Italy Election Watch: Limited downside, limited upside

December 21, 2017

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Executive summary

- **Will Italy turn Eurosceptic in 2018?** In Italy's upcoming parliamentary election in spring 2018 half of the electorate is likely to cast their vote for a Eurosceptic political party. Nevertheless we view the probability of a Eurosceptic government emerging as remote. An outright majority for any single populist party is clearly out of reach. In addition the recently adopted electoral law favors pre-election alliances and hence weakens the relative position of the stand-alone Five Star Movement.
- **No *Italexit*, no problems?** The threat of anti-EU, populist forces coming to power in Italy is receding. However we continue to worry about the rising political fragmentation. A hung parliament is all but certain allowing only for difficult coalition dynamics. Our baseline scenario envisions the formation of a 'grand coalition' government headed by a united centre-right camp and including Matteo Renzi's Democratic Party as a junior coalition partner. The chances of such heterogeneous, ill-suited coalition partners agreeing on an ambitious reform agenda are slim.
- **How will markets react to political uncertainty**? Rather than a tectonic shift the 2018 election looks set to deliver 'more of the same' with Italian politics having long been characterized by uncertainty and instability. Hence we don't expect market confidence towards Italy to decline markedly with the robust macroeconomic backdrop in Europe propping up investor sentiment. Moreover even in an adverse scenario the negative impact of elevated financial market stress on public finances would be mitigated by Italy's favorable debt structure including a low average interest rate, a long average maturity and a strong domestic investor base.
- **The long view:** Italy remains the eurozone's Achilles heel. If in the medium term Italy is unable to generate growth to address its many fundamental problems, from high public debt to a fast aging population and an undercapitalized banking sector, this will represent a considerable challenge for the eurozone, economically as well as politically.

What is the risk of Italy turning Eurosceptic?

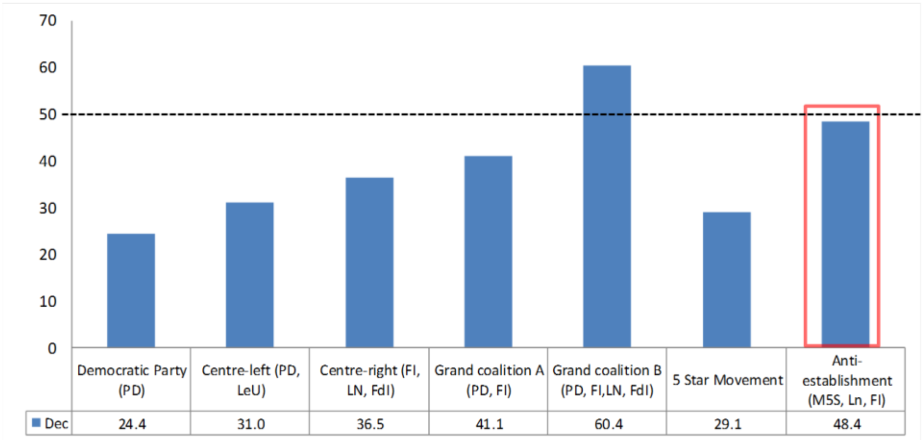
The Italian parliamentary election in spring 2018 will close the European election super cycle which over the previous 12 months saw voters in France, the Netherlands, the UK, Germany and Austria head to the polls. According to recent election surveys the Eurosceptic, anti-establishment Five Star Movement (M5S) looks set to receive the largest share of votes – with close to a third of all ballots. Moreover, almost half of the Italian electorate is planning to support a Eurosceptic political party. Nevertheless it remains highly unlikely that the 2018 general election produces a Eurosceptic government for the following reasons:

1) **Peak populism:** The M5S is Italy's most popular party but its support appears to have peaked over the summer months – at least for now. In recent municipal and regional elections the party suffered notable set-backs. Moreover since winning Rome's and Turin's mayoral races in June rather than proving it can change things it has displayed a lack of governing ability. The party is unlikely to record a further boost in popular support sufficient to win an outright majority in next year's general election.

2) **Advantage establishment:** The new electoral system *Rosatellum* which was adopted in late October favors Italy's established political parties. About a third of the members of both houses of parliament will now be elected by the first-past-the-post method, with the remaining seats allocated by proportional representation. This puts the M5S at a disadvantage given that it lacks organizational strength at the local level and will likely struggle to find suitable candidates for office to compete in first-past-the-post districts.

3) **Weaker divided:** An anti-establishment alliance consisting of the M5S, the Eurosceptic Northern League and the nationalist Brothers of Italy would come close to commanding a majority in parliament (Graph 1). But the M5S has for now ruled out joining any pre-election electoral pacts – which the *Rosatellum* specifically allows for – thereby greatly reducing its chances to take the largest share of the votes. Even if the M5S changed its mind on this issue, divisions among the anti-establishment parties are most likely too great to be simply set aside.

Figure 1: Italy post-electoral scenarios (voting intention, share by party (%), based on December 2017 Ipsos poll)



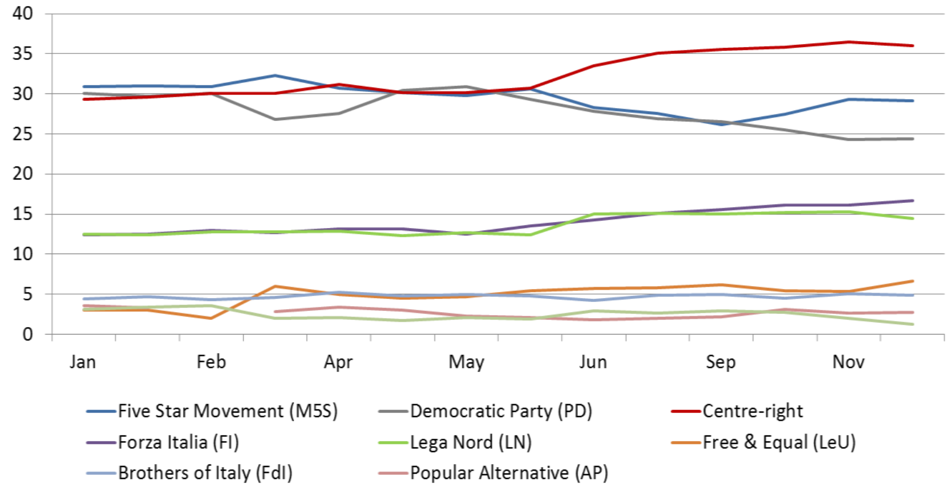
FI: Forza Italia; **FdI**: Fratelli d'Italia; **LN**: Lega Nord; **PD**: Partito Democratico; **LeU**: Liberi e Uguali; **M5S**: Movimento 5 Stelle

Sources: Ipsos, Thomson Reuters Datastream, Allianz Research.

Political fragmentation bodes ill for reform outlook and political stability

Our greatest concern is not that of a Eurosceptic government taking over but rather the rising political fragmentation in Italy, which is bound to weigh on the reform outlook. If polls prove correct Italy's parliamentary election is almost certain to produce a hung parliament given a three-way split between Matteo Renzi's Democratic Party (PD), the M5S and the centre-right camp consisting of Berlusconi's Forza Italia, the Northern League and Brothers of Italy (Graph 2).

Figure 2: Voting intention, share by party (%)



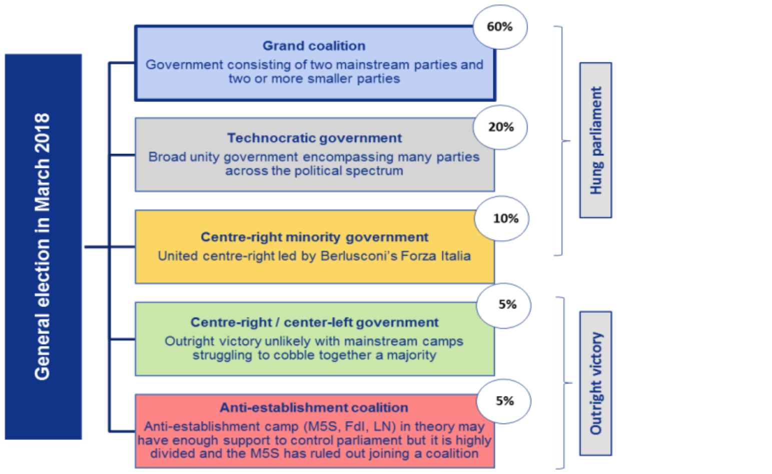
FI: Forza Italia; **FdI**: Fratelli d'Italia; **LN**: Lega Nord; **PD**: Partito Democratico; **AP/CP**: Alternativa Popolare; **M5S**: Movimento 5 Stelle

Sources: Ipsos, Allianz Research.

The centre-right camp will most likely emerge as the strongest political force after forming an alliance also at the national level. While the PD has been a disappointment in the eyes of the Italian electorate and the M5S looks too risky and/or incompetent for national politics, the centre-right has benefitted from being a palatable protest vote in the face of stagnant incomes, banking sector bailouts financed with taxpayer money and ongoing pressures from the refugee crisis.

Our baseline scenario is hence that of a weak 'grand coalition' government consisting of four or more political parties from across the political spectrum. The chances of such heterogeneous, ill-suited coalition partners agreeing on an ambitious reform agenda are in our view remote. Coalition talks are unlikely to be easy and swift and even if they prove fruitful there is a high risk of early elections.

Figure 3: Italy post-electoral scenarios



Sources: Ipsos, Allianz Research.

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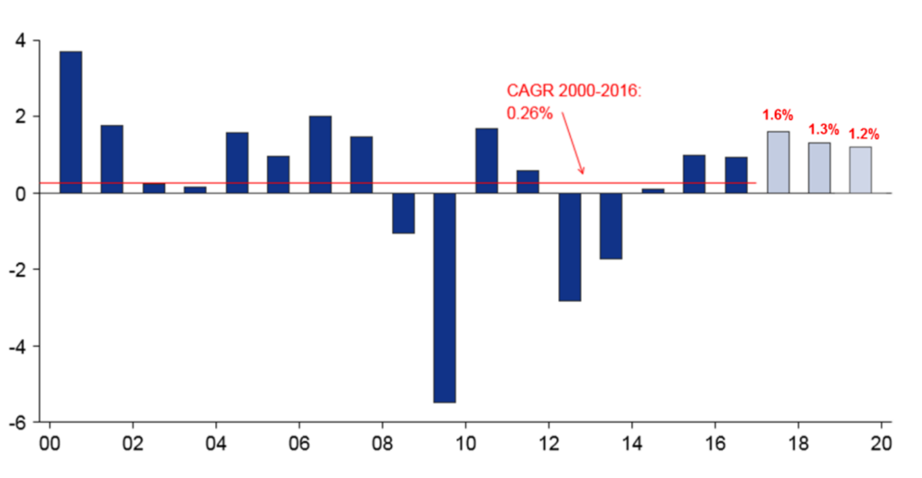
How much will spreads rise around the 2018 general election?

Pre-election spreads to move largely sideways

Around the turn of 2017/18 spreads between German and Italian government bonds are likely to remain around the current level of 140 bps. Next to the decreased probability of a M5S win in next year's election following the reform of the electoral law and the centre-right camp's toned-down Eurosceptic rhetoric, the favourable European macro backdrop is a key driver of tighter eurozone spreads.

Italy grew about 1.6% in 2017 and we expect momentum to be largely maintained next year with GDP growth coming in at 1.3%.

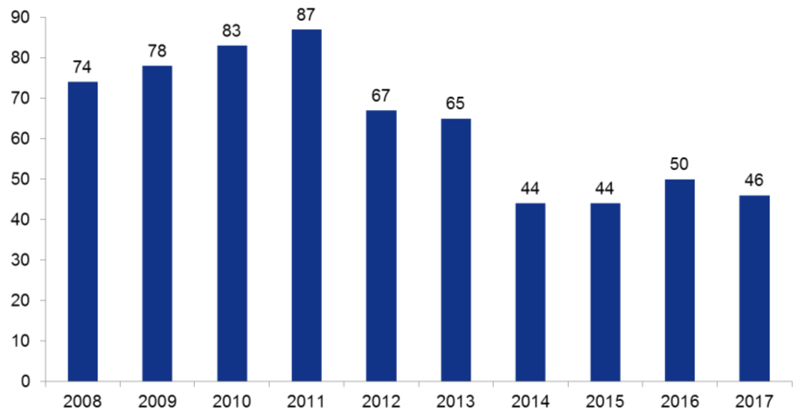
Figure 4: Italy – Real GDP growth (%)



Sources: Thomson Reuters Datastream, Allianz Research.

This marked brightening of Italy's economic growth outlook – since joining the Euro the average annual growth rate registered below 0.3% – has been driven by the broad-based cyclical upswing in Europe, the ECB's ultra-expansive monetary policy and improving competitiveness with structural reforms bearing fruit. Particularly the latter factor is often underestimated: In fact the crisis-induced reform drive that Italy embarked on in 2011/12 has seen its relative competitiveness improve notably. Over the past six years Italy has climbed up the ranks in the World Bank's Ease of Doing Business survey from place 87 to 46 (with 1 being the best) on the back of notable improvements in the areas of paying taxes, enforcing contracts and starting a business – albeit at times from low levels for a developed country (Figure 5).

Figure 5: Ease of Doing Business in Italy (with Rank 1 being the best)



Sources: World Bank, Allianz Research.

The expected continuation of the Euroboom in 2018 – we forecast GDP in the currency area to expand by around 2% in 2018, for the fourth consecutive year – together with the ECB's commitment to continue its asset purchase program until at least September 2018, even if at a reduced monthly pace of EUR 30 billion – should prop up market sentiment and prevent investors to zoom in on Italy's structural weaknesses. Since the height of the Euro debt crisis in 2011/12 the ECB's increasingly accommodative monetary policy has acted as a backstop in Italian bond markets cushioning the impact of political risk. The ECB's very gradual QE exit strategy means that monetary policy will continue to serve as a safety net for investor sentiment over the forecast horizon.

Baseline scenario: More of the same

In our baseline scenario we expect the centre-right camp led by Berlusconi's Forza Italia to form a 'grand coalition' government with Renzi's PD as a junior partner. Rather than a tectonic shift in the political landscape though, this scenario can be filed under 'more of the same' following a brief period of unusual political stability with Italian politics long having been characterized by uncertainty and instability. Nevertheless the implementation of important structural reforms will become more difficult and continued political uncertainty more likely given the constant looming threat of early elections.

Following an inconclusive election outcome spreads between German and Italian government bonds would widen in the short-term to 170-210 basis points. The spread widening would be similar to the market reaction seen in the run-up to the constitutional referendum in December 2016 (Table 1), when it became clear that Matteo Renzi would lose the popular vote in which case he had promised to resign as prime minister.

However operating on the assumption that a 'grand coalition' is formed that attempts to work together constructively, remains committed to the Euro and that – faced by a confidence crisis – is willing to adopt a sensible, albeit limited reform plan to at least partially address financial markets' concerns, spreads would narrow again to around 140 basis points or below over the course of H2 2018. With Italian companies and households used to bouts of elevated political uncertainty the impact on economic growth would be negligible – as was the case in December 2016 when economic momentum remained unimpressed by Renzi's resignation.

Table 1: Impact of political uncertainty on Italian government bond markets

	Phases of political instability	One-day rise	Spread on the day	10Y Italian BTPs on the day	Three-month change
Nov 2011	End of Berlusconi era after months of political stalemate	-56bps	466bps	6.5%	190bps
Feb 2013	Early elections, inconclusive results & strong faring of M5S	60bps	343bps	4.9%	20bps
Dec 2016	Renzi loses constitutional referendum and resigns	4bps	166bps	2.0%	45bps

Note: All figures are based on end-of-day data.
Sources: Thomson Reuters Datastream, Allianz Research

Upside scenario: Renewed reform drive

An upside scenario would entail an outright victory for one of the main political camps or a stable majority for a "grand coalition" with a clear reform mandate. After rising to 170-210 basis points ahead of the election, the incoming government's commitment to a liberal reform agenda would see spreads tighten to 110 basis points while at the same time boosting business and consumer confidence.

Table 2: Financial market impact in key scenarios in Q2 2018

	as of Nov 2017	Scenario 1: Renewed reform drive	Scenario 2: More of the same	Scenario 3: Heightened political uncertainty
10Y German Bund	0.36%	0.7%-1.0%	0.5%-0.7%	0.3%-0.5%
10Y Italian BTPs	1.77%	1.8-2.1%	1.9%-2.1%	2.8%-3.5%
10Y Bund spread (2018Q2)	141bps	110bps	140bps	250-300bps

Sources: Thomson Reuters Datastream, AIM, Allianz Research

Downside scenario: Heightened political uncertainty

Our adverse scenario entails a spike in political instability following next year's vote. The inconclusive election outcome would see political parties unable to agree on a government coalition despite several consultation rounds. The Democratic Party would refuse to join a 'grand coalition' as the junior partner especially one that includes Eurosceptic and anti-immigration parties. Meanwhile a centre-right minority government would struggle to cobble together the necessary parliamentary support. In contrast to the baseline scenario, the prolonged period of political uncertainty would see spreads widen further after the election to a level of around 250-300 bps as markets are growing increasingly more nervous about Italy's weak economic fundamentals amidst a deepening political crisis. The broader European political context may do little to calm investors with Germany likely still struggling to form a new government around that time and potentially heading for a new election. Given the deteriorating reform outlook, elevated political uncertainty and the upward pressure on government debt given rising refinancing costs we would expect a prompt response from the rating agencies.

Such a scenario could still see a 'happy end' if eventually – possibly after a second vote several months later – a government is formed that is functioning sufficiently to announce principal reform measures to boost investor sentiment and/or agree with its European partners on the reform conditions attached to an ECB or ESM support package. An escalation of the situation meanwhile would most likely be avoided, since in the event of heightened market stress we would expect Italian president Sergio Mattarella to step in to address the political stalemate by asking a respected public figure to form a technocratic government that governs in the national interest.

In all scenarios depicted above the impact on other asset classes such as equities, corporates or other European government bonds should be rather muted as the outcome is not considered to be systemic to the eurozone overall. This would obviously change if the M5S would be able to secure an outright majority which we believe is currently highly unlikely.

What is the anticipated impact on government finances?

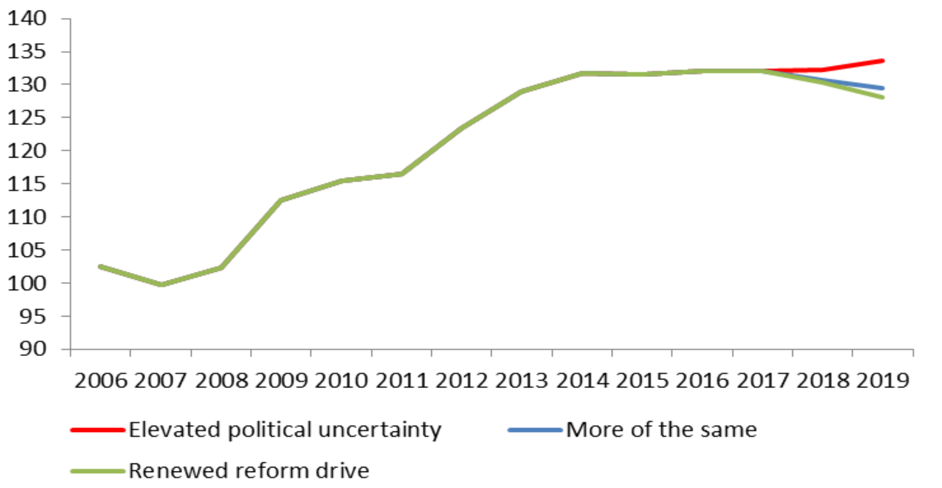
Gradual decline in government debt ratio is our base case

At 132% of GDP Italy has the second largest stock of government debt in the eurozone after Greece. With an average interest rate of 3% on its government debt, Italy requires a primary surplus of 1.7% of GDP and 1.5% of nominal growth to stabilize its debt ratio. Given the current favourable economic outlook, in our baseline scenario Italy's public debt ratio will only embark on a gradual downward trajectory in 2018 reaching 129.6% by 2019 (Graph 6).

Elevated political uncertainty will see limited rise in Italy's debt burden

Meanwhile in our downside scenario the goal of reducing government debt in relation to GDP would have to be postponed. A prolonged period of elevated political uncertainty would see a marked rise in Italy's borrowing costs as concerns about the sustainability of Italian public debt return. Rising yields however would take time to push up average lending rates to dangerous levels with the average interest rate on Italian government debt currently registering close to 3%. Moreover Italian debt benefits from a long average debt maturity profile of 6.8 years and a strong domestic investor base – more than 60% of government debt is held by domestic investors. Nevertheless Italy's sovereign gross financing needs are still notable at close to 20% of GDP in 2018 and 2019 respectively due to rollover needs.

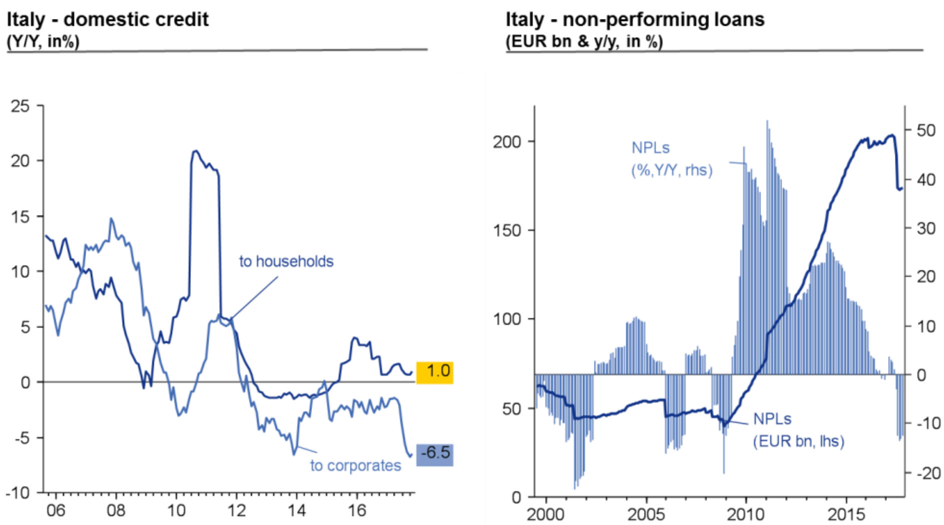
Figure 6: Italian gross government debt (% of GDP)[1]



Sources: Thomson Reuters Datastream, Allianz Research

Elevated political uncertainty and rising interest rates would also weigh on Italy's growth prospects with cumulative nominal GDP growth 1.7ppts lower than in the base case in 2018-19.

Figure 7: Italy – Domestic credit and non-performing loans



Sources: Thomson Reuters Datastream, Allianz Research.

[1] We calculate the change in the debt ratio Δb_t as follows: $\Delta b_t = p_t + \frac{(i-g)}{(1+g)} b_{t-1}$ where p_t : primary balance as a % of GDP, i : average effective interest rate on public-sector debt, g : nominal GDP growth rate, b_{t-1} : debt ratio in the previous year

Higher interest rates and weaker GDP growth would up the pressure on Italy's fragile banking sector again. However given that the decline in market confidence would be limited in magnitude and time – with a political solution put into place to reverse deteriorating investor sentiment – and GDP growth would remain positive, we do not expect a renewed flare up of a banking crisis. Still the recently observed favourable trend of new NPLs which has returned to its pre-crisis rate (Graph 7) would certainly slow if not come to a halt or reverse altogether.

Italy's primary balance would suffer in the face of declining tax revenue and rising social spending coming in 0.7 ppts lower in 2018-19 compared to the baseline scenario. The primary surplus in Italy has proven relatively resilient over the past decade averaging 1.7% even at the height of the eurozone debt crisis in 2011/2012 and turning negative only in 2009 when the Italian economy contracted by more than 5%. In our downside scenario Italy would break the Maastricht treaty's 3% deficit limit in 2019 and its government debt ratio at close to 134% of GDP would be about 4ppts higher compared to the base line scenario.

Table 3: Trajectory of Italian public finances under different scenarios

	2016	2017	2018	2019
Scenario 1: Renewed reform drive				
Effective interest rate on government debt (%)	3.0%	3.0%	2.8%	2.7%
Nominal GDP growth (%)	1.7%	2.2%	2.7%	2.8%
Primary balance (% of GDP)	1.5%	1.7%	1.9%	2.3%
Gross government debt (% of GDP)	132.0%	132.0%	130.4%	128.2%
Scenario 2: More of the same				
Effective interest rate on government debt (%)	3.0%	3.0%	2.8%	2.8%
Nominal GDP growth (%)	1.7%	2.2%	2.6%	2.6%
Primary balance (% of GDP)	1.5%	1.7%	1.7%	1.6%
Gross government debt (% of GDP)	132.0%	132.0%	130.7%	129.6%
Scenario 3: Elevated political uncertainty				
Effective interest rate on government debt (%)	3.0%	3.0%	3.1%	3.3%
Nominal GDP growth (%)	1.7%	2.2%	2.0%	1.5%
Primary balance (% of GDP)	1.5%	1.6%	1.4%	1.1%
Gross government debt (% of GDP)	132.0%	132.0%	132.2%	133.6%

Sources: Thomson Reuters Datastream, Allianz Research.

So is Italy out of the danger zone? Tough decisions looming in the medium term

Whereas in the short term Italy would be able to endure a period of elevated financial market stress, in the medium term, Italy will have to reform its economy to put concerns about the sustainability of its debt burden to rest, but also to address the fundamental causes for the sharp rise in support of populist parties over the past years. According to European Commission estimates Italy's current growth potential registers barely above zero making it one of the lowest rates in the developed world. Tackling the persistent under-performance of its economy – Italy's GDP in 2016 was still 7% lower than at the start of the economic crisis in 2008 and since the year 2000 the Italian economy has grown less than 1% in real terms – requires addressing its key weaknesses including red tape, closed professions, high taxation, low educational outcome, a fragile banking sector and the inefficiency of the judicial system and the public sector with a particular focus on unleashing investment – domestic as well as foreign. Boosting Italy's economic growth prospects will require far-reaching reforms and hence hinges to a large degree on political developments. For that, Italy needs a stable government committed to delivering reforms. Without one, the specter of crisis will continue to stalk Italy – and the eurozone. If the Italian economy continues to stagnate over the medium to long run, this will represent a considerable challenge for the eurozone, economically as well as politically. Germany, France and the other eurozone countries could be unwilling to continue to support a member country that seems to be structurally unable to reform itself in order to remain competitive.

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As always, the evaluations are subject to the following cautionary notes.