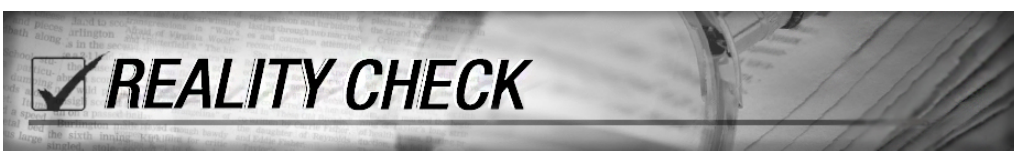
GEOPOLITICAL FUTURES

Italy and Systemic Failure

July 8, 2016 The Italian banking crisis is not only Italy's problem.



(https://geopoliticalfutures.com/wp-content/uploads/2015/11/realitycheck-headerbar.jpg)

By George Friedman

We are now at the point where the mainstream media has recognized that there is an Italian banking crisis (https://geopoliticalfutures.com/an-update-on-italys-banking-woes/). As we have been arguing since December, when we published our 2016 forecast (https://geopoliticalfutures.com/forecasts/the-world-in-2016-2/), Italy's crisis will be a dominant feature of the year. Italy has actually been in a crisis for at least six months. This crisis has absolutely nothing to do with Brexit, although opponents of Brexit will claim it does. Even if Britain had unanimously voted to stay in the EU, the Italian crisis would still have been gathering speed.

The extraordinarily high level of non-performing loans (NPLs) has been a problem since before Brexit, and it is clear that there is nothing in the Italian economy that will allow it to be reduced. A non-performing loan is simply a loan that isn't being repaid according to terms, and the reason this happens is normally the inability to repay it. Only a dramatic improvement in the economy would make it possible to repay these loans, and Europe's economy cannot improve drastically enough to help. We have been in crisis for quite a while.

The crisis was hidden, in a way, because banks were simply carrying loans as non-performing that were actually in default and discounting the NPLs rather than writing them off. But that simply hid the obvious. As much as 17 percent of Italy's loans will not be repaid. As a result, the balance sheets of Italian banks will be crushed. And this will not only be in Italy. Italian loans are packaged and resold as others, and Italian banks take loans from other European banks. These banks in turn have borrowed against Italian debt. Since Italy is the fourth largest economy in Europe, this is the mother of all systemic threats.

Since the problem is insoluble, the only way to help is a government bailout. The problem is that Italy is not only part of the EU, but part of the eurozone. As such, its ability to print its way out of the crisis is limited. In addition, EU regulations make it difficult for governments to bail out banks. The EU has a concept called a bail-in, which is a cute way of saying that the depositors and creditors to the bank will lose their money. This is what the EU imposed on Cyprus. In Cyprus, deposits greater than 100,000 euros ($111,000) were seized to cover Cypriot bank debts. While some was returned, most was not. The depositors discovered that the banks, rather than being a safe haven for money, were actually fairly risky investments.

The bail-in is, of course, a formula for bank runs. The money seized in Cyprus came from retirement funds and bank payrolls. The Italian government is trying to make certain that depositors don't lose their deposits because a run on the banks would guarantee a meltdown. A meltdown would topple the government and allow the Five Star Movement, an anti-European party, a good shot at governing.

The reason for the bail-in rule is Berlin's aversion to bailing out banking systems using German money. Germany is already seeing a rise in anti-European political feeling with the rising popularity of the nationalist Alternative for Germany party. Unlike Italian anti-European sentiment, the German sense of victimization is their perception that they are disciplined and responsible, and they resent paying for the irresponsibility of others. Therefore, the German government's hands are tied. It cannot accept a Europe-wide deposit insurance system as it would put German money at risk, nor can it permit the euro to be printed promiscuously, as that would come out of the German hide as well. The Italians can only try and manage the problem by ignoring EU rules, which is what they are actually doing.

But there is another European economic crisis brewing. As we have pointed out (https://geopoliticalfutures.com/germanys-invisible-crisis/), Germany derives nearly half of its GDP from exports. All the discipline and frugality of the Germans can't hide the fact that their prosperity depends on their ability to export and that the ability to export depends on the effective demand of their customers. Germany exports heavily to the EU, and the Italian crisis, if it proceeds as it is going, is likely to cause an EU-wide banking crisis, and an even greater weakening of the European economy. That would cut deeply into German exports, slashing GDP and inevitably driving up unemployment. Logic would have it that the Germans are acting desperately to head off an Italian default, but Chancellor Angela Merkel has built her government on Germany's pride in its economy. She is not eager to announce to the German people that the German economy depends on Italy's well-being.

But it is clear that German businesses are aware of the danger. German production of capital goods fell nearly 4 percent from last month, and German production of consumer goods rose only 0.5 percent. German consumption can't possibly make up for half of Germany's GDP. In addition, the International Monetary Fund has recently pointed to Deutsche Bank as the single largest contributor to systemic risk in the world. A rippling default through Europe is going to hit Deutsche Bank.

However, the real threat to Germany is a U.S. recession. Recessions are normal, cyclical events that are necessary to maintain economic efficiency by culling inefficient businesses. The U.S. has one on average once every six to seven years. Substantial irrationality has crept into the economy, including new bubbles in housing. The yield curve on interest rates is beginning to flatten. Normally, a major market decline precedes a recession by three to six months. That would indicate that there likely won't be a recession in 2016 but there is a reasonable chance of one in 2017.

Given the stagnation in Europe, Germany has been shifting its exports to other countries, particularly the United States. It is hard to tell how much price cutting the Germans had to do to increase their exports, but it has been useful to maintain the amount of GDP derived from exports. If the United States goes into recession, demand for German goods, among others, will drop. But in the case of Germany, a 1 percent drop in exports is nearly a half percent drop in GDP. And given Germany's minimal growth rate, drops of a few percentage points could drive it not only into recession, but into its primordial fear: high unemployment. A U.S. recession would not only hit the Germans, but the rest of Europe, which also exports to the United States, either directly or through producing components for German and British products. When we look at data on U.S. exposure to foreign debt defaults, there is some, but not enough to bring down the American system. The United States, with relatively low export percentages and low exposure, can withstand its cycle. It is not clear that Europe can.

Compounding this problem is an ever-increasing number of non-performing loans in China. Most of these are domestic loans, but they reflect the fact that China has never recovered from the aftermath of the 2008 financial crisis. It has avoided massive social dislocation by encouraging loans to businesses of all sizes and dubious viability in order to maintain employment as far as possible. There is a new wave of non-performing loans coming due. And as with Italy, non-performing is a euphemism. The problem is not that these loans are late. The problem is that they were loaned to businesses and individuals who should have been forced out of business by a lack of credit, and were kept alive on artificial respirators.

The obsession of figures like European Commission President Jean-Claude Juncker, railing against Brexit, was not a smokescreen. He and others really did see Brexit as the major danger to the EU. That is what is most troubling. Far more significant are Italy's financial crisis and Germany's extreme vulnerability. Whether the British stay or go, Italy's and Germany's problems have to be addressed, and the existence of the EU and its regulations make finding solutions extremely difficult.

This all was put in motion in 2008, but it is not a 2008 crisis. This is most of all a political and administrative crisis caused by a European system that was created to administer peace and prosperity, not to manage the complex gyrations of an economy. Similarly, China introduced the doctrine of enriching yourself to please the Party, but hadn't considered what to do when the party was over.

The argument from those who are against internationalism is simple. Sometimes the major international systems begin failing. The less you are entangled with these systems the less damage is done to you. And given that such systemic failures historically lead to international political conflict and crisis, the case for nationalism increases – assuming you aren't already trapped in the systemic crisis. In any event, increasing nationalism follows systemic failure like night follows day.