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Italian debt is sustainable

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Image credit: REUTERS/Manuel Silvestri

As European leaders debate issues surrounding a massive financial rescue of Italy, let me make a strong statement. Even with Italy's fiscal response to coronavirus, Italian debt is sustainable. The European Stability Mechanism (ESM), established in the wake of the last European debt crisis a decade ago, should come to this conclusion. Germany should accept it, Italy should be willing to enter a program, and the European Central Bank (ECB) should be willing to use its Outright Monetary Transactions (OMT) bond-purchasing vehicle, while interim measures are taken until OMT is ready to be used.

Because I am a two-handed economist, let me hedge (just) a bit. Italian debt is sustainable unless the world economic crisis turns out to be even worse than we currently expect, in which case, sustainability may become an issue, not just for Italy but for nearly all countries.

Back to sustainability: Before the start of the crisis, Italian net debt was equal to 120 percent of GDP. Yet, the yield on 10-year Italian government bonds was less than 1 percent. Thus, as of then, markets clearly did not worry about either credit or redenomination risk.

And indeed, given expected growth rates, and assuming that the Italian government could continue to borrow at those low rates, all the Italian government had to do to stabilize the debt-to-GDP ratio was to run a primary deficit of no more than 2 percent of GDP. Most observers believed that this was both economically and politically feasible.

Suppose that the measures taken by the Italian government, and the decrease in output in 2020, imply a 20 percent increase in the debt ratio (at this stage, a very likely overestimate of what is expected to happen). Then, maintaining the new higher debt ratio would imply an increase in the primary balance of 0.2 percent of GDP. It is hard to believe that this is infeasible.

This argument raises two issues.

What if safe rates—i.e., rates on the safest securities—become much higher in the future? This is where "secular stagnation" and the underlying low safe rates provide a silver lining. All the evidence before the crisis was that rates were going to stay low for a long time. And, if anything, this is even more likely to be true after the crisis. Precautionary saving is likely to be high, and investment is likely to suffer from lingering uncertainty.

What if investors disagree with the analysis above and ask for higher rates on Italian bonds (the way they have in the last few days). Then, we know, this could be self-fulfilling. Italian debt may indeed become unsustainable. But this can be avoided. As I argued in an earlier Twitter thread, the ECB can and should intervene. To do so, it needs the consent of euro area members; it would be criminal for them not to give it.

Bottom line: Italian debt is sustainable. But the ECB and the eurozone have to put their money where my mouth is.

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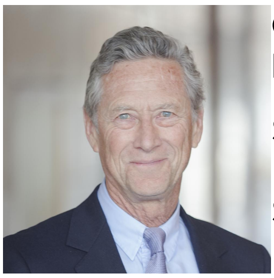

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