Sunday Wrap

Happy Sunday from Chiswick – in the capital city of the Disunited Kingdom.

Yesterday, an estimated 560,000 people marched in London against Brexit in what was one of the biggest public demonstrations in British history. The issue of Britain's relationship with the rest of Europe really has divided this country to an extent where one must wonder if the UK will remain one country. But more on that another day.

Today, I'll rather discuss the combination of three minor looking, but potentially very important, events in European markets towards the end of this past week:

First, on Thursday afternoon we saw the first appearance of contagion from Italy to the other eurozone peripherals and semi-cores, with particularly Spain being hit, probably due to a Spanish court ruling, which implies higher cost for the Spanish banking sector. But the ripple effects hit other countries as well, including Portugal and Belgium. If we have entered a period of more broad-based contagion, it'll clearly increase the probability of a policy response by the ECB and other European policymakers to the turmoil, which started in Italy some six months ago.

Second, Friday afternoon around 4pm CET, EU Commissioner Moscovici made a statement which sounded somewhat constructive towards Italy, and some 90 minutes later, the Italian niche newspaper, Il Foglio, published a piece in which people close to Di Maio and Salvini said that the planned 2019 budget deficit could be cut to 2.1% of GDP, rather than the drafted 2.4%. Di Maio later denied it, but if it were to be confirmed, it would be very positive news for the market.

Third, also on Friday, but only after markets had closed, Moody's announced its generally expected downgrade of Italy to Baa3, but with a "stable outlook", rather than the widely feared "negative outlook." (Strangely, a massive rally in BTPs, tightening spreads by about 10bp, started at 4pm CET, but the rally was completely disproportionate to the news available at the time, so I'm not sure what happened there.)

With Moody's decision to downgrade Italy to the lowest investment grade, the credit rating agencies have again moved center stage in Europe, unfortunately. S&P is likely to change its outlook to "negative" on Friday, thereby setting the stage for its downgrade – along with Fitch (already on negative outlook) – in early 2019 to establish all three major agencies' view of the Italian sovereign as just one notch above junk status – unless we get a policy adjustment, or the credit rating agencies start to connect better with economic reality, rather than relying on their (historically disastrous) assessment of politics. But, whether justified or not, downgrades by the rating agencies to the edge of junk will further fuel recent months' marked retreat from Italy by institutional money, thereby risking a replay of the highly disruptive, pro-cyclical, capital movements inside the currency union we saw during 2010-12.

Erik F. Nielsen,
Global Head of CIB Research,
Group Chief Economist
(UniCredit Bank, London)
+44 207 826-1765
erik.nielsen@unicredit.eu

Bloomberg:
UCGR, UCFR

Internet:
www.research.unicredit.eu

Let me spell that one out in some more detail via the following three points:

- **First, I'll put the much-debated budget into perspective. There are several aspects of it that I don't like, but the general reaction, including in markets, is way out of proportion, largely because of excessive focus on whether debt/GDP will decline or not during the next few years.**

- **I'll argue that the world is absurdly pre-occupied with the public debt to GDP ratio. It provides very little information about debt sustainability and drowns out almost any discussion of much more relevant parameters for sustainability.**

- **The credit rating agencies have still not learned the lesson of sticking with economics and not try their hand at politics. As a result, their approach to sovereigns' creditworthiness continues to be highly problematic. But in a world where – fortunately - everyone has the right to have his or her opinion, the real crime lies in the regulators' reliance on the agencies' opinion, which means that even unjustified changes in ratings are likely to have potentially devastating economic consequences.**

1. The budget in perspective.

Let me start by making the following very clear: I'm not a fan of the draft budget, but for a country with (almost certainly) some remaining output gap, I can't get too excited about a budget that tries to provide a bit of stimulus. And while I, too, would like to see a reduction in debt/GDP, I find the obsession with this specific ratio misguided, as I'll discuss in the next section. My bone with the draft budget is predominantly its composition, and – particularly – the encouragement to retire early.

Quick summary: As you know, earlier this week, the government approved the Draft Budgetary Plan for 2019 and sent it to Brussels. The plan envisages an increase in the budget deficit to 2.4% of GDP in 2019 (from 1.8% in 2018), followed by a decline to 2.1% in 2020 and 1.8% in 2021, based on an assumed acceleration in GDP growth to 1.5% in 2019 (from 1.2% this year), and 1.6% and 1.4% in 2020 and 2021.

The Parliamentary Budget Office did not agree with those growth estimates, but the government ploughed ahead, arguing that the fiscal expansion will boost growth by about 0.6pp next year. To me, this sounds too optimistic, not least if you include the drag on growth now imposed by markets.

As you hopefully know from my colleague, Loredana Federico's notes, the government's new policies will cost about EUR 34bn (or 1.8% of GDP) next year, of which EUR 8bn will be funded via new taxes (mostly on the financial industry, i.e. a tax on the intermediation of savings to loans to investors, thank you very much!), EUR 4bn through cuts in existing spending items, and EUR 22bn via new borrowing. About 90% of the new policy measures fall within the five areas, namely (i) the citizenship guaranteed annual income of EUR 9,360 for a cost of about EUR 7bn per year; (ii) public investment worth EUR 4bn; (iii) the regrettable new pension legislation will allow people to retire earlier at a cost of EUR 7bn; (iv) the previously envisaged increase in both ordinary and reduced VAT rates starting from January 2019 has been cancelled at an estimated cost of about EUR 12.5bn; and (v) a flat tax of 15% is introduced for very small firms that have annual revenues of up to EUR 65,000 for a cost of about EUR 0.5bn. Loredana's detailed note is here, in case you missed it: Economics Flash - The Draft Budgetary Plan confirms the increase in the deficit and the concentration of resources on the key electoral pledges

As noted, my key concern is the roll-back of the pension reforms. The government hopes the lowering of the retirement age will make jobs available for younger people but I'm skeptical about that, and more importantly, by reducing the labor force, the government is reducing potential growth, which is exactly the opposite of what Italy needs. It would have been a much better use of the EUR 7bn allocated here to lower taxes on employment, particularly for younger people.

But with respect to the effect on 2019 growth of the budget, I can easily persuade myself of some stimulus from these measures, but it's almost impossible to get to the government's estimate of 0.6pp. Moreover, whatever fiscal stimulus you achieve will be partly offset by the tightening of monetary conditions hitting the Italian private sector via the higher borrowing costs on account of the market's worry about the sovereign. The cost of new borrowing for the state has increased by about 200bp since the election. If present BTP yields were to be maintained, this would lead to an increase in the average funding cost for the Italian private sector of about 50bp after a year, which, in turn, would slice about 0.2pp off GDP growth.

Finally, on the government's numbers, the fiscal path implies a significant deviation from the budgetary consolidation path presented in April's Stability Program and required by the EU's Stability and Growth Pact. Specifically, the (unobservable) underlying structural budget deficit is now set to widen from 0.9% of GDP this year to 1.7% of GDP next year, where it'll then stabilize during the following two years. This contrasts quite sharply with the consolidation of about 0.8% of GDP in the counterfactual scenario of no policy changes. As you'll have noticed, the EU has registered its concern, and the Italian government will send its formal reply tomorrow. I suspect there'll be some difficult discussions ahead.

2. The misguided obsession with the debt/GDP ratio.

Behind a lot of the noise - in markets, from the EU and from the rating agencies - is this overwhelming concern with debt/GDP. In the case of Italy, the world's wisdom now – apparently – has decided that the ratio must not increase from the present 131%. Part of the problem, of course, is the EU's (arbitrary) reference to a desired debt/GDP level of max 60%, and the credit rating agencies use of the ratio in their assessment of credit worthiness.

However, debt/GDP is an extremely poor measure of anything meaningful simply because it's a peculiar mixture of a stock measure relative to a flow measure - and, as we all learned in high school, you don't want to mix stocks and flows in your analysis. Stocks are for solvency, flows inform about liquidity, and mixing them leads to all sorts of weird (and mostly irrelevant) conclusions.

So, rather than mix them, pick one of the two. Since we are talking about sovereigns (which do not have a well-defined, and somewhat flexible, asset side), the flow-side is the critical one – which, incidentally, also applies to the company level. (You can operate while insolvent, but if the flow stops and you become illiquid, it's game over.)

So, instead of considering the debt stock, you should focus on the required flows, namely interest payments or total debt service payments. In this case, since the average maturity of Italian sovereign debt (6.8 years) is bang on the European average so, for all practical purposes, you can reduce this to just the interest payments (which saves you from making heroic assumptions about shifting maturities in the roll-over game.) Surely, interest obligations (or debt service obligations) relative to GDP are more telling about your debt service capabilities, and thereby your creditworthiness, than debt/GDP is.

But I would go one step further. While GDP captures something about the potential sources of income (relevant if you trust the government can, and will, raise new taxes to service the creditors), when thinking about your debt service capabilities, I would go straight to what you have on hand to pay with, namely actual government revenues. (For me, a bird in the hand is worth more than the two in the bush.) In other words, if you want to consider the ability of a government to remain current on its debt, surely interest obligations as a percentage of revenues is a much more relevant ratio than debt/GDP.

This is really nothing new or revolutionary, so I'm sure you are all on top of this for the various sovereign creditors you invest in, or speak about, but just to be sure:

This year and next (and the following), the Italian government will allocate just over 8% of its revenues to interest payments. This is a relatively high number, since it's partly a reflection of the debt level, of course, but it's not extreme because it's also a reflection of the Italian government's (proven) ability to collect a fairly large amount of taxes. Hence, while it's a higher ratio than in, e.g., France and Germany, it's only marginally higher than the roughly 7% of revenues allocated to interest payments in, e.g., the UK and Spanish budgets.

Now, thinking about what you get paid on your claims on, e.g., the UK or Spanish government, vs. the Italian government, do you really think there is a major difference in these three governments' ability to service their debt because one needs to take 8% of its revenues to do so, while the two others only need to take 7%?

I don't, but apparently, the credit rating agencies think this ratio is irrelevant, so they rate Spain 1-2 notches higher than Italy, and the UK a whopping 8-9 notches higher. Beats me.

But, maybe more importantly, is 7%-8% of revenues a big allocation to interest payments? I'll let you decide for yourself, but I'll remind you that in 1993, after Italy left the EMS in September the year before, which saw depreciation, inflation and sky-rocketing interest rates, the Italian government used a whopping 31% of its revenues for interest payments. (Anyone still think Italy might be better off outside the eurozone?)

Now, paying about one third of your revenues in interest, that's what I call stress on the finances and crowding out of other normal government priorities, and that, therefore, poses a risk to debt sustainability. But, inexplicably, the rating agencies didn't seem too worried. While they had downgraded Italy a few times as the 1992 crisis developed, by the end of 1993, Moody's still had the Italian sovereign rated an eye-watering 7 notches above what they now think of Italy. Can anyone explain the logic – and consistency – here? Because I don't get it.

… but I couldn't think of a better lead-in to my last segment, which I'll call:

3. The damaging effects of rating agencies…

Let me start this specific discussion by emphasizing that while I disagree on a lot of specific sovereign ratings (in both absolute and relative terms, specifically comparing contemporary ratings and historical differences for individual countries), partly because I find the agencies' methodology questionable (Daniel Vernazza and I wrote a paper on this three years ago – call or email us if you want a copy), we fortunately live in a world where everyone has the right to his or her opinion.

And that the rating agencies take whatever economic input their economists come up with, and then override it with their political assessment (unfortunately, as Daniel and I demonstrated in our paper, thereby bending the creditworthiness assessment statistically the wrong way) it also okay. Everyone can have their opinions. We all sell our services, and if anyone wants to buy them, cool.

But here is the problem:

Our policymakers have decided to use the assessment of 3-4 such private businesses' assessment of their own – and their partner countries' – creditworthiness to dictate risks assessments in the financial sector. As a result, when the agencies misjudge the situation, it has dramatic consequences for capital flows, financial conditions and thereby people's income and livelihood.

In a nutshell, and as widely documented in multiple academic studies, when some degree of trouble emerges in a country, here is the sequence:

Hedge funds and other fast money investors leave (in Italy, this happened largely in May), with an impact on markets. Partly reflecting the market reaction, the rating agencies then get nervous (Fitch moved Italy's outlook to "negative" in August) and begin to downgrade the sovereign (Moody's this past Friday), which then accelerates the retreat of institutional investors, particularly when you approach the threshold between investment grade and junk.

The agencies say that they are considering the medium-term outlook, and – specifically – evaluate the default risk three years out. Yet, they are prone to panic and they have a history of completely misjudging the European political landscape, from the commitments by national governments to the pan-European commitment to establish the necessary European architectures, including the ECB's OMT and the ESM, when needed (but, unfortunately, only once the fire is bursting through the front door.)

We know this movie so well from 2010-12. As you'll recall, within just 20 months, Moody's downgraded Portugal by 10 notches (S&P by 8 notches), Spain by 9 notches (S&P by 8), Ireland by 10 notches (S&P by 6), and Italy by 6 notches (S&P by 4). (Fitch made similar downgrades.)

And because of the regulatory reference to these ratings, a direct result was - on BIS statistics – a withdrawal of more than a trillion (with a "t") euros from the periphery by banks based in core-Europe, hence not counting pension funds and insurance companies, adding considerably to the recession in the periphery. This is one of the most bizarre examples of self-harming pro-cyclical policy structures you'll find anywhere in the developed world.

How this 2010-12 misery didn't lead to a re-think of the regulatory regime's dependency on the three rating agencies beats me, but here we are. And we now risk a re-run of this bad movie as the rating agencies line up to downgrade Italy on their (flawed) assessments of the country's ability to pay, and their (historically highly questionable) assessment of the political will.

In spite of the fact that the "objective" rating for Italy, using Moody's own reaction function and Daniel’s model, is still A2, or no less than 4 notches above Moody's new rating (so, the new rating is apparently reflecting Moody’s political analysis), the reality is that the rating agencies are now lining up to put Italy just one notch above junk. Such rating moves will almost certainly contribute to another round of pro-cyclical capital flows inside the currency union (from the periphery to the core) and that will, in turn, put smaller Italian banks under pressure, thereby further impairing the transmission mechanism on a country-specific basis – delivering a real headache to the ECB (unless contagion indeed spreads to other countries, making their policy options much more straight-forward, if less pleasant.)

To avoid this scenario, an adjustment of Italy’s medium-term fiscal plans would have to be put in place, and the communication on the big policy priorities would have to be clearer.

Yes, the European system is more robust now than in 2010-11, with the OMT and the ESM, but these are crisis-response mechanisms, not crisis-prevention mechanisms, like a proper Capital Markets Union, with a de-anchoring of risk supervision away from the rating agencies to an appropriate data-based system, would have been.

But here we are, possibly re-entering the movie theatre not of economic realities, but of political and institutional realities, and specifically the institutional framework policymakers have imposed on themselves, namely via the reliance on the credit rating agencies for the risk assessment among institutional fund managers.

And yes, I hear the argument that the political reality is that there is a measurable re-denomination risk for the Italian debt, but as I have discussed before, I don’t find this argument persuasive. Consider this:

Yesterday, more than half a million people marched through London in anger over Brexit, a decision that has already reduced UK growth from the top of the G7-pack to about the bottom, and which promises considerable further economic and political misery when Brexit is actually implemented. (No, Theresa May will not change course; the UK will sadly leave the EU at the end of March!)

I promise you, leaving the EU for the UK will – both economically and politically – be a walk in the park compared with any attempt by a country to leave the eurozone! The vast majority of those not understanding this now will get it once they start thinking through the practical details – a mega-version of the painful process the UK presently is going through.

And on that note, I’ll enjoy the rest of my Sunday before heading back to Milan tomorrow morning.

Best,

Erik

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UniCredit Research* — Macro Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Control
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Daniel Vernazza, Ph.D.
Chief UK & Senior Global Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

US Economics Research

Dr. Harm Bandholz, CFA
Chief US Economist
+1 212 672-5957
harm.bandholz@unicredit.eu

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Anna Bogdyukevich, CFA
Russia
+7 495 258-7258 ext. 11-7562
anna.bogdyukevich@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006 678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head, Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 9269-390
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.research.unicredit.eu

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