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Special Commentary

Jay H. Bryson, Global Economist
jay.bryson@wellsfargo.com • (704) 410-3274
Abigail Kinnaman, Economic Analyst
abigail.kinnaman@wellsfargo.com • (704) 410-1570

A Pre-Election Primer on the Italian Economy

Executive Summary

Real GDP in Italy is finally growing again at a solid rate, but the economy remains more or less depressed with the unemployment rate elevated and economic output still 6 percent below its 2008 peak. Italy must hold a general election by May 20, and the populist/anti-establishment/Eurosceptic message of the Five Star Movement (5SM) has resonated with some voters. A date has not yet been set for the election, but polls show that the 5SM would do well if the election were held today.

We have written this primer on the current state of the Italian economy to give readers a prism through which to view some of the issues that confront voters in Italy. We are not predicting that a victory by the 5SM in the Italian election, should that occur, will necessarily lead to "Italexit." However, readers should be prepared for potential financial market volatility if the 5SM were to win a plurality, let alone a majority, of seats in the upcoming election.

Despite Decent Growth Recently, the Economy Remains Depressed

The last general election in Italy was held in February 2013. The tenure of the parliament that was seated after that election ends on March 15, 2018, and the next general election must be held by no later than May 20, 2018. Although a date has not yet been set for the next election, it obviously needs to occur in the next few months. We are writing this primer on the current state of the Italian economy to give readers a prism through which to view some of the issues that confront voters in Italy.

Economic recovery is underway in Italy.

For starters, an economic recovery is underway in Italy. On a sequential basis, real GDP growth has been positive for 13 consecutive quarters. On a year-ago basis real GDP was up 1.8 percent in Q3-2017, the strongest growth rate in more than six years (Figure 1). Real GDP growth in Italy is more or less back to the run-rate that was registered in the years leading up to the global financial crisis. That said, the extraordinarily low rate of inflation—CPI inflation averaged only 0.1 percent per annum between 2014 and 2016—means that growth in nominal GDP is still slow relative to the standards of the past decade.[1]

This lack of inflation suggests that the economy is operating well below potential. Indeed, the level of real GDP in Q3-2017 remained about 6 percent below its Q1-2008 peak. The Italian economy fell into a deep hole during the Great Recession, and the pain was compounded in 2011 through 2013 by the European sovereign debt crisis. At its depth in early 2013, the Italian economy was nearly 10 percent smaller than it had been five years earlier. The economy has been growing continuously since mid-2014, but it has not yet emerged from the deep hole into which it fell. In short, the Italian economy remains depressed today.

[1] **Inflation has picked up this year due, at least in part, to the rise in energy prices. But the core rate of inflation, which excludes energy and some other goods with volatile prices, was up only 0.5 percent in October.**

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

Figure 1

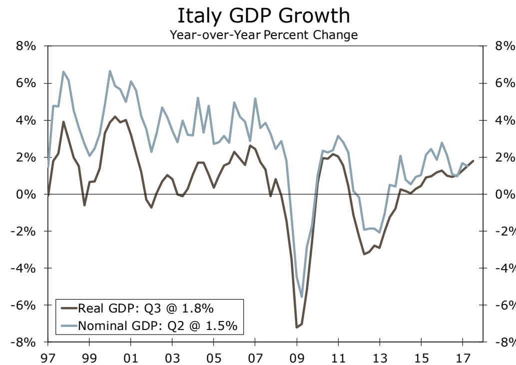
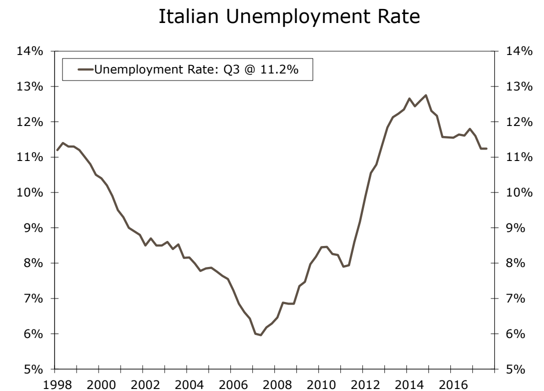


Figure 2



Source: IHS Global Insight and Wells Fargo Securities

The unemployment rate remains elevated.

The depressed nature of the economy also shows up in the labor market. The unemployment rate has drifted lower in recent quarters, but it remains elevated at more than 11 percent (Figure 2). Moreover, the national rate of unemployment masks large regional differences. The unemployment rate in northern Italy is currently around 7 percent, but it stands near 20 percent in the southern part of the country. High unemployment is one factor that is fueling some of the frustration that voters in Italy are experiencing heading into the next election.

Government Finances Are Sustainable, For Now

The debt-to-GDP ratio has stabilized at a high level.

In the years before the global financial crisis, the debt-to-GDP ratio of the Italian government trended down from about 110 percent in 2000 to roughly 100 percent in 2007 (Figure 3). However, the ratio shot up markedly when Italy began to experience economic weakness. Not only did the deep recession cause nominal GDP to contract, which reduced the denominator in the debt-to-GDP ratio, but the fiscal deficit widened significantly as economic weakness caused tax revenues to nosedive. The debt-to-GDP ratio has stabilized in recent years, but it remains elevated today at more than 130 percent. Next to Greece, Italy has the highest government debt-to-GDP ratio among the 19 individual economies in the Eurozone.

Figure 3

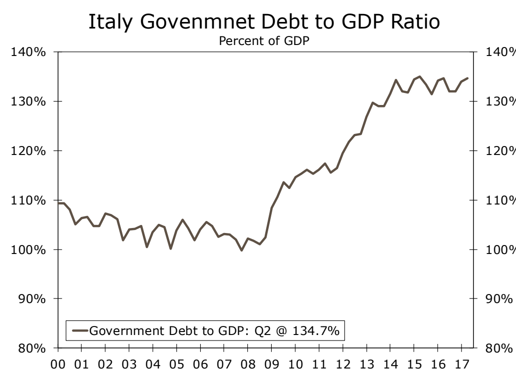
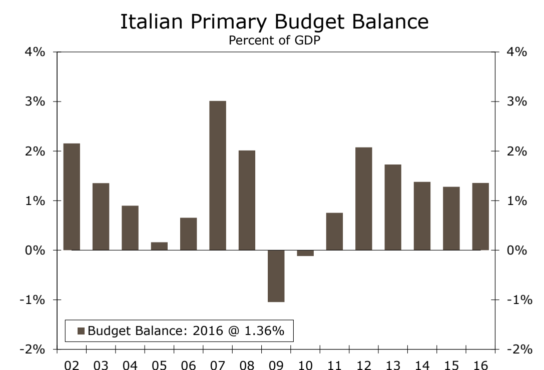


Figure 4



Source: IHS Global Insight, International Monetary Fund and Wells Fargo Securities

The stabilization in the debt-to-GDP ratio reflects three factors. First, the rebound in nominal GDP is causing the ratio's denominator to rise again. Second, the fall in borrowing costs over the past few years—the yield on the benchmark 10-year government bond has dropped from about 4 percent at the beginning of 2014 to less than 2 percent at present—is holding down the

government's interest expenditures. Third, the Italian government has done a good job in balancing its books in recent years. As shown in Figure 4, the government's primary budget balance, which measures the budget balance less interest payments, has been in surplus for six consecutive years. If nominal GDP growth remains solid, if borrowing costs remain low and if the government continues to maintain fiscal rigor, then the debt-to-GDP ratio should recede in coming years.[2]

The Downside Risk Inherent in the Italian Election

The election has the potential to disrupt the debt dynamics of the Italian government.

But therein lies the rub. The looming Italian election has the potential to disrupt the debt dynamics of the Italian government through at least one of the three channels just noted. Polls show that the 5SM would do well if the election were held today. The party's populist/anti-establishment/Eurosceptic message has resonated with many Italians in recent years due, at least in part, to the depressed nature of the economy. Although the 5SM may not win enough parliamentary seats to be able to form the next government by itself, it likely would receive an invitation from President Mattarella to form a government in coalition with other parties if it wins a plurality of seats.

The 5SM has been critical of EU budget rules and it has called for more public investment, so fiscal rigor does not seem to be high on its list of priorities. In other words, the budgetary position of the Italian government could deteriorate if the 5SM were to come to power. Smaller fiscal surpluses, if not outright deficits, would put upward pressure on the government debt-to-GDP ratio, everything else equal.

The party's anti-EU rhetoric would likely cause some investors to fret that the 5SM could eventually put Italy on a path to exit the Eurozone and the European Union. Any path to "Italexit" would take years to realize, but investors would react to that possibility immediately. The yield on the 10-year government bond in Italy moved higher during past episodes of investor angst about the future of the Eurozone. The selloff was especially acute during the first episode in 2011, but yields rose markedly in 2015, when Greece stared into the abyss of "Grexit," and again in 2016 when investors fretted about the health of the Italian banking system (Figure 5). Higher borrowing costs for the government would push up its debt-to-GDP ratio, everything else equal, via more interest expenditures.

Figure 5

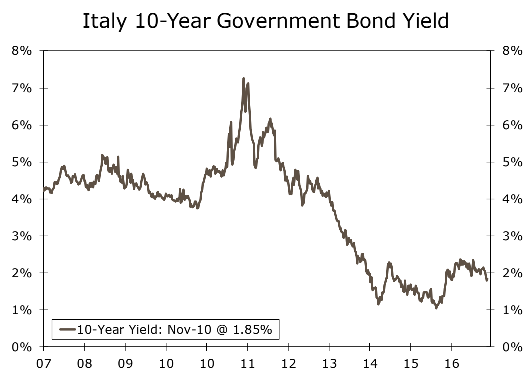
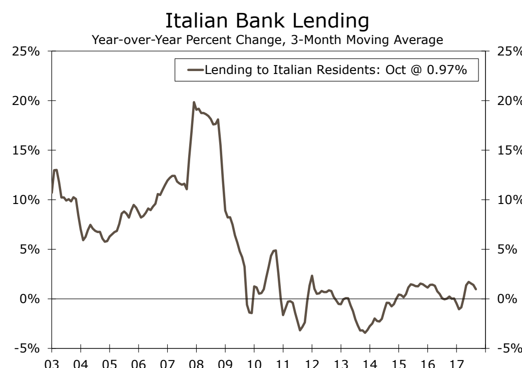


Figure 6



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

[2] **In its most recent *World Economic Outlook*, the IMF forecasts that the government debt-to-GDP ratio in Italy will decline from 132 percent at present to 120 percent in 2022. We discussed debt dynamics in Italy in "Is the European Sovereign Debt Crisis Solved?" (January 27, 2014). This report is available upon request.**

A negative feedback loop could be set in train.

If bond yields shoot up high enough, a negative feedback loop could potentially be set in train. Higher bond yields imply lower bond prices. Italian banks currently hold about €375 billion worth of Italian government bonds, which represents roughly 10 percent of their assets. A significant decline in prices of Italian government bonds would weaken the balance sheets of Italian banks, which could make them more reluctant to extend credit. Bank lending is growing again in Italy, but only barely (Figure 6). A renewed downturn in bank lending in Italy would surely have a negative effect on Italian economic growth. Slower economic growth would lead to wider fiscal deficits, everything else equal. Investors would then begin to fret about the long-run sustainability of Italian government debt, which would push up bond yields further, leading to even slower economic growth, etc.

Who Catches a Cold if Italy Catches the Flu?

If Italy were only a tiny economy then the above scenario, which admittedly may be a worst-case scenario, would hardly matter for the global economy. However, Italy is the third-largest economy in the Eurozone, and it currently ranks among the top 10 largest economies in the world. Are there any particular countries that could potentially be hurt if the Italian economy were to encounter significant weakness again?

Greece and Slovenia have extensive export exposure to Italy.

One channel through which renewed economic weakness in Italy could spill over to other countries is through the extensive trade ties that Italy has with other countries in the euro area. Among individual economies in the Eurozone, Greece has the most relative export exposure with about 11 percent of its total exports destined for Italy (Figure 7). Greece is followed closely by Slovenia, which borders Italy, with a ratio at roughly 10 percent.

The Greek economy, which is more than 25 percent smaller today than it was at its peak 10 years ago, could ill afford another economic downturn in Italy. Slovenia has enjoyed strong economic growth over the past two years, but real GDP in that country is still 3 percent short of its 2008 peak. The Slovenian economy would also be negatively affected by significant economic weakness in Italy. France sends about 7 percent of its exports to Italy, and the comparable ratio for Germany is close to the Eurozone average of 5 percent. These large European economies would "feel" an economic downturn in Italy, but they would probably not slip into recession themselves unless the Italian economy completely imploded.

Figure 7

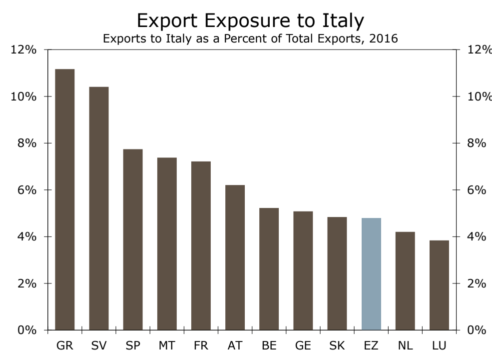
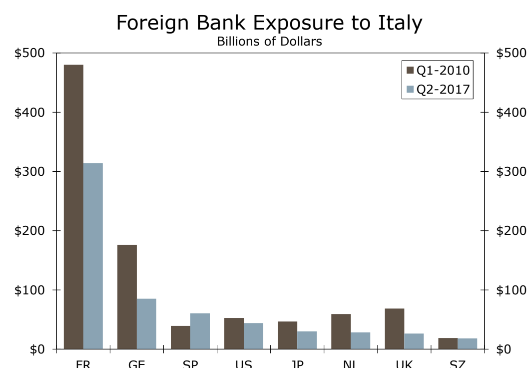


Figure 8



Source: IHS Global Insight, Bank for International Settlements and Wells Fargo Securities

Another way in which foreign economies could be exposed to a renewed downturn in the Italian economy is via bank exposure. Foreign bank exposure to Italy totaled about $1 trillion in early 2010 before the European sovereign debt crisis really started to heat up. Subsequently, foreign banks have become more circumspect in making commitments to "peripheral" European countries. Foreign bank exposure to Italy has trended lower over the past seven years and currently stands at roughly $600 billion.

Among individual economies, the French banking system clearly has the most at stake with more than $300 billion worth of outstanding commitments to Italian businesses, households and government (Figure 8). This absolute amount of bank exposure to Italy is a big number, but it is equivalent to only 3 percent or so of French banking system assets. German banks currently have $85 billion on the hook to Italy, but this amount represents only 1 percent of the assets of the German banking system. U.S. bank exposure to Italy is paltry at $44 billion (0.3 percent of assets). In short, some economies (e.g., Greece and Slovenia) could experience some economic and/or financial difficulties if Italy were to experience significant economic weakness. However, the larger economies in the Eurozone, such as Germany and France, appear to have more limited degrees of exposure to Italy.

France has the largest amount of foreign bank exposure to Italy.

Moreover, there could be policy responses to any post-election financial market tensions that could limit the economic fallout. Under the leadership of Mario Draghi, the ECB has proven to be adroit with its policy responses to bouts of financial market volatility that have arisen during past episodes of the European sovereign debt crisis, and European political leaders have come up with their own solutions, if only slowly. In that regard, the European Stability Mechanism (ESM), an organization that was capitalized by European countries five years ago to provide lending support to crisis-hit countries, currently has a lending capacity of €376 billion. That is, the ESM has significant lending ability available, should Italy need it.

There could be a policy response to financial market volatility.

Conclusion

There is good news as well as bad news in Italy. On a positive note, real GDP is currently growing at its fastest rate in more than six years and measures of business and consumer confidence stand near multi-year highs. On the other hand, however, the double whammy of the global financial crisis and the subsequent European sovereign debt crisis caused the Italian economy to fall into a deep hole so that the level of real GDP still remains well below its 2008 peak. The message of the populist/anti-establishment/Eurosceptic 5SM has resonated with many frustrated voters. Polls show that the 5SM would do well if the next general election, which must be conducted before May 20, were held today.

The yield spread on the 10-year Italian government bond over its German counterpart, which moves up and down as risk aversion waxes and wanes, has trended lower in recent weeks, suggesting that investors are not focused on the Italian election at present. But sooner or later the government will need to set a date for the next election, and when it does investors could very well begin to focus on potential political uncertainty in Italy. We are not predicting that a victory by the 5SM in the Italian election, should that occur, will necessarily lead to “Italexit.” However, readers should be prepared for potential financial market volatility if the 5SM were to win a plurality, let alone a majority, of seats in the upcoming election.

Wells Fargo Securities Economics Group

Name	Title	Phone	Email
Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
E. Harry Pershing	Economic Analyst	(704) 410-3034	edward.h.pershing@wellsfargo.com
Hank Carmichael	Economic Analyst	(704) 410-3059	john.h.carmichael@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

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