

# The Deleveraging Mirage: A Careful Look at Italy Today

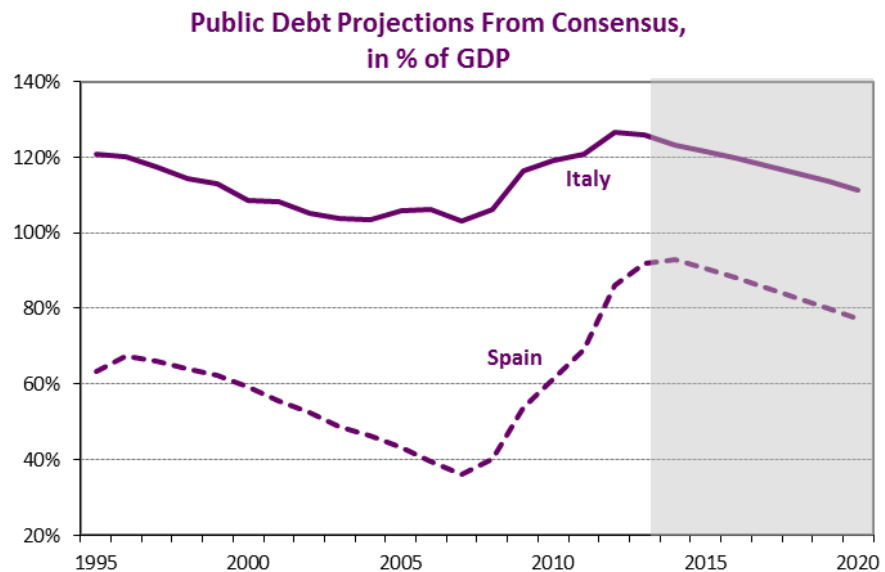
Europe's most distressed countries should see their debt peak in a year or two, before descending to more manageable levels by 2020. Or at least that's what the IMF, the European Commission, and the credit rating agencies all claim. Coming on the heels of the 2012 crisis, this is a heartening forecast—but a pretty surprising one, too. Just what is it based on? We've examined these institutions' various scenarios for Italy and Spain, whose mounting sovereign debt burden loomed large in 2012, and for France, where the sovereign debt outlook raises a whole host of questions. Our assessment is as follows:

- ▶ All these projections are marred by overly-optimistic assumptions about these countries' structural growth outlook and their ability to sustain highly restrictive fiscal policies. **This makes subsequent revisions to the projections a foregone conclusion.**
- ▶ **Italy is a case in point: the projected growth rate is so fanciful that the country stands virtually no chance of deleveraging as hoped.** More conservative forecasts would preclude the prospect of Italy stabilizing its debt in the next few years. They would show rather that by 2020, its debt-to-GDP ratio should verge on 140 percent.
- ▶ **Spain seems to be in a better position to achieve such stabilization in the near term.** Not only is its debt-to-GDP ratio 30 percentage points lower than Italy's, but its potential output is apparently on the way up. Italy's isn't.
- ▶ **Despite recent setbacks, France still seems to have the means to reverse its debt trajectory.** If we assume average real GDP growth of 1.2 percent a year between 2013 and 2020, the country should be able as of 2015 to reduce its debt level just by maintaining a primary budget surplus.

**What emerges from this analysis is that Italy is the exception—and unquestionably the most vulnerable of the large eurozone economies.** This suggests that we're in for further bad news once today's widespread projections come up for revision. Which they probably will after the Italian elections, especially if—as is likely—the new government lacks the leeway needed to convince investors that it can and will do something about the country's huge debt overhang.

## What Assumptions Underpin the Rosy Deleveraging Forecasts?

The European countries hardest hit by the sovereign debt crisis are back out of the doghouse. But does this signal a lasting return to normal, or does it just reflect high hopes that are bound to be dashed? The projections put forward by the IMF, the European Commission, and the credit rating agencies are unanimous: eurozone government debt will peak in a year or two, before subsiding to well below its current level by 2020 or so. **Just what is the evidence for such an optimistic outlook?**



Sources: RichesFlores Research, FMI, Fitch, S&P, Moody's, CE

## A Closer Look at Projections

It isn't easy to figure out how these projections were arrived at. Since just a few of the underlying assumptions have been spelled out, uncovering them requires a fair amount of mental gymnastics. For example, it takes a good deal of detective work to surmise what values a particular credit rating agency used in its forecasting model to predict a fall in Italy's debt-to-GDP ratio to somewhere around 110 percent by 2020, given that the underlying assumptions are nowhere to be found. An educated guess by a seasoned economist might be that the agency based its medium-term forecast on economic data for the five years *preceding* the crisis (collected to track medium-term trends in the Italian economy). And sure enough, that is what we found.

Looking specifically at Italy, we have inferred that the assumptions underlying the sanguine projections are as follows:

- **Average real GDP growth of 1.3 percent a year from 2013 to 2020.** This happens to be the average for the period from 2003 to 2008, when the country achieved its highest growth rates by far in recent times. It also happens to be more than twice the average growth rate from 2000 to 2010.
- **"Normalized" price increases of roughly 2 percent a year.** This assumption is certainly consistent with the growth outlook in the projections, but has little relationship to recent GDP deflator figures (which measure the price level for all

new, domestically-produced final goods and services): 1.3 percent in 2011 and 1 percent in 2012.

- **Extreme fiscal stringency.** The projections assume that Italy will run a primary surplus (the fiscal surplus excluding interest payments) of between 4 and 5 percent each year from 2013 to 2020. As with the GDP deflator, we are nowhere near the 1-percent average recorded between 2008 and 2012.

Such assumptions naturally have a large hand in shaping estimates of future debt levels. Suppose you project nominal GDP growth of 3.5 percent a year. This rate would be too low to erode Italy's debt stock automatically, but it would be high enough to eliminate the negative impact of cyclical factors on the budget deficit, and thus make it much easier for the country to maintain a comfortable primary surplus—a prerequisite to deleveraging.

**So these projections hinge on one key assumption: Italy's economy will achieve structural growth thanks primarily to presumed beneficial effects of hypothetical future reforms.** The IMF, the only institution providing details on its model, has estimated that those reforms will lift Italy's potential output by 8.7 percent between 2013 and 2018. That's quite a bet, to say the least. For one thing, those reforms will probably take much longer than planned—even under the best circumstances. For another, with most eurozone countries expected to enact similar competitiveness-boosting policies, each individual economy can hope to make only limited gains in the process. And once you realize how hard it is to square the negative short-term impact of such structural reforms with the encouraging forecasts for 2013 and 2014, the whole demonstration starts to look frankly unconvincing.

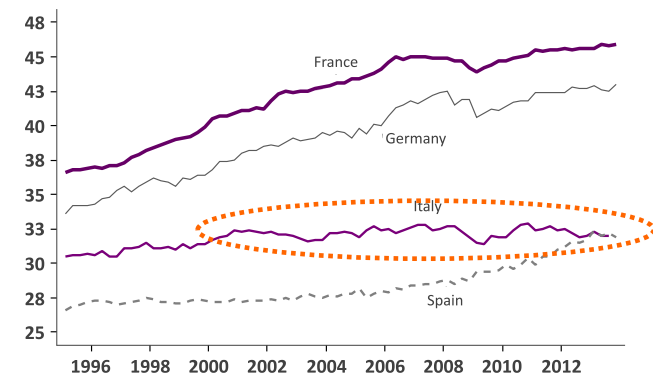
## From Mirage to Reality

Italy's economic decline began well before the financial crisis. A steady loss of competitive edge, compounded by structural rigidities and an aging population, goes a long way to explaining why the Italian economy has been underperforming its neighbors for quite some time. Consider the relatively large share of manufacturing in Italy's GDP (18 percent, versus 13 percent in France and 25 percent in Germany). This ought to be a significant advantage, but as the country now stands it turns out to be a major handicap, and for several reasons:

- Medium-value-added production accounts for a large proportion of Italian industry, leaving it highly exposed to competition from emerging Asia and Eastern Europe.
- Micro-enterprises and SME's predominate (generating nearly 70 percent of added value in Italy, versus 58 percent in France and 55 percent in Germany). Their ability to achieve the economies of scale and productivity gains required to stay in today's competitive race is necessarily limited.
- The economy offers little diversification and not much in the way of high-value-added services.
- The labor market suffers from inertia—upward inertia caused by the paucity of job-rich sectors and downward inertia due to the preponderance of micro-enterprises (45 percent of total employment).
- R&D spending shows chronic weakness. At no more than 1.25 percent of GDP, it stands one percentage point lower than in France and a stark 1.5 percentage points lower than in Germany.

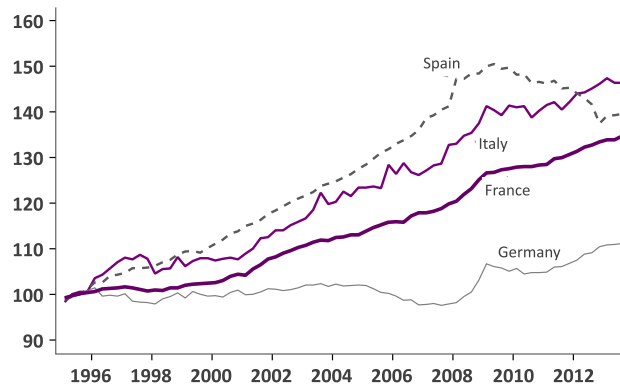
- Last but not least, Italy will eventually have to foot the bill for its rapidly aging population.

**Real Hourly Productivity, EUR/hour worked**



Sources: RichesFlores Research, Macrobond

**Nominal Unit Labour Cost, 1995=100**



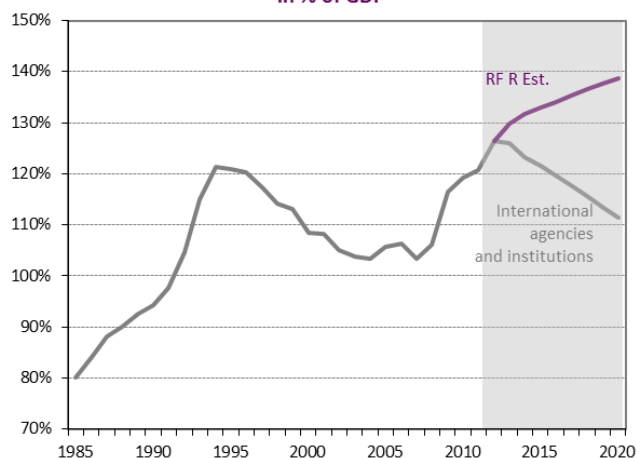
Sources: RichesFlores Research, Macrobond

All in all, not a very reassuring picture. Between 2010 and 2020, Italy's working-age population should shrink by a quarter of a point a year. So even if productivity increases by an average of three quarters of a point a year (which would require substantial productivity gains from 2013 onward to offset the declines in 2011 and 2012), **the Italian economy is unlikely to grow more than 0.5 percent a year.**

This changes the terms of the Italian debt equation considerably. Even if the apparent interest rate (the ratio of debt service to debt) holds steady at 4 percent, interest rates would still exceed nominal GDP growth by two percentage points and the cyclical component of Italy's budget would be lastingly in the red. This in turn would reduce Italy's ability to generate primary budget surpluses and force the country to devote a constantly increasing share of GDP to debt service.

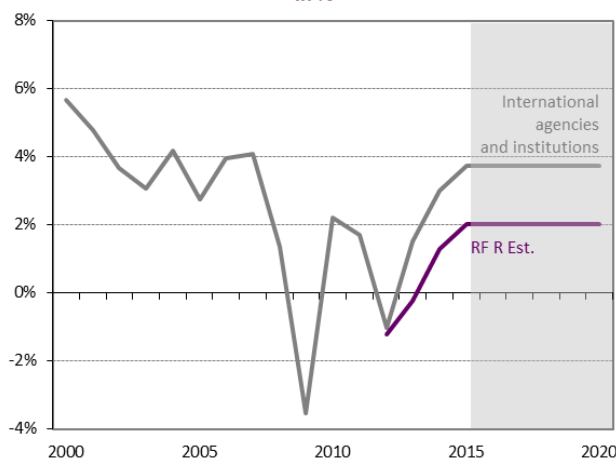
**As a result, Italy's national debt would continue to balloon throughout the period—from 126.5 percent of GDP in 2012 to somewhere around 140 percent by 2020.**

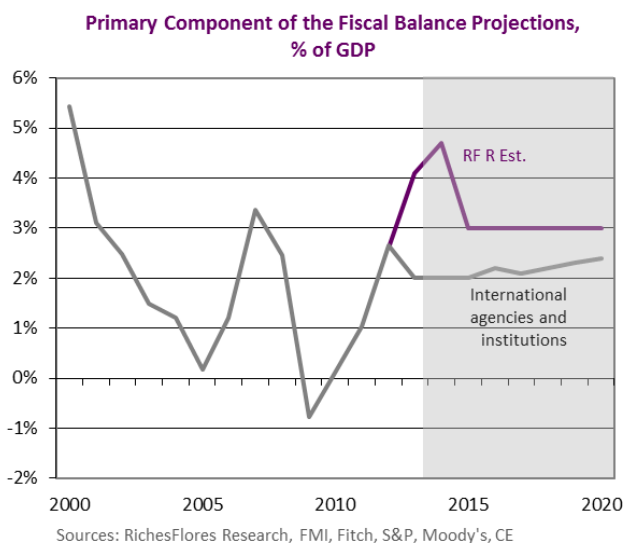
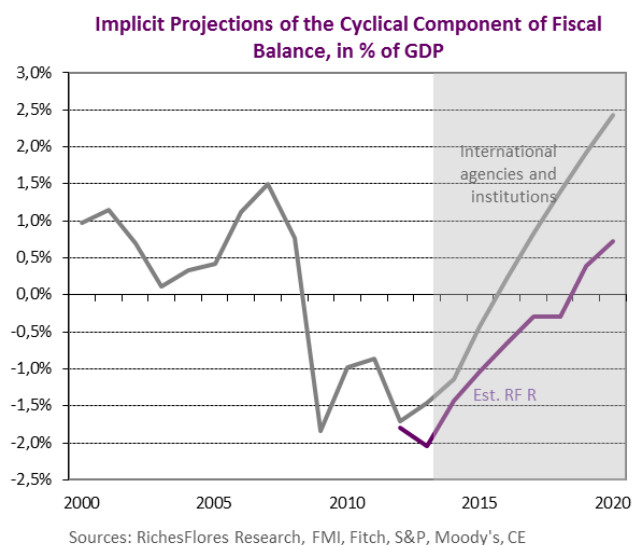
**Italian Public Debt Projections  
in % of GDP**



Sources: RichesFlores Research, FMI, Fitch, S&P, Moody's, CE

**Italian Nominal GDP Projections,  
in %**





## More Room to Breathe in Spain and France

With debt-to-GDP ratios some 25 to 30 percentage points lower than Italy's, both Spain and France are in much less dire straits, even if their economic growth were to remain anemic for a prolonged period.

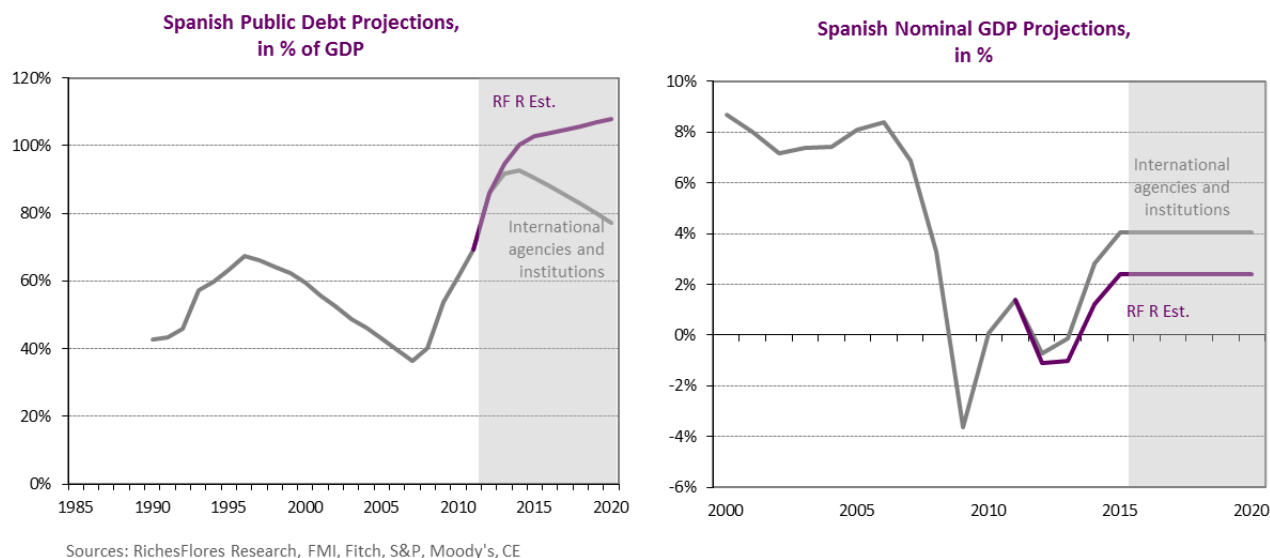
The following table, which gives our estimates of how much fiscal tightening would have been required in each country to stabilize national debt in 2012, highlights the extent to which a country's initial debt-to-GDP ratio affects its chances of deleveraging. Italy's primary surplus would have had to exceed 7 percentage points of GDP, whereas 4.7 percentage points would have sufficed in Spain, and just 1.8 percentage points in France.

### Primary surplus required in 2012 to stabilize national debt

| 2012   | Debt/GDP | Apparent interest rate<br>(debt service/debt) | Nominal GDP growth rate | Primary surplus (% of GDP) required to stabilize national debt |
|--------|----------|---|-------------------------|--|
| Italy  | 126.5    | 4.5   | -1.2                    | 7.2  |
| Spain  | 86       | 4.4   | -1.1                    | 4.7  |
| France | 90       | 3.0   | 1.0                     | 1.8  |

Sources: AMECO, RichesFlores Research estimates

In addition to having a lighter debt burden than Italy, Spain can probably also look forward to more vigorous long-term growth since it has regained competitive strength in the past few years. According to our forecast for Spain—0.7 percent average annual real GDP growth between 2013 and 2020—the trend in its debt-to-GDP ratio could reverse sharply as of 2015. **The country's public debt could stabilize at somewhere between 105 percent and 110 percent of GDP. This is still much higher than what the IMF and the rating agencies have projected, but a good deal lower than what we can expect in Italy.**

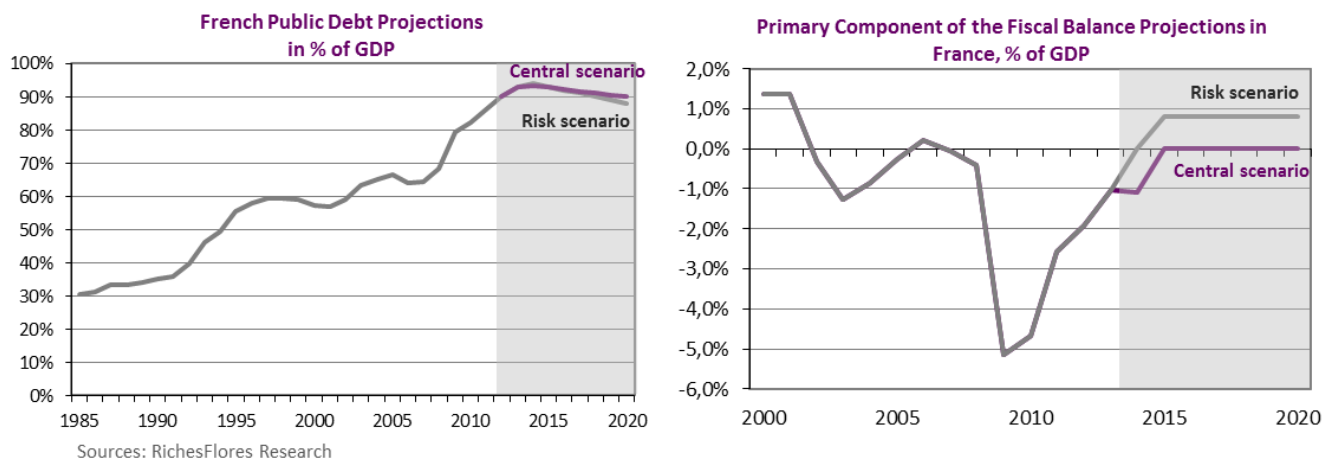


**And then there's France. Although the country's sovereign debt outlook has been a source of mounting concern of late, it bears little resemblance to its two Mediterranean neighbors:**

- First of all, France escaped recession in 2012 and its nominal output has therefore held up better than Spain's or Italy's. This should still be the case in 2013, even with the 0.5 percent decrease in real GDP we are forecasting.

- Second of all, while the country's growth potential has taken a beating, the damage has been much less extensive than in Italy or Spain. Not only is French productivity still the highest in the euro area—and rising—but France is also the EMU country the least affected by a shrinking working-age population.

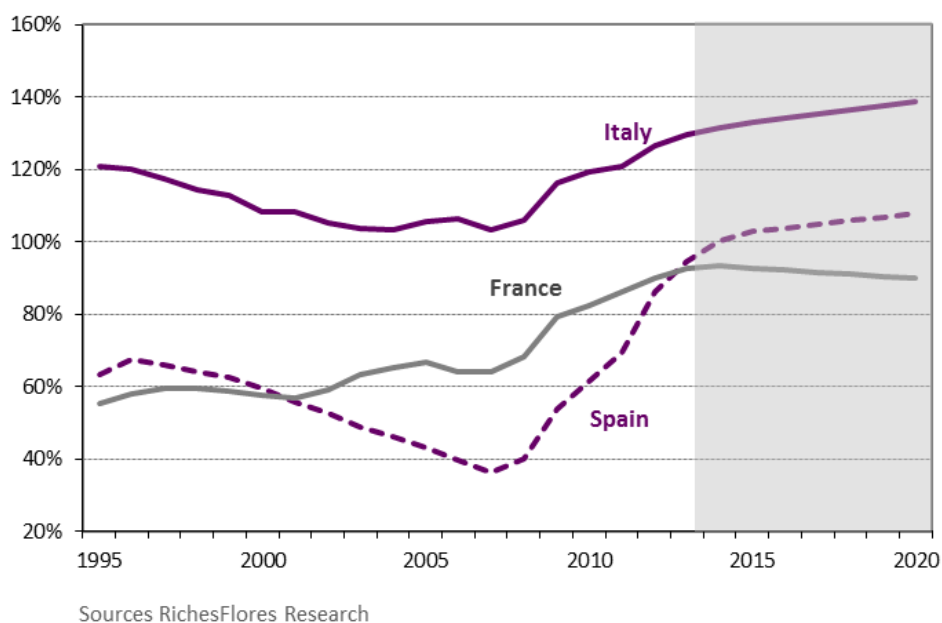
So with a fairly low apparent interest rate—say, 3 percent—the primary surplus France would need to run to stabilize its debt seems entirely attainable. **If we assume average real GDP growth of 1.2 percent a year between 2013 and 2020, with growth picking up to 1.5 percent a year starting in 2015, the country should be able as of 2015 to reduce its debt level just by maintaining a primary budget surplus.** Even under our worst-case scenario of persistently weak 0.8 percent-a-year growth over the same period, deleveraging would require a primary surplus of just 0.5 percent—likewise a readily attainable goal.



The foregoing analysis thus brings to light the issue of whether Italy's debt is at all sustainable—an issue that has apparently slipped below the markets' radar. This suggests that we're in for further bad news once today's widespread projections come up for revision. Which they probably will after the Italian elections, especially if—as is likely—the new government lacks the leeway needed to convince investors that it can and will do something about the country's huge debt overhang.

But in any case, our analysis raises a more critical medium-term question. How will the euro area manage once it becomes clear that its third largest economy is on the road to Japanese-style stagnation?

#### RF R Scenario: Public Debt Projections, in % of GDP



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