



Economic Flash!

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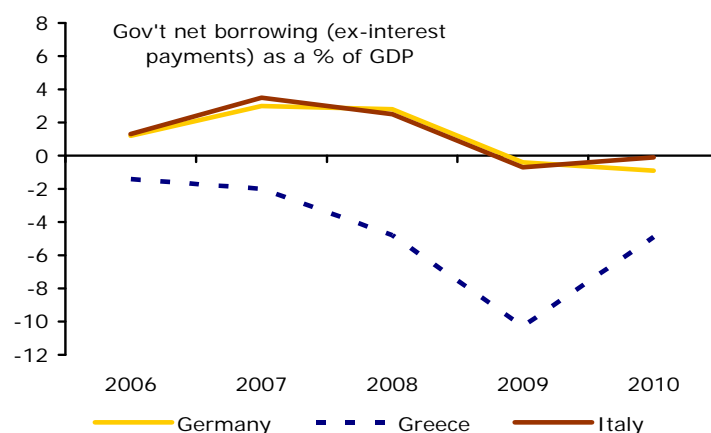
Italian Fiscal Risks and Contagion

Even with its bloated national debt, Italy has been able to distance itself from other European bailout recipients thus far. But a recent sharp selloff of the nation's sovereign debt and banking-sector equities begs the question of whether Italy is the next boot to drop.

It's true that Italy has suffered from chronic economic underperformance and almost non-existent labour productivity in recent years relative to its euro-area counterparts. However, the fiscal and economic situation in Italy differs significantly from that of Greece or other euro-area fiscal laggards.

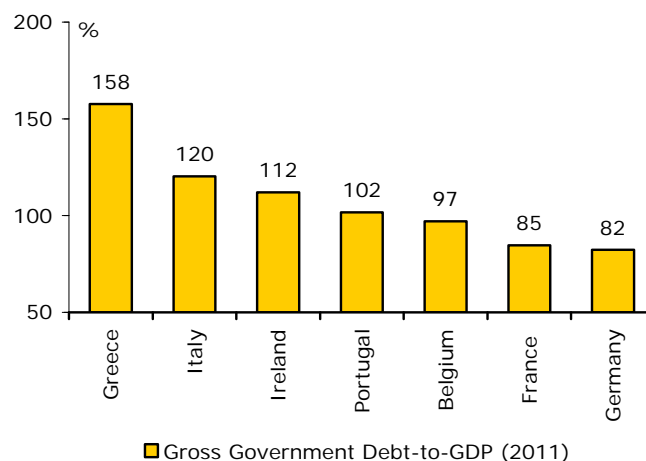
1. Italy's deficit in 2010 was only 4.6% of GDP, a far cry from Greece (10%), Ireland (32.4%) and even below France (7.0%).
2. Italy's expanding deficit during the recession was mainly due to automatic stabilizers (e.g. higher unemployment benefits), and the deficit excluding interest payments in 2008-2009 was barely negative (Chart 1).
3. Italy has already curtailed public sector wage gains, closed some tax loopholes, and divested government assets, broadly moving towards fiscal consolidation. In 2010, Italy reduced its deficit-to-GDP ratio by nearly a percentage point.
4. Italy's unemployment rate is below the eurozone average at 8% and declining, compared to Greece at 16% and rising or Spain at 21% and rising. And despite weak productivity, Italy still has a strong factory sector, which makes a similar contribution to GDP as that seen in Germany. In contrast, Greece's manufacturing base has eroded to less than 10% of GDP.

Chart 1
Italian Primary Deficit Near Balance



Source: Bloomberg, European Commission, CIBC

Chart 2
Italy's Debt Burden is Second Only to Greece in the EU

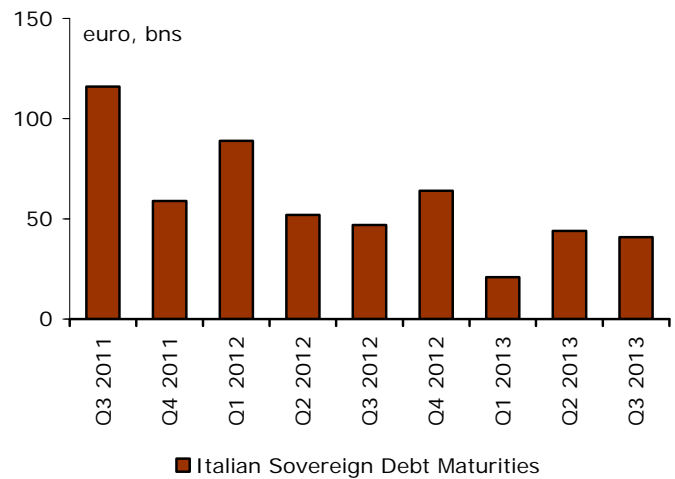


Source: European Commission, CIBC

So Why is Italy in the Crosshairs?

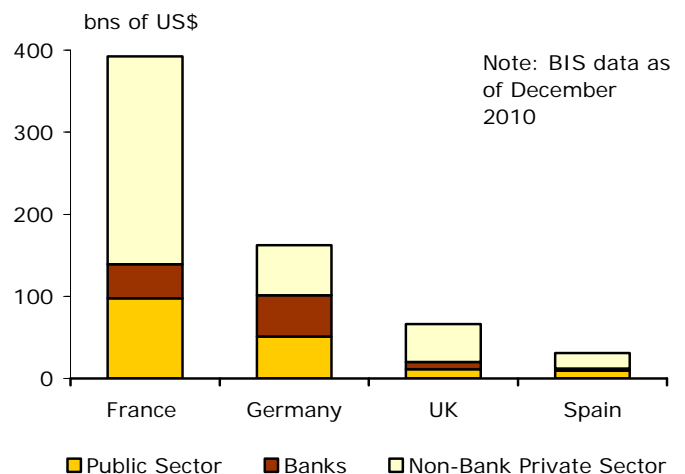
- Italy's debt-to-GDP ratio is 120%, second only to Greece (Chart 2). With recent euro-area discussions on Greek debt turning to longer-term solutions to reduce its debt burden (e.g. haircuts, buybacks, etc), the pressure is escalating for Italy to address its elevated fiscal burden in credible ways.
- As the 3rd largest economy in the eurozone, Italy's debt burden of €1.6tn is beyond the scope of any existing bailout facility.
- Concerns are elevated that Italian banks could perform poorly in the upcoming European Banking Authority (EBA) stress tests due to be released July 15th, given relatively low capitalization levels. Failures would require a new round of capital-raising that could be challenging given the sharp selloff in that market.
- Italy has €116bn of debt coming due by the end of Q3, with around €316bn (equivalent to Greece's entire 2010 debt burden) to be refinanced over the next four quarters (Chart 3). Escalating refinancing costs reduces the sustainability of that burden.
- In-house political wrangling between Prime Minister Berlusconi and Italian Finance Minister Tremonti lately has added to fears of political gridlock, sapping confidence.
- Direct spillovers from Greece sovereign risks are limited. Italian banks' exposure to Greek public sector debt is only around US\$2.5bn, one of the lowest among large eurozone nations. However, second-hand or indirect exposure to Greece implies losses could be larger in the event of a Greek restructuring.

Chart 3
Elevated Refinancing Needs Leave Italy Vulnerable to Market Shifts



Source: Bloomberg, CIBC

Chart 4
Claims of European Banks on Italy



Source: Bank for International Settlements, CIBC

Note that French banks have the largest foreign exposure to Italy in the eurozone. Total claims of French banks on Italy were \$393bn according to the latest Bank for International Settlements (BIS) data, with hefty exposure to the Italian non-bank private sector (Chart 4).

Implications: A sudden breakdown of confidence, rather than an observable deterioration in fundamentals, appears to be the cause of the current contagion to Italy. Even though Italian institutions have remained relatively sound up to now, market panic can become self-fulfilling if elevated yields reduce debt sustainability or banking-sector doubts hamper wholesale funding. Detailed disclosure of sovereign holdings by individual banks upon the release of the EBA stress tests could diminish the selloff in the more sound Italian financial institutions. Weaker banks still have access to unlimited liquidity at fixed terms from the ECB. On the fiscal side, Italian authorities are looking to speed through Parliamentary passage of a €40 bn austerity budget that would close the deficit by 2014. Given the ruling party's majority in both houses, Italy could be on track to pass the budget in the coming weeks, and such a move could avert a more acute crisis.

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