelihood of disorderly defaults in the eurozone.

² The plan to expand it to roughly €1 trillion is going very slowly, and is currently before national Parliaments for their approval.

Diego Valiante is ECMI Head of Research and CEPS Research Fellow. The author is grateful to Alessandro Giovannini for his comments. An earlier version of this commentary was published on the Eurointelligence blog on 14 December 2011.



Papers in the ECMI Policy Brief series provide insights into regulatory initiatives that affect the European financial landscape. They are produced by specialists associated with the European Capital Markets Institute, which is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Unless otherwise indicated, the views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated.

Among those countries exposed to the liquidity crisis, Italy is under the strongest pressures, with a debt of over €300 billion to reach maturity in 2012 (not to mention the issuance of new debt). Most of it should be raised by March (more than €115 billion).³ What could potentially happen if these short-term safeguards and the long-term agreement are not enough or do not consistently materialise or simply if some national court or a referendum would block or delay this process of greater fiscal coordination, preventing the ECB from intervening even in the long-run? What are the potential costs of not responding swiftly to future liquidity crises and allowing contagion to spread even more? This ‘pessimistic’ scenario can be split into three phases, which are likely going to happen in an environment with no or negative growth (see the European Commission’s forecasts; European Commission, 2011) and no ECB intervention. The first phase is partially taking place now.

1. Liquidity crisis and insolvency

- Governments under stress are unable to carry out tough stability measures aimed at restarting growth, abating public expenditures, and curbing public debt. Fiscal measures are not enough to bring debts onto a sustainable path.
- Interest rates on public debt would rise to unsustainable levels. Once above this threshold, rates would become more volatile and go up at a much faster pace, as the market would gradually become illiquid (fewer investors would be willing to buy).
- The ECB does not intervene with a long-term transparent plan to reduce and control interest rates (quantitative easing). Other institutions may not have enough firepower.
- A lack of liquidity and the gradual loss of market access to money worsen the country’s ability to repay the debt. In a few weeks or months (depending on the country’s solvability conditions), the widespread eurozone crisis would transform from a liquidity crisis into an insolvency crisis. In effect, in a broader downturn, privatisations and sales of public assets would be less profitable than in stable market conditions. For instance, there might not be enough liquidity to sell Italy’s public real estate at a price reflecting fair market value.
- Liquidity crisis and inability to meet key public expenditures (salaries, pensions, etc.). The State may become temporarily insolvent with respect to its obligations to its citizens and firms.

- The ECB and IMF still do not want to intervene, as member countries may have not reached a political agreement on how such an intervention should be done.
- Italy and/or other member states declare ‘default’ on some part of their debt. It does not matter whether this is partial or total default, but when it does happen, the loss of confidence – and with it, market access – is irreparable, often for years to come.⁴
- In the hope of avoiding default, some member states may decide to organise a quick exit from the euro area. However, this solution is unworkable, at least in the short-term. There is no way, without a third-party intervention to inject liquidity, to avoid the default.

2. Deflationary pressures

- With no possibility for the country to curb debt and repay the loans closest to maturity, and with 60% of debt held by domestic investors, huge losses are passed onto savers and banks, and not only in Italy.
- Fear quickly spreads in the financial and economic system, and capital moves definitively away to ‘safer’ euro countries. Italian banks are already experiencing capital flight and they are heavily dependent on the short-term (up to 3 months) lending windows of the ECB. The quantity of M3 in the Italian financial system is at a historically low level (Manasse, 2011). The ECB already today struggles to make the interbank market properly work.
- Other euro member states would freeze foreign assets of Italian banks to deal with losses imposed on foreign banks by an Italian default.
- Due to the high risk of insolvency for individuals and firms, a strong credit crunch would bring down the whole Italian economy and indirectly its banking system, pushing them in a downward spiral. There are early warnings that a huge credit crunch has already started.
- Knock-on effects will be felt by small investors and firms, which will start to queue at banks to withdraw money from their deposits for fear that the banks are undercapitalised and may be on the brink of default.
- The Italian government is forced to block or limit withdrawals from current accounts, to save the financial and economic system from total

³ Italian Treasury’s estimates at the end of November 2011.

⁴ Since its default in 2001, Argentina has been unable to access markets, despite having defaulted on a debt of only 40% of GDP. Italy only has a debt of 120% over GDP.

collapse.

- There are no resources at any level to be invested in growth, and strong deflationary pressures would push the country into a prolonged period of negative growth.
- Lower-than-expected fiscal revenues and the bad shape of the financial system would make Italy's situation even more unsustainable.
- If even the ECB and IMF do not intervene substantially to provide liquidity directly to the country, the exit of Italy from the euro area would become inevitable, with huge direct and indirect costs for the whole euro area (Eichengreen, 2007). The re-denomination of contracts in national currency would entail an additional dead loss on savings and investments. Many transactions may be blocked (also in court trials) for months or years.
- The Italian banking system definitely collapses. The eurozone would fall apart or would be re-built around a few 'safer' countries, such as Germany, Luxembourg and the Netherlands.

3. Inflationary pressures and political/economic instability

- In addition to salaries and pension cuts, due to the inability to access financial markets, the devaluation of the national currency to generate cash flows in the aftermath of the euro exit would increase inflationary pressures on individuals and firms, who would incur additional losses if they were not able to transfer assets abroad.
- Due to the high insolvency risk, interest rates for loans and mortgages would skyrocket and the additional credit crunch would plunge the economy and the financial system into a long period of crisis.
- The economy may grow again soon, thanks to the strong devaluation (see Argentina), but this would happen in a long-distressed financial and economic system, left with no resources to boost long-term investments and to meet public expenditures.

With no economic and financial stability, direct foreign investment would drop even more, at least in the short term.

- Indices of population poverty would rise.
- These intertwined mechanisms and low internal consumption would generate a dangerous spiral that would throw the entire country in a prolonged period of economic, political and social crisis.
- In this difficult situation, radical and extremist parties may gain strong consensus over time.
- Migration flows towards other European countries would grow at unsustainable levels, causing strong diplomatic problems among EU countries. If the euro breaks up, most likely the whole European Union would fall apart. Agreements, such as Schengen, would be suspended in the short-term.

The intensity and speed of such a 'doom and gloom' scenario may change depending on the fundamentals of the country. However, the likelihood of avoiding an escalation of the problem is certainly higher if European institutions, in particular the ECB, would intervene to prevent the default and then to launch a eurozone federalist agreement for fiscal policies and a stronger budget to narrow countries' disparities. Member states would be free to take it or leave it.

References

- Eichengreen, Barry (2007), "The Breakup of the Euro Area", NBER Working Paper No. 13393, National Bureau of Economic Research, Cambridge, MA, September.
- European Commission, "Autumn forecasts" (available at http://ec.europa.eu/economy_finance/eu/forecasts/2011_autumn_forecast_en.htm).
- Manasse, Paolo (2011), "Early Warnings of Italian Banking Crisis", (<http://paolomanasse.blogspot.com/2011/11/early-warnings-of-italian-banking.html>).
- For more information, see also Diego Valiante (2011), "The Eurozone Debt Crisis: From its origins to a way forward", CEPS Policy Brief, CEPS, Brussels, August (available at <http://www.ceps.eu/book/eurozone-debt-crisis-its-origins-way-forward>).

About the European Capital Markets Institute (ECMI)

ECMI is an independent, non-profit organisation created to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the policy and business implications of the latest market trends.

These exchanges are fuelled by the publications that ECMI researchers regularly produce – including commentaries and research papers, a statistical package, an annual report and a quarterly newsletter – as well as occasional workshops and conferences. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the numerous subjects it follows.

ECMI is managed and hosted by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of private firms, regulatory authorities and university institutes.



www.eurocapitalmarkets.org | info@eurocapitalmarkets.org

Place du Congrès 1 | 1000 Brussels | Tel: + 32 2 229 39 11 | Fax: + 32 2 219 41 51

About the Centre for European Policy Studies (CEPS)

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is among the most experienced and authoritative think tanks operating in the European Union today. CEPS serves as a leading forum for debate on EU affairs. Its most distinguishing feature lies in its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world.

CEPS' funding is obtained from a variety of sources, including membership fees, project research, foundation grants, conferences fees, publication sales and an annual grant from the European Commission.



www.ceps.eu