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THE EUROPEAN SOLIDARITY DEFLATES THE RISK OF ITALEXIT

By Marcello Minenna

Among the few positive sides of the pandemic is the rediscovery of a spirit of mutual support between European countries, as evidenced by the agreement reached last week on the Recovery Fund, the €750 billion loan and grant program allocated to EU countries to revive their economies hard hit by the virus.

Until a year ago, such a result would have been unthinkable: the relationship between Italy and Europe had cracked and the country appeared increasingly isolated.

The main indicators of Italy's risk were also on worrying levels, with the yield spread between Italian and German government bonds steadily around 250 basis points to signal the high credit risk of the Italian Republic. A significant part of this risk was represented by the redenomination risk, that is, the risk of Italy leaving the Euro area and returning to the lira. In such a scenario (*Italexit*) the lira would most likely devalue causing a loss to the holders of Italian Treasuries (BTPs). On financial markets, this risk is measured by the *ISDA Basis*, i.e. the price difference between credit default swaps (CDS) compliant with the ISDA-2014 standard and those compliant with the ISDA-2003 standard, since only the former includes the redenomination/devaluation among the credit events triggering the protection provided by the CDS.

After a period of relative stability (September 2014-December 2016), a turbulence phase of the *ISDA Basis* began in 2017 with several surges until

August 2019. The initial surge occurred in connection with the election campaign in France where the victory of the anti-European parties was feared. In May 2018 it was instead the evolution of the internal political situation with the establishment of a populist government to ignite a new and more marked widening in the *ISDA Basis*. The objectives of increasing public spending pursued by the new government did not find the approval of the European institutions traditionally supportive of the need to contain deficit spending, especially by high debt countries like Italy.

This period was for Italy (as it had been before for Greece) the climax of the critical issues related to its membership in the Euro area. Given the binding European budgetary constraints and the no-bail out clause enshrined by the EU treaties, for Eurozone countries fiscal sovereignty is *de facto* purely formal: national economic policy decisions are in fact subject to the double assessment of markets and European authorities, Commission first. In parallel, the continuous postponement of concrete steps towards a true fiscal union and a European federal public debt has imposed counter-cyclical fiscal policies on the most indebted countries which, by curbing growth, ended up negatively influencing the debt-to-GDP ratio.

The anomaly and the growing unsustainability of this set-up emerged in all their evidence in the way in which Europe managed the response to the global financial crisis by adopting since 2010 (in the aftermath of the Deauville's Franco-German summit) a policy of risk segregation within peripheral countries. Since then, most of the interventions made by the European institutions to restore stability to the monetary union took care to avoid risk sharing on public debts and on national banking systems.

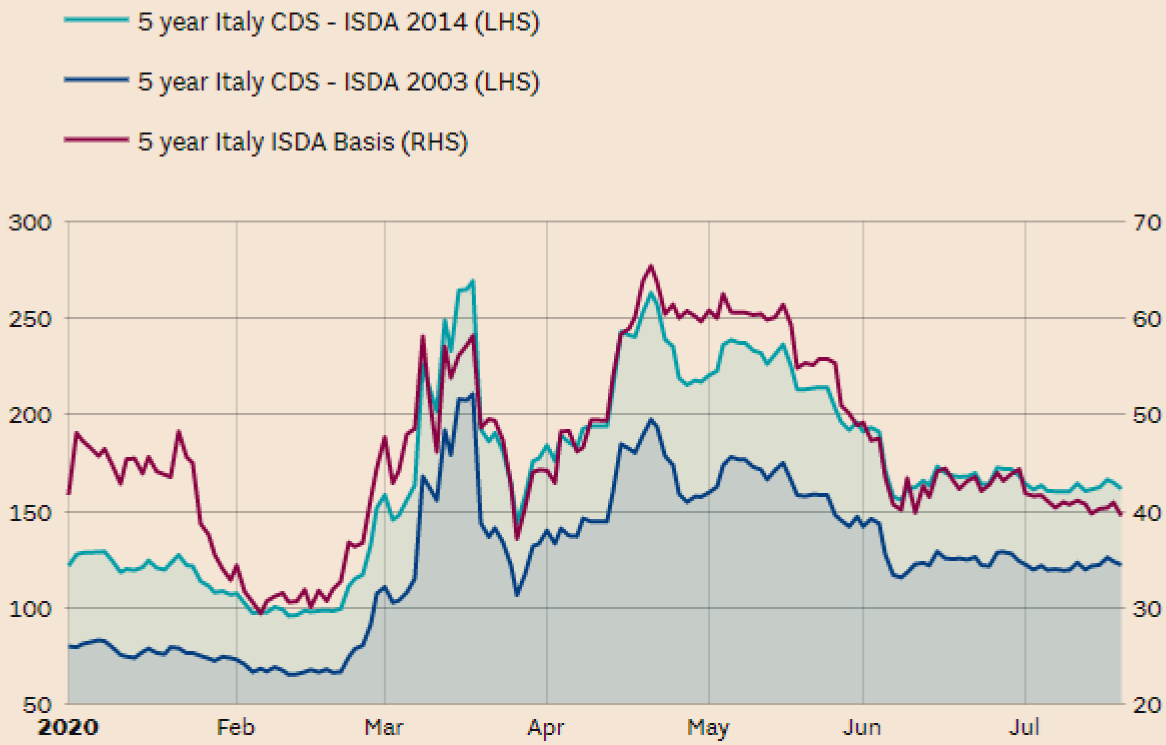
The reaction of peripheral countries to this policy has oscillated between the attempt to remain compliant with European rules and an anti-Europeanist sentiment that has favored the rise of sovereign political forces. In the case of Italy, this explains why, at the height of tensions with Europe, the *ISDA Basis* has exceeded 110 basis points, equal to a probability of *Italexit* of 9%.

At the end of August 2019 it began a phase of normalization of the redenomination risk on Italian debt, a signal of newfound harmony with Europe. The subsequent outbreak of the pandemic in Italy has again threatened this delicate balance. In particular, between March 9 - when all of Italy was entering the lockdown - and last May 15, new fibrillations of the risk of Italexit were recorded albeit without ever reaching the peaks seen in the previous two years. This time markets' jitters were not triggered by the confrontational attitude of the Italian political leadership, but rather by the disappointing initial response of the European institutions to the Covid emergency, as Mrs. Lagarde's first statements on the fact that "closing the spreads" is not in the ECB objectives and the initial hesitations of the EU Commission on easing the fiscal constraints established by Brussels. Fortunately, Europe promptly reconsidered the seriousness of the situation and acted accordingly already in the second half of March with the launch of the pandemic QE, the suspension of the Stability and Growth Pact and the suspension of the issuer/issue limit on bond purchases by the ECB.

Thanks to this changed attitude of the European institutions the *ISDA Basis* has never exceeded 65 basis points. After some gasps in April (in conjunction with a mega-issue of BTPs for a total of €16 billion) and in early May (with the ruling of the German Constitutional Court on the legitimacy of QE), redenomination risk started to deflate returning to the values of the beginning of the year (see Figure).

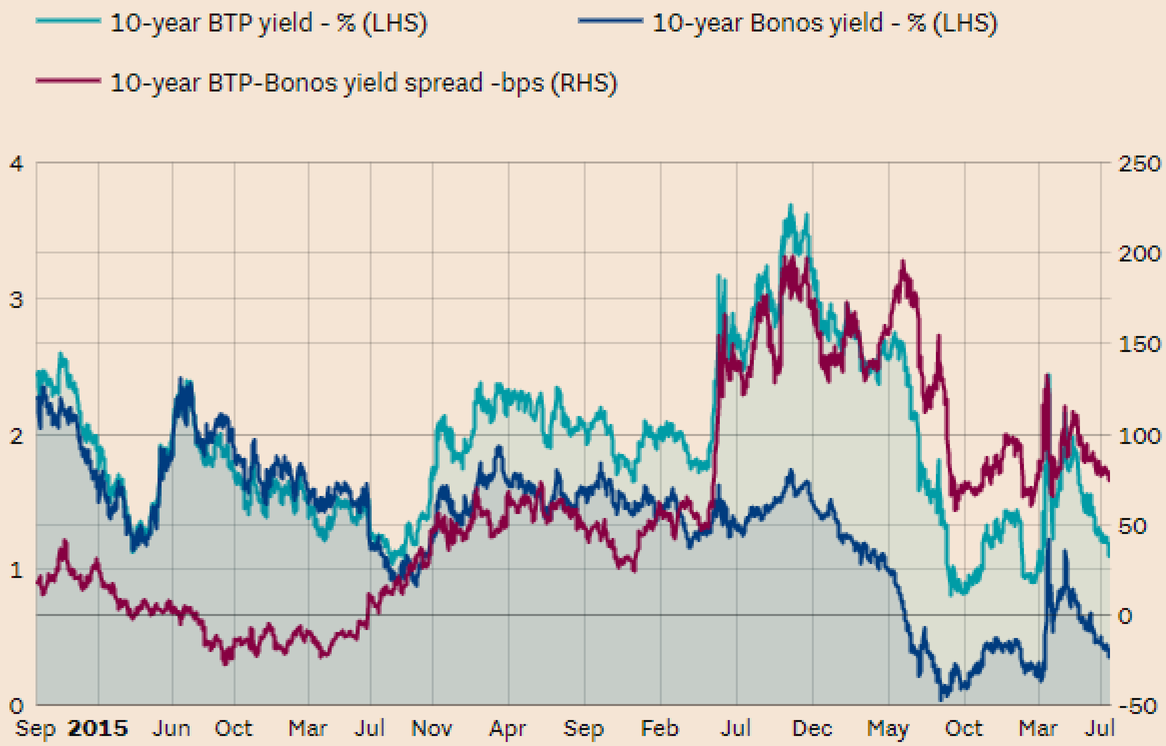
ITALY'S REDENOMINATION RISK DURING THE PANDEMICS

Bps

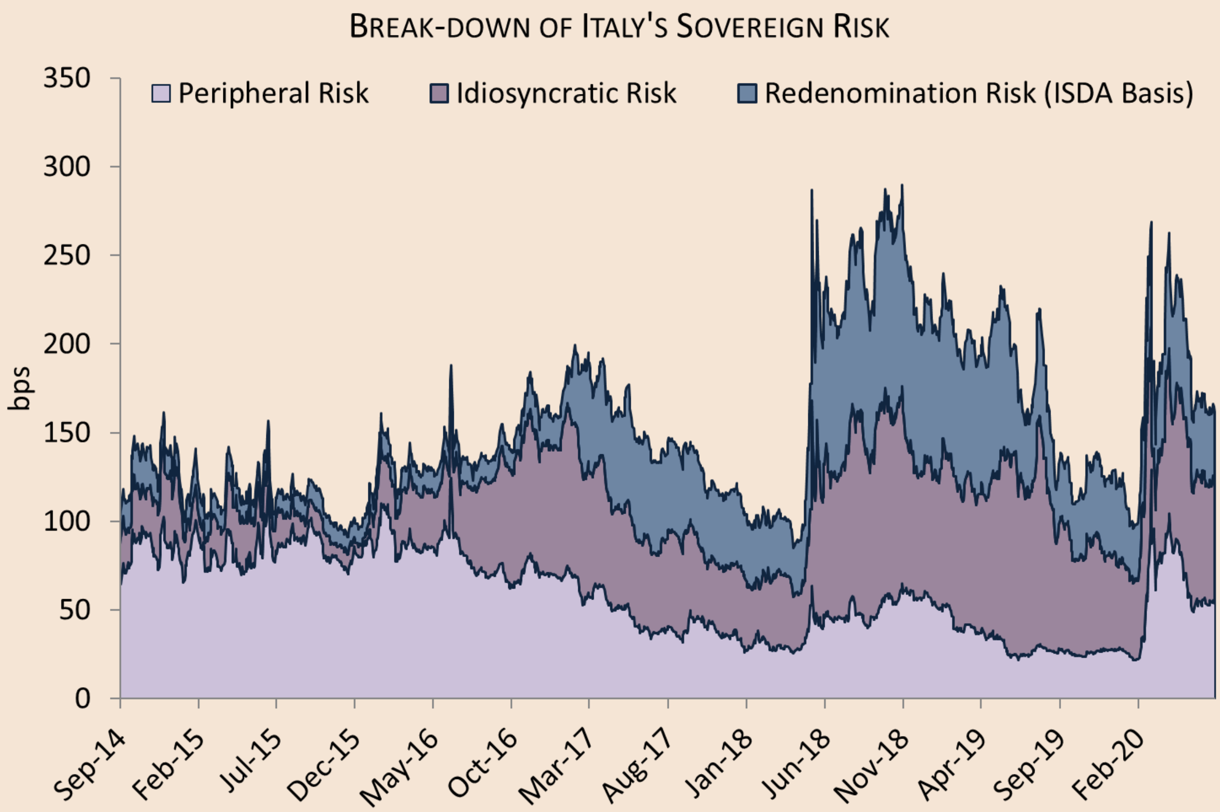


A further confirmation of the newfound harmony between Italy and Europe comes from the relative dynamics of the yields on Italian and Spanish government bonds: during the most turbulent phase of the *ISDA Basis* (May 2018-June 2019) the divergence between two yields had risen to 200 basis points, then declined to below 100 basis points in the second half of 2019. In the first weeks of the pandemic in Italy (March 2020) this realignment was put to the test, but the subsequent multiplication of signals of Europe's willingness to counter the economic consequences of the virus avoided a new divergent pattern (see Figure).

COMPARATIVE PERFORMANCE OF ITALIAN AND SPANISH GOVERNMENT BOND YIELDS



Similar dynamics have also been observed in the relative behavior of Italy and Spain sovereign CDS. Assuming, without excessive simplifications, that in recent years Spain has become the benchmark for "peripheral" risk, i.e. the risk of belonging to a sub-optimal monetary union for the reasons mentioned above, Italy sovereign CDS under the ISDA-2014 standard can be broken down into 3 components: a redenomination risk component identified by the *ISDA Basis*, a peripheral risk component identified by Spain's ISDA-2003 CDS and an idiosyncratic risk component in Italy. This latter component reflects the expectations of the markets on the future dynamics of the country's main economic and financial variables and is reasonably approximated by the difference between the ISDA-2003 CDS of Italy and that of Spain (see Figure).



Between May 2018 and June 2019, the increase in Italy's sovereign risk was due to the surge in the redenomination and idiosyncratic risk components, while the incidence of the peripheral risk component remained substantially unchanged. Conversely, this year, faced with the pandemic shock, there was an upward leap in all three components of the Italian risk and their subsequent reduction starting from the second half of May as proof of the less asymmetrical nature of the shock (soon shared with Spain and other European countries) and of the positive markets' reaction to the decisions of the European institutions in the direction of concrete support to the most affected countries.

The behavior of the market indicators therefore shows that the assessment of Italy's sovereign risk is very sensitive to the internal political climate (pro-Euro or Euro-skeptic) and to the concrete manifestations of solidarity by the European Union towards the most fragile countries. This awareness should govern the next steps on the horizon: the imminent expiry (5 August) of the ultimatum of the German Constitutional Court to the ECB on the QE legitimacy, the finalization of the Recovery Fund in the terms that have been agreed a few days ago and the risk of new waves of infections from Covid-19. Europe has the duty of protecting the agreement on the Recovery Fund and of refraining from inserting insidious conditions in the final text, and individual States have the duty to efficiently and effectively spend the huge resources placed on them arrangement. The challenge is open and the stakes are the fate of the European project.

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The views expressed are strictly personal.