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Twin risk of rising rates and slowing economy spark Italian attack on ECB

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FRANKFURT — Rome's latest attack on the European Central Bank and its unprecedented policy tightening have struck a chord, but perhaps one that would have been better left alone.

Italy's prime minister, deputy prime minister and foreign minister all chorused condemnation earlier this week after ECB President Christine Lagarde signaled that there's no quick end in sight to the bank's series of interest rate increases. The comments hint at growing nervousness about the country's economic prospects and — inevitably — the sustainability of its massive debt load.

"The ECB's simplistic recipe of raising interest rates does not appear to many as the correct path to pursue," Prime Minister Giorgia Meloni told the Italian parliament on Wednesday. "We cannot overlook the risk that the constant rise in rates will end up affecting our economies more than inflation. The cure will prove more harmful than the disease."

The ECB has raised interest rates by 4 percent over the past year and Lagarde, in a high-profile keynote speech on Tuesday, hammered home the point that there's still more to come.

"Rome must be extremely worried about borrowing costs," said EFG Bank chief economist Stefan Gerlach. "Spreads have not shot up very much yet, but at some point, they will … If rates continue to rise, at some stage the music will stop playing."

Italy, the eurozone's third-largest member state and its most indebted in absolute terms, is the eternal vulnerability of the eurozone: too big to fail and too big to rescue. Its debt-to-GDP ratio is hovering around 144 percent. That puts it in a tight spot if interest rates rise and stay high for any length of time — as the ECB is currently signaling.

Analysis from Citigroup indicates that every 1 percent rise in Italy's average bond yield raises its debt servicing costs by 0.5 percent of GDP after four years. Data from the Ministry of Finance and Economics show the average yield has risen over 3.1 percent in the last 18 months.

Higher debt servicing costs divert precious tax receipts away from investments needed to guarantee the country's economic future. And tax revenue will be even scarcer should the country's economy slow or fall into recession.

While Italy has proven surprisingly resilient at the start of the year, growing by 0.6 percent, the country's top business association earlier this week warned of darkening prospects.

“Signs of weakening continue to mount, particularly in manufacturing and construction, despite a 0.6 percent quarterly increase in gross domestic product in the first three months of the year,” Confindustria said Monday. It warned that rising interest rates “are hindering consumption and investment” at a time when the tailwind from a strong export performance is fading.

On Wednesday, Italy’s statistics office Istat reported that underlying industrial turnover dropped by 1.8 percent, both in month-on-month and year-on-year terms. Italian confidence data also pointed to a slowdown in the second quarter while the European Commission’s economic sentiment indicator on Thursday showed confidence in Italy declining for the second straight month.

“There’s no question that a lot of people are starting to worry that the economy is slowing down,” said Alessandro Merli, a fellow at the Johns Hopkins University in Bologna and ECB expert.

He ascribes the government’s latest comments not only to looming risk but deeply ingrained political conviction. “These people have been preaching this anti-Europe, anti-euro message for all their political lives and a good part of their voters are still convinced that we should get out of Europe,” he said. “They have trouble adjusting to reality.”

Such attitudes are reflected in Deputy Prime Minister Matteo Salvini’s indifference to the idea of central bank independence. Calling ECB policies “senseless and harmful,” he said he would seek a meeting with the Italian “representative” on the board of the ECB, Fabio Panetta.

The infringement comes at a particularly sensitive time as the government wants Panetta back in Rome to lead the Italian central bank, a move that would create a vacancy on the ECB’s influential six-member board. As POLITICO previously reported, Meloni’s inexperience in Brussels horse trading and strained relations with European partners may jeopardize Italy’s influence in the bank. The more openly Rome tries to sway its ‘representative’ in Frankfurt, the more it risks seeing Panetta’s seat taken by a member state that is more comfortable with the idea of central bank independence.

The latest interventions “will certainly not help” Italy’s chances of securing an executive board seat after Panetta departs, Gerlach said. However, this might not be Italy’s priority in any case, Gerlach argued. “If their candidate doesn’t replace Panetta, they can get outraged and blame Europe again.”