LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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A Historical Compromise on Italy's Financial Sustainability

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1. Before the British referendum, political risks were already increasing across the euro area. They now arguably represent the most serious challenge to the stability of the common currency in the next 18 months. For quite some time now, government weakness in several countries and uncertain electoral outcomes in others, such as the recent Spanish election results, have made financial investors extremely sensitive to institutional and political developments down the road. While it is too early to credibly forecast the full economic, social, and political impact of Brexit, it is safe to say that market volatility will increase, impacting investor, consumer, and even electoral behavior in other EU countries.

Next year will be electoral crunch time for Angela Merkel. However, one can assume that the German chancellor is likely to once again win the federal elections and lead a new grand coalition. She will remain a bulwark of stability for the entire Union. Equally safe predictions cannot be made for other European countries, where next year's elections are fueling political uncertainty. Moreover, the possible global fallout of the November 2016 American elections adds to the current climate of uncertainty in the European Union. Political events at the national level show their effects on a much wider range. For instance, the Austrian presidential election and, *a fortiori,* the uncertainty due to the ballot recasting managed to disrupt Europe's strategy on migration. There is reason to believe that each of these elections will have consequences on the stability of the Euro area.

Against this backdrop, with the German leadership staying the course while several other countries face political uncertainty, Italy may find itself exposed to political, financial, and fiscal weaknesses. After the administrative elections, a bout of political uncertainty has emerged in Italy, as many start to doubt Renzi's capacity to win the constitutional referendum in October. Should Matteo Renzi lose the referendum, Italy could find itself mired in a new round of speculative attacks, which may very well threaten the cohesion of the entire Euro area.

This short brief merely seeks to alert all of Italy's political forces to the increasingly difficult political framework in Europe. As was already the case with our policy brief last January, the risks connected to Italy's high public debt and the fragility of its banking system need to be fully recognized.

2. As the European Central Bank recently observed, "Euro area sovereign stress conditions continue to be relatively benign, but debt sustainability concerns remain." Setting aside the reaction to the macroeconomic shock caused by Brexit, systemic stress in Euro area sovereign bond markets remains close to the low levels seen before the start of the global financial crisis in 2008, not least due to the Eurosystem's quantitative easing measures. These stable conditions also reflect a gradual improvement in fiscal balances, thanks in part to the gradual economic recovery. At the same time, debt sustainability concerns remain, partially as a result of persistently insufficient growth, while political uncertainty has slowed down progress in budgetary consolidation efforts. A balanced implementation of these efforts would not only improve long-term government debt sustainability, but it would also generate fiscal space to support the economic recovery. Country-specific reform efforts have also lost momentum in the Euro area, denting hopes of a steady and vigorous recovery of the European economy.

The results of the British referendum already have re-awakened investors' doubts on the long-term sustainability of the Euro area, as reflected in the widening spreads of peripheral sovereign bonds over German bunds. Peripheral stock-exchanges have declined significantly, notably for banking stocks, as investors flee from fragile institutions that may need new capital injections and deep balance sheet restructuring, especially in light of the forthcoming new round of ECB stress tests. In general, volatility has markedly increased.

The battering of banking stocks also reflects the failure to complete the Banking Union, which is still lacking the critical pillar of cross-border deposit insurance (EDIS) cum credible fiscal back-stop. The new regulatory environment, built upon on the ECB's new Single Supervisory Mechanism (SSM) and the single European mechanism for the resolution of failing banks, has moved toward greater uniformity in the rulebook for the Euro area, as well as strengthened capital reserves and decreased leverage ratios of banks. It also created credible barriers against the socialization of private banking losses. However, the risk of a re-emergence of the vicious circle between strains in domestic sovereign debt markets and the weak banks in some banking systems remains, unfortunately, especially for Italy.

The credibility of the resolution mechanism for insolvent banks is weakened by the Single Resolution Fund's insufficiency. The problem would be particularly evident if a large cross-border bank needs to be resolved, or if a systemic banking crisis occurs in one of the member states. The sudden enforcement of the "bail-in" clause in Italy and Portugal has sent shockwaves across capital markets for bank shares and bonds. Furthermore, ECOFIN concluded its June 2016 meeting with the announcement that discussions on EDIS are frozen–basically, until after the German elections in September of next year–due to insufficient progress in risk reduction measures for banks with high sovereign debt holdings. These developments are fueling the national segmentation of the European banking market once more, creating fresh risks of short circuits between government bond markets and bank balance sheets.

3. Although political instability is not EU- or euro-specific, given the evident institutional fragility of the common currency area, concerns about debt sustainability in the euro-periphery could resurface if the political outlook deteriorates. Political instability would limit governmental maneuvering room for fiscal adjustment, while making foreign investors wary of the future course of economic policies and the integrity of the Euro area as a whole. Moreover, political uncertainty will harden fronts between Germany and the countries disputing Berlin's notion that country-specific reforms without fiscal accommodation can get their economies back on track. In fact, reform implementation has become more politically costly for governments confronting a surge of euro-sceptic political formations on the home front.

These rising political risks at both the national and supranational levels, as well as the increasing support for less reform-oriented political forces, may potentially widen the distance–and the mistrust–between Germany and the weaker countries. A more cooperative stance is unlikely since the balance between *risk-sharing* at the Euro area level and *risk-reduction* at the national level is clearly tilted in favor of the latter. The above-mentioned decisions at the recent ECOFIN on banking union have shown that "risk-sharing" comes a distant second from "risk-reduction." This, in turn, may cause renewed pressure on more vulnerable sovereign states and potentially contribute to contagion and re-fragmentation in the Euro area.

Italy has less than satisfactory growth prospects in the long term, and it has experienced the steepest fall in economic activity as a result of the two financial and 'real' crises (2007-09 and 2010-13). In the Eurozone, its debt-to-GDP ratio did not increase above the EMU's average as a result of these two crises; however, the starting point was so high that this ratio is currently close to 135%. Moreover, Italy remains weighed down by non-performing loans (gross and net) and sovereign debt securities on the balance sheets of banks.

Italy's public debt is seen in many quarters as one of the major threats to the very survival of the euro. Hence, it is not surprising that the EMU's 'core' countries were troubled by the Italian government's decision to exploit all the flexibility margins in the government budget deficit. As a result, it is unlikely that the debt-to-GDP ratio will decrease in 2016, as originally expected. This might further tighten the fiscal constraints imposed on Italy by EMU rules for 2017. Against this backdrop, Germany is pushing for an automatic restructuring of sovereign debt for countries requesting financial assistance from the European Security Mechanism (ESM).

4. The outcome of the recent Italian administrative election has been overshadowed by the Brexit debate. However, it holds a message that is as relevant to the future of the Euro area. Prime Minister Matteo Renzi has acknowledged the outcome of the vote as dismal. The rift within his party has widened. The prospect of political stability until the end of the legislature is less certain now than it was at the beginning of the year. The referendum on constitutional reform in October is already seen by many as a make it or break it moment. Investors are already considering that, if Renzi were to lose the referendum, his government might fall, or it would remain in charge only for a short period, until new elections are called. The growing consensus for euro-critical parties of a different nature might become a major factor in assessing the stability of the country.

The last statement is strengthened by one significant example. Rome's newly elected mayor, Virginia Raggi, who was chosen by two voters out of three, announced the municipality's intention to renegotiate its debt. Her party's economic platform also considers debt renegotiation at the national level a clear priority. After next October, investors might see political instability in Italy as a premise for public debt instability. Far from suggesting any political preference, we urge all Italian political parties to consider the need for fiscal certainty. New and old parties need to take into account the possibility that Italy could face yet another financial crisis. The current strategy in Berlin is to immediately attach conditionality to any request for financial assistance. If Italy loses access to market financing, it will likely end up under an "assistance program" of the kind other peripheral countries have experienced.

We urge all Italian political parties to take due consideration of the need for fiscal stability and for good governance of the country through effective political institutions. In order to prevent a Greek scenario, where new vigorous political protagonists wound up in an agonizing negotiation with the Troika, a general national understanding should be built on the foundation of a commitment for long-term fiscal stability. In this respect, we suggest a kind of *compromesso storico,* limited to fiscal policy and aimed at stabilizing Italian public debt, without any impact on the future Italian governments' composition and without constraints or *mésalliance* on other fundamental political issues. Challenges to debt sustainability would in many ways be best addressed by sound macroeconomic policies. This should also be considered in the compromise. As we have already explained in a previous policy brief, Italy's risk-reduction endeavour needs to be framed in the context of European policies aimed at risk-sharing. Placing debt on a sustainable path would also create space for more effective countercyclical stabilization policies, while country-specific reforms would support the economy's potential growth, giving citizens a reason to trust their country and its leaders.