Fortnightly Report
Early views from the Italian political and institutional environment on the Brexit referendum and the incoming negotiations between the EU and the UK

09 December 2015

1. Government views on possible Brexit and on the incoming negotiations with the UK

Negotiations between UK and its fellow EU partners to define new EU membership conditions - as requested by PM Cameron - are seen as a great chance for Italy to enhance its international role. Beyond the typical benefits stemming from an improved international standing, this would be functional at increasing Italy's chances to get additional benefits in the future.

However, it is a widespread view that very little would change with regards to the EU functioning should the UK actually quit, even though many in the political environment are still struggling to have a clear picture of what the EU would look like under such a scenario.

The view we got in our talks with the national Government can be summarised as follows: "*Italy is the fourth largest country in the EU by economic size, and we have a duty in taking a leading stance in the incoming negotiations between London and Brussels. We will make our voice heard to contribute avoiding Brexit and - at the same time - keeping our national interest in European integration unaltered.*" Italy-UK economic relations are very well-established[1], so "*should UK leave, investment and trade relations would be negatively affected. Also, we would have to deal with the many expats* [around 150,000] *living in the UK, which, in all probability, will be required to come back to Italy. The UK deems us a crucial ally for successfully renegotiating EU membership: we should exploit this situation to increase our political and diplomatic weigh and to free ride what UK could get*".

The Italian Government's focus is, as usual one may say, on budgetary flexibility: therefore Italy can be expected to try to exploit EU negotiations on Brexit to get as much as possible on this front.

<u>Views on Cameron's letter to Tusk</u>

In our talks with the Government bureaucracy, we also got the impression that the letter the British government sent on 10 November to President Tusk has been not unanimously received in Italy. While many have seen it as a promising first step and gave an overall positive assessment of UK's requests *("all reasonable, expect perhaps the stance on immigration"),* others have maintained that the current situation in not as unsustainable as British claim. and claim that many of the proposals put forward by Cameron[2], they argue, could have been debated in normal EU negotiations. According to those who do not see Cameron's stance and requests as reasonable, the British PM's letter is, in fact, *"nothing but a blackmail or, rather, a display of political opportunism – since the entire Brexit referendum story seems ultimately aimed at burking the Conservative Party's Eurosceptic faction and strike UKIP down."*

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[1] Italy is the third largest European investor in the UK, with bilateral agreements in force worth € 20 billion in the first half of 2015. See https://www.gov.uk/government/publications/ukti-inward-investment-report-2014-to-2015

[2] PM David Cameron has pledged that he will campaign for the UK to stay in the UE, in view of the national referendum on Brexit, should action be taken in the 4 policy domains he raised in his 10 November's letter to President Tusk for recalibrating the EK-EU relationship.

The key areas are:

- Economic governance and balance between Eurozone members and non-members
- Competitiveness and completion of the single market
- Sovereignty, i.e. UK's resolve not to integrate further and request for a greater involvement on national parliaments in EU decision-making
- A more strictly regulated intra-EU migration.

Those who view Cameron's initiative more favourably, instead, have pointed out that the British PM *"may be cynical, but he is realistic. Only France and Germany have the same influence and - consequently - the same bargaining power as the UK. By threatening for Brexit, Cameron is undoubtedly playing hard, but he knows he can afford it because no one wants a country as economically, politically and strategically important as the UK to quit.* ***Should others try and emulate Cameron in the future, they will find that some MSs are more equal than others****. Moreover, Cameron himself aims at making EU membership more sustainable in domestic politics, but he certainly does not want the single market to break up and will be very careful in ensuring that UK's requests do not lead to a progressive disintegration of the Union".*

<u>Italy's strategic approach to the negotiations</u>

Overall, the approach the Italian Government can be expected to follow can be summarised as follows: "*we should support the UK with regards those request that can benefit the entire EU and acknowledge that* ***some degree of differentiation should not be seen as a temporary exception any more, but rather the new normality in the EU, for the sake of the very survival of the Union****. The alternative - an EU without the UK - is in fact a diminished EU, and this would be contrary to Italy's interest. For the same reason, we should oppose those UK's proposals potentially hampering - or even reversing - key integration achievements."*

We got some more detailed views on the Italian Government's stance on specific issues:

a. Italy is going to support the UK's demand for the prompt establishment of a **truly single digital market and common capital market**. In particular, the Italian Government appears to believe that capital market integration would increase availability of financing sources for the Italian banking system and, consequently, for Italian SMEs
b. Italy does not intend to abandon its integrationist commitment and is therefore cautious with regard to any request from the UK that emphasise the notion of national sovereignty. *"It is not a matter of accommodating London's demands. Actually, flexibility has become a fact. Special arrangements, not by chance most of them with the UK, are a reality of EU integration, therefore it must be acknowledged that a multi-speed Europe already exists. But multi-speed implies a differentiated pace towards a common goal, i.e. the same level of integration: this can no longer be taken for granted. Rather, today's EU is a multi-level system of governance, for example in monetary, budgetary and home affairs. By accepting UK's request in this field we would do nothing but ratifying an existing situation".* At the same time, however, Italy should not agree on Cameron's idea that national Parliaments should be given more powers, as initiating or blocking EU legislation. Still, Italy could be available to consider proposals to give national Parliaments more time to review the proposed legislation, thus only temporarily blocking it.
c. With regards to **economic governance**, Italy will reject any commitment affecting the well-functioning of the Economic and Monetary Union. Accordingly, the Italian Government is not inclined to accept the establishment of any formal safeguard clauses for non-Eurozone members, e.g. allowing them to block regulations possibly impinging

on the integrity of the single market. "*So far, Member States have managed to protect Euro-outs with ad hoc agreements. For example, these Member States have been refunded when the EU budget has been used to support Eurozone only. We should continue agreeing on such specific safeguards*". Also, Italy opposes the establishment of double majority procedures - except for a limited number of well-defined cases - giving a majority of non-Eurozone countries the power to block decisions, even when these are approved unanimously by the Eurozone ones. "*Cameron's request for some form of protection for non-Eurozone countries makes sense, but not to the extent of granting them the power to prevent decisions from being taken. Also because, as the number of Euro-outs can be expected to lower, this would mean granting a single nation State - the UK - almost a veto power*".

From a different angle, the Italian Government understands that a well-designed double majority mechanism might be a powerful weapon in the hands of any Eurozone member intending to counter the hegemony of Germany and its satellites, but they recognise it should be handled with care: "*Many crucial decisions are now agreed upon at Eurogroup meetings, where no formal voting is foreseen and those who raise their voice can easily prevail. This prevents any blocking minority of peripheral Member States from successfully emerging at the subsequent Ecofin meetings. The possibility for Euro-outs to counter Eurogroup decision could prove an effective tool for those opposing a German-centric EU, but we must be careful in supporting such a mechanism*"

d. Finally, Italy can be expected to be firm with respect to the **immigration issue**. "*We cannot support measures which would end up in restricting EU citizens' right to accede other countries' labour market. Still, we know this is a crucial area to the British Government, to the extent that any possible agreements on the other areas may be nullified if progress is not made in this field too. For this reason, albeit reluctantly, we could be forced to explore a way by which free circulation of workers would be limited on a temporary basis*".

Views on Brexit

When confronted with the **possible impact Brexit on EU Agenda and balance of power**, the Italian Government appears to think that the consequences of a Brexit on the concrete functioning of the Union would be rather limited: "*Should UK really quit, it would have a symbolic effect on the European integration path and detrimental consequences with respect to the EU's international/diplomatic standing and commercial/economic weigh. But* ***I cannot see a real impact over the functioning of the EU****. The UK is a peculiar case, they consider the Union only as a large free trade zone. They have not joined the ESM Treaty, are not part of the Banking Union and have not ratified the Fiscal Compact. They enjoy so many derogations that at the end of the day, should they definitively call themselves out, very little would change in the EU in practice.* ***Paradoxically, it will be much more interesting to see how the European institutions would react and adapt their functioning to a much diversified British membership, should Brexit be eventually averted****".*

Balance of power between the largest Member States is another interesting angle, but from this perspective as well, we got the view that from Italy's standpoint, British membership has now lost the strategic value it has had for decades: "*it is true that, traditionally, Italy has* *considered London as a crucial ally to counter the Franco-German axis. But even from this point of view a Brexit would have no significant impact on us,* ***because there is no more Franco-German axis to be countered and because, since the UK decided to undertake a differentiated integration path, starting from its decision not to join the Eurozone, they are not a valuable back-up for us****.*"

In other words, the prevailing view within the Cabinet appears to be that the UK already enjoys such a peculiar membership that its exit would be little more than a ratification of an existing situation, with very minor concrete effects.

For the very same reason, we did not find any support to the view that Brexit may give rise to strengthened Franco-Italian relations, possibly counterbalancing the German hegemony: "*Actually, the political convergence between Paris and Berlin is rather in a poor state, with Angela Merkel being the undisputed European Kaiserin. Perhaps, the problem of Europe is precisely that Germany is too big to be just one of the many players in the European game, but too little accustomed to exercise his newfound influence to the benefit of the continental system as a whole. The result is a halved Germany: the dominant power in Europe, but not truly a European leader. At this stage, should Italy scale up its role and influence, we should rather exploit it to exercise a positive influence on the German leadership, not to counter Berlin's hegemony."*

With regards to the possible impact of Brexit over specific EU policies, it is still early to make any sound prediction. The view we got is that the Italian Government expects only small changes in the approach to EU trade policy, even without a traditional free trade champion as the UK: *"the outcome of trade negotiations depends crucially on the counterpart, much more than on the negotiations between Member States. Take the case the TTIP: I fear that Europe has suffered it from the United States more than it contributed in designing it, and I do not think the absence of the UK would have led to a different final outcome".*

2. Views on Brexit collected from political parties

We collected very different and sharper views from the Italian Parliament. The positions on Brexit clearly reflect the parties' different views on the European integration process.

The prevailing view emerging from the **parliamentary majority** appears to be extremely critical towards the UK, which is widely seen in the centre-left field as a major, historic obstacle to the continental integration process which the European Socialists warmly support: "*we should let the British go their way. They are dictating conditions that call into question the very foundation of the European project that politicians wiser than us conceived sixty years ago. They are no longer satisfied with being recognised as the slowest ship in the integration convoy: they are now asking for the ratification of their complete freedom of action on currency, tax and even immigration issues, as well as for an* erga omnes *veto power. They seem to consider all the other Member States as their Empires' dominions, with no right of taking any decision without Westminster's consent. But this is no surprise, indeed: they have always worked to break off any attempt for a greater European integration. For this reason they have exploited the Soviet collapse to facilitate the massive enlargement eastwards, thus widening the free market (the only thing that matters to them) and throwing sand in the EU decision-making mechanism, to cause the system's paralysis. As a matter of fact, they succeeded, as Poland and Hungary are now the main rivals of the European model. We need to* *return to a small group of States, getting back to the old federal ideals, and I think that this task falls on those Countries which already share their currency. The possible UK's quit is an opportunity to cut the dead branches; we should not force anybody to stay and above all, we should not accept their conditions.*"

The Brexit referendum is seen with considerable interest by the Five Star Movement, which has long advocated for a consultative referendum on Eurozone membership in Italy. It seems to be a widespread view in Grillo's Movement that London's requests for more national sovereignty on economic matters are going to lead other non-Eurozone Member States at the Northern and Eastern periphery of the Union (Sweden, Denmark, Poland) to do the same, for the sake of "*avoiding being swept away from popular bitterness against EU fiscal and monetary constraints."* This would leave *"Eurozone Member States including Italy to remain under the yoke of a German-centric, antidemocratic and more and more intrusive system*".

Lega Nord (another opposition group) is the only major political party which is overtly in favour of quitting the Eurozone. They look with sympathy at the requests advanced by the British Government, which in their view emphasised that the entire EU project is now "*irreversibly in crisis. The shared sovereignty is claptrap, as Europe is more divided than ever. There has never been solidarity: France and Germany managed to impose unbearable austerity parameters. At the Nice G20 we have been humiliated, the Fiscal Compact has been the bitter medicine they have imposed on us: the balanced budget goal (that France has never been forced to meet), has resulted in recession and unemployment everywhere. The EU has gradually developed into a nightmare and the UK Government's attitude is perfectly logical, as it protects its British citizens and that country's pride. It is a much more loyal and coherent behaviour than the one displayed by our Government. Look at the Banking Union, for example: we did our homework and transposed the EU Bank Recovery and Resolution Directive* [BRRD], *then, just a week after, the Government was forced to urgently adopted a Decree-Law to prevent the Directive from applying to some struggling Italian banks*[3]."

[3] Please refer to the Appendix on p. 7 for further details on the measures taken by the Italian Government to bail out 4 struggling banks.

Appendix - The Cabinet's Decree-Law to bail out 4 Italian struggling banks

The Cabinet approved on 22 November a Decree-Law "*providing urgent provisions for the credit sector*", aimed at **bailing out 4 Italian banks** currently under the Bank of Italy's compulsory administration, namely:

- *Banca delle Marche*
- *Cassa di Risparmio di Ferrara* (CariFerrara)
- *Banca dell'Etruria*
- *Cassa di Risparmio di Chieti* (CariChieti).

The Decree,:

- establishes **4 new bridge banks**, fully owned by the Bank of Italy's Bank Resolution Fund, which will deal with the bail out of each of the 4 lenders respectively, and will ensure continuity in the banking activities during the resolution phase. The 4 companies will divest the banks' capital once market conditions are appropriate
- provides for an **additional contribution to the Bank Resolution Fund**, due by all the Italian banks and the Italian branches of extra-EU banks. Such extraordinary contribution will be needed to fund the 4 banks' resolution, worth approx. €3.6 billion. The amount of individual contributions is to be set by the Bank of Italy, within the limits laid down in Article 70 of the EU Regulation 806/2014 (Single Resolution Mechanism).

As the Government promptly made it clear, the Decree does <u>not</u> provide for any form of public funding to the 4 banks or to the Bank Resolution Fund, as the intervention will be completely shouldered by the banks active in Italy. After Cabinet's approval, the European Commission green-lighted the Decree and raised no State aid concerns.
The Government's intervention avoided the activation of the **bail-in mechanism** (involving shareholders, bondholders and - if needed - depositors over €100,000 in bank resolutions), introduced by the EU Bank Recovery and Resolution Directive (BRRD - 2014/59/EU), which had been transposed into the Italian legislation on 17 November and will enter into force in January 2016.
However, it is a widespread view particularly within the parliamentary opposition that the operation - which is in the political debate's spotlight in these days - is not without its risks and it could have an impact over public accounts - in spite of the reassurances from the Government that only private funds will be used to bail the 4 banks out.

Please note that:

- The Bank of Italy's **Bank Resolution Fund** (BRF) - which took over the 4 banks' shares, pursuant to the Decree - is fully financed by the banks operating in Italy. As BRF has not the liquidity (€3.6 billion) needed to rescue the 4 lenders, resources will be paid in advance by Intesa Sanpaolo, UBI and Unicredit
- This allowed the Treasury not to be involved - at least directly - in the bail-out operation
- The advance payment should consist of two lines of credit: a €1.6 billion long-term one and a €2 billion one to be paid back by BRF within 2015.

The long-term line of credit will be refunded once the 4 banks are healed and BRF manages to sell them. The short-term one will be paid back with the extraordinary contribution that the other Italian banks will fuel in the BRF. As this is expected to be a burdensome effort for many banks, many observers and financial experts wonder whether the short-term credit line will be repaid within the December 2015 deadline. Should it be not the case, ***Cassa Depositi e Prestiti*** **(therefore the State, since the Cassa is controlled by the Italian Treasury) will intervene**, as the Government decided to put its guarantee on the short-term loan granted by Intesa, UBI and Unicredit.

Also, experts claim that such an burdensome effort to help 4 very minor lenders (1% of Italian deposits in total) might prove not to be a wise move, since it leaves BRF almost without any further room for manoeuvre, should new interventions in favour of other struggling banks be needed in the near future.