Italy's debt sustainability in the new interest environment: More challenging but still doable

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The European sovereign bond markets digested the rapid monetary policy turnaround since 2002 relatively well thus far. The government bonds of Italy, which has come under close scrutiny for its government debt-to-GDP ratio of just under 150%, are no exception. In October, shortly after Giorgia Meloni's election victory, yields of 10-year government bonds briefly rose as high as 4.8% before slipping back to around 4%. During the euro crisis of the years 2011 and 2012, on the other hand, yields peaked at 7%, while the risk premiums on German government bonds in particular sat at around 500 basis points, significantly higher than in 2022 (~200 basis points). So how has Italy's debt sustainability evolved?

Inflation is lowering the debt-to-GDP ratio but over time it will get harder

The development of the government debt ratio depends heavily on the relationship between the effective interest rate and nominal growth. In 2022 the unexpected inflation surge combined with strong real growth send nominal GDP in the denominator of Italy's debt ratio significantly higher, so that despite higher government spending it fell from 150% to about 145%. Given the stock of bonds with longer maturities in circulation, it will take time for the interest rate rise introduced to combat the high inflation rate to pass through to the effective interest rate for government debt. In 2022 the effective interest rate still stood at 2.8%, and the average residual maturity of Italian government debt was nearly 8 years.

But if persistently higher interest rates are the only way for the ECB to achieve its inflation target of 2%, or if the market prices in higher inflation expectations, in the long term the inflationary surge can contribute to making debt sustainability more difficult. The IMF estimates Italy's potential growth rate at 0.8%. Assuming this real growth rate, average inflation of 2%[1] and an effective interest rate of 4%, it would be enough to have an only slightly higher primary surplus (government revenue – government expenditure without interest payments) than that achieved in the 2010s to slowly bring down the government debt ratio (2011–2019: avg. 1.6%). However, if the effective interest rate rises above 5% and/or nominal growth ends up lower, primary surpluses greater than 3% of GDP would then indeed be necessary to reduce the government debt ratio (see table). To be sure, in the past decades Italy has achieved higher primary surpluses than most other major industrialised countries. But the experience of the past decades has also shown that primary surpluses of more than 3% are rarely maintained for long.[2] It is true that long average residual maturities of government bonds prevent an abrupt increase in interest payments. But if the expectation materialises that Italy's interest rate level settles in at 5% or more, doubts about its debt sustainability could arise immediately, sending risk premiums soaring higher.

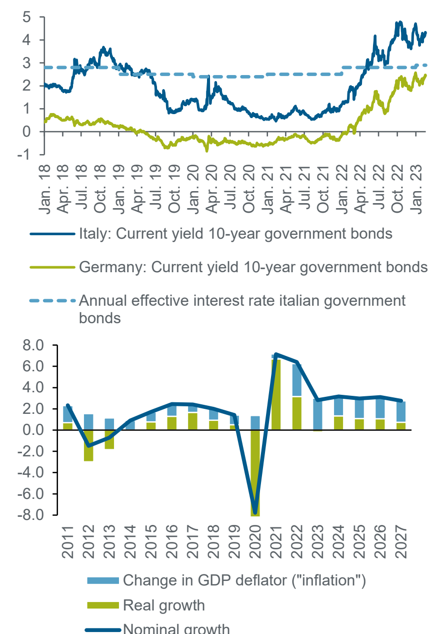
On balance, the comparison with similar calculations from early 2021 shows that the burdens resulting from the interest rate reversal outweigh the benefits of a presumably higher nominal growth rate driven by inflation.[3] At the current interest level, however, debt sustainability nonetheless appears realistic.

Primary balances necessary to stabilise the Italy's government debt ratio as a function of interest and growth rates

		Effective interest for government debt		
		low	average	high
Nominal growth		3.0%	4.0%	5.0%
high (inflation above target or growth significantly above trend)	3.5%	-0.7%	0.7%	2.1%
average (inflation on target; potential growth)	2.8%	0.3%	1.7%	3.1%
low (inflation < 2%; weak growth)	2.1%	1.3%	2.7%	4.1%

The starting level is the debt-to-GDP ratio of 145% forecast by the EU Commission in November for the year 2022. Sources: KfW Research; European Commission (AMECO Database)

Charts: Interest and growth rates



Sources: Bloomberg, European Commission; IMF World Economic Outlook Oct. 2022

[1] This refers to changes in the GDP deflator. In the past, this was typically close to consumer price inflation. But at a time when most inflation is imported, like 2022, the change in the GDP deflator is well below consumer price inflation.

[2] Cf. Scheuermeyer (2021), Debt sustainability after the coronavirus crisis, Focus on Economics No. 327, KfW Research.

[3] Cf. ibid.

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Note: This paper contains the opinion of the authors and does not necessarily represent the position of KfW.