showCASE
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Overview: In this week's showCASE, our experts discuss the US Senate's initiative to strengthen sanctions against Russia, and how it relates to the natural gas market in Europe. Our analysts then examine the condition of the Italian banking sector using as a departure point the recent purchase by Intesa Sanpaolo of two underperforming banks.

The US Senate bill: helping Europe or interfering in its affairs?

By: Givi Gigitashvili, CASE Analyst

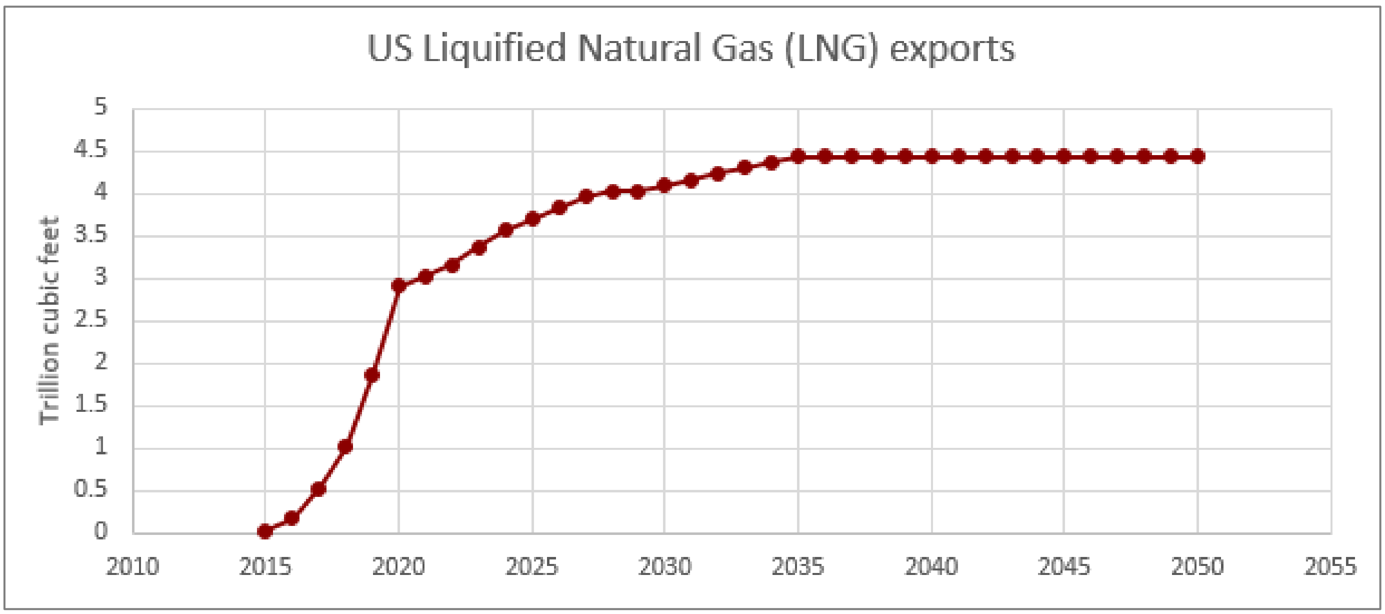
Capitol Hill, Washington DC. Source: Flickr, CC BY 2.0

The US Senate voted on June 15 to reinforce existing sanctions against Russia, a move welcomed in Kyiv but one that has reignited controversy between Washington and Europe. With their joint statement, German Foreign Minister Sigmar Gabriel and Austrian Chancellor Christian Kern criticized the Senate bill and called it unacceptable, as it entails imposition of extraterritorial sanctions on European companies which invest in natural gas projects involving Russia. They went as far as to claim that the bill is aimed at saving jobs in the US natural gas industry by curtailing Russian gas imports to Europe and replacing it with supply of liquefied natural gas (LNG) from the US.

The main cornerstone of the bipartisan Senate bill is that it codifies into law the existing US sanction regime against Russia, imposed via three different executive orders under Obama's presidency. With this bill, Senate seeks to effectively constrain Donald Trump's power to unilaterally roll back sanctions, as the President's administration needs to justify any lifting of sanctions before Congress.

The White House has already expressed its uneasiness with the Senate bill, as it was conceived as a potential obstacle for the President's flexibility to maintain a constructive dialogue with Russia. To enter into force, the bill does need to be signed by the President, but the Senate is likely to have a veto-proof majority (as the bill was approved by a margin of 98 yeas to 2 nays).

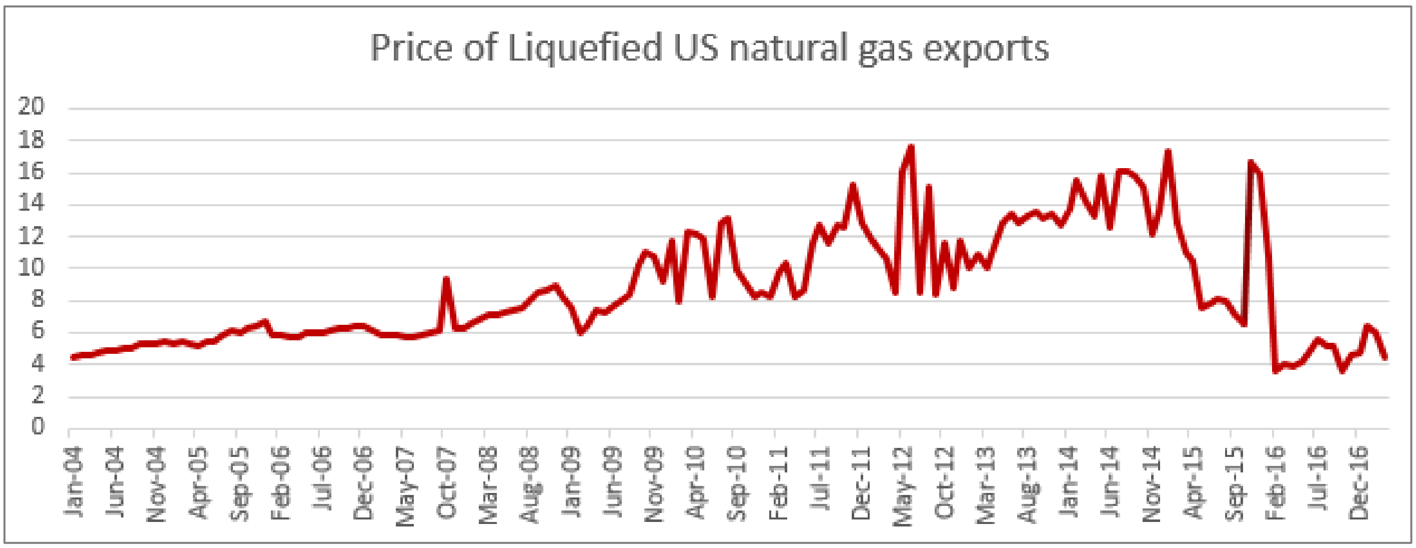
Moreover, the bill introduces new sanctions in response to Russia's alleged interference in the US presidential elections and for Moscow's support to the Assad regime in Syria. The most controversial provisions of the bill are secondary sanctions against non-US companies, which invest or help Russia to construct energy export infrastructure. This expansion of US policing powers is has raised the ire of European leaders, who claim that the bill poses danger for European companies participating in Gazprom's flagship Nord Stream 2 pipeline project. In April 2017, companies such as Shell, Engie, OMV, Wintershall and Uniper agreed to provide long-term financing for 50 percent (€9.5 billion) of the total cost of the Nord Stream 2 pipeline construction. Washington strongly opposes this project and, like a majority of Eastern European countries, the United States deems it a threat to Europe's energy independence. As an alternative, the US is attempting to help European countries diversify gas supplies by boosting its own liquefied natural gas (LNG) exports to Europe to compete with Russia's dominance in the European market.



Source: United States Energy Information Administration

However, such a move may not be entirely altruistic, as US companies stand to gain immensely from a retreat of Russia from European markets; as US Secretary of Energy Rick Perry argued, the US aims to become a "dominant energy force", and energy policy is "a vital element of US economic policy." US liquefied natural gas (LNG) exports to Europe began in 2016 after the lifting of a self-imposed four-decade ban on exports. Since that time, the appearance of US LNG on global markets have considerably increased LNG export volumes worldwide. According to the International Energy Agency, demand for natural gas in Europe will have doubled between 2014 and 2020, giving the US additional incentives to expand its LNG exports to Europe. Nevertheless, shipping the LNG to Europe will remain economically feasible for the United States only if its price does not fall below $4 per thousand cubic feet. Furthermore, gas prices in the Asian market are also progressively declining, nudging the United States to redirect their sales to the European market.

Russia's energy export strategy in Europe in recent times has been based on value maximization rather than securing its market share (34% of the EU gas imports) via competitive pricing; this approach also forms part of Russia's geostrategic thinking, where national industries are meant to serve the interests of the state by overcharging abroad and undercharging at home. However, if the growing LNG supply to Europe undermines Russia's position on the market, Moscow will likely reduce its price on exported gas below the variable costs of US LNG exporters, as its spare gas production capacities allow it to behave so. Due to the incredibly cheap production and transportation costs of Russian piped gas, it can be relatively harder for the United States to engage in a price war with Moscow. As noted, however, Russia's energy dominance poses a direct challenge to European stability, as European countries have become targets for Russia's supply manipulations several times in the past. Nevertheless, the current apprehensions in Germany and Austria have once again revealed that perception of this project as a commercial venture outweighs national security concerns of other European states.



Source: United States Energy Information Administration

Overall, the latest Senate bill sends ambiguous signals to Europe. On the one hand, if the bill becomes a law, it should placate worries of those countries, which strongly oppose the relaxation of sanctions against Russia that Trump might roll back sanctions without consultations. On the other hand, the secondary sanctions seem to be politically counterproductive for the US, because they antagonize two major European players. Reasonably, it can adversely affect to transatlantic unity with regard to sanctions against Russia. Therefore, the US should balance Russia's growing energy influence in Europe without damaging its ties with European partners. The latest Senate sanctions have not been coordinated with European partners in a multilateral format and such unilateral approach reduces chances of reconciling the different interests at play.

Italian banks: an awkward attempt to pull the sector away from the brink

By: Iakov Frizis, CASE Economist

The Intesa Sanpaolo logo, Milan, Italy. Source: Reuters

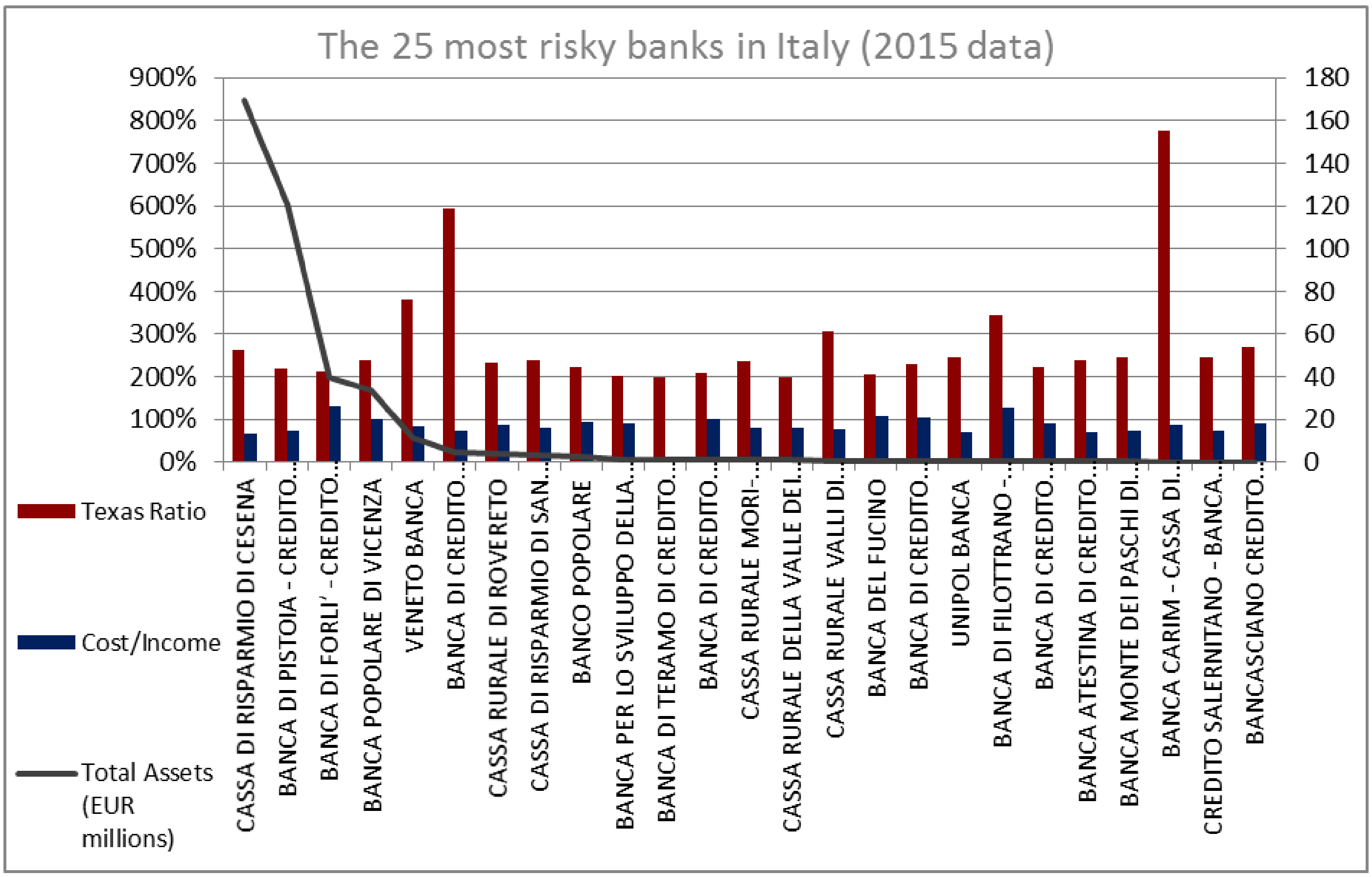
Since the onset of the Eurozone crisis, the Italian economy has flirted repeatedly with a full-blown banking crisis. The recent purchase of two of the country's ailing lenders, Banca Popolare di Vicenza and Veneto Banca, by Intesa Sanpaolo, does not provide room for respite. Instead, it underscores how close to the brink the Italian banking sector stands. Will it be a thousand cuts or a major blow that finally sets banks adrift in Italy?

By the deadline for submission of proposals at sundown on June 24th, Intesa Sanpaolo, the largest banking group in Italy in terms of market capitalisation (second in terms of total assets), was the only bank with an interest in the acquisition of certain assets and liabilities of the two troubled lenders. The proposal presented to Rothchild, advisor to the Treasury, involved the symbolic purchase for one euro of healthy receivables from Banca Popolare di Vicenza and Veneto Banca (this is distinct from the recent purchase of Banco Popular, where Santander took on troubled loans in an attempt to clean them up but also paid a one euro fee). In particular, Intesa's proposal explicitly rules out the purchase of non-performing loans, subordinated bonds and any form of shareholding or legal relationship considered non-functional. These limitations translate to the de-facto creation of two corporate vehicles: a good bank to be bought by Intesa and a bad bank (comprised of approximately EUR 10 billion in non-performing loans) to be acquired by the Italian state.

In this awkward attempt to rescue the two Veneto-based banks, Italy is taking advantage of European laws which enable the state (rather than European authorities) to handle insolvency proceedings of non-systemically important banks. In doing so, the country has decided to allow Intesa Sanpaolo to cherry-pick prime assets for a pittance, thereby setting a highly unsustainable precedence in dealing with banks on the brink of default.

As the Italian state takes over the non-performing loans as part of the acquisition of the bad bank, the spillover of the risky loans to other credit institutions can (possibly) be limited. However, this precautionary recapitalization is going to burden Italian tax payers by an amount close to EUR 5-6 bn. (on top of savings lost), while doing little to address the country's core problem, its "zombie banks." According to research on Italian bank balance sheets conducted by Mediobanca Research, out of 500 Italian banks 114 are at risk, exposed to an excessive amount of credit that surmounts the net value of their tangible assets.

What makes matters worse is the nature of Italy's banking problem. The compound effect of three separate factors appears not only to have laid the groundwork for a full-blown banking crisis, but also to have set the stage for an impossible quick fix: First, impaired loans, due to the Eurozone crisis, which claimed 10% of Italian GDP and a quarter of the country's industrial production, weigh heavily on the balance sheets of smaller banks. Second, the Italian housing crisis has added to the stress on banks by impairing debt coverage ratios, as falling property prices damaged the face value of personal guarantees or real estate collateral (the two account for 2/3 of bank loan coverage in Italy). Third, the politicized governance of lending institutions in Italy has had a dual effect over the health of the financial sector in the country. On the one hand, it impaired on the efficient allocation of funds across borrowers; on the other hand, non-commercial motives prevented bankers from reigning in the extension of the system's non-performing exposures.



Source: Mediobanca Research

Despite the high-risk in Italy's banking sector, there is a silver lining, as each bank individually is too small to tip the system over; indeed, only five banks have a value of more than EUR 20 million in assets held. However, this is counterbalanced by the fact that Italy belongs to the EU country-group with the highest level of non-performing loans, with an NPL coverage ratio of 49% (December 2016), above the 45% EU average. Within such an environment of financial duress, almost *any* bank failure could send shockwaves across the system, pushing other banks closer to the tipping point. One needs only to turn towards the two largest Italian banks, Unicredit and the aforementioned Intesa Sanpaolo, to see how this could play itself out. Despite having a

Texas ratio (measure of credit trouble amongst banks, calculated as the ratio of non-performing loans of a lender over the sum of tangible common equity capital and loan loss reserves) below the 100% threshold, their weak solvency score underscores their dependence on the health of other Italian banks. As long as the financial health of lending institutions across Italy continues to worsen, staying upright will become increasingly challenging. If either Unicredit or Intesa begin to quiver all bets are off.

This week: Last week, the Ministry of Family, Labor, and Social Policy announced an increase in pensions by 2.4%, as of March 2018. This will represent a short-term cost of more than 4 billion PLN for the Polish budget. More troublingly, experts warn that this level of pensions is unsustainable in the long-term, as it does not take into account rising life expectancy.

GDP (Q1 2017)

4.2% y/y (est.)

Up from 2.9% in Q4

Inflation (May 2017)

1.9% y/y

Down from 2.0% in Apr

Unemployment (May 2017)

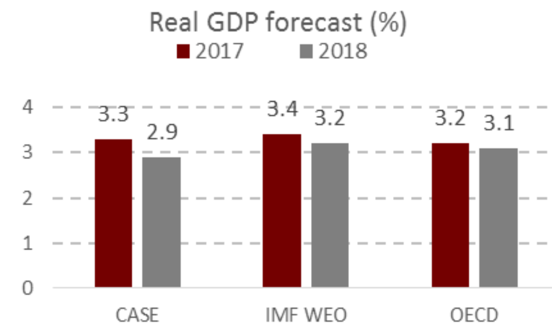
7.4%

Down from 7.7% in Apr

NPB Base rate

1.5%

From 2% Mar 2015



This week: The Russian Central Bank cut its key interest rate by 25-basis point for the third time in May, following a 25-point cut in March and a 50-point reduction in April. The Bank said that it would continue its “moderately tight” monetary policy to keep inflation close to the long-term target of 4%. By the end of 2017, the Central Bank is expected to bring the key rate to between 8% and 8.25%.

GDP (Q1 2017)

0.4% y/y

Up from 0.3 in Q4

Inflation (May 2017)

4.1% y/y

Down from 4.3% in Mar

Unemployment (Apr 2017)

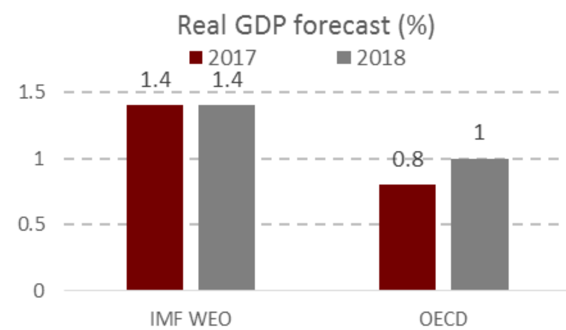
5.3%

Down from 5.4% in Mar 2017

CBR Base rate

9 %

Down from 9.25%



This week: The German stock index DAX reached 12,825 points this Monday, buoyed by a mild recovery of oil prices and the bail-out of two struggling Italian banks (discussed in detail in the showCASE article above). Over the past six weeks, DAX booked record levels several times, only to fall back again on each occasion, resulting in little net progress.

GDP (Q1 2017)

1.7% y/y

Down from 1.8% in Q4

Inflation (Apr 2017)

1.4% y/y

Down from 2% in Apr

Unemployment (Q4 2016)

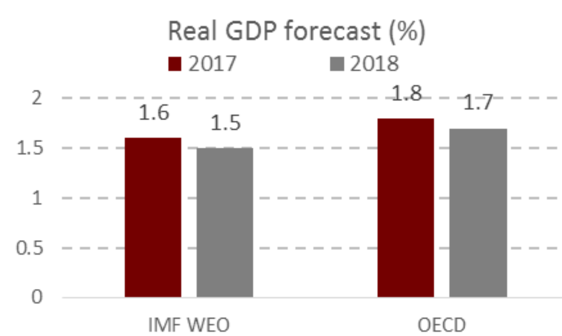
3.9%

Down from 4.15% in Q3

ECB Deposit rate

-0.4%

From -0.3% Dec 2015



This week: The Ukrainian economy grew by 2.5% y/y in Q1 (compared to the previous estimate of 2.4%) and by 0.3% q/q (seasonally adjusted). The slowdown in growth from 2016 has been largely caused by the renewed conflict in the Donbas region, including a freight blockade of Russian-held territory. The National Bank of Ukraine also notes that the contribution of the agricultural sector to GDP has proven smaller than expected.

GDP (Q1 2017)

2.5% y/y

Down from 4.7% in Q4

Inflation (May 2017)

13.5% y/y

Down from 12.2% in Apr

Unemployment (Q4 2016)

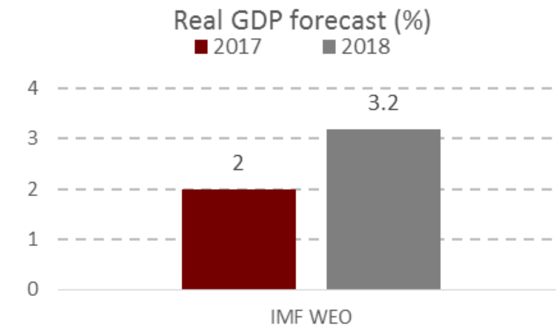
10.0%

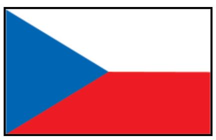
Up from 9.2% in Q3

NBU Base rate

12.5%

From 13.0% in May





This week: According to an interview from the governor of the Czech National Bank (CNB) on June 21, the Czech economy is prepared to join the euro zone. Thus far, however, the government has refrained from naming any specific date for accession. In the meanwhile, the CNB announced it might postpone the planned interest rate hike until after Q3 if the Czech crown continues gaining value at its present pace.

GDP (Q1 2017)

2.9% y/y

1.9% in Q4 2016

Inflation (May 2017)

2.4% y/y

Down from 2.0% in April

Unemployment (Q1 2017)

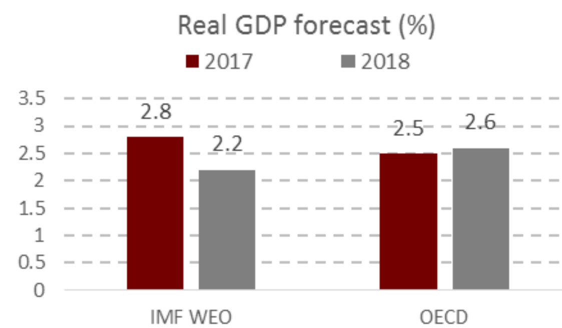
3.4%

Down from 3.6% in Q4

CNB Base rate

0.05%

Unchanged since Nov 2012



This week: Hungary joined the Asian Infrastructure Investment Bank (AIIB), as the documentation process was finalized and the initial capital installment was transferred to the institution. According to Minister of Economy Mihály Varga, Hungary has acquired a stake in the bank that corresponds to the country's economic weight. After Poland, Hungary is the second country from Central and Eastern Europe to join the AIIB.

GDP (Q1 2017)

3.6% y/y (est.)

Up from 1.6% in Q4

Inflation (May 2017)

2.1% y/y

Down from 2.6% in Apr

Unemployment (Q1 2017)

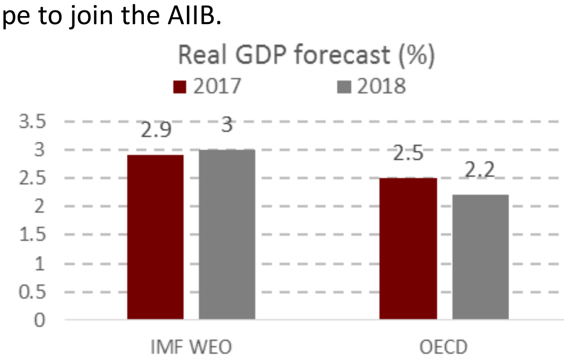
4.7%

Up from 4.5% in Q4

MNB Base rate

0.9%

From 1.05% May 2016



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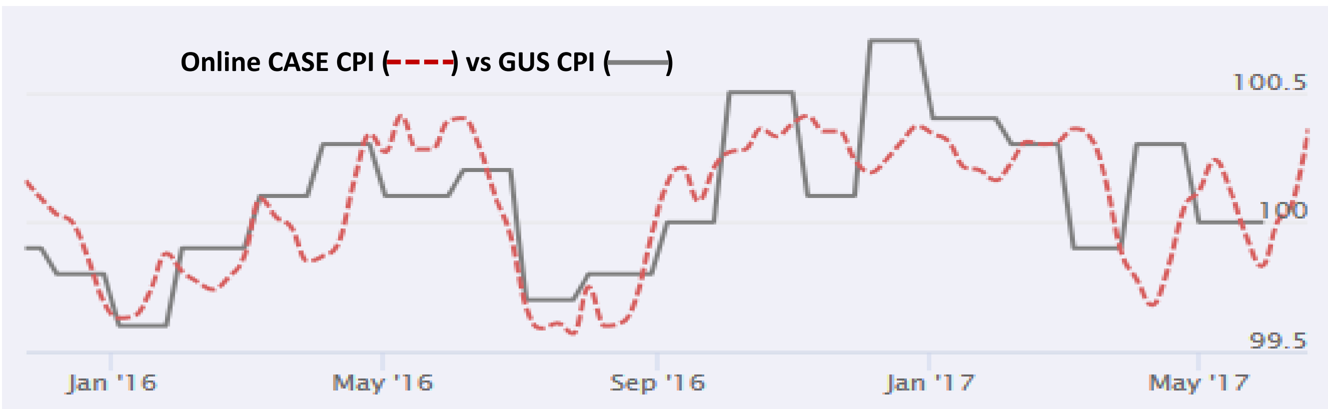
The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

Our weekly online CASE CPI



Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, CPI, among others.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2017	3.3	3.5	2.9	3.8	1.9
2018	2.9	3.0	2.7	3.7	2.0
	Nominal monthly wages	**Merchandise exports (USD, bn)**	**Merchandise imports (USD, bn)**	**Merchandise trade balance (USD, bn)**	**CA balance (USD, bn)**
2017	4.7	201.6	201.8	-0.2	-4.7
2018	3.5	211.3	213.1	-1.8	-5.9

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Contributions: Iakov Frizis, Givi Gigitashvili, Krzysztof Głowacki, Katarzyna Mirecka, Aleksandra Polak, Katarzyna Sidło
Editor: Krzysztof Głowacki Editor-in-chief: Christopher Hartwell