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Italy: Europe's "Sleeping Beauty"

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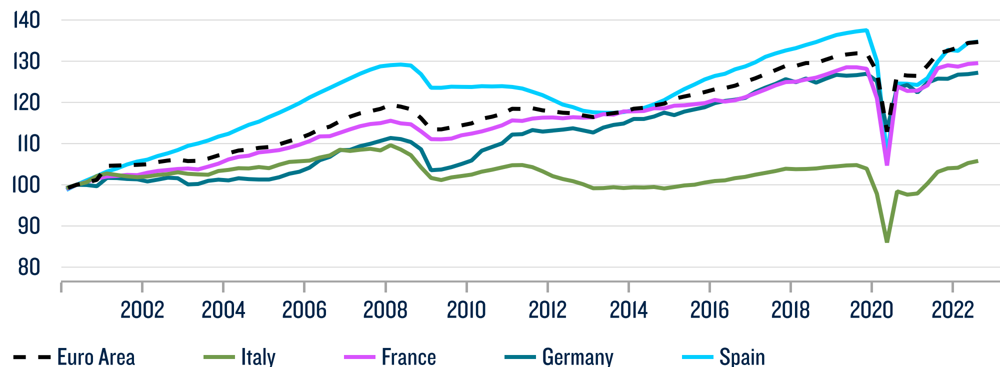
Following the recent election of a centre-right government, a key question for investors is whether this could trigger another round of market stress in Italy that threatens a euro area break-up. This note takes a step back to consider Italy's economic potential—evocatively described as "the sleeping beauty of Europe"[1], current vulnerabilities and exposure to market stress. Italy's legacy of high government debt means that risks will remain live for many years to come. That said, a robust post-pandemic recovery coupled with substantial EU and ECB support programmes should translate into greater resilience in financial markets barring any further downside shocks to the region. The key deliverable for Italy now is to grow over the medium term.

ITALY'S ECONOMIC CHALLENGES THROUGH THE AGES

Italy's economy has effectively not grown since joining the euro area (Figure 1). This fact has fuelled a powerful anti-EU narrative among some voters and politicians. Most studies, however, attribute the country's economic malaise to globalisation. They point out that Italy was particularly vulnerable to the emergence of China on the global trade scene.[2]

Figure 1: Euro Area GDP by country

(Index, 2000 Q1 = 100)



Source: Macrobond, October 2022

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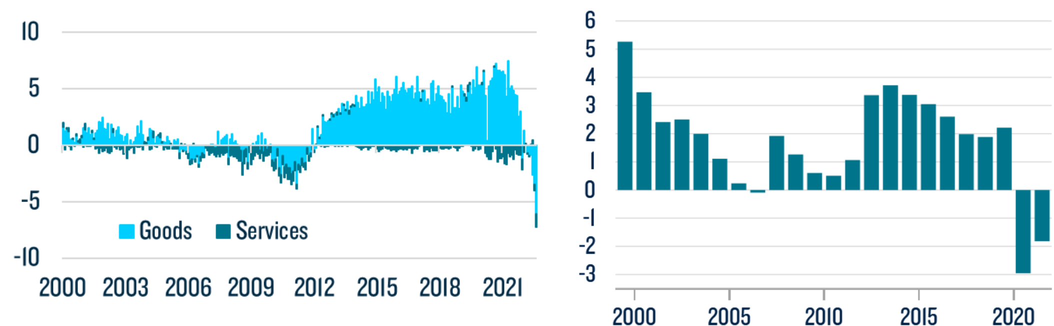
[1] Hassan and Ottaviano (2013) describe Italy as "often regarded as the sleeping beauty of Europe -- a country rich in talent and history, but suffering from a long-lasting stagnation."
[2] Calligaris, Gatto, Hassan, Ottaviano and Schivardi (2016), "Italy's productivity conundrum", European Commission

Italy was one of the fastest-growing economies in post-war Europe, particularly in the 1980s. It specialised in labour-intensive industries such as clothing and footwear, furniture, textiles and ceramics, produced mainly by small and medium-sized enterprises (SMEs). Many see these pre-existing structural factors, together with a radically changed competitive environment, as key to the country's weak performance since then.[3]

Surprisingly to some, Italy has run current account and government primary *surpluses* since the twin global financial and European sovereign debt crises (Figures 2 A, B). The country's competitiveness increased during that time, so its exports rose and imports fell. This led to a sharp turnaround in the current account.

Similarly, estimates of discretionary fiscal spending show that Italy was running primary budget surpluses in the years leading up to the pandemic.[4] But in the absence of growth and due to the higher interest paid on legacy debt, these surpluses were insufficient to meaningfully reduce the country's government debt-to-GDP ratio.

Figure 2: Italy, current account balance (lhs) and cyclically-adjusted primary balance (rhs)
(lhs: EUR, billion; rhs: percent of GDP)



Source: Macrobond, October 2022.

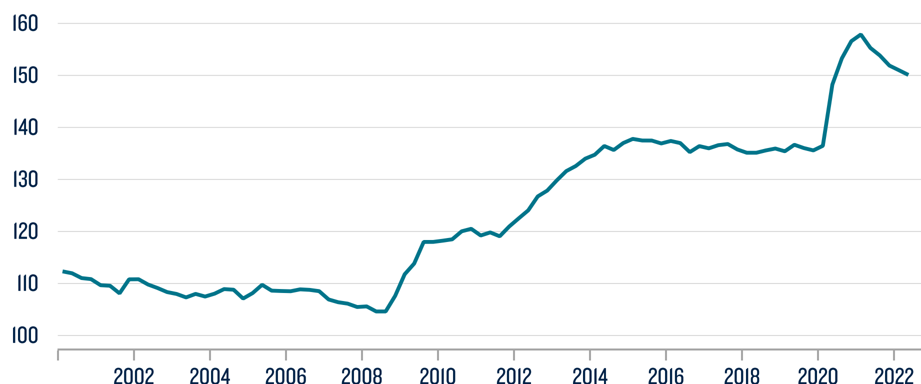
Since the pandemic, Italy's debt-to-GDP has increased to over 150% (Figure 3). But its economic recovery from the pandemic has been a saving grace. Nominal GDP has expanded robustly as labour market participation has recovered its pre-pandemic level and the unemployment rate has fallen below 8%.

The robust recovery and soaring inflation has translated into higher-than-expected government revenues, which offer some relief from the high debt-to-GDP ratio. Higher revenues have also provided a cushion this year to shield vulnerable households and firms from the energy price shock.

[3] Mody, (2014), "Why does Italy not grow?", Bruegel
[4] Discretionary spending excludes automatic stabilisers, such as rising unemployment benefit expenditure in a downturn and interest payments on debt.

Figure 3: Debt-to-GDP ratio

(percent of GDP)



Source: Macrobond, October 2022.

However, the cost of servicing Italy's legacy debt remains a major drag on the Italian economy, and that risk will be live for many years to come. Therefore, key questions for investors are : can Italy grow again? And does the political will exist for this new government to follow through with much-needed reforms?

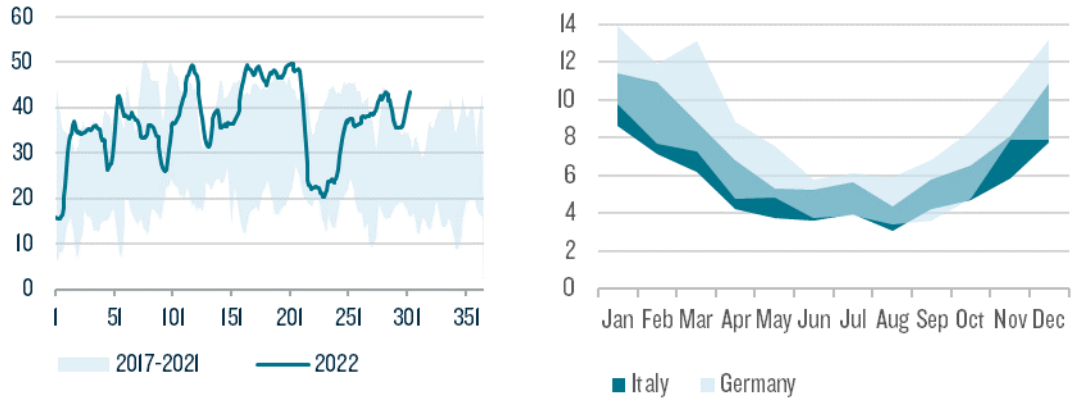
ITALY MAY BE BETTER POSITIONED TO OUTRIGHT RATIONING RISKS THIS WINTER

There is no doubt that the energy crisis sparked by Russia's invasion of Ukraine poses a challenge to Italy's growth outlook. In every European crisis in recent memory, it seems that Italy has been a weak link, and so it would seem again.

Before the invasion, Italy was the second-largest buyer of Russian gas after Germany, heavily reliant on gas as a percentage of its total energy consumption. Moreover, as Europe's second-largest manufacturing economy, Italy's economy is particularly vulnerable to an energy shortage. The bottom line is that Italy's near-term growth prospects will be challenged by the energy crisis.

That said, Italy has done better than expected at finding alternative gas supplies and is geographically less exposed than, say, Germany. Algeria is now its top supplier of gas via the Transmed pipeline, with the prospect of further increases in 3-4 years' time. The country also benefits from several liquefied natural gas (LNG) terminals and plans to add LNG capacity by 2024. Finally, Italy is less exposed to cold weather shocks that could trigger spikes in demand for gas (Figures 4 A, B). Overall, therefore, our view is that Italy is relatively better positioned when it comes to outright gas rationing risks.

Figure 4: Italy LNG capacity (lhs) and range of monthly gas consumption (rhs)
(lhs: cubic metres per day, million; rhs: 2008-21, billion cubic meters)



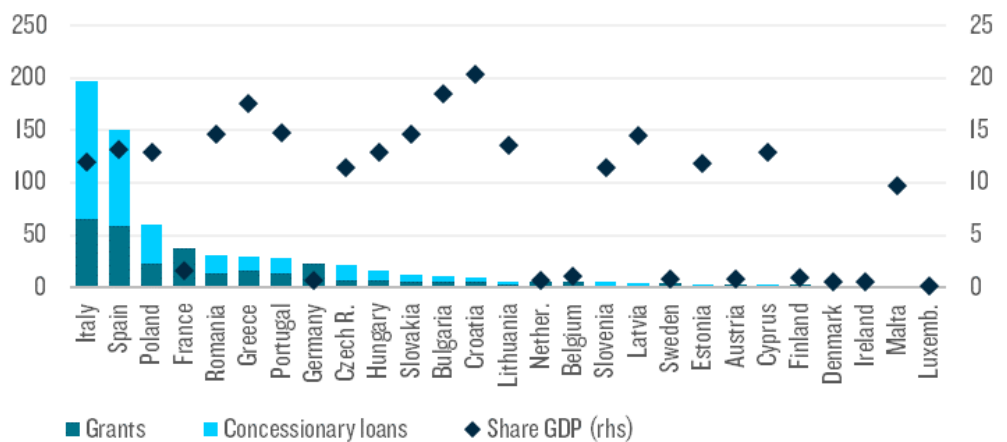
Source: Macrobond, October 2022.

ITALY NOW BENEFITS FROM A BROADER RANGE OF EU SUPPORT

Despite the near-term energy crisis, we see new and substantive EU support as a game changer for Italy's growth. The sheer scale of support—more than 10% of Italy's GDP—has the potential to be transformative (Figure 5).

Italy is the largest recipient of Next Generation EU funds, which the European Union agreed during the pandemic to support hard-hit countries. In the past, Italy has struggled to meet EU requirements and to absorb available funds. Under Next Generation EU, improvements have been made in this direction. Subject to continued absorption and meeting reform milestones, such as reforms to public and tax administration, these funds will continue until 2027.

Figure 5: NGEU allocations
(billions of Euros)



Source: European Commission, PGIM Fixed Income as of October 2022.

With a change in Italian leadership, how confident are we that reforms will continue and that the EU will disburse funds? A number of guardrails have been put in place that reassure us.

First, grants and loans under Next Generation EU were frontloaded, with cross-party support that limits roll-back risk to reforms. Second, light-touch conditionality for accessing the funds

creates strong political incentives to comply. Third, as discussed in the accompanying box, Italy's new Prime Minister Giorgia Meloni has pledged to work constructively with the EU.

The timing of the election was awkward: it delayed a draft budget and reforms needed to receive the next tranche of Next Generation EU funding. However, for the reasons laid out, we see the change in leadership as delaying, rather than derailing, reforms and investments initiated under former Prime Minister Mario Draghi.

Moreover, Italy could benefit from any potential additional funding under RePower EU, the EU's plan to reduce its dependency on Russian oil and gas. Given the country's vulnerability to Russian energy imports, it would be in a strong position to request additional funding under this programme.

The bottom line is that Italy's strong post-pandemic recovery, combined with large inflows of EU funding, takes significant pressure off the Italian government to increase its budget deficits. The shift in mood music from centre-right parties and Meloni's stated commitment to fiscal responsibility provide further reassurances. The experience of the UK's mini-budget, which featured unfunded tax cuts, and subsequent market reaction should offer further restraint. That said, the publication of the 2023 government budget later this year will be an important first test for her new government.

MARKET STRESS REMAINS A RISK, BUT THERE IS HEADROOM FOR RATES TO RISE

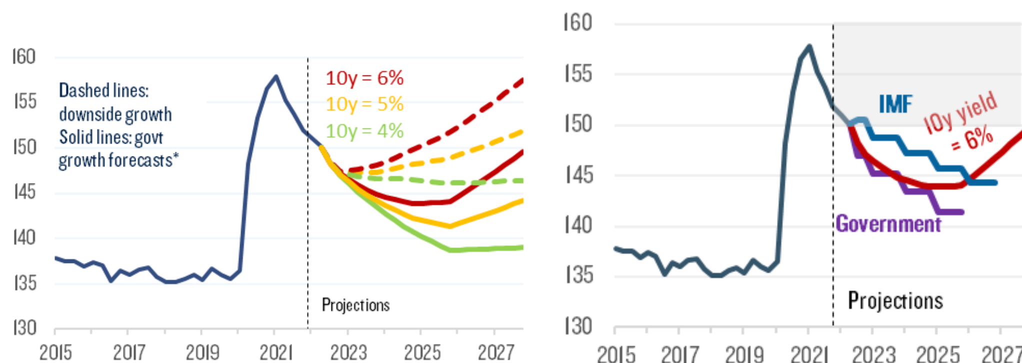
In addition to EU funds, Italy benefits from the European Central Bank's (ECB's) newest tool, its Transmission Protection Instrument. This tool comes on top of the ECB's existing flexibility to skew its reinvestment of maturities from PEPP (the Pandemic Emergency Purchase Programme) in favour of Italian government bonds. These additional ECB tools provide firepower that should limit moves in Italian bond spreads. Like other governments, Italy has benefited from the last decade of low interest rates to reduce interest payments on its legacy debt.

All these factors together mean that Italy's debt sustainability is now less sensitive to rising interest rates or rising budget deficits than in previous years. At the end of the day, what really matters for debt sustainability is economic growth.

Our in-house debt sustainability analysis illustrates Italy's sensitivity to growth (Figure 6). Our downside scenario assumes an annual nominal GDP growth rate of 2.4% between 2023 and 2025 – just above the 2015-19 average and well below the government's projected 4% average.

If nominal GDP growth remains very low at 2.4%, interest rates of more than 4% on Italian government bonds would push debt-to-GDP onto an unsustainable, upward path. At higher, but plausible, growth rates made more likely by elevated inflation, that ceiling could be as high as 5%. This added resilience, alongside substantive EU support, points to additional headroom for interest rates to rise, relative to the years before the pandemic, when 3% was seen as a threshold. Our sensitivity analysis also identifies a 3 ½ year window over which, if higher rates were to be sustained, debt-to-GDP would again be on a rising trajectory.

Figure 6: Italy, debt to GDP ratio
(percent)



Source: Macrobond, Italian MEF, IMF, PGIM Fixed Income. *Govt growth forecasts out to 2025, 2.4% nominal GDP growth thereafter.

ALL'S WELL IF IT ENDS WELL

This month's election of a centre-right Italian government is not a rerun of 2018. At that time, clashes with the EU over budget deficits risked putting Italy's debt-to-GDP ratio on an unsustainable path. That, in turn, raised the risk that the country might ditch the euro and return to a currency of its own.

Italy's high level of legacy debt means that some risk will probably continue for years to come. But this time may truly be different. Italy has emerged robustly from the pandemic and now benefits from substantive EU and ECB support measures not in place before the pandemic. Moreover, political unity at the European level, as when agreeing to Russian sanctions, is a key underpinning. Barring further severe downside shocks, we are constructive on the medium-term prospects for the country and its bonds.

That said, a scenario of rising rates against a backdrop of weakening growth would inflict a double whammy on Italy's debt trajectory. In a world of financial market fragility, scrutiny of fiscal plans—so visibly experienced in the UK—and the associated debt sustainability present ongoing risks.

A MELONI GOVERNMENT IS LIKELY TO PROVIDE NEAR- TO MEDIUM-TERM POLITICAL STABILITY

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Lead Geopolitical Analyst

In October's parliamentary elections, the centre-right coalition, which includes the far-right Brothers of Italy (BoI), the League (9%), and Forza Italia (8%) parties, garnered 44% of the vote, a clear parliamentary mandate to govern over the next four years. Based on a pre-election agreement, the leader of the largest party, BoI leader Giorgia Meloni, has now become Italy's first female prime minister.

Some investors fear that Meloni might put EU recovery funds at risk by delaying or reversing recent reforms, that she might undertake fiscally irresponsible measures, or take a confrontational stance with the EU. Others claim that the new government would deepen Italy's cultural and political divide by promoting anti-immigration and identity politics.

Many of these concerns may be misplaced: Meloni's credentials as a social and political conservative have never been in question, but they're not the reason for her meteoric political success in recent years. Her political rise has mainly been a by-product of political crises since 2018 elections, during which three different government coalitions tried to govern. Unlike the anti-establishment Five Star (M5S) party, the League and DP, BoI chose to remain outside of Mario Draghi's most recent government of national unity, and used its "outside" status to weaken its political rivals.

So, Meloni's rising support did not come from a surge in converts to her social conservative agenda, but rather from a shift in support away from a politically weakened League and its leader towards a new face and a more credible outside party. As her political star rose and her support solidified, she set out to normalize her party's image and assuage investors' concerns over its goals. Her three main policy priorities now are income tax reduction, measures to address the cost-of-living costs, and pension reform.

In pre-election interviews, Meloni said that her coalition would not risk access to the EU pandemic funds and that she intends to operate within rules set by Brussels. She also suggested that she does not support the League's big spending plans and that she does not want to increase Italy's already large debt burden. She has even signaled that she is ready to scrap the expensive "citizens' income"—M5S' flagship program. On the geopolitical front, Meloni does not want to destabilize Italy's position within NATO and the EU, and she has vowed to support Ukraine's war effort.

In our analysis, a Meloni government will remain cautious on the spending front, at least in the near term, and not upset financial markets at a very sensitive time for both Italy and Europe. Whether she succeeds, however, will also depend on the political dynamics within the coalition, especially with the League's leader Matteo Salvini, whose downfall has coincided with Meloni's rise. Despite this tension, Meloni's dominance of the center-right coalition will likely provide near- to medium-term stability.

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