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The greatest danger for Italy is the looming loss of the ECB shield

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The ECB's Mario Draghi faces a grueling Kulturkampf with Germany

The moment of real danger for Italy will come as soon as the European Central Bank starts to taper bond purchases, or even hints at a change in course.

This is imminent. It is a looming threat regardless of whether Matteo Renzi wins his make-or-break referendum this weekend, and regardless of whether he stays or goes as prime minister. Mr Renzi's opera buffa is largely a side-show.

The only outcome that would make much difference is if a technocrat government were to take over and request a €40bn bail-out package for the Italian banks from the European Stability Mechanism, effectively putting Italy under economic occupation.

This would need a vote in the German and Dutch parliaments. While it would allow the ECB to carry out a surgical rescue of Italian debt, the terms would be intolerable. Such a request would invite a populist revolt. An EU 'commissariato' of this kind would play straight into the hands of the anti-euro Five Star Movement and the Lega Nord.

Italy's problems never went away. They were disguised by quantitative easing and the artificial suppression of borrowing costs. The ECB's €80bn purchases each month jammed the signalling system for sovereign credit risk.

But even this has not been enough to stop the risk spread on Italian 10-year yields rising for several months as the banking crisis deepens, hitting a two-year high of 192 basis points earlier this week.

Italian bond spreads have been rising for months. Reassuring talk by the ECB has calmed jitters for now CREDIT: IL SOLE

It dropped back on talk that the ECB would step in to stabilize the Italian debt markets for a few days or weeks if there is a 'No' vote on Sunday, but intervention of this kind is a band-aid. Italy's difficulties run far deeper.

The global reflation shock since the election of Donald Trump is bringing matters to a head faster than anybody could have imagined weeks ago. Italian borrowing costs have risen in lockstep with US Treasury yields, even though Italy is not reflating at all and is certainly not about to enjoy a fiscal shot in the arm.

Italy is in a sense the biggest casualty of the Trump effect and the tornado of imported monetary tightening. Its banks own €400bn of Italian government bonds and these are suddenly worth less. Some paper losses must be marked to market, further eroding core capital ratios.

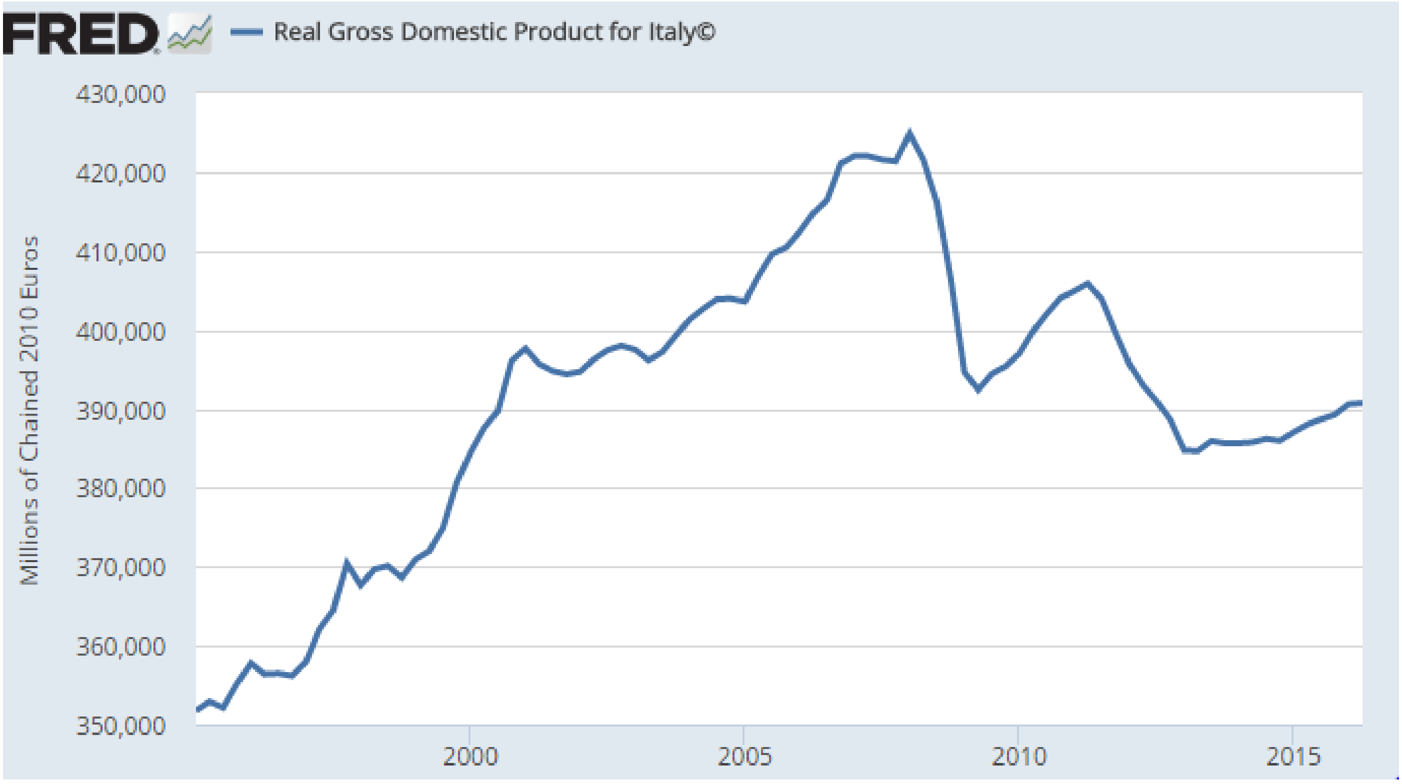
It is our old friend the 'doom loop'. The banking crisis is driving up sovereign bond yields, and higher yields are in turn driving the banks into deeper trouble.

The painful saga of Italy is by now well-known. The country is stuck in a depressionary debt trap. Trend growth is below zero. GDP is still 9pc below its pre-Lehman peak. Industrial output is back to levels reached thirty-five years ago.

The contours are worse than the 1930s. It is a lost decade turning into a second lost decade. No large developed country in modern times has ever suffered such a fate.

Italy is the victim of a vicious cycle of labour hysteresis as economic stagnation and weak productivity reinforce each other. Its exchange rate is overvalued by 20-30pc against Germany.

How easily we forget that Italy used to run a big trade surplus with Germany in the old days of the lira, and its real growth rate tracked German growth almost exactly with the help of devaluations. Each country was true to its political anthropology.



Italy's GDP is back to the levels seen at the start of the century. It is two lost decades CREDIT: ST LOUIS FED

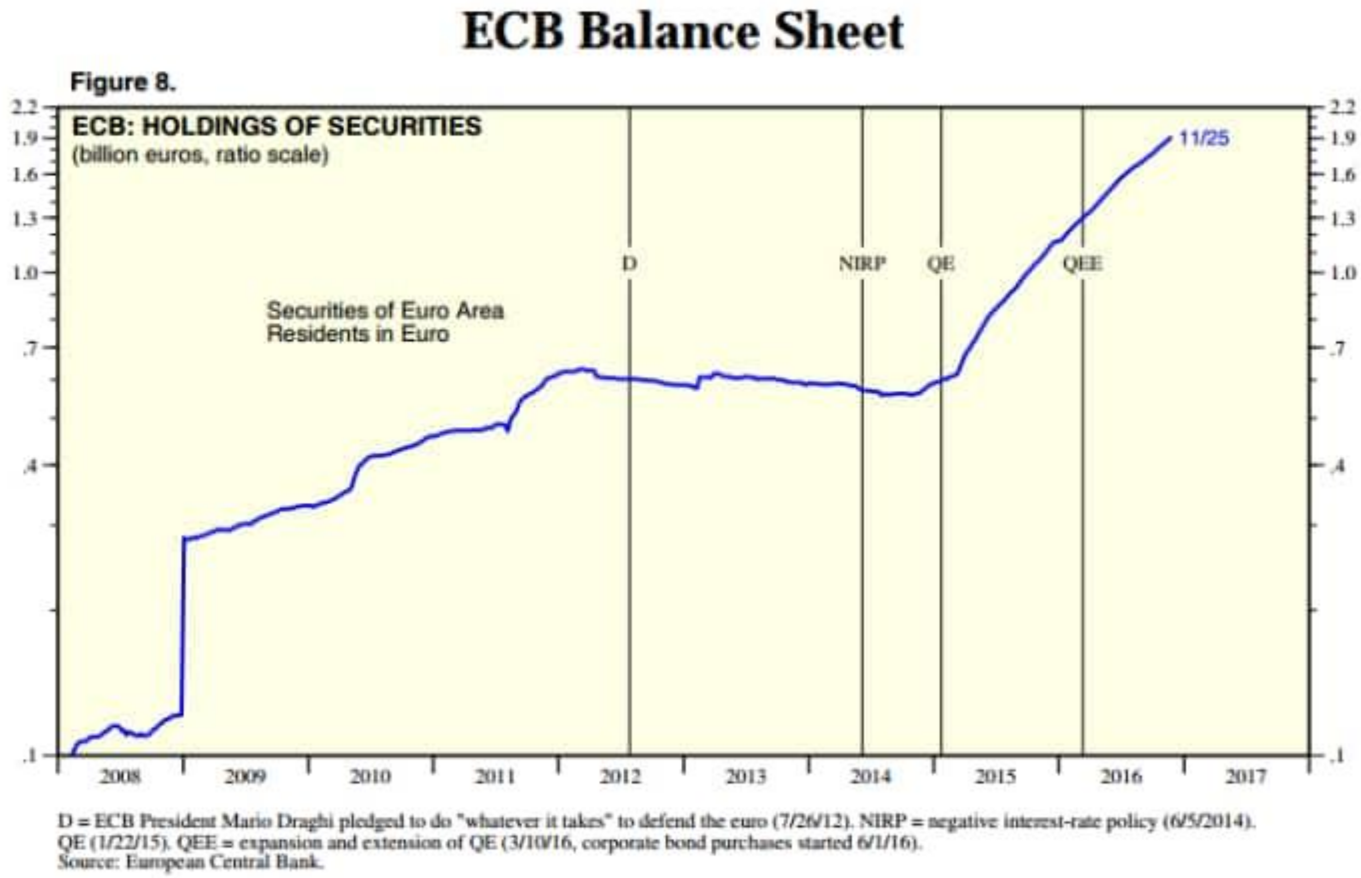
Italy cannot now deflate its way back to viability since this shrinks the underlying base of nominal GDP and automatically steepens the debt trajectory. It is impossible task for a country with a public debt ratio of 133pc of GDP, and is self-defeating in mechanical terms.

Reform is a beautiful word, but is almost meaningless at this juncture. There is no plausible way out for Italy within the current contractionary structure of monetary union. Only ECB bond purchases forever can keep the lid on this pressure cooker.

Yet it is patently obvious that QE is nearing political, legal, and technical limits. The ECB already faces a lapidary attack by Otmar Issing, its founding chief economist and a figure of towering authority in Germany.

He accused the bank of sliding down a "slippery slope", straying from genuine monetary policy and instead rescuing bankrupt states in violation of the treaties. "The no bailout clause is violated every day," he said.

The ECB has so far bought €1.4 trillion of bonds. Its balance sheet will reach 35pc of eurozone GDP by the end of the year at the current torrid pace, much higher than it ever reached in the US. Mr Issing said QE is nearing the point where the ECB may not be able to extricate itself without disastrous losses.



The ECB's balance sheet will soon reach 35pc of GDP CREDIT: YARDENI

The inevitable taper battle is now raging within the ECB's governing council, with the two German members leading a swelling mutiny before the next meeting on December 8. Any suggestion that the programme will not be rolled over in full when it expires in March risks a financial storm. Italy will be the epicentre.

The context is fundamentally more dangerous than the events leading up to the US taper tantrum in May 2013, when the Federal Reserve first began to talk tough.

It invites the perennial question whether Italy, Portugal, and perhaps others, can fund themselves at all in the capital markets, given that the eurozone has done almost nothing since the debt crisis of 2011-2012 to put monetary union on workable foundations.

There is still no fiscal union, no shared debt issuance, no banking union worth the name, and no expansionary New Deal to lift the economy off the reefs once and for all. All it has done is to tighten surveillance, hoping somehow that it can muddle through by riding on world demand.

So Europe's taper tantrum - when it comes - ineluctably turns into a fresh stress test of monetary union itself. "The feeling once again is that the eurozone is not entirely safe," said David Owen from Jefferies.

"Asian investors were badly burned in the last crisis and they don't want to risk being caught out again. We're seeing 'redenomination risk' creep back into the equation," he said.

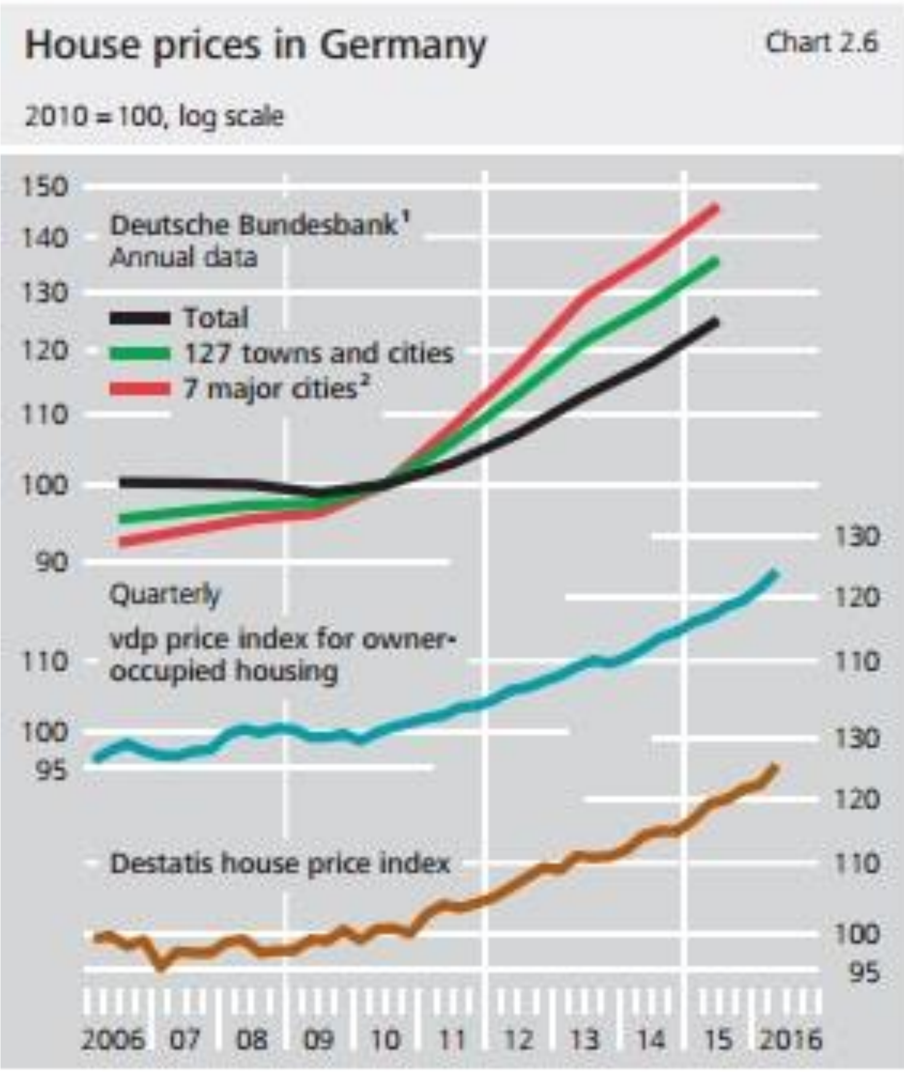
The ECB's Mario Draghi knows the dangers but he is caught in a Kulturkampf with the dominant power of Europe. Germans regard the experiment of QE and negative rates as a violation of the 'Ordoliberal' orthodoxies that anchor the nation's post-War political and economic thinking.

“ECB policy is threatening the European project as a whole for the sake of short-term financial stability," said Deutsche Bank’s chief economist David Folkerts-Landau in an astonishing outburst over the summer.

"The benefits from ever-looser policy are diminishing while the litany of distortions, perversions and disincentives grows by the day. Savers are punished and speculators rewarded. Bad companies survive while good companies are too scared to invest. Central bankers can lose the plot. When they do, their mistakes can be catastrophic,” he said.

What he said publicly is more or less what is said privately at the Bundesbank and the German finance ministry. It is the view of the *Frankfurter Allgemeine* and large swathes of the German press.

A cottage industry has sprung to life warning of an ECB-induced property bubble in Munich, Stuttgart, Hamburg, and Berlin, with Bild Zeitung publishing 22 stories over the last six months in a crescendo of hysteria.



Talk of a housing bubble is building in Germany CREDIT: BUNDESBANK

It is a tame bubble by Anglo-Saxon standards but that is not the same point. Nor is it confined to Germany. A report by the European Systemic Risk Board this week cited "significant systemic risks" in the property markets of Austria, Belgium, Finland, Luxembourg, and Holland as well.

If Mario Draghi keeps pushing for more QE in this context, it will become almost impossible to silence criticism that his real objective is to hold down Italian yields and stave off the insolvency of his own country. Perhaps it is already impossible.