Global Political Drivers

ITALY AND THE FRENCH WHITE KNIGHT

Christopher Granville/ Constantine Fraser

- **The latest widening of BTP spreads over Bunds has switched the focus of the Italian problem from politics towards markets, while contagion to other peripheral EA government bonds has been limited.**
- **In this perspective, the threat of a systemic shock to the Eurozone from Italy may no longer seem either a very 'political' or even a 'global' driver.**
- **We beg to differ: the systemic risk has not disappeared, and present financial market tensions are politically toxic. A game of chicken between Italy and the EA establishment with undertones of M.A.D. remains very much on the cards.**
- **Perhaps Italian 'hysteresis' is incurable and the best the country can hope for is to become a giant 'Mezzogiorno' in relation to the rest of Europe: but even reaching that mediocre haven will require a determined political intervention.**
- **Macron has sought to provide this, but his initiative is foundering not only on the usual German objections but now also on the increasing political fragmentation showing up this month's elections in Bavaria and Hesse.**
- **A more plausible – hence effective – way for Macron to cushion Italy and stabilize the Eurozone might be by putting his 'own' central banker into Mario Draghi's chair at the ECB. Draghi for his part may tee up what we regard as the best instrument for this purpose: a new Italy-focused TLTRO programme**

Italy risk: Still global and political

Italy fears are back. Always lurking in the background, the spectre of another Eurozone crisis centred on Italy has loomed back up since the new Italian government finalized its annual budget proposal earlier this month with a projected 2.4% of GDP deficit. As measured by the BTP yield spread over Bunds (by now a household term in Italy), the latest scare has now surpassed last May's yield spike caused by fears of an 'Italexit' from the single currency under the Five Star (M5S)-Lega government.

Politicians' statements about their commitment to the single currency are having little effect amidst downgrade fears. The trigger this time has been a combination of ratings agency downgrade fears and the European Commission's decision this week to reject that draft budget. The scare has not been calmed by the reiterations of Italy's intention to remain in the Eurozone on the part of the political leaders of the Italy's governing coalition – Luigi di Maio for M5S and the Lega's Matteo Salvini. Such verbal interventions do not work amid fears of the Italian government and banks losing market access, in turn reviving the 'Italexit' threat.

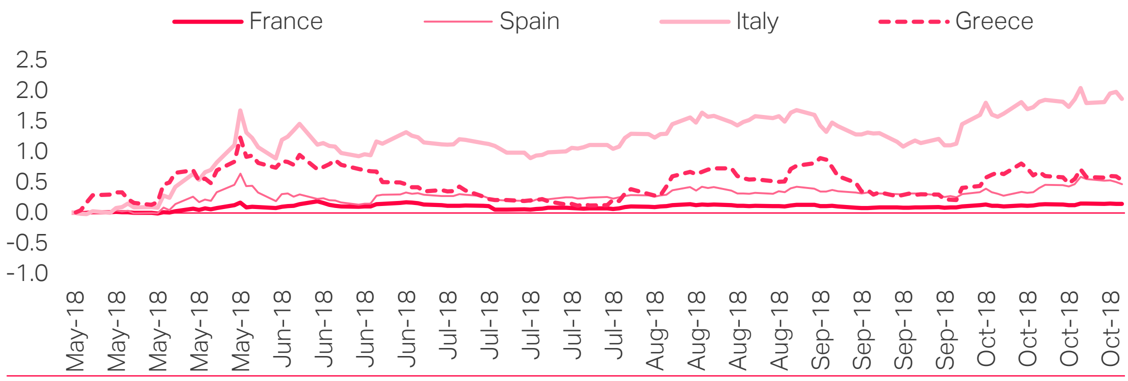
For now, then, financial markets rather than politics seem to be in the driving seat. This financial vicious cycle feeds on itself. It starts with fundamental doubts that Italy's fiscal expansion will boost growth and worries, therefore, that it will instead make public debt less sustainable. By pushing up sovereign debt costs, such fears are self-fulfilling: public debt ratios deteriorate anyway, and the negative effects of higher sovereign yields on Italian banks will constrain credit – offsetting the anyway modest stimulus coming through the fiscal accounts. This feedback loop spells rating downgrades.

"Houston, we have a problem"

ECB collateral requirements mean that credit downgrades matter. Junk ratings for Italian sovereign debt would, as Mario Draghi said in his press conference after yesterday's meeting of the ECB governing council, "be a problem". The ominous elephant-in-the-room feel was even sharpened by his further comment that "we did not discuss this problem". Downgrades to junk by all the agencies would make BTPs ineligible as collateral at the ECB's repo window, with the resulting liquidity squeeze then leading to a market access crunch – and a full-blown Euro crisis.

Contagion fears are still limited, to judge by the recent action in the EA government bond markets (see chart below). Unlike at the height of the original Euro crisis in 2011-12, markets may now take comfort in the armoury of instruments and institutions (OMT, the ESM) that could provide instant relief to other potentially vulnerable countries in the event of Italy 'blowing up'.

Limited contagion in the most recent widening
Change (ppt) in spread over Bunds since 1 May



Source: Bloomberg, TS Lombard

But that does not make the risk any less global – nor any less political. If the contagion threat has waned, and if Italy's fate now depends more on financial markets rather than government action, the risk of a new Italian financial crisis may no longer count as either "global" or "political". As you will have gathered from seeing this new note on the subject in our Global Political Drivers series, we do not see things that way.

Systemic risk still present

Banking linkages guarantee a systemic shock. On the contagion point, the idea that an Italian crisis being localized seems far-fetched. This is not just because of the sheer size – €2.3 trillion – of Italy's public debt stock. Despite the firewalls that are now available against direct contagion in government bond markets, banking linkages guarantee a systemic shock – certainly throughout the Eurozone, and probably further afield. As our colleague Shweta Singh explains in her note on this topic in our Global Financial Trends series, the fraught linkages work through two channels: balance sheet impairment from Italian bond exposures and cross-holdings between banks.

And financial market tensions are politically toxic. As for the political driver, it is alive and well – precisely because, rather than despite, the financial market focus of the present action. Mandated by voters to address the twin grievances of economic degradation and mass illegal immigration, Italy's new political leaders gain strength from railing against "speculators" – or, in Salvini's rendering, *i signori dello spread*. For his political purposes, the European Commission has conveniently put a human face on the 'enemies of the [Italian] people' that shadowy financial speculators cannot supply.

The timeline for confrontation with the Commission will stretch well into next year. The Commission's activities as enforcer of the Fiscal Compact are lengthy and inconclusive. On the safe assumption that the Italian government refuses to modify its budget plans, an 'Excessive Deficit Procedure' will not be formally launched before January (by a decision of the Council of Ministers acting on a Commission recommendation). Thereafter, it would be another three or more likely six months before the question of fining Italy was even considered. All this will keep the political temperature high – to the satisfaction of Salvini and di Maio, who will hope to reap dividends in the European parliamentary election in May 2019.

A game of chicken looms. Escalating political tensions over Italian fiscal policy will be compounded by the Italian government's broader anti-establishment agenda on questions ranging from immigration to – as signalled by Prime Minister Conte's visit to Moscow this week – sanctions against Russia. This will fuel financial market jitters in a mutually reinforcing way.

As and when those tensions heighten the threat to Italy's market access, the predictable game of chicken will go live. The Commission and ECB would doubtless signal that the Italian government could apply for OMT at the price of accepting a pro-cyclical fiscal retrenchment programme, while Rome would demand OMT without conditionality – "or else", implying possible Italexit.

This threat – or, depending on one's point of view, bluff – recalls the logic of Mutually Assured Destruction (M.A.D.) of nuclear deterrence. Asked recently about Italexit, Salvini said:

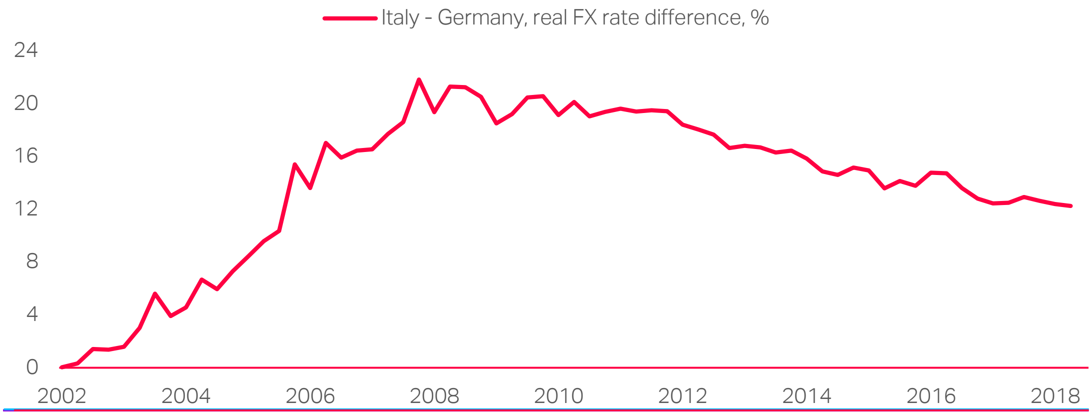
"Nothing is certain apart from death, but Italy right now is not going to leave the Euro."

That mention of "death" might imply a threat that if the EA establishment is determined to 'kill' the Italian economy, Italy might take the rest of Europe down with it.

No exit

The basis for such grim scenarios remains the same as ever: the absence of any credible solution to the Italian economy's predicament inside the single currency. That predicament is summed up in the chart below showing Italy's real over-valuation versus Germany that has undermined Italian competitiveness and productivity.

The true spread



Source: OECD, TS Lombard

It is hard to see any credible solution to Italy's predicament. The damage to Italy's productive and social fabric has arguably gone beyond the point of no return. In the hypothetical fiscal and political union required to underpin the existing monetary union, even massive transfers and investment finance directed towards Italy from a central EA budget might fail to rehabilitate degraded skills and technological capacity. This discussion of whether Italy could ever recover from this 'hysteresis' problem is in any case as theoretical – or fantastical – as the idea that Germany would engineer a domestic inflationary growth spurt thereby delivering the real-terms 'devaluation' needed for Italian productivity and living standards to recover.

Franco-German reform proposals have little to offer Rome. This fantasy was there to be indulged again when Emmanuel Macron launched his Eurozone reform initiative that resulted in last June's joint "Meseburg Declaration" with Chancellor Merkel. This was a symbolically notable moment insofar as it signified German government acceptance that fiscal policy was a legitimate area of EU competence. But there has been little substantive progress since then.

- Banking union: The European Deposit Insurance System is not going to happen on any realistic timeframe. That the ESM should serve as backstop for the Single Resolution Fund – via a credit line that will roughly double the financial firepower of Eurozone's mechanism for financing bank resolutions - was agreed in principle in June, and the details should be ironed out in December. But this is the lowest common denominator of reform.
- Fiscal: Meseburg included Franco-German agreement in principle on a Eurozone budget to fund investment, funded in part with its own tax resources. But Merkel has already made clear that Germany's vision for the latter is as a macro-economically irrelevant budget in the low two-digit billions.

  At the same time, Macron and Merkel also opened the door to a possible unemployment re-insurance mechanism, which the German Finance Ministry under Olaf Scholz is now pushing – although he is encountering stiff resistance from the CDU.

Meanwhile, the Commission has split the difference with its proposed European Investment Stabilisation Function, which now seems like a scheme to offer World Bank-style loans for capital spending projects and anyway primarily involves repackaging already-existing funds.

- The ESM will now be souped-up, and perhaps (though misleadingly) rebranded as the European Monetary Fund. It could potentially be given more leeway to give out low-conditionality loans to help with liquidity issues. It might also be eventually given the job of overseeing a sovereign debt restructuring mechanism, although this would only be introduced on a very long timeframe.

But Germany is still sceptical of French proposals. In addition to the Scholz initiative on a federal dole running into the domestic political sand in Berlin, the German establishment is now pushing back against the Macron school of thought across the board. In an interview with the *Financial Times* last August, Scholz's deputy Jőrg Kukies signalled that the only European budget that Germany was interested in discussing was the next general EU-wide budget for 2020-27 – into which, he said, elements could be incorporated to help struggling Eurozone countries. And other member states – above all the Dutch – remain even more sceptical.

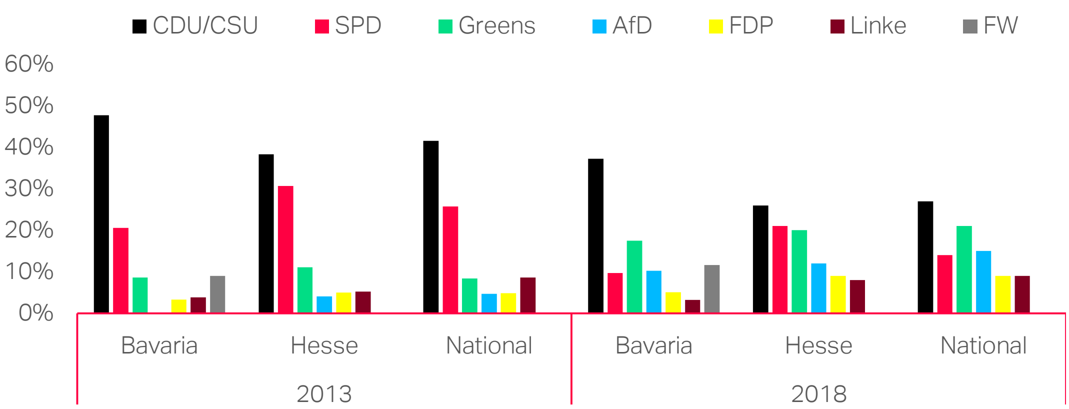
German political fragmentation and paralysis

This German blockage also has an increasingly important structural component. The fragmentation of German politics was held at bay by Merkel's dominance during the Eurozone crisis and the "big-tent" qualities of her centre-right CDU. But voter fatigue at the succession of grand coalitions, the 2015 refugee crisis and the broader realignment of politics around issues of identity and openness have caught up with it. Now the latest round of state elections in Germany has served as a further catalyst for change.

In Bavaria earlier this month, the CDU's more conservative sister party the CSU saw its share of the vote fall from almost 48% four years ago (and over 60% as recently as 2003) to around 37%. Meanwhile, the centre-left SPD saw its vote share halved to under 10%, in 4th place. A similar story is likely to play out in Hesse this weekend, where the CDU looks set to fall from 38% to 26% and the SPD from 30.7% to around 21%.

Germany's traditional parties are being squeezed. The winners in both cases have been the parties with the clearest positions on the "culture war" issues of the day: the AfD to the right, and in the centre the Greens, who have positioned themselves in Germany as a socially progressive *bürgerlich* (bourgeois) party, and as stronger supporters of Merkel's premiership than her own internal party rivals. With the Linke continuing to challenge from the economic left, the SPD and the CDU are each caught in a pincer, and are struggling to hold together the broad electoral

State of the German parties



Source: TS Lombard, representative recent polling coalitions on which they traditionally relied. As shown in the chart above, that is borne out in the recent national polls, several of which show the Greens surging into second place – most recently on 21%, snapping on the heels of the CDU at 27%.

This fragmentation is yet another source of blockage for the Eurozone. None of this means a decline in the aggregate weight of German political support for some kind of Eurozone reform. These developments simply compound the pre-existing problem of such support falling below critical mass with the additional blockage caused by fragmentation. The blockage stems from the resulting domestic introversion and weaker central leadership – not only during what has clearly become the lame-duck period of Merkel's chancellorship, but also under her realistic successors. Indeed, the CDU leadership has anointed former Saarland premier Annegret Kramp-Karrenbauer as Merkel's heir presumptive precisely on the grounds that she is the candidate best-placed to fight a political rearguard action, as German politics fragments and the CDU declines to a 20-25% vote share. And it is hard to see any of the other would-be contenders for the succession doing any better.

A French ECB

Macron is being hampered by German inaction. The European monetary union would never have come into being but for the political will and clout of the (then) man in the Elysée Palace, François Mitterrand. His present-day successor has inherited the power and voluntarism that stem from France's political system and institutions. This legacy now looks more precarious than in Mitterrand's heyday, since it rests on almost the whole of the old establishment falling back into a single redoubt, and its hold on power hinges on the apparent impossibility of the challengers on the far right and left ever joining forces in the way that M5S and the Lega have now done in Italy.

That being so, Macron can – and does – push to address the fundamental flaws in the Eurozone as bequeathed by Mitterrand. His problem is, as we have seen, that Germany is politically and institutionally incapable of serving up a counterpart.

The ECB may be where he can make some progress. Macron's mission as the White Knight of the Eurozone may progress further on a different front. We are thinking here of the ECB – the one existing federal institution with hard power. In a recent detailed preview of next year's succession to Draghi, we highlighted the strength as candidate of the current governor of the Banque de France, François Villeroy de Galhau. A consummate Paris insider, a Draghi fan and an enthusiastic European, his prospects have risen as Germany's interest in the job dissipates, and he and Macron are said to be liaising closely about his likely candidacy.

The best way forward for Italy could be a new Italy-focused TLTRO programme. The most plausible outcome of the chronic Italy-Eurozone problem is a permanent purgatory in which Italy would have the same relationship of needy financial dependency on the rest of the Eurozone as southern Italy (the Mezzogiorno) has had with northern and central Italy since the Risorgimento. It may well take another full-blown Italian crisis to reach that destination. There is, however, a chance of reaching that mediocre haven without a new blow-up. As we see it, a key to that chance lies in the ECB rolling out an aggressive new TLTRO programme under which Italian banks could repo their BTPs for cheap liquidity.

The volumes and conditionality could be very much at the ECB's discretion without any need for the kind of delicate political manoeuvring with which Mario Draghi gained acceptance for, say, OMT – first in the ECB Governing Council itself and then in Germany and the other conservative EA member states. Draghi will probably try to tee this up as his legacy. François Villeroy de Galhau would, as his successor, surely take up that baton.

GLOBAL POLITICAL DRIVERS – OUR THEMES

Theme	Why it matters	Recent views	Risk
The squeezed middle	Squeezed lower/middle income households in DM countries might be inclined to look for radical solutions – whether to the left or the right.	Corbyn's Labour is interested not so much in redistribution, but in ideologically-driven supply-side changes. The new Italian government could be an unexpected safety valve for discontent.	
Great Power conflict: East Asia	North Korea's nuclear drive threatens to spark conflict in a region that already possesses its share of large-country tensions.	Kim Jong-Un's "Gorbachev gambit" raises the possibility of a geopolitical realignment.	
Cold War 2.0	The new US National Security Strategy implies a global geopolitical backdrop of great power tension.	The logic of Cold War 2.0 suggests that any truce will be temporary – US-China confrontation is here to stay.	
Great Power conflict: Middle East	The Middle East is a flashpoint for conflicts – with potential for spillovers that could affect the oil price, European security or Israel – a key American ally.	The possibility of Chinese intervention means that oil markets might be overpricing US sanctions on Iran.	

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GLOBAL POLITICAL DRIVERS: DEFINITION AND BENEFITS

Political and social developments are for the most part inseparable from economic drivers of risk and opportunity in the global economy and financial markets. But there are times when purely political factors play a decisive role. Global Political Drivers is a component of TS Lombard's macro research service that identifies and analyse such factors. As the title suggests, the selection criterion is the scale of the potential impact – that is, large enough to make the theme relevant for global asset allocators. The detailed insights on the subject matter of many themes should also offer value to portfolio managers and analysts focused on particular geographies and asset classes.

What are these drivers?

The drivers fall into two broad categories:

Geopolitical:

The risk of great power conflict in:

- Western Eurasia
- East Asia
- The Middle East

Domestic politics:

- Voter revolts in Europe
- Trump risk

Publication content and cycle

At any one time, we expect to have around six themes under active coverage. While we only focus on political drivers that we assess to be globally important, we occasionally challenge a consensus view on the high importance of some topic that, in our view, is less risky than widely believed.

GPD notes are published every other Thursday (alternating with Macro Picture). Each note leads on a particular driver, while noting more briefly any marginal changes in the risk profile of other topics on the service's current roster.

Core team

The service is led by Christopher Granville, a former UK diplomat who has two decades of experience providing political economy analysis for investors on Russia and the rest of the former Soviet Union. The other lead analyst is Jonathan Fenby, the Chairman of LSR's China Research service and the author of several books on Chinese history and contemporary China. The core team also includes Marcus Chenevix and Constantine Fraser, specializing respectively in the Arab world/wider Middle East and Europe. The team draws systematically on the insights of our senior economists and market strategists.

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