# The euro has pushed Italy's debt crisis beyond the point of no return

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VIEWPOINT

A forensic report by Italy's Mediobanca has landed with explosive force on desks across Rome, Milan, and Turin.

It lays out in minute detail why Italy is running out of road after 18 years of economic depression. The awful possibility of a full-blown debt crisis in a country that is too big to save – and by now too angry to bully – must be faced head on.

"Our conclusion is that a voluntary debt re-profiling, an 'Italexit' scenario, or a combination will inevitably gain traction with investors," it said.

The report said the optimal moment to leave the euro has already passed in financial terms, and that it will become progressively more costly to do so as each year passes. Within four years it will become prohibitive.

The message that some may draw is that the country must strike immediately – or very soon – if it wishes to break free of monetary union. "Fare presto" was the telling verdict of Five Star leader Beppe Grillo.

As of today, Italy can still switch half of its €1.9 trillion (£1.62 trillion) of traded debt to lira under the legal prerogative of Lex Monetae on what are roughly neutral terms, but this calculus will shift as new debt with collective action clauses (CACs) displace the old bonds.

Mediobanca's premise is that Italy is heading into a perfect storm as a host of troubles come to the boil and the Italian treasury runs out of buyers. The European Central Bank will soon start to wind down its programme of bond purchases, while new rules on tangible equity will force Italian banks to slash holdings of government bonds by €150bn.

This will take place against a background of US monetary tightening and the Trump reflation shock. Everything is combining to push up real interest rates for an Italian economy still stuck in a low-growth deflationary trap.

The ECB system has already bought €210bn of Italian debt. This covered the entire budget deficit last year and covered the roll-over of old bonds. "Tapering will leave Italy without the key buyer of its debt," the report suggested.

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The country will face what Mediobanca calls an "ownership problem" on €1 trillion of debt due after the ECB steps back, which may come soon given the brewing revolt in Germany over inflation.

Italy's creditors will then face a choice: do they offer debt-restructing on friendly terms within monetary union, or do they hold out and wait for the political storm sweeping Italy to smash the eurozone system?

The report, by Antonio Guglielmi and Marcello Minenna, says voluntary debt exchange is the cleanest way to put Italy's debt on a "sustainable path". It could be done by stretching maturities, or by an interest rate haircut, or both.

"Without these changes, the debate regarding a unilateral exit from the eurozone and a consequent return to the lira looks likely to gain momentum based on the political situation on Rome."

They said Italexit with a cheaper currency and the restoration of "monetary sovereignty" could be the right medicine to rescuscitate the Italian economy, and the Italian people are listening.

"The genie is out of the bottle. Every talk show in Italy is openly discussing whether or not to leave the euro. It is escalating by the day, and sooner or later the market is going to move," said Claudio Borghi, the economic guru of the Lega Nord party.

Four political parties are flirting with the lira – led by the Five Star party and the Lega – and they may amass over half the seats in the next elections, now likely in June.

Investors are taking precautions. The risk spread on Italian 10-year bonds has spiked to 187 basis points this week and are flirting with pre-crisis levels again.

Mediobanca said the ECB's various schemes (LTRO lending and QE) have essentially financed "capital flight" from Italy, and allowed North European banks to extract their money. The risk has been switched to the eurozone taxpayer – a la Grecque.

Over €220bn has left the country and ended up in mutual funds in Germany, Luxembourg, and Holland. This slow break-up of monetary union shows up in the Bank of Italy's liabilities to the ECB in the Target2 payments system, now a record €359bn.

The ECB's Mario Draghi warned in a recent letter to Italian MPs that if a country was to leave the euro, "its national central bank's claims on or liabilities to the ECB would need to be settled in full".

This is dangerous territory. Mr Draghi is stating that Italy's public debt is 20pc of GDP higher than officially acknowledged – 153pc rather than 133pc – in which case why is this not recorded in the official debt figures?

**A report by Italy's Mediobanca says the possibility of 'Italexit' will begin to gain traction with investors**

*'When facing such a threat, you need a flexible exchange rate and all your sovereign tools to dig yourself out'*

Whether or not Italy would in fact owe such Target2 sums is hotly contested. The ECB has until now always rubbished any suggestion that these vast sums (Germany has €754bn in credits) involve real money. Suddenly Target2 is no longer Monopoly money after all.

Mediobanca's argument on CAC debt clauses is that they make it more difficult to "redenominate" bonds from euros into lira. As of late last year, Italy had €932bn of old debt, and €902bn of new CAC debt. The contracts are migrating from one to the other at a pace of €200bn a year.

Whether Lex Monetae would still prevail is disputed in Italy. What all the country's euro critics can agree on is that monetary union has been calamitous for the particular case of Italy.

Mediobanca says Italian productivity rose in lockstep with that of Germany for most of the post-war era – with the help of devaluations – but then stalled under monetary union.

There has been no rise in per capita income for 18 years. The economy is still 7pc smaller than it was before the Lehman Brothers crisis. Two lost decades threaten to become a third. It is worse than anything ever suffered before by a developed economy in peacetime.

Luigi Zingales from Chicago University says the euro is merely a coincidence. It happened to be launched just as globalisation and the China shock were starting to hit Italy with asymmetric force, exposing the failures of its education and mid-tier industries.

This may be true. But it is precisely when you face such a threat that you need a flexible exchange rate and all your sovereign tools to dig yourself out of the hole.

The elemental failure of policy elites in Europe and Italy is that they ignored all the warnings from currency theorists – and indeed ignored the historic north-south divide that blighted Italy's internal lira union after the Risorgimento.

Now it is too late. Italy has gone past the point of no return in monetary union.