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Financial Markets and the Real Economy: The Inevitable Recoupling

Much use has been made in recent years of the term "decoupling," understood as two realities diverging from their normal pattern of correlation and embarking instead on separate, independent paths. Thus, at the start of the U.S. financial crisis, European delegations queued up outside the office of Dominique Strauss-Kahn, then Managing Director of the IMF, to complain that the organization's projections failed to recognize the protective shield offered by the single currency, and that Europe was much more resilient to cross-Atlantic difficulties than implied by the forecasts. Shortly thereafter, it was the turn of the United States to argue its own imperviousness to the euro crisis – but the U.S. recovery was then also curbed by developments abroad. And for some time now many observers theorized a decoupling of emerging markets from the advanced economies. But all it took was a sneeze from the Fed, in the form of tapering, for all the Brics to catch a cold. Such historical evidence has not, however, prevented several European politicians from arguing that emerging market difficulties will not dampen the euro area's feeble recovery. That, of course, remains to be seen.

The hypothesis that different geographical areas could enjoy independent economic developments in a highly interconnected world is clearly untenable. The IMF itself is increasingly focusing on both spillovers (how major countries' policy actions affect others) and spillbacks (the subsequent return home, or feedback, to source countries). It is of course true that some countries exhibit greater potential and dynamism, and differentiating between them thus makes sense. It is not, however, that these countries have "decoupled," but rather that they exhibit a greater resilience to shocks, even when these are of a common nature. In the case of economies – such as those of the advanced countries – which do not enjoy demographic or natural resource advantages, the only way to secure such greater resilience is to endow themselves with flexible and dynamic economic structures – as is indeed the intention of the new government in Italy. In the awareness, however, that complete decoupling is beyond any country's reach. Hence the need for coordination and supportive policies at the European level – another issue at the centre of the government's agenda, and which will hopefully unfold more fully during Italy's upcoming tenure of the EU Council Presidency (without pursuing, as rightly observed by Economy Minister Pier Carlo Padoan, whimsical "axes" with other countries).

If there can be no true and lasting disconnect between the economic performances of different areas of the world, much less can there be one between developments in the real

economy and the financial markets. Yet in recent times that is exactly what we seem to be witnessing. In the very week that IMF Managing Director Christine Lagarde warned about the prospect of "years of slow and subpar growth," world stock markets surged ahead, reaching – in some cases – record highs. In Europe, markets were buoyed in particular by bank stocks. Here, too, despite newly-released ECB data showing that bank holdings of sovereign bonds (an indicator of potential mutual vulnerability, which European leaders have repeatedly vowed to break) had reached a new peak since the start of the euro crisis. In this inverse ranking, in which it would be good for Italy to (as usual) "bring up the rear," it is instead among the leaders (with holdings of government debt amounting to 10.2% of combined assets, versus 5.8% in the eurozone). Given the sharp decline in government bond yields, bank balance sheets are of course for now benefiting. But the fall in peripheral yields to pre-crisis levels seems yet another disconnect from reality. In every eurozone country, debt levels are now higher than before the crisis, in some cases significantly so. At the same time, the crisis itself has compressed potential growth, while low inflation is a hurdle to debt reduction. While not belittling the progress achieved by crisis countries, the fact is that debt sustainability has deteriorated everywhere. If it is true that markets were too benevolent in the pre-crisis years, what is one to say when yields return to those levels against the backdrop of a deteriorated debt situation?

Clearly, the disconnect between economic and financial developments cannot persist for too long. Sooner or later, one has to adjust to the other. It would of course be far preferable for economic developments to align with the markets' implied expectations, rather than for valuations to adjust to disappointing economic developments. Which of these two scenarios prevails depends in turn on the major countries' economic policies. The question at the heart of the matter is that raised in a recent op-ed by the former CEO of Pimco, Mohamed El- Erian: Will policy makers be as bold as markets expect? Only a positive response to his query will ensure that the inevitable recoupling of financial markets and the real economy will unfold along a virtuous path. The steps that Italy needs to take have been known for a long time. And time is now running out.

alessandro.leipold@lisboncouncil.net
Twitter: @ALeipold