Italy Revives Euro Area Concerns

Earl Sweet, Head, Economic Risk • earl.sweet@bmo.com • 416-359-4407
Art Woo, Senior Economist • art.woo@bmo.com • 416-359-4525
Sarah Howcroft, Senior Economist • sarah.howcroft@bmo.com • 416-359-8458

Euro Area breakup risks returned to the spotlight, with the focus clearly on the current political gyrations in Italy. The initial failure of the populist Five-Star/Northern League alliance to form a government triggered fears of another election, which could have been positioned as a referendum on the euro. In response, investor angst pushed the cost of insuring Italian government debt (CDS spread) out to 275 bps (higher than Turkey's; *Chart 1*) and the government risk spread over 10-year German bunds to 270 bps on May 29th (*Chart 2*). Contagion fears caused sovereign risk spreads in other Euro Area countries with challenging fiscal conditions, such as Portugal and Spain, to also widen.

Risk spreads have subsequently eased following a successful second attempt to form a government, which removed the threat of a near-term election, though they are still well above pre-turbulence levels last week. However, market volatility may remain pronounced, given ongoing political/policy uncertainties and the country's very weak fiscal finances. Italy's general government debt/GDP ratio stood at 131.5% at end-2017, among the highest in the world (*Table 1*). Interest payments on government debt amounted to 8.2% of revenue in 2017, compared to an average of 4.3% for the Euro Area as a whole. Rising yields in Italy raise debt-servicing costs, compounding the government's funding challenge. Of particular concern, principal and interest on Italian government bonds due within the next year amounts to 20% of GDP, high relative to the Euro Area average (including Italy) of 13%.

Neither Five-Star nor the Northern League campaigned on leaving the Euro Area. Rather, they redirected attention toward an ambiguous plan to rework Italy's relationship with the Euro Area and EU. Nevertheless, both members of this rather unusual, left-right populist coalition did make fiscal promises totalling in the range of 5%-7% of GDP (e.g., minimum income, significant personal and corporate tax cuts, flat tax, repeal of the VAT increase, scrapping pension reform), greatly raising their attractiveness to voters. Such a plan, however, would clearly violate the country's commitments to the EU on fiscal consolidation (i.e., budget deficit below 3% of GDP), rendering the prospect of a reworking of the country's position in the Euro Area or EU highly unlikely.

Recent opinion polls show that a slim majority of Italians do not want to leave the Euro Area, albeit by a narrower margin than in recent years. (Recall that there are no provisions in the Maastricht Treaty for a member country to exit the Euro Area and it is unclear

Chart 1
Rising Cost of Insuring Italian Government Debt

(bps : as of June 1, 2018, 10:00 am)

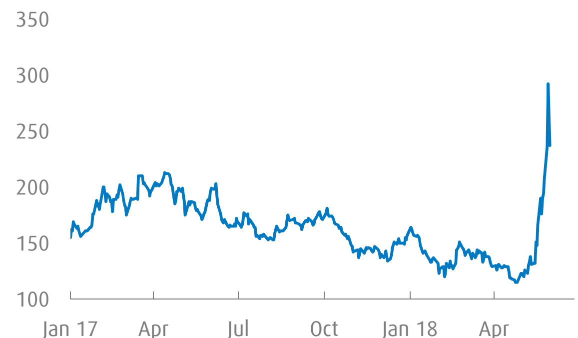
5-year Credit Default Swaps

Sources: BMO Economics, Bloomberg

Chart 2
Italy's Sovereign Risk Spread Spikes

Italy (bps : as of May 31, 2018)

10-year Government Bond Spread over Bunds



Sources: BMO Economics, Haver Analytics

Table 1
Italy Leads in Debt/GDP and One-year Roll-overs

Gross Government Debt — 2017 (% of GDP)

	Total	Due in One Year[1]
Italy	132	19.9
Portugal	126	15.1
Spain	98	16.6
France	97	15.0
U.K.	88	8.5
Austria	78	8.6
Ireland	68	5.9
Germany	64	9.1

[1] as scheduled at end-April, 2018; includes principal and interest
Sources: BMO Economics, Haver Analytics

whether such a country could remain part of the EU.) However, polls also show continued popular support for the anti-establishment, eurosceptic Five-Star and Northern League parties. This dichotomy is not dissimilar to the U.K. and *Brexit*, though in Italy's case, risks would be significantly heightened, given its much softer economy, unsustainable fiscal finances, weak banks, dysfunctional government, and the fact that a break-up would entail a new and likely very weak currency.

Though a coalition government has now been formed, its longevity is questionable given significant differences among its members on policy. Another issue is whether its policy package will remain consistent with EU fiscal rules and, if it is not, whether exceptions will be allowed by the EU authorities. Down the road, any signs that another election might be in the works and that it could become a referendum on the euro would reignite adverse reactions in asset markets. In such a scenario, falling Italian bond prices would place capital and liquidity pressures on Italian banks, which hold 17% of outstanding Italian bonds, and slow economic growth or possibly cause a recession, further exacerbating bank asset quality and capital adequacy concerns. As the recent experience of Greece shows, there also would be a meaningful risk that banks' deposit bases become eroded.

In the event that instability of the new government or conflict with the EU were to once again roil financial markets, the Euro Area authorities, in conjunction with the ECB, have several mechanisms with which they could support a country in crisis and have shown flexibility in the past in using them. However, this would depend on the Italian government's cooperation and willingness to meet specified commitments. In a full-blown crisis, the sheer magnitude of Italy's economy (nearly 10x larger than Greece) and sovereign debt (2.3 trillion euros or 20% of Euro Area GDP) would make a Greek-style bailout nearly impossible. Clearly, negotiations between the new government and European authorities will be intense over the next several months. The next flash point to keep an eye on is Italy's submission of its budget in the autumn.

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