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Italy: slipping into a crisis in confidence

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The heightened uncertainty over whether Italy will repay its debts and whether it will remain a member of the eurozone has led to a sell-off in securities. The key benchmark, the yield on two-year Italian government bonds, rose from minus 0.30% in early May to 2.50% on May 29 (source: Bloomberg).

Note: Past performance is not indicative of future development.

Stagnation leads to dissatisfaction

The starting point is the stagnating level of prosperity in Italy. The real gross domestic product per capita last year was at the level of 1999, at around 34,000 US dollars, adjusted for purchasing power, (Source: IMF). This stagnation has led to increasing dissatisfaction with the established parties and the EU. This resulted in gains for the two populist parties M5S and Lega in parliamentary elections last March.

… and to populism

In recent weeks, one could follow what it means when populist parties can determine government affairs. 1) increase in government spending, 2) tax cuts, 3) disregard of treaties with other countries (Eurozone regulations), 4) fiscal stimulus takes place in the “boom” phase of economic growth (real GDP growth of 1.5% in Italy in 2017 was very good.) Sounds almost like Trumponomics. The measures announced have shaken investors’ confidence because they are in conflict with low competitiveness, the high public debt level (2017: 131% of GDP, source: IMF) and the architecture of the Eurozone, whose survival depends on the good conduct of member countries.

It is likely that the new interim Prime Minister Carlo Cottarelli appointed by President Sergio Mattarella will not win the vote of confidence in Parliament. This will be followed by new elections in autumn with a similar result as in March. The statements during the election campaign will at least not be particularly trust-promoting.

Confrontation with the eurozone

For the long-term existence of the Eurozone further communitarisation steps are necessary. Several suggestions are at the table will be processed in tough negotiations. These include the upgrading of the European Stability Mechanism (ESM) to a European Monetary Fund (EMF) and the introduction of an EMU-wide guarantee scheme for bank deposits. With the statements of the two populist parties in Italy, further integrative measures have become (even) less likely.

Protection mechanism with horse foot

Compared to the Euro crisis 2011/2012, there is one important difference: Two bailouts funds have been created. 1) As part of the Outright Monetary Transactions (OMT) program, the European Central Bank can buy unlimited short-term government bonds in the event of a crisis. 2) The ESM (European Stability Mechanism) can provide loans and guarantees to countries that are limited in amount. The horse’s footstep in this case becomes obvious: it only gives support if a EU member country accepts the economic policy conditions associated with the aid (= austerity, de facto partial loss of state sovereignty).

Whatever it takes

The main burden for the unity of the eurozone continues to lie at the ECB. As far as she can, the European Central Bank will try to stabilize the situation. The rationale will be the guarantee for the functioning of monetary policy throughout the euro area. One has to think of the famous three words of ECB President Mario Draghi in the summer of 2012 (“Whatever it takes”), which managed to calm the euro crisis at that time.

In fact, the ECB can take its time with the targeted reduction of its extremely expansionary monetary stance: 1) Economic growth slowed significantly in the first quarter compared to the fourth quarter (0.4% quarter-on-quarter after 0.7%, source: Eurostat). 2) More importantly, at 0.7% annual inflation, the core inflation rate is very low (source: Eurostat) and will only increase slightly in the coming years in the most likely scenario.

The next meeting of the Governing Council of the ECB on 14 June therefore is particularly important. Market participants' expectation that the press statement on the financial environment will be dim – with appropriate measures in the event of an escalation – is likely to be ample. As a reminder, the bond purchase program runs until at least September 2018 and can be extended if necessary.

Legal note:

Prognoses are no reliable indicator for future performance.

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