Meketa Investment Group
Global Macroeconomic Research Series

Is Europe on the Verge of Another Devastating Crisis?

July 2018: Issue Twenty Five

We started this publication in December 2011 with an analysis of the European debt crisis. At the time, the Global Financial Crisis morphed into a sovereign debt crisis in Europe affecting Spain, Portugal, Ireland and, above all, Greece. Contagion was spreading to Italy and even France. Many thought the days of the euro were numbered. Nonetheless, it survived. While the economic situation in the euro area has improved significantly over the past 7 years, we now experience a new bout of European financial turmoil following the formation of a Eurosceptic governing coalition in Italy. How is Europe doing in 2018? What are the implications of the recent events in Italy? Is Europe on the verge of another crisis? Is it equipped to deal with it?

How Did the Sovereign Crisis of 2010-2015 Come to an End?

The Global Financial Crisis hit Europe particularly hard. Deep recessions and bank bailouts resulted in a sharp deterioration of fiscal positions in most euro area countries, leading financial markets and rating agencies to question the solvency of several countries with large fiscal deficits and high debt. This was especially the case in Greece, which had been underreporting deficit and debt levels since joining the euro, as well as in Portugal, Spain, Ireland, and Cyprus, where excessive lending and the bursting asset bubbles weakened financial institutions. A negative feedback loop started between banking and sovereign credit risks (Figure 1). Public bond yields soared (Figure 2), further weakening financial institutions that held large portfolios of sovereign debt. Interbank money markets froze as, in the absence of risk sharing mechanisms at the euro level, credit risks of financial institutions were perceived as tied to their home sovereign risk (Alvarez et al., 2017).[1]

Figure 1. The European Sovereign-Bank "Diabolic Loop"

Sources: Brunnermeier, M., L. Garicano, P. Lane, M. Pagano, R. Reis, T. Santos, S. Van Nieuwerburgh, and D. Vayanos (2011), "ESBies: A realistic reform of Europe's financial architecture" Voxeu, Open letter, Oct. 25.

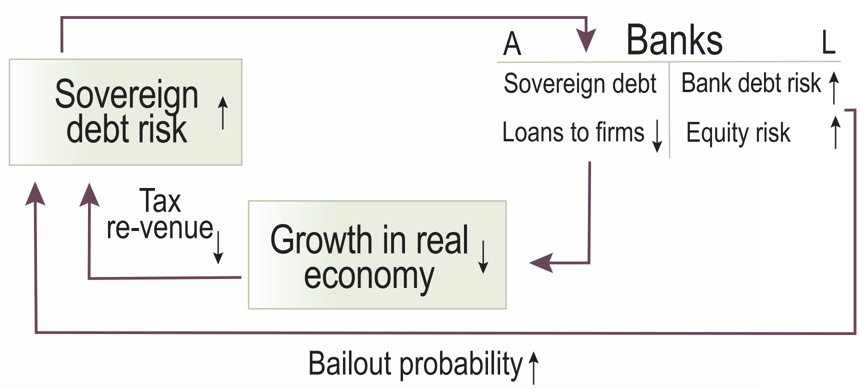
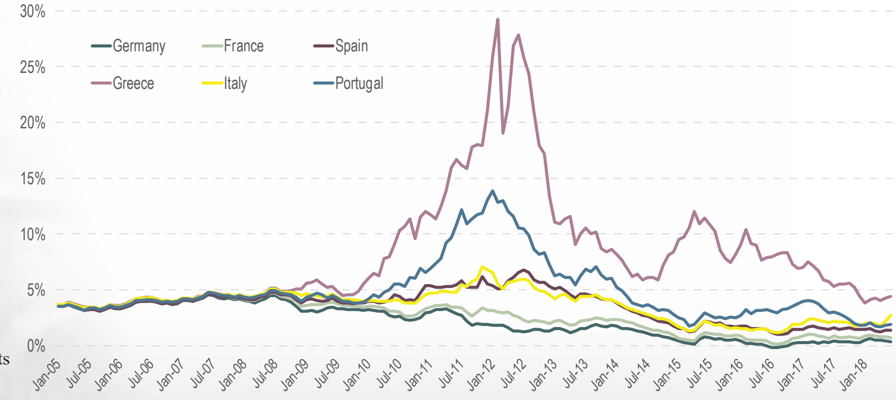


Figure 2. 10-Year Government Bond Yields

Source: ECB



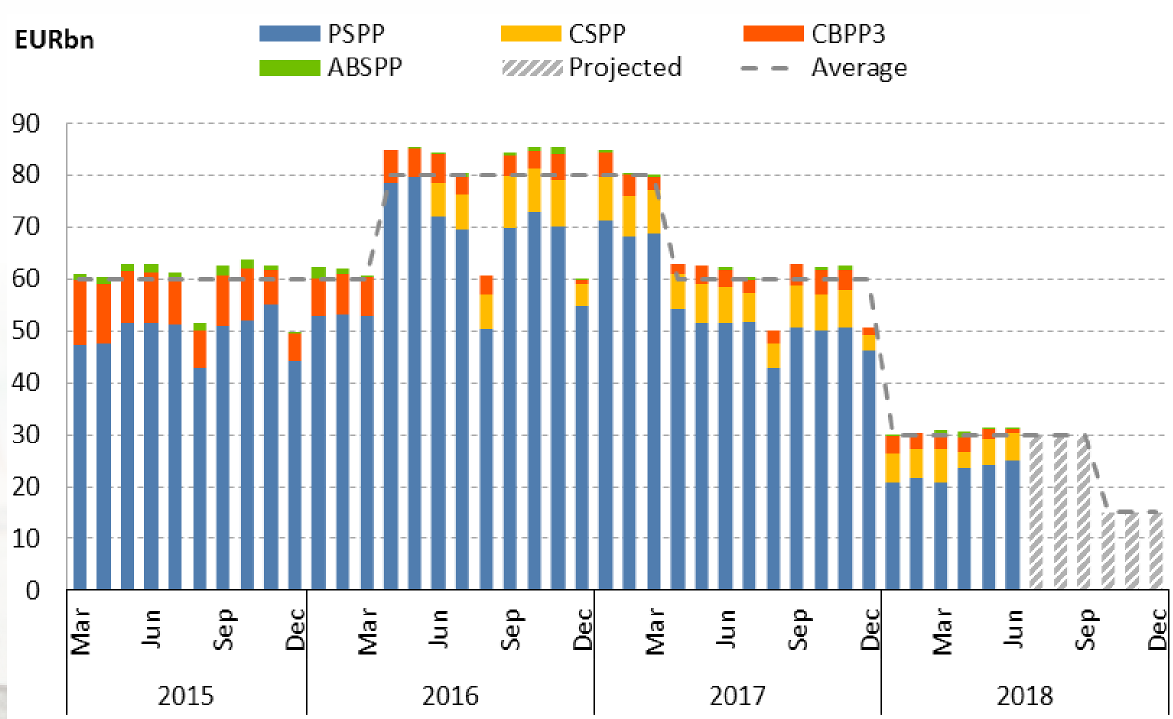
1 Alvarez et al. (2017) "The use of the Eurosystem's monetary policy instruments and operational framework since 2012" ECB, Occasional Paper Series No 188.

Greece (2010), Ireland (2010), Portugal (2011), and then Cyprus (2013) lost access to financial markets and had to turn to the IMF and EU for support. Under the newly created European Financial Stability Facility/European Stability Mechanism (EFSF/ESM), support was conditional on fiscal austerity programs.[1] Spain did not go through the full EFSF/ESM and only got a loan to recapitalize its banks.

However, this was not enough to restore the confidence of financial markets. The crisis continued, threatening to spread to Italy and France. The turning point came from the commitment of the ECB to do "whatever it takes" to save the euro in the summer of 2012, followed by the introduction of the Outright Monetary Transactions (OMTs) to support crisis countries in September. The OMTs allow the ECB to buy an unlimited amount of government bonds issued by countries under an EFSF/ESM program.[2] In practice, its announcement was enough to calm financial markets and break the negative feedback loops; it has never been activated.

Most euro countries registered negative or very low growth between 2009 and 2013, as well as fast rising unemployment and, for several of them, deflation. Faced with weak economic activity and credit growth that fueled deflationary pressures, and given the limited room for fiscal expansion and policy rates already near zero, the ECB engaged in unconventional monetary easing including "targeted longer-term refinancing operations" (TLTROs) to ease banks' liquidity constraints, a negative interest rate on the deposit facility, and quantitative easing (QE) with the asset purchase programs launched in 2015/2016 (see Figure 3).

Figure 3. APP Monthly Net Purchases, by Programme



Source: ECB, https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html. APP stands for Asset Purchase Programmes.

1 See https://www.esm.europa.eu/financial-assistance

2 or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html and Alvarez et al. (2017) op cit for more details.

Meketa Investment Group

Global Macroeconomic Research Series

The Euro Area Expansion Gained Strength in 2017

After 2 years of slow recovery, 2017 was the year with the strongest GDP growth rate in a decade (2.4%), but also the first since the crisis with positive growth in all euro members. Labor markets have been healing with unemployment levels moving back towards pre-crisis levels in most countries. Business and household confidence indicators are relatively high. Deflation is over in all countries, even though inflation remains somewhat below the ECB's goal to "keep inflation below, but close to, 2% over the medium-term".

The European Commission foresees a continuation of the current expansion phase with slower, but still dynamic, growth in 2018-19 (Figure 4), while inflation is expected to remain below 2%. These projections are close to those released by the IMF (April) and the OECD (June).

These favorable forecasts rely on the continuous support from monetary policy, with the ECB expected to only very progressively normalize its stance – reducing net asset purchases, ending them by the end of 2018, and raising interest rates in the second half of 2019. The forecasts also rely on improved fiscal positions following years of austerity. While public debt remains high, especially in Greece, Portugal, and Italy (Figure 5), it has started to decline everywhere and all countries are running deficits below the 3% of GDP EU thresholds. This allows for a less restrictive stance and suggests a better shock absorption capacity. Moreover, stronger labor markets are expected to support consumption.

Figure 4. GDP Growth in Selected Euro Area Countries and the UK

Source: European Commission, European Economic Forecast. July 2018 update

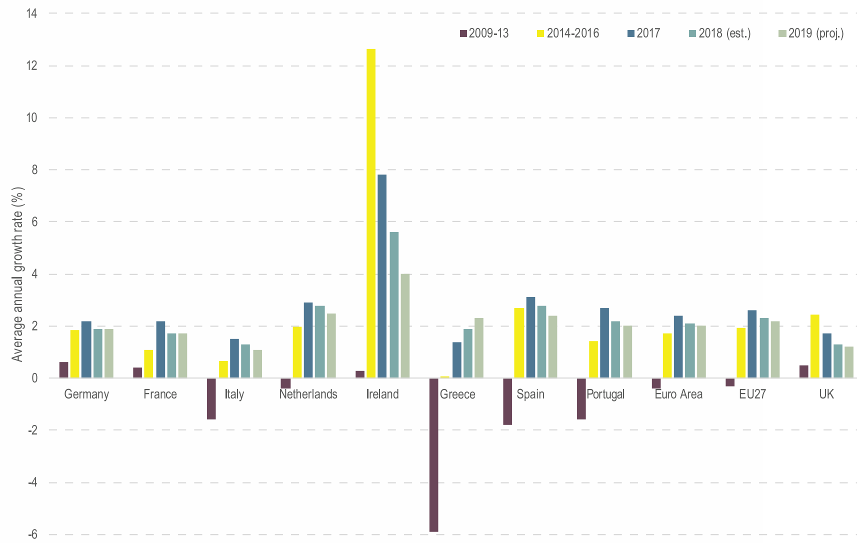
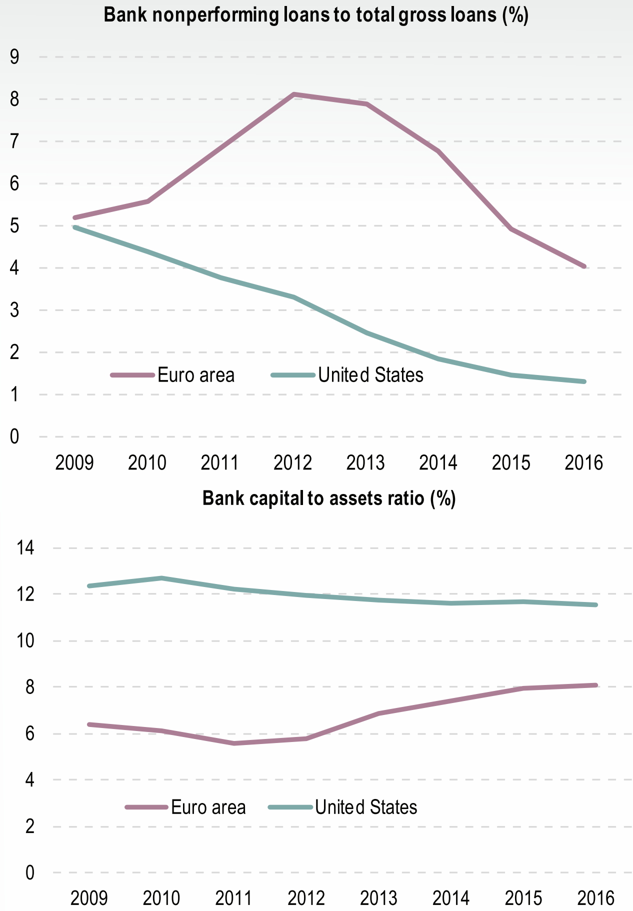


Figure 5. Public Debt Levels are High but on a Downward Trend

Source: European Commission, European Economic Forecast. Spring 2018

Figure 6. Financial Institutions are Getting Stronger



Source: IMF, World Bank

In addition, the health of financial institutions have improved, supported by ECB lending programs and the stronger economic activity. Profitability picked up last year, capital ratios improved, and the amount of non-performing loans (NPLs) has declined since 2015 (Figure 6). After years of deleveraging, private credit growth has started to recover.

Still, there are major disparities in country performances. On the one hand, Germany has had relatively strong growth since 2015 and very low unemployment. On the other, Greece is still dealing with the crisis, although following the further debt relief approved in June 2018 the country is set to exit the bailout program this summer. As for Italy, while it avoided the worst in 2011-2013, its economy has been stuck in low gear for almost two decades. Italian debt is the second highest in the euro area after Greece, at 132% of GDP in 2016-2017. Italian banks are among the weakest in the region, with NPLs still representing 12% of banks' loan portfolios (vs. 50% in Greece).

A Soft Patch or Something More Serious?

The euro area has experienced a softer patch since the beginning of 2018. While this has led the European Commission to reduce its 2018 forecast by 0.2% for 2018, it has been considered as mostly temporary. However, major risks have built up in recent months, especially following trade tensions with the U.S. and political uncertainty in Italy; these risks are already affecting business confidence in Europe. Their materialization would prolong the soft patch and possibly derail the expansion.

The deterioration of trade relations with the U.S. is likely to affect European exports. European exports of steel and aluminum to the U.S. now face tariffs of 25% and 10%, respectively. According to calculations by ING, these exports account for only 0.3% of all goods exported by the EU.[1] Still, some countries are more exposed: for instance, the U.S. receives over 5% of French and Italian aluminum exports and 14% of Greek steel exports. Moreover, European retaliation was met by the announcement of further U.S. retaliation that could target EU car exports. Such an escalation would be damaging to growth on both sides of the Atlantic and to global trade.[2] Moreover, a lack of agreement on Brexit could also lead to higher tariffs and non-tariff barriers for EU exports to the UK. By itself, however, the materialization of trade risks may not bring Europe back into recession and deflation.

1 https://think.ing.com/articles/time-running-out-to-avoid-us-eu-trade-war/

2 See previous newsletter, "The European Debt Crisis", December 2011, Issue One

The risks arising from Italy are of a different nature. In March 2018, two anti-establishment and Eurosceptic parties, the Northern League and the Five-star movement (M5S), jointly won the majority of parliamentary seats in the Italian general elections. While driven by fundamentally different ideologies, the two parties have similar positions against European integration and immigration. They formed a coalition government in June, after months of negotiations and political tensions.

The election results reflect some major weaknesses in the EU policy framework regarding immigration and fiscal policy that have been seen as disproportionally harming Italy.

First, Italy is a main point of entry for migrants seeking better lives in Europe. It has received almost 700,000 migrants since 2013, the equivalent of over 1% of the Italian population.[1] Most of them arrive from Africa by sea. The EU regulation ("Dublin Regulation") requires Italy to bear the cost of registering them and most of them have to stay in Italy, as they have to seek asylum in the country where they entered the EU. The cost associated with the reception of migrants is estimated at €4.3 billion in 2017, a bit under 0.3% of Italy's GDP.[2] It has fueled anti-immigration and anti-European sentiment, especially for those Italians who cannot make ends meet given the fiscal restraint imposed by the EU.

Italy entered the euro with a public debt that was over 100% of GDP. After some reduction, it sharply rose again in the wake of the crisis, severely limiting the ability of fiscal policy to support growth. At the same time, Italy lost competitiveness that it could formerly recoup with devaluations in the lira. As a result, growth has lagged the European recovery. While there are major structural obstacles to growth in Italy, the country has no macroeconomic tools to support growth besides the common monetary policy. It also needs infrastructure investment and better education and training systems, which cannot be financed under the current fiscal stance. In turn, low growth pushes up the debt-to-GDP ratio, calling for still more fiscal restraint.

The Northern League and the M5S have approved both an anti-immigration stance and a very expansionist fiscal policy program, with a flat tax and the introduction of a universal basic income. These plans would increase the public deficit by about €100 billion or 6% of GDP, which would imply breaching the European fiscal rules and a major increase in public debt. Markets reacted negatively to the proposals, with threats of ratings downgrades and increases in Italian sovereign yields. Fears of European disintegration have also resurfaced.

There are several potential scenarios going forward for Italy:

- The coalition goes ahead with fiscal expansionary plans; debt and deficit increase leading to a sovereign debt crisis. This could potentially, but not necessarily, lead Italy to leave the euro.
- The coalition decides to leave the euro even before facing a crisis. This is not part of the government's official program, but their real intentions remain unclear, especially in the absence of change of euro/EU policies.
- Realism wins and fiscal expansion plans that cannot be financed are postponed in light of possible economic damage. However, the problems are not solved and tensions could reappear any time.
- The coalition succeeds in pushing for change in the euro/EU framework, goes ahead with some, but not all, fiscal expansion plans, and avoids a crisis.

1 The flow has slowed since mid-2017, following some agreements with Libya to prevent as many as possible from crossing the Mediterranean Sea.

2 see http://www.dt.tesoro.it/modules/documenti_en/analisi_progammazione/documenti_programmatici/def_2017/Sez.1_-_Programma_di_Stabilita_2017_EN.pdf

Can the Situation in Italy Trigger a Full-Fledged Euro Crisis?

A main question at this stage is whether unfavorable developments in Italy could be contained or trigger a full-fledged euro crisis.

Italy is the third largest economy in the EU, the fourth largest bond market in the world, and a founding member of the EU. An Italian sovereign debt crisis, or Italy leaving the euro, would have an unprecedented impact. Greece, Portugal, and Spain's debt crises endangered the euro, but they are relatively smaller countries and not founding members of the EU. Brexit presents some trade risks to the EU but, while larger than Italy, the UK is not part of the euro and has always been on the sideline of European integration.

As Italian banks are among the weakest in the euro area with public debt among the highest, the negative feedback loop between Italian banks and sovereign debt would reactivate. Propagation to the rest of the euro region would go through European institutions that hold Italian sovereign and private debt, and more broadly lead to speculation on a forthcoming breakup of the single currency.

The euro area has put in place mechanisms to prevent banking crises and to deal with bank failures, but the framework is still incomplete and the euro area is not properly armed to deal with such a major crisis. It lacks a euro-wide deposit insurance and a common backstop to the Single Resolution Fund. Moreover, the bail-out of mid-size Italian banks in 2016-17 by the Italian government has undermined the credibility of the EU bail-in commitment. The mechanisms to deal with sovereign debt crises may not be applicable to Italy; under current rules, the OMTs will only be accessible to Italy (i) if its debt has not been downgraded to junk and (ii) in association with a rescue program, requiring austerity conditions that would most likely not be acceptable for the coalition.

Can Italy Revive the European Monetary Union?

Because of its economic weight and the risks associated with a crisis, Italy is in a stronger bargaining position than previous crisis countries vis-à-vis-the European institutions. It may be able to negotiate a softer fiscal stance and changes in European policies. This would open the door to the fourth and most optimistic scenario where not only a crisis is avoided, but also there are necessary changes in the functioning of the EU/euro going forward.

Indeed, something needs to be done to address the flaws in the euro framework and the European unfinished agenda. Despite progress in strengthening its economic architecture, fiscal policy remains the euro's Achilles heel.

When we analyzed the European debt crisis in 2011, we argued that it was mainly the product of major flaws in the European economic architecture, and in particular lack of a common fiscal authority. Rather, fiscal policy is set at the national level with tight limits on fiscal deficits. This means that there are no cross-border fiscal transfers within the euro area and, hence, limited room for counter-cyclical fiscal policies for indebted countries. This has fed the negative feedback loops. Moreover, it has meant that fiscal consolidation is the only option to reduce debt levels.

Still, progress has been limited. European countries strongly disagree on the need for a common fiscal authority and for new rules that would improve fiscal discipline, but also allow for risk sharing and stabilization mechanisms. The lack of consensus on the creation of a common budget, pushed by France, but rejected until recently by Germany, has led to the status quo. In the meantime, ineffective fiscal rules gave rise to Euroscepticism and populism both in creditor and debtor countries.

The risks caused by the situation in Italy, combined with domestic political pressures in Germany, may move the lines in the coming months. The Euro Summit on June 29th can be seen as a first, but still small step in this direction. In a nutshell, Italy may either put an end to the euro adventure or start a new phase of EU integration.

What Does This Mean for Investors?

It is unlikely that the situation will clarify quickly. Whatever the final outcome, negotiations will take time and Europe may continue to operate in a drama and last-minute solutions mode. This means that the months to come will be potentially shaky for financial markets, especially during the period around the Italian budget preparation. In the meantime, further financial turmoil and risks to growth may lead the ECB to postpone normalization. Turmoil would also lead to a flight to safety towards other EU currencies, the dollar, and the Swiss Franc. In the U.S., it would mean higher volatility, a stronger dollar, and lower than otherwise bond rates.

BOSTON
100 Lowder Brook Drive, Suite 1100
Westwood, MA 02090
781.471.3500

CHICAGO
One E Wacker Drive, Suite 1210
Chicago, IL 60601
312.474.0900

LONDON
41-43 Brook Street
London W1K 4HJ,
United Kingdom
+44 (0)20 37098485

MIAMI
5200 Blue Lagoon Drive, Suite 120
Miami, FL 33126
305.341.2900

PORTLAND
205 SE Spokane Street, Suite 300
Portland, OR 97202
503.444.3434

SAN DIEGO
5796 Armada Drive, Suite 110
Carlsbad, CA 92008
760.795.3450