



# COULD ITALIAN POLITICS CAUSE ANOTHER EUROPEAN DEBT CRISIS?

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The political situation in Italy, where the anti-establishment parties League and 5-Star have formed a ruling coalition, has revived painful memories of the European sovereign debt crisis of 2011/12. Then, the perceived inability of several governments to service their debt or bail out their national banks sent yield spreads soaring and led to a collapse of confidence in European businesses and economies. Now, the prospect of a populist coalition in the eurozone's third biggest economy taking on the European Union (EU) has prompted concerns that another crisis may be around the corner.

These concerns are understandable. Italy is the second-most indebted government in the eurozone after Greece, with around 133% debt to GDP. The size of its debt means that if Italy ran into trouble, the EU would not be able to provide the kind of rescue package it provided for Greece, Ireland and Portugal in 2010-12. A European-IMF joint monitoring programme, backed by the ECB's OMT (Outright Monetary Transactions) bond market stabilization programme, is theoretically possible – but the new coalition has publicly called for fiscal expansion and more autonomy from the EU, and would therefore be extremely reluctant to ask for, or welcome, outside help.

## COALITION PARTNERS NOT 'NATURAL BEDFELLOWS'

There are also concerns about the prospects of the coalition itself. While the right-wing League and left-wing 5-Star have found enough points of agreement to form a partnership, they are not natural bedfellows and differ significantly in a number of key policy areas. Either party might choose to walk away if polls indicate that it would make substantial gains in a new election, enabling it to form a government without the other. If the somewhat eurosceptic League won a new election and ruled on its own, or as the dominant partner in a new coalition, Italy's future membership of the euro could come under question.

Despite these issues, we do not believe that the situation in Italy is likely to trigger major debt crisis soon. For one thing, Italy's current account balance is in a healthy surplus, which means that the country as a whole is saving more than it is spending. In fact, the country's net international investment position is now about flat, which means it is neither a creditor nor a debtor to the rest of the world. By contrast, all of the periphery countries were running large current account deficits ahead of the European debt crisis of 2011/12, sparking higher interest rates and economic dislocation when foreign financing was withdrawn.

It is also important to note that Italy's central bank, due to the ECB's quantitative easing (QE) programme, owns a little over 20% of Italian sovereign debt (equivalent to 27% of GDP), which we expect it to hold indefinitely on its balance sheets. This debt carries no refinancing risk and a portion of its interest payments are recirculated back to the Italian government in the form of dividends. This means that, overall, the Italian financial position is much stronger than it was in 2011.



## RISK OF NEW ELECTIONS OVERSTATED

Simple analysis suggests that the new coalition government will push for a massive increase in the fiscal deficit, possibly up to 6% of GDP, but we believe that it will moderate its plans. If Italy breached the EU's 3% fiscal deficit limit, it would result in more direct monitoring of its finances by Europe, which is not something the coalition wants at this point in time. We also think that the risk of one of the coalition partners pulling out and triggering a new election has been overstated. If the coalition collapses, President Mattarella's first objective will be to see whether a new coalition could be formed – and while not easy, this would not be impossible to achieve. It should therefore not be assumed that a collapse in the coalition would lead to new elections.

Risks remain, of course. The League is an unpredictable political force. There are figures in the party who openly seek to leave the euro, though it's not clear whether Salvini himself favours this. Certainly, the party is not united on this issue, and it is possible that at some point its more extreme elements become more influential. However, we regard this as improbable at this stage.

Overall, we are generally underweight Italy at the moment as we wait to see how the budget develops in September and October. It is likely that early drafts will be provocative, designed to push against EU rules. If there is no attempt to compromise in later drafts, we may become concerned. However, if there are signs that the new coalition government is moving towards a pragmatic approach, it may create a buying opportunity.

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