DWS

CIO Flash

Italian takeaways

Budget haggling in Rome and Brussels looks set to continue. No wonder markets are nervous.

In recent days, Italy has once again caused plenty of market jitters. At one level, that should come as no surprise. Whatever the budget plans other flaws or merits, the new coalition in Rome has done a poor job in managing investor expectations.

For weeks, finance minister Giovanni Tria has been sending reassuring messages. Based on this, markets were led to expect a deficit target of around 1.6% of gross domestic product (GDP) for 2019, potentially followed by further fiscal consolidation in subsequent years. That would have been both broadly in line with Italy's commitments to its European partners and quite sensible. After all, Italy already has accumulated public debt of just over 130% of GDP.

Instead, Italy is now aiming to run a deficit of 2.4% of GDP not just in 2019, but for two years thereafter. It is no wonder that markets, not to mention other European policymakers were miffed. Officially, all Eurozone countries are supposed to get public debt down to 60% of GDP, though to be fair, few do. When it comes to budget rules, the European Commission (EU Commission) has a long history of occasionally going easy on large countries, especially at politically sensitive moments. Then again, the European Commission might feel that it has rarely been as indulgent for quite as long, as in the Italian case.

Seen through the lens of recent domestic Italian politics, things look rather different. Skepticism towards the European Union has been on the rise for several years. It contributed to the defeat of Matteo Renzi, prime minister at the time, in the 2016 constitutional referendum as well as the defeat of Mr. Renzi's centre-left Democratic Party in the general election of March 2018. How large that contribution was is debatable. As we wrote about the two parties now governing in Rome back in February: "Both Five Star and the Lega have lately toned down their rhetoric on Italian membership in the Eurozone, but it remains anybody's guess how lasting this change will prove."

What is not debatable, based on both polling data and voting patterns, is that Italian voters were fed up with austerity. From that perspective, it is worth noting that the cumulative impact of all of the electoral promises by the right-wing Lega and the populist Five-Star movement probably would have led to a deficit to the tune of 6% of GDP. Since those initial fears first caused market jitters earlier on this year, we have seen a couple of selloffs in Italian bonds, usually followed by reassuring tones from Rome and a return of relative market calm, however temporary.

In a nutshell

- The haggling over Italy's budget continues. Compared to initial plans, however, the new Italian government has already moved quite a bit.
- We expect bond-market tensions to persist, but no default and no Italian exit from the Eurozone for the foreseeable future.
- The role of rating agencies will be critical.

It seems plausible that this will also be the pattern ahead, in coming weeks and months. One way to think about this is to imagine that the government has been trying to test out limits for deficit spending, in order to gauge the reaction by financial markets, rating agencies and the European Commission. If so, you might imagine that a certain level of pushback by the Commission is necessary in order to reign in excessive demands by populist politicians. Between two rational sets of decision makers, initial harsh rhetoric, followed by face-saving compromises, would have benefits for both sides. This would probably include accepting some fairly optimistic GDP-growth assumptions from 2020 onwards. Perhaps, there could also be a tacit or explicit agreement that these will be revisited, following European parliamentary elections in May 2019, which will help determine the composition of the European Commission too.

The new budget needs to be submitted to Brussels by October 15. The outgoing commission might not like what will be presented. However, Brussels has little incentive to trigger an escalation and has limited powers to interfere directly in the short term. Parliamentary approval in Rome will proceed in parallel. Key political dates to watch are:

- October 20, the latest date by which Italy's government has to present its final budget proposal to parliament.
- November 30, when the EU Commission will give an initial assessment of the draft budget.
- December 31, by which date the budget must be approved by both houses of the Italian parliament.

So, what could possibly go wrong in the coming months? In descending order of probability, we see three potential sources of risk. First, the role of rating agencies in general and Moody's in particular will be critical. Moody's has had Italy on negative watch and will probably review the rating by the end of October, at the latest. Our base case remains a downgrade of one notch. This would still leave Italy one notch above junk.

However, there are risks to the downside of this base case. Depending on the political noises coming out of Rome in the coming weeks, it is possible, though unlikely, that one of the rating agencies will lose its nerves and deprive Italy of its investment credit rating. That could have potentially catastrophic consequences, with knock-on effects not just in government-bond markets, but also the financial sector of Italy and the broader Eurozone. In a milder version of such a risk scenario, a Moody's downgrade accompanied by a negative outlook could also cause stress in financial markets. Events of recent weeks as well as market movements certainly have made it harder for Moody's to issue a single notch downgrade, while insisting the future outlook is stable going forward.

So what? Some investors might feel reasonably sanguine about market volatility and even rating agencies remaining vigilant. A few might perhaps even welcome market pressure as a budgetary disciplining device. By all accounts, Italian policymakers are closely watching bond-market volatility as well as higher spreads – the spread of 10-year Italian government bonds over German bonds

reached almost 300 basis points. However, we would caution investors to be careful with what they wish for, which takes us to the third source of risk.

From the very beginning, many observers have described the latest Italian crisis as more "political" than "economic." At one level, that distinction is sensible enough. Following the period of austerity under the previous government, Italy's finances improved when Lega and Five Star got in. Modest supply-side reforms also helped Italy's growth prospects. To be sure, some of them, such as the pension reform, have since been scaled back. It is too early to say, however, what the new government could mean for longer-term growth prospects.

What has become increasingly clear, however, is that Italy has become ever more politically fragmented and less governable. By all accounts, Tria's unexpected U-turn on the deficit target was basically the result of some last-minute brinkmanship on the part of the Five-Star movement. Having promised a "government of change" and, perhaps, mindful of its disappointing performance in public opinion polls in recent months, its leader Luigi Di Maio saw an opportunity to score a political victory. His fellow deputy prime minister, Lega leader Matteo Salvini, had little choice but to give in – or risk charges of betraying his voters. All this does not sound like a rational attempt to test Brussels or market-imposed limits. Nor will it be the last time that political and financial-market instability in a Eurozone country will interact in potentially volatile ways. Against this backdrop, it is no wonder that the euro has been weakening against the dollar, that gold has strengthened and that Italian bond and equity markets look set to remain under pressure, until the dust clears.

Glossary

Basis point

One **basis point** equals 1/100 of a percentage point.

European Commission (EU Commission)

The **European Commission (EU Commission)** is the executive body of the European Union (EU) which represents the interests of the EU.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Five Star Movement

The **Five Star Movement** is a populist political party in Italy. It is led by the popular comedian and blogger Beppe Grillo, who was also among its founders in 2009. It is considered anti-establishment, environmentalist, anti-globalist and Eurosceptic.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Lega

The **Lega** (formerly "Lega Nord") is a right-wing populist party in Italy. It was founded in 1991 through the merger of various parties. It is considered anti-globalist and Eurosceptic.

Moody's

Moody's is a firm providing credit ratings and other financial research and analysis.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

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