Global Strategy Weekly

Brexit is a symptom, not the cause of our problems, but who's next – Italy?

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The post-Brexit economic and financial market turmoil reminds me of the immediate aftermath of Lehman's September 15, 2008 bankruptcy, when economists used the subsequent turmoil as an excuse to revise down their previously wildly over-optimistic forecasts. Most economists blamed the post-Lehman turmoil for the subsequent deep recession. But in fact the US economy was already in freefall well before Lehman hit a brick wall. Lehman's was a symptom of the crisis, not its cause. Similarly in the aftermath of the Brexit vote there is an increasing fear of other dominoes falling within the heart of the EU – the eurozone. Italy is bleeping very loudly on most people's radars with its banking crisis and impending referendum seen as leaving the country on a knife-edge. But, as in Japan in the 1990s, recapitalising the Italian banks will not solve their problems. The Italian banking crisis is a symptom of the problem, not its cause. The cause being that Italy is a country condemned to perpetual economic stagnation within the strictures of the eurozone. And with almost 50% of Italians saying they would vote to leave the EU, Italy is indeed key for global investors.

Global asset allocation

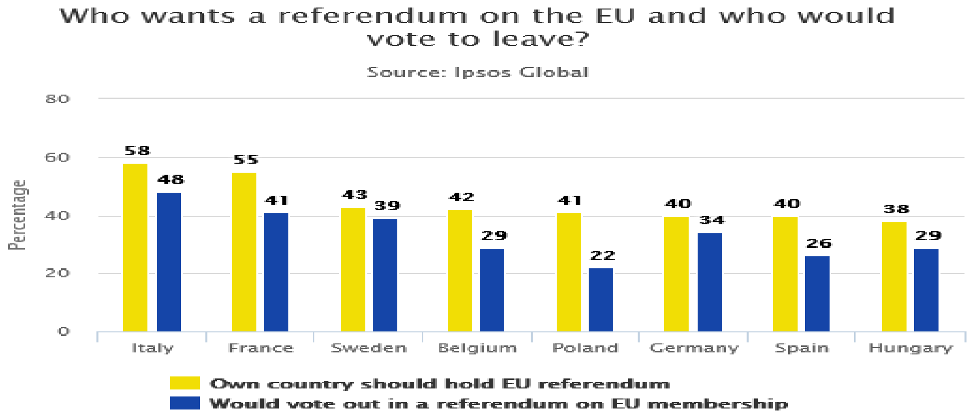
%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

■ I'm going to resist the urge to write about Brexit as you all must be so bored by it by now. I can't promise I might not write about it later though, perhaps when tempers subside a bit. But my views closely coincide with UK philosopher/economist John Gray, that the vote represents a seismic global shift that will leave the political elites gasping for breath as an increasingly rebellious electorate seek to throw off the establishment yoke (article here).

■ In a sign that **the UK government has understood nothing from the Brexit vote**, what was George Osborne's first move after abandoning his pre-election threat of an emergency budget to raise taxes and cut spending to fill any fiscal hole Brexit might leave? Why he thought it was a great idea to cut corporation tax from an already low 20% to 15% - it was 28% when he came to power in 2010. These are exactly the policies that have alienated UK blue collar voters and prompted them to vote for Brexit en masse. For despite the government mantra after the 2008 financial crisis that *"we are all in this together"*, the UK has seen tax rises for the 99% and benefit cuts for the poor while at the same time finding the money to slash corporation tax! And they wonder why they lost the referendum? As for the performance of Bank of England Governor, Mark Carney – I reaffirm my 2013 view.

Antipathy to the EU high in Italy, France and Sweden (survey taken before the UK referendum)



Source: Ipsos Global, Daily Telegraph, 10 May

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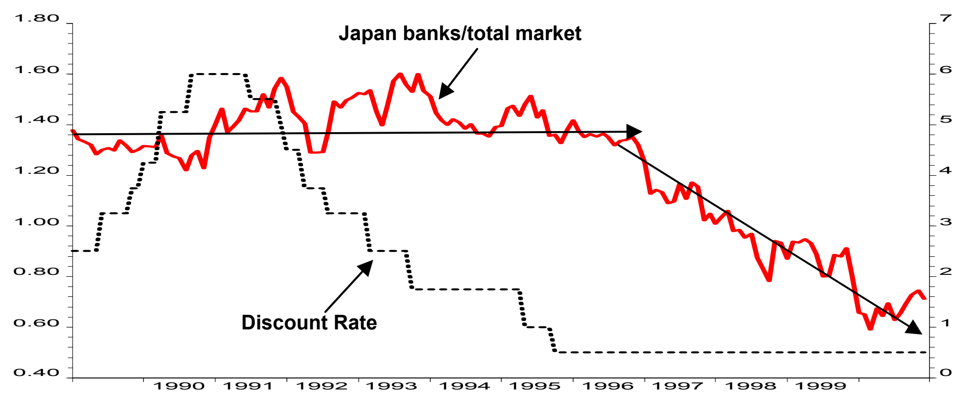
Let me remind readers that the views I express here are my own views and not the SG House View. My own view is that I believe it is only a matter of time before the eurozone project fractures. Clearly the UK referendum has not helped matters. For me the problem is Italy and France in that order. Why? Because you have got disaffected populations in 'too-big-to-fail economies' who are disillusioned with what the eurozone project has delivered in terms of employment and economic growth. AND much more significantly, you have major opposition parties who are committed to leaving the eurozone and who would be likely to do so if they were to attain power. That is not the case in Greece recently, or in other eurozone countries in economic and political difficulties such as Spain and Portugal.

I'm going to focus on Italy in this note as I do think that is the weak point in the eurozone both economically and politically. This note is a little longer than normal but I am going to minimise the text and maximise the interesting charts. In particular **my economics colleague, Yacine Rouimi, has done some great work on why Italy's economy is permanently stagnant and I share some of his interesting charts with you.** And even if you are a US, Japan or UK only investor, it is extremely important to your own investing to understand why the seventh largest economy is in an economic straitjacket from which it must break free or it will surely die.

I'm not going to go into the risks surrounding October's referendum on constitutional reforms that might usher in the anti-eurozone Five Star Movement, or the desperate issues in the Italian banking sector. What I would remind readers though is that the Italian banking crisis, although important, is not Italy's main problem. It is a symptom of the problem – that problem being a perpetually stagnant economy and deflation. We remind readers of the experience of Japan in the 1990s. Back then, when the western economists were hubristically lecturing the Japanese on how to fix their economy, recapitalisation of the banks was seen as the key. It was not. For Japanese banks did not start becoming a problem and underperforming the overall equity market until *AFTER* Japan had slid into outright deflation in 1997 as its second deep 1990s recession unfolded (see chart below). Following the western advice, recapitalising the banks did nothing to solve the economic problems, without targeting the deflation monster itself. All that happened after each bailout was that Japan's bank balance sheets continued to incubate a whole new set of bad loans as deflation destroyed their customers' solvency.

Japanese banks were not the source of Japan's economic problems – they were a symptom

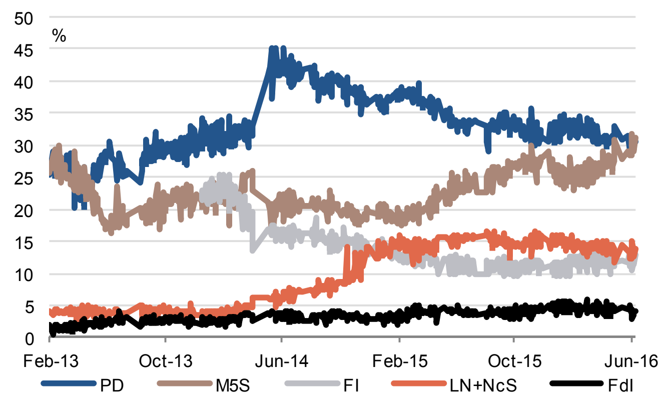


Source: Datastream

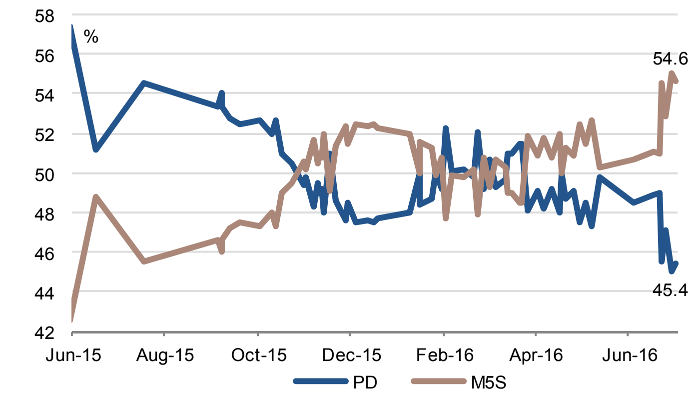
Even if the impending hurdles of an Italian bank bailout and October's referendum are navigated safely the central issue will not go away. *Italy simply does not appear to be able to grow inside the eurozone and more importantly probably never will.* That is why after the next recession I believe a majority of Italians will have had enough of the eurozone experiment and vote in the radical Five Star Movement, whose openly stated policy is for Italy to leave the eurozone – no one-sided negotiations with Germany will occur as they did with Greece. There will be no bluffs. Yet even now, before another recession hits, the Five Star Movement (M5S in charts below) has pulled ahead of the ruling Prime Minister Renzi's

Democratic Party (PD) in the latest opinion polls, energised by the post-Brexit backlash against the establishment parties – (see Reuters link and charts below). The political scene in Italy is set to be wrenched asunder as it was recently in the UK. The people are angry.

Italian opinion polling : First round results



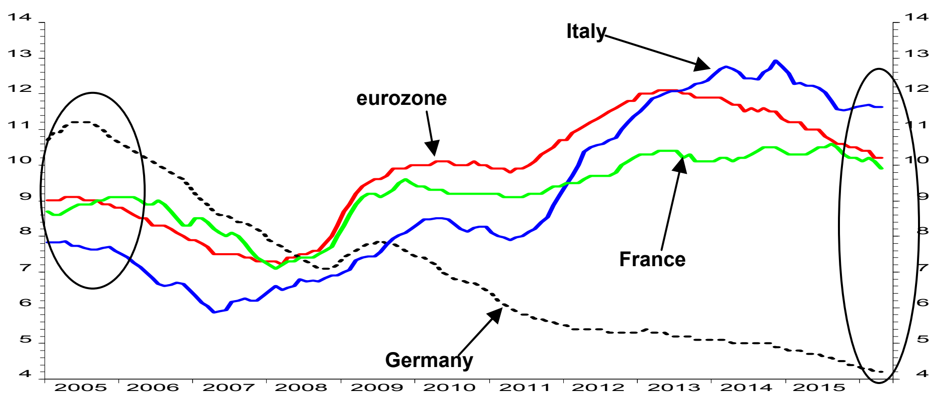
Italian opinion polling : Second round results



Source: SG Cross Asset Research/Economics

Unemployment is the toxic effluent running through the veins of much of the eurozone economy. The boom and bust of the economies of Spain, Greece, Portugal and Ireland should have come as a shock to no-one. It played out exactly as a classic emerging market balance of payments crisis, eg the 1994 Mexican Peso crisis and the 1997 Asian debacle. An initial economic boom results from pegging the exchange rate and importing the wrong monetary policy. This ultimately led to an uncompetitive exchange rate, a gaping current account deficit, and finally an economic and credit bust. **What is far more shocking is what has happened to Italy and France**. Ten years ago not only was German unemployment above that of France and Italy, it was ***SUBSTANTIALLY*** above them! Now look at the situation (see chart below)

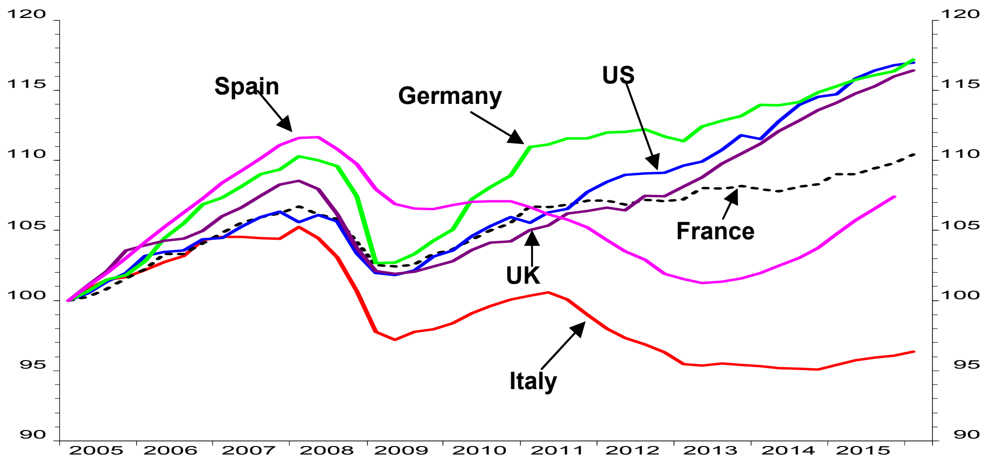
Was it only a decade ago that Italian and French unemployment was way below Germanys'



Source: Datastream

The eurozone total unemployment rate (red line) has declined since the 2011/12 eurozone crisis as a reasonable economic recovery has unfolded in economies like Spain after what turned into an economic depression from their 2007 peak. **But both France and particularly Italy did not 'enjoy' (if that is the right word) any economic bubble in the run-up to the 2008 Global Financial Crisis.** At least in Spain, Ireland, etc, people understood why they had a hangover, having partied hard and drunk to excess from the credit punchbowl. But in France and particularly Italy, no such party occurred in the run-up to 2008. Italy did not experience boom and bust - it experienced stagnation and then bust and now more stagnation (see chart below). Italians are much more discontented than say, the Spanish, as they fear stagnation is a now permanent state of affairs. Indeed the Italian economy has barely grown one jot since it joined the eurozone at the start of 1999 while Germany has grown rich. As inevitably people compare their fortunes with that of their neighbours, the Italians are mighty pissed off.

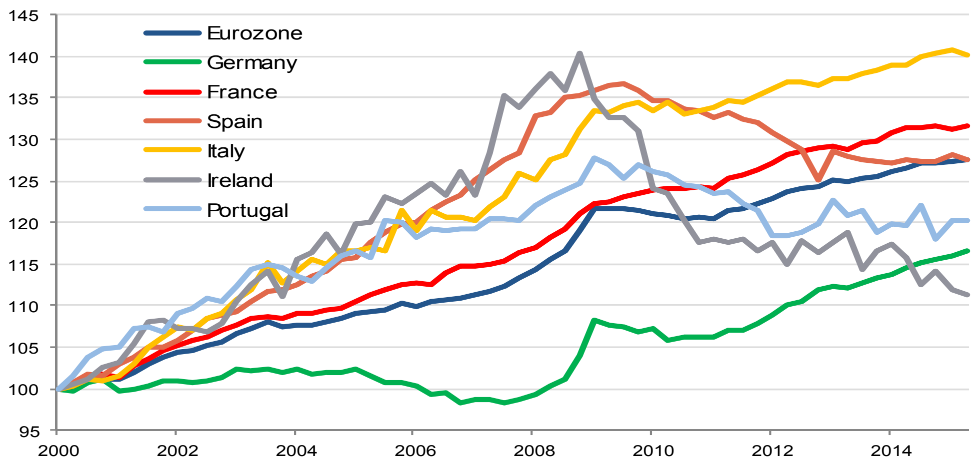
GDP (indexed at 100 in Jan 2005) – Italy is in a league of its own



Source: Datastream

One key feature of the classic EM boom-and-bust cycle the eurozone experienced was the major loss of competitiveness the periphery suffered being part of a fixed exchange rate system and importing totally the wrong monetary policy, ie way to loose. For as the periphery boomed (ex Italy), inflation rose strongly and so did wage inflation (relative to productivity growth), leading to a major rise in unit labour costs relative to Germany (see chart below). In a fixed exchange rate system the rise in unit labour costs relative to Germany also represented a rise in their real exchange rate and a major loss of competiveness in the run-up to 2008 - that was clearly apparent in Spain, Ireland and Portugal (see chart below).

Unit labour costs in the eurozone



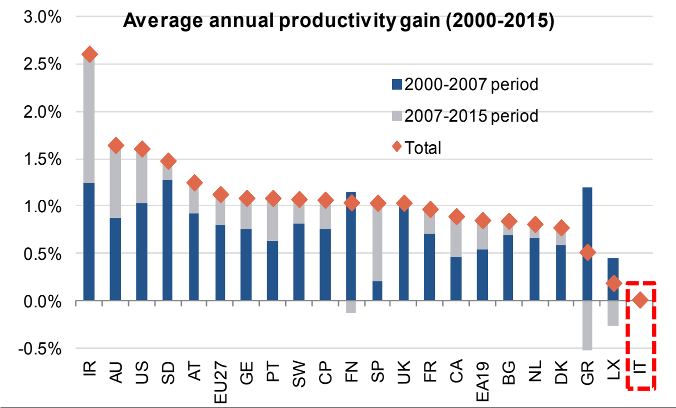
Source: SG Cross Asset Research/Economics

Again what is more surprising from the chart above is the rapid rise in unit labour costs in France and especially Italy, as neither country enjoyed the credit fuelled economic boom seen in the peripheral, bubble economies.

What is more even more significant for the current situation in the eurozone is that the economies of Spain, Ireland and Portugal have seen a convergence in unit labour costs with Germany, partly though internal devaluations (commonly known as falling wages) and partly because labour shortages in Germany are causing rising wage inflation. **What is even more notable is that there has been no restoration of Italian or French competitiveness.** Things have carried along as they have done before, which leaves these countries ill-equipped to compete within the eurozone on a cost basis.

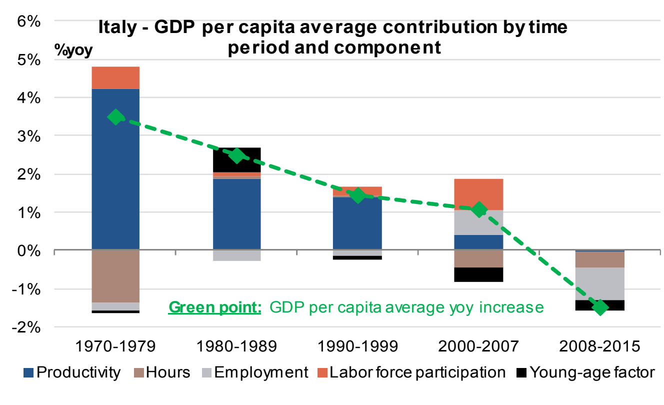
Certainly in terms of Italy (the focus of this note), my economics colleague, Yacine Rouimi, shows exactly why Italy has such a problem on the cost side – namely **Italian productivity growth has been stagnant since the start of the millennium, the worst performance of any European economy *by far*** (see left-hand chart below). And with no offset from labour force participation etc, Italian GDP per capita has stagnated totally since 2000 and declined sharply since the 2008 crisis (see right-hand chart below). Since productivity growth is widely accepted among economists as key to long-term prosperity, and without the ability to devalue to restore competiveness as Italy would have done prior to joining the euro, the lack of productivity growth is a massive problem and needs to be rectified as quickly as possible.

Italy dismal productivity record since 2000



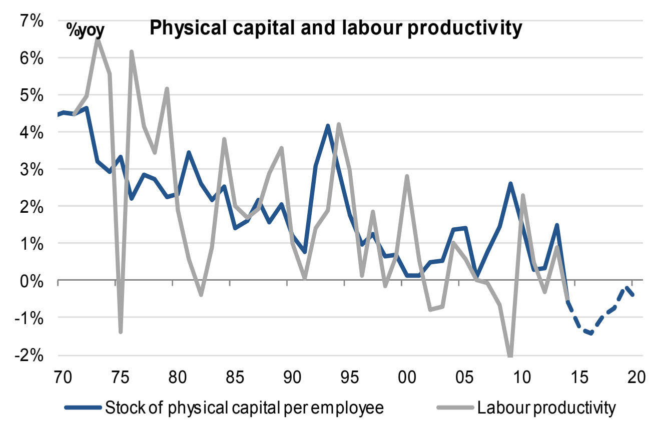
Sources: Conference Board Database™, SG Cross Asset Research/Economics

No element to offset slowing productivity since 2007



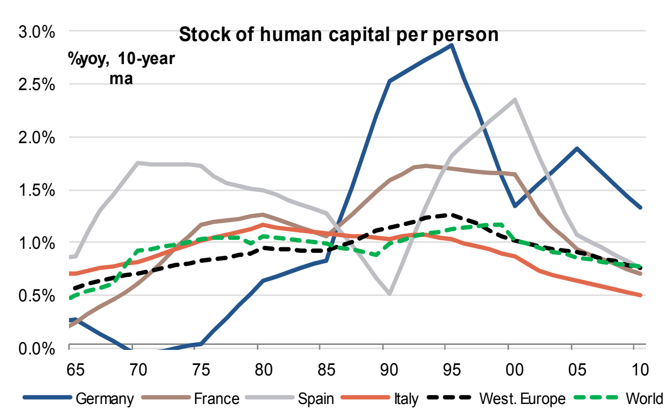
So why has Italian productivity growth stagnated since 2000 and Italy now fallen so far behind its peers in the productivity race? A key driver for long-term productivity growth is investment in capital equipment and this has begun to contract in Italy in recent years to such a degree (-5% pa on average from 2008 to 2014) that, very unusually for a developed economy, the *actual total capital stock per employee is now shrinking* (see left-hand chart below).

Slow capital accumulation = Slow productivity gains



Sources: Istat, European Commission, SG Cross Asset Research/Economics

Human capital accumulation will not help either

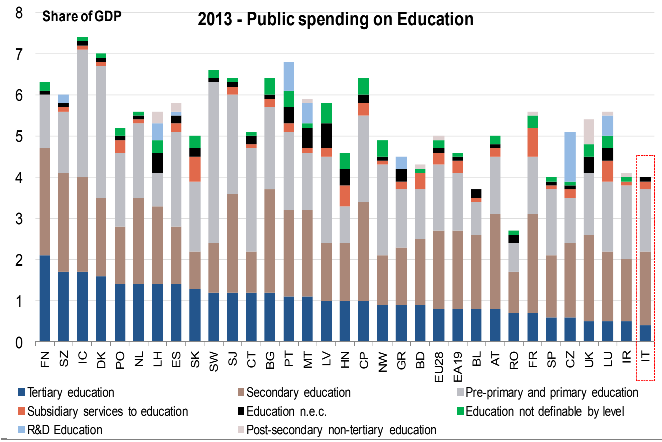


Sources: Groningen database, SG Cross Asset Research/Economics

My economics colleague, Yacine Rouimi notes that in the absence of investment, one way to sustain productivity growth could be to improve the quality of labour, also often identified as one of the key determinants of long-term economic prospects. Western European economies, like most of the world, experienced a notable improvement in this area until approximately the middle of the 1990s (see top right-hand chart above). Since then, however, human capital accumulation has slowed markedly, probably in part attributable to the 2008 crisis which led to a significant rise in long-term unemployment and the associated destruction of skills. But Italy's performance has been woeful, with growth rates slowing down alarmingly to rates well below European norms over the past decade. Why?

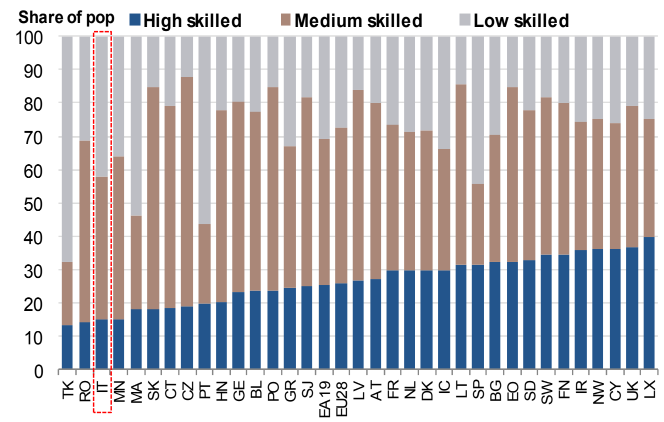
Rouimi explains "That is not really surprising: Italy is, among European nations, one of the lowest spenders in the field of education (universities in particular, see left-hand chart below). Academic attainment statistics substantiate that fact, as ***only 15% of the Italian population had attained tertiary education in 2014 (only Turkey and Romania are in a worse position in Europe*** – see right-hand chart below). This means that one should not expect Italy to return to more satisfactory growth levels on the labour quality front for a very long time, as it usually takes decades for gains from an improved education system to materialise."

Italy devotes little resources to education



Sources: Eurostat (COFOG Database), SG Cross Asset Research/Economics

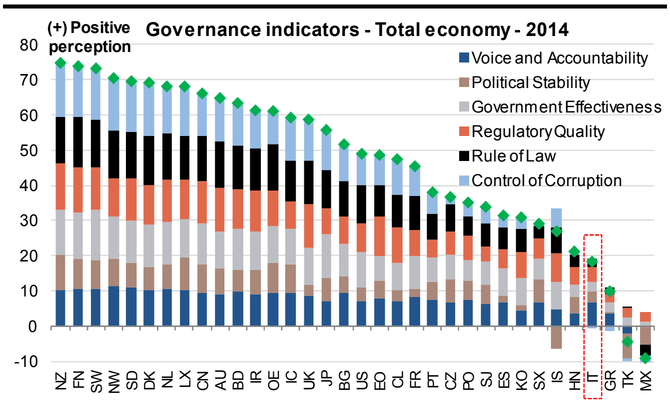
Share of high-skilled people in the population is low



Sources: Eurostat, SG Cross Asset Research/Economics (reference year is 2014 for every country; age group is 15-64). We built this chart according to the International Standard Classification of Education (ISCED). It represents the share of the population with: - Low skills ---- >"Less than primary, primary and lower secondary education" (ISCED levels 0-2) - Medium skills ---- >"Upper secondary and post-secondary non-tertiary education" (levels 3-4) - High skills ---- >"Tertiary education" (levels 5-8)

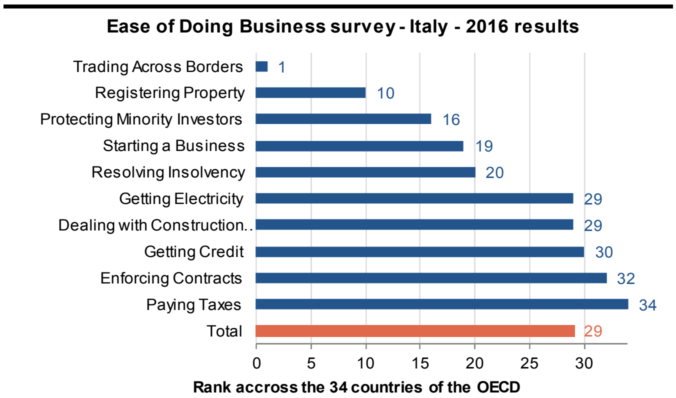
Improvements on education and capital stock will take years to come through in terms of improving total factor productivity and economic well-being. Is there anything Italy can do quickly to kick-start their moribund economy? Yes there is. Rouimi believes that improving governance and regulation that creates an environment encouraging risk-taking and technological innovation is a potential quick and easy win for any reform minded government. **Looking at the World Bank's governance indicators, Italy ranks appallingly low on almost every governance metric (regulatory quality, political stability, control of corruption, rule of law,** see left-hand chart below). The European Commission also notes that there are too many vested interests and barriers to entry, especially in highly-protected sectors such as taxis, notaries and pharmacists. If these sectors could be de-regulated rapidly more investment and productivity would quickly result.

Italy scores poorly on almost every governance metric



Sources: World Bank (Governance indicators database), SG Cross Asset Research/Economics

Still difficult to do business



Sources: World Bank (Ease of Doing Business survey database), SG Cross Asset Research/Economics. Note: Italy got a perfect score in the "Trading Across Border" category of the survey along with 13 other OECD countries – mainly due to being within the eurozone .

Stifling business spirits seems to be a specialty of Italy (surpassed in the EU only by Greece). My own favourite measure of business efficiency is the *World Bank Ease of Doing Business.* This is not about the ability of companies to hire and fire at will and pay low wages. The World Bank looks at ten sub-categories such as ease of starting a business, registering property, etc. (the sub-categories are listed in the right-hand chart above). It is an excellent survey.

Overall **Italy ranks among the worst in the high income OECD at 29th out of 34 nations. Most shamefully of all, it is 34th out of 34 on the sub-category of "paying taxes".** The "Paying Taxes" sub-category is not just about the total rate of taxes companies have to pay, but the number of payments necessary and the time and paperwork it takes – see here for the rankings and methodology of the survey.

Still looking at the "Paying Tax" sub-category, when you rank Italy with all nations the World Bank measures, Italy is 137th out of 189 nations surveyed. Above it in the rankings are, among others, Columbia, Yemen, Sierra Leone, Iran, Liberia, Uzbekistan, Ethiopia, Papua New Guinea, Ghana, Uganda and I could go on and on. No disrespect to any of the nations listed but Italy's performance on these measures *is an absolute disgrace for a high income OECD economy.* Even Greece, (yes *even* Greece), which comes way below Italy in the overall ranking, achieves a not wholly discreditable 66th place in the taxes sub-category (and by the way in case you are impressed that Italy ranks number 1 in the "trading across borders" sub-category, don't be. It is purely a function of being within the eurozone and having standard rules forced on them. (Left to their own devices I am sure they would be down the bottom of the list as they are with virtually every other measure.)

If you think I'm being harsh here, yes I am. It makes me genuinely angry that the citizens of Italy are being impoverished under the weight of excess business regulation and their citizens employment prospects are being needlessly destroyed because of it. This is not about the ability to hire and fire – this is about strangling business entrepreneurship at birth.

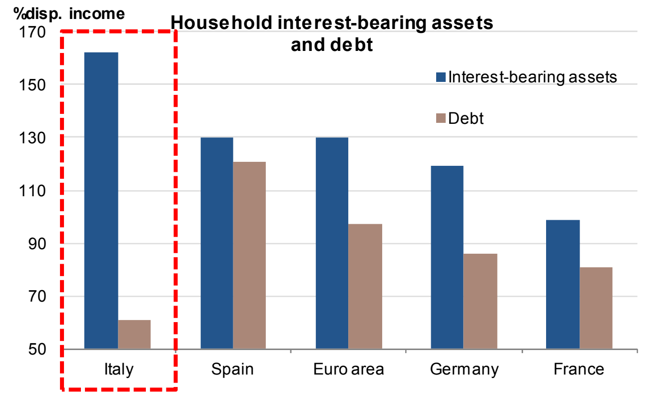
And those who say to me, oh it is because Italy is a high tax and spend 'semi-socialist' economy, just like France (which is also pretty poor on most measures), I say nonsense. My former colleague Dylan Grice used to point out that France's government spending as a share of GDP was on par with Cuba and that might account for its economic malaise! Indeed the top countries in the World Bank's *Ease of Doing Business Ranking* are predictably low tax and spend economies such as Singapore, Hong Kong, the UK and the US. But you also find Denmark, Sweden and Norway at the top and these are all countries where tax and spending is as high if not higher than France and Italy. The lesson here is whatever your social model, it does not stop a country having a vibrant business sector. Indeed the more vibrant it is the more taxes can be collected to finance social expenditures. The Skandis seem to have worked this out but it is a shame for their populations that the Italian and indeed French have not. What any Economy Ministry in any country, especially Italy, needs to do is go down these sub-categories and if they find themselves unacceptably low, do something about it - quickly!

I must apologise. I get a bit over-emotional about this topic. As you can tell it is a bugbear of mine. Anyway, enough ranting, and back to Italy to finish up.

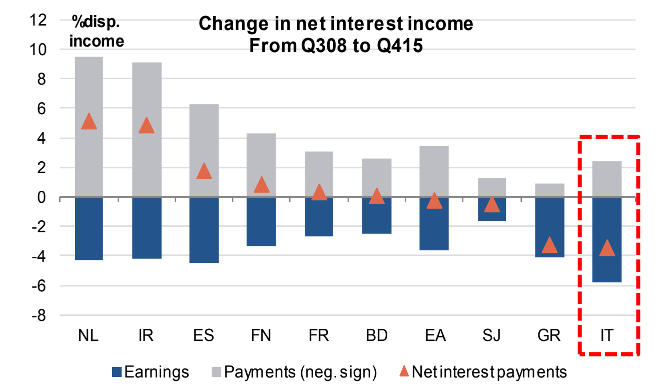
But for those of you who are economics-minded, let me commend my economics colleague, Yacine Rouimi, who has written three excellent reports on the subject of reviving Italy's appalling productivity performance. Much of what has gone above can be found here but in a lot more detail and better explained. Rouimi also writes a Part 2 on the particular problems encountered in the non-tradable professional services sector in terms of the shocking barriers to entry in the legal, accounting, architecture and engineering professions. Finally in Part 3 Rouimi writes about the regional issues and how the south of Italy is rapidly going backwards on most measures and dragging the overall economy down. He notes that the regional variation in terms of government efficiency/quality of public service provision is huge compared to other European countries. Best national public service practices need to be implemented fast, with troubleshooters demanding best management practice and delivery in this beleaguered part of the country. Their citizens deserve better.

Finally let me come to the here and now. Still borrowing from my colleagues work, they note that Italy's recovery this year has been consumer-driven as households have spent the entire gains from the recent low oil price. Going forward consumer spending is likely to stall and the new tailwind to drive the economy forward will be....well nothing really! One thing to note though is that Italy is not helped by further cuts in interest rates as traditionally the household sector has been very conservative in terms of taking on debt (unlike the public sector). Indeed the Italians make the Germans look like debt-junkies (see left-hand chart below).

As their Italian's net interest bearing wealth is significantly above average…



....Italian households' disposable income is negatively affected by the low rate environment



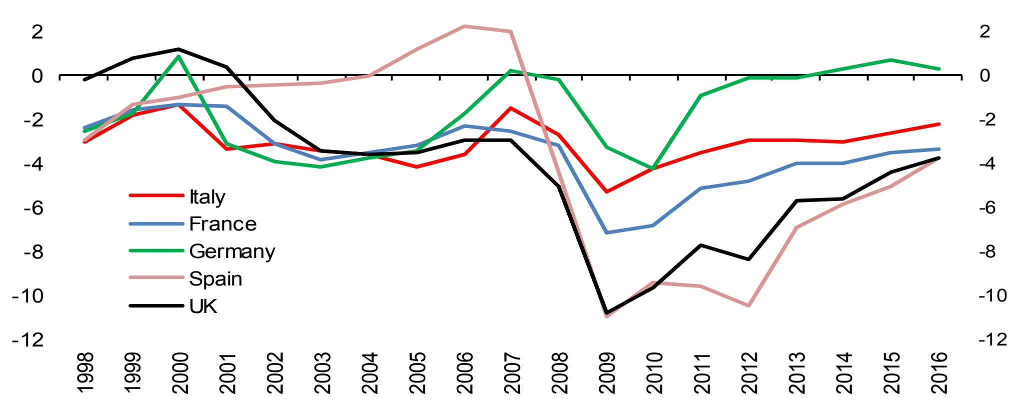
Sources: Eurostat, European Central Bank, SG Cross Asset Research/Economics

BD=Germany; EA=Euro area; ES=Spain; FN=Finland; FR=France; GR=Greece; IR=Ireland; IT=Italy; NL=Netherlands; SJ=Slovenia.

Interest income has been hit unusually hard in Italy compared to other eurozone countries in recent years and many Italian households rely on this interest income. I agreed previously with the comments made by the German Finance Minister Wolfgang Schäuble, who blamed the ECB interest rate policy for incubating extremism in Germany. And if that is true for Germany, think what it is like in Italy!

The last point I would like to make on Italy is on its fiscal deficit. For me an expansion of the deficit is Italy's only short-term weapon they can use to alleviate a relapse in GDP growth, a Five Star Movement in government, and an ultimate fracture of the eurozone. Italy's net government debt/GDP income ratio is among the highest in the developed world at 133% last year, exceeding even Japan's 128% of GDP (but not Greece's 144%), but Italy has endued a triple-digit government debt burden for a long, long time. But its general government *deficit* is a low, Maastricht compliant 2.3% of GDP (OECD estimate, see chart below).

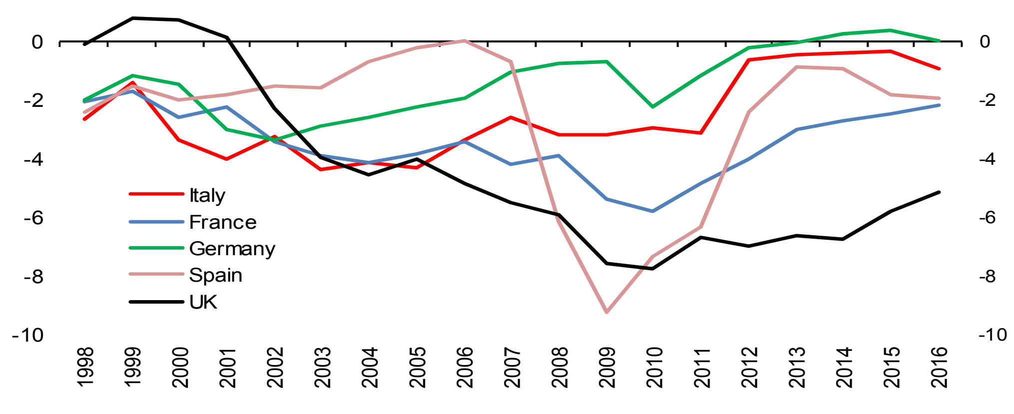
General Government Financial Balance (as % of GDP, negative is deficit)



Source: Datastream

It is notable that because Italy never suffered a private credit bubble in the run-up to the 2008 Global Financial Crisis, its public sector deficit never ballooned out into double-digit deficits in 2009 as occurred in the US, UK, Spain, Portugal, Ireland and Greece. So in that respect, Italy is fiscally lucky. The OECD estimates that adjusting for the impact of the economic cycle and removing some one-off items, the Italian fiscal deficit is in even better shape (see chart below).

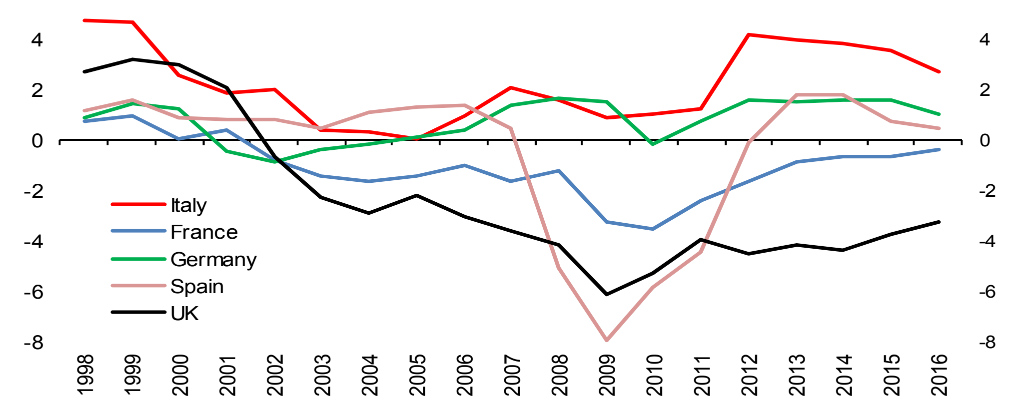
General Government Underlying Balance (as % of GDP, negative is deficit)



Source: Datastream

The OECD makes one final adjustment to seek out the 'best' measure for the underlying fiscal deficit/surplus. It removes interest payments to calculate the *General Government Underlying Primary Balance* (see chart below). Italy's underlying primary fiscal surplus peaked at 4.2% of GDP in 2012 and since PM Renzi came to power in February 2014 there has definitely been an easing of the fiscal brake with the surplus falling by 1% over the last two years to 2.7%. Italy still remains in a very favourable position to stimulate its economy through fiscal means (note how poor the UK situation is, while Japan has a 5% deficit on this measure and incredibly, has run a deficit in every single year for the last 20 years – in stark contrast to Italy's surpluses).

General Government Underlying Primary Balance (as % of GDP, negative is deficit)



Source: Datastream

If the Italian PM Renzi is going to have a battle with the European Commission (EC) and the German government about the terms of the Italian bank bailout and whether retail bond investors have to contribute, he might as well pick one more fight. In my opinion he should announce an aggressive fiscal pump priming package of 2% of GDP (which would take the headline deficit to 4% of GDP). And if the EC or Germany complains, Renzi should quote the Head of the EC, Junker, who in signalling he was willing to give France leeway on continuing to exceed the 3% deficit target, gave his justification as *"because it is France"* – link. Italy has played by the fiscal austerity rules for too long. Although its problems are structural in nature, after running a underlying primary fiscal surplus for some 20 years it is time to break free from its self-imposed deflationary fiscal chains and tell the EC, *"because we are Italy"*. Otherwise I fear that the eurozone project, which the EC so cherishes, will soon start to break apart.