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The coronavirus is tearing at the fragilities of Italy and the eurozone

Solutions to appease the crisis face political hurdles. A default or euro exit are possible.

'il Boom' is how Italians describe the 'great transformation' of Italy over the 1950s and 1960s when a poor country turned itself into a modern industrial powerhouse with a stable currency, the lira. During those decades, rural southern Italians flocked to the industrial north and their cheap labour helped turn Italy into an exporter of capital goods, and companies such as De'Longhi, Ferrari and Gucci into global brands. As the economy achieved world-leading growth rates (matched only by Japan), the era featured a property frenzy, a baby boom, bountiful jobs and the rise of an entrepreneurial class. Such was Italy's rising wealth and status, the country in 1957 became one of the six founding members of the European Economic Community that later became the EU. "Italy was on fast forward," is how one historian describes the country's economic miracle.[1]

Italy's progress, however, soon faltered. The country's political system became corrupted and the rule of law patchy amid the post-war boom. The Christian Democratic Party was allowed to cement itself in power to keep out the main opposition Communist Party, albeit under an unstable republic political system designed to thwart the rise of another Benito Mussolini. The Christian Democrats let state-owned companies dominate key areas such as infrastructure and banking. The party used money earmarked for the south's renewal to enshrine its grip there. The corruption along with low productivity, militant trade unions, suffocating bureaucracy, poor education, emigration, a fragmented banking system, an ageing population and unaffordable welfare hampered Italy's competitiveness. As the economy stagnated from the 1970s, Rome's main policy response was to endlessly devalue the lira – in 1970, a Deutsche mark was worth 170 lire; by 1998, it could buy 1,000 lire. Italy's government debt at 120% of output in 1999, twice the limit allowed by the Maastricht Treaty that governed the euro, prompted the Netherlands and Germany to oppose Italy joining the common currency. Rome, while accusing the Hague of "spaghettiphobia", pledged to fix its finances. Germany's then chancellor Helmut Kohl chose to accept Rome's promises instead of the warnings of compatriots and allowed Italy into the eurozone.[2]

Perhaps he shouldn't have. Two decades later, Italy is so weak economically, financially and politically it poses an existential threat to the eurozone. A euro overvalued compared with the lira on top of Italy's economic flaws and demographic handicaps – its ageing population, Europe's oldest, is shrinking – has frozen Italian living standards at 1999 levels.[3] Italian banks are burdened with bad debts, sometimes beyond 15% of all loans. Rome's finances have deteriorated over the past two decades such that Italy's public debt stood at 135% of GDP on 31 December 2019.[4] The upending of Italy's political system after corruption scandals broke from 1992 led to the rise of populists such as three-time prime minister Silvio Berlusconi, Giuseppe Grillo's Five Star Movement and Matteo Salvini's League. The country's 65th government since World War II in power now is an unlikely coalition of the centre-left Democratic Party and Five Star headed by Prime Minister Giuseppe Conte who is not a member of either.

Such was the state of Italy when the coronavirus struck the eurozone's third-largest economy. Rome, in response, enforced an economically ruinous lockdown that is shaping up as the shock many cautioned the eurozone could not withstand. The question troubling Italy, which will only grow in menace over time, is how will Rome fund a recovery from the virus-induced recession when it can only borrow in euros, amid projections its debt could soar towards a default-prone 180% of GDP. Knowing the country faces higher borrowing costs, Rome has pleaded for help from fellow euro users and once again exposed the central flaw of the eurozone. The great weakness of the common currency is that it is a monetary union without fiscal union (and is far short of a banking union). Brussels is incapable of directing substantial funds to help Italy and other strugglers – Brussels-directed loans from Europe's inadequate rescue fund, the European Stability Mechanism, are conditional. Europe's conundrum is that domestic politics hampers Rome's ability to accept conditional loans and substantial fiscal transfers can only happen with the sanction of creditor governments or parliaments. But creditor countries such as Germany and the Netherlands, which are battered too by the coronavirus, are refusing the closer fiscal ties that would help Italy. The flashpoint has been the pair's refusal to sanction eurobonds dubbed 'coronabonds'. Such pooled

debt instruments would allow debtor countries to access funds at lower interest rates than if they sold sovereign bonds because eurobonds would be covered by eurozone, not one country's, taxpayers.

A standoff only serves to fan the euroscepticism that lingers over the continent and Italy especially. In the absence of steps towards a fiscal union, Italy in the near term is hurtling towards three outcomes, one of which could herald an imminent shock for the world economy. The turbulent outcome is that Italy's government, which is barely rated investment grade, defaults like Greece's did from 2012 but perhaps with fatal ramifications for the eurozone because Rome's debts are estimated to be 20 times larger than were those of Athens. The second possibility is that Rome defaults in an undisruptive way because Italy swallows a bailout that, while imposing microeconomic reforms, offsets the damage of an 'extend and pretend' solution. The third possibility is that Italy accepts some conditional aid to avoid a default. Under the latter two possibilities, the eurozone would be preserved for now but Italy would still be struggling enough to pose a longer-term threat to the euro. Whatever happens in coming times, Italy's woes are bound to eventually trigger a watershed event for the eurozone. Europe could become a much closer union or, at great cost, fragmented again.

Let's acknowledge that no officials can outdo eurozone policy makers in finessing last-minute fudges that postpone reckonings. Europe's elite are almost bound to conjure some quasi-solution that heads off a denouement – a small fiscal transfer could be trumpeted as a mega amount or Italy might accept loans with pseudo conditions from Europe's rescue fund. But big sums are needed to help Italy, the country requires genuine reforms, and more debt for the country might hasten its insolvency and fan anti-EU passions, perhaps trigger a government collapse. Maybe the ECB can save the eurozone for now.[5] But that will only condemn Italy to a stagnation that might shape public support for a euro departure come a future shock. Italy has some economic advantages that combined with micro reforms could help overcome its crisis. Italy's pluses include relatively low consumer and business debt and the industrial might centred on precision machinery and manufacturing that helps the country generate a current-account surplus. Creditor nations have a point that their taxpayers should not pay for southern profligacy. But the creditor governments allowed Italy (and others) into the eurozone, northern economies have benefited from a lower exchange rate than otherwise and creditor-enforced austerity has fed the euroscepticism in the debtor nations that now menaces them. The eurozone could fulfil the perverse destiny foreshadowed by its founders; they seemed to understand that Europe could only become a fiscal and political union should a crisis pose such a threat to peace and prosperity that national governments would have no choice but to succumb to unification.

While there are few signs that Europe is ready for closer union, the likelihood of a reckoning happening in coming years is rising. Italy is on a downward spiral because any widening in the Italian-German government bond spread boosts the possibility of a denouement. The 'doom loop' nature of Italy's plight – that the solvency of Italian banks is linked to the value of the large amount of Rome's debt they hold – is the most likely trigger that forces watershed choices on Italy and the eurozone.

LAGARDE'S GAFFE

Christine Lagarde (born 1956) is among the most accomplished people on earth CV-wise at least. The successful lawyer, minister of France from 2007 to 2011 and the managing director of the IMF from 2011 to 2019 last year became president of the European Central Bank, replacing Mario Draghi, whose "whatever it takes" statement in 2012 quelled the first eurozone debt crisis. On March 12, Lagarde chaired the first ECB policy-setting meeting since the virus began tormenting northern Italy. As investors looked for assurances, Lagarde said the ECB "is not here to close spreads" on government bonds.[6] With that slip, Lagarde triggered a record daily slump in Italian bond prices that intensified the Italian crisis.

Radical ECB steps since and even Lagarde invoking Draghi have failed to quell the crisis. On March 18, the ECB unveiled the Pandemic Emergency Purchase Program, under which the central bank has 750 billion euros to help companies and governments avoid bankruptcy. "There are no limits," Lagarde said when announcing the program, mimicking her predecessor.

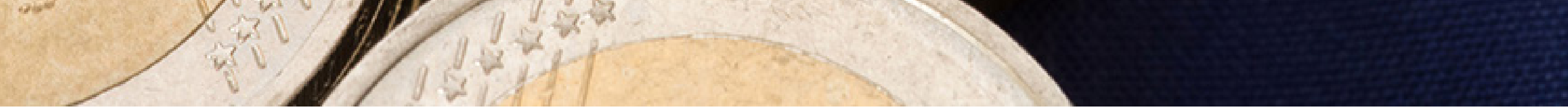
The ECB cannot smother the crisis centred on Italy because it has limited powers for a central bank – it cannot act as an unconditional lender of last resort for insolvent governments.[7] Ultimately only politicians can sanction the decisions needed to rescue governments and protect the euro and constitutional courts could even limit what lawmakers can do.

Europe's handicap is that political cohesion has fragmented. The refugee crisis of 2015, the rise of autocrats in eastern states and the original eurozone debt crisis when the 'Troika' of the EU (read Germany), IMF and ECB crushed debtor nations to protect the common currency have reversed the thrust for a united Europe. Another tension is the UK's EU departure; its missing financial contributions have boosted wrangling over the EU's budget, which is being formulated for the next seven years. Perhaps the most cohesive political force in Europe is the potential damage of a euro exit or default by a country of Italy's size.

The EU's existing response to emergencies is moored in the European Stability Mechanism that was created during the debt crisis of 2009 to 2012. But this rescue fund offers loans laced with austerity measures that bailed-out citizens view as servitude to Brussels and Berlin. That's why Rome is baulking at tapping the fund even though to recover from the covid-19 crisis, Italy (and others) need a fiscal injection of at least 10% of GDP – the IMF predicts Italy's economy to shrink 9.1% in 2020 and that forecast looks conservative as the lockdown persists.[8]

Knowing fiscal generosity from wealthier euro members is wishful thinking, Italy and others pushed for coronabonds as the quickest and cheapest way for them to raise funds. Without eurobonds, troubled euro users only have national fiscal policies and a limited central bank to fight the health and economic emergency.

That a joint debt instrument is politically difficult was shown when eurozone finance ministers met in March. One largely Latin bloc of nine led by Belgium, France, Italy, Spain and Portugal clashed with a bloc of northern members led by the 'frugal four' of Austria, Finland, Germany and the Netherlands over a development that could burden northern taxpayers.[9] Such division[10] limits solutions to the ECB's questionable firepower



and politically unfeasible responses such as the 500-billion-euro package that the EU announced on April 9 that provides help for workers, businesses and governments.[11]

Even though Italian Finance Minister Roberto Gualtieri helped formulate and sanctioned the package, Conte said it was a "trap"[12] that Italy had no intention of using because the package calls on funds from the European Stability Mechanism. Vito Crimi, the acting leader of Five Star, the largest group in the ruling coalition, called the package a "rip off" and refused to consider the aid (though the Democratic Party was more open to the proposal).[13] The League described Gualtieri as a "traitor".[14]

Everyone connected to Italy knows that the lack of fiscal transfers from neighbours will inflame euroscepticism and deepen the threat that Italy poses to the eurozone.

THE EURO CURSE

The euro, Europe's most ambitious attempt at unification, was born flawed. Rather than design a common currency with the fiscal and political integration it needed to endure, Europe's elite saw the euro as a tool to achieve such political and fiscal assimilation that they knew they couldn't attain through voter assent. For this reason, the treaties surrounding the euro make its adoption 'irreversible'.

But the euro's central weaknesses push users to leave. One central defect is that, unlike other fixed-exchange-rate regimes including the gold standard, the euro regime offers no way to resolve member current-account imbalances. Another weakness is that eurozone members only have fiscal policy and regulatory powers, say over labour markets, to fight downturns. To avoid such austerity measures that boost government debt and poisons politics, countries have pondered euro escapes to reclaim an independent monetary policy and regain a unique currency.

Italy's most credible plan is to introduce a parallel currency, a scheme pushed by the League's Salvini, the power in Italy's 64th government and the country's possible prime-minister-in-waiting who once described the euro as a "crime against humanity". Under the plan, Rome would create 'minibot' Treasury notes to pay government employees, households and local creditors, who in turn could use the notes as de facto currency, even trade them on credit markets. The plan, according to reports, is to goad the EU into expelling Italy from the monetary union, even though that might set precedents for other struggling euro users or risk broader mayhem tied to the eurozone's interbank system where creditor (current-account-surplus) countries have claims on debtor nations.[15]

While microeconomic reforms combined with Italy's manufacturing prowess place Italy in a better position to leave the euro than Greece ever had, Italy's departure from the common currency would most likely still be fraught – the economy would likely plunge into a recession that shattered household wealth and purchasing power. That might make a Greece-like default a more tempting option for Italy though it's hardly a cure-all. In 2012, Greece conducted the biggest default in history when its non-government creditors accepted losses of more than 100 billion euros. Three bailouts and more technical defaults later Athens is still the eurozone's most indebted government – its debt-to-GDP ratio is 177% – while about 33% of the country's population is said to live in poverty.[16]

The coming times could see the ECB hold together the eurozone status quo. Or creditor nations might sanction closer fiscal ties to help Italy. Or Italy might embark on a post-default or post-euro future. Whatever happens, it's unlikely that anyone any time soon will describe Italy's upcoming era as "il Boom".

By Michael Collins, Investment Specialist

[1] John Foot. 'The archipelago. Italy since 1945.' Bloomsbury Publishing. 2018. Pages 81 to 84. The quote is on page 81.

[2] Ashoka Mody. 'Euro tragedy. A drama in nine acts.' Oxford University Press. Pages 116 to 121. The quote is on page 120.

[3] Italy's GDP per capita was 26,356 euros in 1999. In 2019, it was only 26,757 euros measured in constant prices. IMF. World Economic Outlook database October 2019.

[4] Eurostat news release. 'Government debt down to 84.1% of GDP in euro area.' 23 April 2020. europa.eu/eurostat/documents/2995521/10294660/2-23042020-AP-EN.pdf/82252e2f-7336-a45b-9735-5dc29176aa06

[5] See Martin Wolf. 'Why the European Central Bank can save the eurozone.' 22 April 2020. ft.com/content/7d7f83fc-832c-11ea-b555-37a289098206

[6] European Central Bank. President Christine Lagarde. 'Introductory statement. Press conference.' 12 March 2020. ecb.europa.eu/press/pressconf/2020/html/ecb.is200312~f857a21b6c.en.html.Financial Times. 'Lagarde triggers investor jitters as ECB launches virus response.' 13 March 2020. ft.com/content/11ab8f84-6452-11ea-b3f3-fe4680ea68b5

[7] The ECB's unused Outright Monetary Transactions bond-buying program that Draghi invented to back up his euro pledge is more a bluff because it is conditional.

[8] IMF. Latest World Economic Outlook forecasts released on 18 March 2020. imf.org/en/Countries/ITA

[9] One way Europe might get coronabonds is if the German Constitutional Court in Karlsruhe in early May were to give an unfriendly ruling on the legality of the ECB's quantitative-easing program. If southern bond yields blow out after a hostile judgement, European policymakers might need to issue coronabonds to transfer the burden of financing the fight against covid-19 from the ECB to the ESM. See Melvyn Krauss. Bloomberg News 'Coronabonds are inevitable. Everybody knows it.'30 March 2020. bloomberg.com/opinion/articles/2020-03-30/coronavirus-coronabonds-are-inevitable-everybody-knows-it

[10] Italians complained that Europe's only unified stance since the virus struck was to do nothing when it called for aid as thousands died of covid-19 in Lombardy; inaction EU President Ursula von der Leyen has apologised for.

[11] European Union. Media release. 'Report on the comprehensive economic policy response to the covid-19 pandemic.' 9 April 2020. consilium.europa.eu/en/press/press-releases/2020/04/09/report-on-the-comprehensive-economic-policy-response-to-the-covid-19-pandemic/

[12] The Telegraph. 'Rift fears as EU bailout fund is sunk.' telegraph.co.uk/business/2020/04/14/rift-fears-eurozone-bailout-fund-sunk2/

[13] Reuters. 'EU bailout rescue fund opens rift in ruling party.' reuters.com/article/health-coronavirus-italy-esm/eu-bailout-fund-opens-rift-in-italys-ruling-coalition-idUSL5N2C35K1

[14] Financial Times. 'Support for eurozone rescue deal sparks backlash in Italy.' 11 April 2020. ft.com/content/f77dad8b-2827-4719-81da-3afaab1162ed?segmentId=3f81fe28-ba5d-8a93-616e-4859191fabd8

[15] Italy to activate its 'parallel currency' in defiant riposte to EU ultimatum.' The Telegraph. 29 May 2019. telegraph.co.uk/business/2019/05/29/epic-clash-building-italys-triumphant-salvini-brussels/

[16] For a timeline of Greece's ordeal within the European Monetary System, see 'Greece's debt 1974 – 2018.' Council on Foreign Relations. cfr.org/timeline/greeces-debt-crisis-timeline

info@magellangroup.com.au +61 2 9235 4888