

HouseView

Special Edition



Italian election may result in a prolonged deadlock

The main area of contention in Italy no longer seems to be EU membership but rather the outlook for fiscal policy. Combined with a strong upturn in the Italian economy, this may be a reason why the upcoming elections are not a big market theme. However, we believe investors should better not be too complacent.

Italy's main issue remains a low potential growth rate and in order to embark on a higher growth trajectory, the only hope Italy has to bring down its 132% debt-to-GDP ratio is structural reforms. However, implementing these requires a strong and stable government and the probability that Italy will be able to elect such a government on March 4 seems rather small.

Italian election does not seem to be a big market theme

Italy will hold general elections on March 4 and, contrary to the general opinion last year, this does not seem to be a big market theme. The reason for this is twofold:

- First of all, the Italian economy enjoys a strong cyclical upturn which is probably the dominant factor for market pricing. In addition to this, a strong economy tends to reduce voter dissatisfaction.
- Related to this, the second reason is that the anti-EU parties in Italy have significantly toned down their rhetoric and no longer want a referendum on either the euro or EU membership.

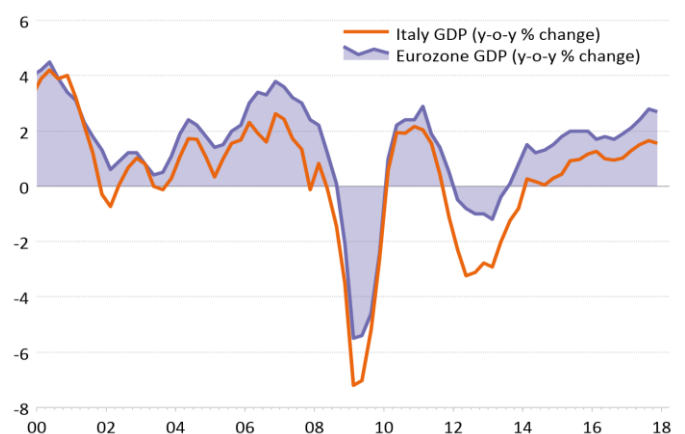
Italy enjoys a recovery, while the ECB remains a backstop

The cyclical recovery in Italy is driven by external and domestic demand, where the latter benefits from considerable momentum in employment and capital expenditure (capex) growth. Combined with past structural reforms, this has the potential to improve potential growth to some extent.

However, high levels of public debt could be a problem in the future as they may require fiscal austerity. Nevertheless, the average maturity of Italian debt has risen over the past few years, because of which any rise in Italian bond yields will only gradually feed through into a rise in the average interest rate cost of the debt.

At any rate, we expect the ECB's policy normalization to be very gradual and the large stock of Italian bonds on its balance sheet should help in preventing Italian spreads from rising too much. This effect will be reinforced to the extent that investors anticipate the ECB to step in again should a liquidity problem cause a renewed blow-out in spreads.

Italy's GDP has improved but remains below the Eurozone average



Source: Thomson Reuters Datastream, NN Investment Partners

Italy's main issue is a low potential growth rate

The Italian government has made some steps towards improving the health of the banking system. A fund for bank recapitalisation was launched, measures to improve the market for non-performing loans (NPLs) were taken and insolvency procedures were reformed. It is generally estimated that the capital shortfall related to remaining NPLs is in the order of only 1% of Italian GDP. These developments, combined with an increase in confidence, have resulted in an easing of credit supply.

The large share of NPLs was not the result of a deflating bubble as it was in Spain and Ireland, but rather of a slow burning issue on the back of persistently low productivity growth rates. A low potential GDP growth rate, driven by low underlying productivity growth, is Italy's main issue. In the 1970s and 80s, Italy could make up for a lack of structural reform through fiscal expansion and devaluations of the lira. This kept the demand side of the economy going and resulted in some positive supply side effects as well. Since the mid-1990s, however, these demand side boosters can no longer be used. Structural reform is thus the only option.

A low potential GDP growth rate, driven by low underlying productivity growth, is Italy's biggest problem

Some reforms were undertaken but more is needed. The labour market is still characterized by a dichotomy between permanent contracts and flex workers, while the wage bargaining process is still centralized. This prevents firms from responding to idiosyncratic circumstances. Moreover, inefficiencies in public administration and the judicial system need to be addressed and service markets need to be liberalized.

Such reforms are necessary for Italy in order to embark on a higher growth trajectory which will enable the country to bring down its public debt burden of 132% of GDP. However, implementing these reforms requires a strong and stable government.

Hung parliament is the most likely outcome

Whether or not Italy will get a strong and stable government remains to be seen. The new electoral law that was approved in October 2017 favours the formation of coalitions. The Lower House and the Senate are subject to the same system where 36% of the seats are allocated using a first-past-the-post system and the remaining 64% according to proportional representation, with one round of voting. What's more, voters cannot split their votes for the individual candidates from their votes for the party list. This makes it very difficult to translate the share of the vote into the number of seats.

The general consensus is that a coalition needs at least 40% of the votes to have a majority. The latest voter surveys suggest a hung parliament, however.

The Italian political spectrum consists of three main groups: the anti-establishment Five Star Movement, led by Luigi Di Maio; the centre-left, led by Matteo Renzi of the Democratic Party; and the centre-right, headed by Forza Italia's Silvio Berlusconi. The latter group also consists of the Northern League and the Brothers of Italy, which in the recent past have been vocal about their disapproval of the European Union. The positive side of the story is that the latter two parties have become significantly less anti-EU in their rhetoric, however.

According to the polls, this centre-right coalition will win the election. The latest polls suggest that about 35% of the votes will go to them. The centre-left currently stands at 29% and the Five Star Movement at 28%. This means that none will be able to form a government. The expected result is either an unstable "grand coalition" or a prolonged gridlock, leading in due course to new elections.

As said, the main area of contention will no longer be EU or euro membership but rather the outlook for fiscal policy. Many parties want more room for fiscal easing, which may well bring them into conflict with the European Commission and the core Eurozone countries. **Nevertheless, we can imagine a compromise involving a trade-off between more fiscal flexibility and improved structural reform efforts.**



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