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Italy: Has that much changed?

Post-Berlusconi risks still the same in Italy

Years of scandals, prosecutions and diplomatic embarrassments all failed to unseat PM Berlusconi. However, pressure from financial markets, that intensified last week after the PM played down the situation facing Italy, have seemingly taken their toll, as defections by members of his own party denied Berlusconi a majority in a budget vote yesterday. While the bill passed, it did so only because of abstentions, thereby providing an implicit vote of no confidence which Berlusconi could not withstand. As a result he has said he will resign after an austerity package passes parliament hopefully sometime in the next few weeks, also stressing that he will not seek power again if fresh elections are called.

Politics still uncertain

However, the question remains has much essentially changed in what will be the post-Berlusconi era. For a start, the political backdrop does not seem that much clearer, with it uncertain how and when a new government will be formed. PM Berlusconi has suggested that early elections are likely in the new year, but opposition parties are seemingly against this, understanding the urgency created by the current financial backdrop. An alternative option, mimicking what appears to be occurring in Greece, would be the creation of an emergency or technocrat government to be led by a respected non-politician. However, even he would have to win support in a far from sympathetic Parliament for unpopular tax increases, spending cuts and reforms to pension and employment law.

Fiscal outlook worsening

In the meantime, doubts about the Italian financial backdrop may only intensify. Indeed, doubts could grow pending the results from an EU Commission delegation expected to arrive in Rome later this week to monitor compliance with debt-reduction targets and the long-promised measures to boost the economy, with similar investigations possible from the IMF to follow. All will underscore the perilous fiscal outlook in Italy, where the two percentage point rise in bond yields over the last three months will add a similar amount to the budget deficit outlook as a percentage of GDP given the 120% debt/GDP backdrop. Admittedly, bond yields could fall back from the current highs. But even if they do, the tight bond spreads seen in the last decade (that largely ignored the large prevailing debt/GDP ratios) are very unlikely to be repeated, with it clear that liquidity in and around the likes of repo markets are now factors acting to intensify the pressure on Italian bonds.

As a result, with interest rates at these levels, Italy may need to run a primary budget surplus in coming years nearly twice the 2% currently forecast by the EU Commission. The austerity this may entail, alongside the fall-out from banking sector fragility, is likely to put only more downward pressure on growth, the expectations for which have already been reined in markedly of late. Indeed, the consensus now sees GDP flat-lining next year as opposed to the circa-1% rise envisaged only three months ago, something that in itself will damage the budget balance outlook by a further 0.5% of GDP. The risks is that things may be much worse, with key industrial production data due on Thursday likely to underscore the extent to which gloomier surveys are being echoed by actual activity data.

Will the ECB come to the rescue?

It is clear the disdain that many Eurozone leaders had for PM Berlusconi. However, the likes of Germany and France must be aware the fact that PM Berlusconi will be leaving power changes nothing: Italy needs a higher growth rate and/or lower interest rates in order to stabilise if fiscal outlook. Market pressures are actually working against both goals, raising the question as to whether Italy will either need a bail-out that the Eurozone cannot afford or that German-led resistance to the ECB acting as buyer of last resort folds.