

POLICY BRIEF – JANUARY 18, 2017

ITALY'S RECENT SUPPORT TO ITS BANKS: THE START OF A NEW WAVE OF PUBLIC INTERVENTION IN THE EU

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- The banking crisis in Europe has three distinct waves. The first wave was pure financial contagion from the sub-prime crisis in the US to toxic assets held in European bank portfolios. The second wave was equally intense, occurring amid the negative feedback loop between banks and sovereigns.
- The third wave is the lagged impact of the economic crisis on the quality of loan portfolios, which has just triggered intervention by the Italian government and may require additional public money across the EU.
- The public funds injected recently is only a fraction of what was injected at the outset of the crisis. However, more than nine years since the sub-prime crisis started, it is striking that the EU is still facing banking problems.

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State aid for an “extraordinary event” in Italy

On 21 December 2016, the Italian Parliament authorised up to a 20 billion euro (1.2% of GDP) increase in the public sector borrowing limit to provide capital support to Italian banks, justified as a “precautionary” and “extraordinary event” that is “beyond the control of the State” and integral for preserving financial stability. As the Bank of Italy put it, this was perceived as a “necessary step since many Italian banks face a number of interrelated cyclical and structural challenges to sustainable profitability. This includes long-term macroeconomic headwinds such as low potential growth and low inflation, a flattening yield curve compressing margins, and weak diversification of business models that are highly reliant on the growth outlook.” Ironically, this does not sound like an “extraordinary event”.

On 23 December, the Italian government released its “Salva Risparmio” decree that creates a fund of up to 20 billion euro to support the banking sector. In particular, the allotted funds will provide capital and liquidity to troubled domestic financial institutions and protect retail savers. The initiative is designed to help Italian banks in need of additional capital and unable to raise it on their own. The capital injection will alleviate the problem for some weak banks and help the whole system achieve more stability.

Monte dei Paschi di Siena (MPS), the third-largest Italian bank, will be the first institution to benefit from public intervention. On 22 December, MPS announced it will not be able to complete its planned 5 billion euro capital increase by the year’s end, as requested by the European Central Bank (ECB) following the results of the July 2016 stress tests. As a result, MPS applied for extraordinary government financial support on 23 December. On 26 December, the bank announced that the ECB increased its capital request to 8.8 billion euro, which will come from the conversion of subordinated debt and a fresh capital injection by the government as part of the already approved 20 billion euro public support. This is the latest casualty of a European banking crisis that started in 2007 and has continued in different forms until today.

State aid granted during the crisis

Since 2007, the financial crisis has had a major impact on financial institutions across the EU. To reduce the adverse effects of the crisis and restore confidence, EU governments approved State aid to financial institutions in different forms: recapitalisations, impaired asset measures, guarantees, and other liquidity measures. For each category, the European Commission provided information on the maximum amount of aid EU Member States were allowed to grant (approved State aid) and the amount of aid actually implemented (used State aid). The amounts of the four types of measures cannot be summed as they are of different natures. In particular, the sum of recapitalisation and impaired asset measures depicts the actual amounts of funds authorised or injected to support the banking sector, while the authorised or used guarantees and other liquidity measures are contingent liabilities and depict the exposure to risk.

For the whole of the EU, the total amount of authorised recapitalisations reached 802.1 billion euro, and the amount actually used was 453.3 billion in 2008-2014, according to the State Aid Scoreboard of the European Commission. The amount of authorised impaired asset measures reached 603.3 billion and 188.5 billion were used. The sum of recapitalisation and impaired asset measures, i.e. crisis funds, gives a huge 1,405.4 billion authorised, i.e. 10.0% of 2014 EU GDP, and 641.8 billion used, i.e. 4.6% of 2014 EU GDP.

However, governments also used guarantees on liabilities and liquidity measures other than guarantees on liabilities, i.e. contingent measures. In the same period, the maximum outstanding amount of approved guarantees reached a whopping 3,249.0 billion or 23% of 2014 EU GDP, although only about a third was used, i.e. 1,188.1 billion, or 8.5% of 2014 EU GDP. Authorised liquidity measures reached a maximum of 229.7 billion, with 105.0 billion actually used. Summing the two types of contingent measures, the maximum exposure reached was almost 25% of 2014 EU GDP for authorised measures and 9.3% of 2014 EU GDP for actually used measures. See the Table 1 below for a summary.

Table 1: Total amount of State aid approved and used, EU-28 (2008-2014)

Aid instrument	Amounts of State aid approved		Amounts of State aid used	
	EUR billion	% of 2014 EU GDP	EUR billion	% 2014 EU GDP
Recapitalisations	802.1	5.7	453.3	3.2
Impaired asset measures	603.3	4.3	188.5	1.4
Guarantees on liabilities ⁽¹⁾	3249.0	23.3	1188.1	8.5
Liquidity measures, other than guarantees on liabilities ⁽¹⁾	229.7	1.6	105.0	0.8

⁽¹⁾ Maximum outstanding annual amounts during the period 2008-2014

These amounts depict State aid granted to financial institutions within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU). However, the banking sector received additional support that do not qualify as 'State aid' such as, for instance, capital injection into a State-owned bank. The amounts used for the State-owned Landesbank and Sparkasse interventions in Germany are not included in State aid statistics for that country.

Table 2: State Aid used in 2008-2014

Member State	Recapitalisations (sum)	% GDP	Impaired asset measures (sum)	% GDP	Guaranties (maximum ¹)	% GDP	Liquidity measures (maximum ¹)	% GDP
Belgium	20.8	5.2	21.8	5.4	46.8	13.4	0.0	0.0
Bulgaria	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Czech Republic	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Denmark	10.8	4.1	0.3	0.1	145.0	60.1	2.0	0.9
Germany	64.2	2.2	80.0	2.7	135.0	5.5	4.7	0.2
Estonia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ireland	62.8	32.5	2.6	1.3	284.3	167.5	0.9	0.5
Greece	40.8	23.0	0.0	0.0	62.3	32.6	6.9	3.1
Spain	61.9	6.0	32.9	3.2	72.0	6.9	19.3	1.8
France	25.0	1.2	1.2	0.1	92.7	4.8	0.0	0.0
Croatia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Italy	8.0	0.5	0.0	0.0	85.7	5.3	0.0	0.0
Cyprus	3.3	18.8	0.0	0.0	2.8	14.6	0.0	0.0
Latvia	0.5	2.3	0.4	1.7	0.5	2.9	1.0	5.2
Lithuania	0.3	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Luxembourg	2.6	5.3	0.0	0.0	3.8	8.1	0.1	0.4
Hungary	0.2	0.2	0.0	0.0	0.0	0.0	2.5	2.6
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Netherlands	23.0	3.5	5.0	0.8	40.9	6.5	30.4	4.9
Austria	11.8	3.6	0.5	0.2	19.3	6.6	0.0	0.0
Poland	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Portugal	12.7	7.4	3.1	1.8	16.6	9.9	3.8	2.1
Romania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Slovenia	3.6	9.6	0.3	0.7	2.2	5.9	0.0	0.0
Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Finland	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0
Sweden	0.8	0.2	0.0	0.0	19.9	5.4	0.0	0.0
United Kingdom	100.1	4.4	40.4	1.8	158.2	9.3	33.3	1.8
Total	453.3	3.2	188.5	1.4	1188.1	8.5	105.0	0.8

Note: (1) Maximum outstanding annual amounts during the period 2008-2014, % of GDP refers to the relevant year; the total for the EU refers to 2014 GDP.

Source: Our calculations based on European Commission's State Aid Scoreboard and Ameco databases.

Moving on to individual countries—the country that used recapitalisation funds the most over 2008-2014 was the United Kingdom (100.1 billion euro), with Germany coming in highest for impaired asset measures (80.0 billion). Summing the actual amounts used of these two instruments of State aid, Germany was the country that most extensively intervened to support its financial sector during the crisis, for a total of 144.1 billion euro or 4.8% of its GDP. On top of this, there was a sizeable exposure through guarantees (135.0 billion in 2009) and liquidity measures (4.7 billion in 2010). However, in percentage of German GDP, these figures are relatively small (about 5.3%). The country that used guarantees the most was Ireland for a maximum exposure of 284.3 billion in 2009, i.e. a monstrous 167.5% of GDP, with the UK on its heels at 158.2 billion in 2009 (9.3% of GDP). Liquidity measures other than guarantees on liabilities were mostly used in the Netherlands for a maximum exposure of 30.4 billion euro in 2009 (4.9% of GDP).

Banks directly exposed to assets that became impaired following the sub-prime crisis in the US experienced major problems at the beginning of the crisis, i.e. in 2008, 2009, and 2010. The most exposed countries that injected public money at the outset of the financial crisis were Germany, the UK, Ireland, Belgium, the Netherlands, Denmark, Luxembourg, Austria, and, to a lesser extent, France. In 2008-2010, Germany spent 139.2 billion in crisis-related State aid

funds for financial institutions, 134.1 billion the UK, 48.9 billion Ireland, 25.6 billion Belgium, 23.9 billion the Netherlands, 23.7 billion France, 7.8 billion Austria, and 2.6 billion Luxembourg. Germany and the UK accounted for almost 62% of crisis-related State aid funds spent in the first three years of the crisis in the EU. This does not include support to State-owned financial institutions, which account for a very large share of the banking sector in Germany.

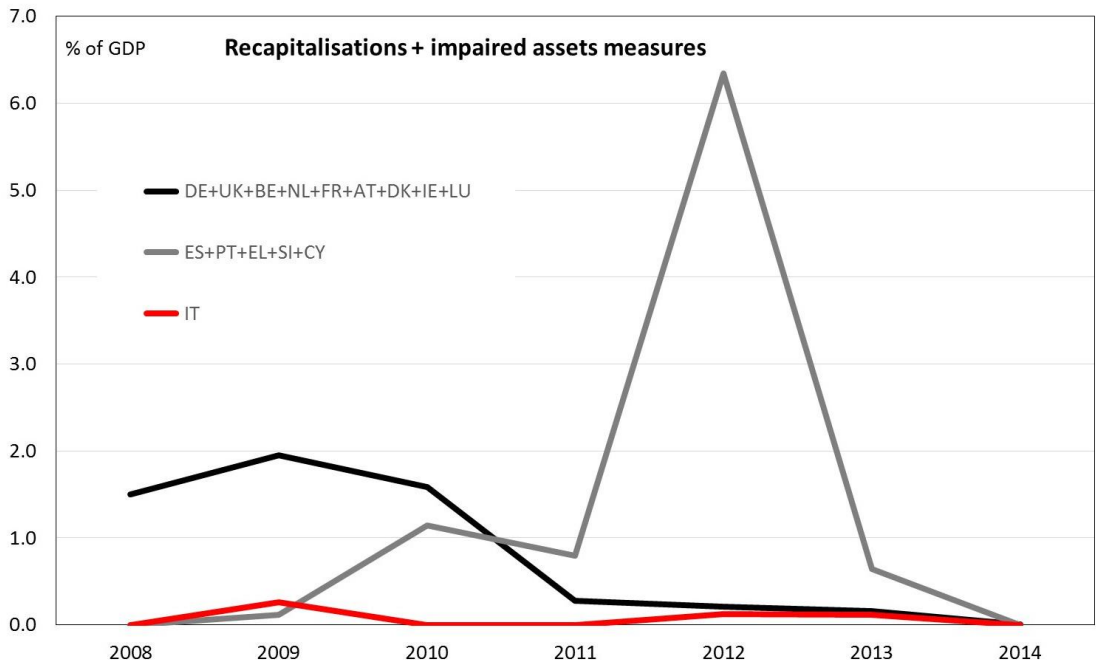
Summing up crisis funds (recapitalisations and impaired assets) for all the nine mentioned countries, we reach almost 92% of State aid actually used in the EU in 2008-2010. Spending in France was limited to recapitalisation and to the initial years of the crisis, i.e. 2008-2009. The same holds true for Belgium and the Netherlands (although more sizeable as a percentage of GDP). The crisis was massive as a percentage of GDP in Ireland, and it lasted longer (there was also a public capital injection in 2011). During the first phase of the crisis (2008-2010), aid spending was very limited in Italy (4.1 billion in loans, mostly for Monte Paschi in 2009), Spain (13.7 billion), Portugal (3.1 billion), Greece (3.8 billion), Slovenia (0.0 billion), and Cyprus (0.0 billion).

Stylised evidence suggests that the global financial crisis immediately affected banks in the first group of countries, and the countries recognised the problem and reacted swiftly by injecting public money. In Ireland, this happened with some delay, with the major capital injection only happening in 2010, also courtesy of substantial European support. Irish State aid may be regarded as a lagged reaction to the first wave of the crisis. Since 2010, public money injection declined sharply. Moreover, sharply rising public deficit and debt were a result of the banking crisis rather than the other way around. Therefore, we consider Ireland in the first group of countries.

Spain suffered from the crisis since the very beginning. However, the response was delayed and the major problems started with the negative feedback loop between the sovereign and the banks. Public money injection only peaked in 2012. Therefore, we consider Spain as part of the second group of countries or the second wave of government intervention linked to the government debt crisis.

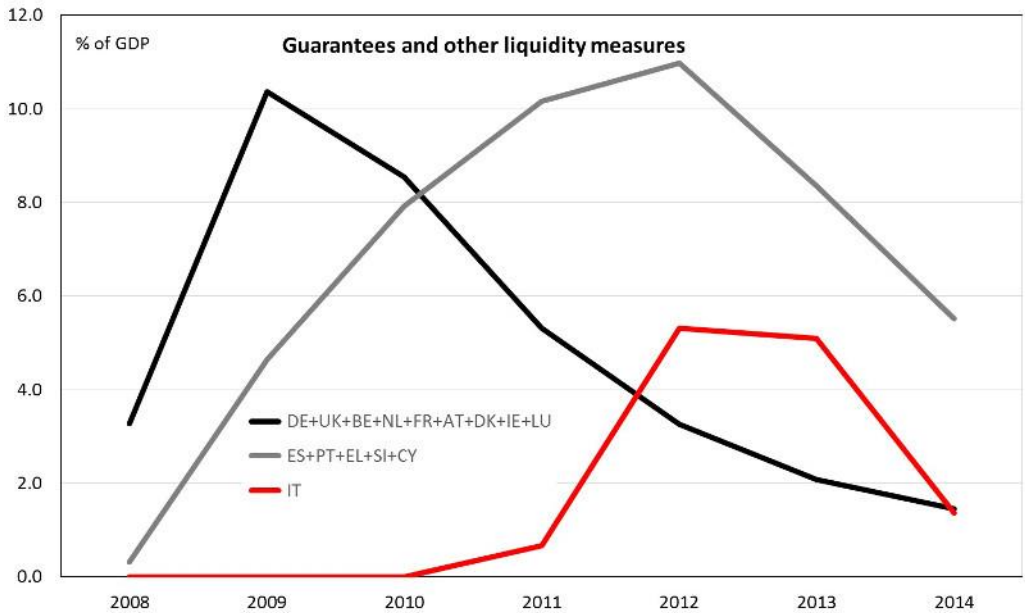
The first group of countries also massively intervened with contingent measures. The sum of guarantees on liabilities and other liquidity measures other than guarantees peaked in 2009 to 807.5 billion, i.e. 10.4% of their GDP and 89.1% of the total amount used in the EU.

Figure 1: State Aid funds used in 2008-2014



Source: Own calculations based on the European Commission's State Aid Scoreboard and Ameco. Aggregated figures are weighted by countries' GDP.

Figure 2: State Aid contingency measures in 2008-2014



Source: Own calculations based on the European Commission's State Aid Scoreboard and Ameco. Aggregated figures are weighted by countries' GDP.

The government bond crisis affected banks in peripheral European countries in three main ways: (1) a liquidity squeeze (disappearance of liquidity and activity in interbank markets, needed for the financing gap), (2) losses in the portfolios of assets, and (3) negative economic feedback on the loan portfolios. The government debt crisis started in 2010 and affected Greece, Spain, Portugal, Slovenia, Cyprus, and Italy. We exclude Ireland for the reasons previously mentioned and we isolate Italy as it behaved differently. In fact, since the outbreak of the government debt crisis, peripheral countries (ES, PT, SI, CY) injected plenty of government capital into their banking sectors. Crisis State aid funds used amounted to 146.4 billion between 2010 and 2013, i.e. 10.0% of their GDP. In 2012, as a percentage of GDP, there was a spike due to public interventions in Spain and Greece (Figure 1).

Meanwhile, contingent measures also steadily increased in peripheral countries and declined in core countries. Peripheral countries started very late in providing contingent support to the banking sector and the maximum exposure was only reached in 2012.

Italy was late in recognising the problem, either overly confident about the ability of banks to withstand the crisis or overly worried about the negative sovereign-banks feedback loop. As a matter of fact, intervention was very limited and effectively restricted to loans to Monte Paschi and a few other banks. In 2012, guarantees skyrocketed but the government mostly used them to guarantee an interbank institution (Confidi), which in turn provided partial guarantees for bank loans to SMEs. It peaked to 85.7 billion, i.e. 5.3% of Italy's GDP in 2012.

What was the impact on government deficit and debt?

State aid data do not represent the actual cost for public finances resulting from public intervention in favour of financial institutions. For instance, recapitalisation data show the gross amount of funds injected into the banking sector. However, some funds provided to financial institutions during the crisis have already been re-paid, some banks have been re-privatised, and some loans have been reimbursed. Data on impaired asset measures show the amounts of aid calculated as the transfer value minus the market value, and the unwinding of impaired asset measures is not taken into account. In other words, State aid data depict the gross, rather than net, injected amount. Moreover, the overall exposures to guarantees or “contingent liabilities” represent risk but not actual cost. It becomes a cost if the guarantees are called, which only happened for a small fraction of them.

To see the fiscal impacts of government intervention on government deficit and debt, we need to look at Eurostat data, which show the fiscal impact of public support measures. Recapitalisation measures and impaired asset measures are split into an expenditure component (the part of the transaction that is written off immediately) that is reported in flows and impact government deficit/surplus, and an investment component that has no impact on the deficit/surplus and is only reflected as an addition to the stock of financial assets. Eurostat data include flows and the stock of liabilities include an imputed component related to the government's cost of borrowing.

The case of capital injection into state-owned banks mentioned above does not give rise to State aid, but it does affect debt and, potentially, deficit/surplus figures. The increase in assets is recorded, but it does not contribute to reducing government debt (according to Maastricht criteria, debt is recorded on a gross basis). Overall, Eurostat data are more comprehensive as measures of the economic and financial impact of government intervention since State aid figures serve a different purpose.

In 2015, the database's latest available year, the increase in deficit was particularly large in Greece (4.1% of GDP), mainly due to past recapitalisation of the National Bank of Greece and Piraeus Bank. The second most significant impact on the deficit was recorded in Portugal (1.6% of GDP) in the context of the Banco Internacional do Funchal S.A. resolution operation. Slovenia followed with 1.4% of GDP, where the impact was mostly due to loan write-off operations and conversions into real estate and equity carried out by BAMC (a bad bank classified inside the government).

Then, there was the Cyprus case for 0.9% of GDP. Ireland used 0.7% of GDP for the recapitalisation of the Cooperative Central Bank and Austria 0.6% of GDP for the nationalisation of Hypo-Alpe-Adria-Bank International AG. Over 2008-2015, the most sizeable impact on the deficit as a percentage of GDP was recorded in Ireland in 2010 (21.3%), Greece in 2013 (10.8% of GDP), Slovenia in 2013 (10.2%), and Cyprus in 2014 (8.5%). In cumulative terms, Ireland recorded an impact on the deficit of 27.4% of GDP.

In the period 2008-2014, the worsening of deficit figures was much smaller than the total amount of State aid actually used, meaning that a number of interventions were considered as 'investment' and thus only affected debt figures (liabilities) and asset positions in 2008-2015. In a few countries (Denmark, France, Luxemburg, Hungary, and Sweden), the cumulative impact on deficit/surplus figures was positive due to fees on guarantees granted to financial institutions, property income (interests and dividends) received from financial instruments acquired by governments, and other revenues such as specific capital taxes.

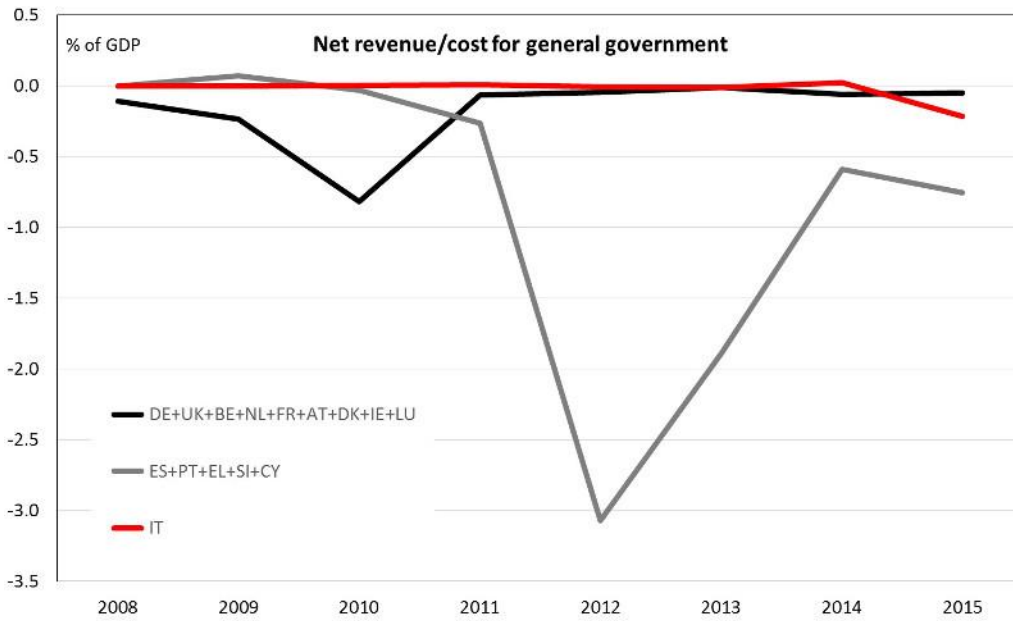
The cumulative negative impact on deficit/surplus was 114.0 billion for the first group of countries and 94.7 billion for the second group; for Italy, it was 3.2 billion. As a percentage of the relevant GDP, the impact was negative for 1.4%, 6.5% ,and 0.2% respectively.

The total impact on government debt for the EU reached a maximum of 765.1 billion in 2012 (4.3% of GDP). For the first groups of countries (DE, UK, BE, NL, FR, AT, DK, IE, and LU), the maximum impact of debt was recorded in 2010 at 584.9 billion (7.2% of their GDP). For the second group (ES, PT, EL, SI, and CY), the maximum impact was recorded in 2015 at 127.7 billion (8.6% of their GDP). For Italy, the peak was reached in 2013 at 4.1 billion (0.3% of GDP). It should be stressed that the first group accounted for 66.6% of EU GDP in 2015, while the second group only accounted for 10.1% and Italy for 11.2%.

Interestingly, the impact of general government debt peaked in 2010 for the first group of countries and has since then declined; for the second group, it has increased throughout the period. Moreover, for the first group of countries, the amount of assets was close to that of liabilities at the beginning of the crisis. The gap widened in 2010 and has remained broadly stable ever since, suggesting moderate losses on the 'investment' in the financial sector. For the second group of countries, the gap has continued to widen since 2011, suggesting significant losses on the 'investment' made by the governments. In 2015, the outstanding amounts of liabilities and assets related to government intervention were 8.6% and 2.0% of GDP, respectively (Figure 4).

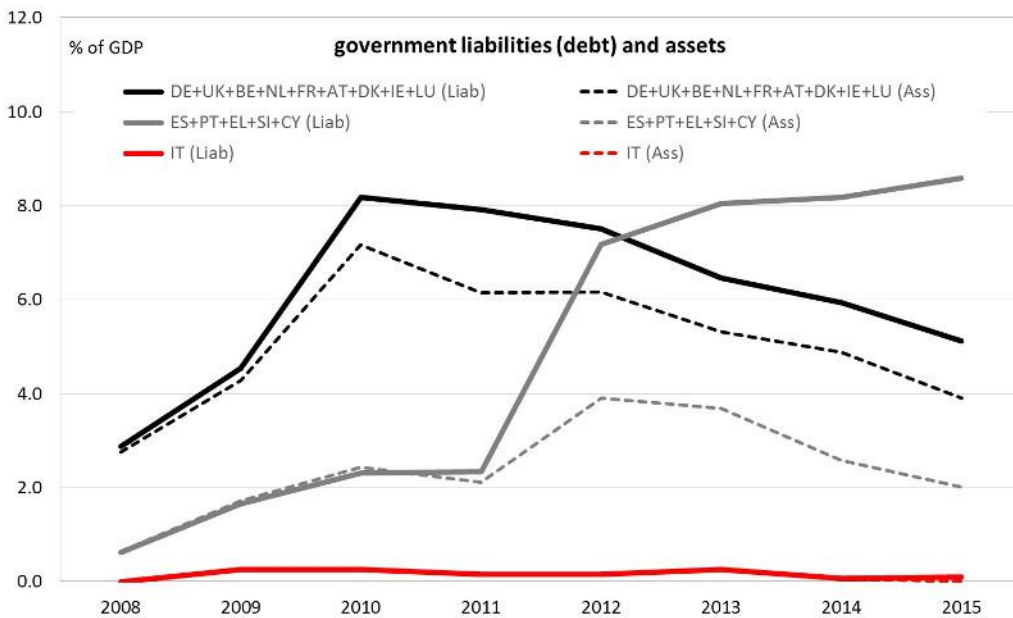
The widening gap is explained by loan write-off and conversion into real estate and equity (Slovenia), a fall in the market value of bank shares held by governments (Greece), or redemption and conversion of preferred bank shares (Ireland). In all cases, it is an effective loss for the governments according to market valuations.

Figure 3: Impact on general government net borrowing requirement

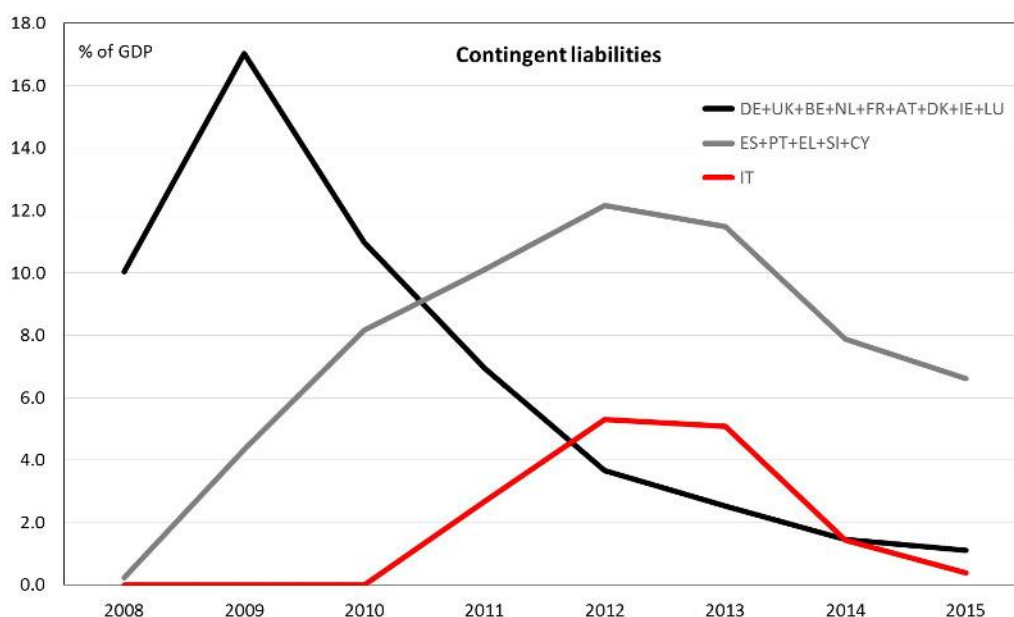


Source: Own calculations based on the Eurostat and Ameco data. Aggregated figures are weighted by countries' GDP.

Figure 4: Impact on general government debt



Source: Own calculations based on the Eurostat and Ameco data. Aggregated figures are weighted by countries' GDP.

Figure 5: Contingency liabilities

Source: Own calculations based on the Eurostat and Ameco data. Aggregated figures are weighted by countries' GDP.

The banking crisis has not yet come to an end

While the first two factors that affected peripheral countries since the debt crisis (a liquidity squeeze and losses in the portfolios of assets) were immediate, the negative economic feedback on the loan portfolios is a creeping slow-moving phenomenon, which may eventually force a new wave of government intervention.

Table 3 shows the stock of non-performing loans in EU countries. While, in some countries, courtesy of a decent economic recovery, the stock has moved back to low levels as a percentage of the country's GDP, it remains very high in others.

With the MPS intervention, Italy is the latest European country to use State aid for banks. As State aid is no longer allowed by European rules, it used Art.32 of the Bank Restructuring and Resolution Directive (BRRD) to circumvent bail-in and inject what is called "precautionary recapitalisation" to preserve financial stability.

It is not clear whether the 20 billion allotted by Italy for intervention in the banking sector will be enough. The non-performing exposure (bad debt, likely defaults, non-performing past due loans/exposures) amounted to 356 billion and net provisioning to 191 billion in the second quarter of 2016. In the third quarter, they declined to 328 billion or 16.5% of total loans, almost 20% of GDP. Bad loans were 199.1 billion in November 2016 and net provisions 85.2 billion. Banks are working on their positions, writing off loans or selling portfolios where there is enough capital leeway, but the stock remains high.

There is a chance, however, that this extra help from the government, by avoiding financial stability risks, puts in motion a virtuous cycle through which stronger valuations in financial markets could attract more investors, with the economic recovery and the recovery in real estate prices speeding up the reduction in the stock of NPLs. In other countries, it is less likely

that banks will be able to steadily reduce their stock without government intervention. As a result, the recent intervention in Italy may well be the start of a third wave of government intervention in the countries most exposed to non-performing loans, with an increasingly lower probability that the injections of capital will produce positive returns over time.

Table 3: Non-performing loans to total gross loans and advances.

	Dec-15	Mar-16	Jun-16	Sep-16
Austria	6.9	6.5	6.0	4.8
Belgium	3.9	3.7	3.6	3.4
Bulgaria	13.7	13.7	13.7	13.2
Cyprus	48.9	48.5	47.4	46.7
Czech Republic	3.3	3.0	2.7	2.5
Germany	3.0	2.9	2.7	2.6
Denmark	3.6	3.6	3.4	3.2
Spain	6.3	6.3	6.0	5.9
Finland	1.6	1.5	1.6	1.6
France	4.0	4.0	3.9	3.9
United Kingdom	2.4	2.3	2.2	2.2
Greece	46.2	46.6	46.9	47.1
Croatia	12.5	12.5	10.8	10.5
Hungary	14.0	13.8	13.9	12.8
Ireland	17.8	15.1	14.6	14.4
Italy	16.8	16.6	16.4	16.4
Lithuania	5.1	4.9	4.5	4.1
Luxembourg	1.2	1.2	1.1	1.2
Latvia	4.0	3.9	3.5	3.6
Netherlands	2.8	2.7	2.7	2.6
Poland	6.8	6.9	6.8	6.5
Portugal	19.6	19.8	20.1	19.8
Romania	14.6	14.5	12.1	10.7
Sweden	1.2	1.1	1.1	1.0
Slovakia	5.2	5.0	4.8	4.6
Estonia	NA (*)	1.6	1.5	1.4
Slovenia	21.5	19.7	19.2	16.3
Malta	6.2	6.8	5.4	4.6
Europe	5.7	5.6	5.5	5.4

Source: EBA - Risk Dashboard data as of Q3 2016.

* Data before Q1 2016 is not disclosed because it was reported for less than three institutions

Conclusions: a stylised look at the three waves of the crisis

Having addressed banking problems in earnest was a plus for the countries that did it. The first massive intervention happened right after the shock in financial markets induced by the US sub-prime crisis. With the exception of contingent liabilities, interventions were both deficit and debt increasing. Impaired assets resulted in substantial capital needs to address the losses, and this was done more or less swiftly in 2008-2009 and affected mainly Germany,

the UK, Ireland, Belgium, the Netherlands, Denmark, Luxembourg, Austria, and, to a lesser extent, France. Government intervention to support the banking sector in the initial stage of the crisis was truly massive, but it seems to have resulted in a somewhat smaller economic impact and a quicker recovery in credit.

The second wave of banking problems started with the Greek crisis and affected State aid, deficits, and debt, mostly from 2011 onwards. This second wave again triggered massive public intervention and resulted in an ESM programme for the Spanish government to support the banks. In parallel, European leaders said “never again” and wanted to break the link between banks and sovereigns. This led to the re-introduction of State aid rules in the summer of 2013 and then the introduction on the Bank Resolution and Restructuring Directive (BRRD), which became effective in January 2016.

The second wave of government intervention was much smaller in absolute terms but massive relative to the GDP of the affected countries. Intervention was severely constrained by deteriorated public finances and the negative feedback loop between sovereigns and the banks to the point that, in the case of Spain, European money became necessary.

Since then, the attitude has changed and the European framework moved in the direction of forcing investors and depositors to pay for any future crisis. In the meantime, however, policymakers did not recognise the creeping deterioration in non-performing loans and their effect on lending and the broader economy promptly enough, and the possibility of intervention became much more limited.

As a result, the situation continued to deteriorate up until today’s crisis in Italy, which may be the start of a third wave of government intervention in the EU. It mainly relates to the leftovers of the previous crisis and the lagged impact on non-performing loans. Luckily enough, the economy has improved in the meantime and banks have worked out their own solutions as well. Today’s banking problems in Italy are manageable and are likely to require substantially less public money than in the past in other countries. However, the stock of non-performing loans is much higher in other peripheral countries and, thus, more casualties are expected during the course of 2017.