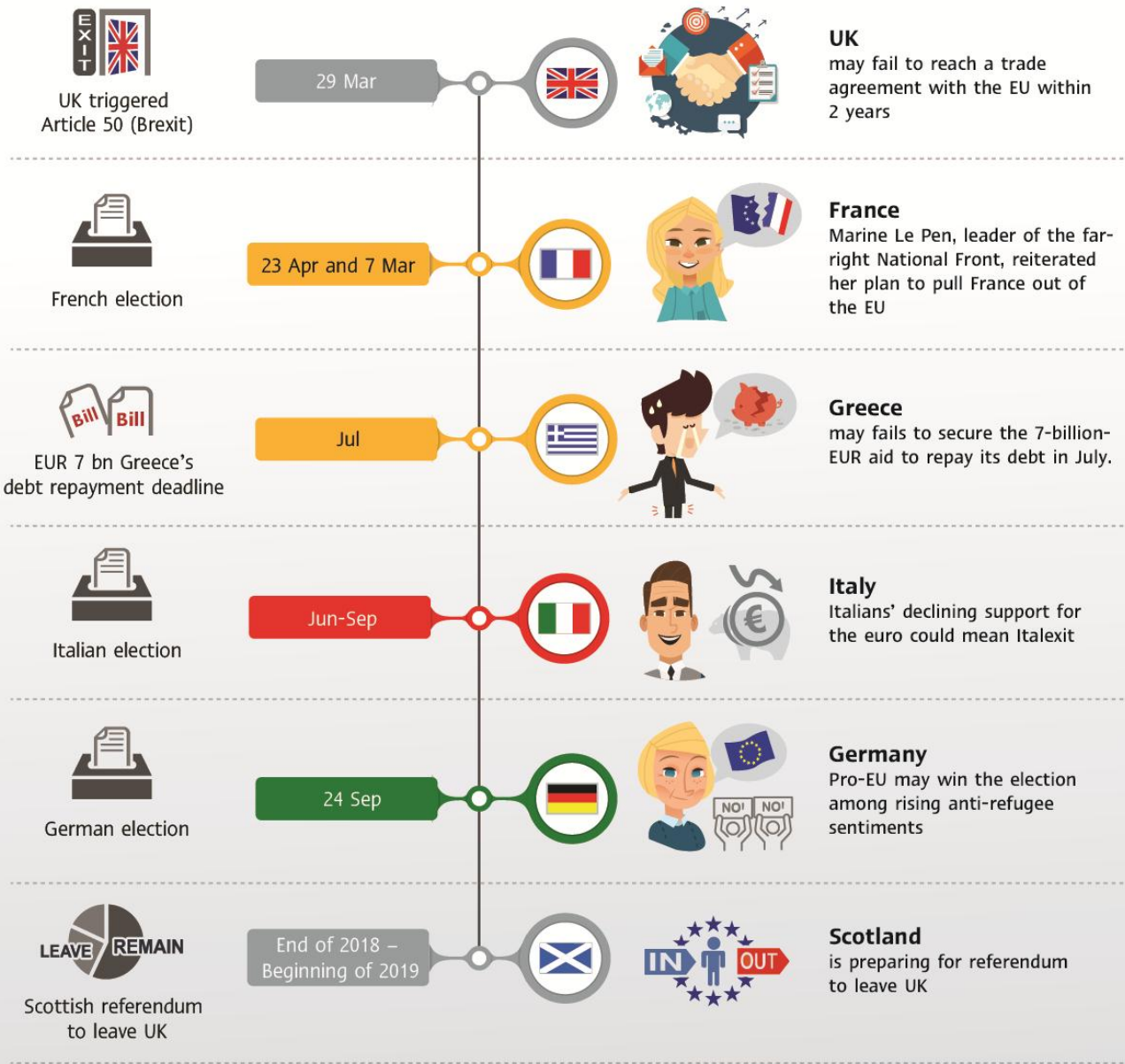




Note by EIC

4 April 2017

Possibility of EU breakup to stir financial markets and threaten the recovery



Color represents probability to hold referendum on membership of the EU



Key political events in Europe throughout 2017 pose significant risks not only to economic recovery in the region, but also to the very existence of the European Union. While the global economy has shown signs of recovery, political uncertainty in Europe now tops the list of potential disruption to investor and consumer confidence. Inevitably, this risk event will affect the Thai economy through global financial markets, fund flows, and Thai exports. The results of these elections will also reflect whether the European citizens still support political and economic integration in the form of the European Union. Economic inequality across Europe, which is partly a result of the introduction of the common currency, remains at the center of the conflict among member states and could eventually lead to an end of the euro. Elections in France, Germany, and Italy must be closely watched as the three countries make up 65% of the entire Eurozone economy. Indeed, the results of these elections will dictate the future of the EU.

France – Frexit is unlikely even with Marine Le Pen’s victory. Uncertainty in the upcoming election in France on April 23rd, and May 7th have been causing a ruckus in the financial markets. Particularly, the gap between yields of 10-year French government bond and German bund reached a record high in the past 4 years on the day that Marine Le Pen, leader of the far-right National Front, reiterated her plan to pull France out of the EU (Figure 1). Nonetheless, latest polls by the Financial Times as of April 3rd suggest that Le Pen has a high probability of entering the second round of election but stands little chance of winning the final round to become the next president. She will likely lose out to Emmanuel Macron, a former minister turned independent presidential candidate. Besides, even in the case of Le Pen’s becoming the next French president, it will be difficult to hold an exit referendum because such a move would have to go through parliament process. A survey by Ifo in July 2016 also shows that more than 67% of the French public will choose to stay in the EU.

Germany – Anti-refugee rallies pose a challenge for Angela Merkel in her bid for the fourth term as chancellor. Angela Merkel, the current German chancellor, will face a tougher competition than before, as she struggles to lead her country through the European economic crisis and rising popularity of extreme-right politics. Also, her approval rate has suffered from brewing anti-refugee sentiments. So far, campaigns on refugee restriction have won the Alternative for Germany (AfD) local elections in some regions. However, nationwide popularity of the AfD remains limited. The key rival to Merkel is, in fact, Martin Schulz, the former EU Parliament President and the leader of Germany’s Social Democrats (SPD) party. His pro-EU stance means the case of Germany leaving the EU is not an immediate concern right now.

Italy – The rise of Five Star Movement (M5S), a far-right political party, could mean Italexit. Since Matteo Renzi, the former Prime Minister of Italy, resigned after having lost in a referendum to reform the parliament in late 2016, the Eurosceptic M5S has been gaining popularity among Italian voters. At the same time, Italians’ support for the euro has been on a steady decline, down to 41% at present, according to Eurobarometer. Anti-EU sentiment in Italy has been on the rise partly due to its chronic economic problems especially in the banking sector, where NPL level is as high as 18%. Italy is one of the European countries that have suffered from the introduction of the common currency and the regulations set by the EU. For example, using the common currency that is tied to a stronger economy like Germany, the weak Italian economy could not rely on exports to speed up recovery because the

euro remained too strong. Moreover, the Italian government cannot bailout its troubled banks due to restrictive EU rules. The rules mandate that equity shareholders and debt holders of a failing bank must take at least 8% loss of total liabilities before the government can bail in. However, doing so could lead to big financial losses among the Italian public. For now, the issue has been partly alleviated, yet many voters have expressed frustration towards the government and called for an exit from the EU.

What will happen if EU members leave the euro?

In the worst-case scenario, the far right's victory may lead to a disintegration of the European Union and eventually the common currency. The desire to pull out of the EU and the common currency has been gaining steam in different countries, supported by political parties such as the National Front, the Alternative for Germany, the Five Star Movement, and the Party for Freedom (the Netherlands). All argue that a return to a national currency would once again give each country control over monetary policy, leading to more country-specific policy development for better long-term prospects. A weak currency, for weaker economies, will prove beneficial for the export sector, while cutting down import and boosting foreign exchange reserves. This could become key in solving many of the economic issues facing some European countries. In addition, leaving the EU would, of course, allow countries to break from the EU's requirement for a free flow of people, a long-standing point of dispute. The issue of refugees, for example, has time and again been a major talking point among far-right politicians.

However, the end of the Euro may have a severe impact on the economy. Investors may not have confidence in the new currency amid political uncertainty after the exit from Eurozone. The new currency may, therefore, experience massive depreciation. If France were to leave the EU, for example, government bond worth more than EUR 2 trillion would have to be converted into the franc, while the falling franc might induce a massive bond sell-off, pushing bond yields up. With high bond yields and a weak currency, borrowing costs would rise, dampening economic recovery prospects. For Greece, already in the throes of a public debt crisis, a return to the drachma would result in higher debt as the majority of Greek debts are in the Euro. A weak drachma would push up Greece's debt burden, resulting potentially in continuing defaults. As for Italy, problems stemming from bad debt in the banking sector would exacerbate due to a weaker currency, driving up recapitalization costs and potentially leading to an economic crisis. A currency switch would, in addition, lead to higher prices of imported goods, affecting the cost of living and economic growth. And if the government were not careful about printing new bank notes, hyperinflation might follow, as happened in Russia in 1992. Even if only one country decided to forgo the use of the Euro, consequences may be wide-ranging as all countries in the Eurozone are closely linked economically.

Implication ■ A victory of an Eurosceptic party could ramp up volatility in the financial markets similar to the case of Brexit referendum. Unexpected election outcomes will cause panic among investors. Fund flow could fluctuate leading to sudden changes in exchange rates. Among others, the French election is the most concerning event as the market participants currently believe that Emmanuel Macron will win. This investment position is reflected in the closing gap between French and German government bond yields and falling credit default swap rates in France. Given this development, an opposite

outcome could weaken the euro. However, the depreciation should be smaller than in the case of pound's reaction to the Brexit vote given that Brexit referendum is still a low probability event. According to a Bloomberg survey, most analysts forecast that, if Le Pen wins, the euro could depreciate by 7% to its 15-year low at 1 EUR/USD.

- **The European Central Bank (ECB) may postpone its monetary tightening if political developments pose risks to the region's recovery.** The ECB may not be able to taper its quantitative easing (QE) program further. As of current, we expect the ECB to reduce the QE's monthly asset purchase amount from 80 to 40 billion euros in January 2018 onward. The Bank may also delay its policy interest rate hike from the current projection in the second quarter of 2019.
- **In the long run, an exit by an EU member could cause an economic recession, hurting Thai exports. But, such event could open opportunities to make new trade deals that are more beneficial for Thailand.** A scenario of economic recession caused by an exit by a member from either the EU or the use of common currency could hurt the region's demand for imports. If the Eurozone economy contracts by 1%, demand for imports could shrink by more than 1.5%*. Note that Thai exports to the Eurozone make up 9% of all Thai exports. Key products include computers and parts, and cars and parts (Figure 2). On the contrary, by leaving the EU, a country could negotiate for new trade deals with other countries. This opens up new opportunities for a bilateral trade deal with Thailand and ASEAN. The negotiation in this bilateral deal should have less constraints now that the involved parties are not as complex as the case of the EU. For example, in the upcoming Brexit, the UK is preparing to make new trade deals with many countries. The UK leaders believe that new deals will better answer to demand from both sides of the negotiation table.

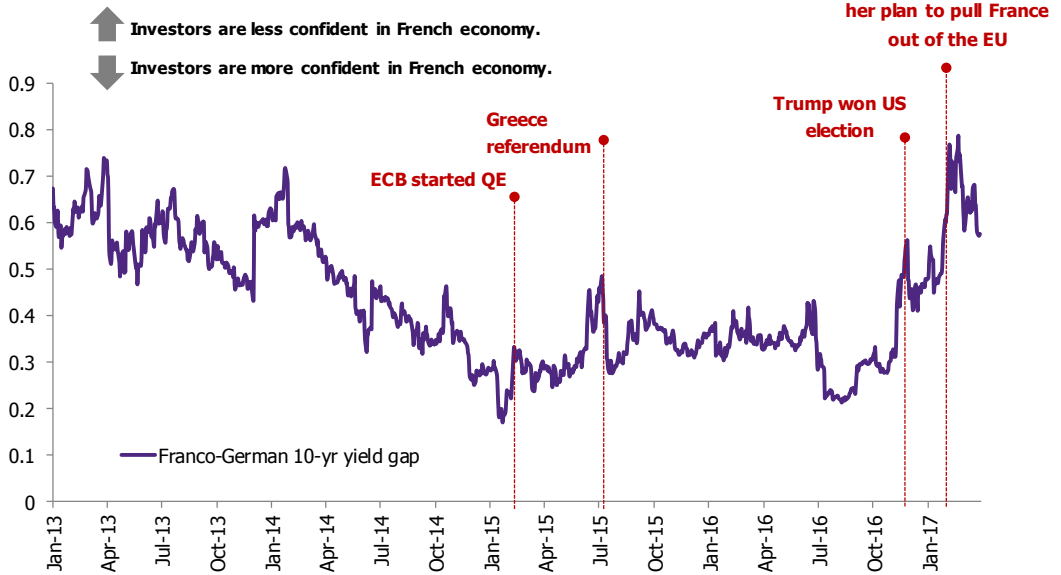
Remark: Average Income Elasticities of Import Demand among German French and Italian

from Aiello F., Bonanno G., Via A. (2015), Trade-elasticities for China and OECD countries. Facts and myths of global disequilibria, European Trade Study Group 2015 Paris, Italy

Figure 1: Uncertainty of the French election has caused panic among investors

Yield gap between 10-year French government bond and German bund

Unit: %

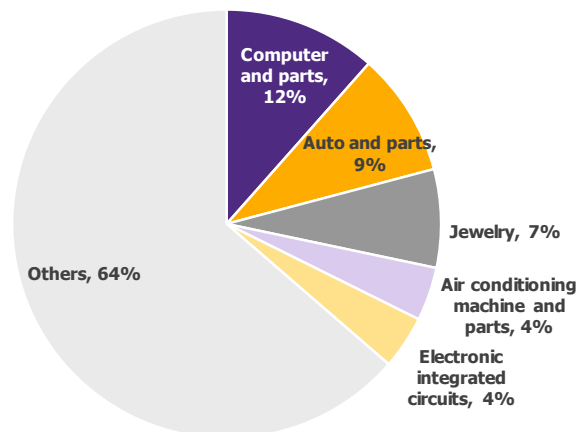


Source: EIC analysis based on data from Bloomberg

Figure 2: Computer and parts and auto and parts are Thailand's major exports to EU

Thailand's export to EU – by products

Unit: %



Source: EIC analysis based on data from the Ministry of Commerce

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