20 July 2022

# Flash comment

## Italy is falling back into old habits

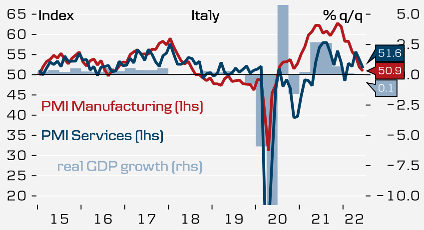
**Italy has been plunged into a new government crisis**, after three of the four biggest parties of Mario Draghi's unity government (Five Star Movement, League and Forza Italia) announced they would not support him in a confidence vote. For the past 18 months, Draghi has served as a rare unifying force in Italian politics and has overseen the implementation of important structural reforms (e.g. in the justice system) that are a pre-requisite to receive NGEU funds. If no alternative parliamentary majority can be formed – which currently seems unlikely – President Mattarella would likely have to call for early elections (possibly held on 25 September), just as the crucial budget season is kicking off in autumn. With the exception of Brothers of Italy, early elections are not in the interests of most parties and as a result of recent constitutional changes, lower and upper house seats will be reduced by a third after the next election. Based on current polling, a centre-right coalition led by Brothers of Italy might be the most likely outcome in our view, although a lot could still change once the election campaign gets underway.

**While Italy has a tradition of recurrent political turmoil, the government crisis could not have come at a worse time.** The economy has lost momentum at the end of Q2 and a drought is putting one-third of agricultural production at risk. Renewed political uncertainty, coupled with tighter financial conditions and persistently high inflation, risks weighing further on investments and consumption. Despite recent diversification efforts, Russia still supplies 25% of Italy's gas (down from 40% since the start of the year), and a complete Russian gas cut-off could lead GDP to decline by 2-3% next year (according to *Bank of Italy* and *IMF* estimates). Overall, we see the recession risk increasing for H2 22. The political crisis also has negative repercussions for Italy's long-term growth prospects, as structural reform implementation will likely slow down, in the worst case even endangering continued NGEU disbursements (*EUR145.5bn still outstanding*).

**A renewed spike in yields could reignite market fears about a looming Italian debt crisis**. The debt to GDP ratio stands at 150% of GDP and neither the *Italian Finance Ministry* nor the EU Commission expect Italy to run a primary surplus before 2025. While Italian borrowing costs remain below levels seen during the Eurozone crisis or the 2018/19 government crisis, it would not take much in terms of yield rise to bring the debt ratio to a dangerous upward-sloping trajectory (see chart on the right), especially if potential growth remains stagnant. That said, the country has succeeded in lengthening the average maturity of its outstanding debt to c.7.7 years, giving it at least some breathing space to address adverse public debt dynamics, before rollover risk becomes a concern.

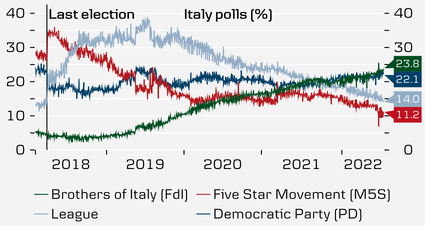
**If early elections are called, we would expect further underperformance of Italian government bonds as well as the EUR.** We see scope for BTP-Bund spreads widening to 250-260bp, but expect them to remain below 2018/19 crisis levels, as Euroscepticism has been toned down. Pressure on the ECB to limit a blowout in peripheral spreads will likely increase in the near term in our view. However, bond buying under the new *Transmission Protection Mechanism* would still be tied to conditions. We doubt the ECB would cap spread widening if it ultimately reflects dimming growth prospects and rising fiscal vulnerabilities, especially if the political situation should turn more EU hostile.

### Economy is already slowing



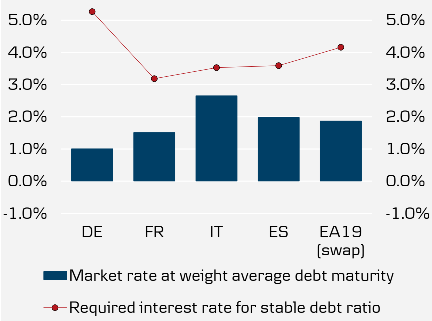

*Source: Markit, Eurostat, Macrobond Financial, Danske Bank*

### Five Star has lost support in the polls




*Source: Macrobond Financial, Danske Bank*

### Further rise in Italian yields could reignite debt crisis fears in the market




*Source: Bloomberg, Macrobond Financial, Danske Bank*

*Note: Past performance is not a reliable indicator of current or future results.*

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