European macro outlook: Italy

Published 19 July 2017

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Elections risks and vulnerable banks to pressure the Euro

Italy's failure to pass a new electoral law last year means it must now hold elections during a period when the 2018 budget must be approved. This presents a risk to political stability. Unless Italy gets budgetary flexibility and is allowed more leeway for deficit spending from the EU, the budget is unlikely to get sufficient parliamentary backing. The instability this creates politically provokes renewed speculative attacks on Italian sovereigns and bank stocks. Italy's fragile government and banking sector means the President and head of state Sergio Mattarella —who has the sole power to dissolve parliament—will not risk elections to take place without a budget signed off first. Given the high stakes, it may mean elections get pushed back to 2018. The Eurosceptic 5 Star Movement, despite having suffered several setbacks in recent local elections, continues to poll strongly nationally and is neck-on-neck with the centre-left Democratic Party.

Italy's banking sector is also not out of the woods. Stability has been fostered through an orchestrated effort by the Italian government and the ECB to promote bank restructuring and consolidation. For instance, in 2016 struggling Banca Popolare di Milano and Banca Popolare merged into Banco BPM, now Italy's fifth largest bank by assets, to cut costs and restore profitability. Unicredit, Italy's largest lender pre-empted a fallout from the banking sector's bad loans crisis by raising EUR 13 billion in capital and hiving off its Polish operations to bolster its balance sheet.

Problems persist with Italy's third largest lender, however. Banca Monte dei Paschi di Siena (BMPS) received a bailout after the Italian government won a hard-earned exception to take advantage of a provision in EU bank rescue rules that would allow the use of public funds if it addresses the bank's capital shortfalls and restores the bank's long-term health "aka a precautionary recapitalisation". Through a EUR 4.3 billion debt for equity conversion, and the Italian Treasury paying EUR 2 billion in compensation to subordinated bond holders while also pledging EUR 9 billion of fresh capital injection into BMPS, retail investors were largely shielded from having to take otherwise significant losses, as is now required by the newly introduced EU bank rescue rules. It helped avert a political crisis at a time when—following PM Renzi's resignation last year when in a referendum Italians rejected his constitutional reform bill—the government was significantly weakened. But the precautionary recapitalisation deal is leaving BMPS poorly capitalised to absorb potential further loan losses and write downs. Some EUR 29 billion of asset securitisations are planned to help BMPS divest its bad loans portfolios. But unless BMPs attracts more funding, it's going to struggle to offer the securitised loans at a deep enough discount to lure private investors to the fore.

Hence, the ECB and the European Commission will continue to rely on Europe's largest lenders to pick up the tabs, as evident by the recent rescue of Spain's Banca Popular by Santander. While the deal was completed swiftly and considered - so far - a success, the Italian government is having to blush new fires in the banking sector with increased difficulty. European authorities have ruled out precautionary recapitalisations for Veneto Banca and Banca Popolare di Vicenza, two regional lenders with their own self-inflicted balance sheet problems. Some EUR 5 billion of equity is needed for sufficient recapitalisation and with no interest coming from private investors, the Italian government has heavily relied on Intesa Sanpaolo—Italy's second largest lender by assets and amongst Italy's healthiest—to step in.

Vulnerable Italian banks to prolong ECB QE stimulus

The fragility of Italy's banking system and the importance of stabilising it cannot be overstated. With limited fiscal means to do provide liquidity and capital support given the constraints imposed by the European Commission, the onus remains on the ECB to continue to provide it. Expect the term facilities to obtain liquidity on the cheap to remain widely available. It is the only means for Italian banks to recycle bad loans at a low cost and take advantage of better margins in the trading book. Mutations of the asset side of Italian bank balance sheets show this risk-aversive behaviour in the unabated purchases of government debt since the end of the financial crisis and in the marked pick up in interbank lending since 2016, the latter largely due to an orchestrated effort by the government and large lenders to support the weak local lenders. In contrast, willingness by the banks to assume more credit risk is resisted, with loans extended to the private sector stagnant, and in the process undermining the recovery in the real economy.

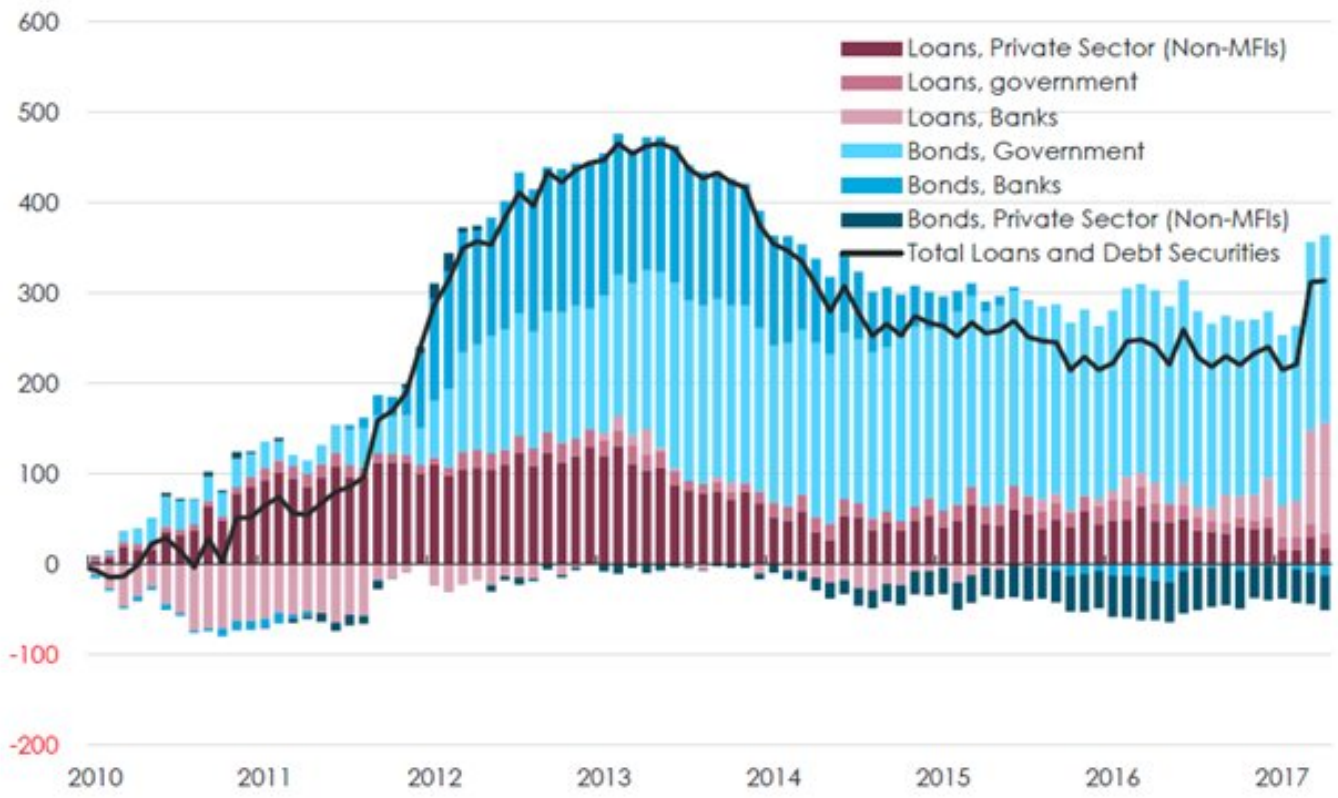
Given the risk averse behaviour by Italian banks and the systemic risks to remain at large, the ECB will do what it can to accommodate and allow QE to be prolonged. Near term the ECB will aim to buy time and choose to adopt dovish rhetoric until clarity emerges over Italy's new government, the budget and the restructuring of banks' bad loans. The weakening of initial high inflationary pressures stemming from food and energy imports, coupled with the Fed tightening that is pressuring bond markets in Europe, will work in the ECB's favour to continue justifying the merits of the QE programme.

Borrowing costs, for the sake of the budget and Italian banks' trading book must stay suppressed to preserve political stability and contain systemic risks. Failing to do so will provoke speculative attacks on Italian sovereigns and the banks of not just Italy, but potentially also of other Eurozone members. For instance, according to the BIS, which sizes bank counterparty claims globally, Q4 2016 data show French banks in particular looking exposed, with claims on Italy worth an estimated $278 billion, or nearly 60% of total EU claims on Italy. Such market tensions will also reverberate negatively on the euro. Even if proven unfounded or short lived, approaching election day there will give is plenty of ammunition for speculators to raise their bets and heightening volatility of the euro. For instance, based on BIS (Bank of International Settlements) data on bank counterparty claims for Q4 2016, French banks in particular look exposed, with claims on Italy worth an estimated $278 billion, which is nearly 60% of total EU claims on Italy.

Chart 1: Italian banks shun risk-taking:

BTPs and interbank lending drive the balance sheet, not private sector loans

Cumulative asset flows in EUR billion



Source: WisdomTree, ECB.

[1] Effectively this means no bailouts without bail-ins first, in an effortto reduce the bill for tax payers.

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