Global Political Drivers

EUROPEAN FIGHT CLUB

Christopher Granville/ Constantine Fraser

- **Politics is the decisive factor that keeps the Eurozone on its twentieth birthday stuck in a turbulent, crisis-prone adolescence.**
- **The heart of the problem is depressingly familiar: Italy's inability to grow while it remains in a monetary union with Germany under present arrangements, while the core political driver stemming from that dismal reality is that the Italian public's patience has snapped.**
- **At the same time, public support for the Euro is recovering even in Italy. Italy's political leaders will seek to make the Eurozone operate in a congenial way – in the sense of ensuring demand for Italian government bonds.**
- **Their efforts will focus now on alliances with like-minded politicians across Europe in the run-up to the European parliamentary election in May, in which they will not defeat mainstream political forces but still build considerable influence.**
- **Meanwhile, the Eurozone roof has not been fixed while the sun still shined: the Macron-backed reform initiatives had faltered even before the recent depletion of his political capital, while the CDU leadership election in Germany signifies passive continuity.**
- **With the ECB remaining as sole fire-fighter, this year's leadership rotation in the EU institutions matters mainly for the read-across to the crucial ECB appointment.**
- **The next Italy-centred Eurozone crisis will hinge on a game of chicken between Italy and the EZ authorities over ECB purchases of BTPs.**
- **The ECB has the means and, ultimately, the political cover to deal with the next crisis, but markets will still have to price in the preceding game of chicken and its collateral damage – especially to banks.**

Italy vs EA rules

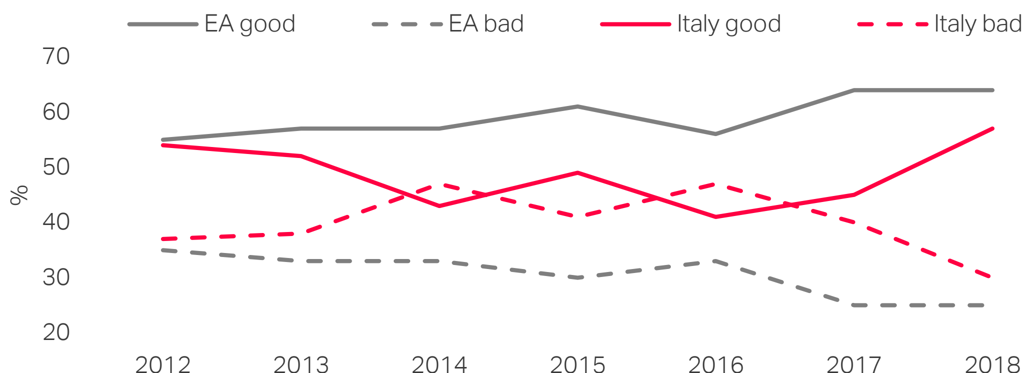
We look ahead to the politics of the next Eurozone crisis. Last week's twentieth anniversary of the launch of the Euro has produced much commentary on the lessons of the boom-bust experience of the first two decades of this monetary union. The coincidence of this anniversary with the EA's sharp growth slowdown, as now underlined by the latest data points on contracting industrial outlook, prompts a more forward-looking view to the next Eurozone crisis with a focus on the political factors that will shape the handling of the crisis and hence its outcome.

The prospect of a new Eurozone crisis remains firmly centred on Italy. Market tensions over Italy's budget plans subsided last month, after the new Italian government opted for a face-saving compromise with the EU Commission based on a commitment to reduce the planned headline budget deficit by raising more privatization revenues. Questions about the credibility of that plan were outweighed by the advantages for all concerned of veering away from confrontation. Since then, however, the focus has shifted back from Italian fiscal policy to the related problems of the Italian banking system through the case of the teetering Banca Carige, the country's tenth largest bank by assets. After the ECB's intervention on 2 January, the Italian government declared this week its intention to stage a state-financed rescue of the bank.

As on the fiscal side, Rome's plan for Carige flies in the face of EA rules – or, to be more precise, the principles that underpin the EA banking union. In this case, this is the principle enshrined in 2014's BRRD of making unsecured bondholders share some of the cost of recapitalizing failing banks. Italy's political leaders retort that others – very much including the EA's core countries, Germany and France – routinely get away with non-compliance or, in the case of the banks, completed state bail-outs before the introduction of new bail-in rules.

Political discontent in Italy still spells systemic market risks. Italy will continue to campaign for existing rules to be abandoned or ignored or changed. Italy's economic weight – and, more specifically, outsized public debt relative to output – ensures permanent tensions in the Eurozone. In the near-certain event of rising economic and financial stress, let alone shocks, this spells systemic risks affecting global markets. While the political driver of this threat is clear enough, it should be kept firmly in view especially as blow-by-blow media coverage of particular situations (such as Carige this week) tends to obscure it. This driver is the discontent of the Italian public in the face of declining living standards that resulted last year in the anti-establishment challenger parties – the Five Star Movement (M5S) and Lega, led by Luigi di Maio and Matteo Salvini – forming a government.

Chart 1: Is having the euro a good or bad thing for the EA/your country?

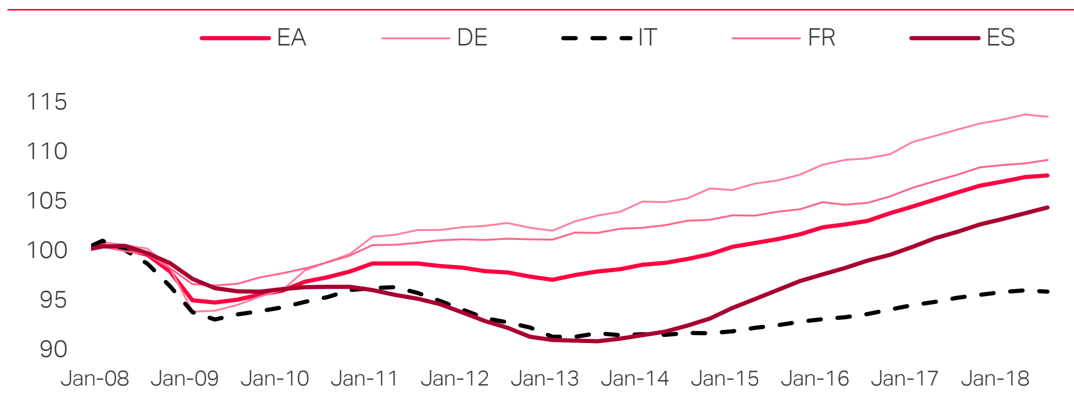


Source: Eurobarometer, TS Lombard

Support for a euro exit remains limited. Neither of those coalition partners came to power on a pledge to take Italy out of the monetary union. While M5S had only ever flirted ambiguously with idea, in the Lega's case Salvini abandoned a clear 'Italexit' pledge six months before the March 2018 election. His French political counterpart as leader of the populist right, Marine Le Pen, did likewise at a late stage in her bid for the presidency in 2017. The lesson is that even protest voters fear the effects of a Euro break up. Such fears are reflected in the latest annual Eurobarometer poll findings (from last November) on public attitudes to the Euro. The highlights of this survey shown in the chart above are a recovery in public approval of the single currency, including even in Italy – albeit from a lower base, since many more Italians than other EA publics attribute economic failure to the existence of the Euro.

But Italy's chronic economic problems remain, and the political mood is angry. This brings us to the root cause of the whole problem: economic failure, and the resulting chronic and dangerous weakness of the public finances and banking system. These spurs of the general Euro crisis at the start of this decade remain alive and well in present-day Italy. An important difference now is that the political reactions have crystallized. As noted, the majority mood among Italian voters amounts to saying "we can't go on like this". The economic recovery of 2016-18 was too mediocre to shift this mood. Far from outperforming the wider EA growth average thanks to some bounce-back from a lower base, Italy's recent growth lagged others and real output remains lower than on the eve of the global financial crisis (Chart 2 below).

Chart 2: Just not growing
Real GDP, 2007Q4=100



Source: Eurostat, TS Lombard

To satisfy its supporters, the Italian government must therefore push for growth and shield the public from further hardship. This has to involve challenging the way the Eurozone works while not appearing to have precipitated a crisis, starting with a sustained blow-out in the BTP-bund spread with all its negative ramifications up to and including the effects of a perceived threat of Italy crashing out of the monetary union. These political imperatives explain the compromise with the European Commission over the budget.

This time, both sides had political motives to compromise. The general political motive for this truce also had a specific component to do with next May's European parliament elections. Salvini in particular aims to use this election to translate the Lega's growing popularity into increased political clout – not only domestically but also for the purpose of shaking things up at the European level in alliance with like-minded political forces from across the continent. Coming from the opposite starting point, the Commission had a similar motive to compromise. The economic and political effects of a confrontation with Italy in the formal guise of an "Excess

Deficit Procedure" risked inflaming Eurosceptic opinion in Italy and more widely ahead of the parliamentary election.

All change in Brussels

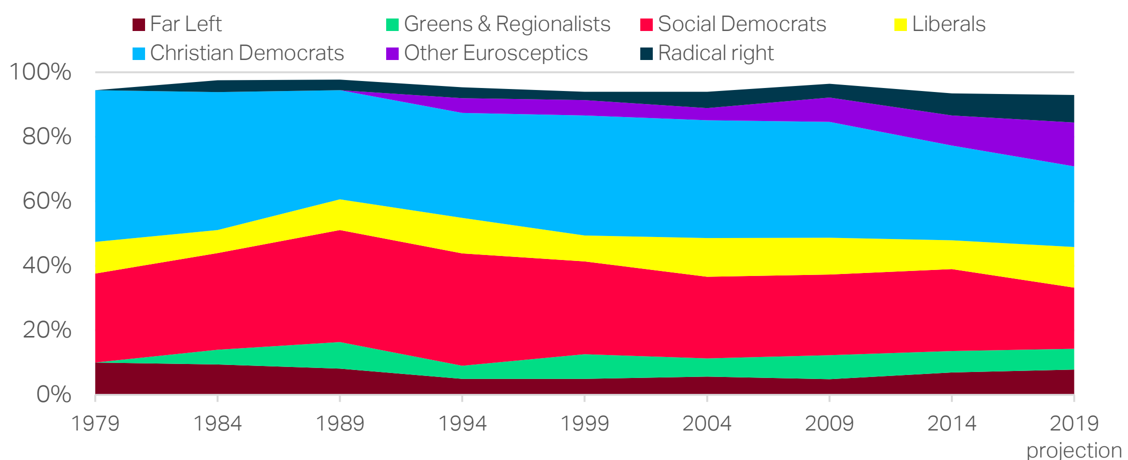
Salvini has mused in public about an EU-wide anti-establishment alliance winning control of the European parliament. He and his allies could then use the powers of the parliament that have been steadily enhanced in the past decade to press on the Commission to act in the ways they want. This agenda might include easier enforcement of the Fiscal Compact and harder enforcement (or rather enforcement for the first time) of the Macroeconomic Imbalances rules against Germany in particular, in the light of its chronic current account surpluses in excess of the 6% of GDP threshold defined in those rules.

2019 will also see the EU's leadership in Brussels comprehensively overhauled – but Salvini's dream will not come to pass. The main set-piece here will be the European Parliament elections, which will take place between 23-26 May (depending on the country). Assuming Brexit has indeed taken place by then, 705 MEPs will be elected across the 27 remaining member states. And for the first time, this election looks set to be properly "European" – defined as never before not by national issues, nor even by generic anti-European protest votes, but by genuinely different visions of the EU, on a spectrum from Macron to Salvini. The paradox of the single currency is that the stakes are so high that even its critics have been forced to take their politics to Brussels.

Insurgent parties will gain vote share, but mainstream forces will retain a comfortable majority. The headline result is not really in doubt: insurgent parties of all stripes will substantially increase their share of the vote, as Europe's traditional, Cold War-era party system continues to break down (Chart 3 below). Moreover, the centre-right EPP and the centre-left S&D groups will probably lose their combined majority. But mainstream parties will still win considerably more than half of the seats; and rather than collapse, the "grand coalition" will simply have to expand to bring in more parties – likely the liberal ALDE group, which is well-represented among heads of government in the European Council and which has established close relations with Macron's LREM party.

Chart 3: Mainstream majority holds, but anti-establishment forces strengthen

European Parliament makeup, by political family



Source: TS Lombard, Politico.eu projection for 2019

The process for choosing the next Commission is still up in the air. What is still unclear is how this will affect the next Commission, and particularly the choice of Commission President to replace Jean-Claude Juncker. Formally, the two big groups are committed to the *Spitzenkandidat* or "lead candidate" system, whereby they only will give their backing in the confidence vote in the EP to the lead candidate of the largest group.

But this is increasingly felt to be little more than an EPP stitch-up, a problem compounded by the total opacity of the internal process by which the EPP has chosen as its lead candidate the uninspiring Bavarian conservative Manfred Weber. His track record of making excuses for the increasingly authoritarian Hungarian government in particular will make it hard for him to gather the ALDE support he would need. That leaves the *Spitzenkandidat* system all but redundant, and the shape of the next Commission entirely up in the air.

Ultimately, the Commission presidency will probably come down to wrangling in the European Council. Macron thinks the dogged Danish Competition Commissioner Margrethe Vestager would make a good candidate for the presidency – hardly a prospect that will go down well in Washington or Silicon Valley. Berlin wants a German in the top job; Italy wants to secure an economics portfolio, and more generally a Commission which will police German macroeconomic imbalances with the same determination as Italian ones (spoiler: that won't happen). After a lot of arguing, a less right-wing, more liberal EPP figure may yet end up being the compromise candidate. Step forward, Michel Barnier?

Its most important consequence may well be for the ECB appointments process. One way or another, the Commission president will be a mainstream figure – there are no surprises in store there. But at the same time, the European Council will have to make a distinctly more fraught appointment: that of Mario Draghi's replacement as President of the ECB. In our detailed survey of the forthcoming appointments at the central bank published last October, we concluded that the identity of the President will be crucial in the institution having both the instincts and the clout it will need to steer the Eurozone through the next crisis.

But given the "cattle market" nature of European appointments, the question of who gets the top job in Frankfurt will be closely tied to that of the top job in Brussels. A German-run Commission would be odds-on for a French ECB – meaning that the Bank of France governor Villeroy de Galhau would take over form Draghi. But if Macron installs Vestager or Barnier, Berlin may be inclined to push for a northern European in Frankfurt. That could mean the Finn Erkki Liikanen, or even – though we think this remains unlikely – the Bundesbank bogeyman Jens Weidmann.

The shape and style of the next Eurozone crisis

The ECB will again be the decisive player in the next crisis. The future leadership of the ECB takes us back to our starting point of Italy's economic and hence political discomfort from participating in the European monetary union under present arrangements. We would predict that the next Eurozone crisis will be like its predecessor in at least one respect: the ECB will prove the decisive crisis fighter, if not sole fireman.

The reason for this is that push for wider Eurozone reform – championed by President Macron in particular – has run into the sand. While this outcome does not seem very surprising, it was striking nevertheless to see the lack of progress set out in full public glare in the form of the conclusions of the "Eurogroup" meeting (of EA finance ministers) on 4 December. All the key players blocked the reform proposals they disliked. In Italy's case, that

meant opposing any serious pointers to sovereign bond restructuring; while Germany and like-minded countries saw off once again the common deposit insurance project while ratifying the previously announced decision to, in effect, neuter Macron's proposal of a common EA budget (i.e. the first step towards a fiscal union) by folding this into the next EU-wide budget cycle starting in 2021.

This triumph of the crisis-prone Eurozone status quo mirrors political developments in France and Germany. Macron's political capital has now been depleted by the *gilets jaunes* revolt that started last November. This may not have changed much in practice. Even before the eruption of this protest movement coming out of small town and rural France, Macron's Eurozone reform initiatives were hardly prospering.

Merkel's likely successor will continue with her reactive incrementalism. As for Germany, the victory of Annegret Kramp-Karrenbauer (AKK) in the CDU leadership race on 7 December indicates no change from Chancellor Merkel's approach of minimalist reform and reacting to events. Although apparently an instinctive Francophile, AKK has shown no sign of any worked-out views on the euro or even economic policy in general beyond a general 'social market' outlook rather than the more 'economically liberal' profile of her defeated rival Friedrich Merz.

Politically close to former finance minister Wolfgang Schäuble, Merz as CDU leader (hence likely future Chancellor) might have precipitated change of one kind or another. Schäuble's reputation – especially as it developed during the Greek crisis of 2015 – belies the reality of a convinced pro-European politician prepared to see the Eurozone move in a much more federal direction (albeit, a rigidly rules-based federalism, contrary to French tastes) and to envisage the temporary departure of an EA country (specifically Greece) from the monetary union.

And northern European member states remain intransigent. Another consequence of the continuity outcome of the CDU leadership change is the reduced probability of German leadership somehow reining in the drift of like-minded countries from the Netherlands to Finland towards ever firmer opposition even to any baby steps in the direction of the fiscal union required to stabilize the Eurozone and buttress its economic performance. This increasingly hardline stance underlies the language in the part of last month's Eurogroup conclusions dealing with fiscal reform and recording the absence of a "common view on the need and design of an EA-wide fiscal stabilization instrument."

It is against this background that the ECB (re-)emerges as 'the only game in town'. Even before any new acute Italy-centred crisis blows up, and also before the end of Mario Draghi's term as ECB president, we expect the ECB to counter the financial tensions surrounding Italy by means of a new (or extended) TLTRO programme. This would ease the liquidity pressures in the Italian banking system and indirectly support the BTP market. However, As our colleague Shweta Singh has shown, TLTROs are a palliative rather than a cure.

The same would be true in a full-blown crisis in which the ECB ended up applying to Italy Draghi's "whatever it takes" bazooka of Outright Monetary Transactions (OMT). Such a crisis scenario is easy enough to imagine. A combination of the EA as a whole sliding towards recession while the euro strengthened relative to the dollar would undermine the growth assumption underlying Italy's already contested budget. On present form, the Italian government would seek to avoid appearing to have triggered a crisis and announce that it would stick to its fiscal plan (perhaps with some marginal counter-cyclical expansion presented as moderate and judicious).

A crisis could quickly become a game of Rome-Frankfurt chicken. A negative reaction to this situation in the government bond market would then lead to a game of chicken between the

Italian government and the ECB. The outcome would hinge on the extent of political cover that the ECB felt it needed from the Commission and Eurogroup to stabilize the situation by launching a BTP-buying programme under OMT. The European political allies of the Lega and M5S would not, as we have seen, be in a position to dictate terms; but they would have more influence at the European level than in the past. They could, for example, launch a noisy campaign at the European level against any northern European qualms that Italy's refusal to tighten fiscal policy made it ineligible for OMT by demanding that the Commission put Germany into a formal Macroeconomic Imbalances Procedure.

Amid all such noise, the ECB might then find a way to start buying BTPs anyway. In doing so, the ECB would rely on the underlying political will in Germany and France to preserve the Eurozone at all costs resulting in its (the ECB's) decisions being approved retrospectively – as was the case following Draghi's decisive initiatives in 2012.

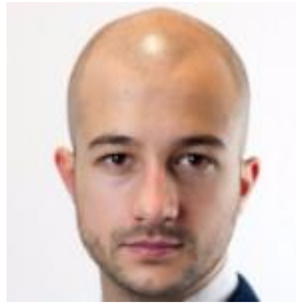
Investment conclusion

Market perceptions that the Draghi toolkit is practically available in future crises might lessen the intensity of such crises. In the best case, Eurozone risk might thus come to resemble geopolitical tail risk. Markets as a rule cannot and therefore do not price such risk on the assumption that the powers will pull back from the brink of conflict in the end while the consequences of conflict actually occurring are too dire to be priced in.

But this best case seems unrealistic. The analogy with military conflict threats breaks down because the political drivers of the recurring crises that are programmed into a monetary union involving Germany and Italy ensure that the expected – and overwhelmingly likely – ECB-driven resolution will be preceded by a game of chicken as described above. That game is the equivalent of the start of a shooting war. Markets will therefore have to price the effects of that essentially political fight – including, crucially, the collateral damage in the European banking system.

Authors

Christopher Granville
Managing Director, EMEA and Global Political Research



Constantine Fraser
Political Analyst