

Italy's referendum holds the key to the future of the euro

EUROPE

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After Brexit and Donald Trump, prepare for the return of the eurozone crisis. If Matteo Renzi, Italian prime minister, loses his constitutional referendum on December 4, I would expect a sequence of events that would raise questions of Italy's participation in the eurozone.

The underlying causes of this extremely disturbing possibility have nothing to do with the referendum itself. The most important was Italy's economic performance since it adopted the euro in 1999. Total factor productivity, the portion of economic output not explained by labour and capital, has fallen in Italy by about 5 per cent since then whereas in Germany and France it went up by about 10 per cent.

The second source was the failure by the EU to construct a proper economic and banking union after the eurozone crisis of 2010-2012 and to impose austerity instead. If you want to know why Angela Merkel cannot be the leader of the free world, look no further. The German chancellor could not even lead Europe when it mattered.

The combination of those two factors are the biggest causes for the incremen-

tal rise in populism in Europe. Italy has three opposition parties, all of which favour exiting the euro. The largest and most important is the Five Star Movement, a party that defies the usual left-right classification. The second is Forza Italia, Silvio Berlusconi's party, which has turned rabidly anti-euro after the former prime minister was forced out of office in 2011. And the third is the separatist Lega Nord. In democratic countries, it is common that opposition parties eventually come to power. Expect that to happen in Italy too.

The referendum matters as it could accelerate the path towards euro exit. If Mr Renzi loses, he has said he would resign, leading to political chaos. Investors might conclude the game is up. On December 5, Europe could wake up to an immediate threat of disintegration.

In France, the probability of a presidential election victory by Marine Le Pen is no longer a remote risk. Of all the candidates that have declared, she is the best prepared. There are some who could beat her, like Emmanuel Macron, the former reformist economics minister, who declared his candidacy last week. But he may not make it to the final round of the elections as he lacks a party apparatus. If Ms Le Pen became president, she has promised to hold a referendum on France's future in the EU. If that referendum were to lead to Frexit, the EU would be finished the next morning. So would the euro.

A French or Italian exit from the euro would bring about the biggest default in history. Foreign holders of Italian or French euro-denominated debt

would be paid in the equivalents of lira or French francs. Both would devalue. Since banks do not have to hold capital against their holdings of government bonds, the losses would force many continental banks into immediate bankruptcy. Germany would then realise a massive current account surplus also has its downsides. There is a lot of German wealth waiting to be defaulted on.

Can this be prevented? In theory it can, but it would require a series of decisions taken in time and in the right sequence. For starters, Ms Merkel would have to accept what she refused in 2012 – a road map towards a full fiscal and political union. The EU would also need to strengthen the European Stability Mechanism, the rescue umbrella, which is not designed to handle countries the size of Italy or France.

Is this even remotely likely? Think about it this way: if you ask the German chancellor whether she wants commonly-backed eurozone bonds, she will tell you no. But if she has to choose between eurobonds and an Italian exit from the euro, her response may well be different. The answer will also depend on whether you ask before or after the German elections next autumn.

My central expectation, however, remains not a collapse of the EU and the euro, but a departure of one or more countries, possibly Italy, but not France. In the light of recent events, my baseline scenario is now firmly on the optimistic scale of reasonable expectations.

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