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Avoiding an Italian bailout: Why and how

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Spain looks set to turn to the EFSF for a formal bailout subject to stringent conditionality. In this column, Francesco Giavazzi – one of Europe's leading macroeconomists and an advisor to the Monti government – argues that Italy's situation is nothing like Spain's. To avoid submitting itself to its EFSF conditionality, Italy should reduce its borrowing needs with a determined programme of public asset sales and bridge financing from the Cassa Depositi e Prestiti.

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Spain has no options, but Italy does.

- Spain will have to accept EFSF conditionality in order to persuade the ECB to buy its bonds.
- Italy is different; Italy should not bow to the EFSF and submit itself to its conditionality in order to persuade the ECB to buy its bonds.

Spain may have no other option than to turn to the EFSF and the ECB for assistance: Italy has, and should pursue them. By going to the EFSF together with Spain – as many in the markets are advising – the two countries would be put in the same basket, one in which Italy does not belong.

Italy can and should avoid engaging with the EFSF for two reasons.

First, Italy's economic situation is very different from Spain's.

- There was no real estate bubble; Italian banks are weakened by the recession but their balance sheets do not bear the legacy of piles of mortgages gone sour.
- At 123% of GDP, public debt is extremely high, but the government runs a primary surplus – 3.4% of GDP this year – while Spain has a primary deficits of 3.3% (1.9% in France).
- Italy's net external position is balanced which Spain run current account deficits close to 10% of GDP per year over a decade.

- If Italians were to swap their foreign assets with the government bonds held abroad, Italy would look like Japan: a high-debt country but one in which all of the debt is held domestically.

In part this has already happened as a result of the ECB's Long Term Refinancing Operation (LTRO). The share of government debt held by foreign residents has fallen in a few months from 45% to 34% of the total.

Second, Italy's technocratic government owes its legitimacy to its ability to steer the country through stormy times – something its politicians proved unable to do. This is the main reason why Italians welcomed Monti's non-elected cabinet.

- The technocrats' legitimacy would vanish the day they admitted they need outside surveillance.
- When that happens, an early election would be inevitable with the likely result being a hung Parliament.
- The good work Mario Monti is doing would be thrown out of the window and Italy would be back to square one.

A general election is due in the spring of 2013. It should not happen before then, if only to give political parties the time to pass a new electoral law that might reduce the probability of a hung Parliament.

The storm to come: When Spain goes to the EFSF

The day Spain goes to the EFSF and the ECB starts buying bonds, Italian bonds will be under renewed pressure. To survive while renouncing to outside help, the Monti government needs a plan. This should come in two parts.

First Italy should reduce the amount of medium- and long-term bonds it auctions from now until the general election because yields will not fall until the political uncertainty is resolved.

- Some €100 billion of these will come due in the next six or seven months; rather than rolling them over, they should be redeemed through the revenue from a resolute program of asset sales.
- The government still owns large fractions of publicly traded companies, among them Enel, Eni and Finmeccanica. It should sell them.

The stock market is depressed, but what the government pays to finance itself is also exceptionally high.

- There is also a huge stock of public real estate, admittedly harder but not impossible to sell: the city centres of most Italian towns have at least a couple of large, empty army barracks.

While it would be possible to raise enough money to cancel almost all the auctions of the next six months, doing so at a sufficient speed is technically impossible.

- Once a credible program of assets sales is launched, bridge financing could be provided by Cassa Depositi e Prestiti – a government-controlled institution which finances itself through saving deposits issued by the Post Office (worth €220 billion).

The Cassa lends to local authorities and these loans are accepted by the ECB as eligible collateral. They could be turned into liquidity that the Cassa could use either to buy government bonds or to lend directly to the Treasury.

Privatisation stigma versus EFSF conditionality

After the large privatisation program of the 1990s Italy has been reluctant to dispose of any of its government-owned assets. The stigma attached to asking for outside help may provide the incentive to start selling, which so far has been lacking.

None of this would solve Italy's underlying weakness stemming from a decade of weak growth. But it would give the country a period of relative calm which Parliament could use to sort out the electoral law and Monti could use to give new impetus to his government.

After raising an unprecedented amount of taxes – and contributing to deepen the recession – Monti has belatedly embarked on a program of spending cuts—the first ever in Italy's history.

Inducing the government to go to the EFSF and thus trigger an early election is the strategy of those that are desperately trying to avoid these cuts.

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