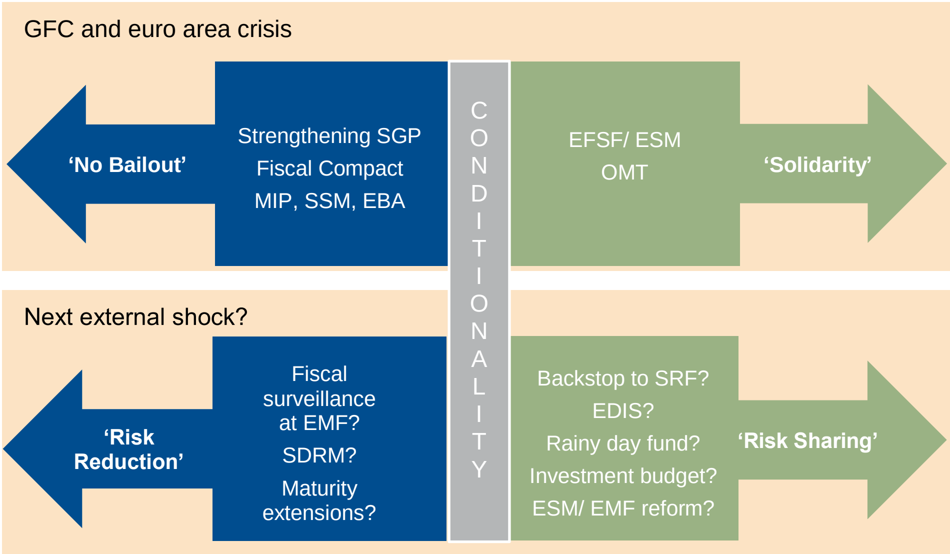
EU & EA reform: United under external pressures and internal distress

Europe's order of policy priorities is increasingly dictated by the migration crisis as opposed to the euro area reform agenda. Scope does not expect this to have any negative rating relevant implications for euro area member states. At the same time, it also restricts rating upside. In Scope's view, while European leaders may postpone crucial reforms to the euro area architecture against the current favorable economic backdrop, they have also shown the ability to react under pressure to take the politically difficult decisions to ensure the sustainability of the euro area, both at the national and the European level. In Scope's view, further euro area reforms will come, underpinning its sovereign ratings. The question is not if, but when, and in which form and sequence these reforms will be enacted.

In Scope's assessment, all euro area sovereigns are affected by the resilience and shock absorption capacity of the Economic and Monetary Union (EMU). Following the reforms to the euro area architecture since the Great Financial Crisis, Scope believes the EU's institutional framework provides for a greater degree of resilience to adjust to crises. Still, Scope has highlighted that the lender-of-last-resort function, currently fulfilled first by the ESM, subject to conditionality, and second, supported by the (yet untested) ECB's Outright Monetary Transactions, is paramount for Scope's euro area ratings. In addition, legislative changes to complete the Banking and Capital Markets unions alongside the development of some form of fiscal capacity in the euro area would be credit-positive.

Figure 1: Europe's evolving dialogue, forced by crisis, resolved via conditionality



SGP: Stability and Growth Pact. MIP: Macroeconomic Imbalance Procedure. SSM: Single Supervisory Mechanism. EBA: European Banking Authority. EMF: European Monetary Fund. SDRM: Sovereign Debt Restructuring Mechanism. EFSF: European Financial Stability Facility. ESM: European Stability Mechanism. SRF: Single Resolution Fund. EDIS: European deposit insurance scheme.

Scope acknowledges that willingness to move towards a banking and capital markets union in Europe and the development of a euro area fiscal capacity is currently limited. However, overcoming the political impasse between 'risk reduction' and 'risk sharing' is critical for further euro area reform. Italy's systemic political, economic and financial market relevance, together with the increasing fragility of the international multilateral system and the realisation that European member states need to rely on each other to address regional and global issues to safeguard their national interests at the global stage, could provide the necessary impetus for further reform. Thus, even if the political will is not found to enact the necessary reforms at the upcoming EU Councils, for Scope, the question is not whether these take place, but when, before or during the next crisis.

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Evolving political priorities

Focus on addressing (im)migration rather than economic and financial reform…

In Scope's opinion, French President Emmanuel Macron's Sorbonne speech and Chancellor Merkel's reply via a newspaper article point towards an emerging order of priority dictated by the migration as opposed to the euro area crisis. In fact, the topics of defence and security as well as (im)migration and asylum ranked above energy and digitalisation let alone euro area institutional reform. This also reflects the European Commission's proposal to almost triple funding for migration and border management to EUR 34.9bn for the next EU budget for the 2021-2027 period[1]. In addition, the recent formation of the M5S-Lega government in Italy, with its euro-sceptic elements and strong anti-immigration rhetoric, combined with the upcoming Austrian EU Presidency, in turn led by a coalition government including the far-right FPÖ, further pressure policymakers to secure Europe's borders rather than concentrate on strengthening the euro area economic architecture.

…but the euro area is 'united in distress'…

However, even if reforms towards deepening the EMU were to take a backseat in the upcoming EU Councils, Scope holds the view that European politicians and policymakers do (and will) react under pressure to take the politically difficult decisions to ensure the sustainability of the euro area. The rationale is, ultimately, the pursuit of national interest by all member states. This view underpins Scope's euro area ratings, including that of Italy (A-/ Negative) and implies that i) at the national level, contrary to recent rhetoric, *in extremis*, any euro area government, including the current Italian formation, would ask for an ESM programme if needed and ii) at the European level, the confines of the existing architecture would be (again) readjusted to cope with the then prevailing market circumstances.

The case of Italy (A-/ Negative)

Constitutional, popular and operational obstacles to *'Italexit'*

Scope is mindful that its view that all euro area governments would request regional financial support under extreme stress, mitigating default risk and bolstering the sustainability of the euro, can be challenged on several grounds. Indeed, markets have raised their evaluation on Italian credit risk significantly in the course of the current crisis, amidst discussions on the probability of Italy exiting the euro. In Scope's view this is highly unlikely, for legal, popular and operational reasons:

- The legislative process requires two votes at a two-thirds majority in each house of parliament, or failing that, a referendum just to facilitate a referendum on the euro. This constitutional setup thus necessitates either cross-party political backing or two referenda in favour of exiting the euro. Both seem highly unlikely at this stage.
- According to the latest Eurobarometer poll, only 29% of Italians are against the euro (compared to the EU average of 32%)[2] and even 56% of Five Star supporters and 38% of League voters want to keep the euro[3]. Thus, even in a scenario in which political and legal barriers are overcome and a euro referendum were to be held, it is unlikely that the populace would vote in favour to exit the euro.
- Finally, in Scope's view, even if the political will were to emerge to circumvent the legal constraints and popular desires to keep the euro, Scope is sceptical that such a complicated undertaking could be executed operationally, especially absent a legal European framework to facilitate orderly exits from the EMU. It is one thing to exit an exchange rate mechanism with one's own currency already in circulation (as the U.K. did in 1992) but quite another to re-introduce a currency overnight, whilst

[1] http://europa.eu/rapid/press-release_IP-18-4106_en.htm
[2] http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/getChart/themeKy/29/groupKy/183
[3] https://cise.luiss.it/cise/2018/03/08/gli-elettori-m5s-pd-e-lega-e-le-possibili-coalizioni-uniti-e-divisi-da-economia-immigrati-europa/

maintaining the functioning of the payments system, re-establishing an independent central bank with a credible monetary policy, providing domestic financial institutions with sufficient capital and liquidity in the new currency, and managing relations with the rest of the euro area.

For these reasons, it is Scope's opinion that Italy's institutional framework will prevent experiments that could be viewed as an introduction of a parallel currency through the backdoor[4]. Scope notes that the ultimate influence of euro-sceptic parties advocating for an exit from the monetary union fades in the legislative process once the difficulties and consequences of a possible exit become apparent, exemplified in the U-turn of the Greek government in the summer of 2015. This view is reflected in Scope's decision on 8 June to affirm Italy's A- ratings but revise the Outlook to 'Negative'.

Reaction function at the national and European levels

Italy is too big to save and too big to fail: the alternative is to further redesign the euro area

In Scope's view, Italy is too big to fail and, right now, also too big to save. It is systemically important, both, politically as a founding member of the European Union, and economically, as the third biggest euro area economy with the region's largest stock of sovereign debt. As such, in the hypothetical case in which Italy is completely unable to finance itself on the markets at sustainable rates, Europe, in its current architectural form, could unlikely afford a financial assistance programme for Italy, given that the ESM's maximum lending capacity of less than EUR 400bn[5] covers Italy's gross financing needs for only about one year[6]. In addition, in such a scenario whereby the Italian government could not honour its financial commitments in full and on time, the costs of spill-overs to other European economies (not to mention the ECB's holdings) would be systemic, given the interlinkages via bank exposures across all European sovereigns. In Scope's view, therefore, in the event of an Italian crisis, the clear alternative is to further re-design the euro area architecture.

Risk reduction versus risk sharing

Progress on deeper European integration is proving slow, reflecting i) diverse starting positions of member states in terms of legacy issues from the crisis including government debt levels, unemployment rates, non-performing loans and investment levels and ii) multiple near-term political pressures, including the (im)migration crisis as well as national and regional election cycles. Still, the broad contours of further euro area reform centring around reducing and sharing risk among member states are clear: northern European countries are focused on crisis prevention, insisting on further 'risk reduction' before any 'risk sharing' can take place while southern European countries point to the substantial risk reduction that has already taken place via the reform of the Stability and Growth Pact, the approval of the Fiscal Compact, the introduction of the Macroeconomic Imbalances Procedure and the creation of the Single Supervisory Mechanism along with the steady decline in NPLs across Europe.

- **Further 'risk reduction'** according to the northern European states includes policies or instruments that would lead to greater fiscal oversight and possibly some form of sovereign debt restructuring mechanism or framework. This latter policy proposal, or varying forms thereof such as introducing automaticity in sovereign debt restructurings or maturity extensions when applying for an ESM programme, is contested by southern European states given their, on average, elevated debt levels and subsequently higher refinancing needs in case such an instrument were to be enacted.

[4] This could include, for instance, any suggestion of an Italian government paying its contractors in IOUs which would also be accepted as legal tenders for paying taxes.
[5] EUR 383bn. https://www.esm.europa.eu/content/what-esm%E2%80%99s-lending-capacity
[6] Italy's 2018 gross financing needs are estimated at around EUR 390bn or around 22% of GDP (IMF Fiscal Monitor, April 2018).

- **Further 'risk sharing'** refers to completing the Banking Union, specifically by establishing the ESM as a credible common backstop to the Single Resolution Fund and introducing a European Deposit Insurance Scheme. Additional policies and instruments include some form of a euro area budget, investment budget or 'rainy day fund', or enhancing the ESM's toolkit and/ or lending capacity.

Banking Union in exchange for SDRM?

In Scope's opinion, the current impasse could be overcome through a "grand bargain" in which the Banking Union is completed, and/ or additional shock-absorbing mechanisms are introduced in exchange for further fiscal surveillance, which could be placed under the auspices of the ESM (or a future EMF) and the introduction of some form of sovereign debt restructuring framework. Scope notes that the sequencing and specificities of such proposals, let alone a 'grand bargain' remain unclear and are highly political.

Reforms in national interest of member states

The question is not whether, but when and in which form and sequence such reforms will be completed. This view is by the track record of the euro area crisis as well as the political context beyond the euro area reform agenda. Recent statements by the German and French leaders attest that further European integration is ultimately a national interest. The increasing economic and financial linkages and spill-overs to all member states, as evidenced via the trade channel, banking exposures and corporate activities across Europe, remain an important, and increasing motivation for further integration.

Political trade-offs extend debate on euro area reform

In addition, the weakening multilateral system and subsequent realisation that European member states need to rely increasingly on each other to address regional and global issues such as the migration crisis, trade or climate change, is a political motivation for all members states, including Germany, to search for compromise at the European level in order to safeguard their national interests on the global stage. The upcoming political trade-offs in Europe between member states seeking to preserve their national interests thus extend the debate on the measures needed to ensure the sustainability of the euro.

The shape and timing of reforms

Member States, not Brussels, real drivers of reform

Scope notes that Chancellor Merkel's insistence on a European Monetary Fund remaining accountable to national parliaments highlights the fact that the implementation of the EMU reform agenda is likely to remain primarily driven by member states via inter-governmental agreements as opposed to via initiatives of the European Commission. This reflects the clear power shift away from Brussels to the capitals of member states, and ultimately Paris and Berlin. Scope notes that with approx. 26% of the ESM's shares, Germany can veto any decision that is taken under the ESM or its possible successor the EMF. As such, the expansion of responsibilities and instruments of the ESM would strengthen Germany's position vis-à-vis that of its European partners.

If external pressures do not suffice to reform during favourable times, the next crisis will

Finally, to date, institutional advancements have mostly happened during the heights of a crisis. Indeed, the robust economic recovery accompanied by the ECB's unconventional and accommodative monetary policy may have seeded complacency among policymakers in recent years. However, the increasing fragility of the international multilateral system and greater insecurity in international alliances, could provide the necessary impetus for further reform at this juncture, despite strong divisions. It is thus Scope's expectation that the euro area architecture will be further reformed and strengthened, if not today during the economically favourable times, then ultimately under the pressure of another crisis, underpinning Scope's sovereign ratings.

The next EU Council is likely to provide some indication regarding the order of priorities among the competing political needs of securing the EU's borders and agreeing on a common asylum policy, negotiating Brexit, the EU's next multi-annual budgetary framework, and strengthening the euro area, all ahead of the next significant political deadline, the European Parliament elections in June 2019.

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