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ITALIAN BASICS: NOISE NOW, TROUBLE LATER

Berenberg Macro Flash

No big surprise in the programme: The latest draft of the government programme which 5Stars and Lega want to present to President Sergio Mattarella early next week includes a list of fiscally irresponsible and economically harmful measures but no direct threat to Italy's euro membership. Before the proposals for more welfare spending, big tax cuts and a stop to key privatisation projects could be implemented, they would likely be watered down substantially under pressure from Italy's president, the country's top court, its European partners and – possibly – the more responsible wings of the 5Stars and Lega. The would-be coalition partners, notably the 5Stars, are a highly diverse lot. Italy's complex political system is designed to retard change. What hobbled pro-reform prime minister Matteo Renzi in 2015-2016 may now hem in his radical anti-reform successors.

We maintain our assessment: Although we have to brace ourselves for significant noise, including clashes between Rome and Brussels, a truly disruptive crisis is probably not on the cards for now. However, if highly-indebted Italy loosens the fiscal reins and reverses some recent reforms such as the "Fornero" pension reform, the country would become vulnerable to a debt crisis if and when the next cyclical recession exposes the country's weaknesses.

To put the risks for Italy and Europe into perspective, remember the basics:

Size matters: A founding member of the EU and the euro, Italy accounts for 15.4% of Eurozone GDP and 23.4% of the bloc's public debt. For comparison, Greece contributes 1.8% to Eurozone GDP and 3.3% to its pile of public debt (2017 data). Germany earns 2% of its GDP by exporting goods to Italy while linkages through the banking system tie Italy closely to its European partners. A major Italian crisis would be a significant shock for Europe.

Contagion control: With the European Stability Mechanism (ESM) and the ECB's OMT programme, de facto a tool to massively scale up any ESM programme if required, the Eurozone now has a lender of last resort and effective means to control contagion risks. Any country that wants to stay in the euro can and will be kept in the euro. Even in the – still highly unlikely – case that Italy were to go badly wrong in the next few years, a repeat of the euro crisis marked by rampant contagion seems quite improbable.

Italy has deep seated problems: Held back by major structural rigidities, arcane regulations, lengthy court procedures, a partly inefficient public administration and a big North-South divide, Italian real GDP has expanded by a mere 8.2% since the start of the euro in 1999, far behind the 35.1% cumulative growth which the Eurozone ex Italy achieved during this period. The success of Spain (44.4%) relative to Germany (30.2% cumulative growth) suggests that Italy's travails reflect genuine Italian problems rather than a general core-periphery divide within the Eurozone. As a traditional mass-market producer, Italy has also been put under more severe adjustment pressure by the rise of China than other developed countries. While Italy's rapid transition from mass-market to top-quality producer has been largely completed, the process has left deep scars.

Italy has made progress: With fiscal restraint, serious cuts in pension entitlements and Renzi's 2015 labour market reform, Italy was on the right track from late 2011 until the March 2018 election. But it remains a half-reformed country. Whereas Spain, Portugal, Ireland and Greece have largely done the hard repair work, Italy is not there yet. Reform reversals would cement Italy's position as Europe's big laggard.

Italy is in a comfortable fiscal starting position: With a fiscal deficit of just 2.3% of GDP in 2017, an average duration of its sovereign bonds of 6.9 years and a ratio of interest payments to GDP of 3.6% in 2017 after 5% in 2012, Italy is not very vulnerable to a modest rise in yields. It can probably get away with some fiscal nonsense for a while during an economic upswing. That helps to contain the risk of an immediate crisis even if relations between Rome and Brussels get noisy shortly.

Crisis 2022? It often takes a recession to lay bare the true costs of misguided policies. If and when the current global upswings turns into a downturn, say in 2021 as seems plausible on current US cyclical dynamics, an insufficiently reformed Italy could be a candidate for a debt crisis, perhaps in 2022.

Europe will not budge: All this Lega/5Stars talk about renegotiating EU treaties, changing Maastricht rules, asking the ECB to forgive up to €250bn of Italian bonds bought under the QE programme, omitting debt purchased by the ECB from debt/GDP ratios and investment spending from public deficit ratios is ultimately for show. The other 26 EU/18 Eurozone members will not even start a serious discussion about it. While Italy can complicate EU/Eurozone reform discussions, other countries could get around Italian objections if they really have to.

In the long-run, Italy will have to choose: It either lives by the rules, which can always be interpreted with some flexibility, and shapes up over time - or it will have to bear the consequences of remaining the laggard of Europe. Whether Italy maintains the political will to stay in the euro is the key long-term issue. It most likely will do so. But that may be put to a test eventually, perhaps around 2022.

For a further discussion of Italy's near term vulnerability, see Tuesday's flash comment..
For a discussion of reform progress and long-term issues, see our 2017 Euro Plus Monitor.

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