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Italy's downgraded debt is a better bet than 'triple A' UK

You would be forgiven for thinking that something has suddenly gone awfully wrong in Italy. It was downgraded last week by both Moody's and Fitch. Moody's cut, by a hefty three notches to A plus, was its first downgrade of Italy in 18 years.

The move came just a couple of weeks after the approval of the biggest fiscal adjustment of any leading country in decades. Then again, markets had already taken absence from fundamentals, driving Italian sovereign funding costs above 5 per cent – so the rating agencies, following tradition, adjusted their rating regardless of economic fundamentals.

But sometimes the market gets it all wrong, as is the case now. Consider the following: while Italy funds itself at 5.1 per cent, the UK government funds itself at 1.6 per cent (and is therefore rated triple A).

Italy and the UK are two countries broadly of the same size, wealth and income. Italy is more geared towards manufacturing, with many corporates plugged into the German export machine. The UK is more geared towards services.

Granted, the Italian government's debt is larger than that of the UK (some 119 per cent of gross domestic product compared with 80 per cent of GDP). But the Italian private sector has stronger balance sheets than the UK private sector, so the two countries' net international investment positions (net debt of anyone in the country to foreign creditors) are both comfortable at minus 24 per cent of GDP in Italy, against minus 13 per cent of GDP in the UK.

This means that the Italian sovereign transfers more resources (as interest payments) to foreign creditors than the UK sovereign, while the Italian private sector transfers fewer resources to foreign creditors than the UK private sector. Hence, the Italian government has stronger private wealth for potential future taxation than the UK.

Coming through the crisis, both governments knew that they had to address their fiscal imbalances, and so they did.

In the UK, the government passed legislation last year that will tighten the fiscal stance by 2.6 per cent of GDP by the end of parliament in 2014-15, and by another 1.1 per cent of GDP for the first year thereafter, for a total of 3.7 per cent of GDP through to 2016.

This comes on top of fiscal measures implemented by the previous government. All in all, the UK primary balance is set to improve from a worrisome deficit of 5 per cent of GDP this year to a modest surplus of 1.3 per cent of GDP in four years.

In Italy, the government passed legislation two weeks ago that will tighten their fiscal stance by 3.5 per cent of GDP by 2014, which comes on top of last year's tightening of 1.5 per cent of GDP, for a total of a sizeable 5 per cent of GDP.

These measures are set to improve the fiscal primary balance from a surplus this year of 0.9 per cent of GDP to a surplus of 5.7 per cent of GDP in four years.

Yes, there are implementation risks, but Italy starts with a primary surplus; the UK starts with a sizeable deficit.

In spite of Italy's better fiscal position and more comprehensive measures, it pays more than 5.1 per cent (in euros) for its debt while the UK pays just 1.6 per cent in sterling. Could the difference be due to investors' expectations of future sterling appreciation? Hardly.

Indeed, the argument seems to go the other way. Curiously, investors seem to like the UK precisely because of the country's ability to weaken its currency (apparently disregarding the loss imposed by such depreciation) because – the argument goes – this will boost future growth and hence tax revenues.

The only problem is that this theory has not really worked that well in practice.

Since the end of 2007, UK GDP has contracted cumulatively by 3.4 per cent in spite of the great sterling depreciation as exports failed to recover. Italy's GDP contracted by 4.4 per cent during the same period.

Meanwhile, weaker sterling has lowered imports as the UK became poorer in real terms through higher inflation. In 2007, the average Brit was 30 per cent richer than the average Italian; now they are just 5 per cent richer, according to Eurostat.

Another curious argument relates to central bank underwriting of the sovereign. Yes, the Bank of England may be more comfortable printing money than the European Central Bank but such printing presumably involves some risk of weakening the exchange rate. And make no mistake about it, the ECB is Italy's central bank and, as already demonstrated, it stands behind the Italian sovereign like any central bank would do in any civilised society. But while the ECB buys Italian sovereign debt, it does so against policy conditionality.

So what would you rather own? The bond on a government being pushed by its central bank to adjust its underlying fundamentals (while backstopping the most extreme market sentiment) or the bond of a government with less ambitious fiscal plans with a central bank behind it that prints without conditionality attached? Oh, and you'll be paid 3.5 percentage points more for the former.

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