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Italy's elections: snapping back?

Fiscal outlook has deteriorated but 2018 repeat unlikely

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EXECUTIVE SUMMARY

- *Rising political risks have exacerbated an already challenging economic outlook for Italy. Ahead of the snap elections on 25 September, a right-wing coalition comprising the Brothers of Italy, Lega and Forza Italia is currently leading the polls and is likely to secure the parliamentary majority. However, with the more moderate Democratic Party polling at 23%, and possible post-election coalitions not clear yet, a certain degree of uncertainty lies over the outcome.*
- *Campaign pledges center on expensive fiscal spending, which could put already stretched public finances to the test. To add to this, NGEU-related reforms will require timely implementation to secure the funds.*
- *Downside risks to the fiscal outlook will increase if the new government "snaps back" to pre-Draghi fiscal profligacy. More spending to shield vulnerable households and firms from the energy-price shock is necessary.*
- *Current debt dynamics are improving due to high inflation (above 5% also in 2023), but stabilizing debt over the medium and longer terms will require more fiscal effort given the expected slowdown of economic activity; we now expect GDP contract by 0.5% in 2023. While we do not anticipate a repeat of the 2018 fiscal struggles, much will depend on the election outcome and the draft budget for 2023.*
- *Capital markets have not reacted strongly (given elections were expected at some point). The widening sovereign credit spread relative to the German Bund mostly reflects the general increase in interest rates rather than Italy's idiosyncratic risk.*

Right-wing coalition ahead in the polls

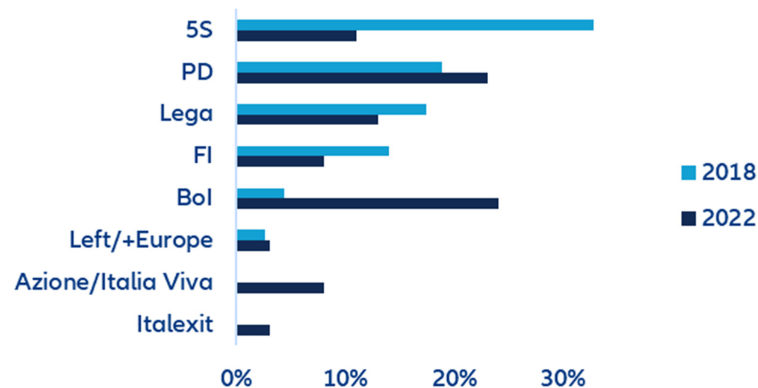
Italy will hold snap elections on 25 September, two months after the coalition government led by Prime Minister Draghi collapsed. The Five-Star Movement triggered the government crisis after withdrawing its support for the planned cost-of-living aid package (worth EUR20bn), which resulted in the coalition's right-wing parties Lega and Forza Italia abstaining from the subsequent confidence vote in the Italian Senate. The snap elections have been scheduled early instead of during the first semester of 2023 as previously envisaged.

The next government is very likely to be right wing, which could challenge the European agenda. The right-wing "Brothers of Italy" is leading the polls at 24%, followed by the Democratic Party (PD) at 23%, Lega (14%), Five-Star Movement (12%), Forza Italia and Azione + Italia Viva (both 8%) (Figure 1). A coalition formed by BoI + Lega + FI seems the more probable outcome (likely to obtain around 45% of the vote), which is likely to obtain an absolute majority

of seats in Parliament, according to the 2017 Italian electoral law[1]. However, the PD can negotiate some support from smaller centrist parties (Calenda's Azione and Renzi's Italia Viva), even though establishing lasting relationships has been more challenging, given the presence of far-left support parties. After having lost many MPs during the year, the Five-Star Movement is running alone, and possible alliances remain very unclear and difficult at the moment. Overall, the risk of a hung parliament cannot be ruled out, given the fragmented structure of Italian parties.

The uncertainty over the political direction has added to worries about Italy's deteriorating economic outlook. We expect a moderate recession starting in Q4 this year, resulting in an economic contraction of 0.5% in 2023 due to soaring energy prices (and broadening price pressures), coupled with deteriorating demand and plummeting confidence. Inflation will remain more persistent and average above 5% next year. Structural headwinds are likely to make for a shallow recovery towards the second half of 2023.

Figure 1: Italy – voting intentions (as of 6 September 2022)



Sources: various voting polls, Allianz Research

Energy crisis weighs on the fiscal outlook

A major concern is the potential for a significant departure from Italy's current fiscal plan. Even under baseline conditions, current crisis support will make it difficult for Italy to stabilize its debt level over the near term. To add to this, the campaign pledges could clash with European ambitions to reinstate fiscal discipline (Table 1). The spending proposals of the right-wing and anti-establishment parties in particular suggest looser fiscal policy, which could challenge Italy's compliance with the EU fiscal framework and, more generally, may lead to a more hostile stance against EU institutions. However, the pledges may not automatically translate into spending.

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[1] *Italy's electoral law stipulates a mixed system, with 37% of seats allocated using first-past-the-post approach. The remaining seats are based on the proportional method, with one round of voting.*

Table 1: Italy – overview of campaign pledges involving fiscally expensive measures

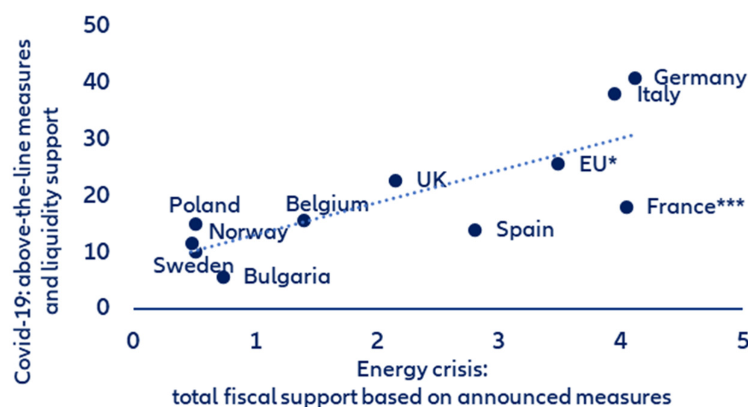
Party	Measure	Detail
Lega	Flat tax "Quota 41" retirement scheme	Extended up to EUR100k income 41 years of work as only requirement
Forza Italia	Minimum pension	Raise to EUR1,000 per month
Five-Star	Citizenship income "Superbonus" (110% tax credit)	Strengthening the scheme Making it permanent
Democratic Party	EUR10k bonus to people turning 18	Partially funded by inheritance tax

Sources: parties' electoral programs, Allianz Research

The 2023 draft budget to be submitted to the European Commission by mid-October will be the first litmus test; meeting the deadline could be a challenge (even if the ECB can approve an extension in case of elections). The budget will show whether the incoming government plans to roll back recently implemented policy initiatives (e.g. the increase in pension payments and lowered retirement age, universal income tax, tax amnesty). However, we expect the current government to initiate the work on the budget, which could provide a source of fiscal continuity.

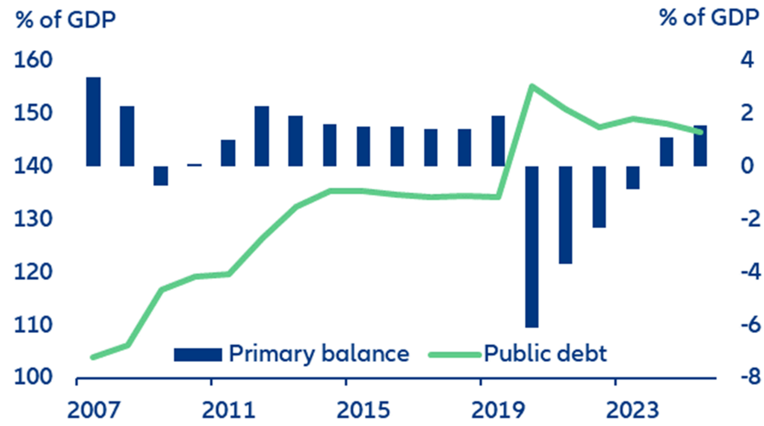
Sustained high energy prices pose additional risks to debt dynamics as further public support will be needed to shield households and businesses. Government support measures have already amounted to some 3% of GDP and fiscal policy is likely to remain supportive in 2023 (Figure 2). We expect the budget deficit to narrow only to 4.6% in 2023 (from 5.9% expected this year), with a limited impact of the proposed spending based on current electoral pledges on next year's finances. Current debt dynamics are improving due to high inflation, but fiscal efforts will be needed to stabilize debt as nominal effects decline. Risks will rise over the medium term as refinancing costs increase and real growth remains low.

Figure 2: Europe–fiscal support during Covid-19 and energy crises (% of GDP)



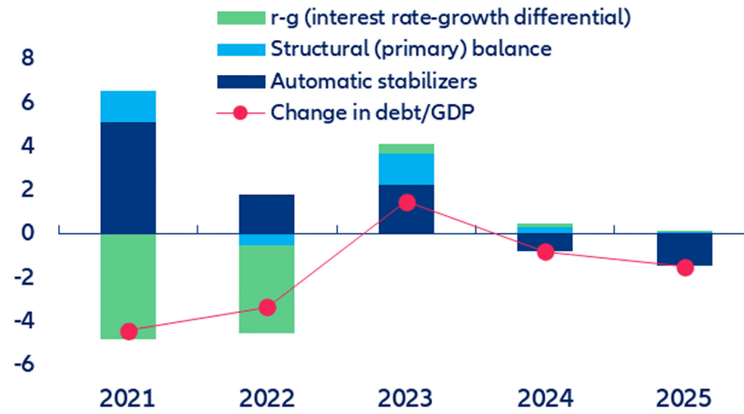
*Sources: national authorities, IMF, Allianz Research. Note: */ EU is approximated as the GDP-weighted average of the sample countries.*

Figure 3: Italy – primary fiscal balance (until 2025)



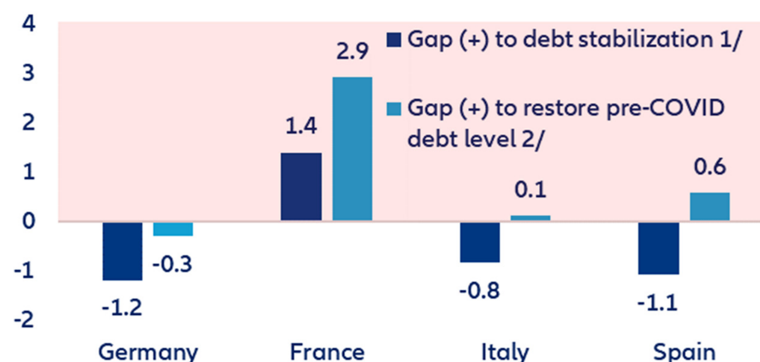
Sources: Refinitiv, Allianz Research

Figure 4: Italy – decomposition of changes in government debt (baseline scenario, % of GDP)



Sources: IMF, Refinitiv, Allianz Research. Note: r=real interest rate, g=real GDP growth.

Figure 5: Italy – required fiscal adjustment to achieve debt sustainability (baseline scenario, % of GDP)



Sources: IMF, Refinitiv, Allianz Research. Note: a positive value indicates that more fiscal adjustment is needed to achieve debt stabilization and restore pre-Covid debt levels.

NGEU commitments: a crucial test for the new government

The end of Draghi's government could also cast doubt on the efficient spending of Next Generation EU (NGEU) funds and the effective implementation of structural reforms. Italy is set to receive EUR191.5bn in the coming years (26.5% of total NGEU funds and 10.7% of Italy's 2021 GDP) in grants and loans from the Recovery and Resilience Facility (RRF). An additional EUR30.6bn from national resources has also been allocated to help the Italian recovery.

Potential implementation challenges might delay important infrastructure investment, including in greening Italy's economy. So far, Italy has received only 24% of available EU resources under the NGEU (13% in the form of pre-financing and a first payment). An additional nine payments each for grants and loans are expected. However, they will depend on the progress made in implementing the plan. The next disbursement is scheduled for December 2022 for the requested amount of EUR21bn. This second payment application relates to 45 milestones (qualitative) and targets (quantitative) covering several reforms, including in the areas of public administration, public procurement, tax administration, education and territorial healthcare, as well as investments in ultra-broadband and 5G, tourism and culture, hydrogen, urban regeneration and the digitalization of schools. These are crucial reforms in areas where investment efficiency has been traditionally low, making the H2 agenda vital for the implementation of the RRP. All in all, snap elections only add to existing fears around the outlook, given that concerns over the country's administrative capacity and spending ability were already deep-rooted (as proved in recent years with the use of resources from the European Structural Investment Funds (ESIF)). However, a U-turn in investment intentions is not foreseen at this stage.

A new right-wing government could also decide to amend the current (and approved) Recovery and Resilience Plan as mentioned in the electoral program, leading to procedural delays and time-consuming re-negotiations. This situation could worsen if the discussion with EU institutions becomes confrontational again (like in 2018 with the Lega), provoking further anxieties in financial markets. In addition, a hung parliament could add further challenges to the NGEU agenda and related disbursements.

On a positive note, all the campaigning parties have committed to pursuing the objectives linked to the NGEU and to allocate the resources in a timely manner. All parties agree on the NGEU as a unique opportunity to reinvigorate Italy's economy and kick off a period of more sustained growth. Moreover, the Draghi government is expected to manage the RRP advancements and make implementation progress until the new government is set up, possibly gaining some precious ground before a likely period of slower implementation. Also, the ECB's new anti-fragmentation tool, the Transmission Protection Instrument (TPI) announced in July, could be a source of continuity. The TPI has been introduced to ensure a smooth transmission of monetary policy across all Eurozone countries, after initial fears over fragmentation. The eligibility criteria (although not binding) to access the TPI requires countries to comply with their commitments submitted in the RRP, together with the EC country-specific recommendations.

Mild financial market reaction so far

The evolving political situation in Italy will also have a significant impact on potential fragmentation risk in the Eurozone. The ECB's tightening monetary stance has increased refinancing costs due to rising sovereign debt yields.[2] Italy has been particularly affected due to its fiscal imbalances. While the risk profile of Italian government debt underpinning the yield curve contains a default risk premium, much like German Bunds, it is also influenced by redenomination risk (i.e. the implied foreign exchange risk if Italy exits the Eurozone). An excessive widening of Italian sovereign spreads can impede the efficient transmission of monetary policy and thus undermine financial stability ("fragmentation risk").

The market reaction has been fairly restrained because elections did not come as a surprise and anti-establishments parties have calmed down their tone. Compared to the 2018 elections, when a vocal Eurosceptic stance kept the electoral campaign busy, 2022 is likely to elicit a more moderate market reaction. The recent widening of Italian spreads is mainly reflecting the general expectations of rising interest rates rather than higher idiosyncratic risk linked to Italy's snap elections, much less an "Italexit" (Figure 6).[3] Over the last three months, Italian yields increased by more than 200bps to 385 bps (as of early September), largely driven by a repricing of the risk-free rate in response to tightening monetary policy (180bps). The risk premium only increased by 60bps, suggesting that the current divergence has not caused fragmentation that could evolve into a systemic crisis. However, if left unaddressed, rising denomination risk could become more probable.[4] This has promptly raised concerns over fragmentation risk within the Eurozone, but the TPI announcement and the reinvestment flexibility of the PEPP have helped to counter fragmentation fears.

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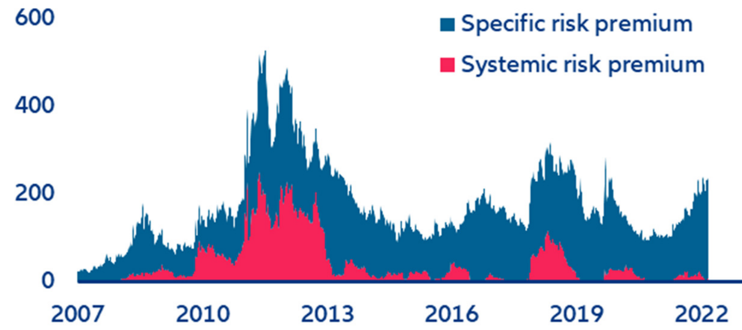
[2] *Governments with weaker fiscal positions already face higher refinancing costs as the end of quantitative easing leaves more sovereign debt in private hands, imposing greater market discipline on debt sustainability.*

[3] *This contrasts with the experience during the European sovereign debt crisis, when fragmentation was largely caused by redenomination risk as rising concerns over a Eurozone break-up resulted in cross-border flows from "vulnerable" to "safe" sovereigns. Redenomination risk explained half of the 250 bps yield increase in 10y Italian government bonds while the risk-free rate (10y Bund) fell by 100bps. The decoupling of yield movements due to spread widening "from below" indicated systemic stress.*

[4] *For instance, the redenomination risk for Italy usually appears when the 10y default risk premium reaches 250bp (currently at 180bps).*

Figure 6: Italy-Decomposition of the sovereign risk premium



Sources: Refinitiv, Allianz Research. Note: based on variance decomposition.

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