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Contagion

Italy and the role of fiscal similarity

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Tensions in financial markets have increased significantly since the populist/ Eurosceptic Five Star/League in Italy took power in May and presented a budget in violation of EU rules. In an unprecedented move, the European Commission sent Rome back to the drawing board. Italy has now provided the Commission with its latest fiscal plan – which is not much different from the old plan.

The Commission has three weeks to take its next step. Given the minimal changes to the draft budget by Rome, we expect the Commission to recommend an Excessive Deficit Procedure (EDP). The only questions are the scale of the fiscal adjustment the Commission asks from Rome and the timeframe for its completion. In our view, contagion and negative spillovers in financial markets will influence the Commission's decisions.

Contagion is of interest to economists because it increases the costs of a crisis. In our note we look at two measures of contagion. First, we examine the correlation among euro member country CDS spreads. CDS is a proxy for default risks. The correlation across countries is not zero, but it has declined sharply from 0.9 before the announcement of OMT to around 0.55 recently. Spain and Portugal, the two countries seen as more vulnerable to Italian developments, have seen the correlation decline significantly since the debt crisis.

Second, we adopt the Favero-Missale (2012) methodology to create a measure of contagion based on the Bund spreads of fiscally similar member states. Such a measure does a good job of explaining the widening of spreads in 2011-2012. Consistent with CDS correlations, the sensitivity of spreads to contagion has eased recently according to the fiscal similarity measure. According to this alternative contagion variable, Portugal is the country most exposed to Italian developments.

The evidence suggests that the strengthening of the euro governance and stability framework – the creation of the ESM and in particular the OMT – was instrumental in reducing contagion, a negative externality due to fiscal similarities between euro member countries. The fact that the recent Italian shock has been an idiosyncratic and not a systemic event implies that the benefits of the new governance and stability framework are holding. Against this backdrop of limited contagion, we can see the Commission adopting a tougher stance against Italy.

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