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EUROPEAN POLITICAL RISKS: A SUMMER OF DISCONTENT?

Berenberg Macro Flash

Migration, Merkel, Italy, EU reforms: A set of partly interlocking key issues in Europe will make headlines in the next ten days. In an unlikely worst case scenario, the current German government may fall in early July and Italy may descend into a debt crisis over the summer. More likely, Merkel and Italy will muddle through and the EU will take some modest steps towards sensible reforms.

THE MIGRATION PROBLEM

Unease about migration from Africa and the Middle East into the EU has fuelled the rise of radical parties across much of the EU, disputes about migration threaten the cohesion of the EU/Eurozone and the stability of governments across the region more than any other issue. To some extent, EU members and the EU have already significant progress:

- 1) After the partial closure of the “Balkan route” in early 2016 and more determined efforts to reduce the inflow of migrants from Libya into Italy last year, the [overall number of arrivals](#) into Italy, Greece and Spain has fallen significantly to 60k in the first half of 2018 after 103k in 1H 2017 and 234k in 1H 2016.
- 2) The main countries of entry, Italy and Greece, are taking their obligation to accept and process asylum applications much more serious than before instead of simply letting many potential asylum seekers move on to the countries such as Germany where the migrants and refugees would like to end up.

Keeping most of the new arrivals in Italy/Greece for longer reduces the incentive for economic migrants to make the expensive and hazardous trip into the EU in the first place. But it also nourishes a sense of unfairness: To some extent, Italy and Greece feel left alone with the problem. This is where the specific German-Italian angle comes in.

European considerations were a key reason for German chancellor Angela Merkel’s decision to let in refugees stranded in Hungary in September 2015 and to not clamp down seriously on the ensuing inflow at the German border thereafter. She wanted to spare politically fragile transit countries the problem of a mounting backlog of stranded migrants. Merkel wants to co-ordinate migration policies with other EU countries rather than any unilateral action at the German border. This has now landed her in deep trouble with the restive CSU part of her CDU/CSU-SPD coalition (see [Political risk in Germany](#)). The CSU demands that all those who have already registered as asylum seekers elsewhere (mostly in Italy) will be refused entry at the German border. Many in Merkel’s CDU largely agree with the CSU demand. However, virtually the entire CDU rejects the de-facto CSU threat to walk out of the government and potentially topple Merkel if she does not meet the CSU demand. The CSU wants Merkel to either get other EU countries to agree at the EU summit on 28-29 June that asylum seekers can be automatically sent back to where they were registered first - or let the German minister of the interior, who hails from the CSU, impose that unilaterally. A CSU suspicion that Merkel may be ready to give in to other EU countries on issues such as EU reforms in order to defuse the migration issue does not make her task any easier.

MERKEL AND ITALY: A TWISTED TALE

Italy has gained some leverage over Merkel courtesy of the CSU. This could be visible at the special summit of most-affected EU countries this Sunday and the regular full EU summit late next week, She needs Italy for any co-ordinated solution in Europe to fend off the immediate CSU challenge. Otherwise, she would either lose face and get into serious trouble on the European level by giving in to the CSU demand for uni-



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lateral German action - or lose her majority in the Bundestag. Also, if Germany were to harden its stance at the border, rejecting asylum seekers already registered in Italy, Rome may simply encourage more of its new arrivals to not register for asylum in Italy but move north of the Alps fast. That would add to the problems in Austria and Germany.

Still, the leverage is far from one-sided. Any serious conflict between Germany and the radical government in Italy would send Italian bond yields up and German yields down, further constraining the leeway for Italy's radicals to finance some of their expensive social spending and tax cut promises without igniting a full-blown debt crisis. Whether or not Lega leader Matteo Salvini already realises this may be unclear. But if any noisy conflict between Rome and Brussels/Berlin were to really get the bond vigilantes going, it would be Italy that would be forced into the very painful decision Greece had to make after the Varoufakis accident in mid-2015: U-turn back to prudence or descend into chaos. At the same time, Merkel may well hang on as Chancellor of a minority government supported by the Greens even if the CSU were to walk out.

WHAT TO EXPECT IN THE NEXT TWO WEEKS

On some issues, the overall direction seems largely clear:

- The stance of the EU and member countries towards migration will continue to harden.
- The EU and member countries will step up efforts and mobilise more resources to police the external border, reduce the inflow of migrants and send back more of those who do not qualify for asylum status.
- Agreements to re-distribute new arrivals between EU countries will not go very far as the issue is too contentious not just in Eastern Europe.
- If Italy plays its hands well, it could end up with some extra fiscal leeway with the argument that the direct and indirect costs of coping with migration should not be fully counted against Italy in any future evaluation of how Italy complies with the fiscal rules. Italy may also receive some extra EU funding for the purpose.

Of course, the process could be accident-prone.

Special migration summit 24 June

Expect a contentious discussion about migration among the most affected countries followed by series of hectic further bilateral discussions right thereafter. Any serious progress or an actual deal, for instance between Italy and Germany or between broader groups of countries, would be a positive surprise.

EU summit 28-29 June

- Expect a general agreement on strengthening **border controls** and provide more resources to top countries of entry such as Italy, Greece and Spain.
- An agreement among major countries including Italy and Germany so that Italy takes back more of those **asylum seekers** who have moved North may not be impossible but still seems unlikely.
- Small-scale progress on **EU/Eurozone reforms**, drawing partly on the Franco-German [Meseberg agreement](#). A general agreement to turn the ESM into the backstop for the common bank resolution fund by 2024 or earlier seems likely. Beyond that, EU27 leaders will probably endorse in general terms the proposals to turn the ESM into a **European Monetary Fund (EMF)** and incorporate some **Eurozone investment and cohesion budget** into the discussions about the EU's 2021-2027 medium-term fiscal framework. EU leaders will likely set a timetable and some guidelines for further discussions of these and other reforms.



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- Lest we forget, **Brexit** will be a side-issue. The UK will likely be encouraged to sort out its own position, continue the process of getting real and listen closely to what EU chief negotiator Michel Barnier is saying about solutions that do or do not work.
- While Trump's **trade war threats** will play a role, the EU will probably be fairly united in its response: the EU won't stoke tensions on its own, is ready to discuss mutual tariff cuts if the US desists from further unilateral action but will react tit-for-tat to any actual US actions against EU imports. After all, the big EU believes that it is in a fairly strong position on trade matters, partly because the US is running a small current account surplus with the EU.

German politics in early June

If Merkel can come up with a co-ordinated approach with Italy and some other affected EU countries that largely meets CSU demands, the issue would be defused. If not, the dispute would escalate. But as CDU and CSU would have too much to lose in the end if the CSU were to really walk out of the Merkel government, I would expect a compromise that comes close to CSU demands for comprehensive unilateral action but contains elements (such as Germany's unilateral action to be phased in step-by-step to give more time for discussions on the European level) that would allow Merkel to save face.

As discussed before, the risks are serious. We certainly cannot rule out a summer of European discontent. Still, as a worsening crisis would hurt all sides concerned, we would rather bet on noisy muddling through in a direction that largely makes sense (more efforts to reduce the inflow of economic migrants, modest EU/Eurozone reforms, Italy's radicals get a bit more real over time). But yes, it may well be noisy in Rome, Brussels and Berlin. See also [Italian basics: noise now, trouble later](#) for a discussion of the Italian risks.

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