TS Lombard

Global Political Drivers

European Voter Revolt

Analysts

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Euro area: New Italian storm brewing

- A conference on Italy and the Euro in the Italian parliament this week helps refresh our view on the risk to European – and global – markets from the political reaction in Italy to the disastrous performance of the Italian economy inside the Eurozone.
- Calls heard at the conference to confront Germany with an ultimatum – to generate domestic (German) wage inflation or else Italy will leave the Eurozone – will not be heeded by the Italian political class, including the main opposition Five Star Movement (M5S) whose leaders took part in the proceedings.
- The good news for markets ends there, however. Despite almost certainly coming to nothing, continued talk of a Euro-exit or launching a parallel ("fiscal") currency will destabilize markets.
- But the main source of market volatility will stem from the highest common denominator of all Italian political platforms: fiscal expansion in the face of prospective ECB tapering and in violation of the Eurozone's 'Fiscal Compact' treaty.
- Any Franco-German Eurozone reform push will be a sideshow. Italy will act unilaterally, rejecting any conditionality in a game of chicken with the European Commission and the ECB. Risk aversion will be heightened by the lack of a clear-cut problem to which the usual kind of fudged solution might be applied.

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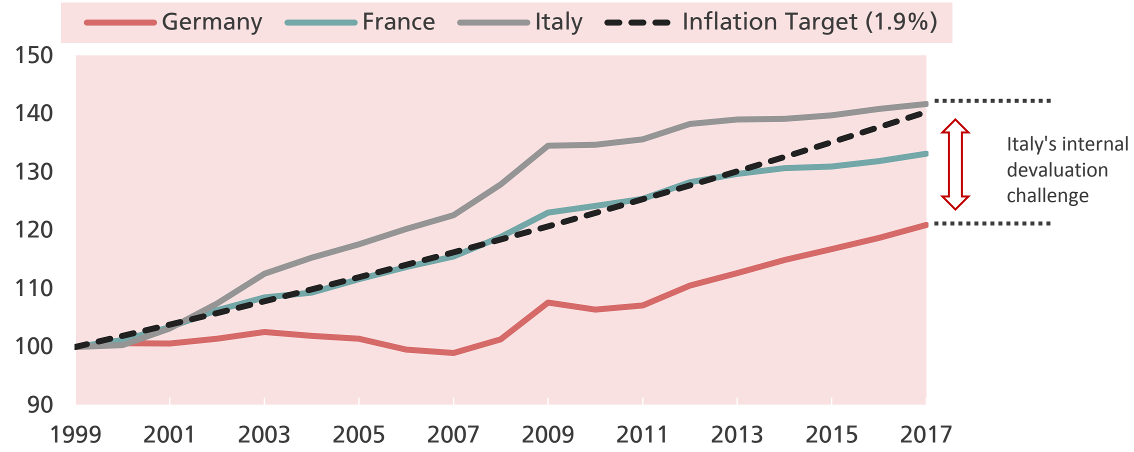
Italy's refusal to lie down and die will shake markets

The author of this note attended a conference in Rome this week on Italy's public debt and the Eurozone

The chart below – and the accompanying commentary by the dissident German economist Hainer Flassbeck – drew by far the loudest applause at a conference that I attended in the Italian parliament in Rome this week on "The Italian public debt in the Eurozone".

Chart 1: Nominal ULC

Index: 1999=100



Source: Datastream, AMECO, TS Lombard

As Flassbeck explained to the assembled members or sympathizers of the anti-establishment Five Star Movement, being stuck in a monetary union with a mercantilist Germany was fatal for Italy. It was his colourful expression of this thought that warmed up the audience.

"You can choose to die slowly by continuing as you are, or you can die quickly by following Greece's example of cutting wages by 30%. You are now on a middle way of trying to push your unit labour cost trajectory gradually down to the German level. But you will definitely die anyway."

Economist Hainer Flassbeck: only a direct threat to the euro would force Germany to drive up its unit labour costs

Flassbeck's recommendation was equally striking. He said that going to Berlin and asking Germany to change was futile ("ask Mr Tsipras"). Only a real threat would make German politicians budge. Italy – together with France – should tell Germany that unless German wages rose such that unit labour cost growth matched the agreed inflation target of 2%, Italy (and France) would leave the Eurozone. At that point, claimed Flassbeck, German industry – fearful of losing its main European markets – would force the politicians to change their tune.

Elections in Italy now look to be held in spring 2018

Were Italian politicians to follow this advice, the resulting volatility in European – and global – markets would rival the turbulence seen at the height of the Eurozone crisis in 2011-12. This Italian political driver has gone on hold since parliament failed to agree an electoral law last month, putting paid to the prospect of an early election in September-October. Instead, the election will be held at the scheduled time – which means on some date in February-May next year. So markets are unlikely to focus seriously on Italy-related risks until the election date at last becomes clear.

Now is still a good time, however, to return to this question of Italy's political choices in the face of its disastrous economic performance since the launch of the Eurozone. One reason is simply that the evidence from this week's conference in Rome is useful for refreshing our view. More important, it is during the present pre-election period that the main political contenders will be deciding their game plans. For investment positioning ahead of the Eurozone storm coming out of Italy, it is worth monitoring this process as it unfolds.

Deep problems, historic mistakes

Flassbeck is associated with the German left. He was an adviser to Oskar Lafontaine, who led the SPD to defeat against Helmut Kohl's CDU in the 1990 election in Germany and who later left the SPD to found the hard-left Linke party. But the core of Flassbeck's way of thinking has now been taken up by the mainstream. Many an orthodox economist might balk at some of the steps in Flassbeck's arguments heard in Rome this week – such as "it is wages that determine inflation, and the EA's 2% inflation target requires unit labour cost growth of 2%, a commitment Germany has violated".

Yet his overall conclusion is reflected loud and clear in, for example, this Bruegel think tank paper published in April about the global trend of the declining share of labour income in gross value added, with particular reference to divergent unit labour costs and current account balances in the EA core (Germany, France, Italy).

The cause of "fiscal federalism" is not enough to make the Eurozone viable…

This emerging mainstream consensus nails the reality that the cause of "fiscal federalism" now being pushed by President Macron is not enough to make the Eurozone viable. Some of the Italian speakers at the conference predictably advocated the standard "transfer union" agenda comprising federal sovereign debt issuance ("euro-bonds") and deposit insurance backed by an EA fund – while adding some novel elements such as BoJ-style yield targeting ("the ECB should target a zero BTP-Bund spread"). Others warned that this is one of those areas where it is important to be careful what one wishes for.

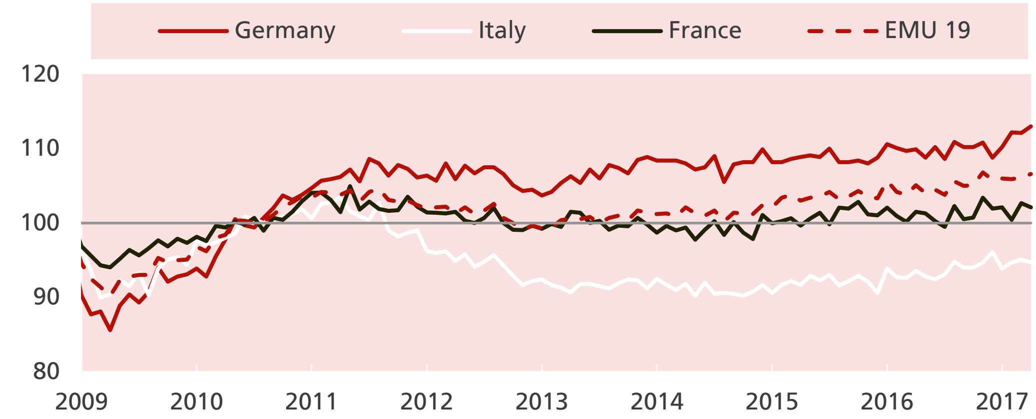
Germany needs to raise its wages, or see the south of the EA become a zombie economy propped up by transfers

In support of his refrain that an increase in German wages is indispensable to prevent the destruction of other EA countries' industrial base by German mercantilism, Flassbeck said that these victim countries could always be maintained in a zombie state by "fiscal federalism" (i.e. German transfers). But that would mean Italy as a whole becoming the "Mezzogiorno" of the Eurozone – "like the desert that is East Germany today".

Warming to this theme of de-industrialization, Flassbeck deplored not only the fact that Italian industrial output declined for half a decade from 2011, but that in Germany itself the compression of domestic demand has caused output to stagnate in the same period (as Chart 2 shows, the German line ticks up only in the past year on the back of the incipient "Deutsche Boom").

Chart 2: Industrial Production

Index: 2010 = 100



Source: Datastream, National Sources, TS Lombard

Italy's productivity decline has arguably even been caused by the euro

The Italian economy has suffered not only from the Eurozone's well-known flaws of German mercantilism and the lack of a fiscal-political union, but also – paradoxically – from its main apparent benefit of allowing weaker brethren to "enjoy" German interest rates. A paper by researchers at the San Francisco Fed makes a convincing case that the productivity decline that is at the root of Italy's problems pre-dates the 2008 crisis and was caused by the sharp fall in real interest rates (the Italian 10-year government bond yield fell from 12% in the mid-1990s to 5% when the euro was launched). "German" interest rates prompted resource misallocations that reduced the average efficiency of production.

This paper was flagged at the conference by the economist Alberto Bagnai, one of the most prominent voices in Italy advocating the country's exit from the single currency. On this view, the main problem is not even German policies but structural divergence between the German and Italian economies. In other words, Italy should never have got into a monetary union with Germany in the first place and that mistake must now be rectified.

Only one Italian part – the Lega Nord – is clearly committed to a euro exit. The Five Star Movement's position is ambiguous.

Of the main Italian political parties, only one – Lega Nord (the Northern League) – is clearly committed to leaving the Eurozone. This position is not shared by the main opposition party, the Five Star Movement (M5S), which was the most visible political force at this week's conference in Rome. At the same time, it clearly suited M5S to be associated with a conference that gave an airing to all points of view, including the economic case for returning to a national currency. In his keynote speech, Luigi di Maio (the 31-year old leader of the M5S's parliamentary group and the prospective prime minister in a M5S government) stressed the imperative of considering all possible options to escape from the "mental straitjacket of austerity".

Mission impossible

But the risks of leaving the euro make it a vote-loser…

Yet there is no easy escape route. The high risks of leaving the euro make this policy a likely vote loser. In the recent French presidential election campaign, for example, the main anti-establishment challenger Marine Le Pen responded to voters' fears of the consequences by making her commitment to a Euro-exit conditional on a referendum. Before the second round run-off she diluted her position further by advocating a parallel currency.

Likewise in Italy, a referendum on continued Eurozone membership is the present M5S party line (though the line frequently shifts). M5S leaders have claimed that the referendum threat would give Italy leverage over Germany.

… and a referendum on it would destabilize markets for little gain.

In reality, the referendum gambit would more likely be regarded in Germany (and elsewhere) as a Greek-style bluff. The Italian government bond market would be destabilized by the announcement of such a referendum (which, for legal reasons, would probably have to be non-binding in any case).

New talk in Italy of a parallel currency is also a dead-end

In what may amount to an implicit acknowledgement of these realities, M5S seems now to be drawn to the parallel currency idea. At any rate, the presentations on this subject were warmly applauded by di Maio at this week's conference (with the M5S supreme leader Beppe Grillo sitting at the back of the hall at that point in the proceedings). The attractions are easy to see: the government would regain some seignorage from issuing a scrip currency. Another fan is Silvio Berlusconi, the M5S's bogeyman who is now making yet another political comeback. As di Maio put it, the escape from the orthodox straitjacket should "not involve a binary choice for or against Europe".

This "solution" looks like another mirage. Even if the stated purpose of the scrip was limited to a fiscal expedient, markets would have to discount the possibility that it was also designed to lay the groundwork for a reinstated national currency into which all domestic law-governed debt might be redenominated. A pre-emptive run on BTPs would be on the cards.

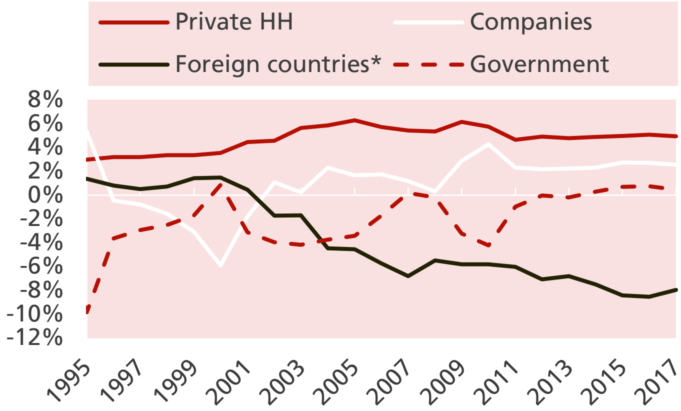
The conference debates underlined the lack of feasible solutions

The conference debates highlighted how all exits are blocked in a great arena of impossibility. Germany's requirement that other EA countries become like Germany (Chart 3) is to "ask the impossible" (to quote Flassbeck again, who enlivened the point with a favourite witticism about "running a current account surplus with Mars").

Were the Italian government to become a saver like Germany (raising the dotted red line in Chart 4 above the zero level), Italy would tip into deep recession.

Chart 3: Germany, Net Borrowing / Lending

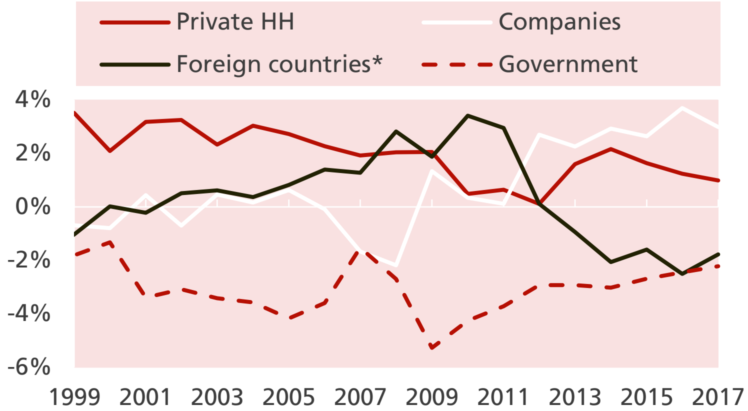
As % of GDP, inverted



Source: Datastream, AMECO, TS Lombard

Chart 4: Italy, Net Borrowing/ Lending

As % of GDP, inverted



Source: Datastream, AMECO, TS Lombard

No less impossible, however, is Flassbeck's scenario of forcing higher German wages by means of threats. As the German Council of Economic Advisers wrote in a paper last March, defending the 2016 current account surplus outturn that had just been announced, "German wage setting is largely independent of politics".

Fiscal stimulus is the path of least resistance

Fiscal loosening is now either advocated or hinted at by all the major players in Italy…

Fiscal loosening is the highest common denominator of all the positions now being adopted, or hinted at, by the various political players in Italy.

- For the advocates of an outright Euro-exit, the immediate negative effect of the resulting balance sheet distress (likely outweighing the devaluation-driven expansion of net export demand) could be offset by monetary deficit financing, with the growth boost all the stronger thanks to the counter-cyclical 'multiplier' effect.
- The parallel currency scheme reflects a thirst for fiscal space. Berlusconi's enthusiasm for this chimera indicates at least that fiscal stimulus would be one of his main conditions for joining a coalition government led by Matteo Renzi's Partito Democratico (PD) – now the consensus base case scenario for the Italian election outcome.
- Even the mainstream pro-EU/EA PD advocates exempting capital spending from the Fiscal Compact rules. The present Finance Minister Pier Carlo Padoan is on record as calling for this principle to be enshrined in amendments to that treaty providing for a 'golden rule' where non-capital spending would balance over the cycle.

… and the fundamental case for it is sound.

Regardless of all such political positioning and arguments, the fundamental case for fiscal expansion is sound. As things stand, the stifling effect of German mercantilism has been relieved since last year by the cyclical recovery on the back of the ECB's QE policies and the oil price collapse. But even this limited oxygen supply risks being cut off as the ECB moves towards tapering in H2/17. Italy is particularly vulnerable to the associated euro strengthening given the high price elasticity of demand for its relatively low value-added exports.

Investment conclusion: Brace for volatility

The winner of the next Italian election is unlikely to choose confrontation with Germany, although there is little relief on the horizon for Italy…

In our view, whoever comes to power after the Italian election in H1/18 will not try to threaten Germany. If he returns to the premiership, Renzi will certainly aim to ride on the coat-tails of Macron in pushing for Eurozone reform. In reality, however, Macron is on Germany's – not Italy's side – of the barricades. Not only would Macron's fiscal proposals fall well short of the German wage surge that is required to bring real economic relief for Italy (and, for that matter, France); in addition, German acceptance of these proposals would not extend to mutualizing existing ("legacy") debt – just as Germany will hold out against mutual insurance of existing ("legacy") bank deposits, at least for the foreseeable future.

… and even a more modest "golden rule" seems sure to meet objections.

For the same reasons, even the more modest-sounding golden rule exempting capital spending seems sure to run into German objections. Italy is simply not regarded – by many Italians, let alone Germans – as a trustworthy fiscal agent. Instead, German politicians and officials are indicating willingness to upgrade the existing European Stability Mechanism into a European Monetary Fund that would raise mutually-guaranteed debt for the purpose of providing conditional BoP and budget support to EA countries in difficulty.

We predict that Italy will go down the road of unilateral violation of the Fiscal Compact and a game of chicken with the ECB.

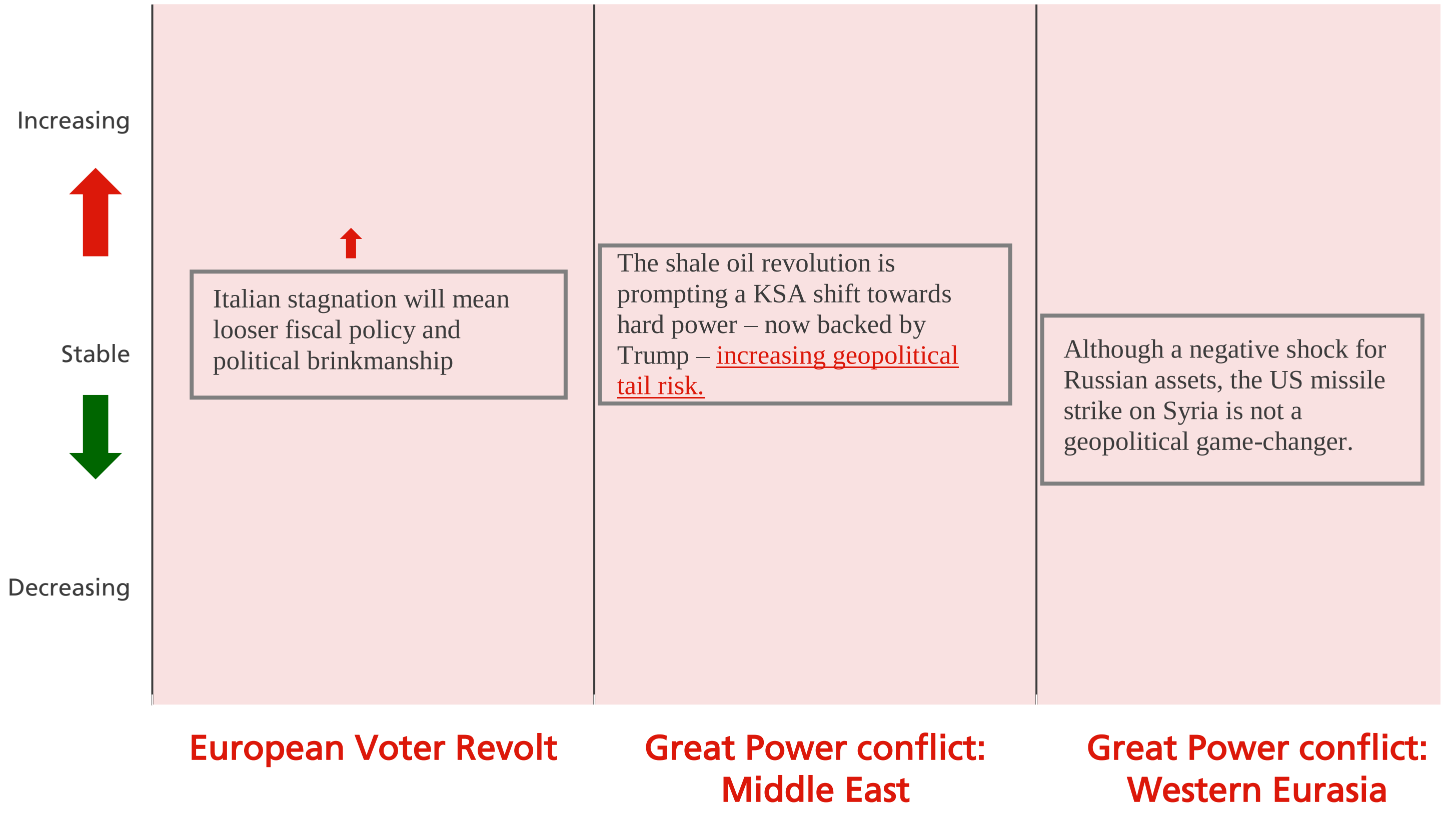
This whole agenda is not at all to the taste of the Italian political class. We predict that the new Italian government, whatever its political stripe, will instead go down the road of unilateral violation of the Fiscal Compact, daring the ECB not to intervene in the face of any resulting blow-out in BTP spreads. If – or rather when – the Italian government did win this game of chicken with the ECB, it would refuse to discuss any explicit conditionality being attached to ECB buying of Italian government paper.

This reinforces our long-term view. The outcome for Italy is not binary, but one of protracted brinkmanship.

This outlook for the most part reinforces the view we set out in March when initiating coverage of this key Italian aspect of the Global Political Driver that we label as 'European voter revolt'. Our view has been that this Italian driver is not binary – will or won't the Italian elections lead to a Euro-exit. Instead, the country's economic plight will generate renewed tensions in the Eurozone.

The latest evidence is that Italy will not even present a question to which Germany (and France) will respond by concocting some new fudge ('can kicked down the road'). Instead, the outlook is one of blurred, indeterminate and – above all – unilateral Italian brinkmanship. Last month's government bail outs of Banca Popolare di Vicenza and Veneto Banca are a harbinger of this approach. Potential medium-term relief from German wage inflation on the back of Germany's structurally improved growth potential does not change the operational conclusion: brace for volatility.

Global Political Drivers – Risk Vectors



Italian stagnation will mean looser fiscal policy and political brinkmanship

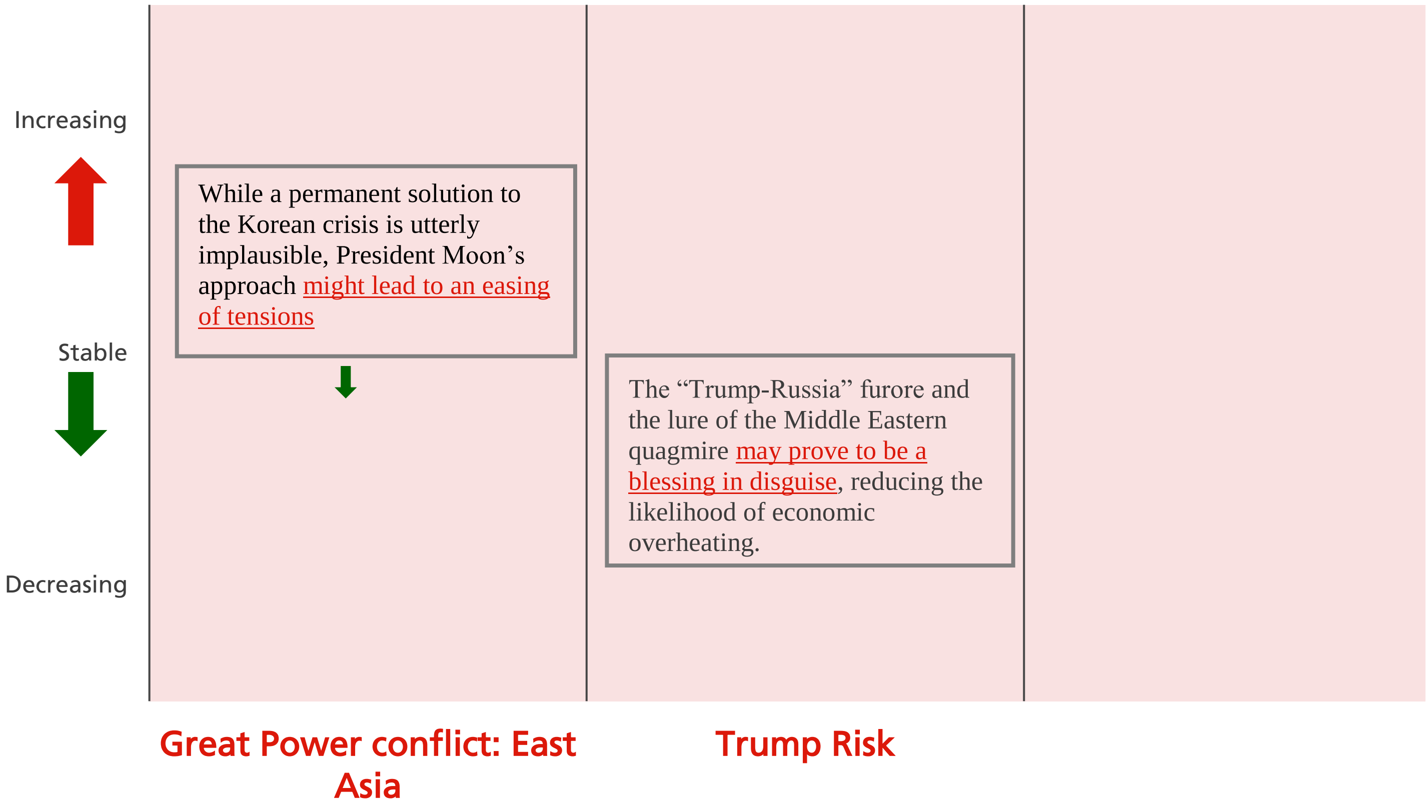
The shale oil revolution is prompting a KSA shift towards hard power – now backed by Trump – increasing geopolitical tail risk.

Although a negative shock for Russian assets, the US missile strike on Syria is not a geopolitical game-changer.

European Voter Revolt

Great Power conflict: Middle East

Great Power conflict: Western Eurasia



While a permanent solution to the Korean crisis is utterly implausible, President Moon's approach might lead to an easing of tensions

The "Trump-Russia" furore and the lure of the Middle Eastern quagmire may prove to be a blessing in disguise, reducing the likelihood of economic overheating.

Great Power conflict: East Asia

Trump Risk

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 new component of our macro research service that will identify and analyse such factors. As the title suggests, the selection criterion will be 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 will only focus on political drivers that we assess to be globally important, we will occasionally challenge a consensus view on the high importance of some topic that, in our view, is less risky than widely believed.

GPD notes will be published every other Thursday (alternating with Macro Picture). Each note will lead 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 will be 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 will be 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 will also include Marcus Chenevix and Constantine Fraser, specializing respectively in the Arab world/wider Middle East and Europe. The team will draw systematically on the insights of our senior economists and market strategists.