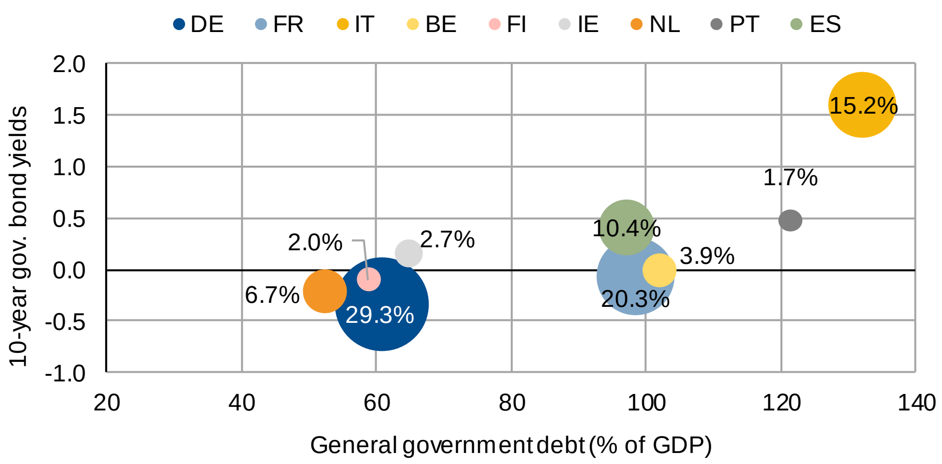
# Scope Policy Insights: Re-establishing fiscal accountability in the euro area – implications from Italy

**High debt levels, fiscal slippage and policy uncertainty in Italy (BBB+/Stable) have reignited discussions about the stability of the euro area's architecture. Italy's economic size and inter-connectedness with core euro area members underpin the country's systemic relevance. In this report, we identify the main channels of contagion risk, the implications for the euro area's fiscal framework and assess three institutional advancements that could help stabilise the currency union.**

The systemic importance of the Italian economy to the euro area is undeniable, granting the country a higher degree of bargaining power in negotiations with the European institutions on debt reduction plans and fiscal programmes than, for instance, Greece or Portugal possessed. In 2018, Italy's GDP accounted for 15.2% of euro area GDP, its public and private debt amounted individually to 20.8% and 23.6% of euro area GDP respectively (see **Figure 1**).

Concerns have emerged regarding the Italian incumbent government's fiscal policies, which have exacerbated pre-existing challenges around debt sustainability. The ruling coalition has avoided an Excessive Debt Procedure from the European Commission for now but tensions between the government and EU institutions have resulted in higher risk differentiation, reflected in the gap between Italian and German 10-year bonds, which remains elevated at around 200 bps.

**Figure 1. Systemic public finance risk, selected euro area countries**




N.B. Bubble size reflects the share of the country's GDP in euro area GDP
Source: Eurostat, Reuters, Scope Ratings GmbH

Spill-overs from an Italian debt crisis to other euro area members could emerge via three key channels, all of which in turn, could affect general market confidence:

1. The non-financial debt channel: Italian non-financial private and public debt held by euro area institutions outside of Italy.
2. The banking channel: contagion risk resulting from bank inter-connectedness.
3. The real-economy channel: Risk of contagion via trade/ other economic links.

As a solution to these potential channels of contagion the euro area's institutional framework could benefit from a set of reforms aimed at reducing the systemic risk from sovereign debt: i) higher capital adequacy requirements for central government debt and/or; ii) limits on domestic bank sovereign bond holdings; and iii) creation of a European safe asset. A gradual implementation mindful of financial stability and sovereign funding concerns would be key.

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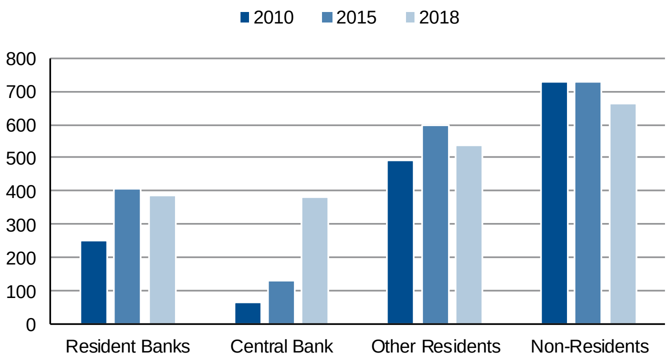
## Direct channel: who holds Italian debt?

**Persistent home bias in banking sectors**

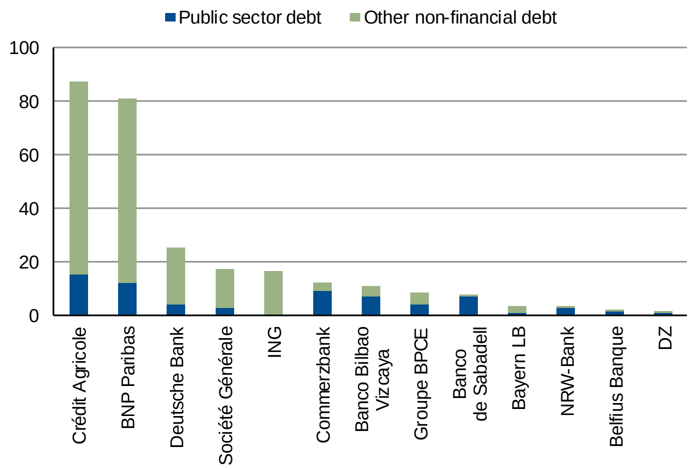
It is not uncommon to observe a strong home bias in the financial sectors of major economies. Italy stands out among euro area countries, however, with over 66% of Italian sovereign debt held by domestic creditors, versus 51% for Germany and 47% for France (**Figure 2**). According to the EU-wide stress test conducted by the European Banking Authority (EBA) and published in 2018[1], Italian banks held roughly EUR 800bn in Italian public and non-financial private debt as of December 2018, equal to 41.1% of total assets. Italian public debt totalled 9.2% of Italian bank assets alone. This results in a strong sensitivity in the Italian financial system to Italian public finance risk.

**Figure 2. Italian sovereign debt holdings by institutional sector** (EUR bn)




Source: Bruegel, Scope Ratings GmbH

**Figure 3. Foreign banks' holdings of Italian debt** (EUR bn)




Source: EBA, Scope Ratings GmbH

**High spill-over risk from public to private debt through the credit channel**

A recent discussion paper by the Centre for Economic Policy Research (CEPR)[2] shows that small- and medium-sized enterprises (SMEs) in the euro area were reliant on loans from domestic banks before the crisis, while cross-border lending activities were the exception rather than the rule. In general, cross-border activities of banks in the euro area decreased after 2008 from already low pre-crisis levels; activities have only gradually recovered since then.

Italy, like many European countries, is characterised by a large number of small firms that are highly dependent on bank credit, and by a banking system with many small local banks and very few multinational banks. Thus, Italy's economy remains mainly reliant on domestic credit, which makes it especially vulnerable to a sovereign debt crisis – given the exposure of domestic banks to Italian government debt securities – and any resulting credit crunch.

**Foreign exposure to Italy through non-financial private debt**

The second largest holders of Italian public and non-financial private debt are French banks with a total share of 3.2% of their assets (EUR 209bn), followed by German banks (1.3% of their total assets). According to EBA estimates for end 2018, BNP Paribas and Crédit Agricole are the two largest foreign holders of Italian non-financial debt, each holding more than EUR 80bn, mainly reflecting activities of Italy-based subsidiaries. BNP Paribas and Crédit Agricole hold mainly Italian non-financial private debt (with exposures of around EUR 70bn each) while their holdings of Italian sovereign debt amount to only EUR 12bn-15bn (**Figure 3**). Therefore, given the reliance of Italian firms on domestic bank credit and the large exposures of Italian banks to sovereign debt, spill-over risks

[1] The stress test was conducted for 48 banks covering broadly 70% of total EU banking sector assets. We use the estimated volume of performing exposure at year-end 2018.
[2] Sorensen et al. (2019): Small firms and domestic bank dependence in Europe's Great Recession, CEPR Discussion Paper DP13691.

from public to Italian private debt could significantly impact the balance sheets of foreign banks as well.

**Euro area banks largely protected from shocks to Italian banks**

Yet, the results of a recent study by the Dutch National Bank show that risks for European banks from a potential Italian sovereign debt crisis remain manageable[3]. The stress test assumes a 20% haircut on Italian sovereign bonds and the results show that banks outside Italy would face only limited write-offs between 3-5% of their core capital (except for Dexia, a Belgian bank with a more sizable exposure to Italy relative to assets). Italian banks would be hit harder, with common equity tier 1 capital losses between 3.5 to 7.6 percentage points excluding additional losses in private loan portfolios, which we consider to be relevant as mentioned above.

**Diversifying holdings of sovereign debt could reduce spill-over risks**

A study by European think-tank Bruegel shows that non-resident investors and banks now hold a lowered share of total Italian debt from 39% in 2015 to around 33% by 2018. The Bank of Italy has more than doubled its share during the same period to almost 20%, related to the ECB asset purchase programme, while the share of domestic Italian residents and banks remained broadly stable with an average decline of around two percentage points.

The inter-dependence between Italian banks' balance sheets and the sovereign's public finances generates not only substantial risks for domestic financial stability but matters for the entire euro area given Italy's economic size. If holdings of government debt were more diversified across euro and non-euro area members, wider private risk-sharing during a sovereign crisis would help to reduce marked spill-overs within national borders, and, as such, also limit eventual contagion to other member countries. The completion of the Banking Union, including a common system for deposit protection, is a further step in the direction of greater risk-sharing but it would not solve the problem of highly-concentrated sovereign bond portfolios in domestic banks.

## Banking channel: is contagion risk material?

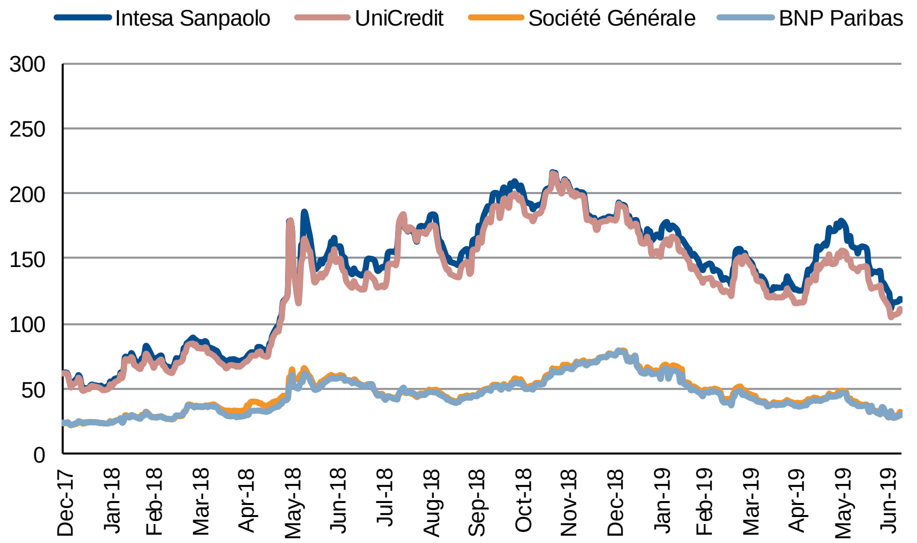
**A degree of spill-over in credit markets…**

Besides the link to Italian non-financial debt, foreign banks could also be affected through cross-border interbank lending, which is more sizable but also more volatile than cross-border lending to the real economy (bank-to-non-bank lending). According to a study by Hoffmann et al. (2019), cross-border bank-to-bank lending reached a peak in 2008 (at above EUR 4trn) and declined rapidly below EUR 3trn thereafter, while cross-border bank-to-non-bank lending remained flat with a volume between EUR 1trn and EUR 1.5trn. This shows that risk-sharing across Europe remains comparatively weak while financial ties are high and pose risks to financial stability.

In **Figure 4**, we plot CDS spreads of four major banks in Italy and France to show the response of financial markets to events in Italy. While these figures are purely descriptive, the correlation between spreads across Italian and French banks signals only a small impact on French banks with the largest exposures to Italian debt from the Italian crisis.

[3] Soederhuizen and Teulings (2018): Capital position of banks in the EMU: an analysis of Banking Union scenarios, DPB Background Document.

**Figure 4. 5-year CDS spreads for major Italian and French banks**

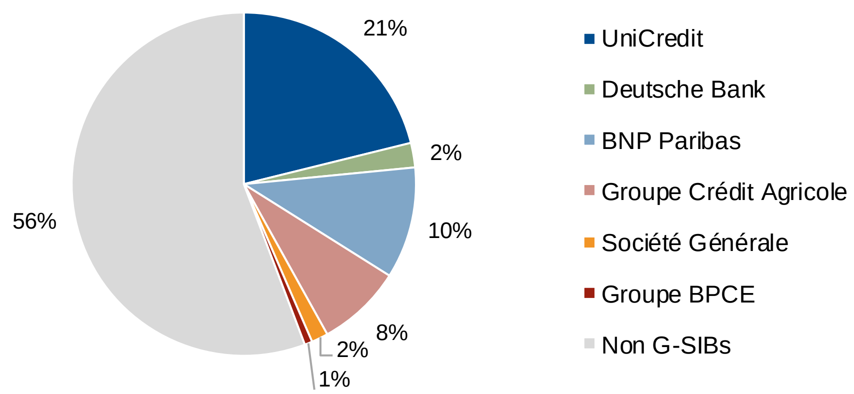



Source: Bloomberg, Scope Ratings GmbH

**… while G-SIB exposures could fuel contagion.**

As we have observed some risk spill-over from Italy to major financial institutions in the euro area, any future escalation of the Italian crisis becomes material for credit risk regionally. Given that most Italian debt is held by global systemically important banks (G-SIBs), risks of more widespread contagion are non-negligible although these institutions have stronger capital bases and lower exposure to non-performing loans than they had in the immediate aftermath of the financial crisis. Using the Financial Stability Board (FSB)'s 2018 list of G-SIBs and combining this with the estimated exposures provided by the EBA, we find that 44% of total bank exposure to Italian debt is held by G-SIBs, with UniCredit Group, BNP Paribas and Groupe Crédit Agricole being the largest individual creditors (see **Figure 5**).

**Figure 5. Share of Italian debt held by G-SIBs, % of total performing exposure[4]**




N.B. This figure only takes into account exposures covered by the EBA stress tests
Source: EBA Stress test results 2018, Scope Ratings GmbH

[4] Using estimates as of 31.12.2018 including total debt held under the standardised and internal-risk-based approach

## Real economy channel: Deep economic integration of Italy

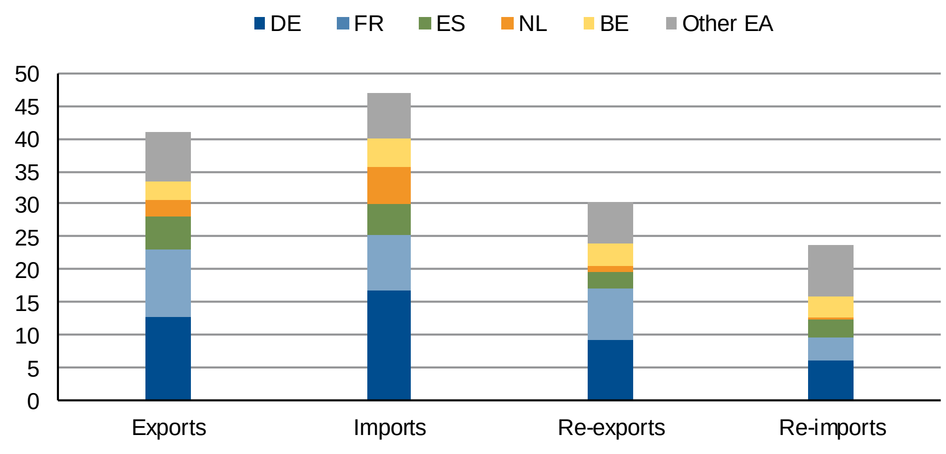
**Spill-over risks are contained by monetary stimulus for now…**

Political events in Italy have had only modest effects on the refinancing rates of other euro area countries, with the 10-year bond yields for Germany and France now in negative territory and those for former crisis countries such as Spain and Portugal at 0.7% and 0.8% respectively at the time of writing. The overall decline in yields and narrowing of spreads to Germany follow hints of further future monetary stimulus from the ECB. The central bank continues to safeguard financial stability and support economic expansion in the currency union.

**... but could become material longer-term.**

Nevertheless, risks stemming from the ties between the Italian economy and other European economies are significant. Intra-euro area trade in 2018 accounted for 41% of Italy's goods exports and 47% of goods imports. Thus, Italy is deeply integrated economically and remains an important import destination and contributor to the supply chains of major industries across Europe. The slowdown in the Italian economy to 0.2% expected by Scope in 2019 (from 0.9% in 2018 and 1.7% in 2017), followed by 0.6% in 2020 presents modest trade-related adverse impacts on the economies of Italy's major trading partners.

**Figure 6. Trade linkages with euro area countries (2018)**
% of total goods trade




Source: UN Comtrade Database, Scope Ratings GmbH

## How to safeguard the euro area against systemic risk

**The loss in credibility of the EU's fiscal rules needs to be addressed**

Given the systemic importance of Italy based on existing trade and financial linkages between Italy and other euro area economies, spill-over risks are non-negligible. These dynamics could limit the extent to which European authorities are willing to enforce regional fiscal rules – through the EU's Excessive Deficit Procedure for instance, if enforcement threatens to precipitate a deeper Italian financial crisis and associated contagion.

In turn, the EU's fiscal rules as set out via the Stability and Growth Pact have come into question with calls for a major overhaul of the EU fiscal framework, owing to the consistent unequal treatment of larger member countries like Italy and France compared with tighter rule enforcement against smaller members such as Greece or Portugal[5].

[5] Vox-EU column by the German Council of Economic Experts: Refocusing the European fiscal framework, September 2018

**Break of doom loop and creation of safe asset restores fiscal sovereignty**

Following enforcement issues related to the rules of the Stability and Growth Pact and learning from the Italian crisis – including issues of an ongoing sovereign-bank nexus, several proposals have been made to complement the EU rules via instruments that would restore fiscal accountability and enhance banking system resilience, in particular: i) the increase of risk weights for central government debt; and/or ii) a limit on domestic bank bond holdings of their own country's sovereign debt; and iii) the creation of a European safe asset[6].

Mindful of implementation and operational considerations that adequately balance the trade-off between strengthening the resilience of the banking sector to sovereign risk and maintain the investor base for European sovereigns[7], in Scope's opinion, the first two proposals could help increase market discipline and reduce the doom loop between bank and sovereign risk, while the creation of a European safe asset could prevent a flight to safety during a crisis while still preventing a mutualisation of sovereign debt. Scope published a study to create a European safe bond last year.

A European safe asset could help realise complementary objectives of higher sovereign risk weightings and limits to bank sovereign bond holdings because the former facilitates the transition of banks' balance sheets from domestic holdings towards a more diversified asset pool. Given that we already observe a scarcity of safe assets in the European marketplace, banks would need additional high-quality assets in order to replace domestic government debt.

**Three proposals could strengthen the Euro Economic and Monetary Union**

If the EU's fiscal rules were complemented by implementing a combination of the above three proposals, this could strengthen the stability of the currency union in at least three dimensions:

1) Less risk of irresponsible domestic lending practices to their own sovereigns, enhancing fiscal sustainability in the long-run and curtailing likelihood of sovereign borrowing crowding out other sectors from bank loans;
2) Less spill-over from instances of fiscal distress to private sectors, reducing the sovereign-bank nexus; and
3) Improved resilience of banking sectors through more diversified risk portfolios and risk weights that more accurately reflect sovereign risk – enhancing bank balance sheet preparedness for sovereign crisis scenarios.

**Safe bond could mitigate risks to financial stability**

The transition to risk-weights and/or domestic sovereign debt limits alone entails risks to the financial stability of countries like Italy, whose banks would be either forced to raise additional capital and/or to sell part of their domestic bond holdings. This in turn could lead to the systemic crisis that was intended to be prevented in the first place by the introduction of either or both proposals to weaken the sovereign-bank nexus. The parallel introduction of a safe bond could thus help provide the additional demand needed for euro area government bonds during the rebalancing period towards more euro-wide bank balance sheet diversification.

Previous discussions around these proposals revealed that the introduction of risk-weights and/or limits to domestic debt holdings are opposed by sovereigns potentially facing market stress and/or carrying high debt burdens (including southern European countries) while the proposal of a safe asset received sceptical views from countries fearing a mutualisation of debt obligations, such as Germany and the Netherlands. The combination of the three proposals could address at least some of the expressed concerns: Weakening the doom loop leads to a reduction of spill-overs feared by northern

[6] For details, see the Vox-EU column of CEPR fellows dated May 2019: "Euro area architecture: What reforms are still needed, and why", May 2019
[7] Lenarcic, A., Mevis, D., Siklos, D. 2016. Tackling sovereign risk in European banks; ESM Discussion Paper March 2016

countries and at the same time, the introduction of a safe asset could lead the way towards more risk-sharing and risk diversification. A major challenge for policy-makers is to implement the proposals gradually and geared towards each other to prevent financial instability in any, and thus, across all euro area countries. The completion of the Banking Union and advancements toward the Capital Markets Union could help support this process.

## Implications for sovereign ratings

**Italy's ratings benefit from euro area membership…**

Currently, Italy's BBB+/Stable ratings benefit from euro area membership not only due to a stable institutional framework and a common market but also because of accommodative regional monetary policies alongside implicit support from the ECB and the European Stability Mechanism (ESM) in severe crisis scenarios, acting as lenders of last resort that could reduce the likelihood of sovereign default.

**… while necessary adjustment is further postponed.**

In the case of Italy, public debt sustainability remains a major challenge in view of the policies being implemented by the current government. This in turn could present greater implications for the rest of the euro area if investors were to question the stability of the currency union. Here, adoption of the three above proposals could help reduce the doom loop and support all euro area sovereign ratings in the long-run, not only that of Italy.

**Restored market discipline could prevent crises ex-ante**

A credible no-bailout regime, i.e. the real risk from a sovereign default in the euro area, would lead governments to take more timely fiscal action if financial markets observe and react to a weakening of public finance management ('going concern'). At the same time, a credible no-bailout regime ensures that national governments remain fully accountable for their budgets while making current arrangements like the Stability and Growth pact less needed to monitor national governments. In turn, national policy-makers are also less likely to blame European institutions for their fiscal situation.

Finally, in Scope's opinion, while market discipline should be usually sufficient to avoid the use of emergency support when it is too late, emergency support instruments such as the ESM will remain important as lenders of last resort ('gone concern').

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