Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

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Brexit Panic: It's The Italian Banks, Stupid

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Donald Luskin

They missed Europe's bail-out window. Now Renzi is using the crisis to open it again.

The governing dynamics of the markets' extreme response to Brexit may not be all the high-falutin' stuff about the end of the post-war world order. It may really be very simple and very familiar, and easily fixed.

- *Brexit, with all its attendant uncertainties and transaction costs, could throw Europe back into a recession that it barely got out of in the first place. If that happens, Europe's troubled banks will be back at the epicenter of global systemic financial contagion. Italy's most of all.*
- The special problem for Italy's banks is something we've been writing about for months – the new Bank Resolution and Recovery Directive, a European version of Dodd-Frank designed to outlaw "too big to fail" by prohibiting future taxpayer bailouts of banks of the kind that other EU banks have already gotten (see "On the March ECB Policy Decision" March 10, 2016). BRRD requires that bondholders and depositors be "bailed in" – that is, lose all their money – as they did in 2013 when Cyprus' banks failed (see "Regime Change Comes to Euro Policy" March 28, 2013).
- All very noble. But the problem is that, prior to Cyprus, Germany had bailed out its *landesbanks* and Britain bailed out Northern Rock in the financial crisis of 2008, and then as the aftermath unfolded, France and Belgium bailed out Dexia, and Europe, collectively, provided funds to bail out or recapitalize banks in Greece, Portugal, Ireland and Spain. *Those were the years when the bail-out window was open. With Cyprus, that window slammed closed – and Italy's banks missed it.*
- *And as we know from the financial crisis of 2008-2009, markets can be very unstable when they don't believe a bank safety net is in place, sometimes triggering the very bank crisis they fear, whether or not there is any true solvency issue that couldn't just be cured with a little patience.*
- The true issue is that Italian banks are reportedly burdened with €360 billion in non-performing loans – about 20% of total loans, and about 20% of GDP. Is that enough to raise substantive insolvency concerns? That's a matter of judgment, but in the present atmosphere of crisis and with uncertainty about the safety net, perhaps so.
- In January, Italy announced an initiative to buy up the bad loans, but even after extensive and painful negotiations with Brussels, the

Update to strategic view

EUROPE MACRO, EUROPE STOCKS: The post-Brexit crisis could boil down to the simple proposition that it will nudge Europe into recession, and that Europe's fragile banks – especially Italy's, which have undergone the least restructuring – will be the epicenter of systemic financial contagion. New EU rules keep Italy from injecting public funds in banks, as Germany, France, Spain and others previously had. Renzi is using the political opportunity of Brexit to argue for an exception, so a €40 billion fund might be announced as soon as this week. In the EU, decisions are never easy – Juncker appears to be in favor, Merkel opposed. But if it happens, after Spain's pro-growth election outcome, this would make two-for-two very positive steps taken by Europe following the UK referendum.

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Italian government could contribute only guarantees. The initiative, christened *Atlante* (Italian for "Atlas" – yes, Ayn Rand is rolling in her grave), debuted in April, and has raised only about €5 billion. A third of this was consumed by stepping up to support the failed IPO of tiny Banca Popolare di Vicenza.

- *Now, as the Brexit crisis lies heavy on Europe, Italian Prime Minister Matteo Renzi is doing exactly what we said he would do* (see "Brexit: Opening Pandora's Brox" May 23, 2016) *– he is using the opportunity to renegotiate with Brussels. Among European nations, Italy has a lot of negotiating leverage because the disruption that would be caused by "Italeave" would be quite intense beyond its banking risk – thanks to Italy's high level of sovereign debt, and its participation in the common currency. And we would think this would be a good time to reward a loyal EU member, demonstrating that membership has its privileges.*
- Renzi is not being shy about pushing the point, and with an Italian constitutional referendum coming up in October concerning his agenda for political reforms, he's eager to bring home a trophy. At a press conference on Monday in Berlin, standing right next to German Chancellor Angela Merkel, Renzi spoke directly to the hypocrisy that has shut out the Italian banks: "There exist European rules, but before there were these rules some countries like Germany, made the necessary [bank capital] injections…and in my opinion they did the right thing…"
- The same morning, in Rome, Renzi had told his parliament – echoing our own outlook (see "On the Brexit Referendum" June 24, 2016) – that "Brexit is a great opportunity for Europe… More growth and more investment, less austerity and less bureaucracy."
- *Renzi is not only relying on an opportunistic political window opened by the Brexit crisis, but on a loophole within BRRD itself – a provision that the bailout rules could be set aside by the European Commission under exceptional conditions that "endanger financial stability."*
- Renzi said yesterday, on the sidelines of an EU summit in Brussels, that *formal* negotiations were not underway. But "there is in these hours a very strong discussion at all levels. I was in Germany yesterday and Saturday in France, today we are in Brussels and we are discussing everything."
- When asked about it after the summit, Commission President Jean-Claude Juncker confirmed, "I don't want to answer directly, but we did discuss with Renzi."
- *Over the last three days, we have seen several reports suggesting that Italy will aim for a €40 billion fund to buy non-performing loans – and that its announcement could come in mere days.* Beyond the technical snap-back one might expect after Friday's and Monday's carnage, these reports could be at the heart of the better market tone on Tuesday and today.
- If the heat of panic continues to subside, perhaps the Commission will be less worried about "financial stability," and will be less inclined to grant the exception. If it makes that mistake, then we would expect the panic to spin up again until the Commission gets the message, hopefully in time. Indeed, yesterday, on the heels of

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

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Max Fisher
New York Times
June 28, 2016

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a relatively good day in global markets, it is being reported today that, according to unnamed sources, Merkel opposes granting Italy an exception to BRRD. But then again, Merkel has a record of talking tough to appease certain austerity-minded Germans, but ultimately agreeing to a softer and more risk-averse course.

- *But this kind of byzantine politics, in which it is never clear who – Juncker? Merkel? – or at what level – European Commission? Germany? – or by what means – votes? leaks? – actually makes decisions, or why, is exactly the reason the UK wanted to leave the EU, and why the EU is so desperately in need of reform.*
- On Sunday, Europe took an enormously positive post-Brexit step when Spanish voters defied a Marxist insurgency in the general election (see "Post-Brexit Europe Passes Its First Test" June 27, 2016). *Now if the European Commission will work with Renzi and a bailout fund is announced, that will make it two-for-two within a week of Brexit.*
- We have no inside information on this. But looking at all the moving parts and trying to understand the political game theory in play, we think there's a better-than-even chance that this happens this week.

Bottom line

The post-Brexit crisis could boil down to the simple proposition that it will nudge Europe into recession, and that Europe's fragile banks – especially Italy's, which have undergone the least restructuring – will be the epicenter of systemic financial contagion. New EU rules keep Italy from injecting public funds in banks, as Germany, France, Spain and others previously had. Renzi is using the political opportunity of Brexit to argue for an exception, so a €40 billion fund might be announced as soon as this week. In the EU, decisions are never easy – Juncker appears to be in favor, Merkel opposed. But if it happens, after Spain's pro-growth election outcome, this would make two-for-two very positive steps taken by Europe following the UK referendum.