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NOTES ON THE ITALIAN RISK

Berenberg Macro Flash

After serious progress since late 2011, Italy's new government is putting the country firmly on the wrong track again. Reversals of labour market and pension reforms coupled with unfunded spending increases are turning the once remote tail risk of an Italian debt crisis into an accident waiting to happen. Unless the government changes tack, the key question is not if but when disaster may strike.

Our base case remains that a full-blown debt crisis is not imminent. Instead, Italy will manage to muddle through for the next few years. It will probably get rather noisy in the next few months, though. In a strongly worded letter, EU Commissioners Valdis Dombrovskis and Pierre Moscovici yesterday gave Italy until noon next Monday (22 October) to explain why Rome is planning an "obvious significant deviation" from EU rules with a draft budget for 2019 that raises "serious concerns" and is "unprecedented" in the history of the EU's fiscal rulebook. By 29 October, the European Commission is likely to formally reject the Italian budget. In December, EU leaders will probably put Italy into the "excessive deficit procedure" that could potentially result in fines, possibly by mid-2019. In the meantime, rating agencies look set to downgrade Italy, probably starting with S&P on 26 October and Moody's (expected by the end of October).

In our view, rising risk spreads, ratings downgrades as well as pressure from the EU and Italian institutions such as its president and constitutional court will nudge Rome to soften its policies by just enough in coming months to stave off an immediate debt crisis. Italy's new leaders probably do not want to end up like Greece's once radical Alexis Tsipras who had to close banks and make a full policy U-turn within six months of taking office in early 2015. Of the two radicals calling the shots in Italy, the 5Stars' Luigi di Maio and Lega's Matteo Salvini, the latter seems to be less fiscally irresponsible. Whereas the Lega stresses its anti-immigration stance, the 5Stars consider expanded welfare spending as their top priority. According to opinion polls, Salvini's Lega would gain in hypothetical new elections whereas 5Stars would not. After a new election, Salvini might even have enough support to lead a government himself with the help of some smaller centre-right and right-wing parties and without the 5Stars. If the going gets rough in coming weeks, as it may, Salvini could use his stronger position to force di Maio into accepting some changes to the budget that would help to prevent an immediate debt crisis. In such a case, Italy would only be a minor drag on business confidence and growth in the Eurozone as a whole beyond some short-term irritation.

But even if Italy continues to muddle through for a few more years, as we expect, we have two reasons to consider the "what if" scenarios now. First, the tail risk of an immediate debt crisis is not quite zero. Second, once the next global recession reveals the underlying weaknesses of the Italian economy in, say, 2021, a massive sell-off in Italian debt may finally force Rome to choose between serious pro-growth reforms coupled with an end to spending excesses - and leaving the euro.

COULD ITALY SPARK A NEW EURO CRISIS? PROBABLY NOT

Reckless policies in Rome could potentially plunge Italy into a deep crisis with significant financial and economic spillover to its neighbours. Although countries with close links to Italy would be severely affected for a while, it would still be an Italian rather than a genuine "euro" crisis. In an unlikely worst-case scenario, Italy may go bankrupt, leave the euro and face a prolonged period of chaos. Beyond losing big Italy, the euro itself would not be at risk, though. Just like Brexit strengthened pro-EU sentiment across the EU-27, a messy Italexit would likely make other countries more, rather than less eager to stay in the euro. See also the "what if" analysis we sent around on 29 May amid an earlier spike in bond yields.

Europe has learned one lesson from the euro crisis: the worst risks stem from contagion. The two Greek crises of 2010 and the first half of 2015 had virtually no impact on overall growth in the Eurozone at the time. However, when contagion spread like wildfire in spring 2011 after a decision to restructure Greek public debt without protecting Italy, Spain and others against the ensuing investor panic, the overall Eurozone fell into recession. The financial panic ended only when the ECB finally outed itself as the lender of last resort in July 2012. The Eurozone today has better tools to contain contagion risks, including the European Stability Mechanism (ESM) and the ECB's OMT programme, de facto a tool to massively scale up any ESM programme if required.

With these tools, any country that sticks to the rules and wants to stay in the euro can be defended in a financial panic. Whether a run of the mill panic turns into a massive crisis largely depends on how markets expect central banks and other policy makers to act. The mere fact that markets now know that Europe has the tools to deal with a crisis/contagion, and would be willing to deploy them to help out rule-abiding countries in need (say, Spain), means that the likelihood that those countries come under genuine pressure is much lower than seven years ago. Serious spillover from Italy to, say, Spain and Portugal makes little fundamental sense.

COULD THE ECB INTERVENE TO HELP ITALY?
As long as Italy questions its adherence to the rules of the euro, it cannot expect to be bailed out in any way. The ECB has clear rules for potential interventions. Activating the ECB's OMT programme to help Italy is out of the question. Italy would first need an ESM programme or credit line, for which it would have to accept certain conditions. If Italy were to meet such conditions, namely a credible commitment to respecting the rules of the euro, any crisis would end shortly thereafter.

Of course, if Italian turmoil were to impact the outlook for Eurozone GDP and inflation significantly, the ECB could employ its standard monetary policy tools, injecting liquidity and adjusting its interest rate guidance in order to lower bond yields in the Eurozone. However, that the ECB would prolong its asset purchase programme seems highly unlikely. Revoking the decision to phase out asset purchases by the end of 2018 would be politically toxic as – under current circumstances – it would be seen as an implicit bailout for Italy.

WHAT IF: IS ITALY TOO BIG TO SUPPORT?
Many observers worry that Italy would be too big to bail out in a crisis. However, that is not really the issue at stake. The question for Italy is whether or not it musters the political will to accept the rules of the euro. Consider two cases:

- If Italy, in an acute crisis sparked by concerns that it may want to leave the euro eventually, changes tack and reverts to the course of prudence, it would probably need very little if any outside support. Italian paper would turn into an attractive buying opportunity. At most, a precautionary ESM credit line might be needed as a de facto stamp of approval for a return to sensible policies.
- If Italy flouts the rules of the euro badly, descends into crisis and refuses to reverse that course, it would neither qualify for nor receive support. In such a case, the EU/Eurozone/ECB would focus on shielding other eurozone members from contagion risks. Italy would face the choice of either doing a Tsipras-style U-turn from radical populism back to sanity or bear the consequences of a messy Italexit. Our clear bet is that, in such a case, even Salvini would choose to stay in the euro as Tsipras had done in Greece in mid-2015.

WHAT IF? ASSESSING THE DAMAGE OF A WORST-CASE SCENARIO

Size matters: A founding member of the EU and the euro, Italy today accounts for 15.4% of Eurozone GDP and 23.4% of the bloc's public debt. For comparison, Greece contributed 2.6% to Eurozone GDP upon the start of the Greek crisis in 2009 and today accounts for 3.3% of the Eurozone's pile of public debt. Germany earns 2% of its GDP by exporting goods to Italy while linkages through the banking system tie Italy closely to its European partners.

In the still unlikely case of a messy Italexit, Eurozone growth (outside Italy) may stall for a couple of quarters while the authorities deploy their tools to contain contagion risks and shore up the most affected banks if required. Thereafter, growth would likely recover back to a healthy pace, at least outside Italy. Of course, it would take many years to work out the consequences of an Italian default that could come with a hypothetical Italexit, including the settlement of Banca d'Italia's Target liabilities to the ECB. Eurozone investors hold roughly 19% of Italy's sovereign bonds.   Italy's net Target2 liabilities amounted to €433bn in September 2018. The longer the time horizon for any such workout after an Italexit, the higher the recovery ratio would likely be. In practical terms, an Italian default on its liabilities to the ECB would probably mean that central banks in the Eurosystem, while they absorb the losses, would not be able to make any profits to send to their national finance ministers for a number of years. All in all, an Italian default would be a serious blow to the Eurozone as a whole, but it costs would be digestible

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