

ECONOMIC NEWS

Rising Concerns about Italy Spark Bad Memories in the Euro Zone

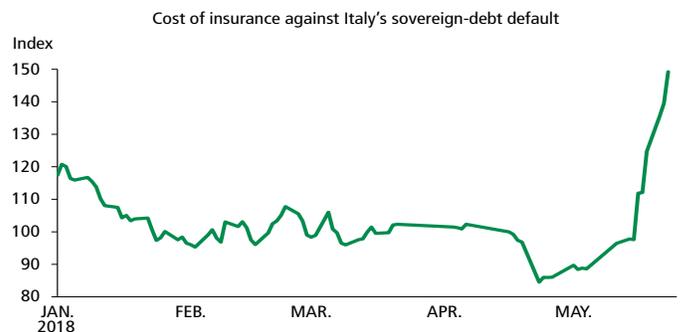
The end of a political impasse is not always good news. Until very recently, the absence of any coming together between Italy's main political parties following the March 4 election suggested that another election might be necessary. International investors did not seem terribly concerned by this situation, which pointed to maintaining some semblance of status quo. Suddenly, everything changed in mid-May, when the possibility of an agreement emerged between two parties that garnered around 50% of the votes during the election, i.e. the Five Star Movement and the League.

Italy now seem poised to adopt a government controlled by two parties with opposing social and economic viewpoints but a common populist vision that goes against Italy's traditional parties and European institutions. The program put forth by both parties calls for major public spending and tax cuts. Fears of a sharp deterioration in Italy's public finances and a confrontation with leaders of the European Union drove Italian bond yields—and default insurance costs—higher in the last few days. This also put some pressure on bonds in other peripheral countries and on bank securities as well.

IMPLICATIONS

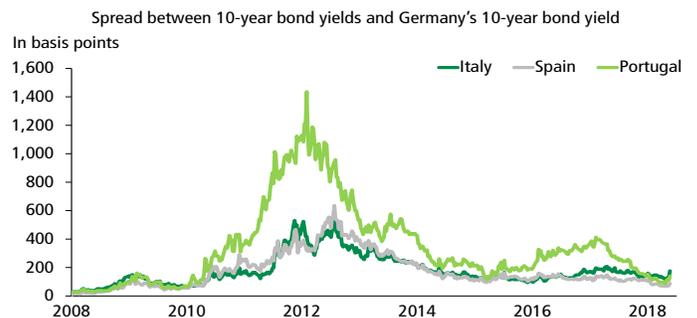
A Eurosceptic government at the head of the euro zone's third largest economy and renewed financial tensions are a reminder that Europe still has challenges to deal with, despite the more favourable economic environment. The problems in Italy's banking system remain also very serious. The situation in no way compares to what the euro zone was dealing with ten years ago, however, and there is no pressing reason to believe the area is heading for a new existential crisis. That said, the situation in Italy is yet another reason for the European Central Bank to be extra cautious its taking action, which could extend the period of weakness for the euro.

GRAPH 1
Investor concerns about Italy have soared in recent days



Sources: Bloomberg and Desjardins, Economic Studies

GRAPH 2
Bond premiums in Europe's peripheral countries remain relatively low



Sources: Datastream and Desjardins, Economic Studies

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