



important reforms in Italy, but not enough. Temptations from the past have recently sneaked back, we would not be too surprised if Italy joins a busy 2017 political calendar with general elections in Germany and France. Rising concerns, in our view overstated, on the Italian banking system could hinder the credit recovery.

Political risk is not only affecting euro-area countries. The European Union as a whole is probably facing its main existential crisis since the treaty of Rome that set the foundation of the union in 1957:

- *The migration crisis is threatening the foundation of the European Union (EU).* The EU is struggling to manage the refugee crisis. This could entail short-term costs for Europe, e.g. if the Schengen zone were to be closed temporarily. There may be other costs. For example, contrasting views among countries on how to deal with the refugee crisis may divert efforts away from important integration processes such as the Banking Union or the Capital Market Union.
- *Brexit is a material risk.* The risks surrounding the UK's referendum on EU membership are non-negligible. Indeed, a poll taken following this week's publication of the draft renegotiation plan shows the lead for "leave" (45%) over "remain" (36%) rising from 4% to 9%. A referendum is expected in late June this year if the draft plan is ratified at the February EU Council meeting. While the risks are high for a Brexit, our base case is that the vote will be in favour of remaining in the EU. After all, when asked how the public will vote if the PM is strongly behind the renegotiation (which it sounds like he is) the polls turn very much in favour of continued EU membership (see accompanying note in this issue of Focus Europe).

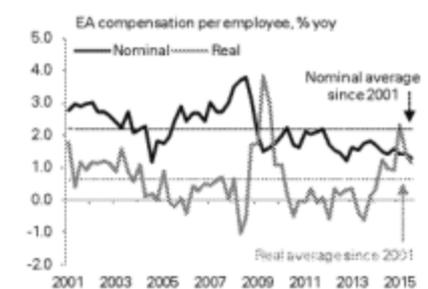
ECB: Avoiding a December déjà vu

In a speech to the European Parliament On 1 February, Draghi said that: *"While the most recent wave of disinflation is mainly due to the renewed sharp fall in oil prices, weaker than anticipated growth in wages together with declining inflation expectations call for careful analysis of the channels by which surprises to realised inflation may influence future price and wage-setting in our economy. Therefore, ...we judged that it will be necessary to review and possibly reconsider our monetary policy stance at our... policy meeting in early March."*

While growth in nominal wages has been declining well below its historical average, real compensation has strengthened well above its average thanks to the fall in oil prices (Figure 7). To meet the inflation target the ECB needs a "good divergence", i.e. the historical gap between nominal and real wages in Figure 7 needs to be reestablished by nominal wages growth shifting higher. For a durable happy ending we consider four factors (i) oil prices, (ii) the credibility of the inflation target, (iii) the unemployment gap and (iv) productivity:

- We think oil prices will increase at a faster pace than implied by the forward curve. (Figures 8 to 10)² The ECB staff forecasts assume that oil prices will move in line with the forward curve. However, oil futures prices are linked by a no-arbitrage relationship to the spot prices. Indeed, 80% of the variation of two-year ahead oil futures prices over the past decade is explained by contemporaneous changes in the spot price (Figure 10). The oil forward curve is not a clean forecast of the outlook for oil prices.
- If we are right on oil prices, will nominal wages grow at a faster rate? All else constant, the ability of employees to demand higher nominal wages will depend on (a) the credibility of the inflation target and (b) the unemployment gap. Although, the picture is far from being homogenous

Figure 7: No recovery yet in nominal wages



Source: Eurostat, Haver Analytics LP, Deutsche Bank

² See "Crude Oil: On Negative Watch", Michael Hsueh, Deutsche Bank Research, 26 January 2016.