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Daily Note

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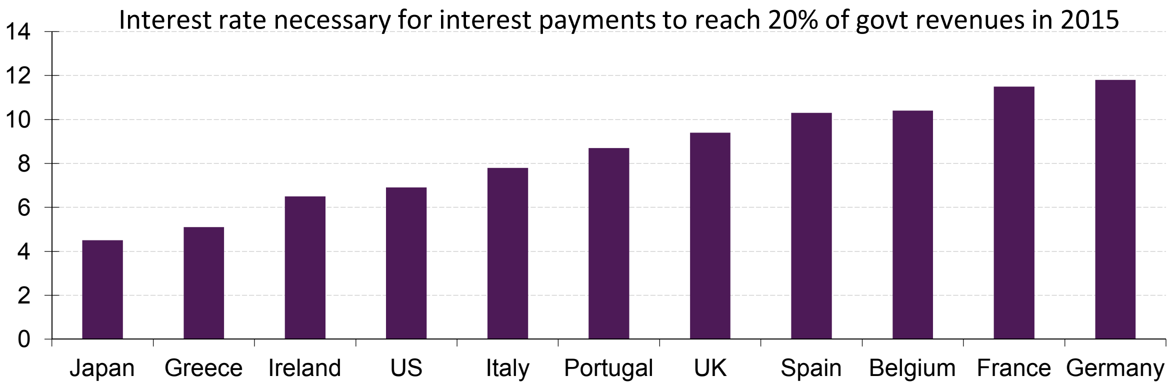
Roman ruins

Italy looks like a one-way bet for global markets. Until something fundamental changes in EMU politics (beyond a change in Italian Prime Minister), it will remain under pressure.

Markets love a one-way bet. The European Exchange Rate Mechanism (ERM) provided this in the early 1990s, when politicians tried to defend their currency pegs by raising interest rates while their economies were already in recession. Investors including George Soros rightly suspected this position would ultimately be unsustainable and bet against it, swamping official interventions and causing the chaotic demise of the ERM. Now, traders can sense another one-way bet in Europe: Italy.

Italy is too big to save, at least using the Europeans' current approach to the crisis. Only full fiscal integration or unlimited bond purchases would be enough. So a bet against Italy is a bet against these outcomes, both of which are politically unacceptable in Germany. Then there is Italy's poor economic outlook – Italy typically doesn't grow much more than 1% annually, even when the global economy is performing well and the government isn't tightening fiscal policy. With external demand slowing (especially in the rest of the euro area), European 'austerity' can only compound these problems. And with the Italian government perpetually on the brink of collapse, it seems unlikely politicians will be able to push through the structural reforms the economy needs.

Italian sensitivity to market rates

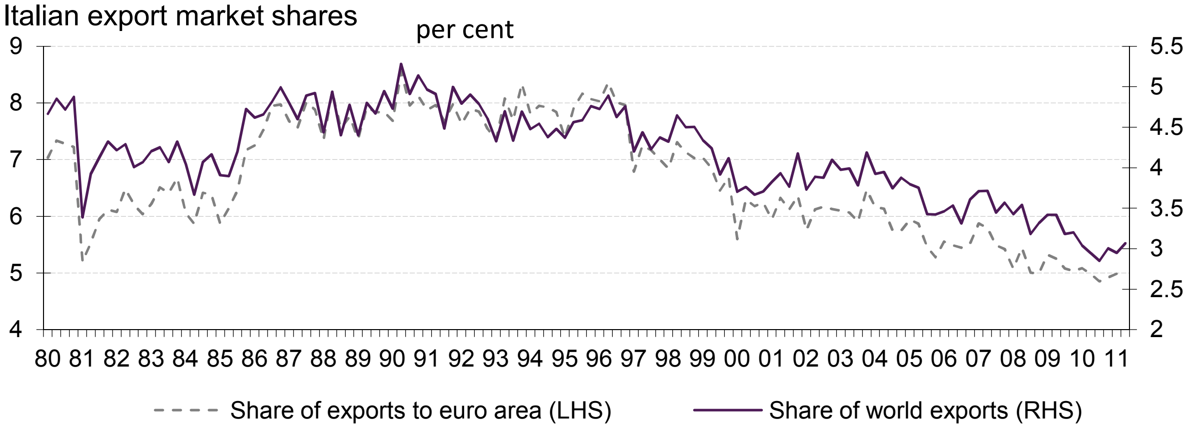


The ‘anti-Italy’ trade has become self-fulfilling. Selling Italian bonds pushes up interest rates and intensifies the pressure on the public finances. Italian government net debt is already around 100% of GDP, so higher interest payments quickly become a major burden on the overall fiscal position. Recent IMF simulations show that if Italy’s average funding costs rose to 8%, its interest payments on outstanding debt would reach 20% of total government revenues by 2015. As the IMF points out, such a burden has rarely been tolerable. By contrast, Spain’s average financing costs would have to exceed 10% before this happened.

Then there is the Italian banking sector, which is weak and heavily exposed to the nation’s public debt - more than 50% is held domestically. This completes the unfortunate loop – any kind of government default would further damage the Italian financial sector’s balance sheets, which in turn makes it one big contingent liability for the government.

So it seems likely investors will continue to push these trades until something fundamental changes in Europe. ECB bond buying has been too hesitant and begrudging to prompt a re-think. In fact, Mario Draghi, new ECB President, downplayed this policy at last week’s press conference, arguing it was merely a short-term measure intended to support liquidity. Presumably, this is exactly what the bond-market vigilantes wanted to hear.

Italian export market shares



Even if current Prime Minister Silvio Berlusconi is eventually jettisoned, which might lift sentiment for a while, it is not obvious his successors would do any better. Italian governments are always fragile and fractious and the economy’s problems are deep and structural. In short, Italy has too many small and medium-sized businesses that specialize in low-valued goods and lack the economies of scale necessary to compete internationally with new producers in Asia and Eastern Europe (producing the same types of goods). Significant parts of the Italian economy need a complete overhaul and this would be politically difficult even for the strongest Italian government (which history suggests is virtually an oxymoron).

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