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Italy's Inflection Point as It Prepares to Unveil Spending Plans

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Controversial spending plans outlined by Italy's populist government caused consternation among investors at the beginning of October. David Zahn, Franklin Templeton's head of European Fixed Income, considers how the coalition government's growing popularity could influence the European Union's response. And, he explores the implications for the wider eurozone.

Italian assets have experienced a very volatile six months since the country's March general election set in motion events that led to the European Union's (EU's) first populist government.

Now as that government prepares to unveil its spending plans for the coming years, we think the country is at an inflection point. And that has potential implications for the rest of Europe, in our view.

Italy's Pivotal Eurozone Role

We consider that Italy's economic wellbeing is central to the future of the eurozone project. Italy is the bloc's third-largest economy, behind Germany and France. Crucially, it also has the largest debt of any eurozone country.

Without Italy's involvement, the eurozone couldn't really function in its current format, in our view.

But the prospect of its €2.3 trillion debt level growing higher is a concern not just for investors but for the EU, which has strict budget deficit thresholds.

So, there is a lot of attention on the Italian government's budget plans.

Populist Government Growing More Popular

Both coalition partners included measures in their election manifesto that would contribute to higher budget deficits, including lower taxes and higher spending. They are now looking to deliver on those pledges as their government outlines its spending proposals for the next three years.

The Italian government's original proposal—for a budget deficit of 2.4% for 2019, 2020 and 2021—was poorly received by markets and the authorities in Brussels.

Final spending plans are due to be submitted for approval to the EU on October 15. Current EU rules require member states to maintain certain deficit thresholds, but we think in this instance the two sides will likely reach some kind of compromise.

Opinion polls seem to suggest growing support for the Italian government. In March's general election the two coalition parties together accounted for just over half the votes. Recent polls suggest they now have the support of around 60% of voters.

If those polls are correct, that's a big difference in terms of the coalition government's mandate to rule, and we'd imagine that support would give politicians more confidence in pushing ahead with their plans.

The opinion poll numbers may also influence the approach taken by Brussels, which knows that if Italy were to leave the eurozone, the whole single currency project could break up.

Markets will likely scrutinise the final budget proposals carefully, not just the headline numbers, but the details as well. If observers feel that growth assumptions are too optimistic, markets may start to question the plans' feasibility.

However, if the numbers seem reasonable, we think the market will probably react more positively.

Possible Impact on Italy's Debt Levels

If Italy can keep its budget deficit under 2% a year, we'd expect that the country's debt dynamics wouldn't change dramatically. Italy would remain highly indebted, but the situation shouldn't be getting appreciatively worse, in our view.

On the other hand, markets currently seem to be pricing in a deterioration reflecting some small possibility that the country could leave the eurozone.

Yields on 10-year government bonds have fluctuated dramatically from lows of around 2.79% in mid-September to around 3.63% in early October. That's very volatile and we think it emphasises how concerned investors are.

Idiosyncratic Risk for Italy or Systemic Threat to Europe?

In our view, investor concerns about Italian debt may be overdone: the average life of Italian debt has traditionally been very long. Therefore, even with a rise in yields, interest costs should not increase dramatically. So, we see it unlikely that rising yields will affect the country's finances for some time.

To be clear, we don't think Italy is on the cusp of leaving the euro. In fact, other indicators, such as the relatively strong showing of French and Spanish bonds, suggest to us that the current situation reflects an idiosyncratic risk for Italy rather than a more systemic risk for Europe.

If Italian bond yields were to continue to rise, it could pose more of a problem for the country longer term with its debt funding dynamics, rather than the small amount of budget deficit.

On the other hand, at current yield levels, some investors may feel they are being compensated for the risks that Italy presents.

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