FINANCIAL MARKETS

ITALY'S NEW BUDGET DISPUTE

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NEW BUDGET WOES?

FOREWORD

In recent weeks, the Italian government and the European Union have clashed over Italy's revised budget plan.

The dilemma is simple: the European Union wants Italy to service its national debt. It fears this revised budget will do the opposite.

The purpose of this eBook is to analyse Italy's new budget plan. We'll also explore whether Italy and the European Union will be able to find common ground.

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THE ISSUE EXPLAINED

BACKGROUND

Before we explore the specifics of the dispute between Italy and the EU, it's important to get some context.

Firstly, Italy is part of the eurozone. This means its monetary policy is controlled by the European Central Bank (ECB). As part of this arrangement, Italy also has to adhere to fiscal rules set for all eurozone members.

Italy's new budget plans break these rules - and the EU isn't happy.

But it's not the first time we've seen a dispute between a eurozone country and the EU. After the financial crisis of 2008, Greece and the EU had different priorities. Greece needed to alleviate the suffering of its people with limited fiscal stimulus. The EU wanted Greece to implement strict fiscal controls to service its debt.

Ultimately, these differences were resolved. But it did demonstrate the complex task entrusted to the ECB in managing the eurozone's monetary policy.

ITALY'S CHANGING POLITICAL SETUP

Italy's economy also suffered greatly from the financial crisis. In fact, at the time of writing (October 2018) the Italian economy is smaller than it was in 2008.

Clearly, this has had an effect on Italian politics. In June 2018, a new 'populist' coalition was sworn in as Italy's government. The coalition consists of the Five Star Movement and The League. Both parties are anti-establishment.

A priority for the new government is to improve economic conditions for Italians. Specifically, it wants to eradicate poverty.

In its most recent budget, the Italian government has made a number of proposals to achieve this, all of which involve increased fiscal spending. Proposals include:

- Introducing minimum income for unemployed Italians
- Tax cuts
- Dropping an extension to the age of retirement

The new Italian Prime Minister, Guiseppe Conte, has insisted that these plans would see Italy's budget deficit climb no higher than 2.4% of its GDP in 2019.

But EU isn't so sure. It's concerned that these budget plans could see Italy's budget deficit surpass its 3% limit (known as the EU's

Stability and Growth Pact).

In such a scenario, Italy could face fines from the EU. Officials want Italy to keep within eurozone rules and to service its existing national debt, which stands at 131% (the second highest in the eurozone).

IS ITALY'S NATIONAL DEBT MANAGEABLE?

There's no question that Italy's national debt is high. In fact, the country's politically independent finance minister wanted any proposed budget to keep the budget deficit between 1.6% - 2.6% of GDP.

But the current Italian government doesn't believe that austerity is the answer to servicing its national debt. Rather, it advocates creating economic growth and internal demand to pay down the debt.

Whether that approach works remains to be seen. But the latter approach is certainly more appealing to the Italian electorate.

CAN A SOLUTION BE FOUND?

OCTOBER MEETING

To resolve their differences, a meeting between Italian government officials and European Commissioners was held on Tuesday 23rd October in Strasbourg. However, the talks didn't produce a compromise.

The Italian government held firm on its intention to implement the proposed budget. The EU responded by - for the very first time for a eurozone member - requesting that Italy amends its budget plans to comply with the EU's Stability and Growth Pact. Furthermore, the EU requested that the revised budget plans be delivered in three weeks.

So far, it appears that the Italian government will not meet this request. Since the meeting, Italian government officials have said they will stick with its original plan, regardless of what Brussels says.

It's unclear what will happen in the weeks and months ahead. But it looks as though the European Commission will be entitled to open an excessive deficit procedure.

EU SCEPTICISM

This is a dangerous time for the EU. Following Brexit, it needs to stabilise the integrity of the European project. So the last thing the EU needs is a standoff with the eurozone's third-biggest economy.

What's more, the Italian government is populist. They are sceptical of the EU and the euro currency. By opposing (and perhaps punishing) the Italian government's plans, the EU risks antagonising the Italian population. If the EU became unpopular in Italy, there's certainly a chance that the current government could push for a referendum on Italy's EU membership.

EFFECT ON THE MARKETS

Of course, a dispute between Italy and the EU has the potential to put downward pressure on the euro - especially if the situation escalates in the coming weeks and months.

But the situation has already caused a noticeable reaction. Italian stocks saw a sell-off after the October meeting, while European shares dropped close to a two year low. Plus, the Italy-Germany 10-year bond yield hit a new high of 315 points.

Investors and traders should expect more market volatility, especially if the EU opts to open an excessive deficit procedure against Italy.


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