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On the Margin: Italy's October Surprise is Here

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Developing items of interest and deeper color on themes from our regular reports.

The "government of courage" is back

We warned again last week that a potentially systemic budget confrontation between Italy and the European Union could still be an "October surprise" for markets, despite seeming confusion in Italy's government coalition (see "On the Margin: Eerie Calm in China and Italy" September 24, 2018). October is only two days old, and here it is: Rome has agreed a budget that forecasts a 2.4% deficit (as a share of GDP), up from the prior government's signaled level of only 0.8%. It won't be officially presented to the EU until mid-month, but Brussels has already signaled it will push back. But it's not really clear how hard Brussels will push.

Scare-mongering headlines say European Commission President Jean Claude Juncker has "evoked Greece." But in fact Juncker said,

- "One crisis was enough. After the toughest management of the Greece crisis, we have to do everything to avoid a new Greece – this time an Italy – crisis."

We can' know with certainty yet what he really meant, but we read that as conciliatory, suggesting that "tough" isn't necessarily the way forward. Someone volunteering to "do everything to avoid a…crisis" isn't exactly playing it tough.

The German government has let it be known that sticking to the EU budgetary rules is important. "Convergence criteria" for joining the euro currency permit a 3% deficit. So technically a 2.4% budget isn't a problem, especially as Italy is no longer under corrective "excessive deficit procedures" of the EU's Stability and Growth Pact that would have formally mandated even lower deficits aimed at reducing Italy's large stock of debt. *So we're not really sure what Brussels' argument against Italy is really going to consist of.*

For its part, the Italian government is talking tough. Deputy Prime Minister

Update to strategic view

EUROPE MACRO, EUROPE BONDS, EUROPE STOCKS, FX: The EU has signaled it will push back against Italy's budget with a forecasted 2.4% deficit as a share of GDP. Press reports exaggerate the toughness of Brussels' response, but the Italian government has hit back hard at even that. Borghi has raised the specter of Italian having its "own currency," but later walked it back. As an official matter, a 2.4% budget is compliant with the Stability and Growth Pact, so we expect that it, or something close to it, will end up being negotiated mid-month after Brussels gives its formal response. Having not seen the details, we have no judgement as to whether Borghi is right in characterizing the deficit as necessary for growth. The biggest risk remains a market-driven run on the euro that gets ahead of actual events. Italy is aware of that risk, and is using it as a negotiating weapon.

[Strategy dashboard]

Luigi Di Maio of the Five Star Movement said Italy would not retreat on its spending plans by "even a millimeter." He added,

- "A 2.4 percent deficit has been tolerated in the past, but this time we are not using it to save banks and oil businessmen but to help people to retire, to find jobs and to lower taxes."

Italy's other Deputy Prime Minister, Matteo Salvini of the League party, lashed out directly at Juncker, blaming Brussels' obstructionist comments for driving Italian bond yields back to the highs of the year, and stocks back to their lows:

- "The words and the threats of Juncker and other high EU bureaucrats continue to raise the spread between Italian benchmark bonds and their German equivalent. We are ready to seek damages from those who want to harm Italy."

The toughest talk came from a lower official no doubt tasked specifically with playing the baddest cop, Claudio Borghi, head of the Budget Committee of the lower house of Italy's parliament, and a member of the League party. He said Italy would have no budget issues if it had its "own currency." This is the heart of the matter – *Italy's unbeatable negotiating weapon is the threat to leave the euro currency, which we believe would risk a global systemic crisis* (see "USD, Euro and the Risk of Italeave" May 25, 2018).

The risk is heightened by the unpredictable and uncontrollable role of markets. Even a sufficiently credible threat of Italeave – even if the reality of it were never seriously intended – could trigger a run on the euro that could destroy Europe's banks overnight, and leave the European Central Bank helpless to do anything about it. Borghi knows it, too. After his remarks, he tweeted that today's market moves against Italy, and today's weak euro,

- "…should make even the doziest understand how ridiculous it is to believe that the strong single currency protects from speculation."

Naturally he later walked it all back (having already said it):

- "There is no plan to leave the euro within this government regardless of my personal conviction."

But now that he has your attention, he went on to say that "We did not get the 2.4 percent deficit number out of a bag," claiming this is the number needed for growth so that debt-to-GDP will fall. He said the deficit is "not a

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[Reading home]

revolutionary move" and "we are not mad, we are not Maduro Venezuela or something like this."

Good that he's talking about growth. Glad someone in Europe is. But for now, as far as we can tell, the details of the budget have not been disclosed – so we have no way to independently judge whether that deficit is pro-growth or not.