Thoughts from the FRONTLINE
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Italy: When Hope Is a Strategy

By John Mauldin | June 22, 2014

Game of Thrones, European-Style
When Hope Is a Strategy
Nantucket, New York, and Maine

I came back from Italy this week, and one of my guilty pleasures was being able to sit down and watch the last three episodes, including the season finale, of *Game of Thrones*. For those readers who are not enthralled with the fantasy epic from HBO or have not read the first five books (will he ever finish?), author George R.R. Martin has written one of the most complex fantasy series ever, about a world where everyone is occupied with who will sit on the Iron Throne.

It is a land of numerous countries and cultures, where the average person might just enjoy a little peace and quiet but where their leaders are seemingly always ready to go at one another, dragging their armies behind them, whether at the hint of an insult or the prospect of the ultimate prize. The series is utterly unpredictable, as Martin seems to routinely to kill off both protagonist and antagonist alike with unexpected finality. You have to be careful not to become too involved with any of the characters, as fate (i.e., the author) can pluck them from the scene all too quickly. Plot twists abound in every chapter, and seemingly minor characters can become major players as time unfolds.

In other words it's a place not unlike Europe.

After spending a few days in Rome trying to deepen my understanding of the situation in Italy – which of late has seemed as convoluted as the plot from *Game of Thrones,* mercifully minus the swordplay but with about the same level of spectacle (who could come up with this cast of characters?), I think I have perceived what might become a significant plot twist in the offing.

So let's look this week at what I uncovered in Italy, which rather surprised me, and think through some of the implications that the new developments suggest for the ultimate outcome of the euro project.

(I want to acknowledge up front the significant help of Christian Menegatti and Brunello Rosa of Roubini Global Economics in setting up key meetings with politicians, bureaucrats, and the Italian central bank. I am also grateful for the candid conversations we had after the meetings, as we tried to work through what we had heard. While this letter will not present a consensus view of our meetings and conversations, I did learn a great deal more than if I had simply gone on my own. Thanks, guys. (They of course are not responsible for any mistakes or inaccurate predictions herein. I can make enough of those on my own.)

Game of Thrones, European-Style

What surprised me about Italy was the emergence of something that felt like *speranza*, which I am told is the Italian word for hope. On my previous visits to Italy over the years, I have seen frustration, anger, and resignation – generally, there was a feeling that there was very little anyone could do to really change things. Even though the names and personalities and even governments changed, there was an underlying assumption behind every conversation that simply said, "This is the Italian way," especially when it came to doing business. Government was slow and inept and bureaucratic; it took years or decades to get anything through the courts; and that's just the way it was. Italians have displayed a marvelous aptitude for getting things done in spite of government, not because of it.

Italy, and especially the north of Italy, is a manufacturing powerhouse; and while it's not the export behemoth that Germany is, the Italians do quite well, thank you very much. It is a testimony to their entrepreneurial skills and design talent that they have done as much as they have, given the ineptitude of their government. That might seem a little harsh, but I think you could find more than a few Italians who would agree.

But something different seems to be happening now. In the last European elections, a clear winner was an upstart politician in Italy. The *EU Observer* explains what happened:

> In June 2013, Matteo Renzi was still pretending that his greatest ambition was to serve a second mandate as mayor of Florence, a mid-sized town of less than 400,000.
>
> A year on, he is rubbing shoulders with the likes of Barack Obama at G7 summits, and is emerging as the biggest counterweight to German Chancellor Angela Merkel on the EU political landscape.
>
> A historic win in last month's European Parliament elections, where his Democratic Party (PD) took 40.8 percent of votes – the best-ever result for the Italian left, and the highest score ever recorded by a single party since the Christian Democrats in 1958 – has given him a strong hand to challenge Berlin-backed austerity policies, as Italy takes on the EU's six-month presidency on 1 July.
>
> "He has meticulously planned his rise to the top for the past 10 years. Not many people, be it in politics, journalism or business, have the same tenacity, drive and determination that he has displayed," says David Allegranti, a political reporter from Florence who has written two books on Renzi. In February, the 39-year-old became Italy's youngest-ever prime minister.

Renzi is photogenic and charismatic, but most of the commentary I read prior to going to Italy three weeks ago seemed to dismiss him as just another one in the series of soon-to-be-sacked Italian prime ministers, there having been four in as many years. Given the current volatility of

Italian politics, it seemed just a matter of (not very much) time before Renzi's government would fall. The only question was what might emerge next from the sausage grinder of Italian politics.

In a little bit we're going to cover in detail some of the rather serious economic realities that face any Italian government. The challenges are daunting, and heretofore the system seemingly just hasn't been properly designed to deal with them. With a debt-to-GDP ratio of over 135%, simple interest costs of 5% of GDP, ultra-low inflation, high unemployment, low to no growth, and rising debt, Italy's economic problems are all too real.

So where is the hope coming from? Renzi is not just going after the economic troubles. He seems to be attacking the very deep structural issues in a novel way. He is seeking serious constitutional reform in a country that has seen no constitutional changes for 30 years. Changing the constitution is difficult and requires a super-majority, which Renzi does not have. But when you meet with Parliament members and ministers from Renzi's party, there is an optimism that is almost catching. Somehow or another Renzi has convinced a lot of people in the Italian political system that reform is possible. In particular, he wants to do away with the upper house (their senate) and streamline the decision-making process in the remaining house of Parliament, with different rules for creating majorities.

Further, he is looking to reform the judicial process in a way that will allow court cases to actually be resolved in a realistic timeframe, removing the "justice delayed is justice denied" issue. Of course, labor reforms are also on the docket.

Meeting with ministers and government leaders who are involved in developing the budget, I found acknowledgment that the only way they can get out of their current situation is to grow their economy. They admitted they needed 2% real GDP growth, 2% inflation, and a 4% "primary surplus" (more on that later). They candidly acknowledged that this outcome is possible is only with significant outside foreign direct investment, substantial growth in exports, and a drop in the unemployment rate. "We have to unleash Italian industry and business."

The current system discourages foreign direct investment and is actually chasing Italian businesses from Italy. The recognition that things need to change if there's going to be any progress in the economy is widespread across the spectrum of political views.

Renzi is seemingly unafraid of pressing ahead on multiple fronts and is perfectly willing to see his government fall and to then hold new elections as a referendum on his policies. For a center-left politician, he is forging political pacts and alliances with an odd cast of characters.

I think the mood can best be summed up by a snippet from a conversation I had late one evening. I was talking with a successful businessman and long-time nominal conservative supporter who told me that he had recently picked up his 18-year-old son at the airport, as the young man returned home from college in another part of Europe. He came back on the day of the recent elections, and as his dad was driving him to the polls, he asked, "Papa, I really don't understand anything about this election, as I've been away. Whom should I vote for?" His father told him to vote for Renzi.

"But Papa, why should I vote for Renzi?" he asked, recognizing that this choice was out of character for his father.

"Because, son, he is the only politician with any hope of changing things so that you can come back to Italy and find a job."

"I understand, Papa." And he went in and cast his vote.

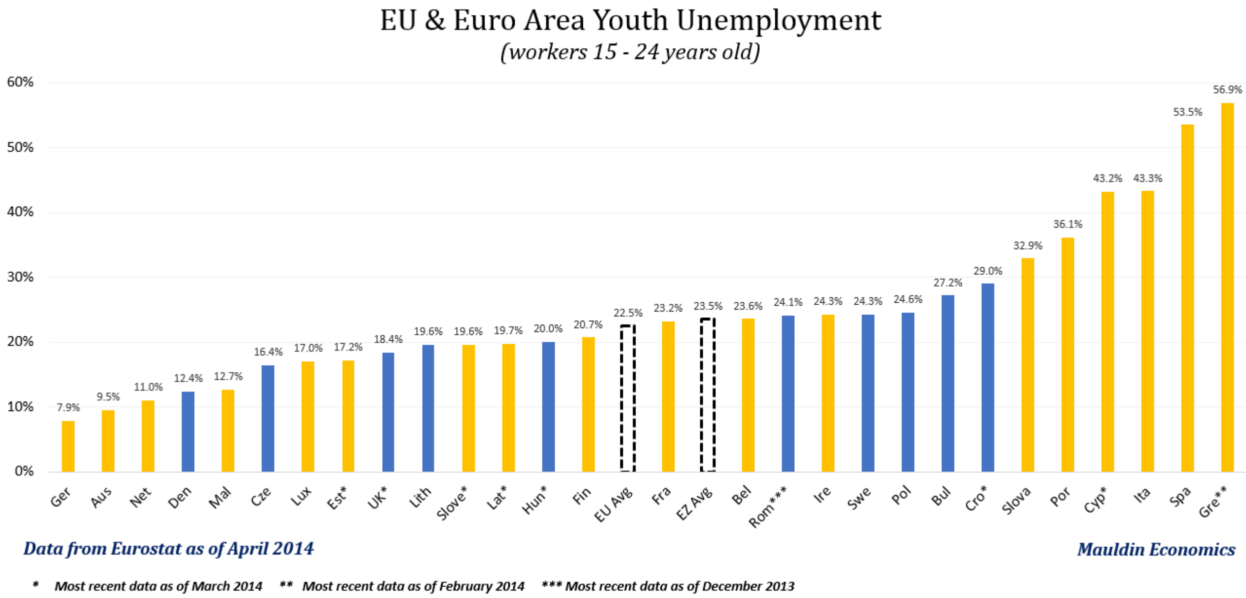
Most of the political types we talked to were a little unusual from my perspective. Some very senior positions were not held by the usual career politicians but rather by former businessmen and bankers who had recently joined the government (in some cases returning to Italy to do so) in order to help bring about change. Something about Renzi just made them want to get involved. These guys were very successful in their former endeavors and brought a level of competency to their current projects.

However, competency and enthusiasm may not be enough. What I think I see developing reminds me in an odd sort of way of an Alcoholics Anonymous prayer. Any realistic assessment of the situation in Italy leads to the hard conclusion that Italy has its back to the wall and that they need everything to go exactly right in order to get out of their current predicament,– which is of their own creation. There seems to be an acceptance of the things they cannot change (the economic realities on the ground) and a willingness to try to change the things that they can. They have to create an environment that can foster economic growth, and anything that is in the way of doing so simply has to be changed. Anything less will prove disastrous.

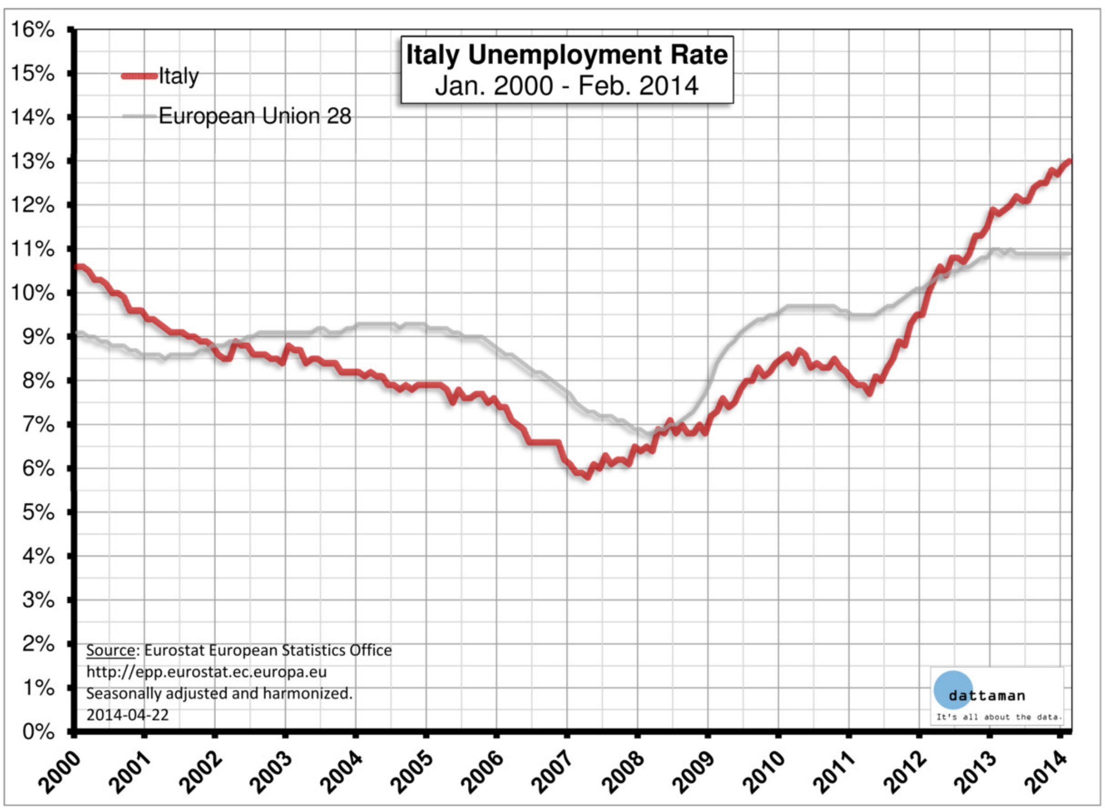
Frankly, the odds of pulling off the significant constitutional changes that are necessary are quite daunting. When we would go over the process with various ministers and bureaucrats, there was an acknowledgment that it would not be easy, but there does seem to be a sense of urgency in the air. And I think that urgency is driven by the serious unemployment problems facing Italy.

And so now it's time to look at the economic realities.

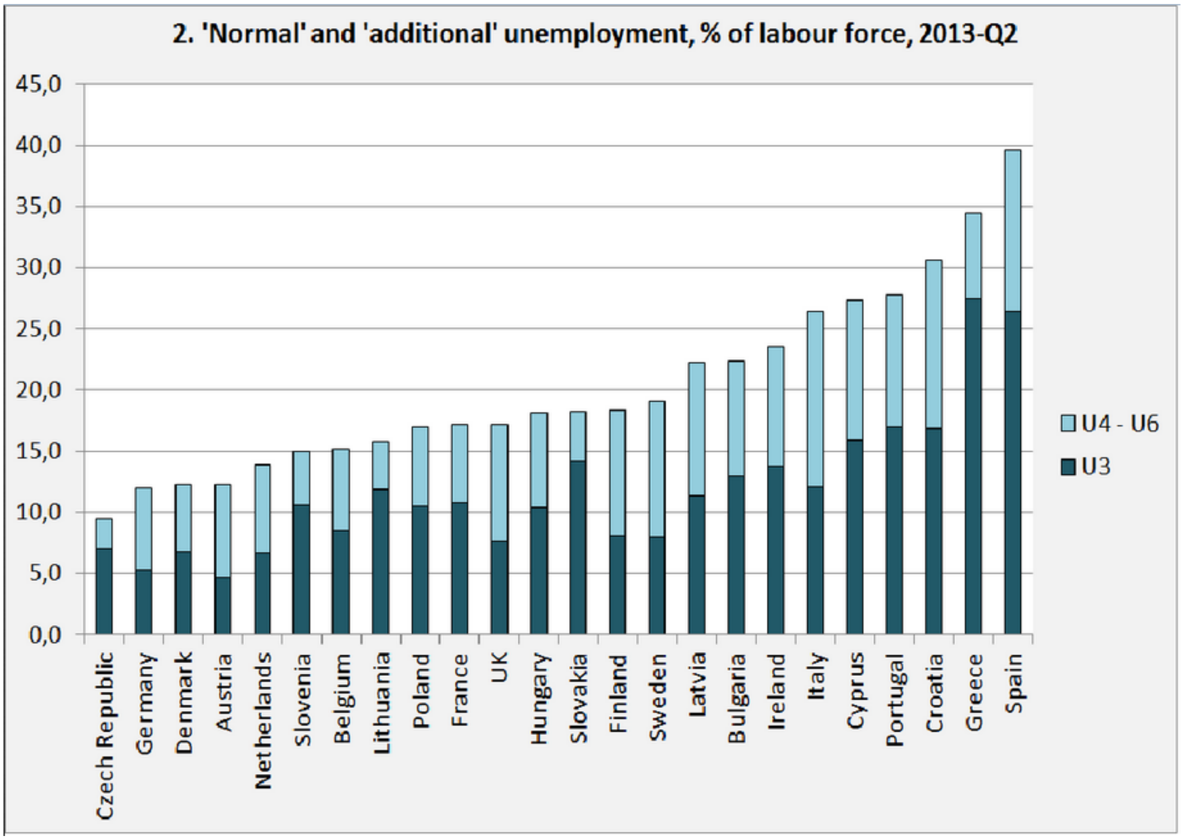
Let's begin with the saddest of the facts. Youth unemployment is the third highest in the European Union at 43%, almost double the EU average of 22%. You can see it when you walk around Rome. While less than in Spain or Greece (which are both over 50%), it is a depressing statistic for any country to grapple with. The plight of our children is a common emotional theme across all cultures and countries. It tends to focus the mind on the problems at hand.



General unemployment in Italy is at 12.6%, and it has been rising since the beginning of the Great Recession. There has been no recovery in Italy.



As in the US, the official unemployment rate masks the true extent of the problem. If you count the underemployed and those employed part-time for noneconomic reasons, unemployment in Italy rises to 25%. The following chart is a little dated (by one year), but the general relationships are the same. It shows the various "U-6" unemployment rates across Europe.



Source: Real-World Economics Review Blog

The next few charts and fact sets are from a lengthy report that interested readers can find on the website of the Bank of Italy (the Italian central bank). We had a lengthy meeting with six members of the bank, which was rather refreshing in its frankness. There has been significant progress in parts of the economy, specifically in the turn-around of the balance of payments, which is now positive and which has long been an important factor in the general malaise of the peripheral European countries. The overall deficit is also being reduced, but that is pretty much where the good news ends.

For the past year, the number of people employed is down, as is the total number of hours worked. While the deficit is down, Italy still had to borrow €75 billion last year. The debt-to-GDP ratio is now at 133%. (Remember when it was "only" 120% and everybody was talking about the crisis that was going to come about?)

Table 8

General government balances and debt (1)
(billions of euros and per cent of GDP)

	2010	2011	2012	2013
Net borrowing	69.9	59.1	47.4	47.3
% of GDP	*4.5*	*3.7*	*3.0*	*3.0*
Primary surplus	1.2	19.3	39.1	34.7
% of GDP	*0.1*	*1.2*	*2.5*	*2.2*
Interest payments	71.2	78.4	86.5	82.0
% of GDP	*4.6*	*5.0*	*5.5*	*5.3*
Debt	1,851.3	1,907.6	1,989.5	2,069.2
% of GDP	*119.3*	*120.7*	*127.0*	*132.6*
Debt net of support provided to EMU countries (2)	1,847.3	1,894.4	1,946.8	2,013.6
% of GDP	*119.0*	*119.9*	*124.2*	*129.1*

Italy is still in a recession and has been for over 2½ years. Prior to that time growth was anemic at best.

The optimistic goal in the bank of Italy's projections is to get the primary surplus up to 4.2% in 2016, from 2.2% today. This bears a little explaining for most readers. You can find a very readable explanation here. Essentially it is the surplus or deficit in a government budget, not counting interest payments. A country is considered to have a "primary surplus" when it can cover all of its actual expenses other than the cost of paying the interest on its debt. What that technically means is that if you are willing to ignore (not pay back) your loans and interest, you can meet your other expenses. Economists and politicians seem to consider a primary surplus as a desirable condition, as opposed to merely being in a complete surplus.

Today it takes 5.3% of the entire GDP of Italy just to pay the interest on its debt, which is the third-largest pile of government debt in the world. By the optimistic projections of the Bank of Italy, that will go down to 5.1% in 2016, even as the total interest payments rise. That means that today Italy has to borrow about 3% of GDP every year. But in order to continue to do so, Italy must achieve significant growth in the next two years.

How do you get out of this debt trap? The easy answer is that you have to grow your way out. If you get 2% real GDP growth and can get the primary surplus well above 3%, you can very slowly make headway. In the government's positive projections, Italy would also have 2% inflation, and the primary surplus would be 4%. Which would mean the debt would shrink by approximately 3 to 4% of GDP per year. (Remember that these are central bank projections. And then remember how accurate US Federal Reserve economists' projections have been. Just saying.)

But is a 2% growth rate achievable? For the last 54 years, Italy has averaged just 0.6% a year GDP growth. How do you get to a primary surplus of 4%? You have to do a lot more cost-cutting, and your tax receipts have to rise. But tax receipt growth in Italy has been negative for the past few years.

And 2% inflation? Inflation is running about 0.5% now and is less than 1% throughout Europe. Furthermore, inflation has been trending down. And as the chart below from Merrill Lynch indicates, in a low-inflation scenario and with realistic growth assumptions, Italy's debt-to-GDP in will be approaching 150% within four years. And that means interest-rate payments will be rising along with the debt.

I spoke at a banking conference in Rome on Monday afternoon. I was the last speaker on a panel in which we were asked to address the question, "How will the markets react when monetary policy returns to normal?" My answer was that we are a long way from monetary policy in Europe approaching anything that one could call normal. I used the above chart and a similar one that depicts even worse dynamics for France. Countries with spiraling debt and a growth problem need a little inflation along with some growth in order to work out of their problems. And that is not an environment that calls for normal monetary policy.

A proper response will require a change of attitude at the European Central Bank. Everyone we talked to seemed to believe that the Italian head of the ECB, Mario Draghi, was getting ready to unleash quantitative easing in the Eurozone in order to begin to bring back inflation. These were people who know him; and whether they are depending on hope or insider knowledge, they are acting as if inflation is going to become a fact.

When Hope Is a Strategy

And that brings us to my rather intriguing conclusion. The current Italian leadership has decided to deal with their problems. They're going to try to restructure their system to the best of their ability to create opportunities for growth. They're going to remove every obstacle they possibly can. They are going to be – or at least attempt to be – at the very forefront of a movement that will be necessary all across Europe to reform the bureaucracy and labor markets.

If everything goes perfectly – and I mean to a degree that has not been seen in Italy in a very long time – they will get their deficit and debt under control and begin to grow their way out of the problem. Anything less than perfection becomes a problem.

I generally followed up every optimistic meeting and presentation with two questions. The first dealt with the elephant in the room that nobody really wanted to talk about: "How do you deal with the rising debt and interest payments if you don't get the growth and inflation you need?" Those of us with a little time under our belts remember the TV series *Happy Days* and the character Fonzie. Fonzie was almost incapable of saying the word *sorry.* In Italy I could not get anyone to say the words "debt restructure." Sometimes they would look away or just ignore the question, but it was evidently a topic that was inappropriate in polite conversation.

Well, that's not entirely true. An English hedge fund manager was quite willing to state that the Italians would be forced to restructure their debt within three years. But that's the English for you.

And that may be the reality. At some point the debt simply becomes too gargantuan for even the most optimistic of Italians. No one wants to admit that they can't deal with their problems; but at some point, if the Italians don't get their perfect economic scenario, the judgment of the market is going to be imposed upon them. Today interest rates for Italian debt are at their lowest in a very long time. But if rates were to rise just 1% – let alone 2% or 3% at 140% debt-to-GDP – interest costs would quickly spiral out of control.

And then there was my second question. At the end of our presentation on Monday, I quickly dealt with my belief that France will be the next Greece. Unlike Italy, France is simply not dealing with its problems and seems to be in a state of denial. What happens when the market begins to demand higher interest rates from France and their debt becomes an even bigger problem? France has a much larger structural issue with their budget than Italy does and cannot handle nearly the debt load that Italy can. The euro, I maintained, is not so much a currency as an experiment, and will remain so until the Eurozone has dealt with the crisis that is going to ensue, starting in France.

(This was evidently a rather provocative statement at the end of the day on Monday. The head of the conference told me Tuesday evening that one of the few consensus notes coming out of the conference was that France would be the next big problem facing Europe. Well, except that the representative from the French central bank took exception. Go figure.)

"Who will lead Europe," I asked, "when there is a crisis in France?" The Germans are going to be very uncomfortable trying to force France into the necessary reforms. Could the role of leadership in Europe actually fall to the Italians? If they make all the necessary reforms to their own economy and government, that leadership role might in fact be theirs. At some point there is going to have to be either a mutualization of debt across the Eurozone, or the ECB is going to have to be allowed to work out financing through a broad restructuring plan. Germany will have to go along or watch the euro collapse.

And upon reflection, that is the basic outline of an unspoken plan I think I see the Italians developing. Fix what we can in our own situation, and if everything works out, then great. But if not, we will have the moral high ground to provide a plan to help all of Europe move out its malaise.

They also believe that ultimately, no matter what happens, Draghi has their back. They really do intend to find out what Draghi meant when he said, "Whatever it takes."

When I look at the choices the Italians have, the concept I have sketched above actually seems to be about the best one available. You can't go back in time to get rid of your debt; you have to deal with the reality on the ground. So create a plan that hopes for the best but includes a backdoor in case you get the worst instead.

And if "the worst" is a restructuring of your debt after you've reformed your economy, then maybe that's not so bad. Of course, there is the problem that Italians own 60% of their own debt. Their banks are loaded with Italian debt. So the word *restructure* is definitely laden. Which is why the Italians need a banking union. And it's another reason why debt mutualization and the moving of some or all European debt to the balance sheet of the European Central Bank, in lieu of a classical restructuring and default such as happened in Greece, make a great deal of sense from the Italian point of view.

Things are going to be very interesting in the next season of *Game of Thrones.* The coming seasons of the Saga of the Euro will be just as captivating. Stay tuned.

Nantucket, New York, and Maine

I know my travel schedule always seems to change, but right now the calendar has me home for more than 12 out of the next 14 weeks. I can't remember the last time that happened. I hope to be able to get into something like a routine at the gym and with work. I'll be in Nantucket and New York City in the middle of July and Maine at the beginning of August. And there's only one short trip so far in the middle of September. I'm sure September will change.

The travel gods didn't cooperate on the return trip from Rome. We got off a few hours late, eventually landing in Chicago. American Airlines conveniently put us on a flight later in the afternoon, but then there was a little weather problem in Dallas. So we sat in the Admirals Club as they moved the departure time back 20-30 minutes every half hour or so. Eventually we got out at about 3 AM and were finally able to leave the Dallas airport at around 5:30 – without our bags, of course. Rather than the full day I'd optimistically planned, I finally got to bed at 7:30 AM and slept most of the day. But eventually the luggage showed up, and by Friday morning all was right with the world. It was time once again to begin to write this letter.

I pretty much finished it by Friday evening and decided I would get up early Saturday morning for one more read. Besides, I really did need to catch up on *Game of Thrones.* Everything was going according to plan until I sat down at my computer Saturday morning. Something, and our techies can't figure out what, caused my computer to crash at 5:30 AM. And I stupidly had not saved my Word file. I know better than that. How many times have I told my kids that the first thing you do is title and save your document? Seriously. And for whatever reason, the crash happened so quickly that Word was not able to back itself up even into a temporary file. After trying everything I know, I got my tech consultants online to see if they could figure it out. Nothing. So there was nothing to do but to start over. Let that be a lesson to you, boys and girls. Always save your work – early and often.

Thinking back on Italy, one of the more interesting parts of the tour last Sunday through Rome was visiting the Church of St. Ignazio. It is an early Jesuit cathedral, evidently built before they had all the money in the world. As they were getting to the end of construction, they ran out of dough before they could build the dome. In stepped Brother Andrea Pozzo, an enterprising priest who said, "You want a dome? I'll give you a dome." Unfortunately he was not an architect but an artist. So rather than building a dome he painted one. And so we have one of the most remarkable pieces of perspective art anywhere in the world.

From the center of the church looking upward, you see this perfectly shaped oval dome structure, full of marvelous paintings and lighting. Except that when you walk around under the "dome," you clearly start to see that you aren't looking at a real dome at all, but a painted picture of a dome. I walked back and forth several times trying to come to terms with the fabulous grasp of perspective that it took to be able to create such a massive architectural artwork.

As I thought about it later that night, it occurred to me that the painting is a marvelous visual representation of the euro. If you don't get too close, it actually looks like a currency. At some point, the members of the Eurozone are going to have to actually create the sort of fiscal union that is required for any successful monetary union. If they don't, the illusion of their currency is going to break down as we get closer to the next crisis. Which is why I'm paying attention to France.

Let's close this letter with a little bit of idle speculation. At the end of the day, I wonder whether France, when confronted with a crisis as I think they will be, will really elect National Front leader Marine Le Pen and let her take them out of the Eurozone. While there may be a complete rejection of the Socialist Party after the miserable performance Hollande is giving, could not the right conservative take second place in the first election and then win in the final? And who might that be? It will be interesting to see what Christine Lagarde does after a few more years as head of the IMF. Silly speculation, I know. But isn't European politics fun?

Have a great week. I have planned my travels perfectly to be in Texas in July and August. But Texas is why God invented air conditioning.

Your saving his work analyst,

John Mauldin

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