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A Changing Europe Monitor

The impact of the Italian general elections

President of the Republic Giorgio Mattarella has called elections for 4 March, so it is time to look at the potential impact of the next government's strategy on the economy and financial markets in the short (12-18m) and long term (24m+).

We see three realistic scenarios: a centre-right coalition victory; a coalition government led by M5; and a surprise victory by PD, with an even more surprising coalition government led by them. In our view, the scenario where no party manages to form a government is, in practice, very low probability and, should elections be called again, we would end up with the same three scenarios anyway.

We assess the divergence in real GDP growth likely in 2019E, which is the first time the incoming government would be reasonably able to influence the economic recovery, between the various scenarios of c.1.4ppts, with a high of 3% growth should the centre-right coalition win, and 1.6% should M5 lead the next government. In all scenarios, the economy is likely to continue to grow above its potential rate thanks to the favourable global backdrop and an increased fiscal stimulus.

In our view, the budget deficit will be widest under a centre-right coalition, and narrowest if PD leads the next government; however, in all cases, the debt to GDP ratio will drop further thanks to the positive impact of recovering inflation and growth in the next two years. The unemployment rate is also likely to continue to drop, albeit less so if M5 is in power.

At this stage, we do not see enough evidence to say with confidence that any of these government scenarios will lead to a material rise of potential growth over a horizon of five years, as none, in our view, seems sufficiently well-positioned to reverse the capital outflow and brain drain the economy is experiencing currently.

Our projections may seem at odds with the occasional warnings seen in the press that an M5-led government would lead to instability due to its lack of experience in government at the national level. On the basis of what other countries have experienced in similar conditions, a lack of experience usually leads to greater policy noise in the first year of a term and slower policy implementation at least initially, but also greater fiscal prudence relative to the election promises. These factors are likely to weigh on asset prices and the private sector's propensity to invest, but are not enough to fully offset the strong pull from the global recovery and the ECB's quantitative easing support.

EU(ro) scepticism is alive and well, and these elections, in our view, are likely to have a material impact on the future of the EU. However, this influence will not be evident in the short term, and thus likely to be ignored by the financial markets. That said, companies and families would do well to think about what would happen if the Euro fails.

Discerning noise vs. reasonably likely reality

Even before the election campaign moved into top gear, it was evident that the upcoming elections are the most controversial Italy has seen in the past 20 years. Somewhat ironicallly, they are controversial in terms of the spirit of the leadership, but not so much in terms of the policies discussed. Here, we provide a roadmap of what we see as the most important factors to consider when evaluating Italy over the next one-to-five year horizon.

Centre-right coalition	Democratic party	M5
• Flat tax for corporates & households. EUR40bn+ • Min income. EUR17bn • Min pension. EUR18bn • Remove IRAP. EUR10-13bn • Repeal pension (Fornero law). EUR140bn by 2020 • Supportive of a parallel currency	• Maintain & extend EUR80 to all families. EUR7.5bn • Cleaning up tax deductions EUR12-15bn budget savings • Tax breaks for companies that reinvest profits • Further tax cuts for companies • Reduction of TV licence fee	• Minimum income EUR15-17bn • Cleaning up tax deductions, EUR 12-15bn budget savings • Replace the Fornero law with a system that allows greater flexibility on the retirement age • Push the budget deficit above 3% of GDP to fund investment and tax cuts • Greater focus on domestic economy of publicly-owned companies • Emphasis on circular-green economy, to boost industrial base • Labour code: facilitate a reduction of the average working week to under 40hrs, boost flexible work arrangements to increase productivity and well-being

The golden rules necessary for discerning election noise from actual likely strategy

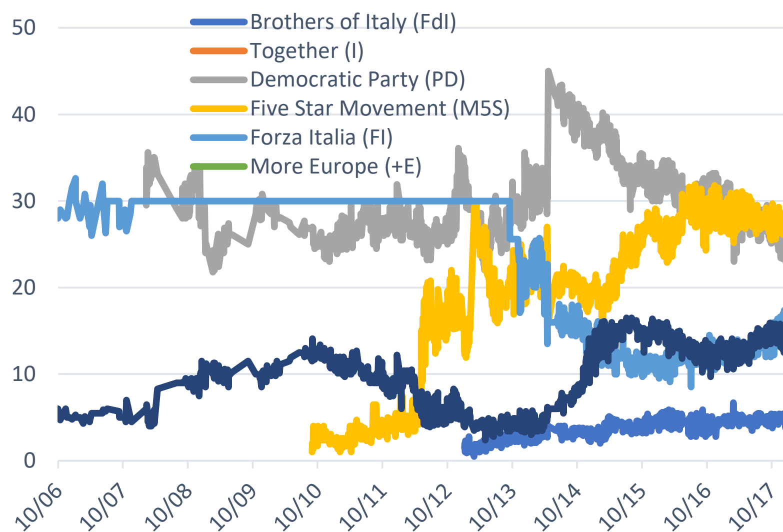
In our experience, when thinking about the likely consequences of a change of government, these are the factors that most influence the outcome, in order of priority:

1) Whether or not the leader of the winning party has a genuine specific economic growth vision that he/she embraces. This vision does not preclude, nor make it less likely, that a government will implement changes (positive or negative), but it inevitably delivers changes in a very specific direction if the vision exists.
2) How strong the external constraints are on the country. This factor is the ultimate constraint on a leader's vision.

3) The level of experience of the team that comes to power, both in the cabinet and among the closest ministerial advisors. This influences the speed at which a leader imposes their view. Governments with little experience, or modest to no ex-ante preparation before they take office inevitably deliver a volatile first year for the financial markets (due usually to bad policy communication) and frequent changes of personnel. That said, a lack of experience, *per se*, does not imply no policy changes, nor does it inevitably translate into bad policy implementation.

   The degree of success depends on the first factor mentioned above: the more a leader has the conviction and desire to get something implemented, the more changes will take place in the background of the government until the right team of expertise is developed, which can deliver such change. Luck (often in the form of how the business cycle is faring) also plays a role, of course, so a lack of experience makes it more likely that the new government breaks before the end of the term without having managed to implement its full plan.

Opinion polls %



Source: Macrobond, ADA Economics Ltd, %

Lags, lags, lags: what the financial markets and analysts forget 99% of the time

An old Italian saying goes as follows: between speech and action there is a gap as wide as the sea (*tra il dire e il fare c'e' di mezzo il mare*). This is true in politics as much as for anything else, so it is useful to keep in mind the following rough guidelines on how long some of the big changes discussed may take:

a) **The time lag between the election and appointment of the government in Italy:** on average, less than 30 days.

b) **The time lag to change major tax rates and tax structure:** at least one year, as they need to be included in the budget, and the first impact usually takes place in the January of the following year. In this case, it means that, if the Northern League were to attempt a flat tax, the first proposal would be included in the 2019 budget and would start in January 2019. The same applies to the housing tax, TV licence, personal income tax rate and VAT, which have also been discussed.

The actual overall tax burden for the average person can change materially at almost any point during the year, and via less well-known tax items via local governments – an example of this is the introduction of the new garbage collection fee a few years ago, which caused mayhem for a good couple of years. As all Italian politicians are acutely aware of the country's debt burden and the need to keep the budget under reasonable control (awareness and legal limits are equally present), it is simply improbable that any bold tax change will take place within one budget, because the fear of losing tax revenues is likely to prevent excessively bold and rapid tax changes.

The combination of the two implies that, if the next government wants to genuinely deliver a proper, full reform of the fiscal system, it will begin in 2019; but it is credible that could take three-to-four years before the full scheme is reviewed, decided on and finally implemented.

c) **Any constitutional change takes, at best, 2.5 years to move through the full process.** The Italian constitution prevents a referendum on the ratification of international treaties, but a consultative referendum on the Euro might be a viable option. This would still imply that any government that is even remotely considering the option of leaving the Eurozone is looking at a process that could last three-to-five years at best.

d) **A pension reform can be implemented relatively quickly** – the Fornero law was proposed, approved and implemented in less than a year. However, it is equally important to stress that any bold change in pensions inevitably triggers unlimited adjustments to the new system: in fact, the Fornero law has been tweaked essentially every year since its approval, in our view. We believe that this, together with factor (b) above, implies that the suggested full repeal of the Fornero law may well be attempted, but it is highly unlikely that what is being discussed in the press will materialise: the law may be repealed, but it is, *de facto*, impossible that the full savings of the Fornero law (est c.EUR140bn by il sole 24 ore) will be lost by the new system, in our view. What is more likely is the full repeal and subsequent changes in the retirement age, but with the bulk of the savings kept intact.

e) **Introducing a parallel currency:** our guess is that, at a minimum, it would take a year to reach the first phase (decision, design and minor initial distribution) and, in any case, its success depends on whether people use it.

f) **The implementation of major "structural" changes usually takes a minimum of three years**, from the time they are proposed, to approval, and implementation in the first and secondary legislation.

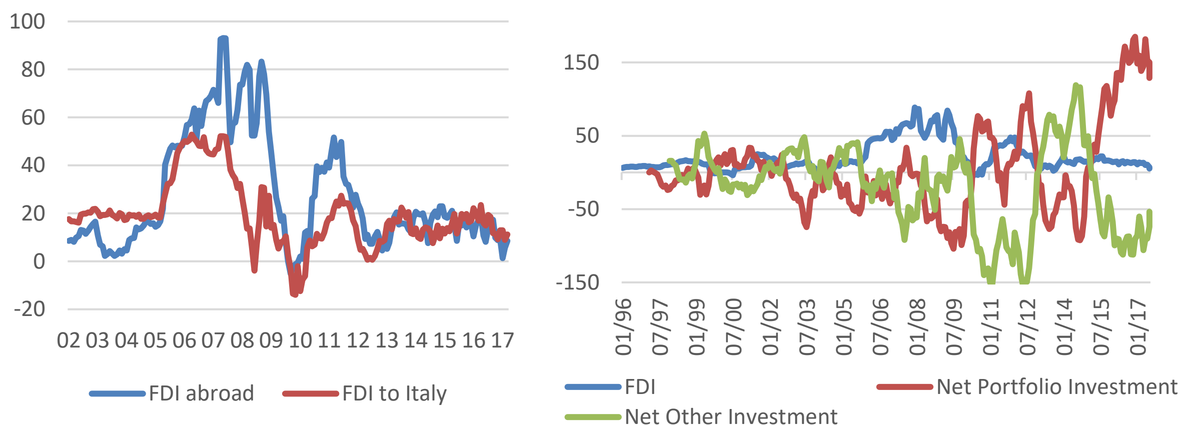
g) **The effectiveness of any policy change – whether small or large – inevitably depends on the state of the economy.** An economy that is undergoing major structural balance sheet adjustments is unlikely to report much of an impact from a regulatory change quickly. In the case of Italy, the ongoing corporate sector balance sheet and the downward convergence effect on wages are impossible to halt or turn around within 12 or even 24 months, in our view.

The cyclical recovery & post-elections

Our assessment of the likely impact of the next government

Below, we present our best guess of how the economy will evolve in the next two years post the elections. We assume that the global backdrop remains bullish, which is our expectation for 2018-19E, and that Brexit does not materialise before 2020E, in line with the recent public comments on a likely transition deal by the end of 2020E. We price in our interpretation of what the political parties genuinely care about and can realistically implement in this relatively short timeframe. Crucially, our projections are highly influenced by the fact that, after years of corporate balance sheets restructuring, competitiveness has improved for Italy, which is both a magnifying factor for the global recovery, but also a *depressing influence* on wages and investment. No government, in our view, can materially change these factors in under 24 months, but could set the conditions for a change of direction for the longer term.

FDI & other investments, 12-month trailing sums, in EURbn



Source: Macrobond, ADA Economics Ltd.

There are three credible scenarios for the election outcome: a government formed by the centre-right; a coalition government led by the 5-Star movement; and a coalition government formed by the Democratic party. The possibility of no government and, thus, another round of elections cannot be ruled out completely, but it is a negligible possibility, in our view, as it would require that both PD and Forza Italia surprise: the former to the upside and the latter to the downside.

Our current "status quo" scenario reflects the effects of the policies in place and the boost from the global stimulus if the current government remains in place – thus, it would be equivalent to a surprise victory by the Democratic party.

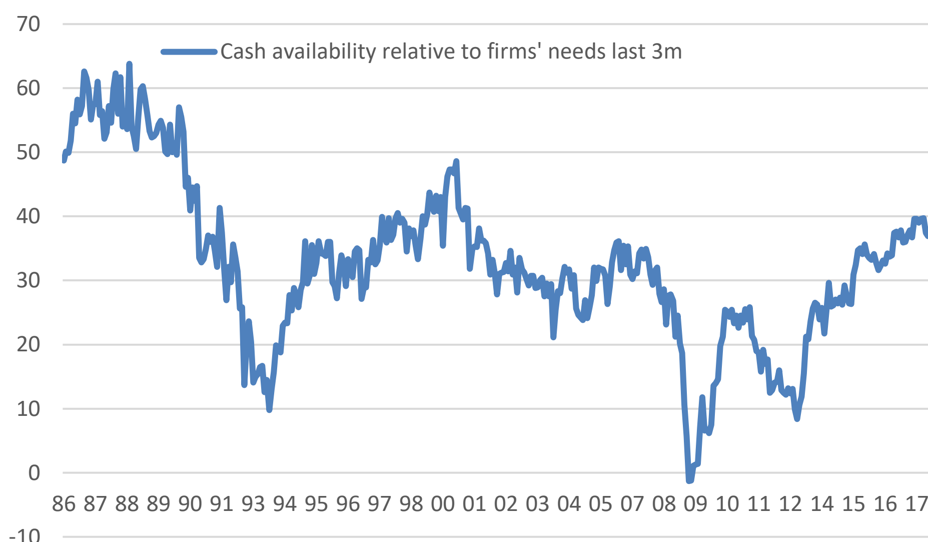
Key macroeconomic indicators, %

	Status quo scenario			Centre-right victory		M5-led government	
	2017E	2018F	2019F	2018F	2019F	2018F	2019F
Real GDP	1.6	1.9	2.2	1.9	3.0	1.6	1.6
HICP, avg	1.5	1.8	2.3	1.9	2.5	1.8	2.1
Unemp. rate eop	10.8	9.5	8.5	9.5	8.2	9.7	9.0
Budget deficit % of GDP	-2.5	-2.2	-1.8	-2.2	-3.0	-2.4	-2.3
Debt % of GDP	131.3	129.0	126.0	129.2	125.0	129.1	126.4

Source: Macrobond, ADA Economics Ltd, %

A centre-right government is likely to be the most fiscally lax of these scenarios, in our view. We would expect it to try to implement a flat tax for businesses, and attempt to simplify the tax structure for households, with a large payout for pensioners/low-income households. We have priced in a total fiscal impact of EUR30bn, *de facto*, starting from 2019E. In our view, the drop in corporate taxation would translate in full into higher investment, but the fiscal boost for consumption would at least go half into higher household savings as the savings rate is low by historical standards and the Northern League's strong anti-Euro stance is likely to raise some long-term concerns among voters.

Manufacturing sector cash availability index



Source: Istat, ADA Economics Ltd.

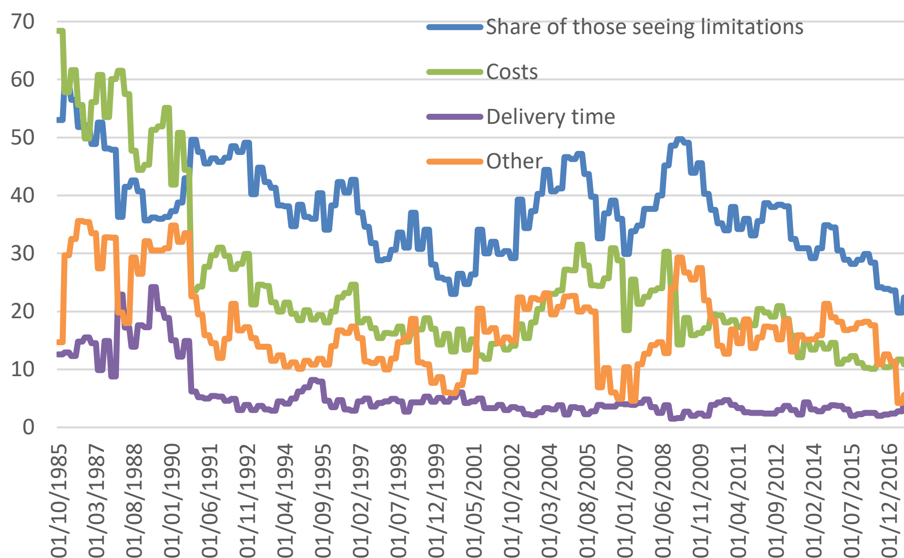
A 5-Stars-led government would be associated, in our view, with the lowest – but by no means a bad performance – growth outlook for 2018-19E, as we believe that the party coming to power would be likely to cause some concern in the financial markets and among private individuals, to the point that it reduces the investment growth outlook mildly. We do not believe it is worth being too sanguine about the impact on the economy with a two-year horizon, because the economy is on a recovery path anyway, driven by exports and the

competitiveness gains accumulated in recent years. Also, lower investment and consumption is likely to have a rapid impact on lower imports as well, which is equivalent to a boost of activity for the accounting of GDP.

We underscore that, as of today, M5 is still working on its policy programme; therefore, for the purpose of this report, we only price in what we believe are the genuine priorities of the party: minimum income for citizens worth c.EUR15bn, and regulatory changes to strengthen corporate governance in the public sector. The party's talk about boosting the budget deficit above 3% of GDP, in our view, is not that likely, at least in 2018-19E, as the experience of other countries has shown that "unorthodox" and "less experienced" governments tend to be slower in implementation and surprise positively on fiscal execution as their lack of experience makes them more cautious (or perhaps the EU Commission's oversight is more stringent on them).

We also show a back-of-the envelope calculation of the impact on the 10-year yield from the various scenarios below. Assuming that the ECB exits QE after September 2018 and inflation trends around 2% (+/-1%), the 10-year yield is likely to converge towards 3.5% by the end of 2019E.

Share of exporters mentioning limitations to production



Source: Istat, ADA Economics Ltd.

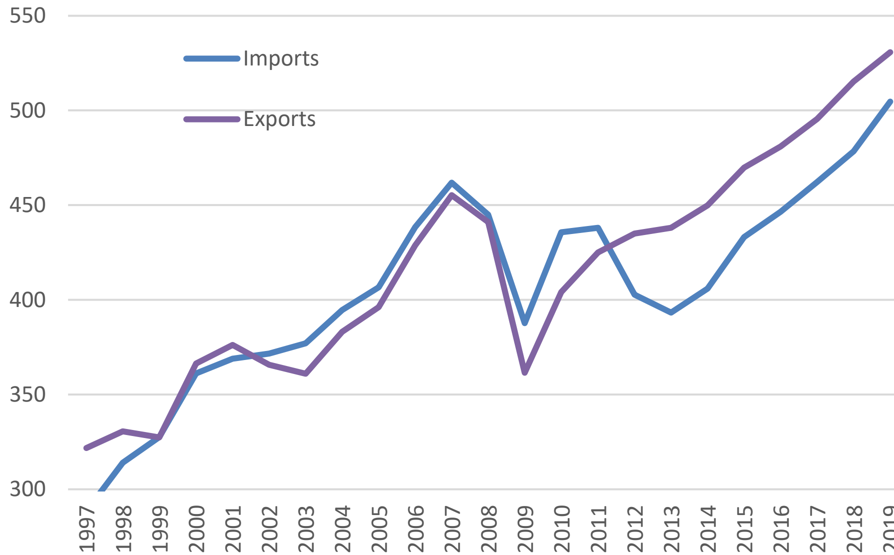
Direction vs. magnitudes: this is the real bottleneck

At a time when the global economy is very strong, it should not be surprising that Italian growth prospects are also rosy. What matters more is whether the average growth of the economy will rise or fall in the long term (potential growth improves or deteriorates from the current rate of 0-0.5%, in our view). Ultimately, whether Italian citizens will be happy to live and prosper in Italy is the only real benchmark that matters for the prosperity of the country and the sustainability of its public debt.

In the past two decades, Italian economic growth has been impaired by two key factors fundamentally: intensified competitiveness pressures on the industrial sector, coupled with a high debt burden of the non-financial corporate sector, which has translated into low investment, high capital outflows, modest profit growth and depressed wages (initially for

young workers or those with flexible contracts, and currently on average across age and experience level), and a steady rise in human capital emigration.

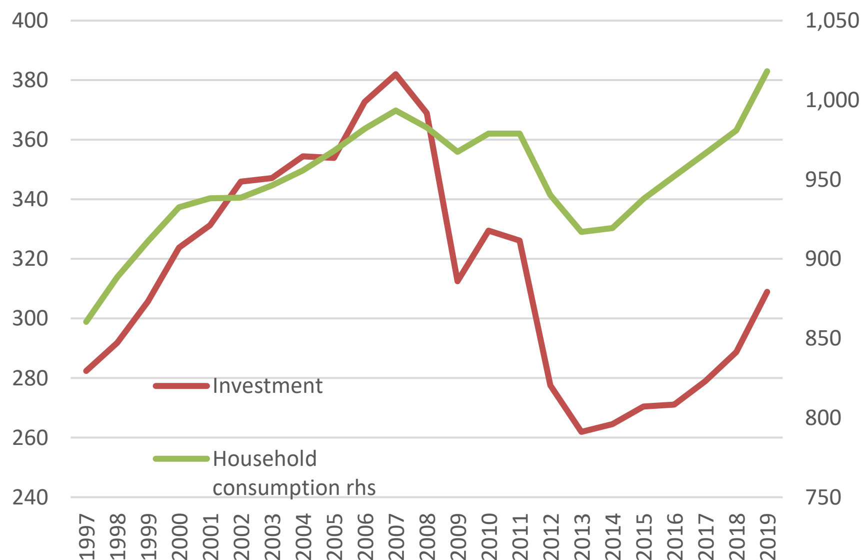
Nominal import and export performance, annual sums EURbn



Source: Eurostat, ADA Economics Ltd.

Looking at the structure of nominal GDP currently (on a four-quarter rolling sums basis) reveals that there is still a EUR70bn annual shortfall in investment relative to the recent peak reached in 2007, and probably as much as EUR200bn if the pre-crisis trajectory had not been reversed. Household consumption is past the previous peak, but much of the improvement appears correlated with a rise of imports, which is a further reason explaining the weak industrial performance of the past few years.

Nominal investment and household spending, annual terms EURbn



Source: Eurostat, ADA Economics Ltd.

Our impression is that Italians' confidence in Italy, on average, would improve under a centre-right government due to its fiscal plans and immigration strategy being closer to what a large share of the population wants. However, the proposal reported to the press of a dual-currency strategy or even an outright exit from the Euro area, although not genuinely viable in the short term, may feed into continuing weak household confidence in the long-term prospects of the country, and thus do little to reverse the capital outflow and brain drain, and may even accentuate it. Also, we believe that the centre right would invest too little in the services that ultimately matter to most people and which are related to the brain drain: justice, public healthcare and public education (at all levels), instead prioritising housing and pensions, plus with a high risk of making the public sector less efficient by once again changing the relative strength of the various levels of governments.

The impact of an M5 government is far less certain due to its experience level and little track record in practice, most likely a lot of policy noise, but it expects to be able to eventually follow a framework of regulatory and fiscal changes that would favour smaller companies, more transparent corporate governance at the private and public sector levels, and stronger support for a green economy and tourism. It is also likely to put greater pressure on publicly-owned companies to boost investments domestically. We have doubts on whether the party would genuinely boost the support for public healthcare and public education – two necessary conditions, in our view, to turn around the brain drain. Capital outflow may accentuate in the first part of the term as a result of the policy uncertainty.

In the case of another PD government, we suspect there will be no improvement in the long-term confidence in the country because, although the party has delivered some positive reforms for the long term and has some very constructive ideas, its track record of ultimate implementation is very weak (the simplification efforts are perceived to have complicated matters further; the "good school" effort has been heavily criticised across parties and lacks sufficient funds to be a material change; there are instances when people had to return the EUR80 support measure, or did not receive what they thought they were eligible for, and so on), which has generated strong disillusionment among the population. As PD promises virtually no changes, nor any explicit commitment to healthcare/education or family support, aside from the EUR80 measure, it is hard to see how the confidence of most citizens would change in the next few years.

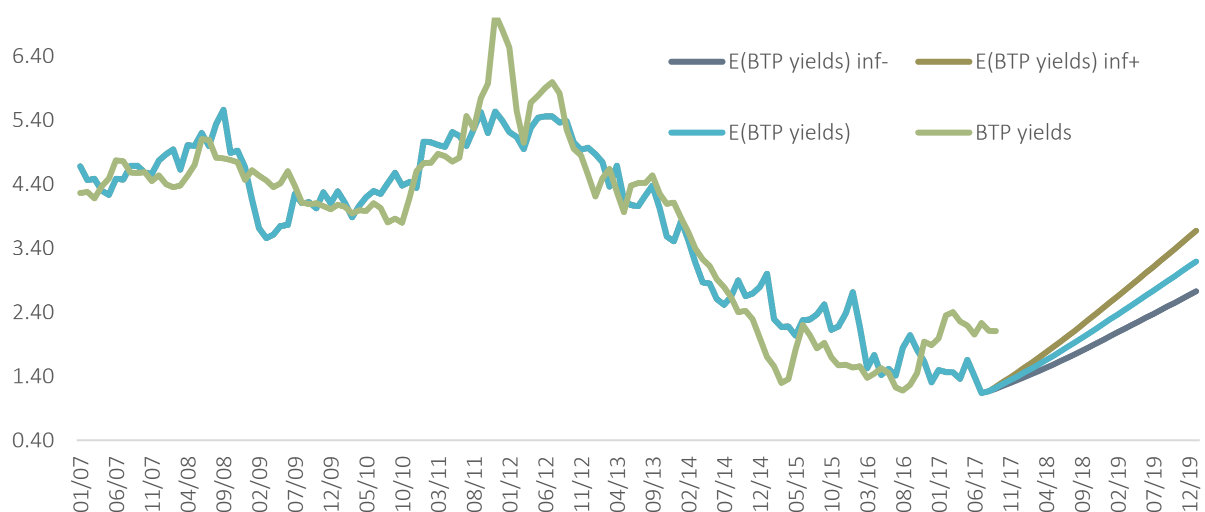
EU-scepticism is real, and why you should care

The field research we have conducted in the past year reveals that a very vast majority of voters across ages and income levels raised severe criticisms on the EU and the Euro, but less than one-third of people genuinely consider an exit from the Eurozone a good, or even viable, idea. In fact, the level of distrust towards those that promise a Euro-exit is so high that it could easily backfire during the campaign, much in line with what we observed during the French presidential elections in 2017.

That said, as we note above, whether the leader of a new government has a strong "vision" or not matters for a country in the long term, in our view. In our assessment, the Northern League and the 5-Star Movement have genuine reservations about Euro membership: the former is strongly convinced that the Euro is no longer in Italy's interests; and the latter is certain that the country must focus more on boosting well-being and if the Euro proves to be the bottleneck, then voters should be allowed to vote on its fate.

Euro membership is not going to be the focus for 2018 and 2019, in our view, in Italy, but intergovernmental negotiations about the future of the EU, including the fate of the EU budget post-Brexit, will start this year. As a result, in any case, from this year (except in a scenario where PD wins the next elections), Italy will no longer be an easy ally for France and Germany, going forward. Secondly, if the next Italian government does not feel that it has gained sufficient fiscal flexibility, especially at the time of the next business cycle downturn, genuine discussions about an exit are likely to resurface – regardless of whether a Euro exit appears to be a rational policy choice, an easy policy choice, or even a viable policy response.

Estimated 10-yr bond yield under various inflation scenarios



Source: CEIC, ADA Economics Ltd.

The outlined model has a fit of 86.5%, and the variables include FED assets, Italian and German CPI, as well as Italy's and Germany's debt/GDP ratios. The prediction for the central scenario assumes the normalisation of the balance sheet outlined by the FED in September 2017 (from USD 4.5trn today to USD 3.3trn dollars at the end of 2019), and the average expected inflation at 1.7% for Germany and 2.5% for Italy. In addition, the model keeps a balanced and conservative approach for Italy's and Germany's debt behavior, respectively. The alternative scenarios (inf- and inf+) show the yield sensitivity to a +/-1 change in inflation relative to the central scenario

Raffaella Tenconi, 16th January 2017

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