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Italy: markets act as the boy who cried wolf

■ Political uncertainty in Italy has caused market turmoil with significant spillover effects within but also beyond the Eurozone ■ Contagion within the eurozone was of a different nature than in 2011 ■ With a new government in place, attention will now focus on its economic policy, in particular in terms of public finances

Italy has seen a strong pick-up in growth and in 2017 real GDP increased 1.5%, the fastest pace since the crisis. This has translated into a significant drop in the unemployment rate and considerable job creation. In 2017, the country had a current account surplus of 2.8% of GDP, and in recent years its net foreign asset position has improved significantly, reaching a very low -7% of GDP. Since 2014 the public sector deficit has been below 3% of GDP. Most importantly, European Union data show that since 1995 the country has been running a primary fiscal surplus for 22 years (only the year 2009, in the depths of a worldwide recession, saw a small primary deficit). Most (65%) of public debt is domestically held. Admittedly, the country faces many economic challenges - it's not alone in that respect –a key one of which is boosting potential growth. Nevertheless, it is worth keeping these numbers in mind when observing market behaviour over the past 10 days. It showed that the spread's widening reflects an increase in worries rather than a deterioration in fundamentals.

The source of these worries was the uncertainty about how the coalition-government-in-the making would handle a number of issues (allowing a considerable increase in the public sector deficit, its relationship with 'Brussels'). Following the proposed appointment of Professor Savona, who is considered to be a eurosceptic, as Treasury Minister, markets went so far as to start to doubt Italy's commitment to the eurozone. All this is reminiscent of the fable about the sheperd boy who cried wolf, frightening the villagers with the danger that their flock of sheep would be attacked by wolves whereas nothing happening.Indeed, it is worth remembering that in the 57-page contract for the new government signed by 5 Star and the Northern League no mention is made of the issue of abandoning the euro.

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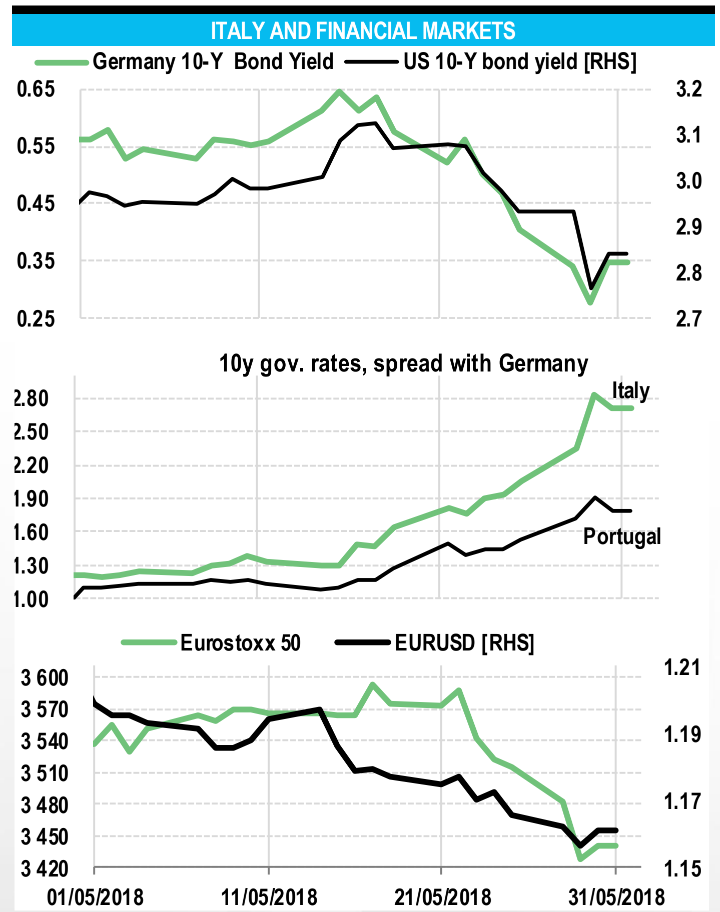
ITALY AND FINANCIAL MARKETS



Sources: Bloomberg, BNP Paribas

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Moreover, in recent days Professor Savona explained that his past proposal of a plan B for an "Italexit" was to be used as simply a sort of bargaining chip, a threat to be made in order to obtain more in the attempt to change European rules.

To some degree, the market's reaction doesn't come as a surprise, if only because of its earlier complacency. Quite unusually, both in the run-up to the elections on 4 March and thereafter, the spread with Bunds has narrowed and Italian equities have outperformed the Euro Stoxx 50 index. Understandably, when uncertainty increases, there is a backlash. The prospect of new elections poured oil on the fire lit by fears they would turn into a de facto referendum on eurozone membership.

With respect to the euro, in addition to what has previously been said (no mention of abandoning it was made in the coalition program), it is good to keep in mind the presidential elections in France last year when an anti-euro stance was severely sanctioned by voters and the fact that the European Union's Eurobarometer 461 of April 2017 shows that 58% of Italians are in favour of the euro (35% against, 7% uncertain). Admittedly, Italy is in the second part of the league table but there's a majority nevertheless. Another point to be taken into account is what the other parties would have said. During the sell-off, markets were increasingly pricing extreme scenarios. Preparing for elections would have meant that more and less extreme scenarios would need to be priced. With the spread between Italy and Germany reflecting a probability-weighted average of possible outcomes, the multiplication of scenarios can actually help to calm things down.

News on Wednesday of a renewed effort to form a coalition was met with a big sigh of relief as the BTP-Bund spread narrowed 40 basis points: markets acted as a pinball machine. The appointment on Thursday of a new government under the leadership of Giuseppe Conte, who in an interview emphasised the absence in the coalition contract of any reference to leaving the euro, should bring more relief. Yet markets will stay on their toes. The focus will be on the public sector deficit and whether the relationship with the EU on this matter will be confrontational or cooperative (on both sides). The importance goes well beyond Italy. As the charts show, the spread's widening has created a contagion effect (the Portuguese spread, to name just one, widened), weighed on the euro and the equity market and caused safe-haven buying that has resulted in a decline in Bund yields and even US treasury yields. On contagion in the eurozone, it should be emphasised that this is not like 2011 when several countries were suffering from the same illness. Today contagion is a reflection of risk arbitrage: investors who feel confident about Italy in the medium term and count on the spread narrowing in due course seize the opportunity of a more attractive return/risk trade-off in Italy by lowering positions in other markets, causing their spread to increase as well.

A final word on 'the boy who cried wolf': whereas the fable has a sad ending when for once the villagers did not react when the boy raised the alarm and the wolves attacked the flock, we can be confident that markets will always cry out when they see fit, thereby sending signals to be taken on board by policy makers. Moreover, eurozone governance is such that the shepherds, unlike the boy the fable, will be sure to protect their flock of sheep.

William De Vijlder