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# Record high inflation could trigger a fresh eurozone financial crisis

## Any crunch would centre on Italy, have no obvious solution and remind that the euro's frailties are unaddressed.

**Italy's 66th post-war government collapsed in January 2021 when Prime Minister Giuseppe Conte was forced to resign after former premier Matteo Renzi removed his minor Italia Viva party from the ruling coalition. President Sergio Mattarella encouraged the parties to revive the alliance so he could avoid calling a snap general election during a pandemic.**

But the talks went nowhere. As concerns grew that any election might usher right-wing populists into power, Mattarella pulled off a masterstroke. In early February, Mattarella unexpectedly contacted Mario Draghi; yes, 'Super Mario' who saved the euro in 2012 with his 'whatever it takes' comment. Mattarella asked the chief of the European Central Bank from 2011 to 2019 to begin talks to form a 'national unity' government. Within days, Draghi had won a parliamentary majority to become Italy's 29th prime minister since 1946 and its fourth unelected (or 'technocratic') premier since 1993.[1]

Investors were pleased. On February 13 when Draghi assumed office, 'lo spread' – the yield at which Italian 10-year government bonds trade over their German equivalents, a number that is judged the bellwether of EU economic and political risks – had narrowed to a five-year low of just under 100 basis points.

Draghi's government retains the confidence of investors yet lo spread has widened to 200 basis points (as the German 10-year bond topped 1% for the first time since 2015).[2] What malfunction occurred that widened the gap towards the 300 basis-point level that is seen by many as the tripwire for a crisis? None that was Draghi's fault. The culprit, like elsewhere in the world, is inflation. Eurozone inflation has climbed to its highest since the euro was created in 1999. Consumer prices surged 7.4% in the 12 months to April due to the ECB's promiscuous monetary policy, mammoth fiscal support during the pandemic, rising energy prices due to the switch to renewables, and supply blockages created by pandemic disruptions. The way Russia's war on Ukraine has boosted energy, commodity and food prices is likely to keep eurozone inflation elevated.

The ECB has one objective; to maintain price instability, which is interpreted as keeping inflation below 2%. The central bank modelled on the inflation-hating Deutsche Bundesbank has little choice but to tighten monetary policy when inflation is nearly four times its target. Since 2016, the ECB's key rate has stood at 0%, while the overnight deposit rate has been negative since 2014 (and at a record minus 0.5% since 2019).[3] When the pandemic struck, the ECB added to various asset-buying programs[4] that gained heft when the bank first undertook quantitative easing in 2015. Over the past seven years, the central bank has purchased 3.9 trillion euros of eurozone assets, including 723 billion of Italian public debt, an amount equal to nearly 40% of Italy's GDP.[5] Given the record inflation, talk is mounting the ECB in July will raise rates for the first time since 2011, in what would be the first step towards boosting the key rate to a 'neutral' level of about 1.5% next year. The central bank is curtailing, and intends to end, its asset purchases.[6]

Many central banks are raising key rates to tame inflation. For most countries, the main threat is the resultant slowing in economic growth boosts the jobless rate, perhaps to worrying levels if economies slump into recession. The ramifications of tighter monetary policy for the 19-member eurozone are wider and more concerning for three reasons.

The first is the ECB is poised to stop acting as the buyer of last resort for its almost-bankrupt 'Club Med' members such as Italy, where gross government debt stood at 151% of GDP at the end of 2021.[7] No financier of government deficits (as some see it) for indebted sovereigns, especially Italy, will likely trigger a bond sell-off that puts the finances of debt-heavy governments on an unsustainable footing. Rising yields might restart the 'doom loop' that triggered the collapses of Greece, Ireland and Spain from 2010, whereby national bank bond holdings held as capital reserves plunge in value and the national government and commercial lenders become entwined in a downward spiral. The ECB would be exposed as lacking any credible way to quell such a government-bank suicide bind short of resuming the asset-buying that fuels the inflation it seeks to kill.

The second way tighter ECB monetary policy is troubling is that the resultant economic downturn will remind indebted euro-users that they have no independent monetary policy to help their economies, nor a bespoke currency they can endlessly print to meet debt repayments, or devalue to export their way out of trouble. The only macro tool domestic policymakers possess is fiscal policy. The problem is many indebted governments are already running large fiscal deficits – Rome's shortfall over 2021 stood at 7.2% of GDP[8] and is forecast to be 6.0% in 2022[9] – and their debt loads mean these dearths can't be widened or prolonged. As talk mounts that indebted countries should quit the euro to reinstall the other macro tools, populist Italian politicians are bound to rekindle plans for a parallel currency as the least traumatic way for Italy to readopt the lira.

The third means by which higher inflation is poisonous for the eurozone is that it creates a fissure between the area's creditor and debtor nations that would make it harder to find durable solutions for the euro. Inflation-phobic but inflation-ridden Germany and other creditors such as Finland and the Netherlands will squabble with France (government debt at 113% of GDP), Greece (193%), Italy, Portugal (127%) and Spain (118%) over how far the ECB should go to rein in inflation. The leaders of the creditor countries will be under domestic political pressure to ensure the ECB smothers inflation. They will battle with debtor leaders over how the ECB might support tottering governments and wobbly national banks sitting atop troubled economies. In line with this hawk-dove split, the Netherlands central bank chief Klaas Knot in July became the first ECB policy-board member to call for the bank to raise its key rate by 50 basis points to tackle inflation.[10]

To maintain its inflation-fighting credentials, the ECB must raise interest rates enough to tame inflation, even if that stance crushes economic growth. The overarching concern is that tight monetary policy will expose how the euro's flawed structure – that it is a currency union without the necessary political, fiscal or banking unions – has become explosive due to the large debts of southern eurozone governments.

To be sure, policymakers are likely to once again thrash out some last-minute fudge that defers a denouement on the euro's fate. But temporary solutions are only, well, temporary and the euro needs a durable resolution. The indebted south could win the political tussle such that the ECB never makes a serious attempt to tame inflation. Due to generous pandemic support, creditor nations have higher government debt-to-GDP ratios – Germany's is 69%, the Netherland's 52%. They thus might tolerate faster inflation as it improves their debt ratios if their economies hold up. But that path might only delay tighter monetary policy and subsequent detonations. The war in Ukraine might undermine eurozone economic growth enough to quell inflation without the ECB doing much. The cost of servicing public debt, while rising, is still historically low, which reduces the likelihood of missed debt payments and a crisis. Eurozone governments are restarting efforts to create a proper banking union, which would mean common bank rules and eurozone, rather than national support for troubled banks.[11] But creditor nations don't want to be part of a mutual deposit insurance scheme if that means subsidising Italian banks holding Rome's debt. Nor do debtor governments want to join a banking union that could restrict their banks buying their bonds to support them. Lo spread is well short of the post-euro record 556 basis points it reached in 2011 during the first eurozone crisis that was triggered by the current-account imbalances among members.[12] But Rome's debt was only 120% of GDP then, and that gap narrowed only due to ECB support that is now waning because the problem today is inflation, not skewed trade and investment flows.

Germany's economic slump and dislike of inflation will ensure Berlin pressures the ECB to prioritise inflation. Lo spread could widen enough to threaten a flawed currency union, especially if member countries are squabbling over solutions. While Draghi the central banker could bluff investors, Draghi the politician has no similar obvious masterstroke. Of note too is that Draghi's prime ministership will likely end when Italy holds a general election next year in Europe's spring that is likely to usher right-wing eurosceptics into power. To all the world's problem, be prepared to add elevated doubt about the euro's long-term future.

## THE CURRENCY SWAP

In 1948, Chris Howland was a 20-year British private who was the most popular radio DJ in northern Germany. On the night of June 17, two British military policemen appeared at the radio station in Hamburg where Howland worked. They made Howland sit up all night before allowing him at 6.30 am to open a sealed envelope and read the content on air. The news? The military government of Britain, France and the US from June 20 would introduce a new currency. Every German would receive 40 new Deutsche marks, which had been printed in the US and shipped in wooden crates stamped 'Doorknobs', in exchange for 60 Reichsmarks. Any other swastika-emblazoned Reichsmarks people held were made worthless come June 21.[13]

A 'currency reform' of some sort was expected. But still. It's estimated that 95% of Reichsmarks were destroyed without replacement and savers were left with only 6.5% of their assets.

The instantaneous currency switch and savings savaging were at the heart of measures under the Marshall Plan designed to revive Germany's economy at a time when millions of Germans were starving, inflation was rife, the currency untrusted and bartering prevalent. The steps, which in the absence of Russian knowledge sparked the Berlin Blockade,[14] worked. The economic revival in the French, UK and US zones that became West Germany was credited with helping Germany adopt a new constitution in 1949 known as the Basic Law.

The currency changeover on top of the rampant post-war inflation and the hyperinflation of the early 1920s left a legacy. Germans adopted a mentality that the value of the Deutsche mark must be protected above all. This job was given to the Bundesbank when it was established in 1957 as the world's first and only central bank still to be granted independence under its country's constitution (whereas other central banks are granted 'independence' through acts of parliament or the goodwill of the executive).[15]

Come 1993, Germany's Constitutional Court confirmed that under the Basic Law the Bundestag (parliament) only had the authority to ratify the Maastricht Treaty that created the euro if the European monetary union was in Germany's interest. The test? "The future European currency must be and remain as stable as the Deutsche mark," the court decreed.[16] Thus the ECB ended up with the same primary objective as the Bundesbank; namely, to maintain price stability.

In Germany, the ECB's loose monetary setting and the inflation unleashed are seen as a betrayal. To the German public, tabloid media and even the German 'father of the euro' Otmar Issing, the ECB is modelled more on Italy's economic mismanagement pre-euro (when Rome's main policy response was to devalue the lira). Issing, the ECB's first chief economist, said the ECB has "lived in a fantasy" that downplayed the danger of inflation and thus the bank "has contributed massively to this trap in which it is now caught".[17]

The ECB lax stance has wiped out returns on German savings, which is seen as income foregone to subsidise lazy southern Europeans.[18] High inflation stings Germans because few invest in equities or other 'growth' assets that might act as a hedge against inflation. Most German savings head to small regional savings and co-operative banks that offer low deposit rates. The German public is unlikely to feel more generous towards the indebted south if interruptions to energy and other imports from Russia send the German economy into recession.[19]

But, as pessimism grows about global prospects, the economic outlook of inflation-tolerant and Russian-gas-dependent Italy is dimming too. Although Italy's economy is supported by consumer savings built up during lockdowns and 192 billion euros from the EU's 750-billion-euro Covid recovery fund, higher energy prices and other tremors from the Ukraine war could slow growth enough to send the country into recession.[20] Many fret about the trouble to be ignited when the ECB halts its asset buying, given how precarious are Rome's finances – the country has the largest budget deficit in the eurozone and the worst public debt ratio after Greece (193%).[21]

In case of any crisis centred on Italy, policymakers have options such as loans from the EU rescue fund and linked ECB bond purchases of struggling members. But such aid would require approval from Germany's Bundestag and other creditor-nation parliaments. Another option is the one revealed when Draghi and French President Emmanuel Macron signed a joint letter last December that implicitly called for the transfer of all eurozone government debt since 2007 to a debt-management agency. But Germany and many other euro members would oppose such subterfuge.[22]

It's probable that sometime soon the talents of Draghi the unelected politician and other policymakers will be tested. Lo spread will reveal what bond investors think. What's unlikely in any upcoming crisis, however, is any solution that cements the euro's future.

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[1] In 1993, Bank of Italy Governor Carlo Azeglio Ciampi was drafted as prime minister. At the height of the sovereign debt crisis in 2011, Mario Monti, who'd spent a decade at the European Commission, was appointed PM. In 2018, rival populist parties tapped Conte, a law professor at a university in Florence, to be PM. A list of Italian prime ministers can be found at: wikipedia.org/wiki/List_of_prime_ministers_of_Italy

[2] The gravest scare for investors during Draghi's time as prime minister occurred in January this year when Italy's parliament failed to elect a new president in seven ballots held over a week and Draghi was touted as the next head of state (and seemed interested in the role). But that would have once again meant a snap general election that might have jetted right-wing populist parties into power. That outcome was avoided when MPs re-elected Mattarella even though the 80-year-old had rejected a second term.

[3] European Central Bank. 'Key ECB interest rates.' ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

[4] The ECB has been buying government bonds under its 1.8 trillion euro Pandemic Emergency Purchase Program known as PEPP and an older Asset Purchase Program known as AAP that purchased at a rate of 20 billion euros a month. European Central Bank. 'Monetary policy decisions.' 10 December 2020. ecb.europa.eu/press/pr/date/2020/html/ecb.mp201210~8c2778b843.en.html

[5] European Central Bank. 'Pandemic emergency purchase program (PEPP).' ecb.europa.eu/mopo/implement/pepp/html/index.en.html. 'Asset purchase programs.' ecb.europa.eu/mopo/implement/app/html/index.en.html#pspp

[6] The ECB ended the pandemic or PEPP asset-buying program in March this year. To promote stability on bond markets, the bank doubled purchases under the older AAP program to 40 billion euros of bonds a month but said it would decrease its purchases to 30 billion euros in May and 20 billion euros in June. See European Central Bank. 'Monetary policy decisions.' 10 March 2022 and 14 March 2022. March: ecb.europa.eu/press/pr/date/2022/html/ecb.mp220310~2d19f8ba60.en.html. April: ecb.europa.eu/press/pr/date/2022/html/ecb.mp220414~d1b76520c6.en.html

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[9] IMF. World economic outlook database. April 2022. General government net borrowing percent of GDP. imf.org/en/Publications/WEO/weo-database/2022/April

[10] 'ECB hawk raises prospect of steeper rate increase in July.' 17 May 2022. ft.com/content/672f7a64-561c-4ce4-b008-6ca5b9013fdf

[11] See European Central Bank. 'Banking union.' bankingsupervision.europa.eu/about/bankingunion/html/index.en.html

[12] World government bonds website. 'Germany 10 years vs Italy 10 years spread.' The post-2008 record spread was recorded on 9 November 2011. worldgovernmentbonds.com/spread/germany-10-years-vs-italy-10-years/

[13] Harald Jähner. 'Aftermath. Life in the fallout of the Third Reich 1945-1955.' Chapter VII. 'The economic miracle and fear of immortality.' Pages 195 to 204. Penguin Random House 2021.

[14] Neil MacGregor. 'Germany. Memories of a nation.' Penguin Random House. 2014. Page 504.

[15] Deutsche Bundesbank. 'The history of the Bundesbank.' bundesbank.de/en/bundesbank/history/timeline

[16] Ashoka Mody Euro tragedy. A drama in nine acts.' Oxford University Press. 2018. Page 107.

[17] "Living in a fantasy': euro's founding father rebukes ECB over inflation response.' Financial Times. 12 April 2022. ft.com/content/145b6795-2d21-48c6-984b-4b05d121ba16

[18] Financial Times. ''German problem' at ECB exposed by Lautenschläger departure.' 26 September 2019. ft.com/content/704240ec-e04a-11e9-b112-9624ec9edc59

[19] See Ambrose Evans-Pritchard. 'A taper tantrum in Europe is dangerous; but so is German inflation.' The Telegraph of the UK. 18 May 2021. telegraph.co.uk/business/2021/05/18/taper-tantrum-europe-existential-german-inflation/

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[21] Financial Times. 'Italy's prospects sour as inflation bites.' 23 May 2022. ft.com/content/8dd69dbb-b476-4192-9db2-944f7e937f8f

[22] Richard Cookson. 'The euro Is facing a make-or-break year.' Bloomberg. 11 January 2022. bloomberg.com/opinion/articles/2022-01-11/the-euro-is-facing-a-make-or-break-year?



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