Written by **Bob Adelmann** on November 9, 2011

A Hard Look at Italy

Jan Randolph, head of sovereign debt risk at IHS Global Insight, said, "Italy will not be out of the heat of bond markets until a solid and stable government actually implements austerity and undertakes reforms with strong credible leadership." That may be asking the impossible.

When Prime Minister Silvio Berlusconi took office in 1994, his government was the country's 62nd in 64 years. His personal popularity was sufficient to quell concerns about corruption, personal sex scandals, and lack of any plan or intention to install measures that would have begun to rein in Italy's spending habits. It was easier to give way to the labor unions, controlling 40 percent of the labor force, and offer additional spending programs to buy the votes to keep him in power. Now that Berlusconi has agreed to step down, it is unclear who the new PM might be, much less whether he will provide Randolph's "strong credible leadership" needed to implement reforms and limit government spending.

Barclays Bank agrees with this assessment, as noted in a recent client newsletter: "We believe that policy reforms in Italy are necessary. However, historical experience suggests that the self-reinforcing negative market dynamics that now threaten Italy are very difficult to break. At this point, Italy may be beyond the point of no return."

Italy has a lot going for it. Its economy is the eighth largest in the world, and the third largest in the eurozone. Its major industries include chemicals, pharmaceuticals, motor vehicles (think Ferrari) and clothing (think Armani). On average the country enjoys a high standard of living (eighth highest in the world), reflecting its position as the seventh largest exporter in the world.

But the other side of the ledger is daunting to contemplate. Since it joined the European Union as a founding member in 1999, the annual growth rate of its economy has averaged less than one percent while its debt has climbed to nearly 130 percent of GDP. It continues to dig itself deeper into debt with spending exceeding revenues by more than $100 billion every year. It has few natural raw materials and consequently must import most of them, as well as the energy to drive the economy. In 2006, Italy imported nearly 90 percent of its total energy consumption. The country suffers from rampant government corruption, high levels of taxation, and government spending that takes nearly half of the economy's output. In October both Moody's and Standard & Poor's downgraded Italy's sovereign debt to just above junk status primarily due to "Italy's weakening growth prospects."

Those weakening growth prospects were underlined by the EU's composite purchasing managers' index, which fell sharply in October from September. This may have prompted the European Central Bank to cut interest rates last week, which caught many observers by surprise.

With its economy virtually flat-lined and interest rates rising, the government is at the point where servicing just the interest will shortly become impossible. And seeking additional help from the European Union, the European Central Bank, and the International Monetary Fund is now causing great dismay among banks which are finding it harder to borrow from each other in light of Italy's increasingly uncertain financial future. John O'Donnell, writing for Reuters, said that Italy's "rising borrowing costs … threaten to unleash a new and more dangerous phase of the euro zone debt crisis," calling it a "creeping credit freeze."

But Italy's problems don't end with its government debt issues. It's the total debt owed by the country, including personal debt (which has grown from 30 percent to 53 percent of GDP over the last decade) and corporate debt (which has increased from 96 percent to 128 percent of GDP over that same period), that pushes Italy's total debt to an astounding, and clearly unsustainable, 310 percent of GDP. If additional austerity measures are imposed by whoever takes Berlusconi's place, then those GDP numbers are likely to turn negative for the foreseeable future.

There is the "demographic" problem as well. With a birthrate that has been below replacement rate for decades, the United Nations estimates that Italy's population will shrink from its current 51 million to 41 million by 2050. And the life expectancy of those growing older and more dependent upon the welfare state continues to grow, putting additional strains on the government's welfare and pension programs. According to Cardinal Angelo Ragnasco, president of the Italian Bishops Conference, Italy is heading for "demographical suicide." As Pat Buchanan puts it,

> Italy is not only aging, with the median age of its population going from 43 today to 50 at midcentury, Italy is dying. If this does not change, what the world knows as Italy will not exist at the end of the century.

And then there's the decades-long and growing economic chasm between the northern provinces of Northwestern Italy, Northeastern Italy, and Central Italy, and those of the south: Southern Italy and Insular Italy. In 2008, the GDP of the northern provinces was more than 120 percent of the average of the European Union while the southern provinces averaged less than 70 percent. This disparity and growing disenchantment with austerity measures designed to help the southern provinces has grown into a push by the northern provinces to secede from Italy and form a new nation called Padania.

Taken altogether then, with Italy's economy stagnant, its population shrinking and growing older, its debt service growing ever larger, its government unwilling or unable to address its national debt to the point where the country is threatened with being split in two, Italy's problems appear to be sufficient not only to sink its economy into permanent depression but to risk the country's disappearance altogether.