SYZ WEALTH MANAGEMENT

SPOTLIGHT

12 July 2016

BREXIT IMPACT ON PERIPHERAL ECONOMIES

ADRIEN PICHOUD
Economist

> *"As the new European banking framework forbids direct government intervention to bail out banks, no solution has yet been found to a situation only worsened by the Brexit shock on financial markets. The fear of a banking crisis starting in Italy is a potential strong headwind for economic activity."*

Six years after the outburst of the euro zone crisis, the saga has entered a new chapter. Without minimizing the scale of the previous episodes, this one may eventually be the riskiest that the monetary union has experienced so far, with the spark coming, ironically, from a country outside the euro zone. In a context of rising popular discontent toward politicians and the EU, high unemployment and a still vulnerable financial system, the Brexit vote has opened a Pandora box for the Eurozone's future.

From a purely economic standpoint, Italy, Portugal and even more Ireland and Spain were all growing till the UK referendum and only Greece was lagging behind, recovering from last year's flirtation with a euro divorce. With the primary driver of this growth being domestic demand, the tangible link between a weaker post-Brexit UK economy and Southern European countries will be limited. Only Irish growth is likely to be significantly impacted as the UK is a major trading partner.

However, the main impact from the Brexit is more likely to be felt through two intangible channels, the financial and political ones. The shock to a London-centric European financial system may indeed result in tighter financial conditions for European banks across the board, which would weigh on European economic growth. The elephant in the room is however the Italian banking sector: Italian banks are still plagued with large amounts of NPL and are clearly undercapitalized. As the new European banking framework forbids direct government intervention to bail out banks, no solution has yet been found to a situation only worsened by the Brexit shock on financial markets. The fear of a banking crisis starting in Italy is a potential strong headwind for economic activity.

As worrying as it may seem, this situation could be like a "Déjà vu all over again" if it weren't for the political factor. And, from that angle, the situation is very different from the previous episodes of the Eurozone crisis: after several years of fiscal austerity, high unemployment and subdued growth, a growing share of public opinion has developed resentment toward the traditional political parties and the perceived overprotection of banks. Immigration concerns have further fuelled that resentment and the UK referendum sets a precedent for the possibility of an anti-European/anti-establishment campaign to gather absolute majority. With elections to be held in all major Euro area countries in the next 15 months, the risk of seeing anti-EU outsider parties gain access to power can not be neglected and Italy is in first line. Its banking sector is under intense pressure, within an already fragile growth context. Brussels is denying the Italian government the possibility of bringing a quick fix to it. Prime Minister Renzi has vowed to step down if the Senate reform is rejected at next October's referendum, which might trigger new elections. And the 5-Star movement, in favour of a referendum on Euro membership, is gaining ground in the polls. Can the cocktail be more explosive? Unless the European Union manages to provide a convincing response not only to financial issues but also to peoples' concerns, the Brexit aftermaths in Continental Europe could well get out of control. And, unlike in previous episodes, this chapter of the crisis will not be closed with a late-night European summit agreement or an ECB magic trick. Fortunately, European regimes are democracies. People have the last word when elections are held. And, as seen in the UK, people can ultimately opt for a leap into the unknown.