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Italy & Brussels standoff - Tension will go unresolved until May 2019. Will not go far enough to cause financial panic

What we sometimes call "thinking outside the box" can help you draw conclusions and some clarity from where there seems to be only uncertainty.

Admittedly, in the current standoff, both Brussels and Rome are not mandated to settle differences, meaning that budget talks will likely end without agreement and both parties will agree to disagree.

However, it seems also clear that Italian budget looks like a political strategy aimed at maximizing government's popularity ahead of May's European Parliament elections (rather than an instrument aimed at causing genuine growth). Thinking this way helps you to conclude that Rome will remain in conflict with Brussels through next May.

What's next?

- I have been said that Rome could go ahead and implement its budget plans even if they were rejected by the European Commission (EC). This is a likely scenario right now.
- In such a case, the rulebook allows the EC to launch the so-called Excessive Deficit Procedure (EDP), which is the corrective arm of the EU's Stability and Growth pact (SGP). What does this mean? The EDP lays down how countries should take action in the event their deficit is considered excessive, and requires the country in question to provide a plan of the corrective action. If the country do not follow up n the recommendations, it can propose sanctions, what will probably also happen, but without them being approved. Why?
- The EDP procedure is based on a state's actual budgetary overshoot. This makes me think that Rome will not breach its fiscal obligations under the SGP until next May (when the European Parliament elections). After that, tension can probably be reduced (as often happens after electoral events).

The implications of this scenario:

- Indeed, investors should expect idiosyncratic volatility in the Italian assets until May 2019, but not enough to cause financial panic. Why?
    1. I have good reasons to think that while the Italian government wants to amass all anti-Brussels votes in the run-up to the upcoming elections, it also wants to achieve this causing as little financial harm as possible.
    2. Foreign money that is still invested in Italian bonds is mainly institutional, and thus restricted investment grade bonds. If the Italian government miscalculates, as a result of a very aggressive stance, then the rating agencies could get serious about downgrading Italy's bonds to junk. Rome is perfectly aware that this would cause a cycle of forced selling in Italian bonds.
    3. We also have to remember that the Italian Constitution requires the obligation of the government to balance its budget. On the negative side, President Mattarella's refusal to sign the budget could trigger a political crisis. In such a case the question is whether Five Stars and Lega could held their coalition.

In summary. Tension will go unresolved until May 2019, but there are reasons to think that will not go far enough to cause financial panic.

Of course I may be wrong, but the combination of needs and pending events makes me think in the terms described

Best regards,