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CIO Viewpoint

Waiting for clarity on an Italian government

Investment Solutions

19 September 2022

On 25 September, Italy's voters will elect a new government. Triggered by the resignation of Prime Minister Mario Draghi, the election is forecast to bring to office a right-wing coalition that must repair a slowing economy, address high inflation and an energy crisis. With so much at stake, and as long as uncertainties persist over who will manage the country's economy and finances, we remain cautious on Italian sovereign bonds.

Mr Draghi took office in February 2021 with a mandate to manage Covid vaccination programmes and oversee the distribution of EU recovery spending. The former chair of the European Central Bank resigned from his post in July and is managing a caretaker administration until the election. If voter polling proves accurate, Giorgia Meloni, who since 2014 has headed the Fratelli d'Italia (Brothers of Italy) party that has extremist far-right roots, will replace Mr Draghi.

Like its neighbours, Europe's third-biggest economy is struggling with high inflation, record energy prices and slowing growth, all linked to the war in Ukraine. Italy's consumer prices rose 8.4% in July, compared with a year earlier. Inflation in the eurozone rose by an annualised 9.1% in August, from 8.9% in July, estimates Eurostat, the EU's statistics agency. The Italian economy may expand by 3% in 2022, the International Monetary Fund estimated in August, before slowing to 0.7% in 2023. Inflation, supply bottlenecks, the energy crisis and political uncertainties could inflict further damage. Italy's economy remains below its pre-Great Financial Crisis size. It has the second-highest ratio of public debt to GDP in the world, at a record 155.3% in 2020. In 2022, we expect this ratio to be around 148%, second only to Japan in the G20, taking into account fiscal spending to support the economy and households.

Italy's trade and current account balance remain slightly positive, despite higher energy prices, and so the economy is not dependent on foreign direct investment (FDI). Still, compared with the EU's largest economies Germany and France, Italy has recorded lower productivity, invested less in its digital infrastructure and been slow to adopt new technologies. The Italian government has highlighted the country's vulnerability to climate change, in particular rising sea levels, heat waves, drought and landslides. It also has a demographic challenge, with more than 23% of the population over 65 years old, the highest share in the EU.

Cutting dependence, fiscal commitments

The greatest immediate threat to economic growth is energy. After Hungary, Italy is the EU economy most vulnerable to natural gas shortages from Russia. In

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Key takeaways

- Italy is expected to elect a far-right wing coalition government led by the Brothers of Italy party under Giorgia Meloni, replacing Mario Draghi as prime minister
- Energy is a key priority for the new government. Italy has cut its reliance on Russian gas, and committed to spend EUR 50 bn to cushion energy impacts on consumers and business
- Rising ECB rates will weigh on Italian debt in the long run, and much depends on a new government's willingness to take a pragmatic approach to meet monetary support criteria
- With questions over a new government's fiscal policies and key posts, we remain cautious on Italian sovereign debt.

response, Italy has stocked up on gas, filling its inventories to more than 83% capacity by early September, and reduced its dependence on Russian energy imports. Supplies of Russian natural gas have fallen from 43% of the country's total in 2020 to around 25% today.

In 2022, Italy has already provided firms and consumers with a package of measures worth EUR 50 billion to cushion the impact of rising energy prices. A further EUR 13.5 billion is pending parliamentary approval. A windfall tax on energy firms that had been projected to raise EUR 10 billion has so far generated only EUR 2 billion. Meanwhile, total spending earmarked for Italy from the 'Next Generation EU' package of support for its members' economies post-pandemic is worth EUR 205 billion, the largest share in the EU's post-pandemic allocations. Taken together, these add up to a sizeable package of support, especially when compared with other countries.

In the best-case scenario – a coordinated EU-wide response to the energy crisis - the International Monetary Fund estimates that an end to Russian gas imports over 12 months would see a -0.6% decline in Italian GDP. In the worst case (lack of coordination, feeble policy support), the economy may contract as much as -5.7% over a year, according to the same estimate. The fiscal spending already committed by Italy's current administration would, we estimate, slash the economic impact of this worst-case scenario to -2.7% of GDP.

Eurozone support

As the energy crisis takes hold and growth slows, we also expect the European Central Bank's benchmark interest rate to reach 1.5% by the end of 2022. At some point, higher interest rates will have an impact on Italy's high levels of government debt; the country has for example, EUR 285 bn in debt maturing before the end of 2023, and a further EUR 228 bn in 2024.

In early August, Moody's Investors Service cut its outlook on Italy's sovereign debt from 'stable' to 'negative,' keeping its rating at Baa3, citing slowing growth, rising capital borrowing costs, and at the political level, "potentially weaker fiscal discipline."

The uncertainties surrounding energy supplies and gas prices in particular have seen bond yields rise across the EU. The spread between Italian and German 10-year debt has widened - to 225 basis points – with German 10-year Bund yields trading at 1.76% while Italian 10-year sovereign bonds now yield more than 4%, their highest level in nine years. That spread is still half difference seen during the European debt crisis of a decade ago.

In July 2021, the EU created a low-interest debt issuance, or debt mutualisation programme designed to improve member states' credit worthiness and support the euro by allowing the European Commission to issue debt on behalf of member states, backed by the European Central Bank. In June 2022, the ECB went a step further, launching an 'anti-fragmentation' or 'Transmission Protection Instrument' (TPI), designed to avoid the break-up of the eurozone by making sure monetary policy is effective in each economy. The TPI adds to the ECB's existing tools for buying Italian bonds to prevent spreads widening. Markets have treated the TPI as credible, removing some immediate risks for Italy.

Pragmatic politics

A coalition of three right wing parties is expected to emerge from the election. In this case, the government would consist of Brothers of Italy (FdI), Matteo Salvini's Northern League (Lega Nord) and Forza Italia, led by Silvio Berlusconi. Between them, the three parties are forecast to win around 45% of votes, putting it about 20 percentage points ahead of the centre left and translating to a majority in each of the houses of parliament.

The balance between the three parties will be key for the country as they have very different positions on topics including fiscal consolidation, their stance towards the EU and NATO. In this scenario of a broad majority for FdI, the coalition should quickly form a government, with potential clashes over European policy over time. In the less likely case of Ms Meloni winning with a narrow majority, the formation of a government will take longer.

Whatever the exact composition of the next government, it will start with the positive fiscal consolidation put in place by the Draghi administration. So far, measures to mitigate the energy crisis have been financed without additional deficits and with fiscal revenues incrementally improving. For now, the right wing coalition has not detailed how it plans to finance its proposals, such as an increase in minimum pensions, which could in turn slow the path of fiscal consolidation.

With so much fiscal support riding on the EU, we expect a new Italian government to take a pragmatic approach to relations with the bloc's executive, including ditching the far right's historic euroscepticism.

In the short term, debt sustainability is not a risk thanks to the longer maturity of Italy's public debt, but the increase in interest rates will weigh in the longer term. Eligibility for the ECB's TPI and the government's willingness to respect the programme's criteria will be key. Italian government bond spreads against German Bunds will therefore be very sensitive to these factors, which may test the current spread in the coming weeks.

Still, if the government adopts an economic policy more focused on protecting small Italian businesses than encouraging investments in larger industries, that may do little to boost foreign direct investment. Lacking more clarity on a new Italian government's fiscal ambitions, and who will take responsibility for its economic and financial policy, we therefore remain cautious on Italian sovereign debt.

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