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Bruised markets brace for third popular revolt of 2016 as Italy rattles eurozone

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28 Comments

CREDIT: PETER DEJONG/AP

The European flag has disappeared from the office of the Italian prime minister. At first it was a gentle rearrangement, then it escalated into a total cleansing.

The latest photograph of Matteo Renzi shows him sitting in front of six Italian flags, the Tricolore in full glory, as if he were Gabriele D'Annunzio preparing to lead his patriots into Fiume.

This has the unmistakable touch of Jim Messina, the Obama strategist brought over to Rome for a fee of €400,000 to help Mr Renzi survive next month's make-or-break referendum. The last 32 polls all point to defeat.

Snake-bitten bankers in the City are bracing for trouble, fearing a third earthquake for the old order in a G7 democracy. Some see it as the logical sequel to Brexit and Trump, this time shaking a structural pillar of the eurozone, precursor to a revolutionary upset by France’s Marine Le Pen next May.

They are muddled. There is no such chain-reaction or contagion. The alleged linkage between Brexit and Trump is greatly overplayed. The former is a free trade movement, resiling from a parochial Europe; Trump is a protectionist.

Nor is Italy's referendum as binary as suggested. What is true is that the anti-euro Five Star movement of comedian Beppe Grillo is running at 29pc in the polls. It already controls the City of Rome and is edging closer to national power. Mr Renzi’s glory days as the wunderkind of Italian politics are long past.

Italian prime minister Matteo Renzi faces an upset at the polls CREDIT: SILVINO/ PACIFIC/BARCROFT IMAGES

It is the whiff of political risk that has amplified the effects of the global bond shock on Italy’s vulnerable debt markets. Italian 10-year yields have risen by 100 basis points since mid-August. The spread over German Bunds has jumped 60 points to 172.

This surge in borrowing costs is not happening because Italy is in good health. The recession scare over the summer may have passed but growth remains stuck below 1pc. The country is still in deflation. Real rates have doubled almost overnight. “It is basically a tightening of monetary conditions, and it is not welcome,” said Lorenzo Codogno, former chief economist of the Italian Treasury and now at LC Macro Advisers.

Italian banks – already grappling with non-performing loans equal to 18pc of balance sheets – are up to their necks in the sovereign “carry trade”. They hold €400bn of Italian government bonds. These assets have suffered a paper haircut. Losses must be “marked-to-market”, eroding core capital ratios. The banks’ covered bonds have to be refinanced at higher rates, a fate shared by Italian companies across the board.

Hedge funds are watching the Target2 imbalances in the ECB's internal payment system. The Bank of Italy's liabilities to eurozone peers - chiefly the Bundesbank - has reached a record €356bn. This is higher than it was at the peak of the sovereign debt crisis.

These Target2 imbalances no longer reflect acute stress - at least as long as the ECB keeps a lid on the problem with quantitative easing, which must end one day. Eric Dor from the IESEG business school in Lille says they show chronic outflows of capital. "It is a sign of growing distrust of Italian assets among domestic investors," he said.

For now premier Renzi is focused solely on his political survival. He gave a hostage to fortune by vowing to resign if he lost the referendum on parliamentary reform, intended to emasculate the Senate and allegedly to end gridlock. He later retracted the pledge - to much derision - but has since coyly reinstated it.

Italy and the EU are struggling to get along CREDIT: BLOOMBERG

He is playing the anti-EU card for everything it is worth, threatening to veto the EU budget and accusing Brussels of wasting Italy's money in a table-thumping showdown hardly seen since Margaret Thatcher.

“We’re tired of ambiguities and contradictions. We’re tired of a Europe that promises but doesn’t deliver,” said his Europe minister in what is clearly an orchestrated campaign.

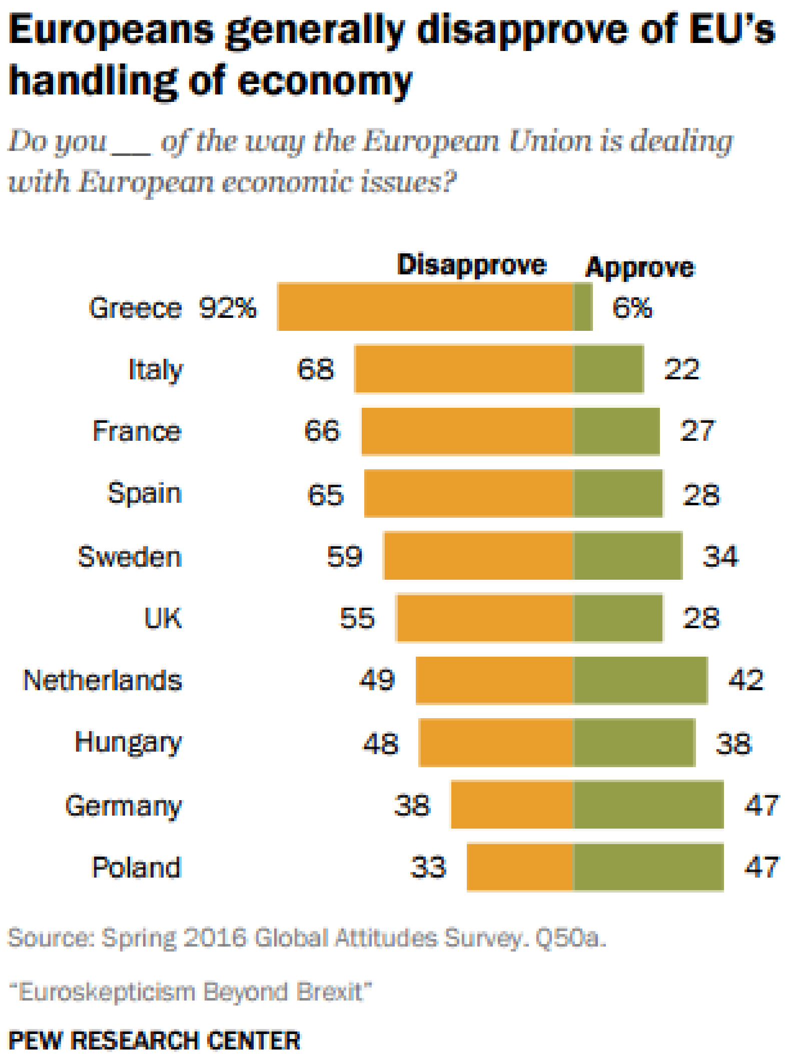
“We’re very tired of a Europe that is petty in what matters and overbearing in what is petty, and we’re convinced that if Europe doesn’t change, we’re looking at the onset of European disintegration,” he said.

Such bluster must be taken with a pinch of salt. Yet the bitterness is real. The EU did a dirty deal with Turkey, paying the autocratic Erdogan regime to shut off the Balkan route for migrants. A razor-wire wall now defends the ancient Hapsburg frontier. The migrant route has switched to Italy, and Italy has been left to fend for itself.

"The feeling is that other countries betrayed us. Renzi knows that bashing Europe is a way to promote himself and win votes, and that itself is revealing," said Mr Codogno.

Eurobarometer and Pew surveys come up with all kinds of answers on Italian attitudes, depending on the question.

But what comes through consistently is a bloc of 35pc that has rejected the euro entirely. It is held at bay precariously by another bloc that fell out of love with the project long ago but fears it would be too dangerous to try to restore the lira. Genuine defenders of EMU are scarce. The structure is held together only by fear.



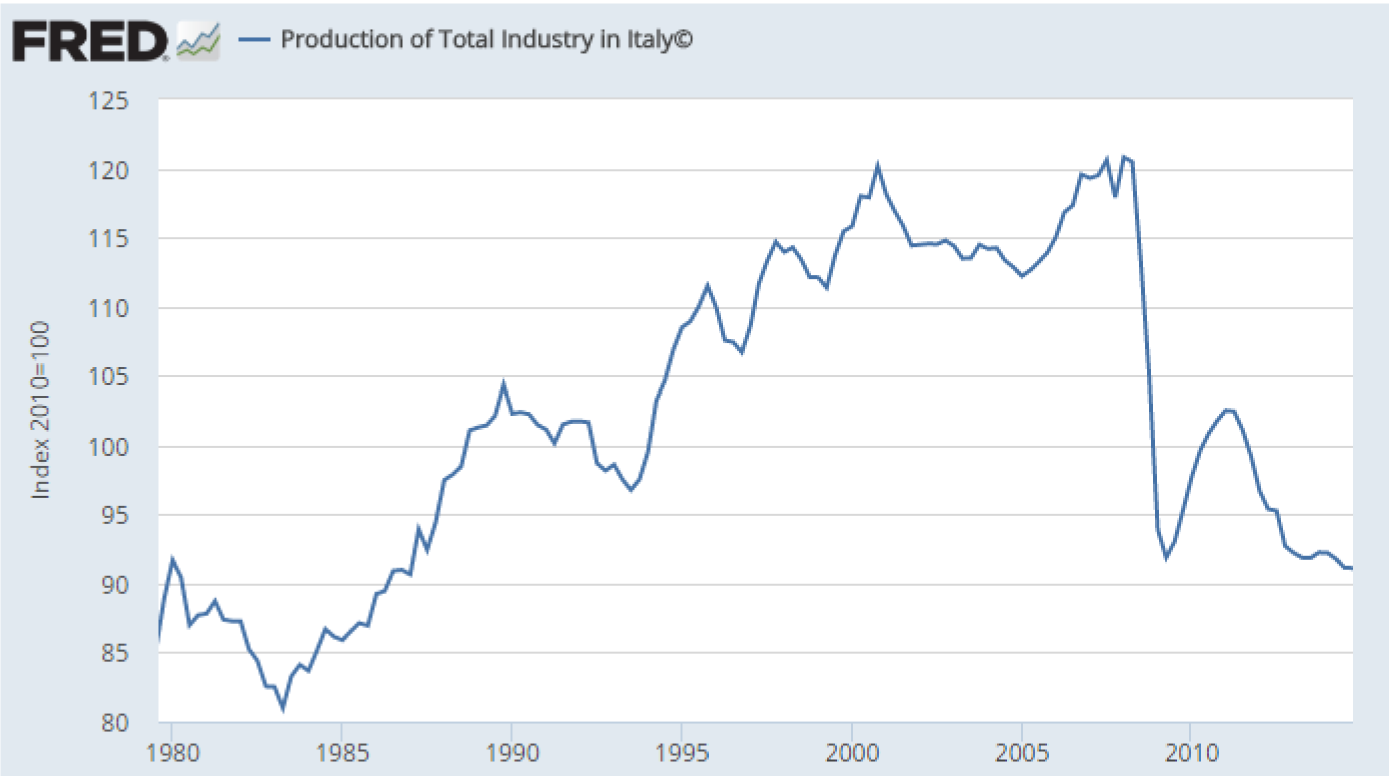
Italians are deeply critical of EU economic policy CREDIT: PEW

By sheer bad luck the launch of the euro happened at a moment in Italian history when productivity was stalling anyway, and the Italian mid-technology niche in the global market was coming under assault from China.

It almost pointless at this stage to remind the Italians that they let wages creep up too fast for year after year under the inflation-linked Scala Mobile, blind to the dangers. The result was 30pc loss of unit labour competitiveness against Germany, and this time they cannot devalue their way back to equilibrium.

The punishment is slow torture. Economic output is down 9pc from the pre-Lehman peak, and is basically back the to levels seen at the end of the last century. Industrial production has fallen by a quarter.

Unemployment is near 20pc - comparable to Greece and fundamentally higher than in Spain - once you factor in disguised jobless rates that are three times the EMU average. Nothing like this has ever happened before to a large industrialized country in peace-time.



Italy's industrial output is back to the levels of the early 1980s. CREDIT: ST LOUIS FED

Italy is now trapped. It cannot deflate its way back to competitiveness because that would send the debt trajectory spiraling upwards. Labour hysteresis would further lower the speed limit of future economic growth. Any such strategy is inherently self-defeating.

"It is the lack of nominal GDP growth that is fatal for public finances. I don't see any way out other than leaving the euro," said professor Alberto Bagnai from Pescara University.

The International Monetary Fund warned in July that Italy faces a second Lost Decade lasting into the mid-2020s. With public debt already at 133pc of GDP, it has “very little room to cope with shocks”.

It is this stagnation that is driving Italy's capital outflows and incubating its populist revolt. The EMU establishment lost the Right long ago. The Lega Nord's Matteo Salvini - running at 13pc in the polls - told me the euro is a "crime against humanity", and he is somebody who has mastered the art of social media and has his finger on the pulse of political fashion.

Italy's loss of competitiveness has been staggering, but now it cannot easily regain this within the euro CREDIT: DEUTSCHE BANK

Now they face a more immediate threat from the new 'Left'. The Five Star movement is shaking the system with an openly eurosceptic platform and might well come first in an election. That would give the party an extra 'premium' of seats under the current electoral law, potentially allowing it to form a majority government.

Whether or not Five Star would try to force a referendum on the euro - technically illegal - its radical plans to repeal labour reform, to hold down energy and transport costs, and to pursue anti-capitalist policies in industry and banking without apology, amount to the same thing. The markets would react instantly.

Debate rages in Italy over what exactly will happen if Mr Renzi loses the referendum. What is clear either way is that the country's predicament is intolerable and eventually something will snap, probably induced by external events.

A weak cyclical recovery, cheap energy, a weak euro, and QE have all disguised the festering pathologies. But little has changed and those tailwinds have been replaced by the Trump bond shock and the eurozone's Brexit trade shock. Talk of an accelerating recovery next year is has become preposterous.

The eurozone remains dysfunctional. There is no fiscal union or mutualisation of debt. The banking union belies its name. Discipline has broken down. Political patience is running out everywhere.

Even its founding economist Otmar Issing has disowned the project. "It cannot go on endlessly. One day, the house of cards will collapse," he said.

Italy is where it will probably happen. It is not beyond the bounds of plausibility that Mr Renzi himself will be the man to deliver the dagger blow if the eurosceptic tide becomes irresistible.