

All Roads Lead to Rome

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You may have noticed that a small footballing victory this week sends our domestic “English” team to Rome for their quarter-final against Ukraine. This prompted us to think about Italy in Europe and to consider one of the few rational reasons for Britain departing the European Union: chronic economic stagnation.

The IMF recently published their half-yearly update to their World Economic Outlook. Many institutions, including ourselves, use IMF data as part of their investment and decision-making processes. What jumps out of the data is the persistent failure of Italy to participate in any growth whatsoever.

During the 1960s, Italy was the cultural and industrial hotspot of the world. Italy was a world-leader in fashion, luxury goods, cinema, and industrial manufacturing; la dolce vita was aspirational across trans-national borders.

However, the economy has declined ever since, worsening since the start of this century.

Since 2000 and despite two major recessions, real per capita GDP in the US has risen by 35%. That is a pretty poor performance; it represents real annual growth of barely 1%. Germany has seen the economy grow by 33% and, by comparison, in the same period, UK real per capita GDP has grown by 26%.

Looking at Italy, the same comparison is quite shocking. In the same period, Italy has exhibited no growth at all.

Almost all major economies today are larger than they were immediately prior to the onset of the financial crisis in 2007. In sharp contrast, the Italian economy is 4% smaller measured by growth in real per capita GDP. At the same time Italy also has one of the highest GINI coefficients (a measure of income or wealth distribution) in Europe.

What does this mean? Firstly, had the Italian economy simply kept up with average European growth rates, real incomes would be up to a third higher and Italy would be a contributor to European growth rather than a detractor. Secondly, the huge disparity between North and South, Germany and Italy, points to a fault-line running through the European Union that led to the Euro crisis in 2010 that has simply not yet been resolved.

Failure of the Euro or the EU is one of those low-probability events, one might say, sleeping “black swans,” that investors need to remain alert to. As the late economist Herbert Stein said, “if something can’t go on forever, it won’t” (a remark now known as “Stein’s law”).

Another way of looking at the divergent fortunes of European economies is through the lens of the Target2 balances at the European Central Bank, which is a measure of the claims on and liabilities to the central bank by member states. At the peak of the Euro crisis in 2010, German claims against the ECB measured EUR700 billion; today they are almost EUR1.1trillion almost exactly balanced by Spanish and Italian liabilities of half a trillion Euros each.

One of the red flags we look for when analysing markets is the scale and persistence of financial imbalances. The economist Hyman Minsky studied this issue in detail giving rise to the notion of the “Minsky moment,” when a financial imbalance reaches a tipping point and comes into balance quickly and occasionally violently. The failure of Bretton Woods was one such event, the sub-prime collapse in 2007 another.

As in so many areas of our lives, the COVID pandemic has obscured many of the underlying economic issues that remain important yet unaddressed. But, in Europe, there is one interesting development that has used the pandemic to push European economic integration just a little bit further.

The way to stabilise the European economy is to mutualise risk, allow transfer payments between states and, to use the current fashionable formulation, “level-up” economic performance North and South, resolving the difficulties of the dangerous financial imbalances in the process.

The NextGeneration EU Recovery fund designed to help EU states out of the Covid pandemic is just such a plan. As Churchill might have said, “never let a good crisis go to waste”, the plan for the first time mutualises EU economic risk in common European Bonds.

It is a first step that just might keep that sleeping Black Swan in repose just a little while longer.

So, whilst we enjoy England thrashing the Ukraine on a balmy night in Rome, we should remember just how fragile the economic bonds tying the European Union together remain.

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