19 June 2018

Italian Politics Monitor

Market pressure on Italy likely to return in September

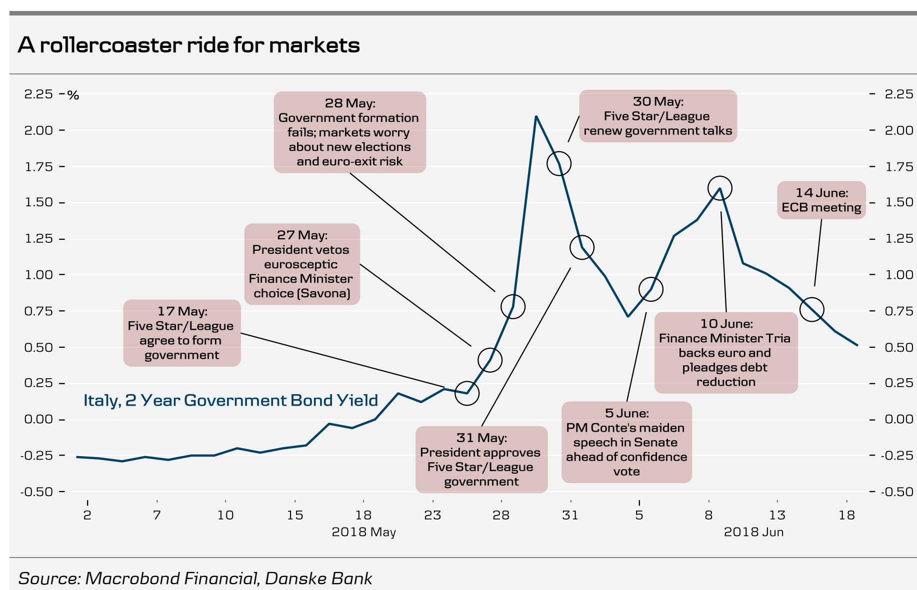
- **Finance Minister Giovanni Tria's comments have calmed markets but we think it is too soon to declare the Italy crisis over just yet. Market pressure is likely to return in September when the government publishes its budget proposal.**
- **The Italian government will have to walk a fine line to placate both the EU and Italian voters.**
- **Spreads continue to tighten, as no news is 'good' news for the Italian market. However, we think markets are a bit complacent, as we still need to see more evidence that Italy is committed to following EU budget lines.**
- **An Italy debt risk premium of a few big figures is set to stick to EUR crosses until a clearer verdict on fiscal sustainability can be made.**

After three weeks of turmoil following the appointment of a Five Star-League led government, market sentiment on Italy has calmed. Here we take a quick recap of the latest developments and outline what to expect.

A rollercoaster ride...

Following the appointment by President Sergio Mattarella, the new Italian government secured confidence votes in both chambers of parliament without a hurdle. Meanwhile, markets were keenly listening to remarks by Prime Minister Giuseppe Conte, who promised in his maiden speech on 5 June that his government would push through populist measures ranging from a 'citizen's income' to tax cuts and curbs on immigration. Many investors had hoped for more conciliatory remarks on spending plans and subsequently took fright. This resulted in a renewed sell-off in Italian government debt (see chart below).

A rollercoaster ride for markets



Source: Macrobond Financial, Danske Bank

Other readings on Italy

- *Italian Election Monitor – Five Star-League government steering towards a clash with the EU*, 1 June
- *Italian Election Monitor – Rising market pressure set to challenge spending plans*, 24 May

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However, market sentiment was calmed by *remarks* from the technocratic Finance Minister Giovanni Tria on 10 June, who not only ruled out any euro-exit plans but also stressed that the new government remains committed to further debt reduction and ruled out any immediate changes to the pension system or the introduction of so-called mini-BOTs to settle public arrears. Tria was saying all the things markets wanted to hear and Italian fixed income markets rallied as a consequence.

...that is not over yet: market pressure on Italy likely to return in September

Both EU leaders and markets took courage from the Finance Minister's remarks but we remain sceptical whether this was already the culmination of the Italian crisis and we think it is **likely that market pressure on Italy might return in September, when we expect the government to release its 2019 budget proposal.**

For us, there remain several unknowns.

- **First, it remains to be seen whether Finance Minister Tria can assert himself** against the implicit government leaders Matteo Salvini and Luigi Di Maio, who still push for a big fiscal loosening. So far, the signals we have received from the government in terms of policy priorities have been very mixed and it is likely we will have to await the final budget proposal to gain more clarity on this front. Judging by comments from Di Maio and Salvini, the government still plans to introduce a flat tax rate without raising VAT. How to fund the spending proposals remains an open question. One possibility mentioned by Tria could be to cut tax deductions. Another envisions higher revenues from a tax amnesty (allowing people to pay overdue taxes at a discount). We remain sceptical that this would cover the envisioned expenses though: (1) Revenues from the tax amnesty are regarded as a one-off measure and, therefore, would not count towards the structural balance. (2) The government's revenue expectations from this measure (EUR35bn) seem highly unrealistic. (3) It could further weaken tax compliance as people speculate on another amnesty introduced at a later stage, reducing their incentives to pay taxes in time.
- **Second, it remains uncertain how Tria will achieve the envisioned debt reduction through investment and growth instead of austerity.** In particular, where will these investments come from? The planned common EU investment fund is likely to be too small even if set up. This leaves domestic Italian investment but fiscal room for public investment is limited and private investment is unlikely to surge in light of impaired bank balance sheets burdened by NPLs and a poor business environment. Tria also mentions structural reforms, which could raise potential growth but here again we remain sceptical about whether the government would push for these if things get 'difficult'.

Government has to walk fine line to placate both EU and Italian voters

As we also outlined in *Italian Election Monitor – Five Star-League government steering towards a clash with the EU*, 1 June, **we still expect to see clashes between the Italian government and the EU on the economic ruleset over coming months**. Although Finance Minister Tria's pledges should not be taken for granted (partly because the degree of his political power as a technocrat within the cabinet remains uncertain), they have made us more confident that we are heading towards a 'deal solution', where the Italian government will eventually moderate some of its spending proposals in return for, for example, a bigger allocation of EU budget funds or more solidarity with handling the migration crisis. A focal point will still be the EU summit from 28-29 June, when euro area integration, migration policy and the next EU budget will be on the agenda.

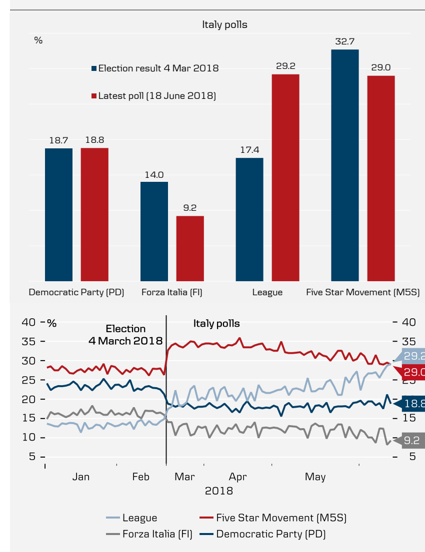
To evaluate Italy's fiscal performance, the EU will assess three important criteria.

- The need to undertake a structural adjustment (improvement in structural balance) by 0.5% of GDP according to earlier agreement with the European Commission.
- The achievement of the Italian Medium-term Objective (MTO) of a balanced budgetary position in structural terms by 2020. Italian *media* have already reported that the government may push back the balanced-budget target to 2021 and expect 'renegotiation' of budget flexibility with the EU.
- The 3% of GDP deficit target. If the Italian budget proposal were to breach this, the country would be put straight into excessive deficit procedure (EDP).

The government will have to walk fine line to reconcile and manage the differing interests and expectations of Italian voters and the EU. Fiscal space is limited and the EU is unlikely to grant Italy any leeway in the face of significant breaches of the EU deficit rules but at the same time abandoning (costly) flagship polices such as the citizens' income and the flat tax rate could prove politically extremely costly for Five Star/League in the next election. Arguments about spending compromises further risk bringing back the inherent fragilities of the governing coalition composed of two political movements with diverging voter bases. Hence, the risk of new elections remains non-negligible, especially if support for the League remains high in the polls.

Should the Italian government not moderate its spending proposals, we expect rating agencies to react relatively swiftly, especially Moody's, which has already placed Italy on negative watch and a downgrade to Baa1 might follow if fiscal prudence is abandoned. A renewed market sell-off would be inevitable in this case. However, judging from Tria's remarks, the government is keen to avoid any further deterioration in market conditions that would push the country towards a euro exit.

League has overtaken Five Star in the polls (18 June)



Source: Macrobond Financial, Interior Ministry, Danske Bank

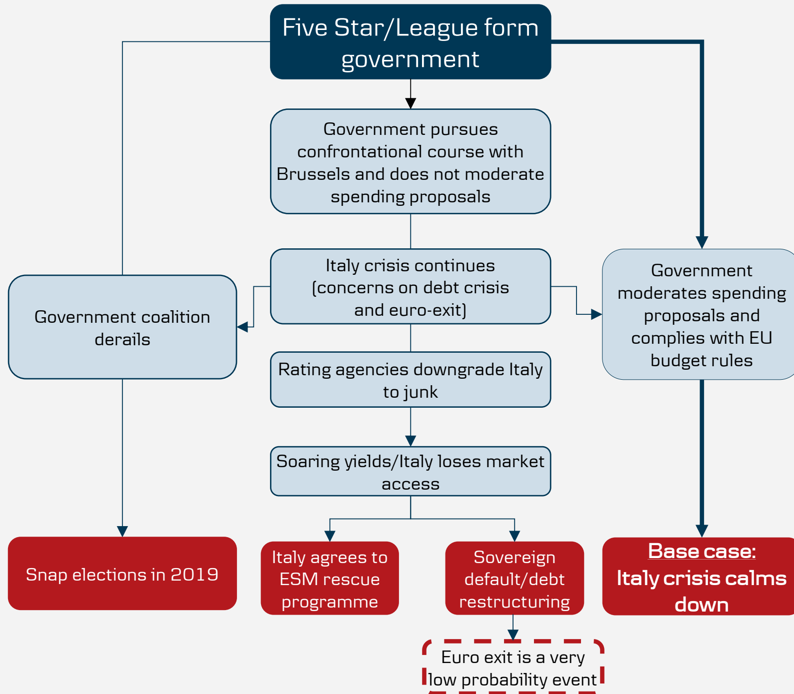
Fixed income implications: no news is good news

The comments from the new Italian Finance Minister and the ECB meeting last week have been very supportive for Italian government bonds. **We think the markets are being a bit complacent, as we still need to see more evidence that Italy is committed to following EU budget lines.** The risk is that we will not get firmer information before the autumn, when Italy is due to present its budget for 2019 to the EU. In the meantime, spreads can continue to tighten as no news is seen to be 'good' news for the Italian market. Furthermore, as there is no firm proposal on fiscal policy, it is also difficult for the rating agencies to react outside the regular calendar for rating reviews.

FX implications: Italy debt risk premium to stick to EUR crosses

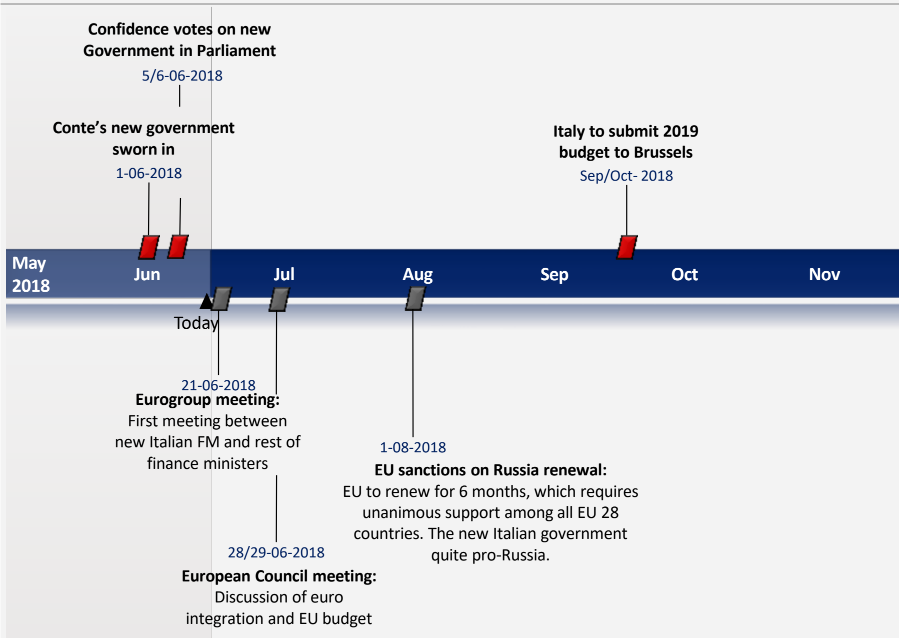
The situation in Italy clearly put Italian fiscal sustainability back on the FX market agenda in late May and although things have calmed down somewhat in this respect, with focus currently on the ECB being on hold, an **Italy debt risk premium of a few big figures is set to stick to EUR crosses until a clearer verdict on sustainability can be made** (see more in *FX Strategy – EUR/USD lower for longer – but not forever*, 8 June.

Italian scenarios: not out of the woods yet



Source: Danske Bank

Timeline: Italian and EU events to watch out for



Source: Danske Bank

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None.

Date of first publication

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