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EUROPE: THE SIX-DAY CLUSTER OF RISKS

Berenberg Macro Flash

The German court verdict on the ECB's OMT programme on 21 June, the Brexit referendum on 23 June and the Spanish repeat elections on 26 June: Europe is heading for a six-day cluster of risks. We expect Europe to dodge the bullets again, as it has done so far. Europe's ability to adjust to shocks is quite remarkable. If the UK votes to stay in the EU, markets may simply shrug off the German and Spanish risks. However, a Brexit could magnify the potential impact of such risks. And once these risks have been dealt with - and once the nice distraction provided by the European football championship is over - we'll need to focus on Italy where Renzi's fate is at stake at the October referendum on political reforms.

GERMAN COURT: A TRICKY TASK

In the summer of 2012, the European Central Bank stopped the spread of contagion in Europe ('euro crisis') by announcing its readiness to back up European support programmes for struggling euro members with major bond purchases if need be. In January 2014, Germany's Constitutional Court voiced serious concerns about this never-activated OMT programme and asked the European Court of Justice whether the OMT is compatible with European law. Following the European court's verdict of 16 June 2015 that endorsed the OMT programme without serious restrictions, the German court will now rule whether the OMT, or the Bundesbank's potential participation in any OMT programme, would breach the German constitution.

The issue is tricky for the German court. Its judges tend to shy away from open conflict with the European court, they have no history of constraining Berlin in serious matters of foreign policy and are aware that a negative verdict may have serious consequences for financial stability across Europe. However, the judges are part of Germany's conservative-liberal elite which harbours strong reservations against current ECB policies. The anger makes little sense. After all, the ECB has delivered more price stability than the Bundesbank ever did. But the irrational anger is real nonetheless.

Our best guess is that the German judges will not outlaw the OMT but place some constraints on any Bundesbank participation in a potential OMT programme. For example, the court could ask for sharp limits on any direct or indirect balance sheet risks that might be borne by the Bundesbank and some explicit quantitative limits on the OMT itself.

Would it matter? Probably not much for the time being. As the ECB is buying sovereign bonds as part of its quantitative easing programme anyway, the OMT backstop is not really needed at the moment. But if the German court were to pick a major fight with the European judges (unlikely) or further stoke the German public backlash against the best guardian of price stability that Germany has ever had (quite possible), it could nonetheless add to tensions in Europe. In turn, that would make it more difficult for the ECB to do its job.

BREXIT: AN AVOIDABLE ACCIDENT

We see a 30% risk of Brexit, slightly above the 25% risk that seems to be priced in judging by discussions with clients and the odds at bookmakers. Last week, market perceptions of the Brexit risk rose a bit as immigration took centre stage in the debate.

A British vote to leave the European Union would not be quite a black swan. Markets have talked about it a lot since last November. In purely economic terms, it would likely mean a brief UK recession later this year caused by a plunge in investment and somewhat lower consumption. That would be followed by permanently lower trend growth (perhaps 1.8% instead of 2.1%) as the EU would restrain Britain's growth machine, its dynamic services sector, by partly restricting access of UK-based service providers to the Common Market. For the EU, uncertainty would weigh modestly on investment and growth later this year. But beyond that, a Brexit need not have any significant economic impact on the continent, where trend growth would likely remain around 1.6%. The small losses from less trade with a less dynamic UK would be offset by some gains in jobs as some UK providers of financial and other services would relocate some jobs into the EU to maintain full market access.

However, a Brexit could open political cans of worms on both sides of the English Channel. In the UK, it could topple prime minister Cameron and chancellor Osborne. More importantly, it would raise the risk that Scotland and possibly Northern Ireland may eventually leave the UK to stay in or return to the EU instead.

In the EU, it could encourage anti-EU populists and force markets to pay more attention to them, triggering potentially a modest echo of the euro crisis and some longer-term widening of risks spreads. To quell talk about domino effects amid doubts about the political cohesion of the EU and the Eurozone, we would expect some German-French led political initiative to strengthen the cohesion of both the EU and the Eurozone. The focus could be on security (anti-terror co-operation, more joint military brigades) and financial issues> that could include faster progress towards joint deposit insurance, possibly even a Eurobond light for certain extraordinary government expenditures for all countries signing up to enhanced fiscal rules.

SPAIN: BEYOND THE STALEMATE

Opinion polls suggest that the repeat elections on 26 June could confirm the current stalemate. The average of the last six polls puts prime minister Rajoy's conservatives at 29% (versus 28.7% at the 20 December 2015 election), the socialists at 21.3% (versus 22.0%), the liberals at 14.9% (13.9%) and the ultra-left alliance of Podemos and communists at 24.2% (24.4%). The only difference to the previous vote would be that the ultra-left would gain some seats at the expense of the mainstream socialists and conservatives. Spanish election rules would award more seats to the new alliance between Podemos and the communists than the two got separately in December even if they don't increase their combined share of the vote.

- In case of a new stalemate, the most likely outcome after some noise would be a **grand coalition** between the two traditional mainstream parties, the conservatives and socialists (55% probability). The pressure on both to avoid a third round of elections would be immense. Such a grand coalition would not reverse many reforms but would not get much done either. For Spain, that would be good enough. It would allow the country to reap the benefits of the earlier Rajoy labour market and other reforms.
- If the result shifts by a mere 2 points in favour of conservatives or liberals, the two could form a **pro-reform coalition**. For Spain, that would be optimal (20% chance).
- If Podemos manages to lead a **left-left alliance** instead, possibly with some regional separatist groups, Spain could be heading for a Portuguese-style situation (25% risk). Such a government would harm trend growth somewhat (from 2.5% to 2.0% for Spain?) by reversing some supply-side reforms. But it would probably shy away from a full confrontation with the EU about fiscal policy.

The Spanish population remains pro-EU and has little appetite for a confrontation with Brussels. The EU may use its delayed verdict on Spain's 2015 fiscal overshoot due in July to put serious pressure on any Podemos-led government in Madrid to not make too much nonsense. A government that does not reverse pro-growth reforms could expect a more lenient treatment.

THE CLUSTER OF RISKS

All three risks are serious, the Brexit risk is paramount. If the UK votes to stay in the EU on 23 June, markets would probably take a harsh German court verdict or an election upset in Madrid in their stride. However, if a vote for Brexit triggers serious concerns about the cohesion of Europe, the German or Spanish risks could exacerbate such concerns significantly.

ITALY: HOT OCTOBER?

Local elections have their own dynamics. Nonetheless, the results of Sunday's first-round votes in Rome and other Italian municipalities will be scrutinized for pointers as to whether prime minister Renzi may lose the October referendum on breaking Italy's perennial political stalemate. Renzi has tied his political fate by to the referendum on downgrading the Senate from a US-style full second house of parliament into a small and mostly toothless chamber with powers more akin to those of the UK's House of Lords, to over-simplify matters a bit.

Most opinion polls still show the pro-reform camp ahead. However, Renzi's lead has fallen from an average of 20 points in early 2016 to just five points in the last five polls, with two of the five showing a lead for the anti-reform camp. Renzi is a good campaigner, he still looks likely to win in October. If not, and if he then resigns, his government may try to soldier on without him until the next regular election in early 2018. But without Renzi's charisma, holding the government together could be quite difficult.

But before we worry too much about Italy in October, let's get beyond the 21-26 June cluster of risks first. With luck, a successful European football championship in France (20 June – 10 July) could provide a positive backdrop. Let's just hope that the three UK teams (England, Wales and Northern Ireland) and their fans enjoy the European experience, that bolshie French trade unionists don't spoil it – and that the English fans bother to vote on 23 June, following the three first-round matches of their team against Russia (11 June), Wales (16 June) and Slovakia (20 June).

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