

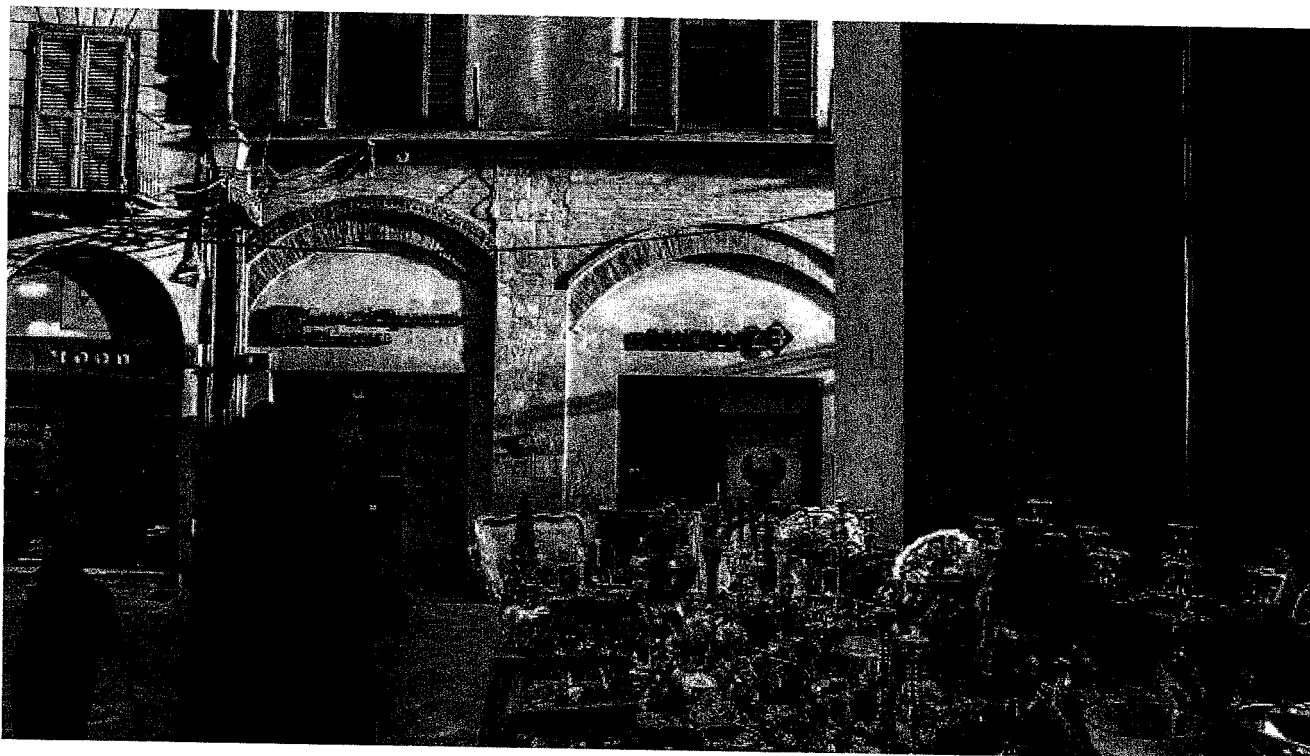
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Italy

Who's afraid of Italy? Premium

The country is on firmer ground than you think

Martin Sandbu's Free Lunch



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NOVEMBER 25, 2016 by: Martin Sandbu

Italy's constitutional referendum, in just nine days, is joining Brexit and Donald Trump at the crowded forefront of elite concern in Europe. Prime Minister Matteo Renzi has framed the poll as a vote on his personal standing, and if Italians reject the proposals (as polls now suggest they will), many fear a political crisis leading to a caretaker government or a [new election](http://next.ft.com/content/c20ab3ec-d761-3cac-95d0-830bbc6a62bd) — with the populist Five Star Movement waiting in the wings.

Some take their worries much further. They expect the political instability of a No vote to worsen the problems of Italy's undercapitalised banks, which may in turn threaten market confidence in the public finances and *in extremis* reignite the sovereign debt crisis. My colleague Wolfgang Münchau (<http://next.ft.com/content/7ea6837a-ad83-11e6-ba7d-76378e4fef24>) even fears “a sequence of

events that would raise questions of Italy's participation in the eurozone".

There is no doubt that Italy has economic problems. Its productivity performance has been awful, as Münchau points out, though this has been true since the early 1990s not since the start of the euro. As I have written before (<http://next.ft.com/content/be7f6260-dc6d-11e5-98fd-06d75973fe09>), the neglect of education and skills, inefficient regulation and tax rules, and cronyism in the banking sector's credit allocation all deserve more blame than the single currency.

Aside from the chronic challenges, the acute problems have worsened recently. The banking system is creaking under one of Europe's largest bad loan burdens, made worse by the long stagnation. Some smaller banks have failed spectacularly (read Rachel Sanderson's dramatic tale of [banking in the Veneto](http://next.ft.com/content/o4869eca-b15e-11e6-9c37-5787335499a0) (<http://next.ft.com/content/o4869eca-b15e-11e6-9c37-5787335499a0>)) and have brought huge losses to retail investors who trusted the system.

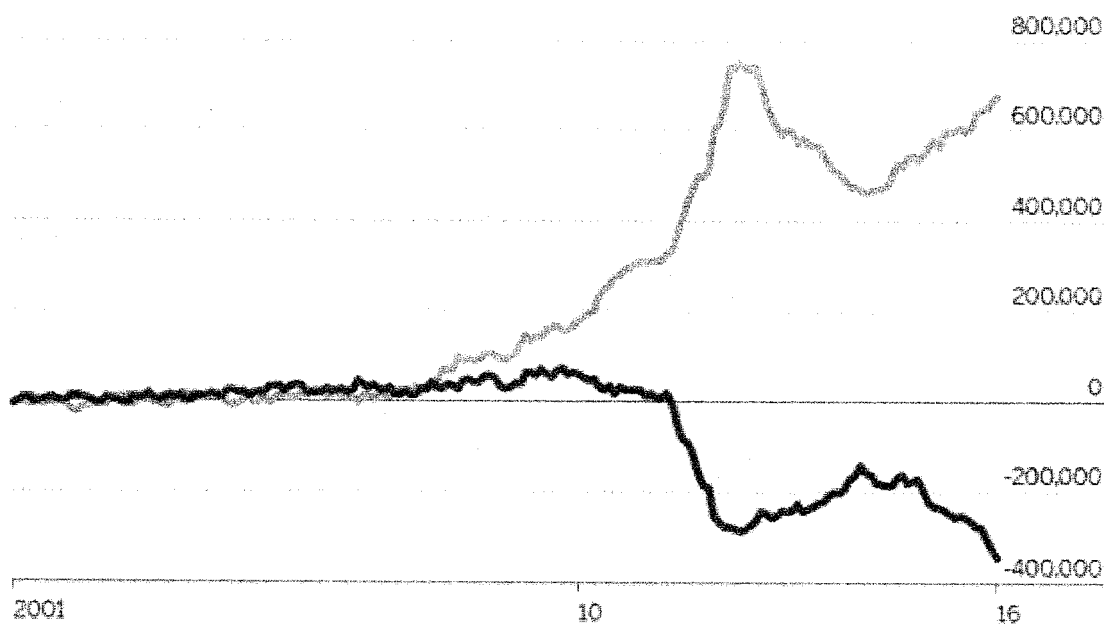
On top of this, there are renewed worries about capital flight. Since the start of 2015, Italy has gone deeper into the red (<https://www.project-syndicate.org/commentary/capital-flight-from-italy-by-carmen-reinhart-2016-11>) in Target2, the single currency's settlement system for transfers between banks in different eurozone countries. That means depositors are taking money out of Italian banks, sending them to banks elsewhere — often Germany, which has seen a corresponding increase in its Target2 credit (<https://www.bloomberg.com/view/articles/2016-10-17/will-italy-leave-the-eu-follow-the-money>).

Target2 balances

Million euros

— Italy

— Germany



Source: ECB via Euro Crisis Monitor

This has been linked to the European Central Bank's purchase of government bonds, including those of Rome. [Eric Dor shows \(https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860545\)](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2860545) that, contrary to hopes that this was mainly foreign investors repatriating their cash after selling their Italian bond holdings, the Target2 movements reflect the actions of Italian investors.

So it is superficially tempting to think that Italy is on a cliff-edge and needs only a nudge — such as a referendum No vote — to fall into a full-fledged financial crisis.

But that would be wrong. Partly because the political instability is not a foregone conclusion, partly because Target2 imbalances are not the bogeyman they are made out to be and partly because Italy faces much more benign conditions today than at the height of the euro crisis.

On the first point, as former Italian prime minister [Mario Monti points out \(http://next.ft.com/content/528a1b06-b235-11e6-9c37-5787335499a0\)](http://next.ft.com/content/528a1b06-b235-11e6-9c37-5787335499a0) in an article for the FT, Renzi neither needs to resign if he loses the referendum, nor should he. Monti seems right: Renzi was wrong to personalise this referendum, and if he loses he should simply accept the political weakening this involves, but not make things worse by leaving office.

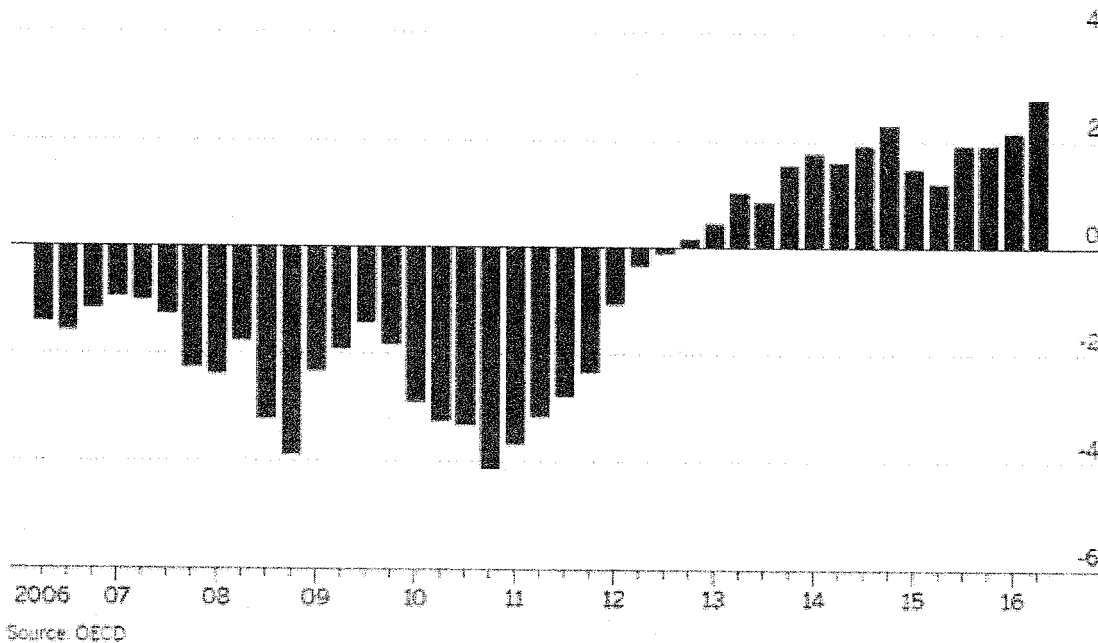
On the second point, Target2 is often misunderstood. Its main function is to facilitate movements of bank deposits without causing a balance of payments

problem. A Target2 liability is something that arises automatically when a deposit is moved from an Italian bank to one in another eurozone country, allowing the Italian national banking system to keep its balance sheet unchanged rather than shed assets to fund the deposit outflow. It is like a gold-backed banking system with an infinite gold supply.

The proof that this is stabilising rather than destabilising is that even as Target2 outflows have taken place, deposits in Italian banks (<http://sdw.ecb.europa.eu/reports.do?node=1000003191>) have continued to grow. So have loans to households (though not to businesses). Far from a harbinger of doom, Target2 has allowed the Italian banking system to continue to function.

Finally, Italy is not living beyond its means. The current account has been positive for the past four years — it hit almost 3 per cent of economic output in the second quarter. There is no reliance on fickle foreign capital to sustain domestic demand here — it is rather depressed Italian demand that funds consumption elsewhere.

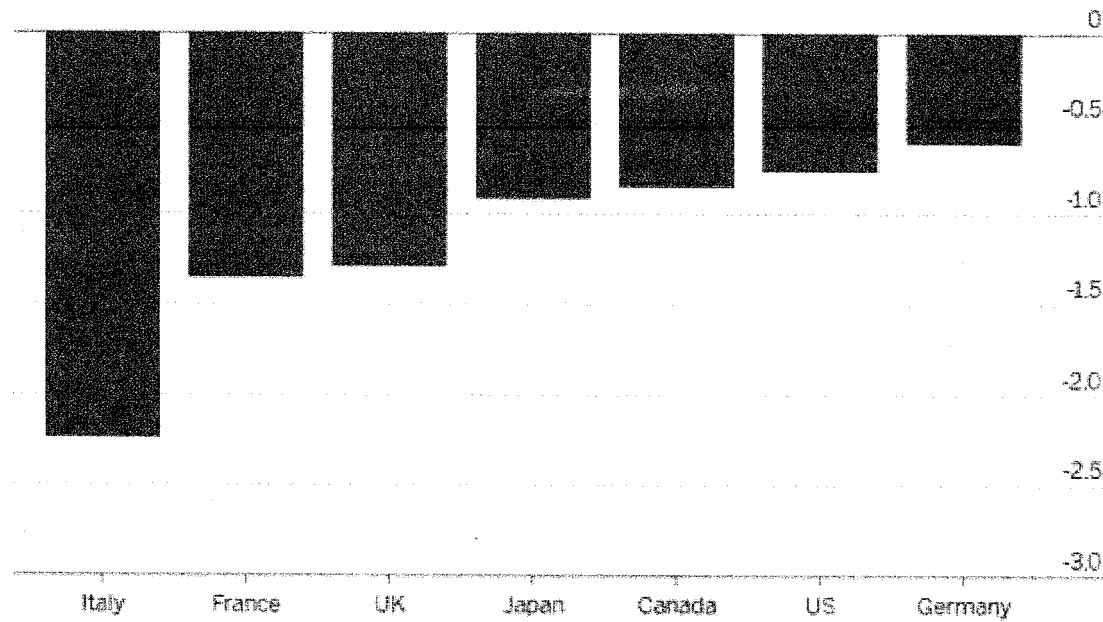
Making ends meet, and then some
Italy's current account-to-GDP ratio, per cent of GDP



Even so, the economy started growing again at about the same time as the rise in the dreaded Target2 deficit. And while public debt is high, Italy has been one of the biggest beneficiaries of lower interest rates, with the government's annual interest costs set to fall by more than 2 percentage points of GDP between 2015 and 2017 on one estimate (<http://next.ft.com/content/fcbfe760-9f3d-3521-98f8-f92fb638d409>) (though since Trump's election, rates have moved in the other direction).

Fall in government interest payments due to lower interest rates

2015 - 2017, % of GDP



Assuming 15% of debt maturing each year

Source: OECD

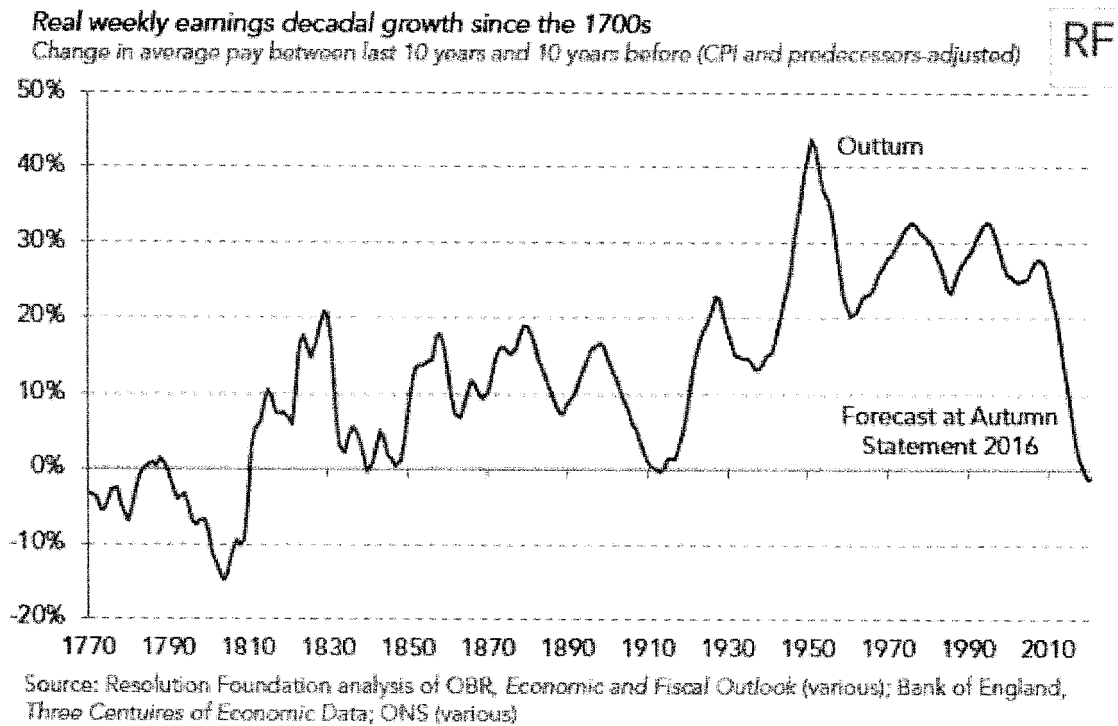
No doubt Italy faces daunting challenges. Of course the economy needs stronger growth and the rot in parts of the banking system needs to be fixed through a proper restructuring of banks (<https://www.project-syndicate.org/commentary/europe-italy-flawed-banking-union-by-lucrezia-reichlin-and-shahin-vallee-2016-10>). A carve-out of healthy banks from the wreckage of failed ones, a writedown of unpayable liabilities in what is left and government indemnification of any innocent retail investors (a system of which Italy has already introduced but needs to improve) are together far preferable to returning to the old sin of bailing out banks whose political connections are better than their financial performance. Italy's banking ailments are one roadblock on the path to stronger growth — but they are not the trigger of an imminent collapse of either Italy or the euro.

Other readables

- Nate Silver has developed a formula to estimate every [US senator's incentive](http://fivethirtyeight.com/features/which-republican-senators-are-most-likely-to-fight-trump/) (<http://fivethirtyeight.com/features/which-republican-senators-are-most-likely-to-fight-trump/>) to work with or oppose Trump.
- Martin Wolf and I discuss this week's Autumn Statement in the [latest FT On Air](https://www.facebook.com/financialtimes/videos/10154695270990750/) (<https://www.facebook.com/financialtimes/videos/10154695270990750/>) live Facebook broadcast.

Numbers news

- This is the worst decade for wages in the UK (<http://next.ft.com/content/d56b46f6-b237-11e6-9c37-5787335499a0>) for in at least 70 years, says the Institute for Fiscal Studies – and that poor average spans decent income growth for the elderly but an even more awful outcome for the young (<http://next.ft.com/content/b15e9cde-b26b-11e6-a37c-f4a01f1b0fa1>). The chart below, courtesy of the Resolution Foundation, shows the decade to 2020 as possibly the worst since about 1800.



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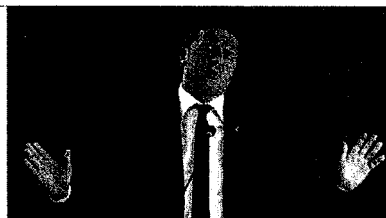
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