Economic Insight

Italy: Stress is here to stay

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Authors:

ANA BOATA
+33.18.411-4873
ana.boata@eulerhermes.com

ALDO PELLEGRINO
+49.89.3800-14543
Aldo.pellegrino@allianz.com

KATHARINA UTERMÖHL
+49.69.24431-3790
katharina.utermoehl@allianz.com

Executive Summary

- 88 days after the Italian parliamentary election, and an episode of exceptional financial market stress, the Five Star Movement (M5S) and the Lega have sealed their governing alliance. Significant uncertainty remains however regarding the political and economic outlook. We defined four key political scenarios based on the fiscal measures implemented by the government and their relationship to the European institutions.
- Baseline scenario *(50%)* foresees the government back down from its initial confrontational EU-stance and ultra-expansive fiscal proposals. Following a policy U-turn it implements only a portion of announced fiscal stimulus and finds a conciliatory approach with Europe. Italian 10-year spreads to the Bund will remain between 180bps and 250bps. GDP growth would more than halve by 2020 to 0.6% with debt-to-GDP embarking on an upward trend to 134% by 2020.
- Upside scenario (*30%)* assumes the implementation of limited fiscal measures while the government maintains a constructive approach towards Europe. Spreads would still be elevated with less volatility, GDP growth would moderate to 1% in 2019/2020 while public debt stabilizes at 132% of GDP.
- Downside scenario *(15%)* assumes a sharp rise in fiscal spending with the coalition embarking on a collision course with the EU. Spreads would rise by an additional +200bps compared to the baseline; Italy could slip in a shallow multi-year recession with debt rising above 140% by 2020.
- Italexit *(<5%)* assumes that a political event or a market default, combined with a confrontational stance causes substantial financial stress (spreads up by +500bps to the baseline). Italy would undergo a very deep recession with debt-to-GDP rising towards 160% by 2020. Contagion would follow.
- In its relation with Italy the European Union will have to strike a delicate balance between upholding its own rules while at the same working constructively with the new government with a view on making more tangible progress on EU reform.

What's next for Italy? Four scenarios for 2018-20

88 days after the Italian parliamentary election on March 4, and after one failed attempt to form a governing coalition that triggered an episode of exceptional financial market stress, the Five Star Movement (M5S) and the Lega parties sealed their governing alliance. Nevertheless significant uncertainty remains regarding the political and economic outlook for Italy particularly given the M5S/Lega government's ultra-expansive fiscal policy which includes tax cuts and higher spending to the tune of EUR126bn (about 7% of GDP). There are

significant doubts regarding the government's ability to implement the proposed fiscal plans given institutional curbs. In addition, further financial stress may as well as limit appetite for Italian government bonds.

There are four key scenarios depending on the new government's policy choices.

Figure 1: Economics and Policy-Making

	Upside	Baseline	Downside	Tailrisk
Scenario	Mild Fiscal Expansion & Conciliatory EU Stance	U-Turn After Significant Fiscal Expansion & Moderately Confrontational Stance with EU	Marked Fiscal Expansion & Confrontational EU Stance	Marked Fiscal Expansion & Extreme Confrontational EU Stance leading to Italexit
Probability	30%	50%	15%	<5%
Policies	20% of fiscal plans implemented in 2019 budget. Constructive stance towards Europe.	30% of fiscal plans implemented in 2019 budget. Relatively constructive EU stance	60% of fiscal plans as soon as 2019. Confrontational EU Stance	More than 60% of fiscal plans as soon as 2019. Extreme confrontational EU Stance
10 year BTPs over Bunds	Markets are reassured but the regime switch will maintain spreads above pre-election level (>180bp)	Spreads remain high (180bps -250 bps) given the announced fiscal spending plans in Fall and a one-notch credit rating downgrade	Downgrade to non-IG by end-2019, spreads climb above +400bp and banks' lose access to ECB liquidity which forces an ESM program	Downgrade to non-IG in H1 2019, spreads climb above +700bp and banks' lose access to ECB liquidity but Italian government refuses an ESM program
Economic consequences	Mild fiscal expansion helps prop up economic activity in the short-run: GDP growth expected at 1% in 2019	GDP growth expected at 0.8% in 2019	Economy in multi-year recession (GDP contraction greater than -2% in 2020)	Deep recession (-3% fall in GDP in 2019)
ECB	Negligible impact. The ECB stays on course: End of QE in December 2018 and first rate hikes in H2 2019		Marked contagion to the periphery. Eurozone in mild recession (0 -0.5%). No ECB rate hike in 2019/2020, new TLTROs & OMT for Italy after signed ESM program .	Significant contagion to the periphery. Eurozone in deep recession (-2% in 2019). ECB implements significant non-standard measures.

Sources: Allianz Research

1) *Baseline: Policy U-turn after Significant Fiscal Expansion combined with Moderately Confrontational EU Approach*

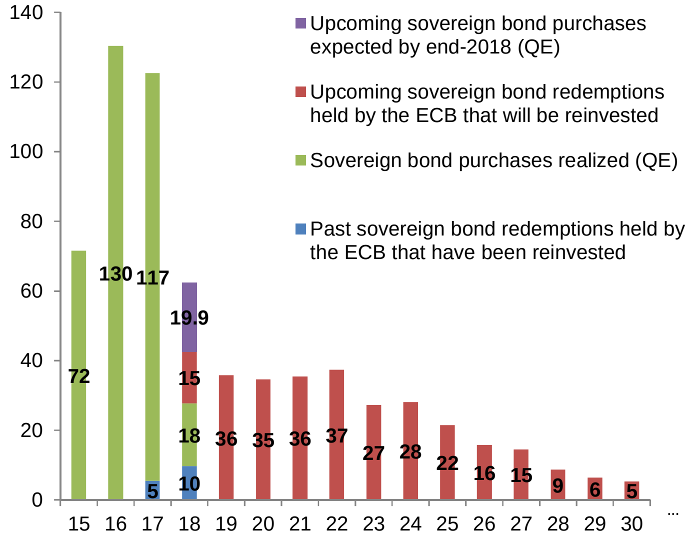
Our base case considers significant fiscal expansion coupled with Eurosceptic rhetoric to trigger a notable increase in market tensions. Substantial financial stress will prevail fueled by the downgrade of Italy's sovereign rating by one notch following the presentation of the government's 2019 budget plans in October. This help explains the expected U-turn in fiscal profligacy (30% of the proposed measures in 2019; 10% additional in 2020), and in the con-frontational posture with the EU.

Such assumptions lead to a fiscal multiplier boost of +0.4pp to GDP growth as soon as 2019 but the deterioration of the fiscal deficit from -2.3% of GDP to -3.5% is expected to keep sov-ereign bond spreads relatively elevated (above +200bp over the 10-year compared to the Bund). In addition, fickle confidence will be a drag on the private sector. Overall, we expect GDP growth to reach +0.8% in 2019 after +1.2% in 2018. Keeping a positive primary balance initially helps avoid a more significant deterioration in market sentiment towards Italy. We estimate the fiscal primary surplus to fall from +1.5% of GDP to +0.3% before turning nega-tive in 2020 – for the first time since 2009. Italian public debt will rise to 134% by 2020 up from 132% of GDP in 2019. The fiscal deficit is expected to be greater than -4% of GDP in 2020.

The spillover to other peripheral countries is expected to remain contained. The ECB will stay on course by extending its QE program until end-2018 and increase interest rates for the first time in H2 2019. For the ECB to do more, financial stress would have to be more tangible: (i) a broad flattening of yield curves endangering banking system liquidity access; (ii) a significant loss of confidence among Eurozone banks (Euribor-Eonia spread above 1%; and (iii) peripheral spreads durably above +400bp. Overall, the ECB holds EUR345bn of

Italian public debt (around 18% of total bonds outstanding). Starting in 2019 we expect the ECB to buy Italian bonds as part of the reinvestment of principal only following its QE exit. The average monthly amount of ECB purchases of Italian bonds will be EUR3bn compared to almost EUR4bn since the start of 2018 or around EUR10bn in 2017.

Figure 2: ECB purchases of Italian sovereign debt (Gross sovereign bond purchases + reinvestment of principal), EUR bn



Sources: Bloomberg, Euler Hermes

2) *Upside: Mild Fiscal Expansion & Conciliatory EU Approach*

Our upside scenario sees the Italian government adopt a constructive stance towards Europe and abandon the vast majority of its fiscal plans, implementing only 20% of the proposed measures. This will reassure financial markets. The mild fiscal expansion props up economic activity in the short-run while triggering only a slight increase in refinancing costs.

In this scenario Italian GDP growth is expected to average +1% in 2019-20 after +1.3% in 2018. Given an increase of the fiscal deficit to above -3% of GDP by 2019, debt-to-GDP ratio would hover around 131% over the forecast horizon down from 132% in 2017. The impact on the Eurozone is likely to stay negligible as contagion to the periphery would remain low.

3) *Downside: Considerable Fiscal Expansion & Confrontational EU Approach*

Our downside scenario includes the governing alliance's pushing ahead its expansive fiscal spending plans while maintaining a persistent confrontational attitude towards its EU partners. This would in turn fuel rising concerns about the sustainability of Italian debt, the stability of its banking sector as well as its euro-membership. The sharp adverse market reaction eventually raises heightened concerns about Italy's ability to access financial markets. A revival of the 2012 episodes would follow.

The deterioration in public finance fundamentals is expected to be rapid with the fiscal deficit greater than -5% of GDP as soon as 2019 (from -2.3% in 2018) and public debt increasing by +6pp to 137% of GDP. The primary balance registers its first deficit since 2009 at -1.3% of GDP which keeps BTP spreads to the Bund above +400bp. The Italian economy enters a multi-year recession with GDP contracting by more than -2% in 2020 alone and there is marked contagion to the periphery.

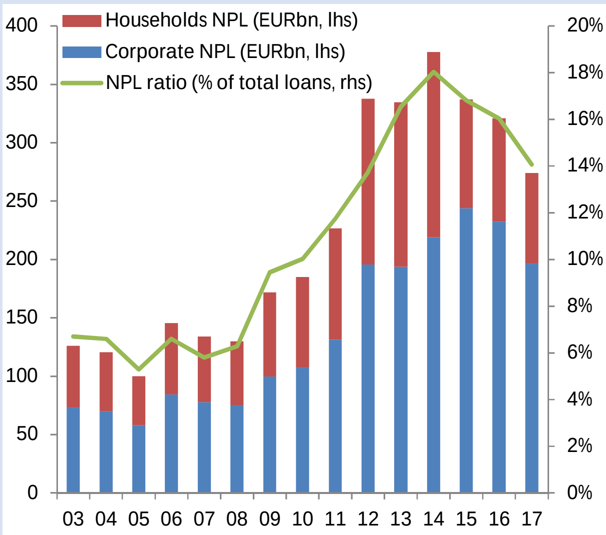
Italy's sovereign debt could be downgraded to non-investment grade as early as H1 2019 pushing the ECB to exclude Italy from its asset purchase program and to no longer except Italian sovereign bonds as collateral in Eurosystem credit operations. The sharp deterioration in market sentiment would trigger a banking crisis. Italy is left with no other choice than to seek an ESM program in an effort to avert a sovereign debt default and subsequent euro-exit. In that case, the ECB could use the full toolbox: Outright Monetary Transactions (OMT); Emergency Liquidity Assistance (ELA); and resume non-standard measures such as Targeted Longer-Term Refinancing Operations (TLTROs).

As a result no ECB rate hike will be implemented until at least 2021. The Eurozone economy is likely to experience a contained recession with GDP contracting by less than -0.5%.

Box: The downside scenario would dry up credit to SMEs

Banks' liquidity risk remains a concern should the shock on Italian financial conditions persist or worsen. If we simulate the spread shock as per our downside scenario, the rise in political uncertainty and the impact on banks' refinancing costs would drive bank rates on loans to SMEs up to 4% from below 2% currently. The +200bp increase in bank loans rates would call for Italian SMEs to use +9pp of their operating surplus to pay the additional interest expenditures on debt. This would mean that as much as 20% of their margin would be used for interest expenditures, which would weigh on their ability to expand investment. In this case, the ECB would likely renew its liquidity support through targeted longer-term refinancing operations (TLTRO).

Figure A: Stock of non-performing loans by type (NPL, EUR bn) and NPL ratio



Sources: Bank of Italy, Allianz Research

4) Italexit

The extreme case of an Italexit cannot be ruled out; but it remains highly unlikely (<5% probability). In that case, not only the government coalition would pursue a marked fiscal expansion coupled with a confrontational EU stance, but a specific event triggers the perception that Italy becomes a systemic risk to Europe. Possible triggers include: the refusal of Europe's financial aid - through the ESM e.g. - because of too stringent conditionalities; a technical default from the Sovereign or a large bank; or a negative outcome to a referendum called by the government, following a constitutional change. The ECB would have to step in to safeguard financial stability.

Spreads would rise by +500 bps from current highs and spillover effects to Eurozone countries would be very concerning. In this tail risk scenario the recession in both Italy and the Eurozone will be deep with GDP contracting by -4.5% and -3.0% in 2020 respectively. Meanwhile Italy's fiscal deficit would reach -6.5% in 2019 and rise above -7% in 2020 while public debt would reach 155% of GDP in 2020.

Figure 3 summarizes economic estimates under our four scenarios:

Figure 3: Scenarios - Fiscal and Economic Impact

		Upside scenario (30%)			Baseline scenario (50%)			Downside scenario (15%)			Tail Risk scenario (<5%)		
		Mild Fiscal Expansion & Conciliatory EU Approach			U-turn After Significant Fiscal Expansion & Moderately Confrontational EU Approach			Considerable Fiscal Expansion & Confrontational EU Approach			Italexit		
Expected implementation of proposed fiscal measures (% of total)		20% - repeal of past reforms with very limited leeway to include new spending plans			40% - repeal of past reforms with limited leeway to include new spending plans			60% - repeal of past reforms and significant new spending measures			above 60% - repeal of past reforms and significant new spending measures		
	2017	2018	2019	2020	2018	2019	2020	2018	2019	2020	2018	2019	2020
Italy													
Real GDP growth (%)	1.5	1.3	1.0	1.0	1.2	0.8	0.6	1.0	-1.0	-1.2	0.5	-3.0	-4.5
Primary balance (% of GDP)	1.5	1.5	0.6	0.6	1.5	0.3	-0.3	1.5	-1.3	-1.0	1.3	-2.2	-2.3
Fiscal balance (% of GDP)	-2.3	-2.3	-3.2	-3.3	-2.3	-3.5	-4.4	-2.3	-5.3	-5.3	-2.3	-6.5	-7.4
Public debt (% of GDP)	132	131	131	131	131	132	134	131	137	142	131	143	155
10 year BTPs/Bund (bps)	absolute level 180 - 250							+ 200 compared to baseline			+ 500 compared to baseline		
Eurozone													
Real GDP growth (%)	2.5	2.2	2.0	1.7	2.2	1.9	1.5	2.0	0.7	-0.3	2.0	-2.5	-3.0
ECB scenario	ECB policy: QE exit end-2018, first policy hike in H2 2019							ECB policy: QE exit end-2018, no rate hike in 2019/2020; new non-standard measures (e.g. TLTROs) ; OMT for Italy after ESM program signed			ECB steps in to safeguard financial stability with significant non-standard measures (incl. equity and bond purchases)		

Source: Allianz Research

Finding the right tone of voice: Europe's amenability will be pivotal

In its relations with Italy, the European Union will have to strike a delicate balance between upholding its own rules and working constructively with the new government, especially with a view to making tangible progress on EU reform. We do not foresee a showdown between the EU and Italy in the near future.

Anti-EU election rhetoric notwithstanding, it remains unclear what the European policies of the new government in Rome will look like. The men in charge of the finance and foreign ministries, and hence of the day-to-day management of EU relations, are rather pro-

European. While party leaders di Maio and Salvini may continue attacking the EU publicly, constructive behind-the-scenes diplomacy may proceed in parallel.

Upcoming meetings of Eurozone finance ministers and EU heads of state between June 26 and June 29 will give first clues. The first big test of EU fiscal rules should come in autumn, when Prime Minister Conte will present his 2019 budget plan to the Commission. Given the extensive spending and tax cut pledges of the new government, we expect Italy's public deficit to increase under any of our scenarios. We do not expect the EU to immediately take a tough stance on Italy. On the contrary, the EU will likely seek to make some progress on migration management, since large inflows of migrants across the Adriatic are the top concern of Italian voters. With some Central and East European governments still staunchly opposed to any compulsory resettling of refugees, the other EU partners may decide to increase fiscal help to Italy in managing the inflows and resettlement.

Italy has traditionally punched below its weight in EU politics. Now, with the UK leaving, it will be the third largest EU member state and its engagement will be indispensable for progress on much needed reforms of the Eurozone, EU security policy and a European migration policy. This is why it is so important that a disagreement about budget numbers does not result in a break between the EU and Italy that may then take years to repair.

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