Will Italy leave the European Union (EU)? What does populism have to do with it? What will become of the Eurozone? The answers to these questions are complex and shrouded in mystery. There was a lot of confusion in March 2018 after the failure of the Italian general election led to the creation of a coalition government headed by the North League and the 5 Star Movement. In spite of holding beliefs at polar ends of the political spectrum, the parties were drawn together in support of their “populist” and “anti-establishment” views. During their campaigns, both parties claimed to represent the people and committed themselves to pushing back against systems of power that no longer work—hence their anti-euro and anti-EU rhetoric. The agenda of the newly established government is generally perceived to be in direct contradiction with longstanding EU values. Despite having shied away from their original rhetoric since their election, the fear associated with the coalition’s move into power has rattled global markets.

The coalition proposed Giuseppe Conte as the Italian Prime Minister and he was successfully sworn in on June 1, 2018. Conte will have to answer to both the Italian people and the European Commission. His coalition’s promises pertaining to spending cuts and tax increases are estimated to cost Italy $147 billion. If the coalition makes good on its promises, it will be violating EU rules. Moreover, there is uncertainty surrounding whether Italy will be allowed to run their desired budget deficit. Ultimately, the new regime will have to act directly against the EU or will have to drop some of its campaign vows, and either of these could result in more economic turmoil.

**Economic Ramification**

The financial markets responded to Italy’s political volatility in several ways. Italian bonds and equities sold off quickly and their 10-year government bond yields rose. In Europe, the euro hit a six-month low and fell to 1.1540/US Dollar on May 29, 2018.

The fear extended to global equity and fixed income markets, despite the fact that Italy represents about 1 percent of the global financial markets. That same day, the Dow Jones fell 1.6 percent, the S&P 500 fell 1.1 percent and the NASDAQ fell 0.5 percent. The MSCI World Index fell 1.1 percent on news of the possibility of another election in Italy. The 10-year U.S. Treasury experienced a 15-basis-points drop by the next day’s close due to investor’s flight to safety.

Since then, Moody’s Investor Services has gone as far as to threaten to downgrade Italy from its Baa2 rating, only 2 notches above junk, which would make it harder than ever for Italy to repay its debt and to borrow money. The overarching fear is that Italy’s instability will affect other countries—at first the usual Mediterranean suspects like Spain and Greece, but ultimately the entire EU, since it is the third-largest economy in the EU representing approximately 15 percent of Eurozone GDP.

To put the issue in perspective, Greece only holds 3 percent of the Eurozone public debt, but...
commanded global attention at the beginning of 2018 during a new round of bailouts. Italy holds 23 percent of the region’s government debt. While there were immediate market responses, the largest issue (luckily) remained unanswered: What would happen if Italy chose to leave the EU?

**Italexit**

While the fear of Italy leaving the Eurozone, and possibly the EU, continues to worry some, given past anti-euro and anti-EU sentiment from the ruling party, there is little indication it would do so. The Finance Minister and others in the party reiterate that leaving the Eurozone is “not on the agenda” and that there is “no discussion.” In addition, the UBS Wealth Management Chief Investment Officer for Italy remarked that “while markets may remain volatile, Italy’s membership in the euro should not be a concern for investors.” However, some have argued that the situation is more “dangerous” in Italy because they have more of a stake in staying in the EU than Britain did, and thus are unlikely to leave. The EU is well aware of the consequences should Italy leave and will act accordingly, especially given the rise of euroscepticism across Europe.

**Global Concerns**

Willem Buiter, economist at Citigroup, stated that there may be a 20 percent chance that Italy will “[exit] the euro zone and in the process [destroy] it”—a truly dim prospect, not only for Italy, but for its neighbors. Buiter also predicted that should Italy leave the Eurozone, the “new” lira would lose almost 50 percent of its value in the first two days.

But Italian contagion is not the EU’s only concern. Spain is also dealing with the introduction of a new PM and government, while Britain is dealing with the aftermath of their Brexit decision. Of course, any of these political risks could individually—let alone collectively—affect the global capital markets with similar “risk-off” results as we have seen in the past: a global flight to quality (lower yields in USTs) with selloffs in equity markets.

**Eurozone Reform**

The Organization of Economic Cooperation and Development (OECD) sees the situation in Italy as an indicator of necessary economic reform. Given Italy’s increased borrowing costs, the OECD is reminded of past “eurozone government debt crisis.” While the Eurozone economy has grown as a whole since the last crisis, individual governments have not made the same strides to fix their own issues, including Italy. Countries are now stuck in what is being called a “sovereign bank doom loop,” meaning the stability of the country’s banks is related to its government’s ability to borrow in the bond market.

Sources:
Contact Us

Please contact your HilltopSecurities representative to discuss any concerns or comments you have regarding the preceding information.

Public Finance 800.678.3792

Structured Products 214.953.4020

Dave Brayshaw, Managing Director
Richard Konkel, Director
Jordan Lee, Assistant Vice President
Cody Miller, Associate