Italian Debt Observer

Independent Analysis of Italian Economic Data

Italy 2011: A Year of Sufferance

MAZZIERO RESEARCH

Contents

Authors

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Abstract:
This study examines the quarterly evolution of Italy's sovereign debt, its stock of government bonds, official reserves, GDP and balance of trade, inflation and unemployment.

Introduction

In the last quarter of 2011, the fourth Berlusconi government passed the baton to the first Monti government. The change made to Italy's leadership was effected in record time, encouraged by the President, Giorgio Napolitano, who probably could not ignore the concerns of the European Union, as well as those from further afield.

The markets have shown a serious lack of confidence in Italy's financial strength, with interest rates between November and December coming close to 7.4% for 10-year BTPs and 9% for CCTs, with a spread against the German Bund of more than 5.5% and a CDS (Credit Default Swap) premium close to 6% for five years.

It was a frantic quarter, and one which led us to the edge, or possibly beyond, of the abyss, forcing Monti to impose sharp corrective measures through the Save Italy and Grow Italy decrees.

Whether these manoeuvres, with their accompanying enormous sacrifices, can set Italy back on track is the subject of conflicting opinions; in any case, it is not the scope of this analysis to give what might seem to be political assessments. Nevertheless, this series of analyses aims constantly to keep the spotlight on the progress achieved by Italy's economy, where possible by comparison with other countries, in order to catch early signs of improvement, or, if necessary, to indicate the persistence of critical conditions.

This issue of The Italian Debt Observer is enhanced by three new contributors: Leonardo Baggiani, Silvano Fait and Andrew Lawford, who with their comments will enable us to go into detail on specific topics, giving life to a new "in depth" section. Leonardo Baggiani and Silvano Fait are Austrian School economists and are the authors of the site IdeasHaveConsequences.org, which offers a wealth of interesting content. Andrew Lawford is a financial analyst of great skill who is dedicated to painstaking research; the daily exchange of opinions with him is for me a source of great professional enrichment. I thank the three of them for their contributions to this analysis. Any inaccuracies that should be found herein can be attributed entirely to myself.

For those readers unfamiliar with Italian debt, economic or political terms, definitions of text appearing in blue can be found in the glossary on page 33.

Maurizio Mazziero

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Ratings

The fourth quarter of 2011 brought a further round of rating cuts by the principal rating agencies, most notably with Spain being cut to A- by Standard & Poor's on 14th October.

13th January, 2012 reserved another barrage of downgrades by Standard & Poor's, this time directed at some nine European countries. The most dramatic change, although widely anticipated, was the loss of triple A ratings for both France and Austria, while Italy was taken down two pegs, moving from A to BBB+, level with Ireland. The negative outlook on the country was maintained. A two-peg cut was reserved for both Spain and Portugal, with the former cut to A and the latter to BB+, with the consequent loss of Investment Grade status. As a result of the loss of triple A ratings by two out of the six AAA rated eurozone countries, Standard & Poor's also lowered the credit rating of the EFSF (European Financial Stability Facility) on 16th January, reflecting a decreased ability to finance itself at contained interest rate levels.

No changes were recorded for Greece, which remains at CC (very high probability of default) during the period under consideration.

Italy was taken down two pegs, moving from A to BBB+.

Standard & Poor's also lowered the credit rating of the EFSF (European Financial Stability Facility) on 16th January.

S&P Rating	Probability of Default	Countries			
AAA	Almost null	Switzerland	Germany	Holland	UK
AA+	Very low	USA	France	Austria	
AA		Belgium			
AA-		China	Japan		
A+	Low				
A		Spain			
A-					
BBB+	Relatively Low	Italy	Ireland		
BBB					
BBB-					
BB+	Medium	Portugal			
BB					
BB-					
B+	Medium-High				
B					
B-					
CCC+	High				
CCC					
CCC-					
CC	Very High	Greece			
C	Extremely High				
D	Certain				

Table 1: Comparison of ratings of principal countries, according to Standard & Poor's (Source: Standard & Poor's)

Countries	Standard & Poor's		Fitch		Moody's	
Austria	**AA+**	*Negative*	**AAA**	*Stable*	**Aaa**	*Negative*
Belgium	**AA**	*Negative*	**AA**	*Negative*	**Aa3**	*Negative*
Cyprus	**BB+**	*Negative*	**BBB-**	*Negative*	**Baa3**	*Negative*
Denmark	**AAA**	*Stable*	**AAA**	*Stable*	**Aaa**	*Stable*
Estonia	**AA-**	*Negative*	**A+**	*Stable*	**A1**	*Stable*
Finland	**AAA**	*Negative*	**AAA**	*Stable*	**Aaa**	*Stable*
France	**AA+**	*Negative*	**AAA**	*Negative*	**Aaa**	*Negative*
Germany	**AAA**	*Stable*	**AAA**	*Stable*	**Aaa**	*Stable*
Greece	**CC**	*Negative*	**CCC**	*NA*	**Ca**	*Negative*
Ireland	**BBB+**	*Negative*	**BBB+**	*Negative*	**Ba1**	*Negative*
Italy	**BBB+**	*Negative*	**A-**	*Negative*	**A3**	*Negative*
Luxembourg	**AAA**	*Negative*	**AAA**	*Stable*	**Aaa**	*Stable*
Malta	**A-**	*Negative*	**A+**	*Stable*	**A3**	*Negative*
Norway	**AAA**	*Stable*	**AAA**	*Stable*	**Aaa**	*Stable*
Holland	**AAA**	*Negative*	**AAA**	*Stable*	**Aaa**	*Stable*
Portugal	**BB**	*Negative*	**BB+**	*Negative*	**Ba3**	*Negative*
UK	**AAA**	*Stable*	**AAA**	*Stable*	**Aaa**	*Negative*
Slovakia	**A**	*Stable*	**A**	*Stable*	**A2**	*Stable*
Slovenia	**A+**	*Negative*	**AA-**	*Negative*	**A2**	*Negative*
Spain	**A**	*Negative*	**A**	*Negative*	**A3**	*Negative*
USA	**AA+**	*Negative*	**AAA**	*Negative*	**Aaa**	*Negative*
Sweeden	**AAA**	*Stable*	**AAA**	*Stable*	**Aaa**	*Stable*

Table 2: Ratings of principal countries, according to Standard & Poor's, Fitch e Moody's (Sources: Standard & Poor's, Fitch and Moody's)

S&P	Fitch	Moody's
AAA	AAA	Aaa
AA+	AA+	Aa1
AA	AA	Aa2
AA-	AA-	Aa3
A+	A+	A1
A	A	A2
A-	A-	A3
BBB+	BBB+	Baa1
BBB	BBB	Baa2
BBB-	BBB-	Baa3
BB+	BB+	Ba1
BB	BB	Ba2
BB-	BB-	Ba3
B+	B+	B1
B	B	B2
B-	B-	B3
CCC+	CCC+	Caa1
CCC	CCC	Caa2
CCC-	CCC-	Caa3
CC	CC	Ca
C	C	C
D	D	

Table 3: Equivalence of ratings between Standard & Poor's, Fitch and Moody's

As always, the comments accompanying this revision of the ratings were particularly harsh, confirming that both the EU and its individual members do not realise, or even completely deny, the precariousness of public finances and the alarming deterioration of the securities held by the ECB. The central bank has now abandoned the path of stability and rigour and could almost be considered to be a Bad Bank with a portfolio loaded with dangerous assets.

The central bank has now abandoned the path of stability and rigour.

Table 1 shows the ratings of the principal countries given by Standard & Poor's, the agency which, excluding the Chinese agency Dagong, appears to be the most severe.

The beginning of 2012 has seen considerable activity also from Fitch, which lowered the ratings of the following European countries on 27th January: Belgium, Cyprus, Ireland, Slovenia, Spain and Italy (downgraded from A + to A-). For all these countries the outlook is negative, which means a probability of greater than 50% of a further downgrade within two years.

Fitch has downgraded Italy from A+ to A-.

On 13th February, Moody's also changed the ratings and outlook for several European countries: Italy was downgraded from A2 to A3, Spain from A1 to A3 and Portugal from Ba2 to Ba3, while the outlook for Austria, France and the United Kingdom has been changed to negative, even though their Aaa ratings were maintained. The European Financial Stability Facility (EFSF) rating has been left unchanged at Aaa for the time being.

Moody's has downgraded Italy from A2 ad A3.

Table 2 shows the rating for most European Union countries given by the three main agencies: Standard & Poor's, Fitch and Moody's, together with their outlooks.

Table 3 shows the correspondence between the levels used by the three agencies.

Public Debt

After having passed the threshold of 1.9 trillion euros, 2011 ended with public debt of 1.898 trillion, showing an increase for the full year of nearly 55 billion. This should be considered too large, especially in the light of the repeated "stabilisation" manoeuvres implemented by both the Berlusconi and Monti governments, but in any case it shows a reduction when compared with the 82 billion euro increase registered in 2010. The debt per capita has reached the sum of 31,190 euros, on the basis of Istat estimated residents in late 2011 of 60.581 million units, of which 4.859 million are foreigners.

2011 ended with public debt of 1.898 trillion, showing an increase for the full year of nearly 55 billion.

(€ Million)	2010		2011	
	Public Debt	Change	Public Debt	Change
January	1,788,196	26,967	1,880,007	36,780
February	1,795,132	6,936	1,876,128	-3,879
March	1,797,808	2,676	1,868,283	-7,845
April	1,812,864	15,056	1,890,566	22,283
May	1,827,181	14,317	1,897,522	6,956
June	1,822,050	-5,131	1,901,874	4,352
July	1,838,296	16,246	1,911,807	9,933
August	1,843,006	4,710	1,899,553	-12,254
September	1,844,817	1,811	1,883,749	-15,804
October	1,867,398	22,581	1,909,072	25,334
November	1,869,924	2,526	1,904,859	-4,213
December	1,843,227	-26,697	1,897,946	-6,913
Increase		**81,998**		**54,730**

Table 4: Monthly variation of public debt from 2010 to 2011
(Source: Bank of Italy)

At the time of writing of this Research Paper (mid-February 2012), the level of debt is probably slightly higher: the current projection, effected by the Istituto Bruno Leoni, is more than 1.91 trillion euros.

Table 4 shows the evolution of public debt during the twelve months of 2011 in comparison with the previous year: the numbers in black represent an increase while those in red with a minus sign indicate a decrease in debt. The positive aspect is that in 2011, six months show an increase in debt and the other six show a surplus; the previous year registered only two months of decreased debt. The negative aspect is the presence of certain months, such as January, April and October, in which notable imbalances are evident, creating a sudden worsening of the debt position.

Table 5 summarizes the progression of the debt position since the year 2000; its increase since the beginning of the last decade has now reached a figure close to 600 billion euros, up 45.96%. It is concerning that the accumulation of this debt appears to be chronically independent of the political philosophy of those in government. The increase for the full year 2011 was equal to 2.97%, down compared to the 2008-2010 period, which was over 4%, but still too high considering the size of the overall debt position.

Public debt has increased by 600 billion euros from 2000 to present day.

In percentage terms, public debt increased by 2.97% in 2011.

(€ Million)	Public Debt	Change	% Change
Year 2000	1,300,341		
Year 2001	1,358,333	57,993	4.46%
Year 2002	1,368,512	10,179	0.75%
Year 2003	1,393,495	24,984	1.83%
Year 2004	1,444,604	51,108	3.67%
Year 2005	1,512,779	68,176	4.72%
Year 2006	1,582,009	69,230	4.58%
Year 2007	1,598,971	16,963	1.07%
Year 2008	1,663,452	64,481	4.03%
Year 2009	1,761,229	97,777	5.88%
Year 2010	1,843,227	81,998	4.66%
Year 2011	1,897,946	54,719	2.97%
Increase		597,605	45.96%

Table 5: Annual variation of public debt from 2000 al 2011 (Source: Bank of Italy)

To give an idea of the huge amount of Italian public debt, it is as if 2.6 million euros of debt had been accumulated every day since the birth of Christ, or 34.5 million euros of debt for every day since the birth the Italian State on 17th March, 1861.
These numbers show a stark reality: there is no possibility to pay down such an sum in a reasonable amount of time (a quarter of a century?), unless elevated levels of inflation are provoked in order to dilute the debt, or, even worse, the debt is repudiated to Italy's domestic and foreign creditors.
To this point, one must add the disturbing shape of the Italian demographic pyramid, as shown in *Figure 1*: it is to be observed that the generation born during the economic boom of the 1960s is approaching the end of its working life. Meanwhile, the generation taking its place is somewhat limited in number, albeit with a modest reinforcement by those foreigners born in Italy (*stranieri nati in Italia*). This demographic situation represents the explosive social situation in Italy.
According to a study by Eutekne, 43.5% of the public debt was formed during the First Republic, until the inauguration of the first Amato government in 1992; the rest (56.5%) is the product of the Second Republic. Another interesting fact is that, of the 11 governments formed during the Second Republic (including the Monti government), 5 were considered "technical" (i.e. put in place not by elections, but to deal with some urgent situation). This fact is an indictment of the ability of our politicians to govern, or perhaps it reflects their propensity to squander resources, distributing unsustainable benefits until someone else must be called in when the time comes for belt-tightening.

2.6 million euros of debt per day has been accumulated since the birth of Christ.

34.5 million euros of debt per day since the birth of the Italian State.

56.5% of the public debt is the product of the Second Republic.

During the Second Republic, 5 out of 11 governments were "technical".

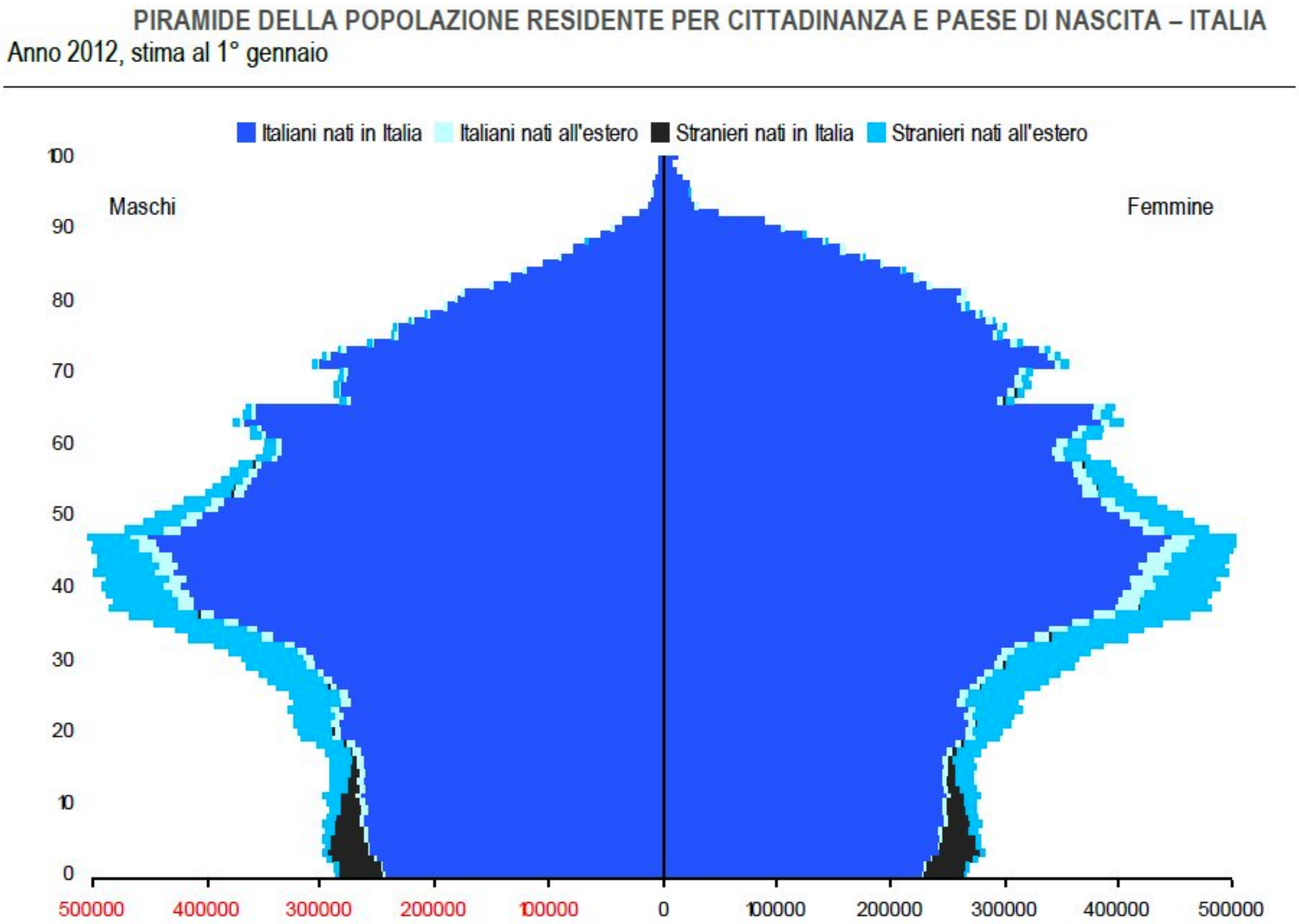

Figure 1: Italian demographic pyramid; estimate as at 1st January 2012 (Source: Istat)

In this context, it is interesting to note the data released by CGIA Mestre on 28th November last year: in the last 12 years, Italy has been subject to 20 stabilisation manoeuvres for a total of 575.5 billion euros (see bibliography for details of the press release).

If we add to this figure the 600 billion euro increase in public debt (from 1.3 to 1.9 trillion), it is clear that political policy has caused a total damage to Italian citizens of almost 1.2 trillion euros in 12 years: an average of 100 billion per annum.

This data only goes to reinforce the evidence of irresponsibility in overall policy as well as the lack of attention towards the interests of the electorate.

Against the background of such a huge level of state debt, the average wealth of Italian households in 2010 stood at 163,875 euros per family, even though as many 27.7% of households find themselves in debt.

Italy has been subject to 20 stabilisation manoeuvres for a total of 575.5 billion euros.

As many 27.7% of households find themselves in debt.

OECD, Press Release, 5th December 2011

OECD Secretary-General Angel Gurría has welcomed the measures adopted by the Italian government to address fiscal sustainability while boosting growth and equity. He said the proposed reforms to the pension system go in the right direction of raising the retirement age while introducing flexibility at the end of a person's career. Such measures should ensure the target of a balanced budget by 2013 is met.

Chamber of Deputies, Fact-finding with regard to the decree law containing urgent measures for growth, equity and the consolidation of the public finances – Testimony of the Governor of the Bank of Italy, Ignazio Visco, 9th December 2011

The decree law reduces net borrowing by €20.2 billion in 2012, €21.3 billion in 2013 and €21.4 billion in 2014. In relation to GDP, the adjustment is equal to 1.3 percentage points in each year. The measures are in addition to those approved during the summer and those introduced by the 2012 Stability Law, which provided for a reduction in the budget deficit of €28.6 billion in 2012, €54.4 billion in 2013 and €59.9 billion in 2014. In total, the measures should reduce net borrowing by about 3 percentage points of GDP in 2012 and by more than 4.5 points on average in the two years 2013-14. […]
The sharp deterioration in growth prospects in recent months and the drastic worsening of state funding conditions mean that last summer's corrective measures, although important, are now insufficient to respect the commitment made at European level to achieve a balanced budget in 2013. There was a further increase in the spread between Italian and German 10-year bonds which, in the second week of November, peaked at 575 basis points. Additional measures were therefore urgently needed to consolidate the budget and even more resolute action to address the structural problems of Italy's economy.

OECD, Press Release, 6th February 2012

Italy has embarked on an ambitious, much needed reform programme to strengthen its public finances, to restore growth and to improve the competitiveness of the Italian economy.
The reform programme is well designed and comprehensive. It recognises the need to advance on several fronts to achieve the ultimate goal of enhancing the performance of the economy and the wellbeing of all Italians. […]
OECD analysis shows that this package of structural reforms has enormous potential to boost growth and competitiveness. […]
Broad-based reforms to open up markets and to ensure open and fair competition could increase the overall productivity of the Italian economy by nearly 8% in the 10 years following implementation of the reforms. Nearly one-half of this increase could come from the liberalisation of professional services alone. Other countries have also benefited from such reforms. In Sweden, for example, opening traditional monopolies to greater competition, strengthening the competition law, reforming regulations governing the taxis, civil aviation, telecommunications, rail, postal services and electricity sectors added almost 0.5% to annual productivity growth between 1988 and 2007. […]
The government is also rightly putting the fight against labour market duality and precariousness at the centre of the reform agenda. […] For example, our analysis shows that a comprehensive reform in this area could boost productivity and jobs. It could also create opportunities for those groups, such as youth, women and immigrants, who are most vulnerable and at greatest risk of being trapped in precarious jobs. […]
On the tax front, the government is taking courageous and important measures. It is strengthening the income tax and the VAT to make the overall tax system fairer and more conducive to entrepreneurship and growth. It is also tackling aggressive tax planning and evasion. We already had identified the need for action in this area, including in our previous Economic Surveys of Italy. […]
The reforms you are implementing are good for Italy and they are also good for Europe. Unlocking opportunities for growth and restoring competitiveness are essential for addressing the European crisis in a durable manner.
The OECD stands ready to continue to work with Italy to promote better policies for better lives.

(€ Million)	2010			2011		
	Revenue	Expenses	Diff.	Revenue	Expenses	Diff.
January	29,551	22,122	7,429	32,068	22,996	9,072
February	26,478	33,501	-7,023	27,028	30,944	-3,916
March	31,332	47,162	-15,830	31,072	49,217	-18,145
April	26,237	37,721	-11,484	28,729	29,328	-599
May	31,689	42,073	-10,384	34,474	34,722	-248
June	43,556	31,860	11,696	38,613	62,066	-23,453
July	39,096	45,482	-6,386	39,361	38,361	1,000
August	35,290	35,075	215	37,200	29,128	8,072
September	25,364	34,433	-9,069	25,449	23,471	1,978
October	29,850	36,270	-6,420	30,933	31,065	-132
November	35,728	44,738	-9,010	32,083	51,614	-19,531
December	75,432	77,190	-1,758	80,859	99,050	-18,191
Total	**429,603**	**487,627**	**-58,024**	**437,869**	**501,962**	**-64,093**

Table 6: Government revenue and expenses – 2010/2011
(Source: Bank of Italy)

This wealth, which represents the famous "chicken of Trilussa", constitutes a certain temptation for bad-thinking economists who have suggested a number of times that it could be used to fill the empty state coffers. This would be, in our humble opinion, an appalling idea, and we hope that desperation never leads to it materialising.
The data on the average wealth of Italian households will be monitored regularly in these pages in order to reveal its underlying trends.

In *Table 6*, one can observe the progression of state revenue and expenditures in 2011; the figures in red represent a deficit (i.e. expenses exceeding revenue), while those in black indicate a surplus. As can be seen, the majority of months were spent in deficit and with much larger amounts than the months in surplus. From this point of view, the public finances have worsened when compared with 2010, with substantial deficits in at least four months out of 12. The final result was a growth in revenue of 8 billion euros compared with the previous year, accompanied by an increase in spending of 14 billion euros, still a huge imbalance in public accounts that now show annual expenses in excess of 500 billion euros.
One must add that according to government financial statistics published by the Bank of Italy on 17th October, government revenues amount to 46% of GDP, while expenditures are 50.6% of GDP. This is a further sign of an incipient imbalance in an elephantine state apparatus which is financed by a tax burden equal to 42.6% of GDP.

A huge imbalance in the public accounts shows annual expenses in excess of 500 billion euros.

Government revenues amount to 46% of GDP, while expenditures are 50.6% of GDP.

The tax burden is equal to 42.6% of GDP.

The Stock of Government Debt

Table 7 shows the trend of the stock of government bonds from 2006 to 2011. The increase was approximately 330 billion euros over six years, 50 billion of which was added in 2011 alone, bringing the total to almost 1.625 trillion in January. As can be seen, the growth is well correlated with the increase in public debt as the needs of the public administration are financed by issuing new debt. These aspects are evident also in the graph at *Figure 2*.

The average interest rates, which between November and December had been close to 7.4% for the 10-year BTP and 9% for CCTs (see *Figure 3*), were significantly reduced in January 2012. This aspect is extremely important for debt sustainability because, as stated by Governor Visco of the Bank of Italy on 30th August, an upward shift of the yield curve of 100 basis points (1%) would result in an increase in interest costs of approximately 0.2 percentage points of GDP in the first year and 0.4 and 0.5 points respectively in the second and third years.

In such a difficult period, it would appear normal that the average debt maturity reached 6.81 years in January, a further reduction from the figure of 6.99 years registered in December 2011 (see *Figure 4*).

Government bonds on issue reached 1.625 trillion in January.

An upward shift of the yield curve of 100 basis points (1%) would result in an increase in interest costs of approximately 0.2 percentage points of GDP.

Average debt maturity decreased to 6.81 years.

(€ Million)	Debt on issue	Av. maturity	Interest expense	Av.Interest %
Year 2006	1,256,946	6.77	68,578	5.46%
Year 2007	1,288,578	6.85	77,126	5.99%
Year 2008	1,356,207	6.82	81,161	5.98%
Year 2009	1,446,133	7.07	71,288	4.93%
Year 2010	1,526,334	7.20	65,952	4.32%
Year 2011	1,586,741	6.99	(Nov. 2011) 67,931	NA
Jan 2012	1,624,583	6.81	NA	NA

Table 7: Government bonds and interest expense from 2006 to 2011 (Source: Treasury Department of Finance Ministry)

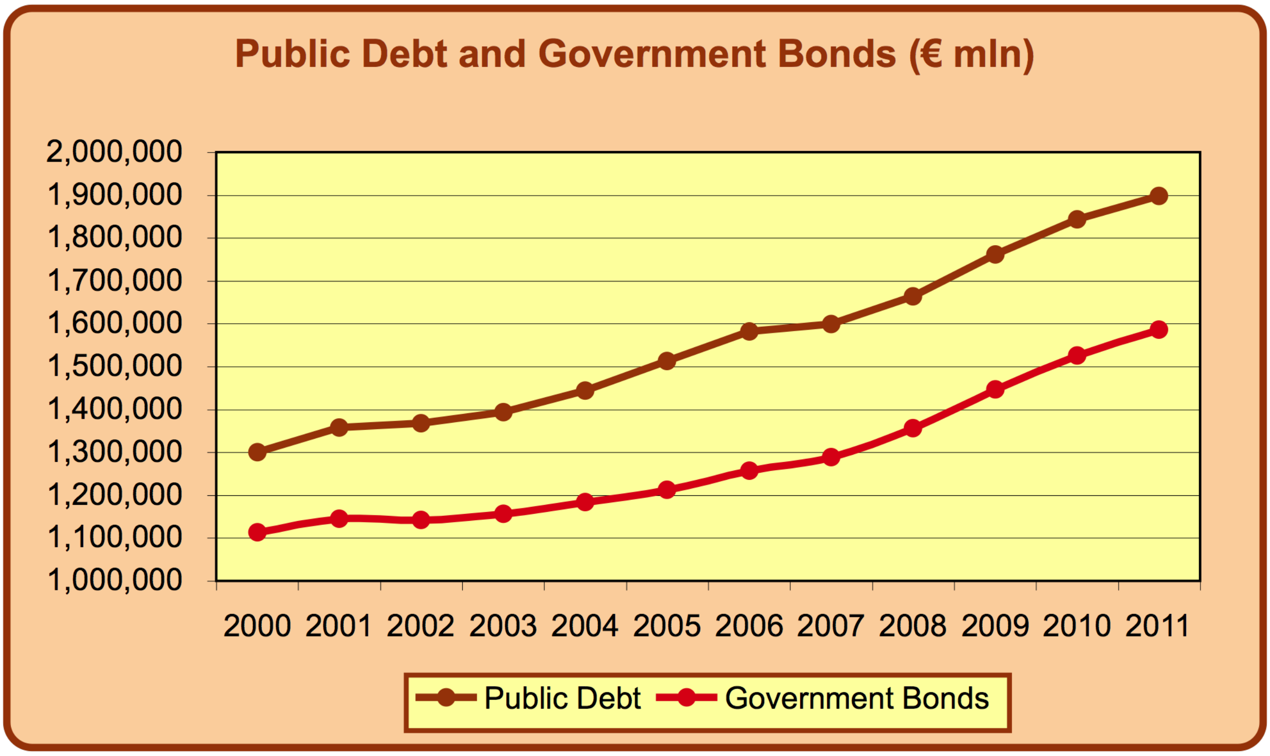

Figure 2: Public Debt and Government Bonds from 2000 to 2011
(Source: Bank of Italy and Treasury Department of Finance Ministry)

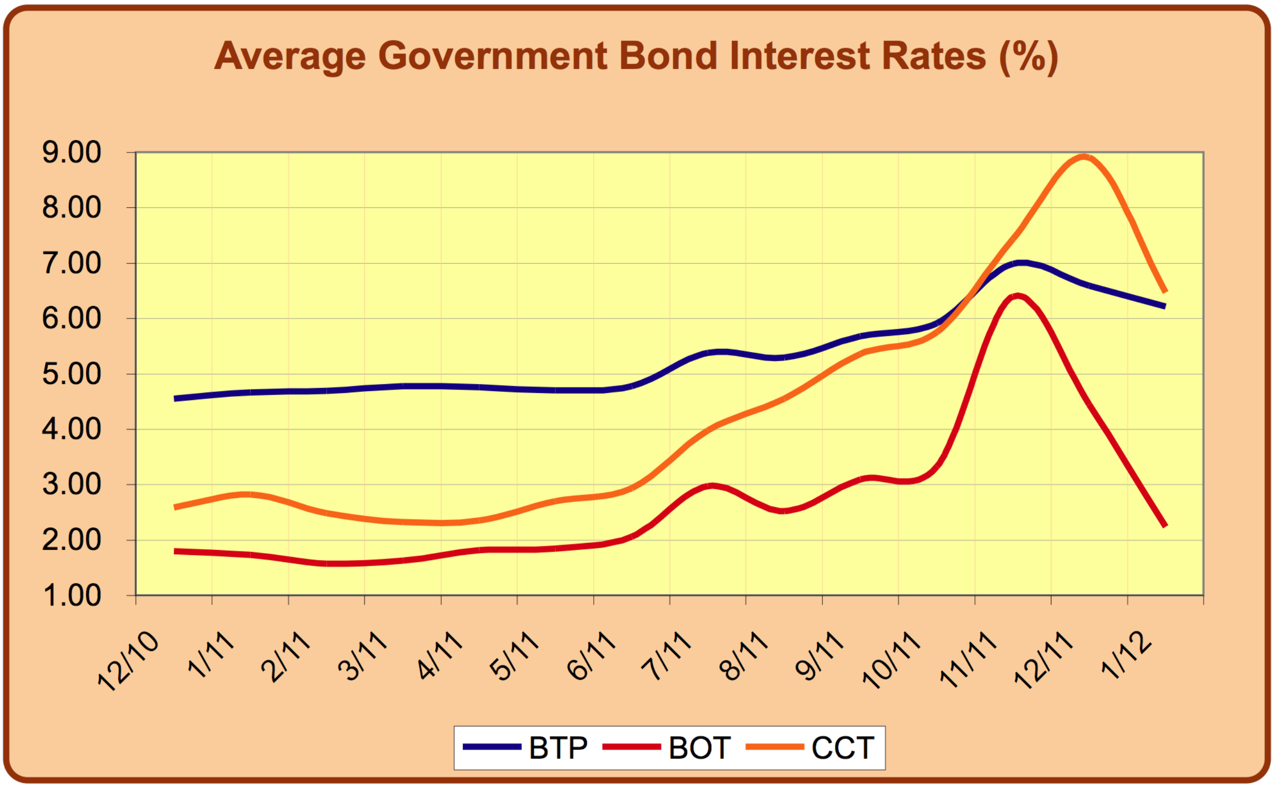

Figure 3: Average government bond interest rates from Dec. 2010 to Jan. 2012
(Source: Bank of Italy)

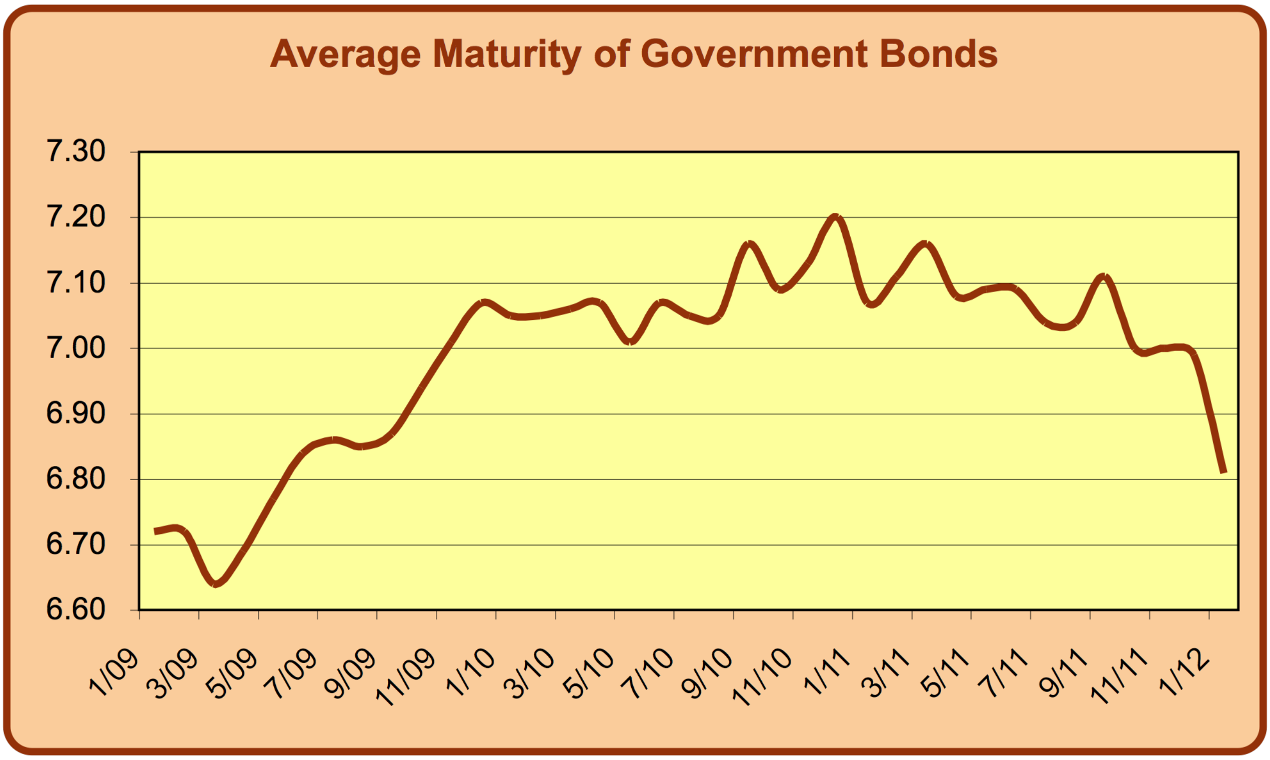

Figure 4: Average maturity of government bonds from 2009 to Jan. 2012
(Source: Treasury Department of Finance Ministry)

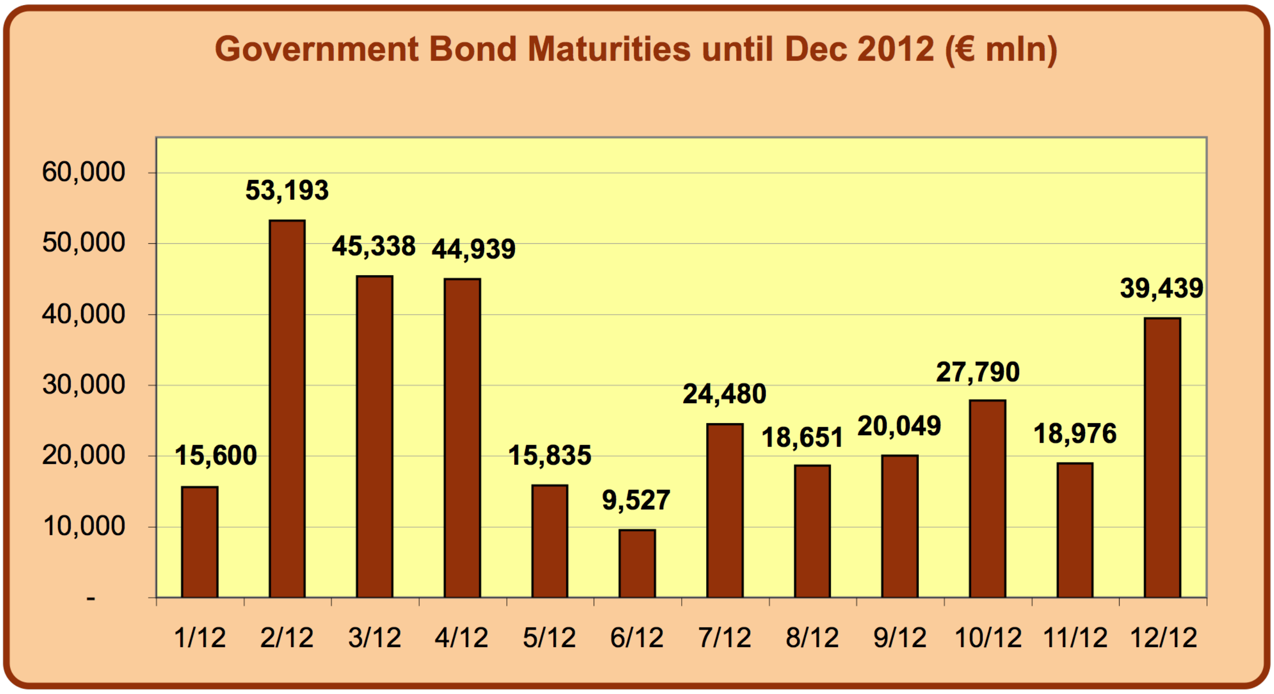

Figure 5: Government bond maturities until December 2012
(Source: Treasury Department of Finance Ministry)

It follows, therefore, that during a hearing in the Chamber of Deputies conducted on 17th January, the Director General of the Treasury, Maria Cannata, stated that particularly in the early months of the year there will be increased issuance of shorter-term Treasury bills and securities with maturities up to three years, with a return to a more uniform distribution of issuance along the yield curve in the second half of the year.

It should be evident that the activity of bond issuance is carefully managed in Italy, having reached the high levels of sophistication without which it would be impossible to sell such an enormous quantity of bonds each year.

It should be evident that the activity of bond issuance is carefully managed in Italy.

In this regard, *Figure 5* shows the maturity schedule up to the end of 2012. February, March and April are months in which about 145 billion euros of bonds must be rolled over, and the second half of the year may also become critical as the short-term bills currently being issued begin to mature.
At the same time, the extraordinary measures launched by the ECB to provide liquidity, especially to eurozone banks, have brought them back as buyers of government bonds (please see the In Depth section below).

February, March and April are months in which about 145 billion euros of bonds must be rolled over.

Figure 6 shows the variation of the composition of the stock of government securities from March 2010 to December 2011; the differences from the previous quarter are a declining share of Treasury Bills (BOT - red) and an increase in longer-term bonds (BTP - blue). The variation in the subdivision of interest rates, shown in *Figure 7*, indicates an increase in fixed rates over the last quarter. These now exceed 70% of the entire stock, a fact that is probably unfavourable, given that the increase in weight for fixed rate debt seems to have taken place during a period of higher average interest rates (see *Figure 3*).

There has been an increase in fixed rates, which now exceed 70% of the total.

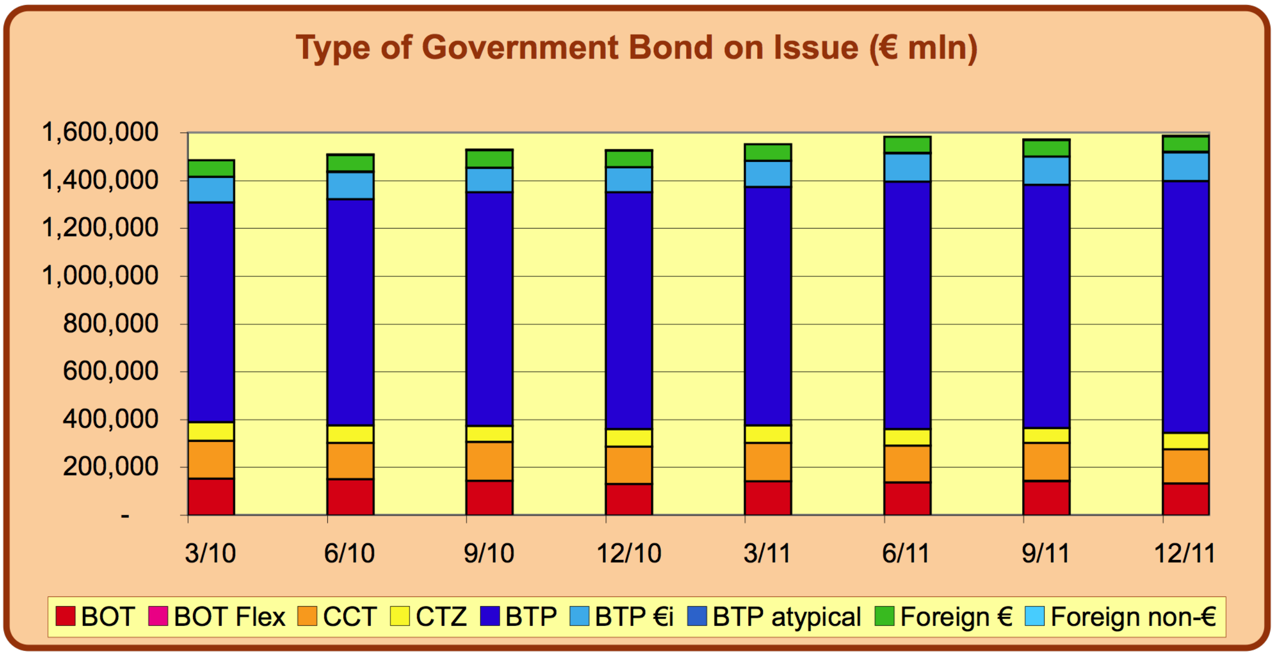

Figure 6: Type of government bond on issue from March 2010 to Dec. 2011
(Source: Treasury Department of Finance Ministry)

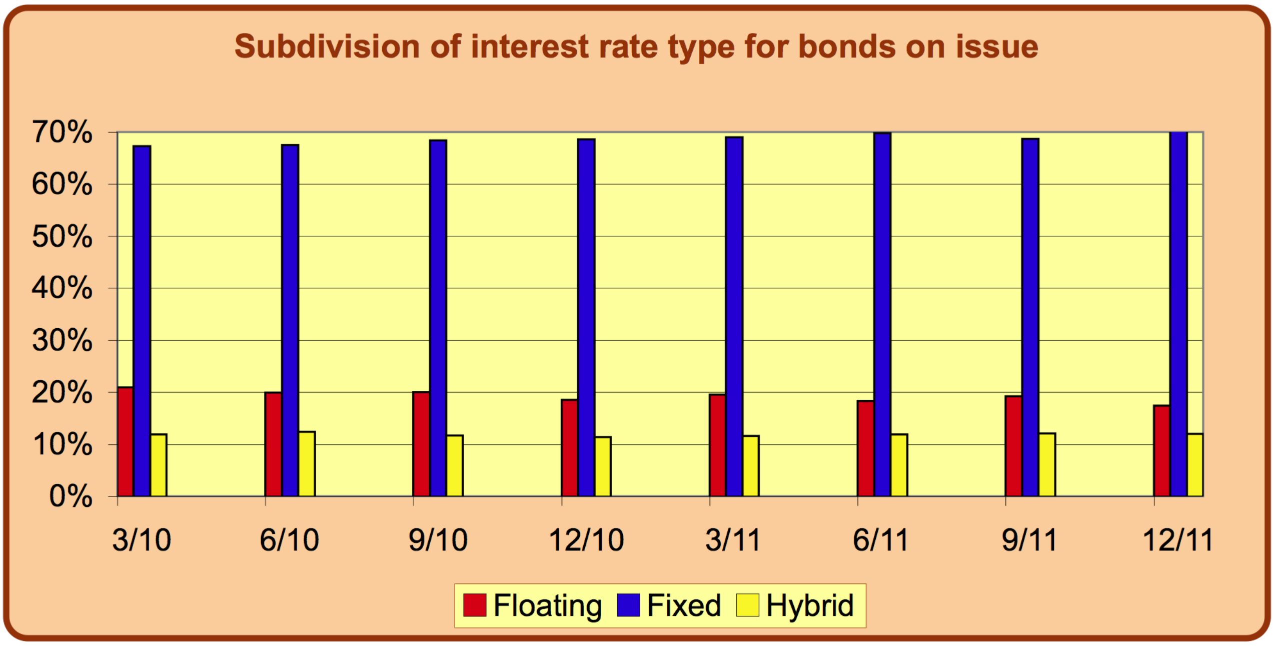

Figure 7: Subdivision of interest rate type for bonds on issue from March 2010 to Dec. 2011
(Source: Treasury Department of Finance Ministry)

Bank of Italy Reserves

	€ million	€ million	%
Foreign currency	26,278		18%
IMF	4,481		3%
SDRs	7,053		5%
Gold	104,339		73%
Other	-		
		142,151	100%
Other foreign currency	4,506	4,506	

Table 8: Bank of Italy reserves - January 2012 (Source: Bank of Italy)

The sum of official reserves in January 2012 stood at 142 billion euros (see *Table 8*), up from the 139 billion recorded in November, as noted in the previous issue of Italian Debt Observer. This change is attributable in large part to the increase in the price of gold in this period. It is worth remembering that Italy is the third largest holder of the yellow metal in the world, excluding the International Monetary Fund, after the United States and Germany. The gold reserves amount to 2,451.8 tonnes, equivalent to almost 79 million ounces.

Despite this positive data, the total amount of reserves is trivial when compared to the size of Italian public debt, of which it represents only 7.5%.

The proposal, every now and again put forward, to use the country's official reserves to lower Italy's public debt to acceptable levels would therefore appear inconsistent with the facts presented above.

Gross Domestic Product

As already reported in the previous quarterly issue of Italian Debt Observer, the updated Economics and Finance 2011 report has revised its estimates of GDP growth for 2011 to 0.7%, for 2012 to 0.6%, for 2013 to 0.9% and for 2014 to 1.2%.

The report of the Governor of the Bank of Italy, Visco, on 9th December last year gave an estimate of nominal GDP (i.e. not taking inflation into account) amounting to 1.582 billion for 2011, 1.622 for 2012, 1.665 for 2013 and 1.714 for 2014.

The debt / GDP ratio would be estimated at 120.6% for 2011, 119.5% in 2012, 116.4% in 2013 and 112.6% in 2014.

Bank of Italy reserves at January 2012.

The sum of official reserves in January 2012 stood at 142 billion euros.

The gold reserves amount to 2,451.8 tonnes.

The debt / GDP ratio would be estimated at 120.6% for 2011.

(€ Million)	GDP	GDP change	% GDP change	Public Debt	Deficit /GDP %	Debt/GDP %
Year 2000	1,191,057		3.69%	1,300,341		109,18%
Year 2001	1,248,648	57,591	1.82%	1,358,333	4.64%	108,78%
Year 2002	1,295,226	46,578	0.45%	1,368,512	0.79%	105,66%
Year 2003	1,335,354	40,128	-0.02%	1,393,495	1.87%	104,35%
Year 2004	1,391,530	56,176	1.53%	1,444,604	3.67%	103,81%
Year 2005	1,429,479	37,949	0.66%	1,512,779	4.77%	105,83%
Year 2006	1,485,377	55,898	2.04%	1,582,009	4.66%	106,51%
Year 2007	1,546,177	60,800	1.48%	1,598,971	1.10%	103,41%
Year 2008	1,567,851	21,674	-1.32%	1,663,452	4.11%	106,10%
Year 2009	1,520,870	- 46,981	-5.20%	1,761,229	6.43%	115,80%
Year 2010	1,548,816	27,946	1.30%	1,843,227	5.29%	119,01%
Year 2011 (est.)	1,582,216	33,400	2.16%	1,897,946	3.46%	119,95%

Table 9: GDP and public debt from 2000-2010 (estimates for 2011)
(Source: Istat, Bank of Italy and Finance Ministry)

Unfortunately, the final figures for 2011 have not yet been released, while the Istat survey of the third quarter 2011 reported a decrease in annualised growth from 0.7% to 0.5%. The preliminary estimate for the fourth quarter showed a further slowdown of 0.7% QOQ. In addition, all components of domestic demand were down, while imports decreased by 1.1% and exports grew by 1.6%.
Even with industrial production rising 1.4% MOM in December, the variation YOY was equal to zero.
It is necessary, of course, to wait for the final data, but going by what emerges from the Istat estimates, GDP growth could end up at 0.4% for 2011; by the same token, the presence of two quarters with negative growth would indicate a recession for Italy.
These aspects could also have a marked negative effect on the data in *Table 9*, especially for the debt/GDP and deficit/GDP sustainability indices. For ease of reading, *Figures 8* and *9* contain graphs that compare the deficit/GDP and debt/GDP data for the main European countries in 2010.

GDP growth could end up at 0.4% for 2011.

The presence of two quarters with negative growth would indicate a recession for Italy.

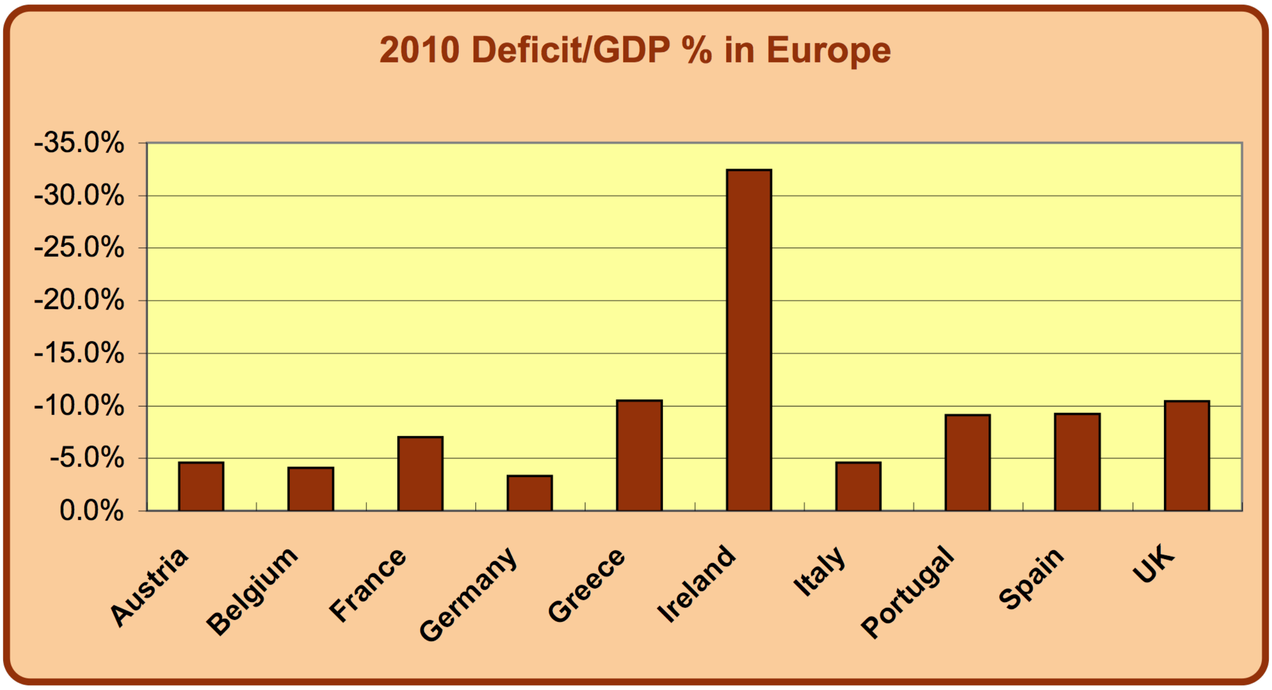

Figure 8: Deficit/GDP (%) in 2010 for selected European countries (Source: Eurostat)

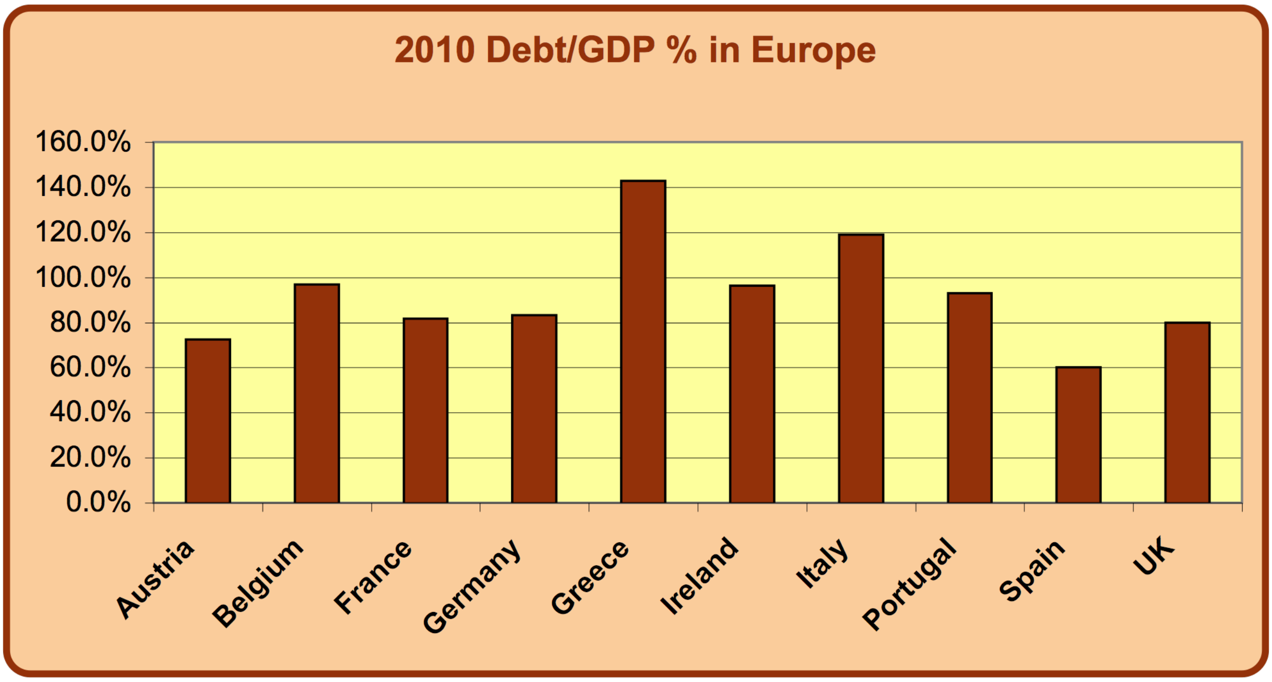

Figure 9: Debt/GDP (%) in 2010 for selected European countries (Source: Eurostat)

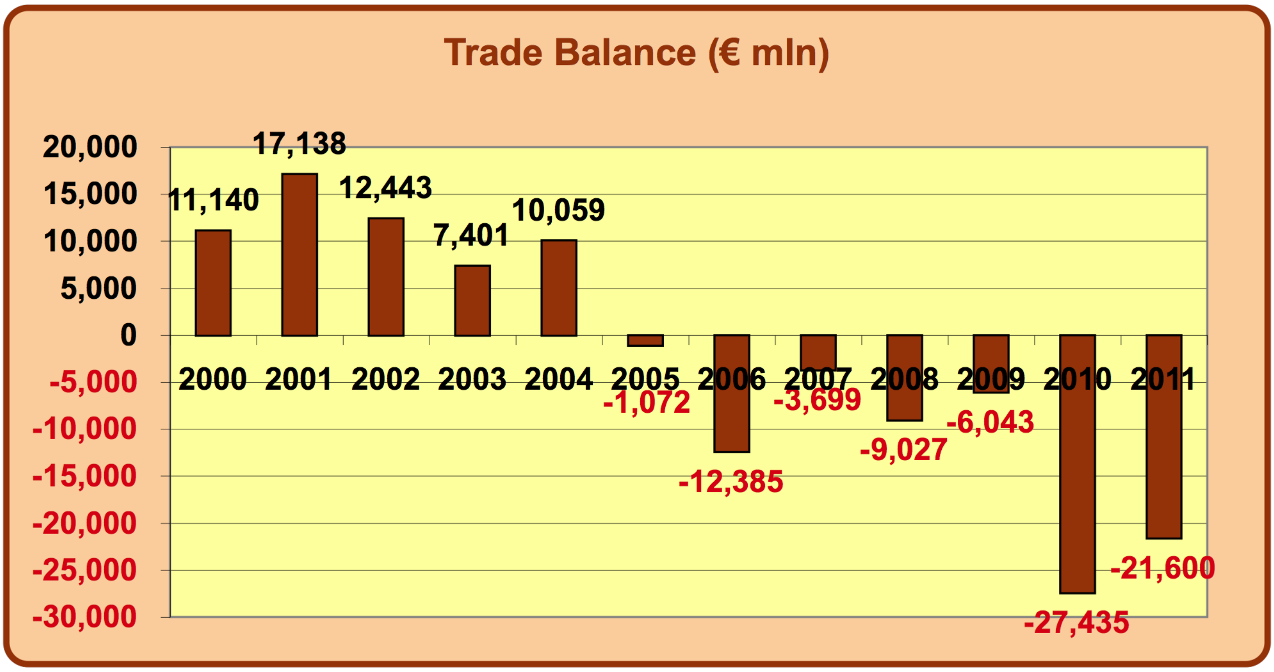

Figure 10: Trade balance in Italy from 2000 - 2011 (estimate for 2011)
(Source: Istat)

The Trade Balance

The trade balance is that component of GDP which measures the ability of a country to export; a positive trade balance facilitates growth and ensures greater sustainability of domestic consumption.
At the moment the full year data for 2011 are unavailable, but a preliminary estimate by Istat shows a slight improvement in the trade deficit, at 21.6 billion euros.
Figure 10 shows the trend since 2000: during this period, Italy has changed from being a net exporter to a net importer. The peak of net exports of 17 billion in 2001 has given way to a record in net imports of over 27 billion in 2010.

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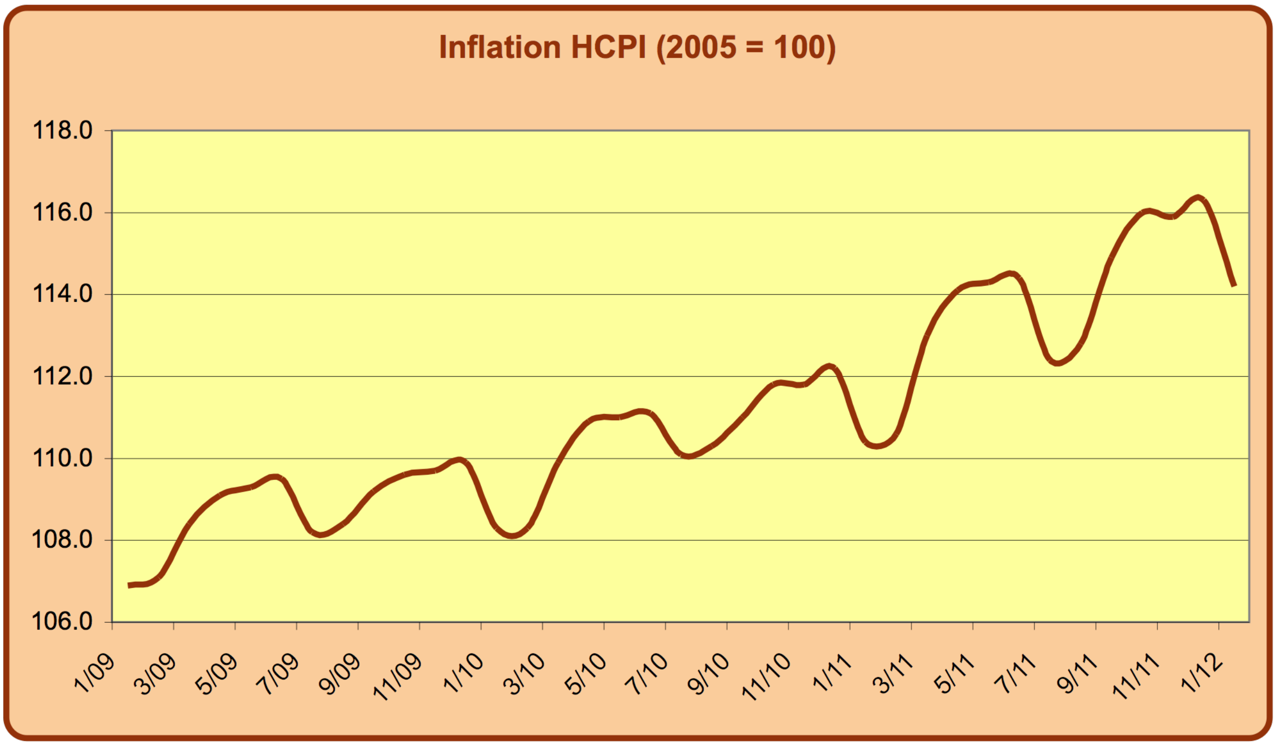


Figure 11: Harmonised consumer price index from January 2009 to January 2012 (Source: Istat)

Inflation

Although the variation measured between December 2010 and December 2011 was 3.7%, the rate of inflation calculated by Istat for 2011 was 2.8%. In either case, there has been a marked acceleration when compared to the 1.5% recorded in 2010.
The January data show a slight reduction in inflation in Italy, with an increase amounting to 3.4% YOY and down by 1.8% from the previous month. *Figure* 11 shows the trend of the harmonized consumer price index from the beginning of 2009 (the HCPI has a base of 100 in 2005), in which one can identify the seasonality of its movements. January normally presents a seasonal fall in inflation, thanks to the practice of post-Christmas sales and promotions by retailers.

Italian inflation reached 3.7% in December.

January normally presents a seasonal fall in inflation.

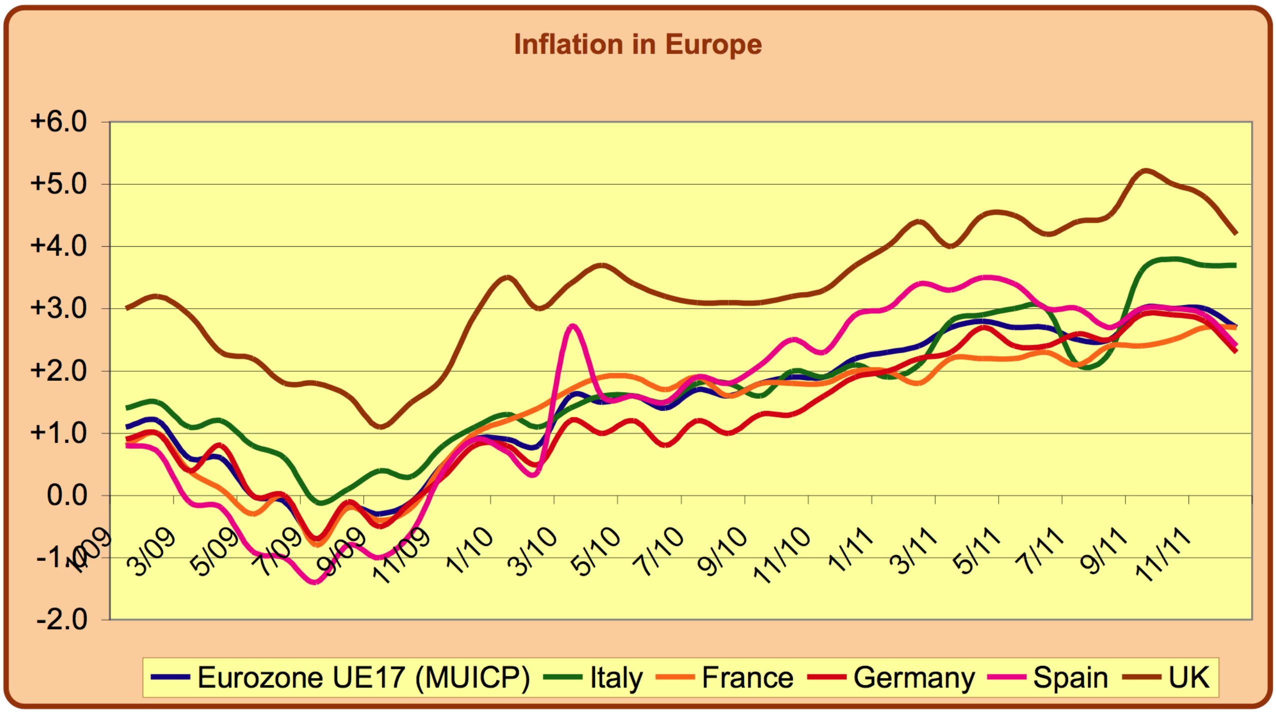


Figure 12: Inflation in Europe from 2009 to December 2011
(Source: Eurostat)

Istat has also indicated an annualised inflation rate for 2012 of 1.6%.

It is worthwhile to note that at the beginning of each year the baskets of goods used by Istat for the calculation of inflation trends is reviewed. The main changes this year are the inclusion of multimedia products such as e-books, compact computers, the evaluation of certain classes of electricity tariff and the expansion of the types of lotteries considered.

The trend of rising prices is clear, despite the periodic slowdowns, and it is not a phenomenon confined to Italy, as it is occurring with similar intensity in all European countries (see *Figure* 12). The inflationary trend in the United Kingdom is continuing and is much higher than in the rest of Europe.

Istat has also indicated an annualised inflation rate for 2012 of 1.6%.

Figure 13: Unemployment rate in Europe at December 2011
(Source: Eurostat)

Unemployment

Unemployment in Italy continues to remain at high levels, registering 8.9% in December, yet the averages in Europe (9.9%) and the Eurozone (10.4%) are even higher. *Figure* 13 shows a comparison between the major European countries, with France at 9.9% and Spain at 22.9%. The most virtuous country is Germany, with an unemployment rate of 5.5%.

The temporary layoff hours (*cassa integrazione*) authorized in 2011 amounted to 953 million hours, a decrease of 20.8% compared to 2010 (Source INPS). It is to be noted that this number of hours corresponds to the abstention from work of about 500,000 units (considering 240 days worked at eight hours each).

If we compare these abstentions to the roughly 2.1 million registered unemployed, we see an increase of almost one quarter in the jobless numbers and a corresponding increase in the percentage of unemployed persons, which in the case of Italy would go from 8.9 to 11%, a level much closer to the Eurozone average (10.4%) and confirmed by a study published by CGIA Mestre that indicates a real unemployment rate of greater than 10%.

Unemployment in Italy continues to remain at high levels, registering 8.9% in December.

Temporary layoff hours (*cassa integrazione*) authorized in 2011 amounted to 953 million hours.

The real unemployment level could be closer to 11%.

Another important aspect is the percentage of unemployment among people under the age of 25, which in Italy has reached 31%, lower than the Spanish figure of 49.6%, but much higher than the 23.8% in France and the astounding 8.1% in Germany.
Below is a table composed by Istat on the composition of the workforce aged between 15 and 74 years in Italy.
Returning finally to the temporary layoff hours updated with INPS data for the month of January: the hours authorised were reduced by 26.7% compared to December. At present, there are insufficient elements to be able to draw more general conclusions on this subject.

Unemployment among people under the age of 25 has reached 31%.

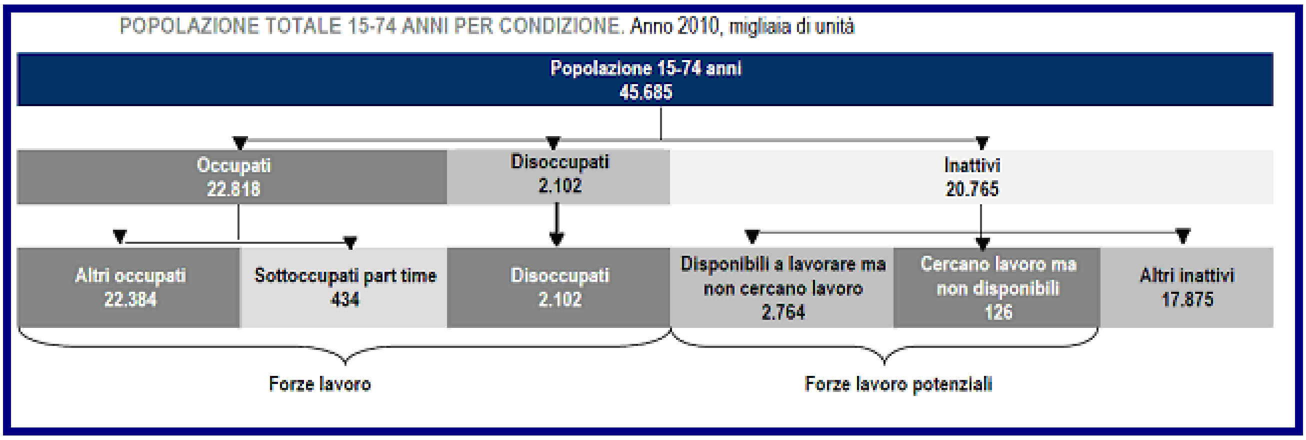


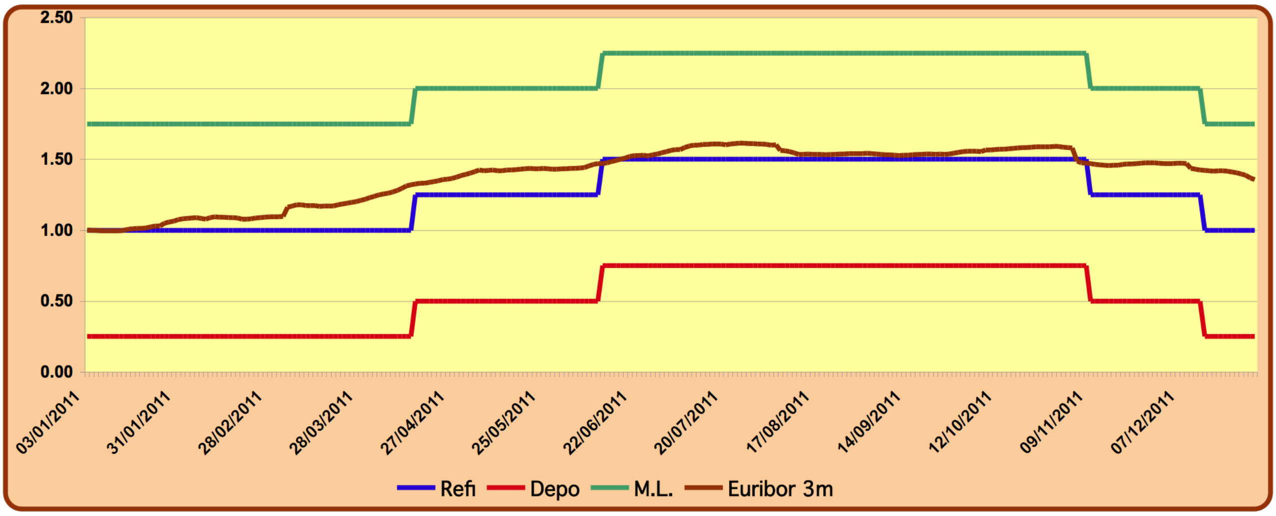
Figure 14: Subdivision of population between 15 – 74 years old in 2010
(Source: Istat)

In Depth

Focus by IdeasHaveConsequences.org

Monetary Policy and the Interbank Money Market

The fourth quarter of 2011 saw the replacement of Jean Claude Trichet as Governor of the ECB by the Governor of the Bank of Italy, Mario Draghi. The ECB proceeded to lower its main refinancing rate twice, on 9th November from 1.50% to 1.25% and then on 14th December to 1.00%. Notwithstanding an inflation rate above its target of 2%, the forecast of a worsening macroeconomic scenario in the first half of 2012 led the ECB to loosen its monetary policy.



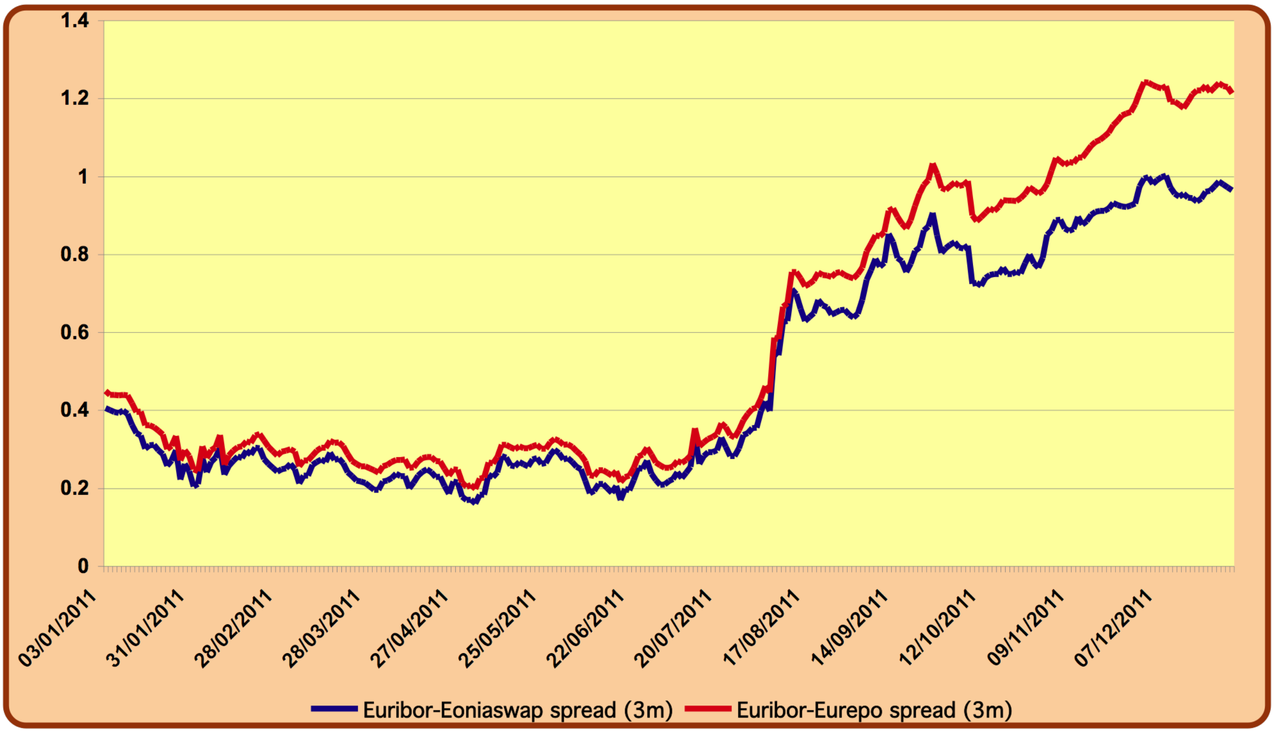
The situation in the interbank market remained particularly weak during the quarter. To ease these tensions and provide greater liquidity, the ECB approved a programme to purchase bonds on the secondary market for 40 billion euros (03/11/2012) and broadened the range of instruments able to be used as collateral in refinancing operations by lowering the eligibility criteria for ABS, MBS, and SME loan securitisations. More importantly, the ECB conducted two long-term refinancing operations (LTRO) on 27th October and 22nd December for periods of 371 and 1134 days, for amounts of 57 and 490 billion euros respectively. A similar round of refinancing is scheduled for February. Finally, the ECB opened a currency swap with the Federal Reserve of New York in the last week of November in order to supply Eurozone financial intermediaries with dollars.

The interbank money market has thus experienced falling short-term interest rates as shown in the table below.

Eonia – Euribor 3m – Eurepo 3m (monthly averages 01/11 – 12/11)

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC
Eonia	0.659	0.707	0.659	0.966	1.033	1.124	1.012	0.906	1.005	0.960	0.790	0.627
Euribor3m	1.017	1.087	1.176	1.321	1.425	1.486	1.597	1.553	1.536	1.576	1.485	1.426
Eurepo3m	0.652	0.785	0.895	1.063	1.138	1.227	1.277	0.883	0.634	0.634	0.395	0.208

In the fourth quarter of 2011 both the differential Euribor-Eoniaswap and Euribor-Eurepo increased compared with the previous quarter. Probably the combination of the results of the stress tests conducted in July and compulsory recapitalisations decided by the EBA was simply the trigger event of a general trend that has seen the widening of the spreads of bonds issued by the "PIIGS" when compared with the German Bund. Italian banks were revealed to be particularly vulnerable, due both to the large share of domestic bonds held in their portfolios and to the precarious situation of our public debt, which precludes the possibility of government-led recapitalisation or support. The Euribor-Eoniaswap spread reached 1%, while the differential Euribor-Eurepo ended the quarter in excess of 120 bps, levels lower than those immediately following the Lehman crisis, but still very high. If the elevated systemic risk was solely the result of contingent liquidity problems, the traditional monetary policy instruments available to the ECB would have been sufficient to normalise the situation, but to the extent that the situation is structurally dependent on counterparty risk, the traditional role of lender of last resort becomes more problematic. The placement of temporary liquidity into the system becomes difficult to reverse, at least in the short term. The interbank money market manifests the tendency to dry up and therefore both funding and lending between financial intermediaries comes about in a centralised manner through the ESCB (European System of Central Banks): the imbalances will become visible within TARGET2 (the payment and settlement system among Eurozone participants).



Euribor – Eoniaswap Spread (3m): This measure represents the difference between the 3-month Euribor and the Overnight Swap Rate for a period of 3 months. Breaking down the Euribor into two factors: 1) the average overnight rates expected in the future and, 2) risk factors and subtracting from these the Eoniaswap rate for the same maturity eliminates component 1 (i.e. the market expectations), thereby obtaining a measure of other systemic risk factors (counterparty risk, liquidity risk, etc...)

Euribor – Eurepo Spread (3m): This measure is the difference between the interbank rate for unsecured loans (Euribor 3m) and collateralised loans (Eurepo 3m). The spread allows us to focus our attention on counterparty risk and to understand the level of confidence that banks and financial institutions have in their reciprocal solvency.

Silvano Fait

Financial repression as a solution to debt

Almost all countries of the Economic and Monetary Union have significant public debt problems, both in terms of its proportion to GDP (for 2011 the figure will be around 86% of EMU area GDP), and in terms of its expected evolution. The case of France, one of the "pillars" of the EU, which recently lost its AAA rating, is emblematic: at the beginning of the European economic crisis, the French government introduced short-term measures (e.g. a three-year moratorium on only a part of public spending) which are now clearly losing their effect, taking the trajectory of the country back to that of 2010, which envisaged a Debt/GDP ratio well over 200% in 2040. Similar projections are common to almost all European countries, with the exception of Italy (see Cecchetti Mohanty Zampolli 2010 "The Future of Public Debt: Prospects and Implications, "BIS working paper no.300) which should see a slow rebalancing of the debt/GDP ratio towards 100%, once certain "small gradual adjustments", such as the recent pension reform, are adopted. Although this is an interesting point, however, it must be noted that it is not the only determinant of rating decisions.

ECB Balance Sheet - Dec 2011 (€ mid)					
Assets			**Liabilities**		
Lending	864	31.60%	Monetary Base	1,526	55.80%
Securities	653	23.90%	Deposits	212	7.80%
Foreign	368	13.50%	Foreign	170	6.20%
Gold	423	15.50%	IMF	56	2.00%
Other	428	15.60%	Other	296	10.80%
			Own funds	476	17.40%
	2,736	100.00%		2,736	100.00%

The strong political resistance to any deep spending review forces the European monetary authorities to take de facto charge of these fiscal problems. Direct purchases of government bonds by the ECB and other open market operations ("securities" in the table above) have increased by about a third since 2010 and 300% since 2008, reaching about one quarter of Authority's balance sheet in 2010, compared to about 8% in 2008. This has clearly been funded with new money: the monetary base has grown by more than one third since 2010 (continuing to be between 55% and 57% of the ECB balance sheet).

At the same time, recourse to the deposit facility has also increased, doubling since 2008 to reach over 15% of the ECB balance sheet currently. This parking facility for cash (usually "hot off the press") by commercial banks goes hand-in-hand with the rise of the Euribor-Eurepo spread (see above): from the second half of 2011 this spread has tended to stabilize at around 120bps, and whilst still below the peak of late 2008, it suggests a banking system with weak balance sheets, of which the use of deposit facility is but another symptom. The weaker the banking system, the greater the call on the central monetary authorities to bear the coverage problems of European public debt: the proof of this can be found in the growth of the ECB's balance sheet.

The effect of the ECB's efforts, by definition inflationary, cannot but influence consumer prices (as well as certain assets and commodities), and it is precisely through this mechanism that the Central Bank can help governments to manage their debt: an inflation rate at around 3% together with a Refi rate (the main ECB refinancing rate) at 1% means a real Refi rate of -2%, that is, an average annual rate of reduction in the real value of European public debt of 2%. Italian debt, taking advantage of price inflation at 4%, can count on a real depreciation of, on average, 3% annually. With this underhand - and profoundly unfair - instrument of financial repression (see Reinhart Sbrancia 2011 "The Liquidation of Government Debt," NBER working paper n.16893) one can reduce the real value of average European public debt to about 60% within little more than ten years (or fewer than twenty years in the case of Italy) without having to make significant cuts to those "sensitive" items of government expenditure.

Leonardo Baggiani

Glossary of Terms

ABS, MBS, securitisations: Structured finance products in which a transferable, autonomous debt instrument is created (usually through a SPV, Special Purpose Vehicle) which is remunerated with cash generated by a balance sheet asset (securitisation); this substantially liquidates the asset on the balance sheet and the relative risk is transferred to the purchaser of the new debt security. The securitised assets may have real or personal guarantees (ABS - Asset Backed Securities), and, in particular, be originated by a mortgage (MBS - Mortgage Backed Securities).

Monetary base: currency issued by the Central Bank through auction procedures (refinancing operations) involving major commercial banks. From an accounting point of view, the amount is a liability of the Central Bank and is broken down in the main forms of employment of banks' liquidity (banknotes in circulation, deposit facility, the minimum reserve account).

Collateral: real or financial assets pledged to guarantee a financing transaction; against their loans to commercial banks, the Central Bank requires collateral in the form of securities with specific characteristics (government bonds or covered bank bonds collateralised with real assets).

Currency swap: forward exchange of amounts in different currencies, associated with periodic exchanges of interest flows calculated in the currencies involved; the instrument is increasingly used among central banks to provide their systems with an adequate supply of foreign currency.

Deposit facility: interest-bearing account at the Central Bank, in which commercial banks can deposit their cash. Created as an instrument of monetary policy and with the scope of managing excess liquidity, to commercial banks it now provides a risk-free alternative to traditional lending operations.

Eoniaswap: interest rate swap transaction, where one party agrees to receive/pay a fixed rate to another party, against paying/receiving a floating rated named EONIA (overnight rate).

LTRO (Long Term Refinancing Operation): the main long-term financing operation for the European Central Bank - an auction for one and three year terms, put in place to tackle the current economic and financial situation.

Open market operations: the purchase or sale of listed financial securities (typically government bonds, but also some types of bank bonds) by the Central Bank, conducted with the aim of reducing or increasing the money supply in circulation.

Main refinancing rate (Refi): official rate applied by the European Central Bank in main refinancing operations with ordinary commercial banks, also called the MRO rate (Main Refinancing Operation). As a reference for monetary policy, it has taken the place of the now insignificant official discount rate.

Comment by Andrew Lawford

The circularity of the crisis

The financial crisis continues to evolve: from the 2008 sub-prime mortgage situation, it has transformed itself into a sovereign debt crisis thanks to the combination of strong imbalances, already present for some time in the public finances of many countries in the Western world, with the extraordinary measures needed to support the financial system. The tolerance of the financial markets for this situation has worn thin in the face of excessive deficits in the budgets of many states, leading us to the current impasse in Europe.

It is easy to see that financial instability is circular in nature: the sovereign debt problem has again put the financial sector into question thanks to its large exposure to these same sovereign debts. The tolerance of the market fell sharply yet again, as evidenced by the declining participation of U.S. money-market funds in the short-term financing of European banks. This phenomenon was well documented during last summer, and it is only recently that there has been a resumption of purchases by these funds.

Another important example of this lack of tolerance has been given by the German company Siemens, which, by making use of a banking license within the Group, has decided to remove about 6 billion euros of liquidity from the European banking system, depositing it all at the ECB.

The "tolerance" discussed above is what is commonly referred to as "confidence". Its lack led the newly installed governor of the ECB, Mario Draghi, to introduce three-year loans to European banks in December, encouraging their extensive take-up (about 489 billion euros were placed).

The Financial Times has reported on the proactive nature of Draghi's efforts, noting that "previously, banks had shied away from such support schemes for fear of appearing weak."

Usually it is said that a chain is only as strong as its weakest link, but, reading between the lines of the FT report, it seems that Draghi wished to draw strength from the fact that all the links (i.e. the individual banks) were weak. Judging by the recent deeply discounted rights issue by Unicredit, the Italian bank, Draghi had reason to worry about the banking system as a whole. Also, according to the indications given by sources of the FT, the European banking system has learnt quickly to appreciate these ECB loans: at the end of February another three-year auction is expected to attract about 1,000 billion euros of demand. The banks evidently prefer this route to capital to the humiliation of heavily discounted rights issues.

These measures have allowed the markets to heave a sigh of relief, encouraging the return of U.S. money-market funds mentioned above, as well as the decline in yields in the government bonds of a number of peripheral euro countries.

The mechanisms briefly outlined above are, in fact, an experiment the outcome of which is still uncertain. If the market believes in the efforts of the ECB, this could lead to a period of substantial profits for those banks most exposed to the riskier government bonds, together with a general calming of the waters in the markets. If not, however, the question is begged about the credibility of the monetary system itself, not only in Europe but also in a number of other regions of the world.

Andrew Lawford

Conclusion

Italy is a country now officially in recession after two quarters of negative growth; it is burdened by a public debt of close to 1.9 trillion euros, financed by more than 1.6 trillion in government bonds and a tax burden of 42.6%.
The trade balance has been negative for seven years, inflation is at 3.7% and unemployment 8.9%, including 31% of young people under the age of 25.
This is the unmerciful picture of a country with an extremely unfavourable demographic profile, where most people are thinking of their retirement instead of the future of their children.
It is useless to affirm that Italy is not Greece, or that the crisis is international in its dimensions; the country as it stands is the result of decades of missed opportunities, of "just struggling along", of wasting resources, of self-interested policies aimed at immediate personal benefit to the detriment of that which is public, and as such belongs to no one.
In the moment of the rude awakening, even though much of the population does not understand the true gravity of the situation, the finger is pointed at the ineptitude of politicians; this fact certainly cannot be denied, but it must be considered together with the negligence of all Italians in the insistence and protection of individual privileges and benefits, notwithstanding their unsustainability. It would seem that accepting responsibility is something that always regards those around us, but never ourselves.
This quarterly analysis, now in its forth edition, is a reflection of the reality in Italy, providing a clear picture of the country's economic data by gathering in a single document information issued by a large number of organizations and institutions. Each quarter in these pages we will continue to monitor the Italian economic system, hoping to catch, even in the smallest of details, the first signs of a change in direction.
This writer is motivated by the hope that the information contained herein may be of interest to a broad audience, including non-professionals. Anyone who comes into possession of this analysis may diffuse it as he or she sees fit, as long as the source is acknowledged.
I sincerely thank Leonardo Baggiani, Silvano Fait and Andrew Lawford for their contributions to this issue.

Maurizio Mazziero

Italy is a country now officially in recession.

The country as it stands is the result of decades of missed opportunities.

This quarterly analysis, now in its forth edition, is a reflection of the reality in Italy.

Anyone who comes into possession of this analysis may diffuse it as he or she sees fit, as long as the source is acknowledged.

Glossary

Italian Debt Issues:

BOT (*Buono Ordinario del Tesoro*): A short-term, zero-coupon security with maturities equal to or less than 12 months.

CCT (*Certificato di Credito del Tesoro*): A 7-year, variable-rate security with coupons indexed to the current 6-month BOT rate.

BTP (*Buono del Tesoro Poliennale*): A long-term, fixed-rate security with maturities from 3 – 30 years at issuance. Also available in inflation-indexed form.

CTZ (*Certificato del Tesoro Zero-Coupon*): A 2-year zero-coupon security.

Italian Economic and Political Terms:

Istat (*Istituto Nazionale di Statistica*): The official Italian statistics institute.

***Cassa integrazione guadagni*:** Or, *cassa integrazione* for short, is a state-sponsored benefit granted to those workers who have been temporarily laid-off, or who have had their working hours reduced. Its effect is to preserve employment whilst lowering the burden of cost on companies facing economic difficulties. It is administered by *INPS*.

INPS (*Istituto Nazionale per la Previdenza Sociale*): The state pension fund.

First/Second Republic: The First Republic is the period from 1946, when Italy shifted from Monarchy to Republic, until the 1992 (the first Amato government), which marked a time of significant political upheaval perhaps best remembered due to the *mani pulite* (clean hands) scandal, involving many political exponents of the day. The period from 1992 onwards is generally regarded as being the Second Republic.

"Chicken of Trilussa": Trilussa was the pseudonym of Carlo Salustri, a well-known Italian poet, comedian and satirist, who was nominated Senator for Life in the Italian Parliament shortly before his death in 1950. One of his most famous poems, *La Statistica* (Statistics), comments that: "…the calculations made by today's statistics mean that you get one chicken per year: and, even if you can't afford it, you get into the statistics all the same because someone else has eaten two." This amusing comment reveals the great untruth of statistics at its most basic level, and has entered into common use in Italian.

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