FINANCIAL MARKETS

HOW ITALIAN FISCAL POLICY COULD AFFECT THE EURO

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A NEW PROBLEM FOR THE EU?

FOREWORD

There's no question that Brexit is the most pressing issue facing the European Union (EU) right now.

But it's by no means the only challenge facing Brussels. Tensions remain between Italy and EU leaders on the country's spending plans.

The purpose of this eBook is to explain Italy's fiscal policy path - and how it could affect the euro.

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ITALY'S FISCAL POLICY

ITALY'S COALITION GOVERNMENT

A new Italian coalition government was established in June 2018. The coalition partners are two right-wing parties called "The League" and "Five Star".

Both parties are eurosceptic.

Once established, the coalition proposed plans to increase fiscal stimulus to spark the Italian economy into life.

Put simply, the goal of these plans were to improve economic conditions for the average Italian. They included three cornerstone policies: introducing minimum income for unemployed Italians; tax cuts; and scrapping an extension to the age of retirement.

EU OBJECTIONS

However, the EU had objections to this new fiscal approach.

Specifically, it was concerned that Italy's budget deficit could surpass its 3% of GDP limit. Remember - Italy is a member of the eurozone - and as a member it needs to follow particular rules.

At the time, this was disputed by Italy's new Prime Minister, Guiseppe Conte. He insisted that Italy's budget deficit would climb no higher than
2.4% of its GDP in 2019.

Why do these rules exist? Well, it's quite simple. The eurozone's monetary policy is controlled by the European Central Bank (ECB). Therefore, it's integral that eurozone members adhere to requirements to maintain monetary stability.

A RESOLUTION (FOR NOW)

An Italian budget deficit of 2.4% in 2019 was unacceptable to the European Commission.

However, a breakthrough (of sorts) was achieved in December 2018. The Italian government and the European Commission agreed to reduce the deficit target to 2.04%.

Fast-forward to April 2019, and it seems that Italy's budget deficit will be higher than the agreed deficit target. In fact, a report from the OECD forecasts that the Italian budget deficit will hit 2.5% of GDP in 2019.

The OECD also forecast that the Italian economy would contract by 0.2% (the Italian government had originally forecast growth of 1% for 2019), citing high-levels of unemployment and low productivity.

If this scenario unfolds, tensions between Italy and the EU will surface once more.

Evidence of this was on display at a recent press conference between Italian Prime Minister Guiseppe Conte and European Commission President Jean-Claude Juncker.

During the press conference, President Juncker said that Italy must do more to encourage growth considering its high level of public debt. At the same press conference, Prime Minister Conte stated that Italy will not adjust its expansive fiscal policies.

WHAT DOES THIS MEAN FOR THE EU?

Brexit has made the EU anxious that other member states could follow suit. The rise of populism - both on the left and right of European politics - has heightened these concerns.

Elements of this populism, especially on the right, are eurosceptic. There are several examples across the continent.

The Italian government coalition of "The League" and "5-Star" is a clear example. In France, the 2017 presidential election saw Marine Le Penne of the National Front in a direct run-off with Emmanuel Macron, although she eventually lost.

There has also been an increase in the support for right-wing parties in the EU's largest economy, Germany. In September 2017, the Alternativ fur Deutschland (AfD) party won 94 parliamentary seats.

Hungary also elected Prime Minister Viktor Orban, leader of the Fidesz party, in 2010.

In many ways, the EU faces a delicate balancing act with Italy. On the one hand, it needs to ensure the eurozone's third largest economy adheres to its rules. However, it also needs to ensure it doesn't fuel anti-EU sentiments in the Italian electorate.

But there's something more fundamental at play for the EU.

It needs to answer the concerns that lie at the root of this rise in European populism (both and on the left and right).

One of those concerns is clearly economic growth. Many EU member states, including Italy, have taken many years to recover from the financial crisis of 2008. This is why electorates are looking to new alternatives to solve stagnant economic growth, unemployment and low wages.

Of course, economic growth continues to be a challenge for the eurozone. Flash GDP data for the eurozone in the first quarter of 2019 was just 0.2% (it was 1.2% a year earlier).

IMPACT ON THE EURO

At the time of writing, shrinking manufacturing output across the eurozone remains a drag on the euro. Investors and businesses are concerned that the bloc is in another slowdown cycle.

Clearly, Italy's economic performance is going to be an important factor in the eurozone's overall health. With the OECD report in mind, there is a chance that Italy's economy could contract in 2019.

Traders should closely monitor eurozone PMI data in the coming months. Poor data readings that miss expectations will likely put further downward pressure on the euro.

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