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PROMETEIA POSITION NOTE n.1 - March 2017

Euro in 2017 and beyond: risks and opportunities for Italy

Main points

- » Support for the Euro remains strong in the main Euro area countries, less so in Italy
- » The decision of a member to leave the Euro area would spark a new crisis
- » The Euro area has the tools to fend off short-term market tensions, but fewer to address the root causes of anti-European sentiments
- » Progress on the banking union is significant, but not sufficient
- » Leaving the Euro area would not solve Italy's problems and would be much more costly than remaining
- » Our baseline scenario does not foresee any disruptive events, but uncertainty will characterize 2017

Prometeia has recently released its quarterly Report presenting the economic forecasts for the global economy and Italy. As usual in the first issue of the year, we also look at the medium term and extend our forecasts to 2024.

*Our baseline assumes that the coming series of elections in the European countries will keep uncertainty at high levels in France and Italy but that it will not deliver major shocks. Actually, in comparison to our December issue we have revised upward 2017 growth, although modestly, in a number of Euro area countries. For Italy, however, we estimate that political uncertainty will keep sovereign spreads at the high levels reached recently, will hinder any reversion of the recent portfolio reallocations outside the country and will limit growth to 0.9 percent.**

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I. Europe is living through a phase of apprehension

Some commentators argue that Europe is in an "existential crisis". After numerous emergencies and substantial institutional changes, Europe is now out of "crisis mode". However, there is a widespread sentiment of disaffection towards the European project, due to the perceived inability of the European Union to provide solutions to the concrete social problems of its citizens (especially in the South) or to the anxieties related to immigration and economic security (especially in the North). The Brexit vote, with negotiations for the UK to leave the EU to start soon, is a clear statement in this direction. European citizens are split between those who want "more Europe", and call for a greater role for fiscal transfers across countries, and those who fear the implications of being part of a "transfer Union".[1] These sentiments are exacerbated by the uncertainties related to the coming elections. After the Dutch elections of March 15th, France, Germany and Italy are going

1 This divide is reflected in the recent European Commission White Paper on The Future of Europe (https://ec.europa.eu/commission/news/commission-presents-white-paper-future-europe_en) where a menu of options is presented, from reducing the role of the EU, to moving forward either in selected areas or groups.

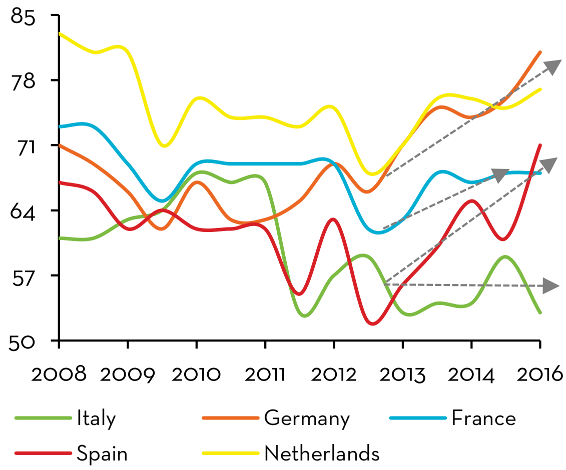
to the polls. Elections are a moment of truth in which anti-European sentiments can come to the surface and can lead to substantial changes.

Support for the Euro among European citizens remains high, less so in Italy. Based on Eurobarometer data, in Germany, the Netherlands, and Spain more than 70% of the population supports the Euro, while this percentage has been relatively stable lately just below 70% in France and it has been falling to marginally above 50 percent in Italy (**Figure 1**). Support for the Euro has been falling in all countries since the 2008 global financial crisis and started to recover in most countries in 2013. Interestingly, in France and Italy support for the Euro has been rather strongly correlated with the support for pro-European parties (**Figure 2**).

The focus is now on France. On April 23rd France will have its first round of Presidential elections and on May 7th the run-off. Marie Le Pen has presented proposals to leave the Euro.[2] Support for Le Pen hovers at around 25 percent, enough to secure her to the run-off, but unlikely to bring her to the Presidency. However, markets have become wary after the Brexit vote and the election of Trump and are in wait-and-see mode. Their strategy seems to be to disinvest ahead of a risky political event and to consider these events sequentially, one at a time. The French elections, for example, are definitely risky as support for the different candidates has been very volatile. No wonder the French bond yield spreads against the bund have been increasing lately (**Figure 3**).

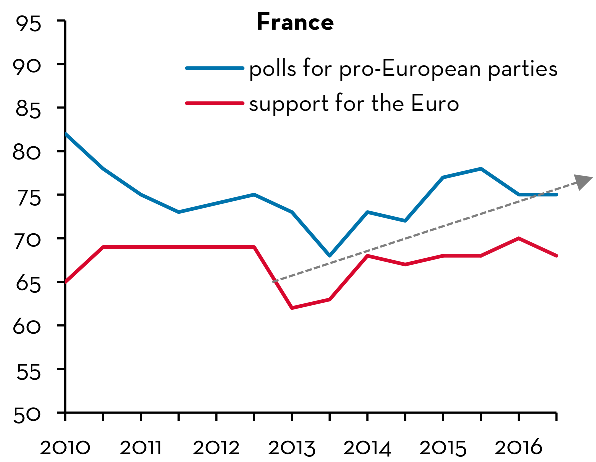
After the French elections, the next risky political event will be the Italian elections. In September there will be general political elections in Germany. Both main contenders, Merkel and Schulz, are pro-Europe and their election does not pose a risk for the Euro. Next will be Italy. After the January Supreme Court decision, the electoral system is for the time being essentially proportional, creating uncertainties concerning which coalition is going to lead the country or whether there will be a clear majority. In the meantime, we observe a capital reallocation out of the country (**Figure 4**) and growing spreads on the Italian government bonds despite the ECB Asset Purchase Program.

Fig. 1 - Support for the Euro growing since 2013 except in Italy - *percent*

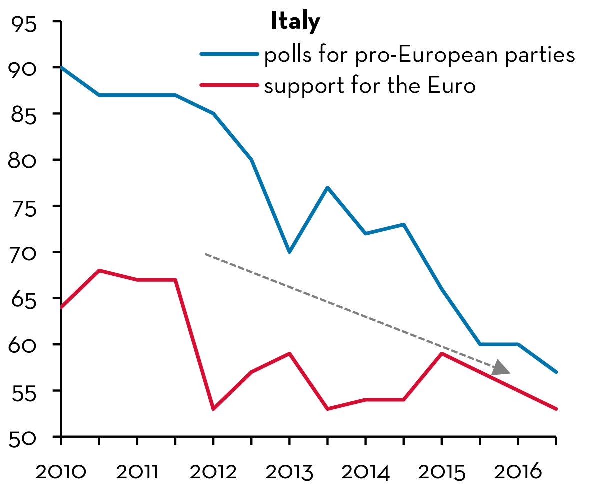


Source: Eurobarometer Autumn Surveys -European Commission

Fig. 2 - Support for the Euro is correlated with support for pro-European parties in France and Italy - *percent*



European parties include all parties except Front National



European parties include all parties except The Five Star Movement and Lega Nord
Sources: polls for pro-European parties is an average of various available polls; support for the Euro: Eurobarometer.

2 See for example http://www.institutmontaigne.org/presidentielle-2017/propositions/marine-le-pen-europe-et-international-sortir-de-leuro-et-restaurer-une-monnaie-nationale-le-franc.

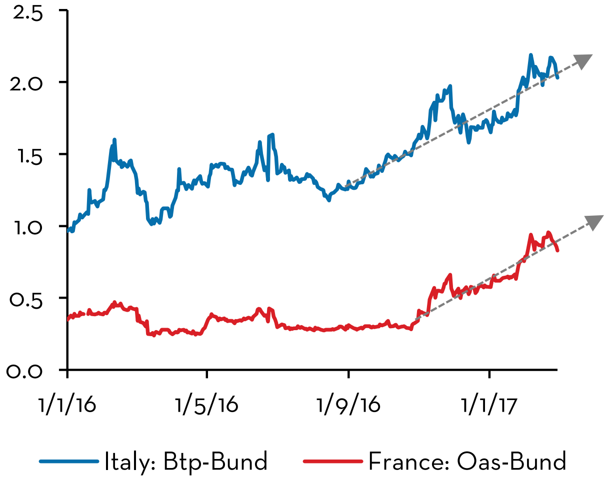
II. The Euro area has the tools to fend off short term market tensions, but fewer to address the root causes of anti-European sentiments

As long as countries are committed to the Euro, severe tensions on sovereign bond yields are unlikely although some volatility cannot be excluded. In case of market tensions and problems in raising the necessary funding on the market, member countries can activate a program with the European Stability Mechanism (ESM) which would allow the ECB to intervene without limits in the secondary sovereign bond market.[3] As the ESM requires an 85% majority for urgent financial assistance, a country needs substantial support from the other member states. The voting rule coupled with the need to agree on the details of a program would take some time and generate considerable uncertainty throughout the process. Therefore, volatility on sovereign yields cannot be ruled out even if a country applies for an ESM program.

The risk is mainly political. If a country calls for a referendum on the Euro it is implicitly contemplating the possibility of leaving the common currency. Although there are legal hurdles in calling such a referendum in certain countries[4], it is clear that the announcement alone would increase the probability of exit and would lead to capital flight. In this context it is difficult to envisage how the European institutions might react. In the case of the July 2015 Greek referendum on the bailout programme, which was perceived as a vote on Grexit, the government had to introduce capital controls and close the banks for a few weeks as the ECB initially decided not to increase the level of liquidity to the Greek banks.

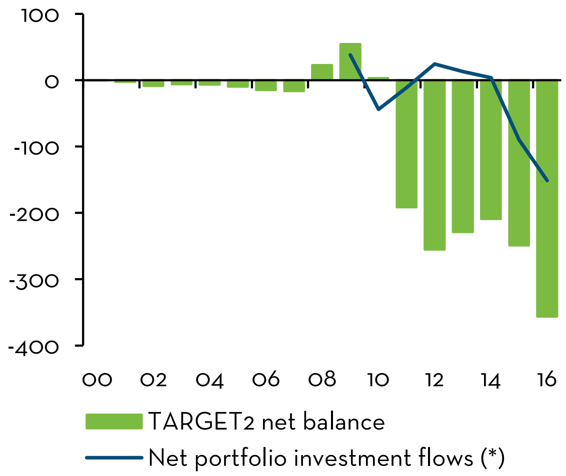
Unemployment and other indicators of socio-economic stress are correlated with xenophobia and anti-establishment sentiments. These socio-political phenomena are complex and develop differently in different contexts. In the US, for example, there is evidence that

Fig. 3 - Italian and French spread vs Bund 10Y on the rise - *percent*



Source: Prometeia calculation on Thomson Reuters data

Fig. 4 - TARGET2 balance and net portfolio investment - *billion Euros*



(*) Outflows have negative values
Sources: Prometeia calculations on Bank of Italy and ECB data

Trump was able to gather consensus in areas of the country with slower job growth and lower wages.[5] Similarly in Germany, last year the Alternative für Deutschland (AfD) became the second party in those areas where the unemployment rate is higher than the national average, specifically in Saxony-Anhalt and Mecklenburg-Vorpommern. There is also evidence of a

3 The activation of Outright Monetary Transaction (OMT) is subject to the agreement on an ESM assistance programme. This programme can take the form of a full ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of ESM primary market purchases. See https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

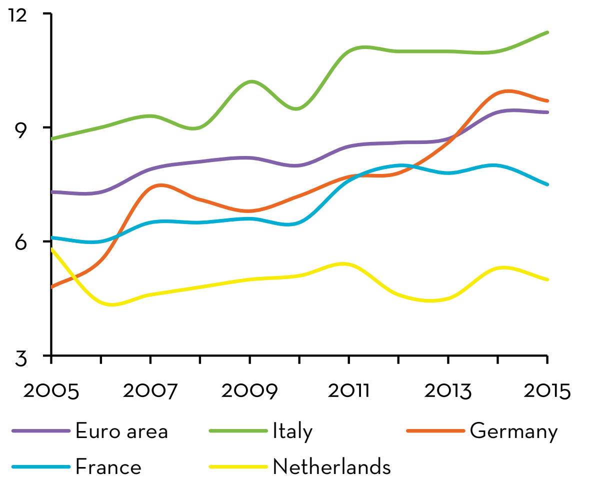
4 In Italy the Constitution does not allow the possibility of a referendum with immediate legal effect to change international treaties, such as the Maastricht Treaty that established the Euro. In France, Art. 89 of the Constitution indicates that a referendum can be called only after obtaining a qualified majority approval from the two Houses of Parliament. Alternatively, the Parliament could be bypassed by forcing the interpretation of Art.11 on presidential powers. This happened once before in 1962 when President De Gaulle used it to call a referendum on the electoral law. Despite these technical hurdles, even a non-binding consultation such as the referendum on Brexit, would have significant consequences.

5 See https://fivethirtyeight.com/features/trump-was-stronger-where-the-economy-is-weaker/.

correlation with future economic prospects, especially in areas that are likely to face prospective economic strain. The in-work poverty rates have been increasing in most European countries in recent years (**Figure 5**).[6]

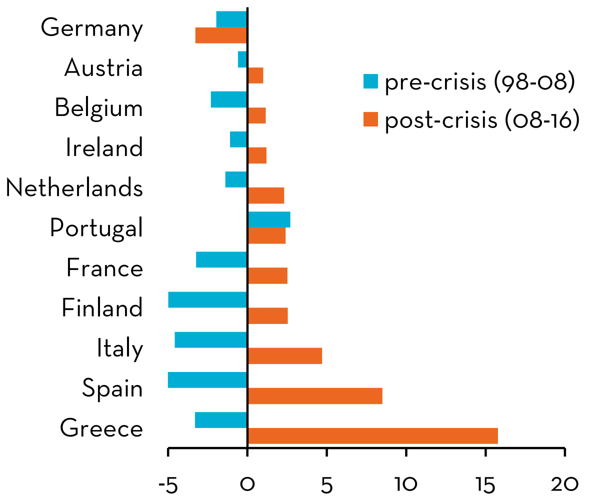
In Europe, divergence in economic performance and unemployment has been growing starting with the 2008-09 global financial crises. Figure 6 shows the pre-crisis period (1998-2008) decreases in the unemployment rates across member states and the massive increases afterwards (2008-2016). The growth in unemployment has been severe in the peripheral countries, while Germany is the only country that has been able to reduce the unemployment rate both before and after 2008. Based on estimated Okun's Law, growth in some Euro area members should increase more than what is currently forecast to bring unemployment back to pre-crisis levels (**Figure 7**).

Fig. 5 – In-work-poverty rates increased also in core Euro area countries – ***percent of total population***



Source: Eurostat

Fig. 6 – Pre-crisis and post-crisis changes in unemployment rate – ***in percentage points***



Source: Eurostat

III. Progress on the banking union is significant, but not sufficient

The Euro area institutions were created to foster economic convergence, not to cure divergence. When the global financial crisis hit, some countries were more exposed and weaker than others. This, as suggested by Figure 6, created large economic and social divergences across the Euro area countries. The Euro is not an optimal currency area and at the same time has a limited set of instruments to address country-specific distress and divergence among member countries. Labour mobility across states and wage flexibility within states are limited (but growing, especially since the 2008-09 crisis), countercyclical fiscal transfers from the centre are non-existent and the integration of the banking and financial systems is still in progress. Moreover, by its own nature, the common monetary policy can address Euro area aggregate fluctuations, but not country-specific circumstances.

The banking union is a very important step forward towards more risk sharing but largely incomplete. The banking union was meant to sever the adverse feedback loop between banks and sovereigns (i.e. the fact that both the banks and the sovereign become weaker when domestic banks hold large amounts of national sovereign debt, if the latter is high). In practice, the bail-in principle has prevailed, implying that problem banks will impose costs on (mainly domestic) bondholders before the common bank resolution authority could deploy Euro area funds. Going forward, a truly integrated capital market will imply that European citizens will hold more assets of other member countries. The cost of a shock that reduces asset valuations in one country will therefore be spread across the entire union. The banking and capital market unions, once completed, could provide substantial risk sharing across

6 *For the definition of "in-work poverty" see: http://ec.europa.eu/eurostat/statistics-explained/index.php/EU_statistics_on_income_and_living_conditions_(EU-SILC)_methodology_-_in-work_poverty.*

Europe. In the US between 20 and 40 percent of state specific shocks are smoothed via the financial markets.[7]

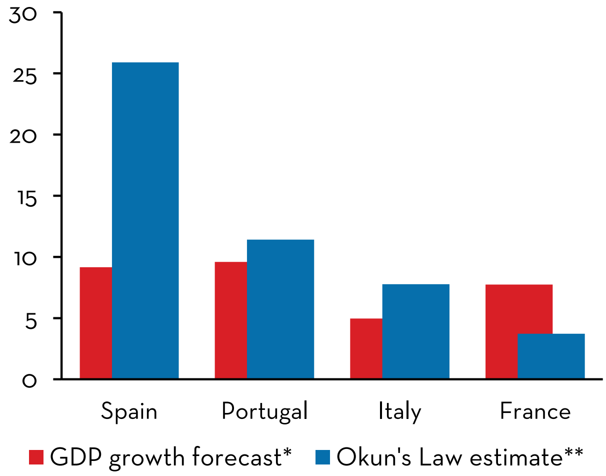
Further progress has been hindered by the disagreement over the nature of the Union. The dominant view within the Euro area is fundamentally against a transfer union. As a result, the banking union remains incomplete. Funding of the common bank resolution authority is still in the early build-up phase and there is no progress on the European Deposit Insurance Scheme. In addition, there are proposals to reduce the contingent risk for the Union coming from the high public debt of some members. One such proposal is to introduce risk-weights for sovereign bonds held by banks, another is to add an automatic sovereign debt restructuring mechanism as a precondition to apply to an ESM programme (although the latter would require a change in the treaty establishing the ESM). It is evident that these measures aim at reducing the room for risk sharing and as such hinder any reduction of the fragmentation of the Euro area banking and financial market.

As a result the Euro area lacks the policy instruments required to address the socio-economic divergence across member states. Given the absence of federal programmes (which would require an expansion of the EU budget) and the limits reached by the common monetary policy, the burden is left with the national authorities. However, due to the limitations on the banking union, problem banks still rely mainly on national resources (through bail-in) or on precautionary state recapitalizations. For high debt sovereigns the negative bank-sovereign loop is still effective, limiting their ability to revive growth. This is a particularly difficult context for Italy.

IV. Despite the current difficulties, leaving the common currency is not the solution to Italy's problems

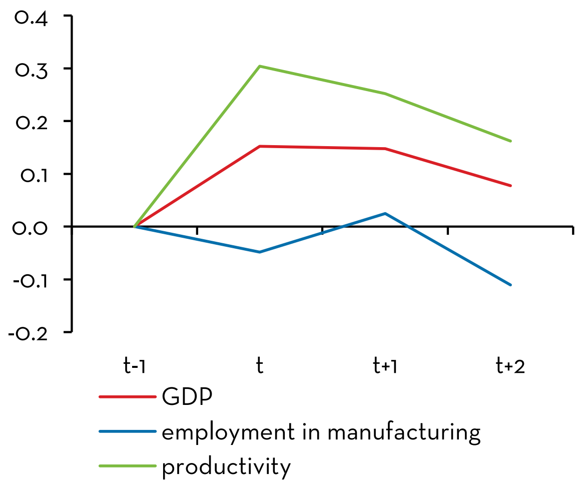
The decision to enter the Euro in 1998 was based on political and economic arguments that are still valid. Entering the Euro was a political decision to be part of a common project for the future of the continent. It would have been difficult for the European partners to keep a country in the common market

Fig. 7 – Cumulative GDP growth in 2017-2022 necessary to bring unemployment rate back to pre-crisis level is higher than projected – ***percent***



** Prometeia March 2017 outlook*
*** GDP growth in 2017-2022 necessary to reduce unemployment rate back to 2003-2007 average according to Okun's Law coefficients (Estimated Gdp growth necessary to reduce the unemployment rate by 1 percentage point: Spain: 2.7, Portugal 2.6, Italy 1.9, France 2.3)*
Source: Prometeia estimations on national statistical institutes data

Fig. 8 – Responses of GDP and productivity to devaluations are short lived with no impact on employment ***– additional % growth compared to pre-devaluation years***



Effect over time of a devaluation at time t for each one percent of nominal effective exchange rate devaluation. We considered only large devaluation episodes (1973-74, 1976-77, 1981-82, and 1993)
Souce: Prometeia calculations on Istat and Bank of Italy data

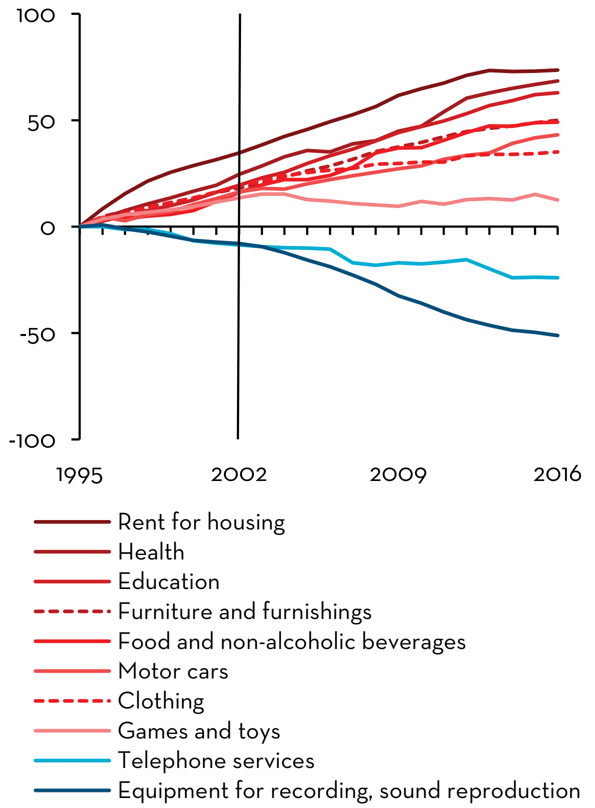
which systematically relied on competitive devaluations as Italy did in the 70s and 80s. Moreover, the experience of those years shows that any real gain from the devaluations vanished after about two years (**Figure 8**) and, contrary to some claims, the dynamic of domestic prices did not increase after the introduction of the Euro in 2002 (**Figure 9**).

7 See http://voxeu.org/article/risk-sharing-across-us-and-eurozone.

Leaving the Euro would not solve Italy's problems. The main argument of the Italexit proponents is that a large devaluation would bring big gains in competitiveness. But these gains would be achieved via a reduction in real wages due to the devaluation and, as we have seen in Figure 8, have proven to be short lived in the past.[8] Moreover, leaving the Euro would breach international treaties, such as the Treaty establishing the European Union, it would open a diplomatic war between Italy and the other countries in the Euro area, likely leading the country to leave the European Union and the common market. So much for the desired gains in exports!

It would not improve the stagnant growth in productivity or ease any of the structural problems of Italy. Price competitiveness (measured on the CPI based real effective exchange rate) has not worsened much since joining the Euro, but Italy has lost ground compared to its main competitors, especially when competitiveness is measured based on unit labour costs (ULC; **Figure 10**). Leaving the Euro and devaluing would imply giving up competing with advanced countries and begin playing in a league where some emerging economies have a leading position. More generally, leaving the Euro would have a host of implications which are difficult to summarize in one single scenario. In the following we highlight some important negative effects that would materialize in the short run.

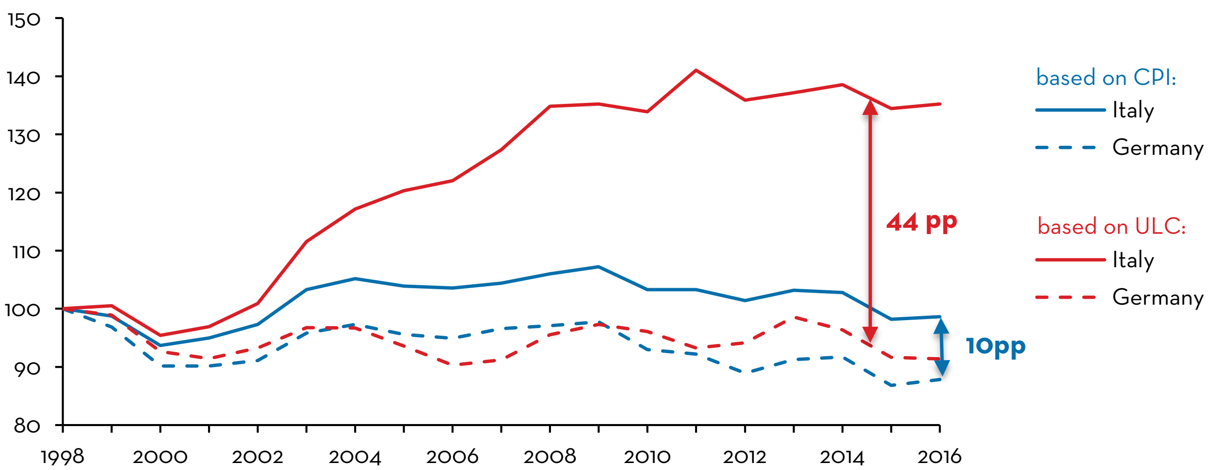
Fig. 9 - Price dynamics not affected by introduction of the Euro in 2002 - 1995=0



Fonte: Prometeia calculations on Istat data

It would have large redistributive implications from savers to borrowers. The country would need to redenominate all contracts written under domestic law from Euros to the new currency. It would not be able to redenominate contracts

Fig. 10 - Loss of price competiveness based on different measures of Real Effective Exchange Rates (REER) - 1998=100



Source: IMF (International Financial Statistics)

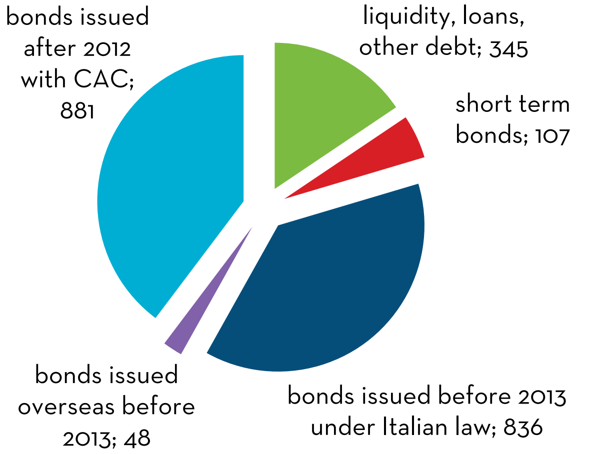
8 On this see also http://www.lavoce.info/archives/18793/ritorno-alla-lira-svalutazione-crescita/.

written under foreign and international law. The new currency would devalue, likely between 10 and 40 percent, as the markets would initially be guided by the real effective appreciation of Italy compared to Germany since joining the Euro (Figure 10). The resulting inflation would reduce the real value of wages and both debt contract and domestic savings (e.g. bank accounts).

Redenomination of a sovereign bond would trigger a credit event, i.e. markets would consider the redenominated bonds as defaulted. This would be largely independent on whether the bond includes Collective Action Clauses (CACs) or not, as it is the case for the bonds issued starting in 2013 (about 881 billion, see **Figure 11**) following a European agreement.[9] After all, protection of bondholders depends on the legislation that regulates the bonds, i.e. which court is going to rule on the matter.[10] However, a government that wants to change the terms of a contract unilaterally should be concerned with the fact that the move might qualify as expropriation, violating fundamental rights protected, for example, under Constitutional rights.[11]

It would entail large costs for the sovereign. The devaluation would mechanically increase the size of public debt in relation to nominal GDP. Bondholders would hold on to their debt titles in Euros, while GDP would be converted one-to-one into the domestic currency.[12] On top of that, the current debt of the Bank of Italy to the Eurosystem within the Target 2 payment system (currently at about 360 billion or 21 percent of GDP) would also represent a liability in Euros and should also be settled.[13] It is true that a country leaving the Euro zone would not be so concerned with settling debt with the ECB, but the important point is that the devaluation would imply a huge increase in the value of the public liabilities in relation to GDP. The government would not be able to honour these commitments and would need to negotiate an agreement with the creditors to restructure the debt. This would have large negative consequences on the country's access to financial markets and would open up a host of legal issues as the creditors would pursue all legal means to protect their investment.

Fig. 11 - About forty percent of Italy's public debt is issued with CAC - *January 2017 - € billion*



Source: Prometeia calculations on Bank of Italy and Ministry of Economy and Finance data

Private sector financial and non-financial companies would also face large capital losses. Italian banks and other financial institutions hold about 830 billion in Euro denominated Italian public debt.[14] As the value of these assets would fall considerably (because of the restructuring), domestic banks would face large losses. At the same time, financial institutions have issued at least about 190 billion[15] of bonds under international jurisdictions and non-financial firms too have issued considerable amounts under international jurisdictions. The assumed devaluation would imply that financial and non-financial companies would need to repay Euro denominated liabilities out of revenues denominated in the new devalued currency. This would bring large losses, likely triggering widespread defaults.

9 Collective Action Clauses have been introduced in Italy with the Decree n. 96717, 7th December 2012. The decree contains all the details regarding its applications.

10 On this issue see also Codogno and Galli: http://sep.luiss.it/brief/2017/02/23/l-codogno-g-galli-italexit-not-solution-italy%E2%80%99s-problems.

11 This is the concern that led the Greek government to introduce CACs retroactively in the domestic-law bond before the 2012 restructuring.

12 The redenomination would imply that all domestic prices would be translated one-to-one in the new currency. Since GDP is the value at market prices of all final goods and services produced in the economy, it would be translated as well one-to-one in the new currency.

13 See http://www.ecb.europa.eu/pub/pdf/other/170120letter_valli_zanni_1.en.pdf.

14 Bank of Italy data.

15 Prometeia calculations based on Thomson Reuters data.

This scenario would be much more disruptive than making the necessary adjustments to remain in the Euro area and it is not our baseline. In the process of leaving the Euro area, given the likelihood of debt default and restructuring, it would be impossible for the country to issue new Euro denominated debt on the market or to roll over the maturing one. In the extreme, the government would need to find financing for all the maturing debt (about 370 billion in 2017 and 340 billion in 2018) and the overall deficit (about 40 billion in both 2017 and 2018), a sum equal to 24 percent of GDP in 2017 and 22 percent in 2018. Even assuming a forced rollover of the maturing debt, which is really an extreme assumption, the government would still need to pay the interest and bring the overall deficit to zero (no new borrowing on the market). This would entail at the very minimum a correction of about 2.5 percent of GDP (approximately the current deficit). On the contrary, remaining in the Euro area, the fiscal adjustment that would be required to reduce the debt considerably over time would be smaller and could be achieved smoothly over a number of years. We estimate that, assuming a nominal growth of 2.3 percent and an average cost of the debt of 3.1 percent[16], an adjustment of the primary balance of about 1.5 percent would be able to bring the debt to GDP ratio down to 100 percent by 2030.

Italy needs to demonstrate its commitment to remaining in the Euro area by making the necessary fiscal adjustments and progressing with reforms. The rest of 2017 will be a difficult year with the French, German and Italian elections imminent. Markets will be nervous and are likely to reallocate funds towards the emerging markets and the US, where interest rates are increasing. In Italy the recovery is progressing but it could be jeopardized if political uncertainty persists and increases. The country needs to commit immediately to setting the debt on a secure downward path and bringing forward the structural reforms necessary to revive growth and to consolidate its position within the Euro area. However difficult this may seem, it will be much easier than facing the disruptions to the economy and the deep recession that would follow a Euro exit.

16 These figures are based on the forecasting scenario up to 2024 presented in the Prometeia Quarterly Report of March 2017. We have assumed constant dynamics for nominal GDP and average cost of the debt after 2024.

prometeia associazione per le previsioni econometriche
via g. marconi 43, 40122 bologna, italia — tel. +39 051 648 0911 — fax +39 051 220 753
lorenzo.forni@prometeia.com, stefania.tomasini@prometeia.com, lorena.vincenzi@prometeia.com
www.prometeia.com
based on data available on March 21st 2017

For media enquiries please contact:
media@prometeia.com