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August 2005 | 1731 North Marcey, Chicago IL 60614 | www.biancoresearch.com

Special Report

August 2005

Who Is Getting "Screwed," Mr. Berlusconi?

By Rich Kleinbauer

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What prompted Italian Prime Minister Silvio Berlusconi to state the euro had "screwed everybody?" Was it his summer holiday reading of a British bank's 33-page report on the European meltdown? Was it his mother's public complaint of how the euro was driving up pasta prices?

Or was it simply a Machiavellian distraction to counter claims that the recently sold $18,000 bar of soap is made from fat from Berlusconi's face lifting and liposuction operations while in a clinic in Lugano?

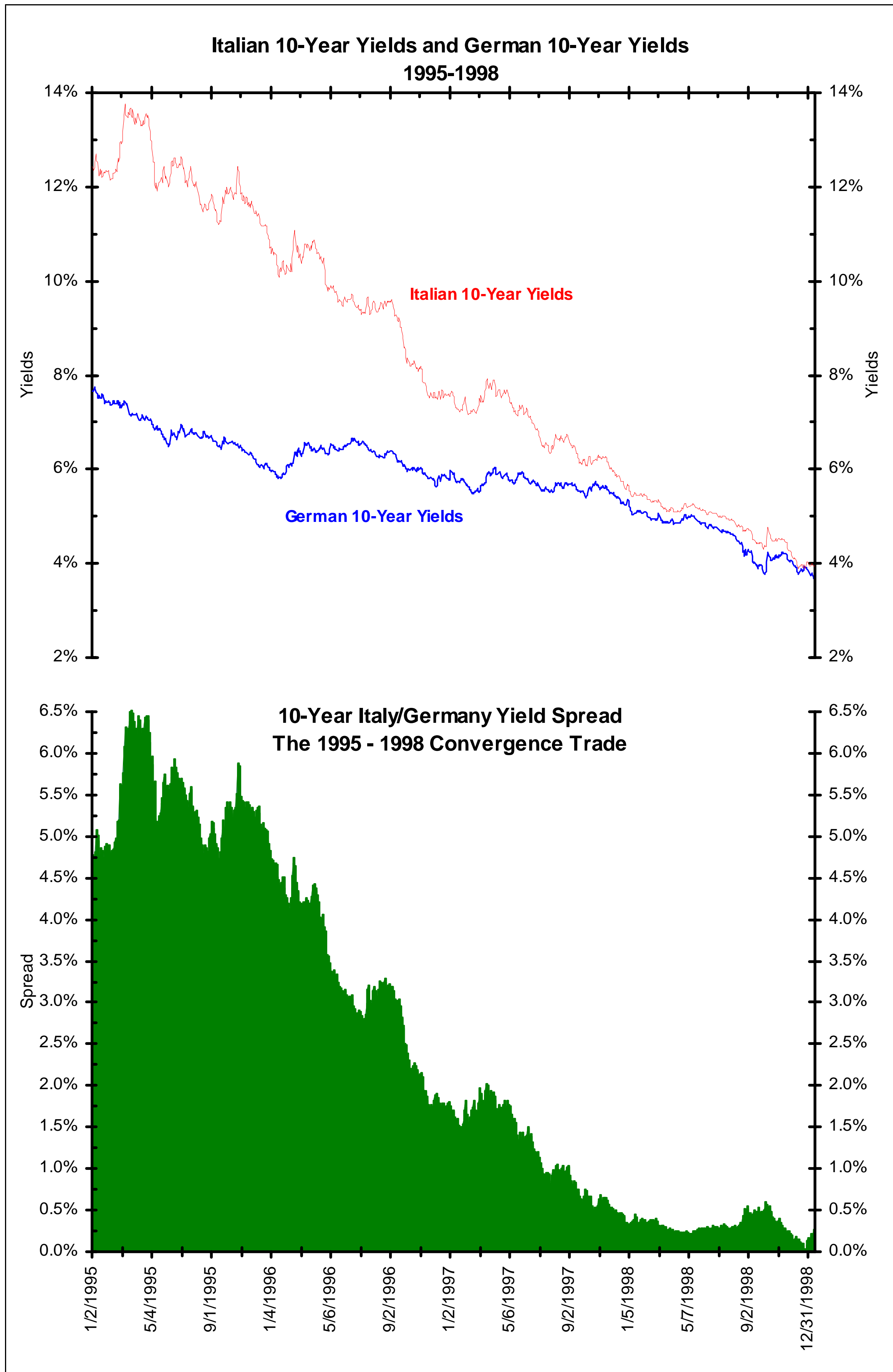
Regardless, we can thank Mr. Berlusconi for diverting Italian politics from its course of three years ago when European Commission President and former Italian Prime Minister Romano Prodi declared the EU's new responsibilities called for intensifying the integration process. Today, a new fondness has emerged for calling for the reintroduction of an independent currency, one which allows the country to seek an advantage in the terms of trade via competitive devaluation. **Whether hollow threat or serious scheme, the implications mark the end of the beginning for the euro.**

The ERM and Bond Yields

The euro emerged from the wishful thinking category in 1992 with the spectacular failure of the European Exchange Rate Mechanism. This not only made George Soros famously wealthy while simultaneously boosting unemployment ranks with redundant sterling forward traders, but it forced Europe to adopt an exchange system which unified monetary policy. The 1992 departure of the lira from the ERM allowed Italy, then unencumbered by today's rigors of fiscal and monetary discipline, time to boost its economic activity relative to the EU average. The rebound provided an easier entry point into the single currency. In November 1996, during Mr. Prodi's Italian presidency, the lira rejoined the ERM, but only after it had rallied 22% from its 1995 lows against the Deutsche mark. This strength cemented the lira's initial exchange rate in the euro. While Berlusconi might be blaming Prodi for what now appears to be an overvaluation, it was the market that set the level in free trade.

The Convergence

The convergence between Italian BTP and German Bund yields during the 1995-1998 period (chart on following page) was dramatic by developed nation standards; the yield spread narrowed from 650 bps at the time of Italy's ejection from the ERM to zero immediately prior to the January 1999 launch of the euro. The one-way trade fueled trading gains for many macro funds of that era, including the ill-fated Long Term Capital Management.



Italian 10-Year Yields and German 10-Year Yields
1995-1998
14%
12%
10%
8%
6%
4%
2%
Yields
Italian 10-Year Yields
German 10-Year Yields
10-Year Italy/Germany Yield Spread
The 1995 - 1998 Convergence Trade
6.5%
6.0%
5.5%
5.0%
4.5%
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
Spread
1/2/1995
5/4/1995
9/1/1995
1/4/1996
5/6/1996
9/2/1996
1/2/1997
5/6/1997
9/2/1997
1/5/1998
5/7/1998
9/2/1998
12/31/1998

Did the Risk Premium Disappear?

Was the convergence trade an elimination of the risk premium to Italian fixed obligations or just a transfer of that risk to the greater EU? Rating agencies maintain, on average, Italian long-term credit ratings at levels similar to those of the mid-1990's. One could argue the risk premium was absorbed by the collective membership.

Convergence was a two-way affair. We must remember that German credit was affected negatively by the costs of reunification, which at an estimated $1.9 trillion can be characterized as the greatest leveraged buyout of all-time.

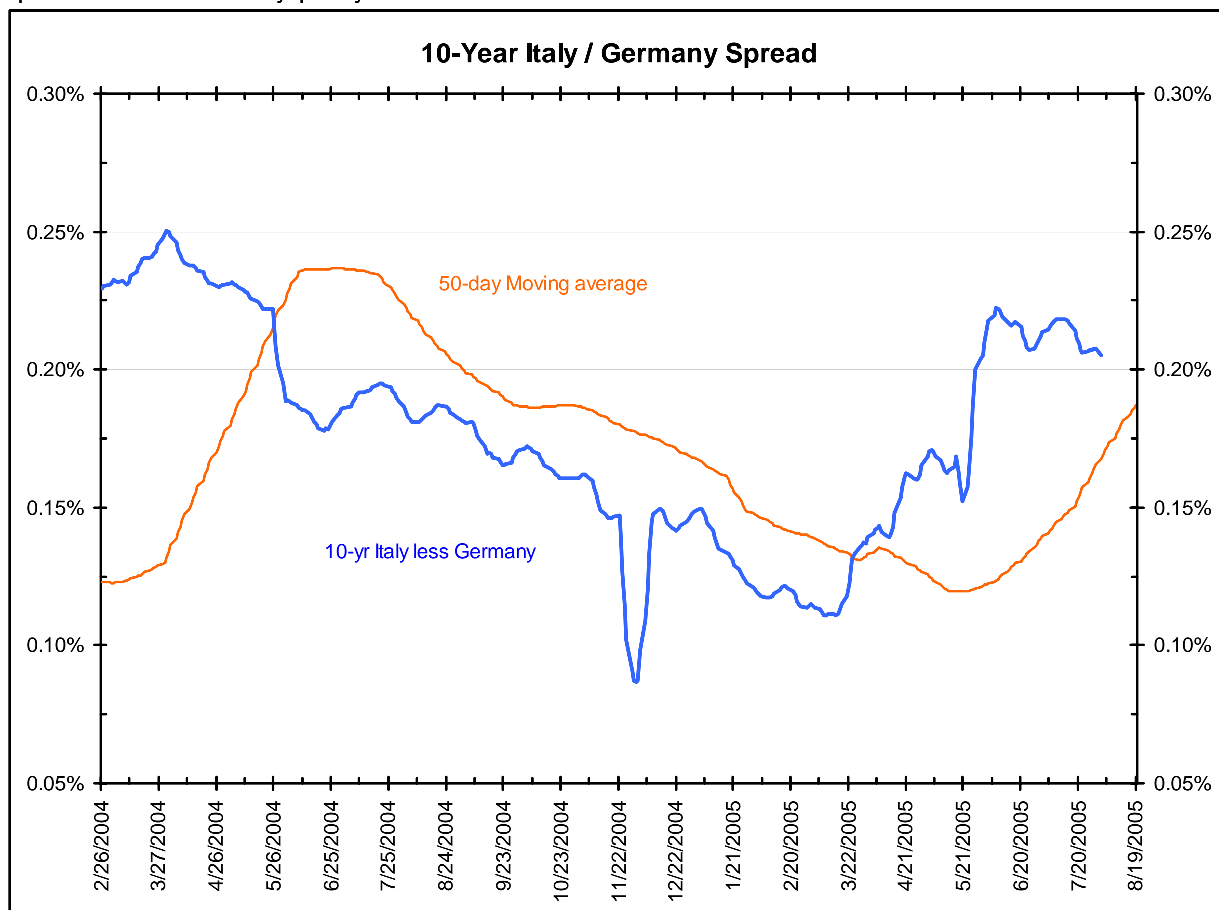
Not only was Italy's ability to maintain its own monetary policy, which included a currency debasement option, transferred to the ECB, the country now had to adhere to common standards of fiscal policy.

Perhaps this is where the bar of soap enters the picture. Facelifts and liposuction, i.e. monetary cosmetic surgery in the form of creating a new lira purely for the sake of devaluing it subsequently, a policy very nearly endorsed by the aforementioned 33-page mid-July report, are no match for sound fiscal procedures. Monetary policy alone cannot do all the heavy lifting; politicians can always find ways to spend. Like a game of chicken, one role a central banker must play is to maintain guidelines which keep politicians accountable.

Conclusion

The Italian government has benefited over the past eight years from substantially lower borrowing costs which today hover around 20 bps above equivalent Bunds (chart below). Italy would have been obliged to pay investors higher rates had it managed its own currency during this period. Not only do lower borrowing costs confer substantial benefits to central governments in the form of lower interest outlays, an attractive option for fiscally promiscuous EU members, but to all Italian borrowers as well. The euro surely benefited Italian mortgagors and corporate borrowers alike in this manner.

These benefits are indirect, though. With Italian elections due in the first half of 2006 and weaker economic data streaming on-line through year-end, debate about breaking from the euro will intensify. Whether Italy is better-off without the EU or the EU better-off without Italy is not the question. **Either way, the risk premium currently attached to the Italian bond market appears inadequate.**



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