From the desk of Komal S. Sri-Kumar, Ph.D.
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The Meaning of Italy's Elections

As election results started coming on Monday, February 25, they were received with cheers by world markets. Pier Luigi Bersani, leader of a center-left coalition that had been forecast to form a new government, seemed initially to be doing well in results for the lower house of parliament (Chamber of Deputies). The euphoria turned to disappointment as it became clear that no party would have a majority. Further raising the concern of global investors, former Prime Minister Silvio Berlusconi's center-right coalition won the most seats in the upper house (Senate) - - a development that unnerved German leaders who had publicly suggested that Italian voters not vote for Mr. Berlusconi. Adding to the political confusion, Italy's President Giorgio Napolitano, who may have to decide who will head the next government, will himself leave office in mid-May.

The country may require fresh elections in its search for greater political stability - - Mr. Bersani, Mr. Berlusconi and another top vote getter, the populist Beppe Grillo, seem unwilling to pool their seats to form a government. Just as important, the elections left the coalition led by the current Prime Minister, Mario Monti, discredited with just about 10% of the votes. Mr. Monti had championed fiscal reforms, and is popular with international institutions and investors. He is also lauded by the financial press for efforts to make the labor market more flexible. Mr. Monti was punished by the electorate for hiking taxes, cutting spending and deepening the recession.

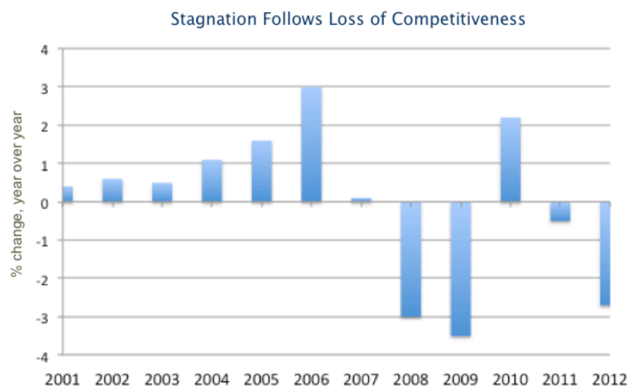
And thereby hangs a tale.

Bailing out the World's Third Largest Debtor

At €2 trillion, Italy has the third largest public debt in the world after the United States and Japan. Even assuming that the fallout from Italy's difficulties on the rest of the debtors in the region will be marginal - - a tall assumption - - it would be difficult to find the resources to repeat for Italy the bailouts that European powers arranged for Greece, Ireland, Portugal and Spain. The fallout from an Italian bailout will, indeed, be significant - - it would raise sovereign yields in other debt-ridden European countries, and make it difficult for them to return to private capital markets.

That is the bad news. The good news is that Italian residents are estimated to hold €8 trillion in assets, several times the public debt. The challenge is to channel a fraction of those assets toward the public debt market. Once we agree that Italy does not have a debt problem when the public and private sectors are combined, a second challenge still remains - - that the economy has posted little economic growth since the start of the 21st century. The loss of competitiveness, the inability to devalue its own currency, and inflexible labor markets, have all contributed to the virtually zero average annual growth in real GDP since 2001.

Italy Real GDP Growth



Debt Reduction to Provide Good Entry Point

The twin challenges may point the way to how the Italian public debt crisis can eventually be resolved. While European leaders will want to use with Italy the same "kick-the-can-down-the-road" strategy they have tried on peripheral nations, Italy's size would give it more negotiating power in refusing to accept more austerity in return for a bailout from the European powers. I expect the rejection of further fiscal tightening to occur irrespective of which political party eventually forms the government in Italy. When recession and austerity become self-perpetuating, it would not be surprising that authorities put the domestic electorate ahead of the needs of foreign bankers!

Allowing a portion of Italy's private wealth to purchase public debt at a discount would both mitigate the debt crisis and provide the first steps toward putting the economy on a faster growth path. The latter would follow because of reduced interest payments, and due to the bigger role for the private sector in decisions relating to production and investment.

While investors would purchase debt at less than face value, the government can accept the same debt as means of payment, at full value, in the course of sales of state-owned companies. This too would be a way of simultaneously reducing the debt burden and accelerating the pace of economic growth.

Why Market Solutions Have Been Slow in Coming

If debt reduction measures can be so beneficial, why have they not been tried yet? The obverse of debt reduction is "haircuts" for lenders, including some of the region's largest banks. Valuing Italy or Spain's debt at less than face value would expose the inadequacy of capital in many of the institutions and force a scramble to raise new capital. Eventually, German taxpayers, as residents of the largest creditor country in the region, may have to bear the cost of the capital raising.

German Chancellor Angela Merkel may want to keep the current status unchanged until after nationwide elections set for September when she will run for re-election. The size of Italy's economy and debt, and the urgency created by the depth of the recession, may not allow that luxury. Political implications in Europe could well stagger a market-friendly mechanism, but cannot completely stop it.

And for global investors, that may be the biggest significance of last week's Italian elections.

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