Eurozone debt disputes make an unhappy union

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Top down views
Will the EU fall apart or stay together?

Bottom up views
Original sin—politics

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Part of our job as bond analysts can be summed up in this phrase: “trust, but verify.” When we decide to invest, we have faith that a government will return our principal plus interest without fail. But not blind faith. We need to see verifiable economic metrics. Governments, however, change. New politicians with fresh agendas can bolster our confidence or rouse concerns.

Top down views

Will the EU fall apart or stay together?

Once upon a time, bonds backed by a government’s full faith and credit pledge were generally considered less risky than corporate bonds. Times have changed. In today’s political climate, not all governments inspire us with the same confidence.

Consider Italy. Last year, Rome’s new government was keen to deliver its pledge of overturning pension reforms and offering a citizens’ income for the unemployed. Widely popular with voters, Italy’s proposed budget rattled bond markets and frustrated European Union (EU) leaders in Brussels. Headlines in Europe and the US warned a new euro crisis was looming. The chief reason? Eurozone firewalls—built to prevent a rerun of the 2010–2012 eurozone debt crisis—depend on Italy adhering to strict fiscal rules. And that seems to be the last thing Italy’s populists want to do.

Italy’s showdown with Brussels revived nagging anxieties about the currency union’s stability. If only the eurozone adopted a “fiscal union” like the US, then things wouldn’t be so bad says the International Monetary Fund (IMF). Establishing a federal EU government with tax and spending authority, however, is a deeply polarizing idea in Europe. It also lays bare a stark rift between the EU’s northern and southern economies.

As a global firm with fixed income teams across Europe and the US, we think the EU and US comparison offers a valuable perspective—one that could reveal a pathway forward for Europe. That said, the US approach by no means offers an economic panacea. The same pension issues that sparked Italy’s skirmish with Brussels loom even larger in the US. For Europeans suffering from US fiscal union envy, we say the grass isn’t necessarily greener across the Atlantic.

In this article, we examine today’s eurozone from the vantage of the US in the late 18th century, and its bumpy evolution towards a happier union. We follow this with our bottom-up analysis of Italian and Spanish sovereign bonds, and why we think they balance risks with returns, for now.

A marriage of differences

At the heart of many EU challenges is the currency union. Like a bad marriage, the euro has shackled together 19 national economies that some economists believe are simply too different to coexist happily. The marriage was largely promoted for political reasons, not necessarily cogent economics. “Nations with a common currency never went to war against each other,” said Helmut Kohl, Germany’s chancellor at the euro’s birth.

Looking at some of the world’s best and worst performers in terms of gross domestic product (GDP) growth, Exhibit 1 highlights the predicament the eurozone’s peripheral economies find themselves. Greece has fallen behind Sudan and Ukraine in terms of growth. Italy and Cyprus have been outrun by Iran and Brazil. And Spain and Portugal by Britain.

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EUROZONE PERIPHERAL ECONOMIES HAVE STRUGGLED
Exhibit 1: GDP per person, % change, real terms
January 2008–October 2018

Despite rising anti-EU sentiment across Europe, we think the US offers some perspective on a pathway forward. We see today’s Europe at an interim stage similar to the US in the late 18th century. The ratification of the US Constitution in 1788 was preceded by a loose confederation of states, which sometimes worked but mostly didn’t. To form a more perfect union, the United States’ first Secretary of the Treasury, Alexander Hamilton, proposed creating a single US currency along with a national bank to take care of the war debt each of the states still owed.

Hamilton’s proposals were quite polarizing in Congress. The most visceral opposition came from congressmen representing agrarian states such as Georgia and Maryland. Most southern states had nearly paid off their debts. In their eyes, nationalizing the remaining liabilities would give an unfair advantage to profligate merchants living up north in states like Massachusetts and Pennsylvania. The belief was those states simply hadn’t managed their debts properly. Southern members of Congress were also opposed to a US currency. Centralizing power away from local banks was dangerous, and likely favored the commercial interests of the industrialists and merchants up north. A backroom political compromise—one that included locating the new US capital in the south—eventually resolved the impasse in 1791.

Cross-cultural relationships
Fast forward to today, and we see a similar north and south divide in the EU. This time, northern EU members like the Dutch are balking at the idea of fiscal transfers and eurobonds. They make the same arguments Thomas Jefferson did against Hamilton’s federal institutions. Their feelings are shared mutually by the eight members of the New Hanseatic League (“the Hansa”). Comprised of

Ireland, the Netherlands, Nordic, and Baltic states, this fiscally conservative, free trade group formed after losing the like-minded United Kingdom after Brexit.

The Hansa’s key policy focus is helping large and small EU businesses access more private capital instead of bank loans, harmonize EU bankruptcy rules, and uproot barriers to cross-border investments. Why is this worth doing? They believe more risk sharing from private capital markets could mean fewer bank bailouts—largely paid for by Germany.

In research papers published by the European Commission, the Hansa points out that small and medium-sized companies—the engine of growth in many countries—receive five times more funding from private capital in the US than they do in the EU.4

When small firms grow into large companies, deep credit markets offer another non-bank source of capital and risk-sharing. Here too the Hansa thinks the US outshines the EU; the value of corporate-bond markets equals 31% of US GDP but just 10% of the EU GDP (once the UK is removed).5 Research from the IMF shows how important deep capital markets are in cushioning economic downturns in federalist countries like Germany and the US, as shown in Exhibit 2.

Despite strident opposition to fiscal transfers across countries, we think the Hansa will eventually make incremental concessions. A chief hurdle in the near term is the cultural divide between northern and southern EU members—an obstacle the early US didn’t have. The term “hanseatic” references a confederation of merchant guilds that grew from a few north German towns in the 1100s.

Enthusiastic about free trade economics, the Hansa’s views on debt line up with older Germans of the post-war era who still prefer shopping with hard cash rather than relying on credit cards. Consider this cultural artifact: The word for debt in German is “schulden.” Schuld means blame or guilt.

In the future, we think the eurozone will evolve to combine its fiscal capacity to help struggling members achieve a sustainable glidepath—one that relieves the young from performing penance for their forebear’s economic sins. We’re not talking about embracing Modern Monetary Theory where public debt has no limits or consequence. In our view, a combination of rewards through fiscal risk sharing and penance through structural reforms can build a more stable and prosperous European Union.

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**EUROZONE RISK SHARING HISTORICALLY LOWER THAN OTHER FEDERAL GOVERNMENTS**

<table>
<thead>
<tr>
<th>EU Member</th>
<th>Fiscal Transfers</th>
<th>Capital Markets</th>
<th>Credit Markets</th>
</tr>
</thead>
<tbody>
<tr>
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<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Canada</td>
<td>80%</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>United States</td>
<td>60%</td>
<td>40%</td>
<td>0%</td>
</tr>
<tr>
<td>Germany</td>
<td>40%</td>
<td>60%</td>
<td>0%</td>
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</tbody>
</table>

Exhibit 2: Percentage of income shock smoothing from fiscal transfers, capital markets, and credit markets* September 2013

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*When GDP contracts by 1% in one of the euro area countries, households’ consumption in that country is depressed by as much as 0.6% (as opposed to 0.2% in the US, Canada or Germany).


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Italy may be the eurozone’s third-largest economy, but it’s also regarded as a wobblier peripheral country; or worse, dismissed as one of the southern debt-laden PIGS—Portugal, Italy, Greece and Spain. That label hasn’t stopped yield-starved investors from flocking to Italy’s bond sales this year. For Italy, it’s been a welcome reprieve. Last fall, bond investors feared the EU might slap Italy with an excessive-deficit procedure—bond markets reacted with heavy selling and spiking yields.

So, what’s changed this year? Two things: (1) Italy forged a compromise with Brussels over its deficit spending last December, and (2) markets don’t expect rising interest rates this year given Europe’s waning growth outlook. We think Italian bonds offer a sweet spot between too risky and too safe, especially relative to German bunds, which are dipping again into negative yields.

This doesn’t mean Italy is in the free and clear. The Italian economy fell into recession at the end of 2018, and the Dutch are demanding Brussels strictly enforce, not fudge, Italy’s spending this spring.

For investors who are concerned about Italy’s debt, it’s important to know this is an old problem, not a new phenomenon; Italy’s debt averaged 111% of GDP from 1988 through 2018, hitting an all-time high of 132% last year and a “low” of 90% in 1988. We think it’s fair to point out the rate of Italy’s debt growth—an increase of around 30% of GDP over the past decade—is just half that of its peer Spain for the same period, as shown in Exhibit 3. Italy’s debt is still undeniably large and merited an explanation from the Italian Treasury last year. They responded by pointing to Italy’s enduring “primary surplus”—this means Italy’s tax revenues exceed program spending (i.e., a surplus) but only if you ignore interest paid on outstanding debt.

Maintaining a structural primary surplus doesn’t absolve Italy’s debt problem, in our opinion. It does, however, point to Italy’s original sin: its unstable political institutions. For decades, Italy has had short-lived and volatile governments—15 prime ministers in 30 years—who added debt and stymied any overhaul of a state bureaucracy typified by infinite red tape and corruption. Italy’s politics were once again front and center in last year’s clash with Brussels over deficit spending. The left-wing Five Star Movement formed a tenuous alliance with the far-right nationalist Lega to push through increased public spending, but not the taxes to pay for it.

If Italy doesn’t get its way with Brussels, will it push to exit the eurozone? We don’t think so. Italy’s coalition government doesn’t have enough parliamentary seats to call for a Brexit-like referendum. More importantly, Lega’s core voters are overwhelmingly pro-trade and pro-business. They want lower taxes and a tough stance on immigration, not crashing out of the eurozone.

Looking ahead, our biggest concern for Italy is—no surprise—debt. If Italy fails to start reducing its public debt over the next two years, we think it faces a potential ratings downgrade which would likely force some institutional investors to reduce their Italian sovereign exposure.

**Sunnier countries**

During the eurozone crisis, investors often lumped Spain together with Italy for their debt. Today, Spain is again being linked with Italy, but this time more for their politics. A surging tri-party coalition, lead by the hard-right Vox party, is
drawing parallels with the rapid rise of Italy’s Lega party. Politics aside, we see stronger economic fundamentals for Spain compared to Italy.

It is true that Spain’s public debt has grown faster than Italy’s since the financial crisis. But it has at least spent some of that money on infrastructure, such as new roads and high-speed rail—necessary building blocks for productive nations. Spain’s growth of GDP per person has also outstripped Italy’s since 2008. Spanish bonds don’t offer Italy’s yields (Brussels is not threatening Spain with sanctions) but are still compelling relative to German bonds, in our opinion. We view Germany’s bonds as being safer than Spain’s—safer even than US Treasuries—but they don’t offer enough returns to meet our requirements. No risk, no return.

Spain has received warnings about its deficits in the past from Brussels, and even a symbolic “zero” sanction meant to encourage better fiscal behavior without fanning anti-EU sentiments. Brussels is currently taking a more lenient approach, however, with France. As the Yellow Vest protests spiraled into damaging riots across France, the government announced new spending measures to mollify protestors. Even though this spending pushed France’s deficit past EU limits, Brussels conspicuously chose not to issue a warning. We don’t think France’s economic fundamentals merit this indulgence from Brussels, nor from bond markets for that matter.

In a union dominated by its productive northern economies, German and French bonds simply don’t offer the return profiles we’re looking for. For the time being, we’re embracing the income opportunities that Italian and Spanish bonds offer, with caution. From our perspective, these bonds are outshining their northern neighbors.
Franklin Templeton Thinks: Fixed Income Markets highlights the team’s ongoing analysis of global economic trends, market cycles and bottom up sector insights. Each quarterly issue spotlights the team’s thinking on different macro forces, and particular sector views that drive our investment process.

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