

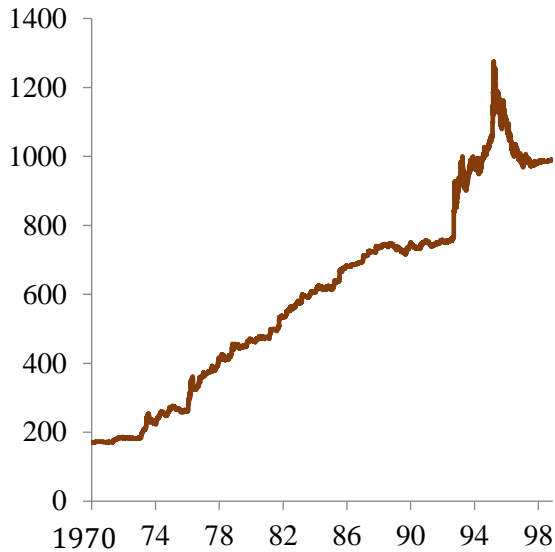
# Italy's Eurozone Trap

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Based on *EuroTragedy: A Drama in Nine Acts*, New York: Oxford University Press, June 2018.

# Italy needed—and needs—the crutch of a depreciating currency to offset its abysmal productivity growth

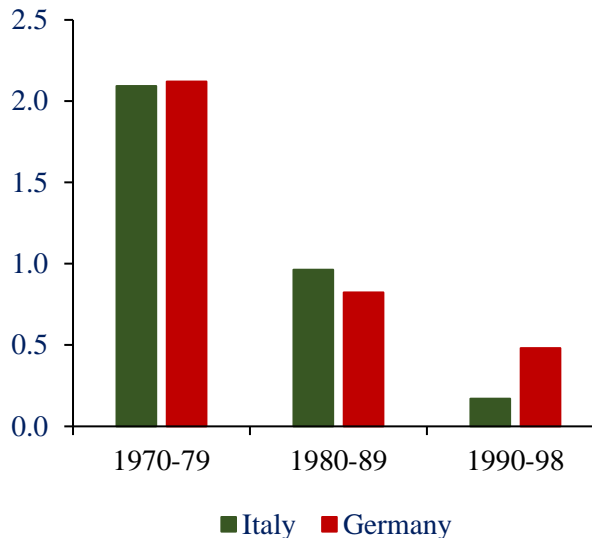
The depreciating lira, 1970-1998  
(Number of liras for one D-mark)



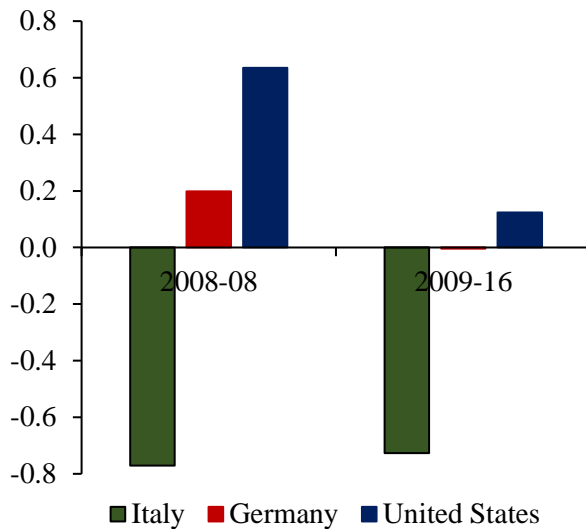
US Dollar/Euro exchange rate is back where it began, 1999-2018



Italian productivity fell relative to German  
(annual average total factor productivity growth)

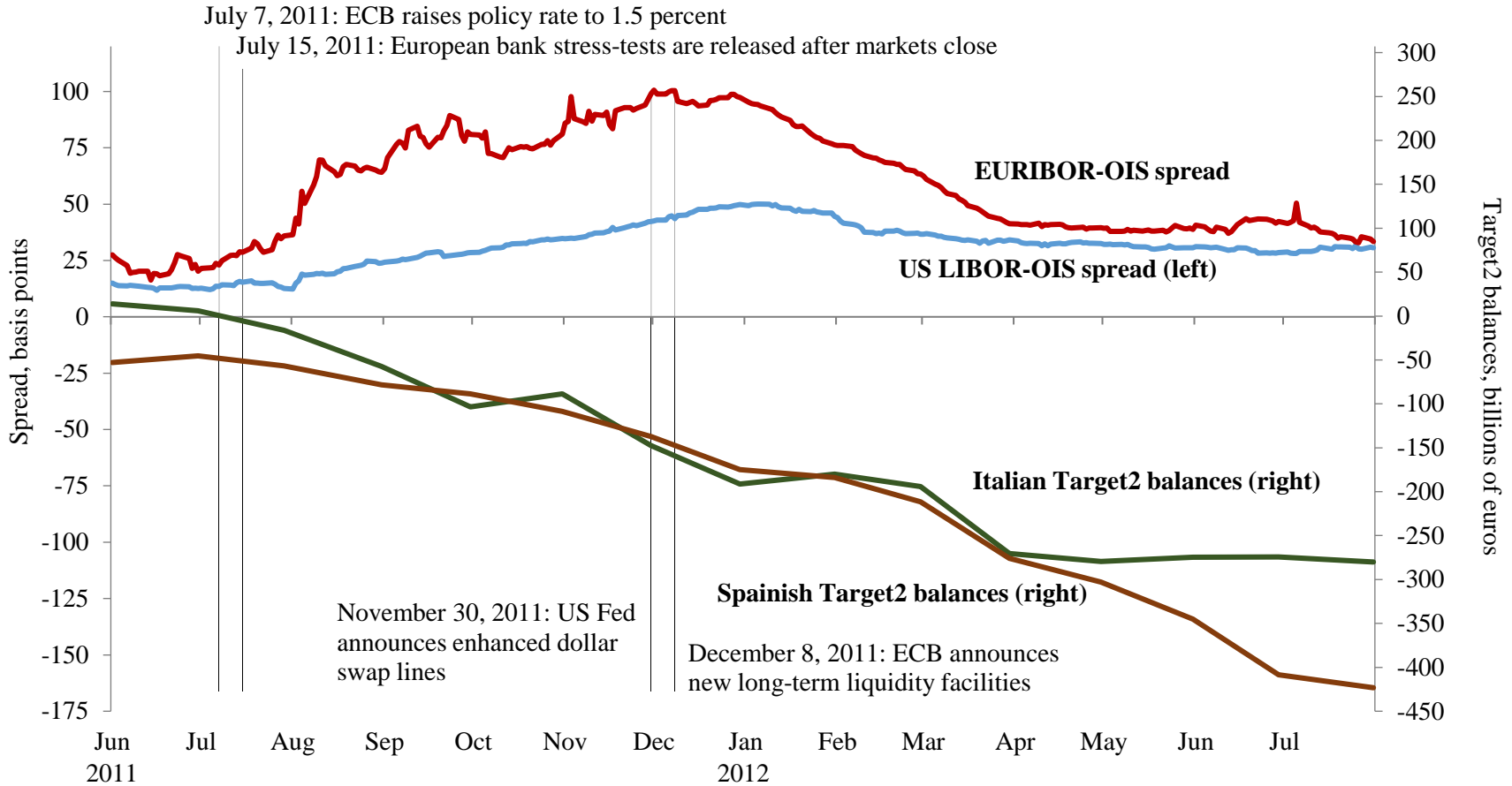


Italian productivity collapsed while even German fell behind the U.S.  
(annual average total factor productivity growth)



Source: Top left panel: Banca d'Italia, <https://tassidicambio.bancaditalia.it/timeSeries>; top right panel: ECB data warehouse [https://sdw.ecb.europa.eu/quickview.do?SERIES\\_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC](https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC); bottom left and right panels: The Conference Board, <https://www.conference-board.org/data/economydatabase/index.cfm?id=27762>.

# Market panic after July 7 interest-rate hike and farcical bank stress tests.



Sources: US LIBOR-OIS spread: Bloomberg, US0003M Index—USSOC Curncy; EURIBOR-OIS spread: Bloomberg, EUR003M Index—EUSWEC Curncy; Target2 balances are end-of-month position from ECB Statistical Data Warehouse.

Note: One hundred basis points equals 1 percentage point.

## **OMTs provided only partial help**

Draghi's July 2012 makes "whatever it takes" announcement

Outright Monetary Transactions (OMTs) approved in September 2012.

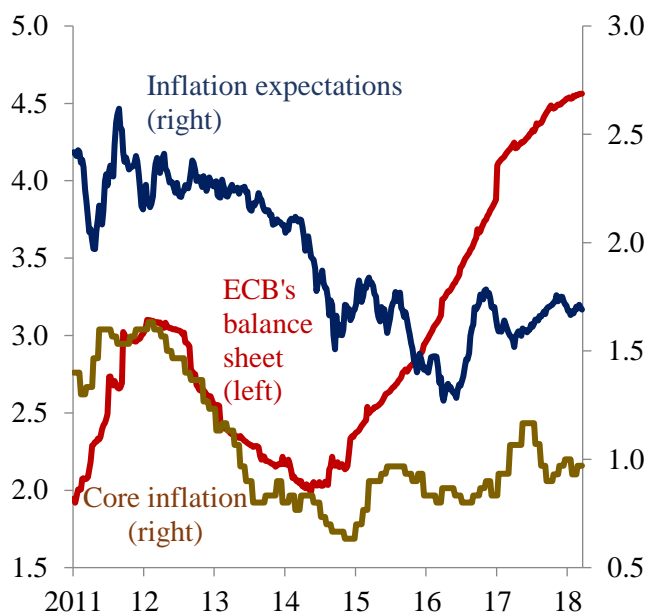
But OMTs only partially undid the ECB's July 2011 error.

German and other "northern" Governing Council members held ECB back from aggressive monetary stimulus through end-2014: real interest rates remained high, between 2 and 3 percent.

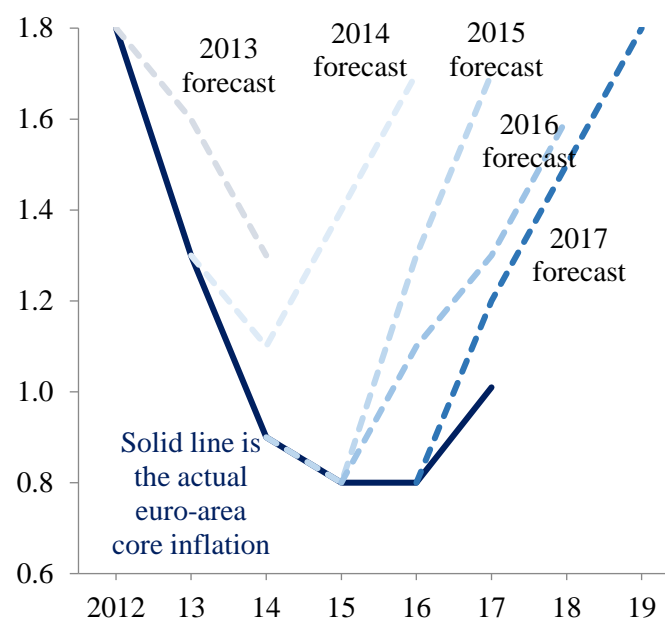
Long-Term Refinancing Operations (LTROs) do not count: passive monetary policy, ease credit supply; do not put money in people's pockets (do not create demand); funds used by banks to buy sovereign debt, aggravating the sovereign-bank "doom loop."

## ECB's delayed quantitative easing failed to raise inflation in the manner the ECB anticipated.

The ECB's balance sheet (left-hand scale, trillion euros) increased rapidly, but the annual inflation rate (right-hand scale) remained low



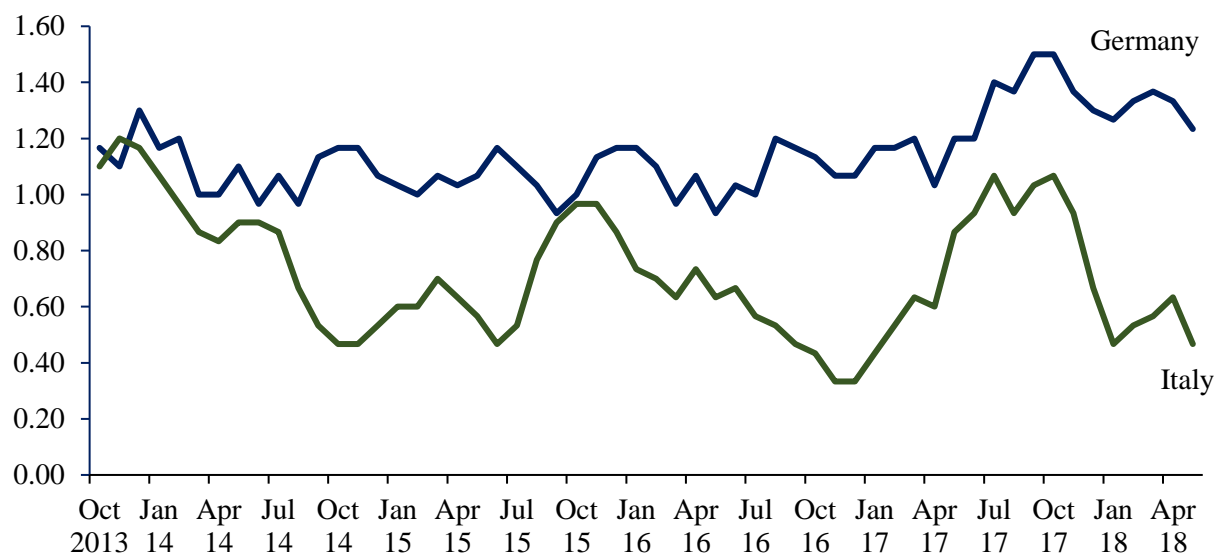
Despite ECB forecasts of rise in inflation, inflation remained at a low level



Sources: Left panel: ECB Balance Sheet, Bloomberg's weekly "EBBSTOTA Index" at weekly frequency; inflation expectations are measured by Bloomberg's daily FWISEU55 index (five-year, five-year inflation swaps); core inflation is the three-month moving average of Eurostat's annual change in the monthly "HICP—All-items excluding energy, food, alcohol and tobacco" index. Right panel: ECB's Macroeconomic Projections made in March of the year, <https://www.ecb.europa.eu/pub/projections/html/index.en.html>. Note: The ECB's balance sheet and inflation expectations are plotted at weekly frequency; the core inflation rate for the week is the same as the year-on-year monthly inflation during the month in which the week falls.

# The eurozone problem: a single monetary policy causes inflation divergence: Italy's lowflation problem.

(Annual core inflation, three-month moving average, percent)

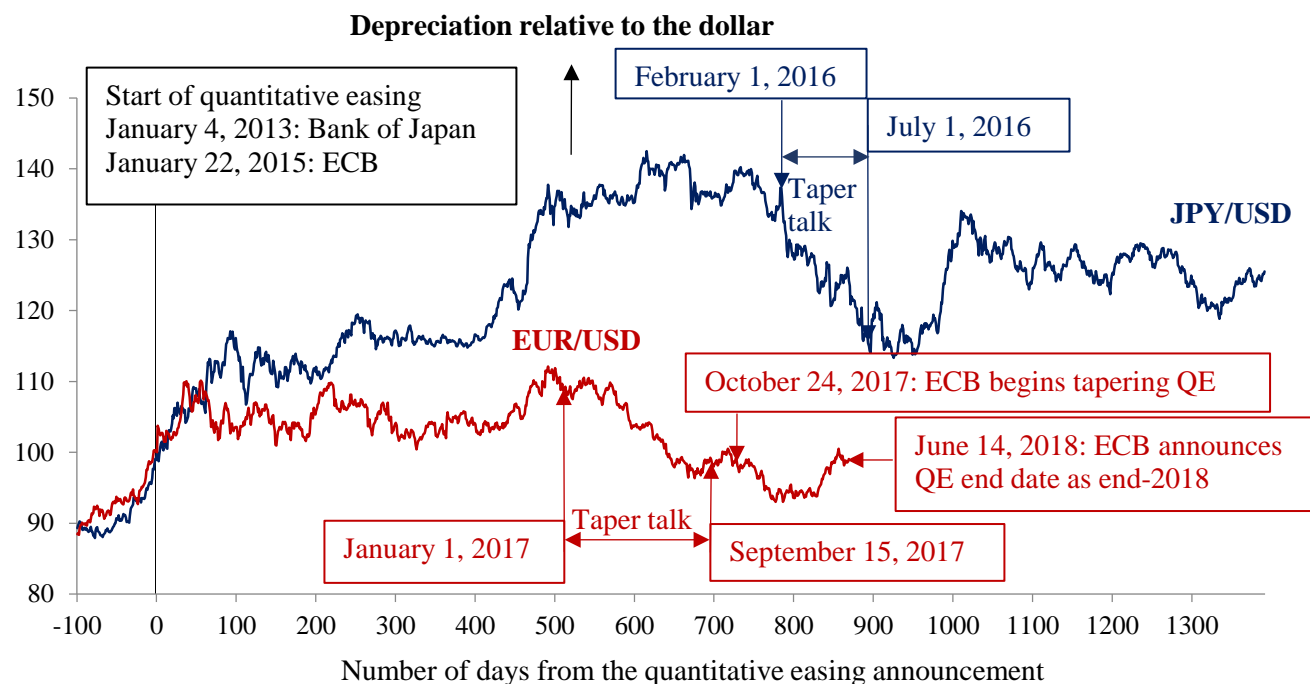


Source: Eurostat. Note: Core inflation is the annual percentage change in the Harmonized Index of Consumer Prices excluding energy, food, alcohol and tobacco.

*With current 10-year government bond yields near just above 2.5 percent, Italian real interest rate around 2 percent, with negative productivity growth and potential growth rate below 1 percent. Inflation divergence can be expected to persist.*

## The cumulative effect of tight money: ECB credibility even lower than BOJ's in maintaining sustained monetary policy easing.

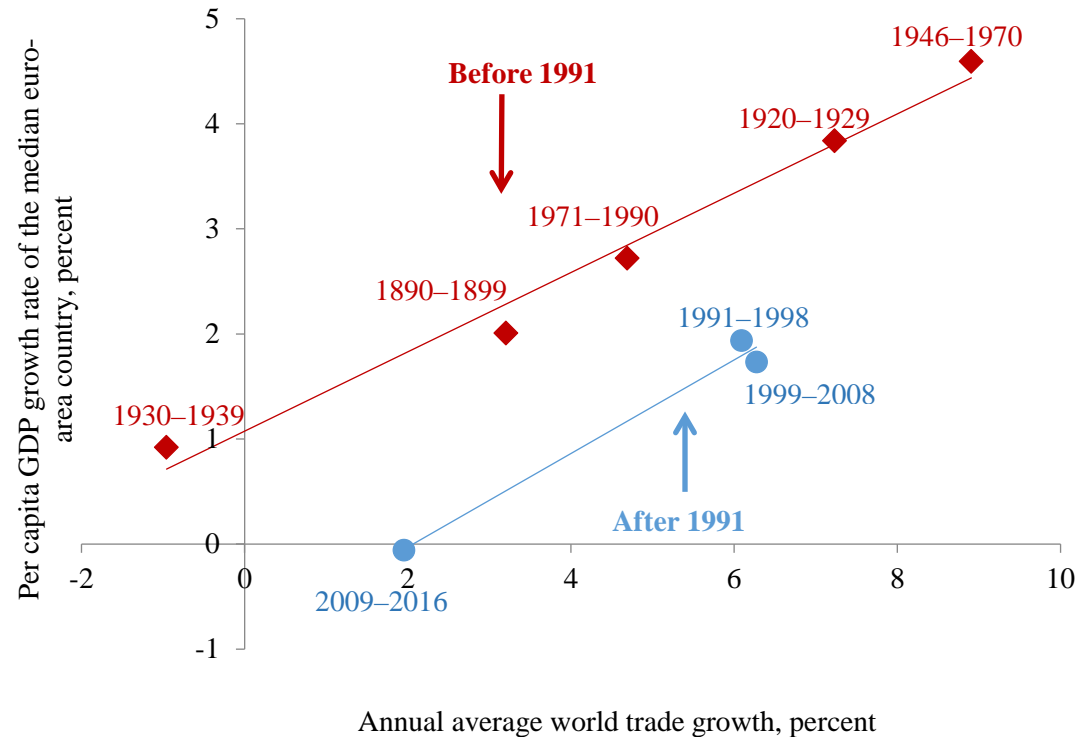
### ECB QE did little to weaken the euro to boost demand and inflation.



Note: Exchange rate for JPY/USD equals 100 on January 4, 2013 (date of the announcement of quantitative easing by the Bank of Japan) and exchange rate for EUR/USD equals 100 on January 22, 2015 (date of the announcement of quantitative easing by the ECB).

Source: For USD and Japanese Yen, <https://www.investing.com/currencies>, for USD and Euro rates ECB, [https://sdw.ecb.europa.eu/quickview.do?SERIES\\_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC](https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.D.USD.EUR.SP00.A&periodSortOrder=ASC).

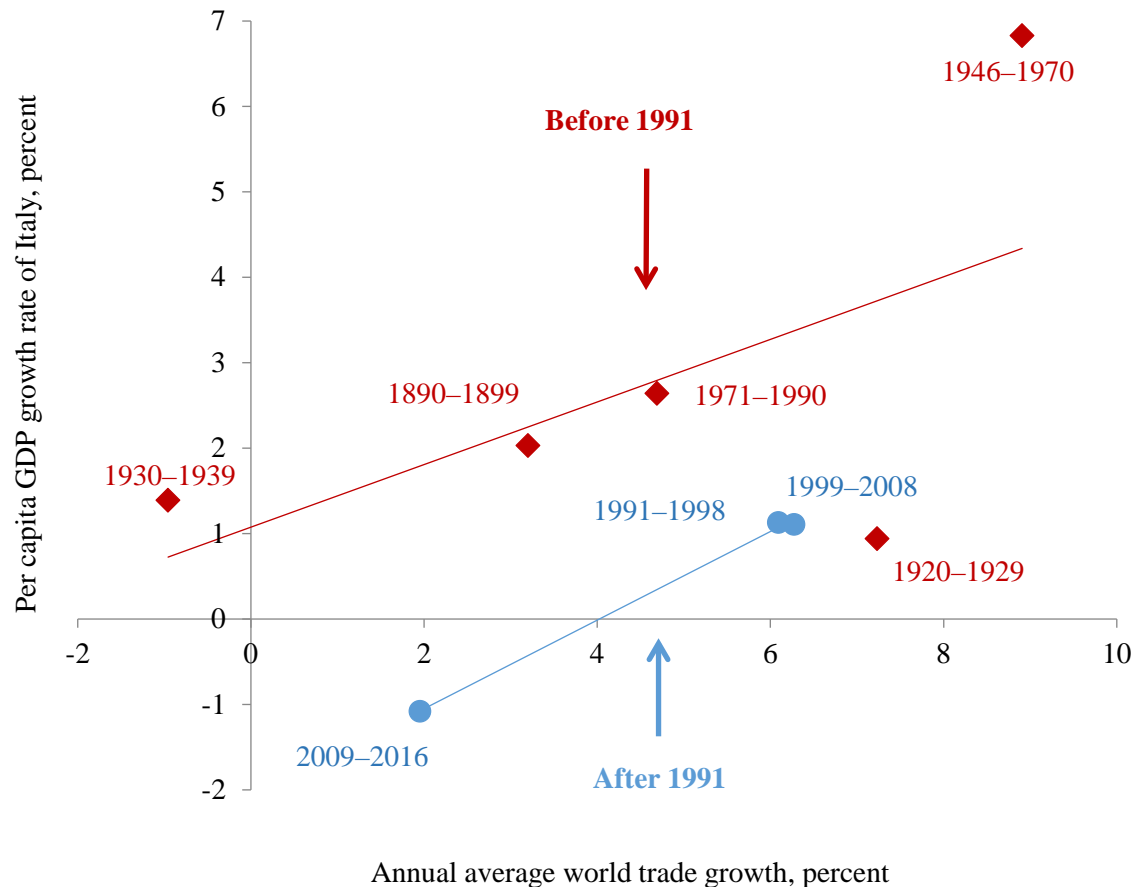
**Short-term growth prospects also looking shaky:  
Euro-area growth marches to the drum of world trade growth, which is  
slowing.**



Sources: Real per capita GDP growth rates: Angus Maddison, “Historical Statistics of the World Economy: 1–2008 AD,” <http://www.ggdc.net/maddison/oriindex.htm>; Penn World Tables 8.0, <http://www.rug.nl/ggdc/>; International Monetary Fund, World Economic Outlook Database, <http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx>. World trade: League of Nations, Monthly Bulletin of Statistics; CPB Netherlands Bureau for Economic Analysis, World Trade Monitor, <https://www.cpb.nl/en/data>. Note: Eurozone countries in this chart include Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal, and Spain. The periods 1914–1919 and 1940–1945 are missing due to a lack of wartime trade data.

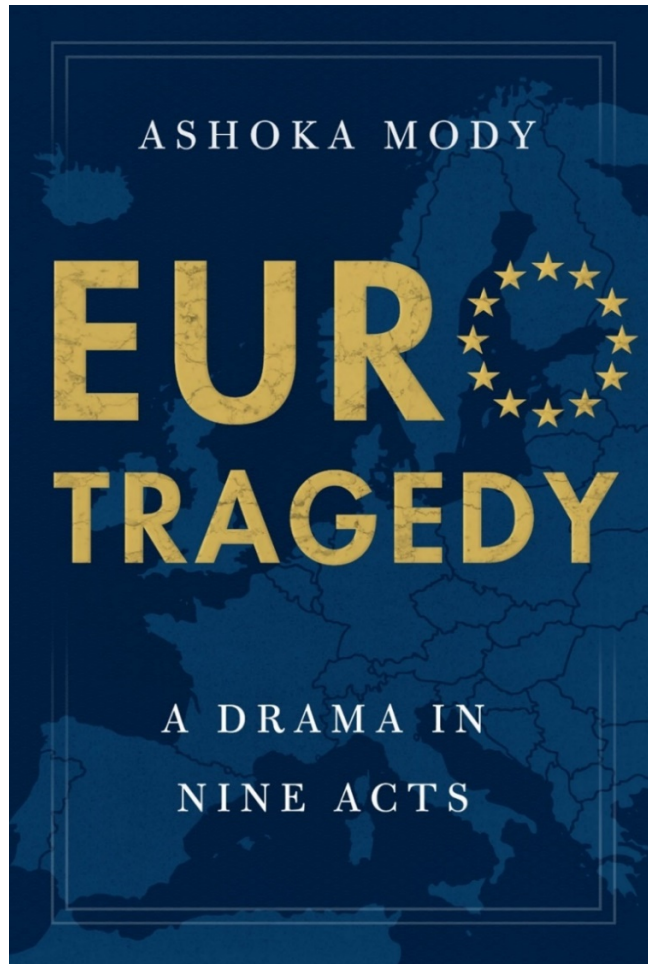


## Italy does even worse when world trade slows



Sources: Real per capita GDP growth rates: Angus Maddison, “Historical Statistics of the World Economy: 1–2008 AD,” <http://www.ggd.net/maddison/oriindex.htm>; Penn World Tables 8.0, <http://www.rug.nl/ggd/>; International Monetary Fund, World Economic Outlook Database, <http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/index.aspx>. World trade: League of Nations, Monthly Bulletin of Statistics; CPB Netherlands Bureau for Economic Analysis, World Trade Monitor, <https://www.cpb.nl/en/data>. Note: The periods 1914–1919 and 1940–1945 are missing due to a lack of wartime trade data.

## The future ain't what it used to be



- With QE tapering, the euro can only strengthen and real interests can only rise.
- Both will further squeeze an anemic Italian economy.
- With world trade slowing down, even the German economy seems to slowing.
- For Italy, everything is going in the wrong direction:
  - Stronger euro
  - Higher real interest rates
  - Slower European and world economy.
  - Q-o-q GDP growth about zero.
- Italian government debt levels are high; the chaotic banks have large volumes of non-performing loans and thin margins.
- OMTs could crack under political limits.