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MACRO UPDATE: BREXIT RISKS, ITALIAN PROGRESS

Berenberg Macro Flash

Unusual times. Until a few weeks ago, we would not have believed that we would ever compare the politics of Rome favourably to those of London. The moment may now be nigh. In Italy, parliament, the president and some gentle pressure from the EU seem to be taming the radical rebels of Rome, allowing Italy to muddle through once again. In the UK, the polarisation of politics seems to be getting worse instead; this accentuates the hard Brexit risk.

BREXIT: BORIS TUNS UP THE HEAT

Amid the torrent of news since Boris Johnson became UK prime minister five weeks ago, four points matter most:

1) Johnson's confrontational approach towards the EU combined with his big tax and spending promises have revived the fortunes of the Conservative Party in the polls - up by some 8 points to 32% since Johnson came to power. That probably encourages him to go on with his hardline approach. He may hope that the EU will cave in at the last minute and seek a compromise to avoid a hard Brexit.

2) Reacting to Johnson's demand to ditch the Irish backstop, the EU has asked the UK to "show us the alternative". So far, the EU does not believe that London can find an alternative that is acceptable to Dublin. However, the EU's message enables Johnson to claim to his home audience that – if he gets enough support from home – he may still manage to clinch a better deal against the odds.

3) Upon the request of Johnson, the Queen yesterday announced that she will suspend parliament from some time during the period of 9 to 12 September until 14 October. Johnson apparently wants to reduce the scope for parliament to thwart a hard Brexit on 31 October. Yesterday's move shortens the time that parliament will sit by less than some of the headlines suggest. Parliament always takes a variable break in mid-September for the party congress season. Last year parliament was in recess from 13 September to 9 October.

4) The early suspension of parliament has infuriated Conservative moderates. Some of them could now be less shy than before about going for the nuclear option of toppling Johnson in order to prevent a hard Brexit.

On balance, these four changes accentuate the risk of a hard Brexit without changing the overall outlook dramatically (yet).

ITALY: TAMING THE RADICALS

Italy's 5Stars and centre-left Democrats have agreed to form a new and strongly pro-European coalition. Today, President Sergio Mattarella will formally give the current Prime Minister

Giuseppe Conte the mandate to build a new government. This reduces the risk of a major confrontation between Rome and Brussels. One of the big risks to our European outlook, that of an Italian debt crisis, has receded significantly further for the time being.

Some 14 months ago, two radical parties formed a government in Italy with wild promises of extra spending, big tax cuts and serious reversals of the prior Renzi/Monti/Gentiloni reforms. Under pressure from bond markets and Brussels, the bigger part of that government, the 5Stars, had to water down their plan for a citizens' income to such an extent late last year that the idea has become almost sensible. Now, the other radical party, the Lega, is being tamed. Having tried to force new elections, the Lega is now being relegated to the opposition benches.

Of course, governing will be tricky for the new coalition. Apart from a joint desire to avoid new elections and to keep Lega leader Matteo Salvini out of government, little love is lost between the new partners. The upstart 5Stars have been the bane of the centre-left Democrats for the last six years. Preparing a budget for 2020 that avoids the pre-scheduled VAT hike from 22% to 25.2% will be a challenge. It needs to be presented to the Italian parliament by 30 September and the European Commission by 15 October.

Still, chances are that the new government will overcome these hurdles. The drop in the 10year bond yield from 3% last August to 1% now creates significant fiscal space for 2020 and for 2021 that will make it easier for the European Commission to strike a budget deal with Rome. Expect Brussels to accept a fiscal overshoot that reflects the economic downturn. The EU will also be inclined to let Italy get away with some creative accounting if Rome at least moves in the right direction and – unlike Salvini – does not insult other European countries and Brussels on a regular basis.

The new government looks unlikely to implement the serious pro-growth structural reforms that Italy needs in the long run. But it probably will not make the situation worse. At a record-low in bond yields, Italy can continue to muddle through for quite a while. However, at some time in the future, higher bond yields or an ever growing gap between dynamic France and languishing Italy could finally force it to get back on a Renzi-style reform path

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