THIS MONTH'S TOPIC

Italy in 2018: between better economic prospects and an uncertain vote

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The essential

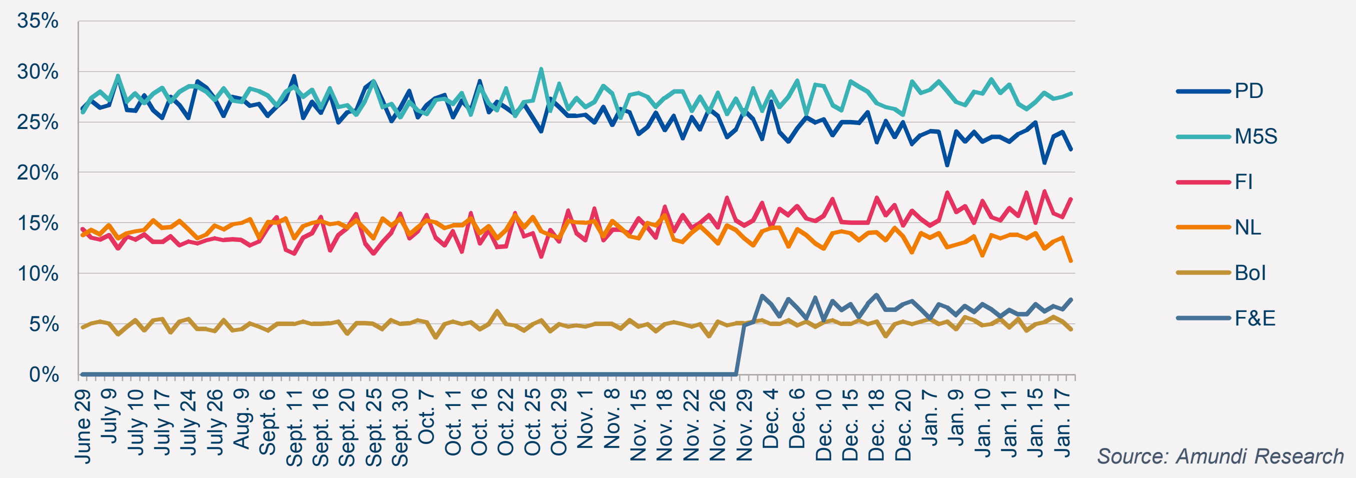
General elections in Italy will be held on 4 March. Polls suggest that the most likely outcome is a hung parliament. What can follow is not obvious, but Italy is quite accustomed to being led by a "non-political" government, meaning a government that is the direct outcome of the electoral result. While the electoral manifestos are a bit worrying in terms of their impact on public accounts, the contenders are reducing their sharper angles. Moreover, the improving economy (with persistent signs of gains in competitiveness) and the likelihood of a mixed electoral result may imply some sort of continuity with the current set of policies. Structurally stronger growth implies that a declining path for Debt/GDP ratio can be entered, lowering country risk and benefitting markets.

Polls ahead of the elections

General elections in Italy will be held on 4 March. The date of the election is just about the only certainty we have at the moment. Polls still suggest that the most likely outcome is a hung parliament. The centre-right coalition is leading the race (Forza Italia (FI), Berlusconi's party, Northern League (NL), its main ally and Brothers of Italy (BoI), with a percentage that is fluctuating between 35% and 39%) and actually gained some traction recently, but it still appears to be below the 40% level that could guarantee a coalition with an outright majority. The populist, and non-Europe friendly M5S will likely be the first individual party, winning between 26% and 29%, but they claim that they will not try to form ex-post coalitions in order to form a government; it must be also said that they have significantly toned down their statements on the Euro-Europe membership. The left is divided in this election and Renzi's Partito Democratico (PD) is credited with 22%-25%, reaching as high as 25%-28% when combined with some small allies. There is a slim possibility that with the combination of the first-past-the-post and proportional representation systems in the new electoral law, the centre-right will manage to get an outright majority, but, still the most likely result is one in which none of the three main groups will be able to form a government.

> "Polls still suggest that the most likely outcome is a hung parliament."

1/ **Polls on Italian Election**



Source: Amundi Research

What can follow is not obvious, but Italy is quite accustomed to being led by a "non-political" government, meaning a government that is the direct outcome of the electoral result. Hence, President Mattarella will try to find a possible agreement among the contenders and establish a new government.

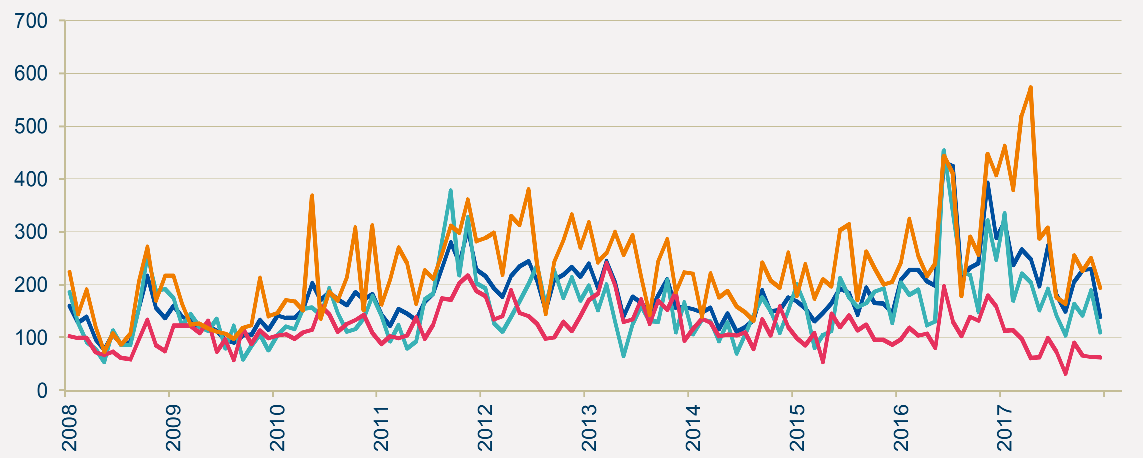
In this case, it is also possible that Mr. Gentiloni, who is acting as a caretaker PM (actually, when he was nominated PM he was already perceived as a sort of caretaker, gaining a certain ground of popular support) will maintain his role.

What scares the market the most is an outright victory for the M5S (a populistic, anti-establishment, anti-European movement) and the odds that this will happen are extremely low. It is also difficult to envisage M5S trying to form an alliance (after the election results) with the other anti-European party – Northern League – because their combined (credited) seats will not allow them to achieve a majority.

As in many countries, there is a growing share of the population that is disaffected with politics and, in recent votes, we have seen the number of abstentions constantly increasing.

It must be said that despite the unclear possible outcomes, dedicated economic policy uncertainty indicators[1], like the one shown in the graph below, have not spiked recently in Italy (unlike in France and, to a lesser extent, in Germany).

2/ **Political uncertainty index**



Source : Economic policy uncertainty website, Amundi Research

Also at the moment, market sentiment is somewhat in a state of benign denial of risk: the Italian equity market is outperforming Europe (YTD the FTSE MIB is up 5.2% vs. -1.1% for the EuroStoxx, mainly thanks to the small- and mid-caps segment that is benefitting from the fiscal incentive for investors); the BTP-Bund spread is relatively anchored, averaging 145 bp since November 2017 (but has fallen below 130 bp in the last two weeks despite the market turbulence and the increase in the Bund yield).

Politics and electoral manifestos

It is difficult to summarise the parties' main proposals; but let's try to focus (on the main three blocks) on those that are more publicly stated and that are likely to have a greater impact on the economy.

M5S has long been proposing a minimum "citizenship" income that should be earned even if one is unemployed, coupled with a strengthening of active labour market policies typical of flex-security. They also want to raise the minimum pension allowance and substantially increase public investment (explicitly arguing the need to use deficit spending) in order to jumpstart a renewed circular economy and promote its de-carbonisation. The M5S manifesto also cites the need to implement policies aimed at supporting families and, hence, birth rates.

Berlusconi's programme is not that far removed from the one he put forward 20 years ago. Cutting taxes and red tape (including the rules and restrictions related to Euro and Europe membership). The two flagship items are the introduction of a flat tax on personal income and the abrogation of the 2012 Pension Reform (Fornero's law).

The PD is aiming to continue the actions of recent years, particularly in terms of reducing the tax burden on labour. The main new item on the manifesto is the proposed introduction of a minimum wage (that does not currently exist in Italy) with a view to enhancing the quality of employment after some success in terms of quantity in past years.

[1] *Here it is the one calculated by http://www.policyuncertainty.com/*

As the election date nears, some contenders are toning down their rhetoric on some of their more radical issues. M5S seems to have considerably softened its position on Europe (until a year ago they claimed they would have called for a referendum on the Euro) and on the possibility of looking for allies. In the same vein, Mr. Berlusconi softened his stance on the 2012 Pension Reform (Fornero's law), but his position clashes a bit with his main ally, the NL, which is maintaining a tough stance in that regard.

Prospects

Needless to say, a lot of these issues are somewhat at odds with the fact that Italy must (the country has no choice) maintain a sizeable primary balance and must hope to be able to maintain a decent growth path in order to reduce public debt.

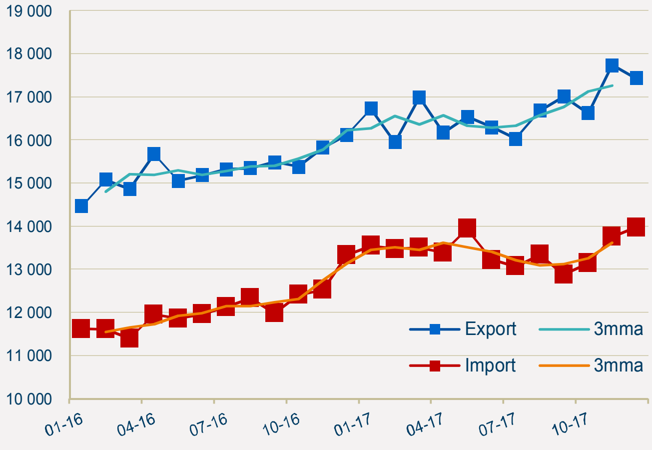
In the press conference after the ECB meeting on 25 January, Mr. Draghi simply and forcefully clarified that in such a phase in which the cycle is favourable, indebted countries[2] should build up fiscal buffers in order to be able to tackle more difficult phases in the future. Mr. Cottarelli, former director of the Fiscal Affairs Department at the IMF and special commissioner for the Spending Review in Italy, commenting about the electoral programmes, said that it must be hoped that this time parties do not maintain their promises after the elections.

The truth is that Italy cannot afford (and the EU Commission / Eurogroup will not allow it) to implement an expansionary fiscal policy. Now that it seems that the country is again able to generate some economic growth, it could enter a debt reduction path without other major efforts (but also without a profligate fiscal policy). This, surely, can lead to a virtuous circle in which country risk diminishes and Italian assets will be positively repriced.

The economy

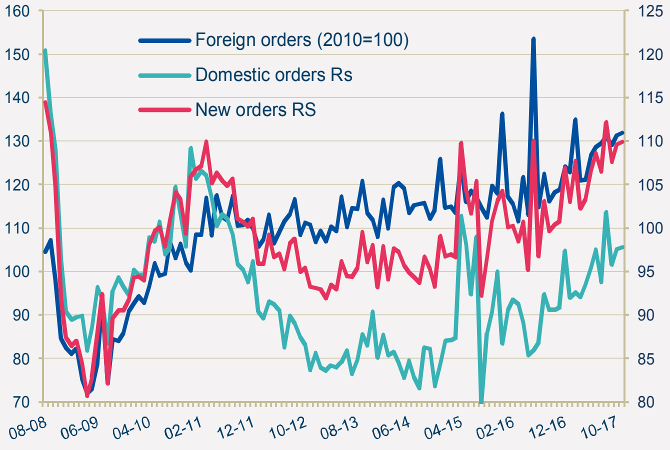
The economy is doing well. Apart from some (natural) volatility, it seems that growth of 0.3-0.4% per quarter is affordable, and this is good news for a country where Total Factor Productivity declined over the 1995-2016 period. In a recent thematic paper (Italy: back to growth[3]), we tried to investigate the reasons that justify the claim that something is structurally improved and the renewed competitiveness of Italian products is probably the best "quantitative" indicator for that. In 2017, the trade balance with countries outside the European Union was a surplus of €39.2bn, in line with 2016's figure, but net of energy related products it hit €71.9bn compared to €65.6bn previously, despite the fact that domestic demand was stronger than last year. With confidence at a high level and manufacturing firms' order books in a strong position, it seems likely that the positive momentum will continue in 2018.

3/ **Italy: extra EU trade**



Source: Amundi Research

4/ **Italy: orders (2010=100)**



Source: Amundi Research

Conclusion

There is a lot of uncertainty surrounding this election. The electoral programmes are not entirely reassuring. However, it must be acknowledged that contenders are reducing their sharper angles and that the most likely result is still one in which there will be a sort of technical government or a grand coalition government. Considering that the economy is performing nicely, it is difficult to think that any government that takes charge after 4 March will radically change something that is doing reasonably well.

[2] *He was answering a question coming from an Italian journalist, hence he generalised, but he was clearly speaking about Italy*
[3] *http://research-center.amundi.com/page/Article/Thematic-paper/2017/12/Italy-back-to-growth*

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February 2018 # 02

Chief editor: **BLANQUÉ Pascal**
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