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MACRO UPDATE: RADICALS RULE ITALY, TRUMP GETS TRADE WRONG

Berenberg Macro Flash

ITALY: CHECKS AND BALANCES IN ACTION – SORT OF

Avoiding a new election, Italy's two major radical parties are forming an anti-establishment government approved by President Sergio Mattarella. Although the radicals could put Italy on a dangerous trajectory, the resolution of the political impasse is still modestly good news, for two reasons:

1. New elections would have strengthened the Lega, the more extreme and more Eurosceptic of the two radical parties. Italy will now likely avoid the spectre of a vote that could have turned into a de facto referendum on the rules of the euro.
2. The checks and balances of the Italian constitution, which give significant power to the president and the constitutional court and which constrain the scope for radical change, are working at least somewhat. Mattarella did not lose his first confrontation with the radical would-be government. After Mattarella's veto and a lot of huffing and puffing, the fiercely eurosceptic Paolo Savona will not become finance minister. Instead, he will get the less influential position of minister for Europe (or is it against Europe?). The finance portfolio goes to the somewhat less eurosceptic academic Giuseppe Tria.

Since the 4 March election resulted in major gains for the radicals, it has been clear that they would have to be part of the next Italian government. As in Greece in 2015, the Italian radicals will need to learn some hard lessons in power. If they want to borrow more, as they are apparently planning, they need to find willing lenders. The more they spook domestic and international investors with a eurosceptic attitude, the more it will cost to borrow. In retrospect, the market turmoil can be seen as a stern warning that they are playing with fire. Their key problem is not a potential noisy confrontation with the EU but their ability to finance their spending plans.

Of course, getting a government does not solve any of Italy's problems. If the radicals in power raise the fiscal deficit, reverse a rise in the retirement age and issue mini-BOTS as miniature parallel currency, Italy's economy will suffer eventually. With luck, the checks and balances of Italy's political system will hem in the radicals to such an extent that the country does not descend into a deeper crisis later this year. But even if a major calamity can be avoided for now, a half-reformed Italy that takes some steps in the wrong direction will be vulnerable when the next recession, due perhaps in 2021 judging by current US cyclical dynamics, exposes Italy's underlying weaknesses. A genuine debt crisis is quite possible in 2022. See Italian basics: noise now, trouble later.

In addition, the risk remains serious that, say, Eurosceptic noises, a serious rise in the fiscal deficit and/or a noisy confrontation with the EU could trigger an Italian debt crisis well beforehand. Having boxed themselves into a corner, Italy's radicals would then have to choose between respecting the rules of the euro again or printing their own money to pay for their spending plans. We continue to believe, that, in the end, Italy will choose to stay in the euro. For what they are worth, three recent opinion polls show that a solid majority of Italians wants to keep the euro.

TIT FOR TAT: HOW TRUMP GETS IT WRONG
Almost 10 weeks after US President Donald Trump first announced new US tariffs on steel and aluminium, he is now applying them to imports from the EU (plus Canada and Mexico) as well. As announced in advance, the EU will retaliate in line with WTO rules, probably applying its countermeasures as of 20 June.

Trade barriers lower real GDP, raise prices and stifle innovation and long-term growth prospects. However, the direct impact of the measures announced so far is tiny, relevant for individual companies and consumers but barely visible in macroeconomic statistics. The US tariffs on steel and aluminum imports from the EU may raise an amount equivalent to less than 0.01% of EU GDP. The measured EU response may be worth roughly half that amount. Even if the US were to levy a 25% tariff on car imports from the EU, the direct damage to be shared largely between US consumers and EU exporters would be equivalent to 0.08% of EU GDP. Lower Chinese tariffs on car imports may offset half the potential damage to EU car producers. Also, stronger domestic demand in the US will likely suck in more imports from the EU despite the trade tensions.

Unlike the direct impact, the uncertainty about future trade and Trump's contempt for international rules can deal a significant blow to business confidence especially in trade-oriented nations. While this has become visible in Eurozone data in the last three months, the concurrent fiscal boost and some domestic deregulation obscures the damage in the US.

Whereas the US and China seem close to a trade deal with some chummy cooperation between Trump and China' new emperor Xi on the ZTE issue, the US and the EU seem far apart on trade issues. That the multinational EU moves more slowly than Trump or Xi can is part of the issue. But the much bigger point is that, on trade, the EU sees itself as a power on par with the US and hence refuses to seriously negotiate as long as the US does not agree to a ceasefire first. That seems to not register with Washington which sees the EU as a bunch of smallish nations which can be bullied individually. As a smaller and less developed economy, China is in a weaker position versus the US than the EU in trade matters.

It still looks quite possible that the US-EU trade tensions will end with an access-enhancing deal. But the probability that this happens soon has now receded from, say, 50% to 35% while the risk of an escalating transatlantic trade war may now stand at 15% instead of 10%. The most likely outcome with a 50% probability could be protracted negotiations during which both the US and the EU lock horns but do not take ever more dramatic headline-grabbing protectionist steps. If so, the fear factor weighing on Eurozone business confidence could gradually fade as companies get used to the background noise, as seems to have happened with the ongoing NAFTA re-negotiations.

In the near-term, the risks to our forecast for Eurozone growth of 0.4% qoq in Q2 and Q3 are still tilted to the downside. Still, unless trade tensions were to escalate dramatically or Italy were to trigger a dramatic crisis soon, chances are that Eurozone growth can re-accelerate to pace above trend later this. The underlying fundamentals remain positive.

SPAIN: RAJOY OUT?
Spanish Prime Minister Mariano Rajoy looks set to lose a no-confidence vote in Spanish parliament this afternoon. Pedro Sanchez, the leader of the opposition centre-left Socialist party (PSOE) will likely replace Rajoy as Prime Minister. The PSOE (Spanish Socialist Workers' Party) has only 84 seats in the 350 seat parliament and the other opposition parties are highly divided. Sanchez is unlikely to be able to govern effec-

tively. New elections in 6-9 months are seem likely. Could Spain face a similar development as in Italy? No. In Italy, a combination of right and left-wing radical parties received more than 50% of the votes in the most recent election. This contrasts strongly with Spain where the three mainstream pro-EU parties (People's Party, Socialists and Ciudadanos) should get around 70% of the votes according to the polls. See also Spain: prospects for new elections

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