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MACRO UPDATE: NOTES ON ITALIAN RISKS

Berenberg Macro View

After three major coalition parties refused to back Italian prime minister Mario Draghi in a confidence vote in the Senate yesterday evening, the risk of snap elections in late September or early October has risen substantially. Draghi is widely expected to tender his resignation to Italian president Sergio Mattarella today. Mattarella, who wields considerable power on such issues, is no fan of early elections, which would be unpopular and disrupt the usual process of preparing the budget for next year. The outcome of the current political crisis is thus not fully clear yet. In any case, however, the events shine a spotlight on Italian risks. To assess these risks, this note deals with Italian fundamentals rather than the potential moves of key political players in the next few hours and days.

Judging by some long-run fundamentals, Italy is slowly turning into an accident waiting to happen. Three major problems cloud the outlook: (i) a trend rate of real GDP growth of 0.5% per year at best, (ii) dismal demographics due an average fertility rate of just 1.3 children per woman in the last 30 years, and (iii) a penchant for political theatrics. As a result, the long-term sustainability of Italy's public debt burden of almost 150% of GDP is far from assured. Nonetheless, the risk that the potential accident may happen soon still seems to be low. For the time being, we have to brace ourselves for disruptive bouts of noise but not a genuine Euro crisis 2.0, in our view.

PUTTING POLITICAL RISKS INTO CONTEXT

- New elections might well sweep Giorgia Meloni into the prime minister's office at the head of a (centre-)right coalition later this year or in spring 2023. She hails from a party (Fratelli d'Italia) with neofascist roots, has repeatedly blamed the EU for Italy's woes and advocated an "Italy first" approach. Markets rightly worry about her agenda. But the EU and the euro have seen off other radicals before. Remember Yanis Varoufakis and Alexis Tsipras? With her support for a strong and common EU response to Putin's war, Meloni has already distanced herself from some other right-wingers in Italy and Europe.

- A coalition led by Meloni could herald a period of uncertainty for Italy and Europe. But the shock would probably not be worse than that of the surprise anti-establishment coalition between the then-triumphant 5Stars movement with the right-wing Lega after Italy's 2018 election. Under the stern guidance of a mainstream president with considerable power, that coalition ended up with policies that were still partly misguided, but not catastrophically so. Europe was barely affected.

- A further temporary rise in the yield spread could be exactly what might be needed to remind any (potential) new government that Italy would have a lot to lose from policies that would put EU payments to Italy under the NextGenEU programme at risk. This programme gives the EU a useful tool to prevent countries from straying too far from sensible economic and financial policies. Unlike the "troika" austerity programmes during the euro crisis, the grants under the NextGenEU programme (worth a total of 5% of its annual GDP in the case of Italy) are seen as a desirable carrot rather than a stick.

FINANCIAL FUNDAMENTALS: STILL OK FOR NOW

- The Italian state is heavily indebted. But 26% of Italy's public debt is held by Banca d'Italia on behalf of the European Central Bank, or by the ECB itself. Even without any further ECB net purchases, this part of the debt pile will probably stay fully on the balance sheets of the central bank(s) until at least the end of 2024.

- At 3.7% of GDP (Q1 2022), Italy's interest payments on public debt are close a 30-year low. A significant part of the interest goes to Banca d'Italia which, after some adjustments, sends it back as central bank profit to the Treasury in Rome. With an average maturity of 7.8 years, it will take a long time for higher yields to raise Italy's debt-service burden dramatically.

- Inflation is bad. But as a side effect, it also lifts tax revenues and reduces the real burden of servicing the current fixed-rate debt.

- The pandemic has hit the public purse hard across the world. Having run primary fiscal surpluses (net of interest outlays and adjusted for the business cycle) of c2% of its GDP from 2017 to 2019, Italy posted a deficit of 1.4% in 2021 according to the IMF's April 2022 Fiscal Monitor. But relative to the G7 average with cyclically adjusted primary deficits of 1.7% of GDP 2017-2019 and 5.4% in 2021, Italy's current fiscal position still looks comparatively prudent.

OUTLOOK: RISKS CAN BE CONTAINED – AT LEAST FOR NOW
Whereas all other erstwhile euro crisis countries have raised their trend rate of growth and hence their likely future tax revenues sufficiently to make their debt burdens sustainable, Italy has not (yet) implemented enough pro-growth reforms to be on the safe side. As prime minister, Draghi has tried hard to streamline bureaucratic and judicial procedures to make the country a better place to invest and create jobs. However, the task remains unfinished.

In the wake of the pandemic, which Italy managed comparatively well after having first been affected rather badly by the virus, and in a Europe-wide common recession caused largely by the Putin spike in energy and food prices, the EU, the ECB and even most fiscal and monetary hawks within the Eurozone have little appetite for a major Italian crisis. Unless a potential new Italian government were to pursue decidedly anti-EU or anti-euro policies, which seems unlikely, Italy would be supported if need be. The discussion about a new "transmission protection tool" for the ECB is more about the conditions under which the ECB would intervene rather than the principle that serious crises should be prevented. For now, we expect some occasional volatility but not a new euro crisis.

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