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MACROCOSM

Will the ECB Kill Italy?

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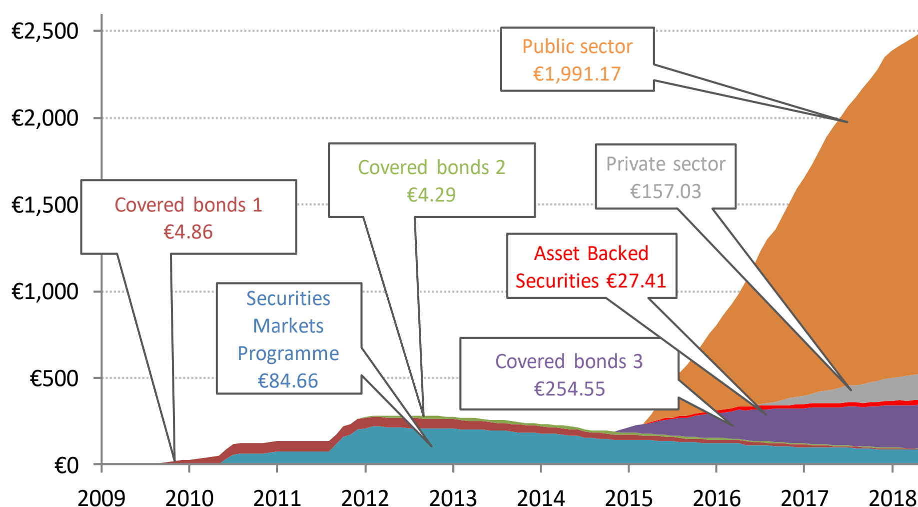
The FOMC will hike (but that will be an easing). The ECB will still do whatever it takes.

FIRST A WORD ABOUT NEXT WEDNESDAY'S FOMC *The FOMC will hike the funds rate to 1.87%, but this will not be a tightening versus the policy posture in March – it will in fact be a slight easing.*

- Based on information known in March, *the 1.63% funds rate was 8.4 bp above the nominal neutral rate* implied by the sum of 1.5% core PCE inflation plus the Laubach Williams model's estimate of "R-star" of 0.041%.
- Based on information known now, the 1.87% funds rate will be *6.2 bp below the nominal neutral rate* implied by the sum of 1.8% core PCE inflation plus the Laubach Williams model's estimate of "R-star" of 0.137%.

NOW, ON TO THURSDAY'S ECB GOVERNING COUNCIL MEETING With all the political and market tumult in Italy (see "USD, Euro and the Risk of Italeave" May 25, 2018), all eyes are on Thursday's ECB Governing Council meeting – hyped up by overexcited media narratives about how the Council will be discussing the "unwind" of its quantitative easing program (just when Italian bonds would seem to need more, not less, support). *We think such concerns are preposterous.*

EBC asset purchases EUR billions



Source: ECB, TrendMacro calculations

Update to strategic view

US FED, ECB, EUROPE MACRO, EUROPE BONDS, FX: The FOMC will hike the funds rate next week, but that will set policy looser than it was at the last hike in March. The ECB may talk about further tapering, but fears of the imminent wrap-up or unwind of sovereign bond purchases are overheated. So far they have done no visible good anyway, and it has made little difference that they have already been substantially tapered form their peak almost two years ago. The ECB will not want to say anything that would destabilize Italy, for whom halted purchases would take 10% to 25% of demand out of monthly refundings. Italy has the strong hand now in negotiations with the EU over tax cuts and immigration, because the threat to leave the euro currency would lead to a global systemic event. If the populist coalition can hold together, it could take the second step after Brexit to truly reform the EU. Like Trump's trade and denuclearization initiatives, it's a high-return high-risk game well worth playing.

[Strategy dashboard]

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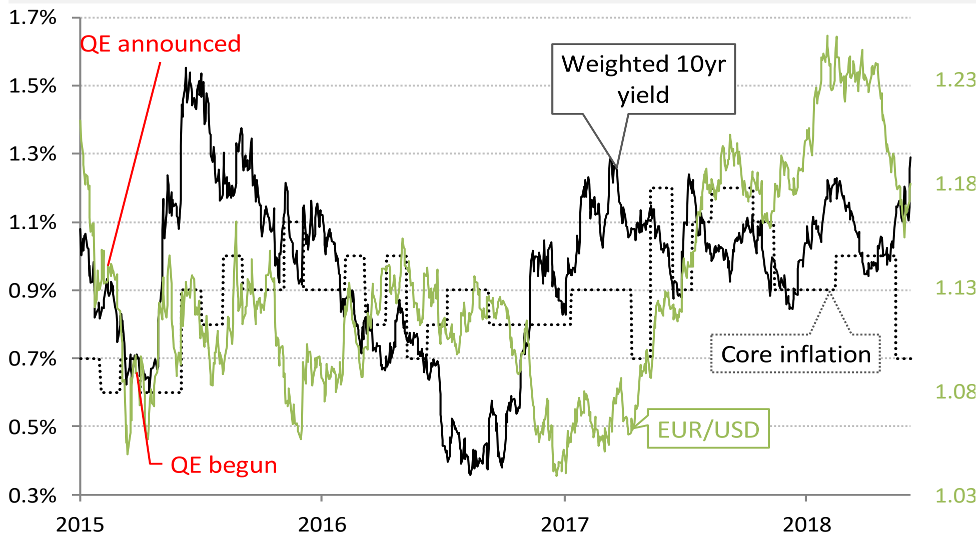
- *It would be inconceivably reckless for a central bank under the leadership of Mario Draghi – he of "whatever it takes" fame – to risk his legacy by rattling fragile markets, by focusing on unwinding the ECB's sovereign bond holdings* (please see the chart on the first page) *before it had even announced the end to ongoing purchases.*
- Even the calmer reports anticipating merely a wrapping up of purchases exaggerate the importance of them. *Since they began in 2015, we can't see that they have made any difference at all to euro area bond yields, inflation, or the value of the euro* (please see the chart below). *So how would winding them down matter, except to Italian politics* (a contingency we will cover in a moment)?

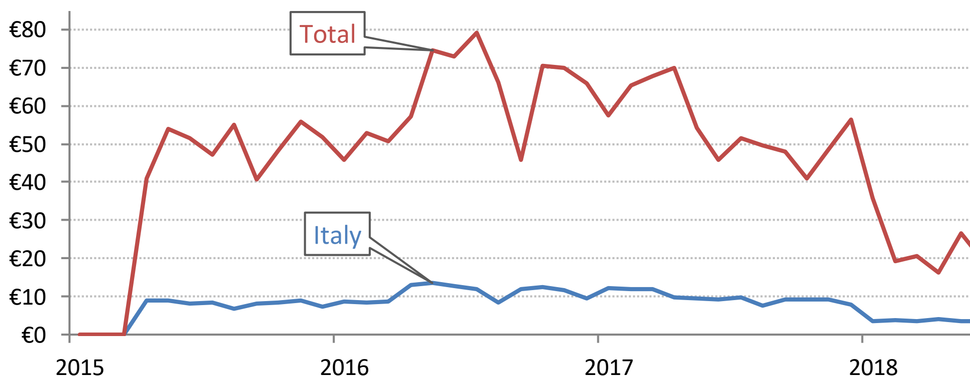
Euro area market reaction to onset of ECB sovereign bond purchases



Source: Eurostat, Bloomberg TrendMacro calculations

- *Besides, there is no true news here – the ECB's purchases of euro area sovereign bonds have already been in a state of taper for almost two years.* They peaked at €79.9 billion per month in July 2016, and now, after two separate decisions to taper (first in January 2017 and then again in October 2017), purchases are presently down to €19.6 billion (please see the chart below).

Run-rate of monthly ECB sovereign bond purchases EUR billions



Source: ECB, TrendMacro calculations

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[About us]

Recommended Reading

Pardon Me, Said the President to Himself
Richard A. Epstein
Wall Street Journal
June 6, 2018

The mystery trader who roiled Wall Street
Miles Johnson and Robert Smith
Financial Times
June 3, 2018

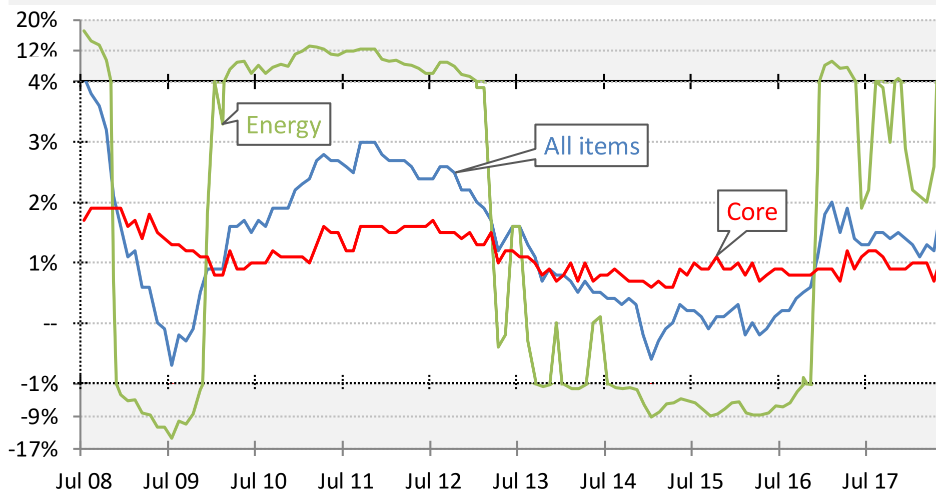
[Reading home]

- Most important, risk in Italy gives the ECB a strong disincentive to rock an already rocky boat – while there is actually no particular incentive to consider rocking it in the first place.
- As the ECB's chief economist Peter Praet put it – in a speech this week cited as evidence that asset purchase will be ending, said that "asset purchases will expire" when "three criteria have been met." Specifically:

> "…first, the convergence of the projected headline inflation to our medium-term aim; second, confidence in the realisation of this convergence path; and third, the resilience of inflation convergence even after the end of our net asset purchases."

- Never mind the apparent fallacy of deciding whether to end asset purchases by judging how markets have reacted after asset purchases have already ended. The clear point here is that these purchases are about nothing but the ECB's single-mandate to target inflation to "below, but close to, 2% over the medium term." If that's the goal, then *the ECB is miles away from being able to declare "mission accomplished" with a straight face* – unless it wishes to willfully ignore the determinative role of energy in producing the few periods of near-target inflation the euro area has enjoyed since the global financial crisis (please see the chart below).

Euro area inflation Year-over-year



Source: Eurostat, TrendMacro calculations

- And as much as the pathologically hawkish, inflation-phobic and Germany-centric Bundesbank president Jens Weidmann may wish otherwise, *the ECB will surely not allow a policy discussion at this Governing Council meeting – presided over by an Italian, Mario Draghi – to be used as a political weapon to scare Italy's new populist coalition government into a more euro-compliant state of mind.*
- It's not that they couldn't do it. Each month now the ECB buys

about €4 billion per month of Italian sovereigns, which represents anywhere from 10% to 25% of net refunding needs, depending on the month (again, please see the second chart on page 2).

- *But Italy has a better weapon – a nuclear one – the threat to leave the euro currency*, the carrying out of which (or, alarmingly, even a strong move in the direction of which) would be likely to trigger a global systemic event of horrific proportions (again, see "USD, Euro and the Risk of Italeave").
- The United Kingdom doesn't possess this weapon, because it has never been part of the euro currency union. So European authorities can be tough on Brexit negotiations. But those authorities have to play nice with Italy, because the non-existence of the common currency used by the world's largest economic bloc is at risk.
- Consider the humiliation last week – while Italy's new populist government was still struggling to be formed – of Günther Oettinger, the German politician who serves as the European Union Budget Director. He made a self-evidently true statement to a German-language television show:

> "My concern and expectation is that the coming weeks will show that the development of the markets, government bonds and the economy of Italy will be so far-reaching that this will be a possible signal to voters not to vote for populists on the right or left.
>
> "Already the developments of the government bonds, the market value of banks, the general course of the Italian economy is clearly overcast, is negative. This has to do with the possible government formation."

- As is typical in today's social media-driven world, these remarks were exaggerated in a tweet by the show's host: "The markets will teach the Italians to vote for the right thing." That was too good to fact check for *Lega* leader Matteo Salvini and *Cinque Stelle* leader Luigi Di Maio, who tweeted their outrage – drawing abject apologies not just from Oettinger, but also from two of the four presidents of the European Union, Donald Tusk and Jean Claude Juncker.
- Tusk tweeted something hitherto unheard of from a haughty eurocrat – "…please respect the voters. We are there to serve them, not lecture them." Juncker's response, in an official statement, was equally atypical for a northern European: "Italy deserves respect."

- With this as backdrop, Giuseppe Conte struck a positive tone in his inaugural speech as Italy's prime minister. *He said all the right things, as far as we're concerned.* He called for reduction of Italy's debt, "but with a view to economic growth." He reiterated The League's call for a "flat tax." Happily, nothing as specific in terms of Five Star's call for expanded welfare payments.
- And, inevitably, he said "We will end the immigration business,

which has grown out of all proportion under the cloak of fake solidarity." And with that, he will be off to Brussels – and to Berlin, where the real decisions will be made – with the aim of "changing its governance, a change already at the centre of reflection and discussion in all EU member states."

- *Conte cut right to heart of the matter, in terms of how we see pro-growth reform arising under threat of Italeave: "We are…confident of our negotiating power, because we are facing a situation in which Italy's interests...coincide with the general interests of Europe, with the aim of preventing its possible decline."*
- German Chancellor Angela Merkel, for her part, responded in a speech by saying, on the one hand, she wants to "breathe new life" into the European project, but on the other hand, that the immigration issue "challenges the very foundations of the EU." Well, perhaps that's her saying no. But she didn't say "definitely no." We'll know more in October when Italy goes to Brussels with its budget.
- The game is afoot. It started with Brexit. As we said at the time (see "On the Brexit Referendum" June 24, 2016) , Brexit showed that a jailbreak form Brussels is possible – just as Chuck Yeager showed you can break the sound barrier, and Roger Bannister showed you can break the four-minute mile. That started an inevitable process of reform for the unaccountable and sclerotic and growth-killing governance of the European Union.
- But again, Brexit posed no systemic risk because the UK didn't use the euro. But the potential for Italeave – even though it is only a threat used to catalyze reform by otherwise unresponsive incumbent powers – carries true systemic risk, because of the potential break-up of the euro and what that would do to Europe's already fragile banks and heavily indebted sovereigns.
- Like President Donald J. Trump's initiatives to reform China trade, renegotiate NAFTA, and denuclearize North Korea and Iran, the reform of the EU is a positive-sum game well worth playing, but nevertheless there is tail-risk in the event that something goes terribly wrong. This is shaping up as the theme for 2018. To borrow the apt phrase of a client, our low-risk bull market has become a high-risk bull market.
- Our point forecast is that – if the Conte government and the coalition of *Lega* and *Cinque Stelle* can hold together long enough in the turbulent Italian political environment (Conte is the seventh prime minister in 10 years – Italy has a chance to kickstart growth and pull out of two lost decades. At the same time, it will provide a template for other European nations for how to do it.
- The threat to leave the euro is just irresistibly strong. And at the same time, the EU doesn't really have very many weapons of its own. There's nothing in any treaty that says a word about kicking out a member nation that misbehaves. As another client put it this week, what's to stop Italy from cutting taxes whether or not Merkel wants it to? Our response to that was that if it's not up to Ms. Merkel, it is nevertheless still up to Mr. Market to let highly indebted Italy try that experiment. Our bet is that Mr. Market would be thrilled.

Bottom line

The FOMC will hike the funds rate next week, but that will set policy looser than it was at the last hike in March. The ECB may talk about further tapering, but fears of the imminent wrap-up or unwind of sovereign bond purchases are overheated. So far they have done no visible good anyway, and it has made little difference that they have already been substantially tapered form their peak almost two years ago. The ECB will not want to say anything that would destabilize Italy, for whom halted purchases would take 10% to 25% of demand out of monthly refundings. Italy has the strong hand now in negotiations with the EU over tax cuts and immigration, because the threat to leave the euro currency would lead to a global systemic event. If the populist coalition can hold together, it could take the second step after Brexit to truly reform the EU. Like Trump's trade and denuclearization initiatives, it's a high-return high-risk game well worth playing.