



## Why Is Brexit Causing Trouble for Italy's Banks?

*Nicolas Véron says Italy's banking problems have been simmering for quite some time and that fears associated with Brexit and controversial efforts by the Italian authorities to rescue domestic banks have further complicated the issue.*

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Pedro da Costa: I'm Pedro da Costa, Editorial Fellow here at the Peterson Institute for International Economics. I'm joined by Nicolas Véron to speak about the post-Brexit fallout on the European banking system. Thanks for joining me.

Nicolas Véron: Thanks, Pedro, for having me.

Pedro da Costa: I'm kind of surprised to see Italy being the first point of contagion or the next perceived domino in financial markets following Brexit. First of all, why Italy, and second, why the concern about banks given that we're supposed to be in a post-crisis world where banks had ample capital to get by with?

Nicolas Véron: So, Brexit's vote on June 23 has been an excellent radar of the situation in Italy, but it really didn't create a problem. Actually, my expectation before the referendum was that we would have a vote to remain in the EU and that after that all the investors' attention would focus on Italian banks because that was the next big thing.

So, unquestionably, the vote has made the Italian situation more difficult and more complicated, but the situation existed before.

You could say that the Italian banking system is a big, unresolved piece of work after the great financial crisis in Europe and the Eurozone crisis. So, you have had a lot of clean up, if you will, of the banking system to varying degrees in Spain, in Portugal, in Greece, in Cyprus, in different ways in France and Germany, even.

Italy has sort of state frozen with an economy that hasn't been growing and an increasing inventory of nonperforming loans. And so, authorities, to say the least, have been very slow in their reaction.

Now, we have banking unions. So, the European Central Bank has taken over a year enough ago as the supervisor of the largest banks in the system, and it is belatedly taking action to make sure that balance sheets are strong, and this is largely what's driving the current situation in Italian banks and the Italian banking system.

Pedro da Costa: Now, how worried are you that what's happening with Italian banks and with Italian bank shares could affect other countries in Europe? And moreover, in the broader context, how much does the Brexit situation affect the European banking integration that you've written so much about?

Nicolas Véron: So, on your second question, I would say it's a bit early to say because it will be driven by politics, and we basically don't know yet what will be the political impact of the referendum

voting in the UK for the rest of the EU. Will it give momentum to anti-system parties or will it trigger a reaction back to the mainstream out of caution, basically, and risk aversion.

Which is actually what happened, for example, in Spain. A couple of days after the UK vote, there was a reversal to traditional parties on the Central Right and Central Left. There will be a big test in September with the rerun of the Austrian presidential election, which will be a good observation point for this.

Now, on Italian banks, I think Italy is pretty much self-contained. So, I wouldn't expect contagion to either of the neighboring countries with the possible limited exception of Portugal, certainly not to France. I would argue not to Spain.

And the Italian financial in aggregate terms of financial equation is not that difficult. So, probably it means more political. It's a question of what is the framework for restructuring banks in the new banking union context and here, there are big disagreements between the Italian authorities and the EU authorities, and that's the core of the current crisis in Italy, more than the pure financial instability situation as we saw, for example, in Spain four years ago.

Pedro da Costa: Sure. Can you speak a little to that? So, basically, what's been happening is that Italy has been kind of orchestrating a bailout of its own banks in discord with what you're supposed to be aiming towards as far as a banking union? Is that a fair assessment?

Nicolas Véron: Exactly, one big piece of banking union is to say we want to eliminate the vicious circle, the financial connection between bank, credit, and sovereign credit or bank credit [inaudible 0:04:09] and sovereign credit [inaudible 00:04:11]. And one big part of it is to avoid national bailouts of bank creditors.

Well, that can be done with European bailouts, and that's what is called into jargon direct [inaudible 00:04:22] of banks by the European stability mechanism which is this European Fund in Luxembourg.

But, preferably, with no bailout at all and the so-called bail-in, which is that creditors of the banks pay for whatever losses there are to and that gaps to fill in the balance sheet.

Now, a part of that is the Italian Government wants to push for a bailout. And for a number of reasons, which have to do with a very peculiar political economy of Italian banking, they want to say, "No, we want the taxpayers to actually fill up the gaps that are in the balance sheets," and there is popular support for this in Italy.

So, it is a very twisted episode of this quest for better banking policy regime in the Eurozone where everybody was paying lip service to the need for bail-in or bailout when it was an abstract situation. But when it becomes concrete, things become very much more complicated, and I guess that a compromise will be found, not sure bailout, not sure bail-in, but it is much part of the learning curve of this whole new banking policy regime, which includes banking union in terms of centralization of supervision and other instruments. But, also includes this newly mooted preference for bail in and bailout.

Pedro da Costa: Sure. And as far as the impact of Brexit on the regulatory landscape over the long haul even if we don't have a complete picture of how it might turn out. Is there a sense that there's

going to be a raise to the bottom of any sort? Our colleague and boss, President of the Institute, Adam Posen, wrote a piece of this effect and he worried that basically Britain would basically resort to throwing favors to the financial sector in order to ask for it to remain there.

And you've seen other cities across Europe kind of vowed to become the next City of London. How do you see that playing out?

Nicolas Véron: I don't think it's really a race to the bottom in terms of the European Union, assuming of course, as I do, that England would be the only part of the Union to exit or secede from the rest.

So, I think Adam Posen's scenario, which is a possible scenario, not sure, is that England outside of the European Union would have basically a sort of rogue tax haven and regulatory haven strategy and would try to undercut any regulatory constraints that exist on the continent.

Now, if you're inside the European Union, things play out quite differently and I actually anticipate that the exit of England from the European Union might trigger actually more harmonization of the financial policy framework in the remaining European Union. Take for example, capital markets, further integration of banking policy.

At this point, that would be my baseline scenario as for the direction of travel.

If this is true, there will be competition, of course, between different financial centers in the EU to sort of eat London's lunch, if you want to put it that way. And this competition, in many ways, has already started. But, it's going to be a competition through infrastructure, the education, the tax environments, why not? But, not on regulation. Because, regulation will be a European overlay.

And therefore, I'm not too worried about the perverse effects of that for the European Union. Even so as Adam pointed out, there is a worry that the UK or England, if that's what remains, could become a bit of a rogue player in one scenario, which is far from sure, but is out there.

Pedro da Costa: Lastly, how do you see the Eurozone's banking situation sorting itself out over the coming months? You mentioned this would be contained. So, do you see this as yet another kind of flashpoint that we're going to muddle through over a 3-month time horizon and then we're going to forget about Italy, or how long is this going to remain in the headlines?

Nicolas Véron: The Italian piece is a big remaining piece. And as I mentioned, the national authorities have been too slow to address in the past year and a half. So, I think this will continue to mobilize a lot of attention. I would say, probably until the end of this year, if not beyond.

Pedro da Costa: Thank you so much, Nicolas, appreciate it.

Nicolas Véron: Thank you.

