Global Markets Update

BTP-Bund spread still likely to narrow this year

- While we remain of the view that the ECB will eventually step up to the plate and increase its purchases of government bonds, concerns about Italy’s debt sustainability and its commitment to the euro mean that we think that the BTP-Bund spread will only fall back part of the way to its pre-crisis level this year.

- Although it has edged down a little over the past week, the spread between the yields of 10-year Italian government bonds (BTPs) over equivalent German Bunds remains significantly higher than before the coronavirus pandemic hit. That is despite the ECB purchasing large amounts of BTPs under its Pandemic Emergency Purchase Programme (PEPP), and the fact that the number of new infections in Italy has slowed and its economy will start to reopen from next week. The European Council’s recent agreement on a (small) fiscal stimulus package and the ECB’s announcement of even more generous refinancing terms have had only a limited impact on the BTP-Bund spread. Elsewhere in the euro-zone periphery, government bond yield spreads compared to Germany also remain elevated, though less so than in Italy. (See Chart 1.)

- In our view, this reflects two factors. First, the increase in the perceived risk of sovereign default has been particularly stark in Italy. Sovereign credit default swap (CDS) premia have risen by more in Italy than in Portugal and Spain. Continued wrangling about how, and to what extent, to fund a common fiscal response to the crisis suggests that a large-scale common euro-zone assistance package remains unlikely. The particularly severe virus outbreak in Italy and the limited extent of fiscal support from other countries mean that the downturn in Italy is likely to be the deepest in the euro-zone. This will leave Italy’s public finances, which in our view already looked strained before the pandemic, on an even more precarious path.

- Second, worries about Italy leaving the euro-zone have resurfaced. For example, the spread between the yield of BTPs linked to euro-zone inflation over BTPs linked to Italian inflation has risen to its highest level since the populist M5S-Lega coalition was in power. (See Chart 2.) Since Italian inflation would probably rise sharply if Italy were to return to the lira, the lower real yield on BTPs linked to national inflation indicates a degree of concern that Italy may leave the euro-zone. Other indicators based on different CDS contracts also point to a rise in the perceived risk of redenomination of Italy’s sovereign debt. That is probably in part because recent polls suggest that Euroscepticism is on the rise in Italy.

- Back at the start of April we argued that the ECB would drive the BTP-Bund spread lower by year-end. While its decision not to increase the PEPP at this week’s meeting leaves some doubts about how far it is willing to go to keep borrowing costs contained in the periphery economies, we still think that the ECB will eventually step up to the plate. That is why we forecast that the BTP-Bund spread will end the year at around 150bp, compared to 235bp currently.

- There are two significant risks to that forecast: investors’ concerns about Italy’s debt sustainability are unlikely to go away anytime soon, and could intensify further. And eurosceptic parties in Italy could capitalise on the crisis to swing public opinion against the EU. The ECB’s willingness to do “whatever it takes” may be tested again.
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