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May

There will be few investors who are not aware of the latest turmoil in Euro land, this time from Italy. Newspapers have covered the story well, particularly Ambrose Evans Pritchard in the Daily Telegraph but interestingly the BBC has barely covered it at all.

Here's the story:

Following large swings in their favour in the recent election 2 former fringe parties, 5 Star and Lega Nord joined together in a coalition, thereby managing to break the lock-hold enjoyed since the end of WW2 by the traditional Italian ruling groups. The coalition subsequently tried to form a government and have it approved by the country's (largely symbolic and unelected) President, Sergio Mattarella. At first Mattarella refused the coalition's nomination for Prime Minister and in the limbo which Mattarella created, he parachuted in one of his own kind as stand in Prime Minister – former IMF economist Carlo Cottarelli. Italians were incensed. They were doubly incensed when German EU commissioner Guenther Oettinger said the Italians would regret what they had done. “The financial markets would teach voters to turn their backs on non-mainstream parties”, he blustered. He later apologised for the remark.

Under pressure, Cottarelli was soon “stood down” and the coalition was able to put in place a man of its choosing, Guiseppe Conte. (This is unfolding as I write).

The election pledges of the coalition parties unsettled the financial markets. (In that sense Oettinger is right.) The risk premium of Italian bonds over German ones shot up as did the Credit Default Swap price for Italian government debt (which prices in the risk of not being repaid).

What are these pledges?

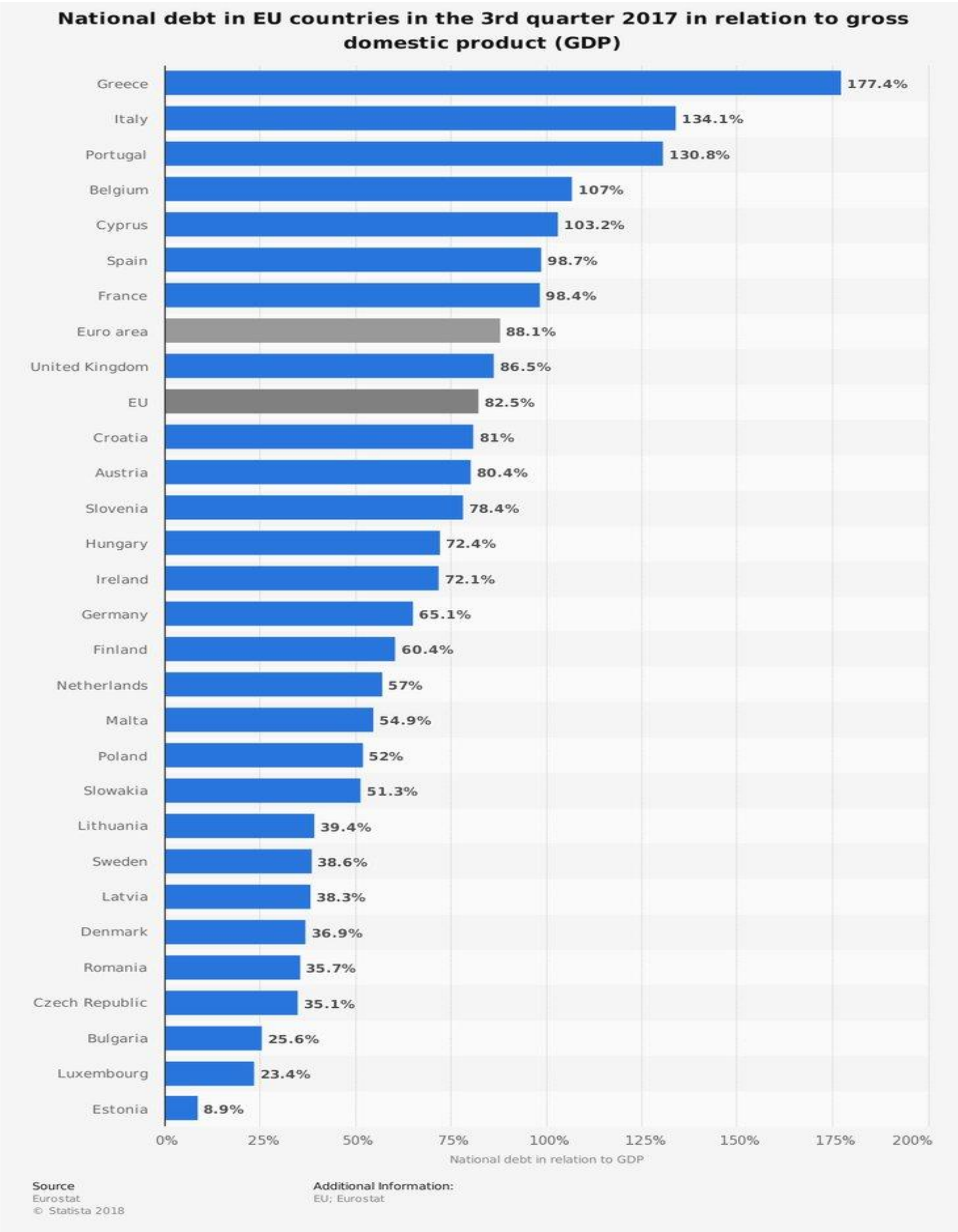
What parties say they will do before an election and what they end up doing are usually quite different things. Nevertheless, if the coalition were to do only half of their election pledges, there will be big changes afoot - not least for 500,000 illegal immigrants who face deportation.

Among the financial plans are to introduce a flat tax of between 15% to 20%, a basic income for the poor of €780 per month , a rise in VAT, a reversal of recent pension fund reform and most radically, a parallel currency called the Mini-bot which would most likely be the first step in the re-emergence of the Lira.

Many commentators say a flat tax is a bad idea because they think it would raise less money than the current progressive system. I am not so sure. I think the opposite could happen ie that more money overall would be raised because few people would object to paying it. Against this, I think a basic income would be a terrible idea because the unintended consequence it would have of keeping everyone in poverty. But my views aside, the market thinks that both of these measures would lead to an increase in the budget deficit (the excess of government spending over taxes raised) which would have to be met by increased borrowing.

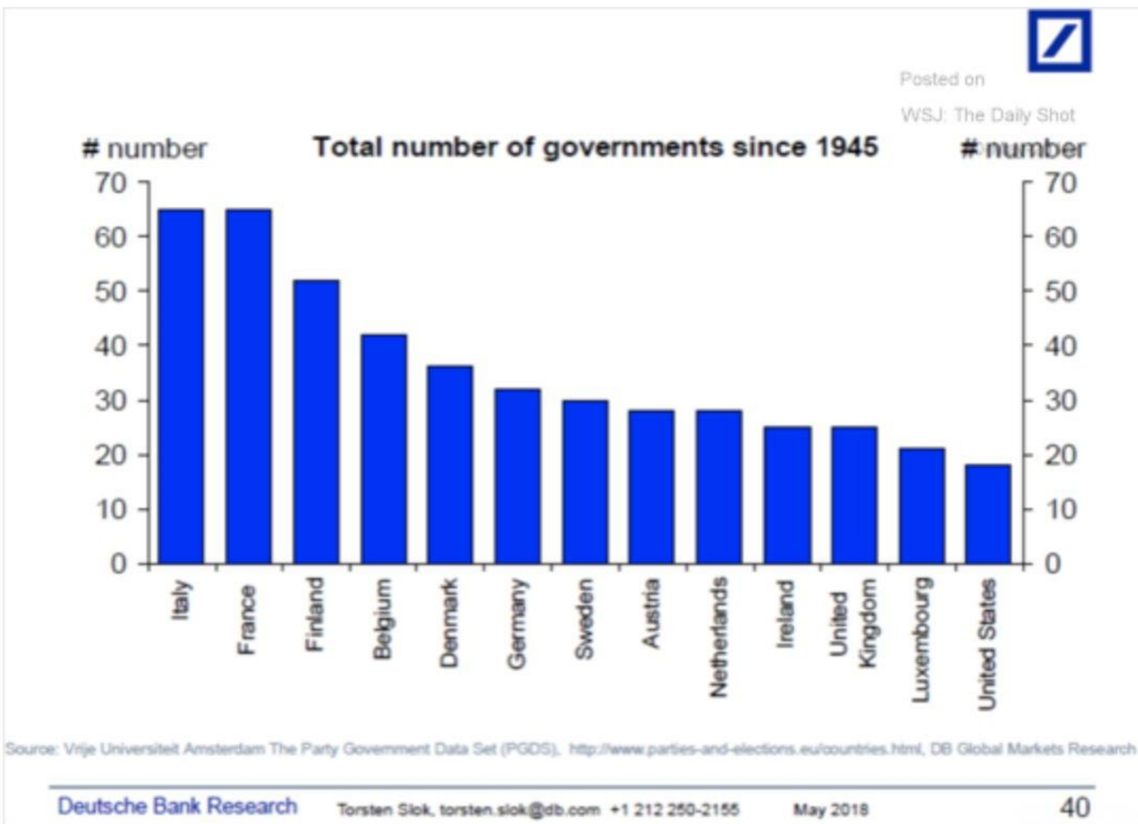
Italy’s borrowings are already high, especially as a percent of GDP and so the prospect of further increases from this already high level is what made investors nervous in May.

Chart 1 - Total accumulated borrowing – the national debt – divided by GDP



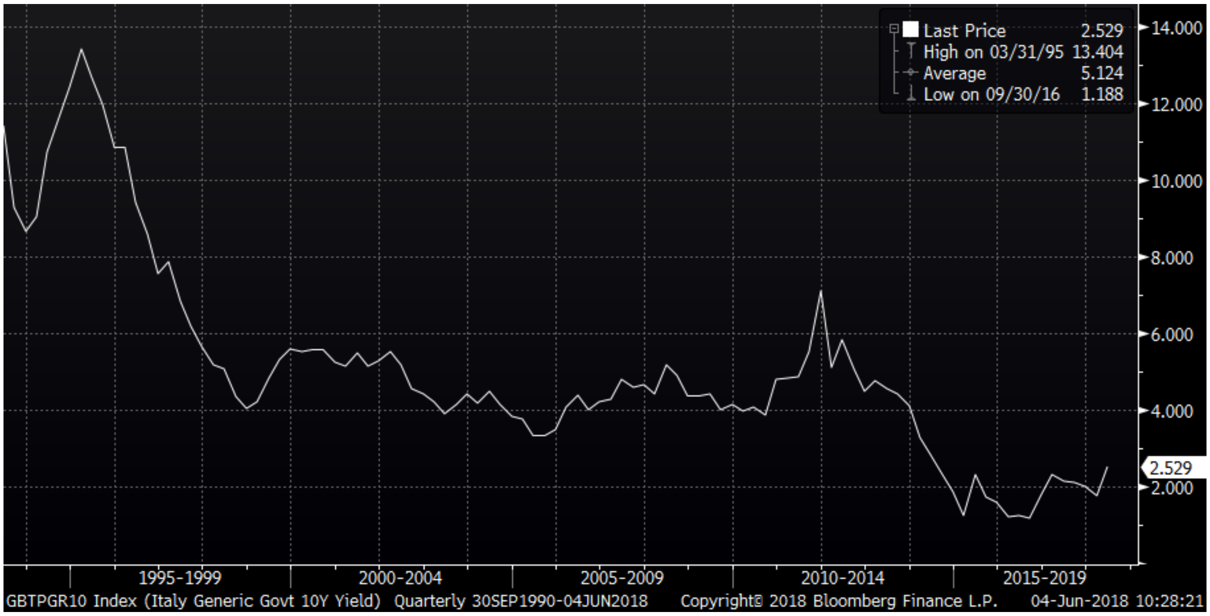
Governments nearly everywhere spend more than they raise in taxes and they have to find the difference through borrowing. The electorate votes for handouts and these must be at least partially met. Italy seems to be particularly difficult to manage as evidenced by the frequent change of government. The country has only existed since 1861 and is made up of quite disparate groups. Perhaps the only way to achieve sufficient order in this circumstance is through the promise of big hand-outs.

Chart 2 Italy has had more governments since 1945 than others in Europe.



By having to offer more to its electorate, Italy's borrowings are high. But a second reason for high debt is that it has been remarkably cheap for Italy to borrow money. Since becoming a member of the Euro, Italy's cost of borrowing fell towards the level applying in Germany and given differences in risk between the two countries, this represents a severe under-pricing of debt in the Italian case. When the cost is low, more is demanded. With super-low interest rates, Italy could continue its borrowing binge.

Chart 3 Italian borrowing costs fell from 12% to 4% in the run up to joining the Euro, and then still further following the bail out of Greece

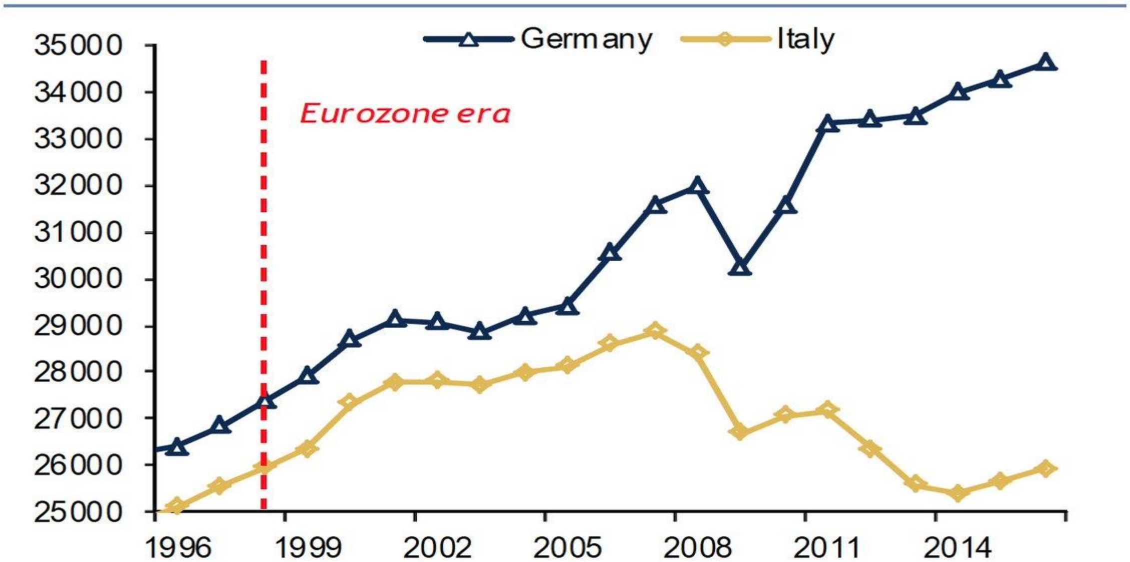


As noted above, the benefit to Italy of Eurozone membership (or at least, the poisoned chalice) was that it could access lots of debt for a low price. But the downside of its membership was GDP growth was heavily constrained so that the debt (which was rising) as a proportion of GDP (which was static) grew to its current high level.

Italians believe (rightly or wrongly) that the Germans have benefitted through currency union at their expense. They see this in GDP per capita data and also in the high levels of youth unemployment.

Chart 4 Since being a member of the Eurozone Italy has had almost no economic growth per capita

Chart 5: GDP per capita evolution over time (Euros)



Source: World Bank

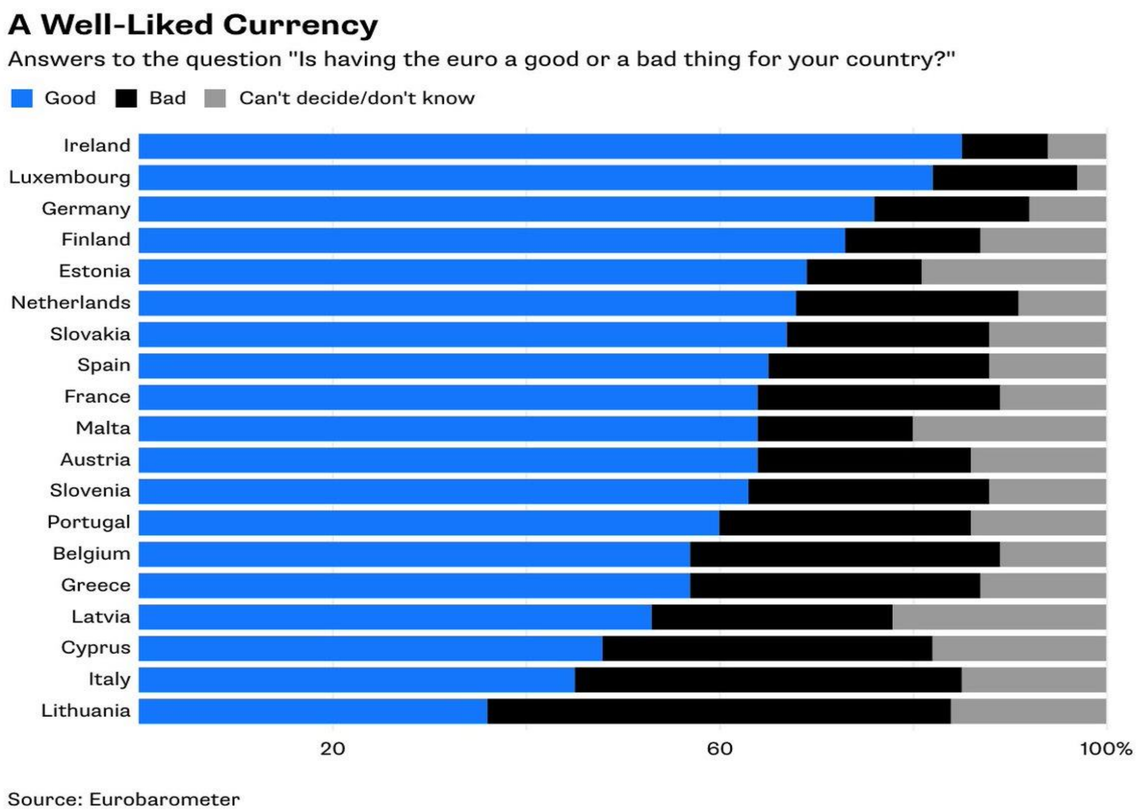
In the pre-Euro days, Italy was a country (a little like the UK) which relied on currency devaluation for its bursts of economic growth. I don't actually go along with this policy over the medium and long term because it just leads to inflation and distortions but it does work over the short term where it can provide an economic shot in the arm.

(It should be said that despite the above analysis, the constraint of the Euro and the lack of devaluation, Italy has done a very good job selling excellent products abroad. It has a current account surplus which is more than can be said for the UK which itself does have a freely floating currency. The argument therefore changes slightly – that the export sector would have performed even better outside the Euro.)

Chart 5 - Historically Italy relied on frequent currency devaluations. Since Euro membership this avenue was no longer open to it.

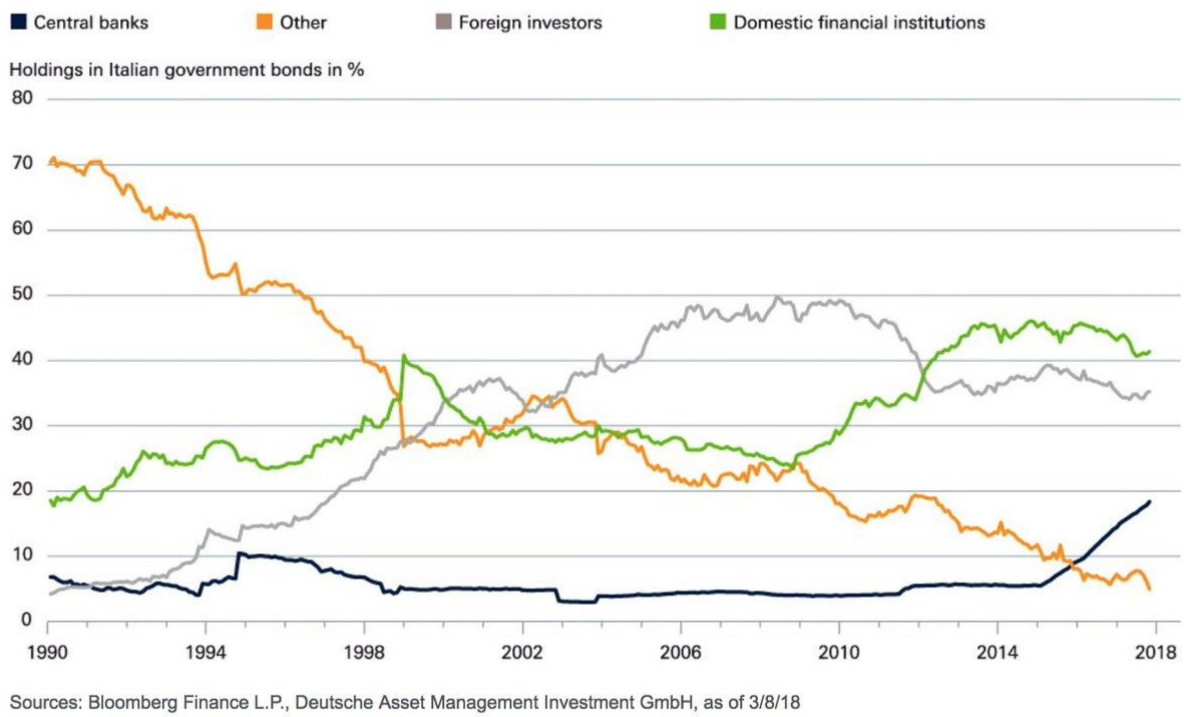
The Italian electorate has partially woken to the problem. I say partially because they see that the Euro has constrained growth but not that debt profligacy of prior years has put them in their current straightjacket. Debt is a prison sentence in that once you have it you are not free to determine your outcome. You are in the hands of the creditor and you are dependent upon his continued goodwill and subject to his terms. Many Italians think that they can break free from their paymasters by ditching the Euro; dissatisfaction with Euro membership is highest in Italy of nearly all the current members.

Chart 6 - Sentiment in Italy towards the Euro is low..



However, Italy could not leave the Eurozone without defaulting on its existing debt. The reason for this is that there are few free market buyers of Italian debt and what few there are would disappear quickly. The biggest buyer of Italian bonds is the European Central Bank under its ongoing QE programme and this buying would stop instantly were Italy to leave. In any event the long term borrowing costs for Italy would have to rise considerably.

Chart 7 – Who holds Italian Bonds?



Italian Banks (green) hold most Italian bonds but foreign banks – mainly French – own the second highest number. (Today Unicredito IT and Societe General FR announced plans for a merger. Blessed by the ECB, I'm sure. Coincidence?). Since 2015 the only marginal buyer of Italian bonds has been the European Central Bank.

Germany would not get away unharmed from an Italian default. German banks hold Italian government bonds too but outside of the bond market, and under the peculiarities of the ECB clearing system, Germany is owned money by nearly all the other countries in the Eurozone, but the biggest balance due is from Italy. This is evident through what is called the Target 2 balance.

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Chart 8 Target 2 Balances. Most Countries owe money to Germany

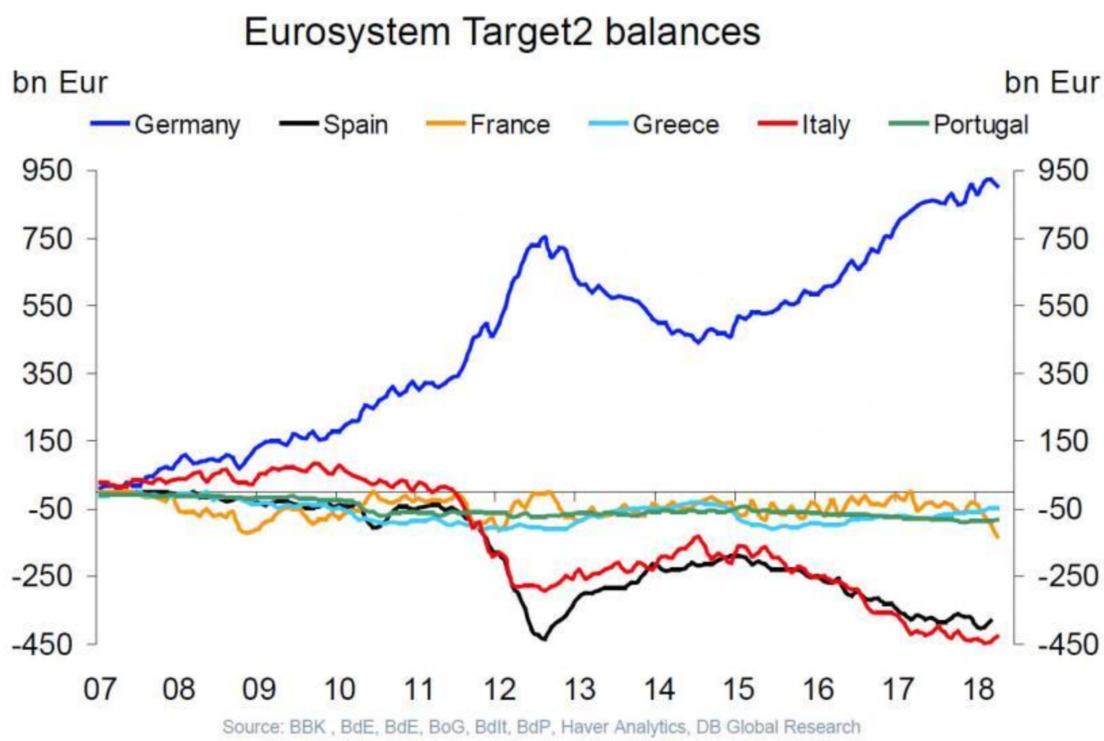
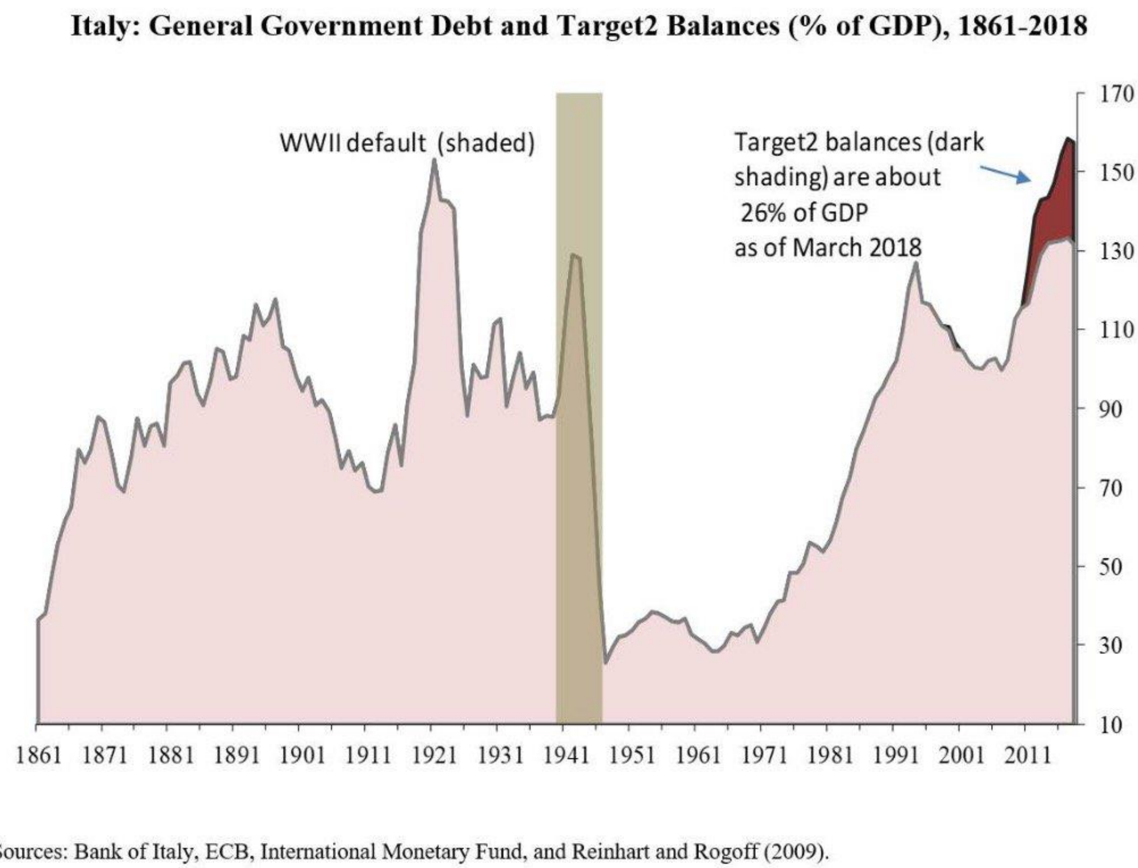


Chart 9 Target 2 Balances. Most Countries owe money to Germany



During the Greek crisis of 2010, I wrote a number of reports the gist of which was that the structure of the Euro was flawed and that it was unlikely to survive in its existing form. I also suggested that the eventual break-up of the Euro may lead to a break-up of the European Union itself. And related to these developments I suggested that there would be widespread defaults of debts issued by both countries and banks.

From May 2010 HLI monthly report:

1 *"The Euro will probably be broken up at some point. Either the weak will be evicted or the strong will leave. Expect either the Drachma or the Deutschmark to make a comeback."*

2 *"The German government will probably lend a lot of money this year. German voters know this. German politicians will pretend it won't happen. The EU will break up at some point. It may survive a decade but member states will default, bringing the EU into disrepute.*

The ECB will save the largest banks but it will not save the governments. No one in Brussels can impose meaningful sanctions on sovereign debt default. "

3 *"The individual states will all default, one by one. The Southern states will go first. We have reached the end of the road for Keynesianism. No Western government can pay off. All of them will default. "*

These comments might have sounded far-fetched at the time but following the events of May, they are not sounding quite so fanciful now. Having said this, none of the events described have actually happened yet. And despite the market flurries in May, the securities markets are by no means pricing in a Eurozone breakdown. So my comments might still be wrong or simply still too early. Underpinning the views though and supporting its stridency are the following:

1 You can't get rich through borrowing. Nor can you solve a debt crisis by borrowing more money. Debt spent on consumption and indeed on anything other than sensible return generating investments will eventually become unrepayable and will blow up in the hands of the last person holding it.

2 A currency union between independent democracies which elect their own governments and absent a centralised (Federal) taxing and spending authority will fail. The economic and political forces are in conflict and something gives – either the democracy part (no more democracy) or the currency part (break out of Euro) or the debt part (default),

Having said this, it has been of little benefit in an investment sense to have made these predictions. Just as it is not really helpful to predict that there will be another San Francisco earthquake. It is impossible to pinpoint the timing and also to know exactly how affairs will play out once they get going.

Bonds denominated in Euros and issued by the Southern countries are unlikely to make good investments. But the equity markets of those countries are a different story. After an initial shock, they could be excellent investments. Were Italy to leave the Eurozone for example, the combination of renewed government spending and a devalued Italian currency could lead to a wave of growth running through the economy, at least for 2 or 3 years to the benefit of company profits and share prices.