MAULDIN ECONOMICS

Outside THE BOX

Italy's Day of Reckoning Is Coming

JOHN MAULDIN | December 14, 2016

Italy has a new government, and Matteo Renzi is not in charge of it. The former prime minister kept his word and resigned following his constitutional reform plan's crushing defeat at the polls. Is all now well in that beautiful land?

Not exactly, though we did see a glimmer of hope this week. Unicredit, Italy's largest bank, announced job cuts and asset sales that may buy it some time. This does not, however, mean the crisis is over. At best, it means the beginning of the crisis is over. We have a long way to go.

Our first OTB selection today begins, "Chronic inability to separate the probable from the desirable has been the tragedy of 2016." Those fateful words come from *Financial Times* columnist Wolfgang Münchau, who is normally very calm but now sees wishful thinking about Italy as a major threat. As much as some might wish Italy to remain in the eurozone, Münchau thinks it's increasingly improbable. Timing is the main question.

A brief sample of his analysis:

> One day Italy will be led by a party in favour of withdrawal from the euro. When that happens, euro exit would turn into a self-fulfilling prophecy. There would a run on Italy's banks and its government's bonds.
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> Italy's fate in the eurozone and the possibility of a President Marine Le Pen of France are two large threats to the eurozone and the EU. If Italy wants to stay in the euro, it needs to send a clear warning to Germany and the other northern European countries that the eurozone is set on a path of self-destruction unless there is a change of parameters.
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> The next Italian prime minister will need to explain to the next German chancellor, presumably Angela Merkel, that her choice will not be between a political union or no political union, but between a political union or Italy's withdrawal from the euro.
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> The latter would imply the biggest default in history.

With those cheery thoughts, we turn next to the *Telegraph's* Ambrose Evans-Pritchard. He profiles a Milanese professor named Claudio Borghi, who may well become the finance minister who takes Italy out of the eurozone.

Professor Borghi is doing the ugly but necessary work of defining exactly how Italy can restore its own currency. He would begin by launching a kind of parallel currency alongside the euro.

> "The Italian treasury has €90 billion (£76 billion) in arrears on contracts. These could be paid with treasury bonds issued for as little as €50, €20, €10, or even €5, giving us time to create a second currency.

> "When the time comes we can then switch to this new currency. It can be done electronically. We don't even need to print paper," he said.
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> Prof Borghi said the cleanest option is for Germany to leave the eurozone. If that is impossible Italy can pass a law to convert its debt obligations into lira overnight – or the 'florin' as he prefers to call it, harking back to the days of Florentine ascendancy under the Medici.
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> "The losses would shift to the national central banks through the Target2 system," he said. This means the Bank of Italy would repay €355bn on liabilities to eurozone peers (chiefly the Bundesbank) in devalued lira. The Bundesbank would face instant paper losses on its credits – effecting €700bn in the likely event that an Italian exit would lead to a general return to sovereign currencies.

I can only imagine the frowns in Berlin upon seeing the line, "the cleanest option is for Germany to leave the eurozone." It may well be true, but it's hard to imagine any German government agreeing to do so.

Münchau and Evans-Pritchard are two of the leading economic commentators in Europe. If they're this worried about Italy, we should be, too. The first 90 days of the Trump administration will be important to the near-term fate of the US economy, but Italy could be more crucial. Italy is a ticking bomb.

I'm writing this on a plane from New York to Atlanta. I'll be home in a couple days, but then I have to turn right around and head back to DC, where we're planning an event for the inauguration. I may have more to say on that in this weekend's *Thoughts from the Frontline*. Meanwhile my shadow complains that it's having trouble keeping up with me!

Before I go, I don't normally mention hotels, but the Melrose Hotel in DC (Georgetown) is a true gem. A boutique that is rated best value and #2 by Conde Nast, and even though not expensive, it was first-class with great individual touches. The restaurant was superb and surprisingly not crowded on a Saturday. Try the sole or pork. My new DC home.

Your thinking of Tuscany analyst,

John Mauldin, Editor
Outside the Box

Italy poses a huge threat to the euro and union

By Wolfgang Münchau
Originally published in the *Financial Times*, December 11, 2016

One day the country will be led by a party in favour of withdrawal from the currency.

Chronic inability to separate the probable from the desirable has been the tragedy of 2016. Wishful thinking is becoming a threat to the survival of liberalism itself.

This tendency is especially evident in the discussion about Italy's future in the eurozone. The complacent now say that Italy is good at muddling through; that the establishment can always stitch up the electoral system to prevent a victory by an extremist party. In any case, the Italian constitution does not allow for a referendum on leaving the euro. So it cannot happen.

Really? I don't think so. Start with the discrepancy in economic performance between Germany and Italy. One metric is the imbalances within Target 2, the eurozone's payment system. At the end of November these reached higher levels than during the height of the eurozone crisis in 2012. Germany's surplus is at €754bn, while Italy's deficit is at €359bn. A part of the imbalances relates to the European Central Bank's programme of quantitative easing, and is thus harmless. But the bulk is due to what might be described as a silent bank run.

Lack of sustainability does not necessarily imply exit. It is possible, in theory, that the political will overrides the economic needs for ever. Or that the unsustainable could be rendered sustainable. For that to happen, at least one of five conditions would have to be fulfilled.

First, Italy and Germany could converge. To do this, Italy would need to undertake economic reforms to clean up the justice system and the public administration, cut taxes and invest in productivity-increasing technologies. Germany would need to run a higher fiscal deficit. Second, the northern European states accept large fiscal transfers to the south. Third, the EU creates a federal political authority with powers to raise taxes in order to transfer income from high to low-income earners. Fourth, the ECB finds a way to bankroll Italian public and private debt indefinitely. Or fifth, Italy's government will forever continue to support euro membership.

Only one of those five conditions may be sufficient for Italy to remain a member of the euro. The problem is that each one is extremely improbable. And I cannot think of a sixth one.

Matteo Renzi's economic reforms have been insignificant, apart from a smallish labour reform package. The former Italian prime minister chose to focus on political reforms instead, and lost when the referendum returned a 60 per cent No vote. After his failure, a reformist government is not in sight.

The selection of Paolo Gentiloni to replace Mr Renzi is not going to change that. His government, after all, has a very narrow mandate. I also cannot see Germany bailing out the eurozone — either before or after next year's national elections. The country's constitution requires a balanced budget. No other northern state is willing to accept large fiscal transfers, let alone a political union.

What about the ECB? Last week, it extended its QE initiative until the end of 2017. The programme has helped Italy but it will not be sufficient to bankroll the country indefinitely, especially given the small size of the programme relative to the total outstanding public debt.

This leaves us with Italian politics. Of the three large party groups, only the centre-left Democratic party (PD), Mr Renzi's party, is pro-euro. There is a theoretical possibility that a resurgent PD might win the next election. I am not sure this will happen but I am sure that the PD cannot remain in power indefinitely.

One day Italy will be led by a party in favour of withdrawal from the euro. When that happens, euro exit would turn into a self-fulfilling prophecy. There would a run on Italy's banks and its government's bonds.

Italy's fate in the eurozone and the possibility of a President Marine Le Pen of France are two large threats to the eurozone and the EU. If Italy wants to stay in the euro, it needs to send a clear warning to Germany and the other northern European countries that the eurozone is set on a path of self-destruction unless there is a change of parameters.

The next Italian prime minister will need to explain to the next German chancellor, presumably Angela Merkel, that her choice will not be between a political union or no political union, but between a political union or Italy's withdrawal from the euro.

The latter would imply the biggest default in history. The German banking system would be in danger of collapsing, and Europe's biggest economy would lose all the competitiveness gains so painstakingly accumulated over the past 15 years.

It has been the historic failure of consecutive Italian prime ministers to avoid this necessary confrontation, and to think that staying off the radar screen constitutes a viable strategy.

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Italy's rebel economist hones plan to ditch the euro and restore the Medici florin

By Ambrose Evans-Pritchard
Originally published in the *Telegraph*, December 6, 2016

The once-unlikely and remote prospect of an anti-euro government in Italy is suddenly becoming a real possibility, threatening to rock the European Union to its foundations within weeks.

Events in Italy are moving with lightning speed. Key figures in the Democrat Party of premier Matteo Renzi have joined the chorus of calls for snap elections as soon as February to prevent the triumphant Five Star Movement running away with the political initiative after their victory in the referendum over the weekend.

Mr Renzi has not yet revealed his hand but close advisers say he is tempted to gamble everything on a quick vote, betting that he still has enough support to squeak ahead in a contest split multiple ways and that his opponents are not ready for the trials of an election.

It could easily spin out of his control, opening a way for a tactical alliance of Five Star, the Lega Nord, and a smattering of small groups, all critics of the euro in various ways.

The man tipped as possible finance minister of any rebel constellation is Claudio Borghi, a former broker for Merrill Lynch and Deutsche Bank, and now a professor at the Catholic University of Milan.

"We are coming to the point where Italy must the make the real decision: are we for Europe or are we against it?" he told the Telegraph.

"What is emerging is a list of four parties or groups who all have one thing in common. We all agree that nothing is possible until we leave the euro."

"Europe has brought us a depression worse than 1929. It has led to entire peoples being broken and humiliated, like the Greeks, all for the sake of preserving the infernal instrument of the euro. This whole disaster has been adorned by a chain of lies, shouted ever louder because they are afraid that the colossal damage they have done will be discovered," he said.

Dr Borghi said the landslide 59:41 result in the referendum is a shock to Italy's powerful vested interests, or "poteri forti". "They are absolutely scared because none of their tools of control are working any more," he said.

"They invested huge prestige in the campaign. Confindustria [Italy's CBI], the chambers of commerce, and all of Italy's big employers were for the 'Yes' side. They said the banks would collapse, that we would lose all our savings, and that we would all go to Hell if we voted 'No', but it didn't work. It was Brexit reloaded," he said.

Professor Borghi said withdrawal from the euro would be messy but there are ways of mitigating the effects, first by creating parallel liquidity and letting it seep into daily life.

"The Italian treasury has €90 billion (£76 billion) in arrears on contracts. These could be paid with treasury bonds issued for as little as €50, €20, €10, or even €5, giving us time to create a second currency.

"When the time comes we can then switch to this new currency. It can be done electronically. We don't even need to print paper," he said.

Prof Borghi said the cleanest option is for Germany to leave the eurozone. If that is impossible Italy can pass a law to convert its debt obligations into lira overnight – or the 'florin' as he prefers to call it, harking back to the days of Florentine ascendancy under the Medici.

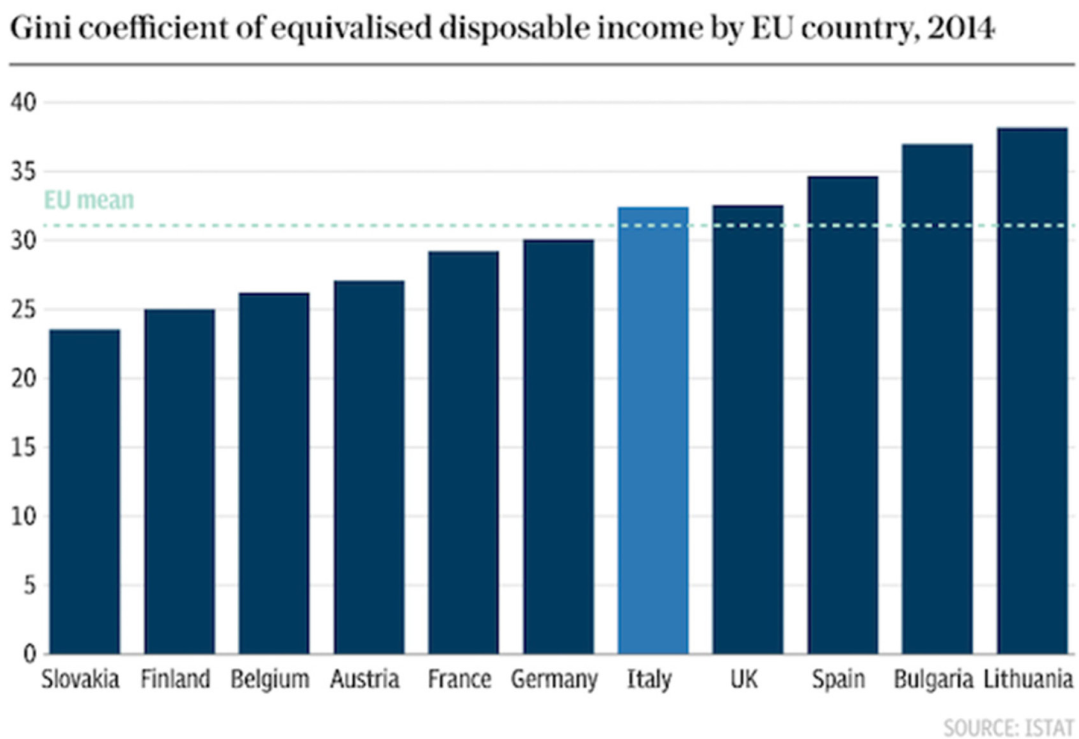
"The losses would shift to the national central banks through the Target2 system," he said. This means the Bank of Italy would repay €355bn on liabilities to eurozone peers (chiefly the Bundesbank) in devalued lira. The Bundesbank would face instant paper losses on its credits – effecting €700bn in the likely event that an Italian exit would lead to a general return to sovereign currencies.

The sums are in one sense an accounting fiction. The trial run was the collapse of the Swiss franc peg against the euro in January 2015. The Swiss National Bank suffered vast theoretical loses on its holdings of eurozone debt when the franc revalued, but life went on regardless.

The gamble is that large sums held by Italians in accounts in London, New York, Paris, or Munich, or held in safe-deposit boxes in Switzerland, would flow back into the system as soon as the boil is lanced, and once Italy has returned to exchange rate viability. Foreign investors would view Italy as a far more competitive prospect.

"I don't see any disaster. There is no way to smash our currency since we have a trade surplus. If we had a weaker exchange rate we would have an even bigger surplus," he said.

For Italy's eurosceptics a return to the lira would be a liberation after fifteen years of economic decay that has hollowed out the country's manufacturing core. Industrial output has fallen back to the levels of 1980. Real GDP per capita is down 13pc from its peak.

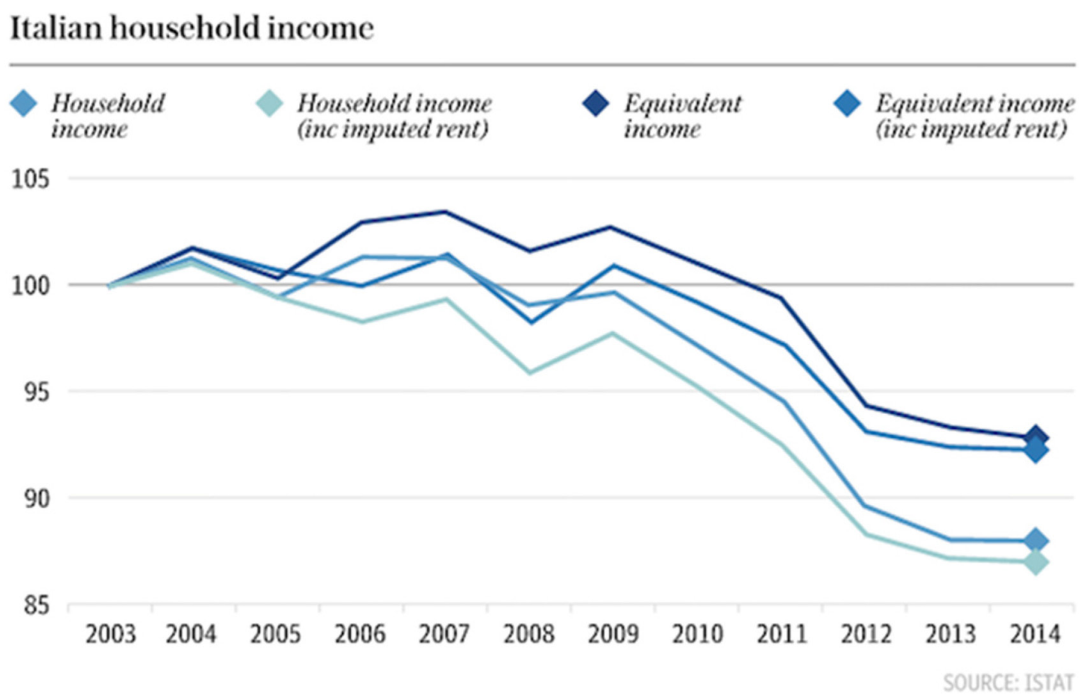


A report this week from the statistics agency ISTAT said the numbers at risk from poverty and social exclusion last year rose to 28.7pc, and a fresh high of 46.4pc in South, and 55pc in Sicily – the epicentre of the 'No' vote in the referendum.

A study by Mediobanca found that Italy's growth rate tracked that Germany almost exactly for thirty years. The pattern changed with the advent of the euro, which precluded devaluations and led to a slow but fatal loss of labour competitiveness – like a lobster being boiled alive.

This was compounded by the eurozone's fiscal and monetary contraction from 2010-2104, a policy error that caused the EMU debt crisis and led to a double-dip recession. This is turn pushed Italy over the edge and into a banking crisis.

Exit from the euro would give the country the fiscal freedom to break out of its deflationary trap, and to save its banking system with a state-led recapitalization along the lines of the TARP programme in the US – forbidden under EU state aid laws, unless Italy agrees to swallow the draconian terms of an EU bail-out.



Prof Borghi said the EU's new 'bail-in' rules must be swept aside. "As soon you start wiping out savers and bondholders – who did not behave recklessly – you are telling people that their money is not safe in the bank," he said.

"All the EU has achieved is a collapse in Italian banking stocks by 85pc since last November. You have to step in to save the banking system in a crisis otherwise everything is destroyed," he said.

Prof Borghi is chief economic strategist for the Right-wing Lega Nord, but what is emerging is a tactical alliance between his party and the Five Star Movement, which has more in common with the Left. The two together are running at 44pc in the polls. Their economists are working together in what is becoming a closely-knit school of eurosceptics.

The grass roots of the Five Star party have always been hostile to pacts with any other group, regarding the whole political cast in Italy as rotten to the core. But Mr Grillo says the party is closing in on power and must be prepared to make compromises. "We are in a spiral towards government," he said.

Prof Borghi is under no illusion that leaving the euro can alone solve Italy's deep-rooted problems, but 'Italexit' is a minimum condition. "It is going to be hard, but without our own correctly-valued currency, we are not going to be able to do anything however hard we try," he said.

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