FINANCIAL MARKETS

ITALIAN POLITICAL CRISIS

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TRADE: THE BIG PLAYERS

FOREWORD

In March 2018, Italy elected the first populist government in Western Europe.

As disagreements sparked between the president and the new government coalition, the government collapsed before it even had the chance to begin.

Now, a lot of uncertainty surrounds Italy and the future of its leadership. Not only this, but it has brewed up plenty of apprehension within Italian and global markets. This has left investors in a nervous state. In this eBook, we will discuss the causes of the breakdown. We will also explore how the markets have responded to the political turbulence.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

WHY THE POLITICAL TURMOIL?

WHAT'S HAPPENED?

After the March elections in Italy, the Five Star movement and the anti-immigration League decided to attempt to form a coalition. Despite the parties having different platforms, they agreed to work together early in May.

The coalition chose to appoint Paolo Savona as the economic minister. As president, however, Sergio Mattarella owns the power to block any individual cabinet appointments under the constitution. Savona's views are very eurosceptic. Due to this, Mattarella rejected the invitation for Paolo Savona to join the government. Despite the backlash, Mattarella believed that he could be a threat to Italy's place in the eurozone. This would go against what the people of Italy have shown they really want.

Five Star and the League would not accept any other finance minister and would not put any others forward. Eventually, this caused the coalition to break down, leaving Italy in political turmoil.

In the meantime, the president has asked for Carlo Cottarelli to act as prime minister. Cottarelli is the former director of the International Monetary Fund. His role is to lead a caretaker government until elections are held again in early 2019.

Due to Savona being vetoed, there have been calls for Mattarella to be impeached, especially by the populist winners of the election. Analysts so far believe that these calls will not succeed.

WHAT ARE THE CONCERNS?

Currently, investors are expressing concern that this political turmoil could cause widespread anxiety in the markets.

If the more radical parties gain ground up until the next election, the opportunity for a referendum on the use of the euro could arise. Some observers worry that Italy may end up striking out of the European Union altogether.

Within the eurozone, Italy has the third largest economy. Overall, it makes up 15% of the regions GDP. If they were to leave the eurozone, this could cause serious harm. The last eurozone crisis occurred from a much smaller contributor: Greece. Because of this, it is hard to imagine the scale of the crisis that Italy could cause.

If Italy were to leave the eurozone, the growth in other countries could be impeded too. Monetary tools would need to be distributed to contain any contagion risks and the most severely affected banks would need support.

Abandoning the shared currency would also cause problems for the US markets too. The US would have to go through the process of monetary policy normalisation. This would help the eurozone to improve its overall economic activity, due to the backlashes of Italy leaving.

The financial service company, Moody's, also expressed concern for Italy's credit rating. They believe that if a populist party holds power, Italy's credit rating could be cut. The radical spending plans of the populists have led to this judgement. Furthermore, aggressive spending could jeopardise Italy's fiscal position and would stall efforts to reform the economy.

REACTION OF THE MARKETS

HOW HAVE THE MARKETS REACTED?

Bond yields are what measure the sovereign costs of a country. On Tuesday 29th May, Italy's 10-year bond yield breached the 3% threshold. It reached the highest point since 2014. This was significant, considering it had only reached 1.8% at the start of May. Though these bond moves are largely isolated, the contagion risks are beginning to pile up.

Traders are currently selling off Italian debt. With fears that the country could leave the eurozone, they worry that they may not be repaid. It has further been noted that Italian consumer confidence has also shown a decline and is weaker than expected for May.

Tuesday 29th May also saw the Italian stock market down 3%. Throughout the month of May, its value has decreased by around 13%. It wasn't just the Italian market that suffered as global stock markets also took a huge hit. The damage forced investors to demand a higher yield in order to face the debt of the Italian government.

We also saw the euro drop 1% against the US dollar, reaching $1.1510. This was a six-and-a-half month low for the currency. It also shows the trepidation of investors who feel Italian politicians may stop following the rules of the euro or discard it altogether.

The British pound did not show signs of benefiting. Though it remained flat against the euro, it also fell against the strengthening US dollar by 0.26%.

It is important to remember that currencies reflect market anxiety. For that reason, it is likely that the euro will show no notable improvement until this the government finds some stability.

The main stock index in Italy dropped by another 3% in the last week of May 2018. It was, however, the banks who were hit the hardest following the chaos. Some stocks fell by as much as 5%.

There were noticeable falls in other global markets too. In Germany, the Dax fell by 1%; Spain's Ibex saw a loss of 2.3%; we saw the FTSE 100 lose 1.25% and the Dow Jones Industrial Average had a fall of 0.8% - causing the US stock market to lose ground.

This political deadlock in Rome is the biggest crisis within the eurozone since Greece was on the edge of leaving, back in 2015. Italy's current sovereign debt lies at €2.3 trillion. This is the biggest debt in the eurozone. It is difficult to completely understand the significant effects that could be caused in the wider financial markets if Italy abandons the euro.


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