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Interest Rate Rise Could Presage #Italeave

by Marcello Minenna on 2 December 2016

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When it seemed the ECB had “hibernated” the spread in its balance sheet for good, back it comes. In recent weeks, the yield spread between Italian and German government bonds over ten years has risen by more than 60 points in 60 days. We can expect a further surge while market fears over the Italian constitutional referendum of December 4 grow. Recent positions taken by the international press make it clear that the financial sector/markets are more interested about the political stability of the government than about the results of the referendum nor the contents of the constitutional reforms. The hypothesis of #Italexit (or #Italeave) is not so far off the radar while bank Monte dei Paschi is battling for its survival amidst talk of *bail-in* and resolution. Moreover, the pressure of the ‘euro-bureaucracy’ to tighten Italy’s 2016 budget has only been postponed to after the referendum.

The rise in Eurozone interest rates has not appeared from nowhere in the last weeks but has structural reasons. First, Eurozone inflation is subtly rising; not uniformly and not in line with the ECB’s expectations of a level below but close to 2%, but it is going definitely up. Since April, prices in Germany have risen by 1 percentage point, while Spain is out of a tremendous deflation, with the prices level rising from -1.1% to 0.7%. Even Italian deflation has improved slightly from -0.4% to -0.1%. Consequently, the yield component that compensates the risk of rising prices has been slowly growing for over six months, pushing up interest rates on European bonds, without exception.

A second factor that involves the entire Eurozone is the rumors about the end of ECB Quantitative Easing. From the end of September, we noticed a big step-up in all the time series of European government bonds yields; not surprisingly, rumors about the gradual withdrawal of monetary stimulus began to circulate then. If the ECB stops progressively buying government bonds, a part of secure and predictable demand will disappear, that the market will absorb only if higher rates are on offer. Despite official denials, the step-up in the yield charts has not been absorbed; this means that the market is looking beyond the reassurances of Mario Draghi in the short term and views the reduction (“*tapering*“) of bonds purchase by the ECB in 2017 as inevitable.

Hence the rise in yields is not only an Italian phenomenon. For sure, since the end of September, the ten-year Italian government bond has risen by 80 basis points, but also Spanish *Bonos* are up almost 70 points. Even the rock-solid German Bund has undergone an increase of more than 30 basis points.

Of course, if we look at what is happening to real returns (the nominal interest rates adjusted for inflation), the situation becomes paradoxical. In fact, in Germany rates have gone up at a very moderate pace while inflation has grown significantly. Accordingly, the real rates have become negative, almost -1%! A negative real rate implies that investing in Bunds is more expensive than it looks, while the German government takes the benefit of debt devaluation due to higher inflation. In this way, not only can Berlin take advantage of the negative nominal rates on the *Bund* that characterize the bonds term structure up to eight years, but also receive more than a little help from inflation. Not surprisingly, the Germany debt/GDP ratio is unique among Eurozone countries in that it is in decline and probably this year will drop below the symbolic threshold of 70%.

In Italy, there are obviously much higher nominal interest rates (now the 10-year bond is yielding well over 2%); moreover, ongoing deflation makes debt harder to repay in real terms. In fact, the negative rate of inflation (-0.1%) adds to the nominal rate and pushes the real rate higher. There's no discount therefore for the Italian Treasury, but rather an increase in the debt burden expressed in real terms, comparable to the level experienced in 2012.

Again, we must recognize – bitterly – that the spillover effects of the ECB's monetary policy benefit the core countries more. If we consider that many of the savings achieved by the Italian government with the fall in interest rates in 2012-2015 (around €20 billion) have been "returned" to European and US banks through the losses on derivative contracts the Treasury subscribed to during the period 1994-2006, the overall benefits of QE for Italy are far less than expected. These losses on derivatives reached the impressive value of € 21.2bn at the end of 2015 while a further €40bn of potential losses are very likely to materialize in the following years.

From a broader perspective, we can conclude that the yield spread between Italy and Germany has grown since the structural conditions of the two economies have continued to diverge and financial operators have realized that the insurance given by the ECB's presence on the markets has a not so hidden deadline in the near future. Italy's referendum will pass over, despite the usual proclamations of market apocalypse. Whatever the result, the markets will soon find a new equilibrium. But the *spread* phenomenon is likely to worsen and take its toll on the Italian economy. Past experience tells us that a prolonged rise in nominal interest rates increases the refinancing cost of government debt and reduces the amount of bank lending to the private sector. The timid progress made in loans to the real economy we have seen during the weak recovery of 2015-2016 would surely suffer a sudden stop. Apart from the political risk, the banking crisis and the economic stagnation would not fade away, threatening the long-term permanence of Italy inside the Eurozone.