



This is an excerpt of Focus Europe: [Contagion: Italy and the role of fiscal similarity](#), published on November 12, 2018.

Contagion

Italy and the role of fiscal similarity

November 15, 2018

Authors

Mark Wall
+44(207)545-2087
mark.wall@db.com

Clemente Delucia

Kuhumita Bhattacharya
+44(20)777-94106
kuhumita.bhattacharya@db.com

www.dbresearch.com

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



Contagion

backdrop of limited contagion, we can see the Commission adopting a tougher stance against Italy.

For important disclosure information please see: <https://research.db.com/Research/Disclosures/Disclaimer>

© Copyright 2018. Deutsche Bank AG, Deutsche Bank Research, 60262 Frankfurt am Main, Germany. All rights reserved. When quoting please cite "Deutsche Bank Research".

The above information does not constitute the provision of investment, legal or tax advice. Any views expressed reflect the current views of the author, which do not necessarily correspond to the opinions of Deutsche Bank AG or its affiliates. Opinions expressed may change without notice. Opinions expressed may differ from views set out in other documents, including research, published by Deutsche Bank. The above information is provided for informational purposes only and without any obligation, whether contractual or otherwise. No warranty or representation is made as to the correctness, completeness and accuracy of the information given or the assessments made. In Germany this information is approved and/or communicated by Deutsche Bank AG Frankfurt, licensed to carry on banking business and to provide financial services under the supervision of the European Central Bank (ECB) and the German Federal Financial Supervisory Authority (BaFin). In the United Kingdom this information is approved and/or communicated by Deutsche Bank AG, London Branch, a member of the London Stock Exchange, authorized by UK's Prudential Regulation Authority (PRA) and subject to limited regulation by the UK's Financial Conduct Authority (FCA) (under number 150018) and by the PRA. This information is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. and in Singapore by Deutsche Bank AG, Singapore Branch. In Japan this information is approved and/or distributed by Deutsche Securities Inc. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product.