Political uncertainty adds to Italy's banking sector and public debt challenges in 2018

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1. Introduction

2018 is an important year for Italy. At the moment, the economy is doing relatively well. Dragged along by the global upswing and booming European neighbours, growth is likely to be considerably above potential. However, there are well-known problems which should be resolved while the going is good. First, the banking sector remains troubled despite recent encouraging progress. The share of non-performing loans to total loans is improving but remains a clear vulnerability. Second, efforts to reduce Italy's towering public debt are very slow.

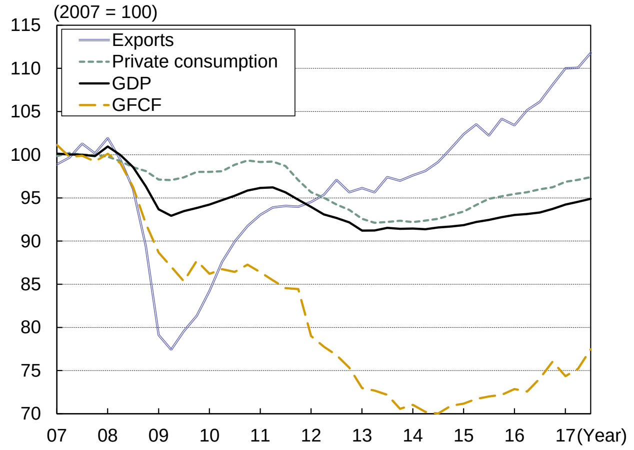
These two issues would be daunting enough under normal circumstances, but they are compounded by political uncertainty. Italy will hold a general election on 4 March 2018. The polls are neck-and-neck between the ruling Democratic Party and the Populist newcomers Five Star Movement. Berlusconi's Forza Italia is bearing down on them along with some possible allies (recent election reform means coalition building is more important). A hung parliament looks likely. This could be followed by a weak minority government or a fractious coalition.

Either scenario would make ambitious structural reforms to the banking sector less probable. Nor would we likely see any meaningful reduction to the public debt stock. Even in the absence of further fixes, both problems will steadily improve if economic activity remains firm (and we are cautiously optimistic over the near-term). But a downturn could be severe for Italy. Public debt, very unlikely to fall below 115% of nominal GDP over the next five years, could balloon as growth slows, interest rates rise and the primary surplus becomes a deficit (on a non-cyclically adjusted basis, the primary balance fell from a surplus of 2% of nominal GDP in 2008 to a deficit of 1% in 2009). Costly banking sector recapitalisations would be necessary but scarcely affordable.

2. An economy on the mend

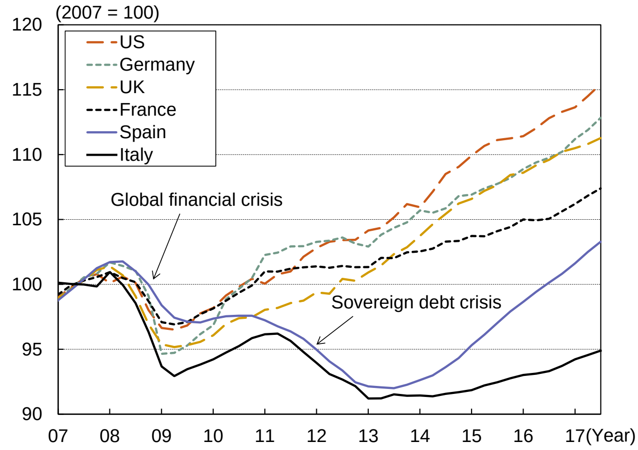
The Italian economy's recovery is taking some time. Real GDP remains below the pre-Global Financial Crisis (GFC) level, weighed down by a collapse in gross fixed capital formation (GFCF) (chart 1). This looks especially dire when compared to peers (chart 2), and headwinds from weak productivity and challenging demographics suggest a quick turnaround is unlikely.

Chart 1: Real GDP and Expenditure Components



Source: Eurostat, BTMU Economic Research Office

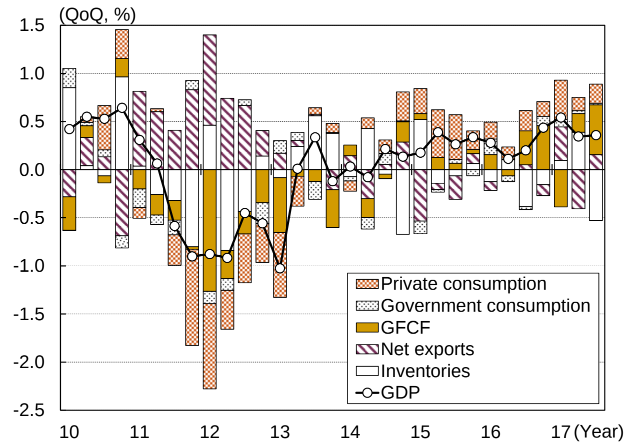
Chart 2: Real GDP Recoveries



Source: OECD, BTMU Economic Research Office

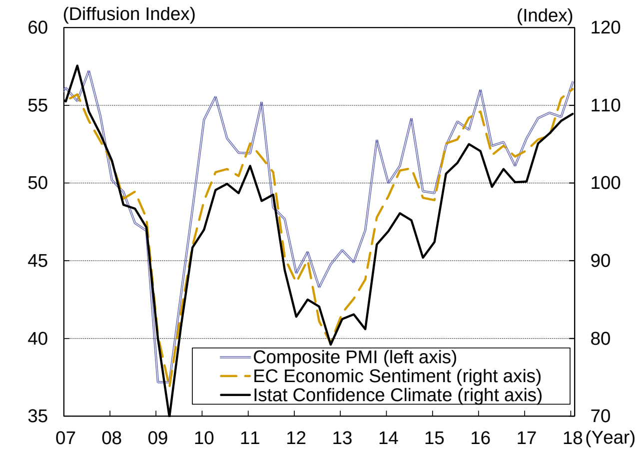
However, against that background, there have been positive signs of late. Real GDP grew by 0.4% QoQ, or 1.7% YoY in Q3 2017 (chart 3). This was revised down from an initial estimate of 0.5% QoQ, but the breakdown by expenditure component is encouraging. There was a notably strong 0.5pp contribution from gross fixed capital formation, while the only drag came from inventories and is likely to be reversed in Q4. There was no sign of a slowdown in economic activity in Q4 2017 with business surveys at very high levels (chart 4). The composite PMI, at 56.5 in December, is well above the long-term average of 52.2. The manufacturing component is even higher, pointing to the strongest growth since early 2011, while the Istat Business Confidence gauge is at its highest since 2007.

Chart 3: Real GDP Growth by Expenditure Component



Source: Istat, BTMU Economic Research Office

Chart 4: Italian Business Surveys



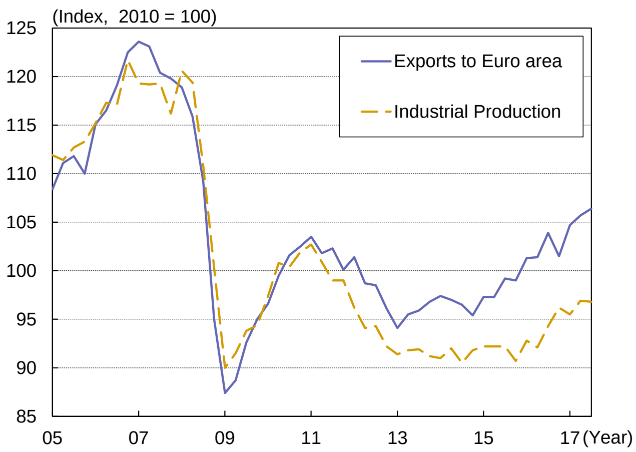
Source: EC, Istat, IHS Markit, BTMU Economic Research Office

Hard data is reflecting this buoyant sentiment, especially in the manufacturing sector. Industrial output grew by 2.7% YoY in the three months to November. Retail sales are a little more disappointing but inflation remains low (0.9% YoY in December) so there is scope for some improvement in real wages and an accompanying modest boost to consumption.

Hiring intentions are also looking healthy, reflecting a slowly improving labour market. While unemployment remains relatively high at 11.0% in November 2017, it has steadily decreased from 11.9% a year previously. Total employment is almost back at the early 2008 peak (but we note this is driven by older workers – the picture for under-30s remains bleak). While the economic news flow is positive for Italy, it is disappointing when compared to euro zone peers. The German economy is motoring along (0.8% QoQ real GDP growth in Q3 2017, matched by Spain, with France not far behind).

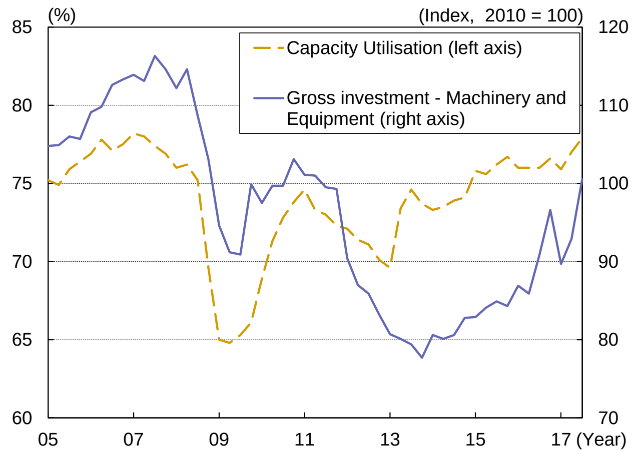
Against the backdrop of the synchronised global expansion, exports, which are still weak, could pick up. This will likely be driven by European demand (the recent euro strength is a particular headwind for Italy which is less competitive than peers such as Spain due to high unit labour costs). Higher external demand may help the Italian economy more generally. Italy is still the second largest manufacturer in the euro zone, behind Germany, despite years in the doldrums. Now, it seems industrial production is finally bottoming out (chart 5). Capacity utilisation has risen steadily to 77.9% in Q3 2017 (chart 6). There are already signs of higher fixed capital formation, and if strong external demand persists then we could see a meaningful pick-up in investment.

Chart 5: Industrial Production and Exports to Euro Area



Source: Istat, Eurostat, BTMU Economic Research Office

Chart 6: Capacity Utilisation and Machinery Investment



Source: Istat, BTMU Economic Research Office

Indeed, forecasters are becoming ever more confident that the upturn is sustainable. The Consensus forecast for real GDP growth in 2017 was 0.7% YoY at the start of the year, but this improved to 1.5% by December. 2018 forecasts have also improved (0.9% in January 2017 to 1.4% YoY in the Janaury 2018 release). These numbers would be well above potential growth, which the Italian Treasury estimates at 0.5% in 2018.[1]

[1] See Italy's Draft Budgetary Plan for 2018 (http://www.rgs.mef.gov.it/_Documenti/ENGLISH-VE/Public-Fin1/DBP/2017/DRAFT_BUDGETARY_PLAN_2018.pdf). The Treasury estimates that potential GDP YoY growth will increase gradually from 0.4% in 2017 to 0.7% by 2020.

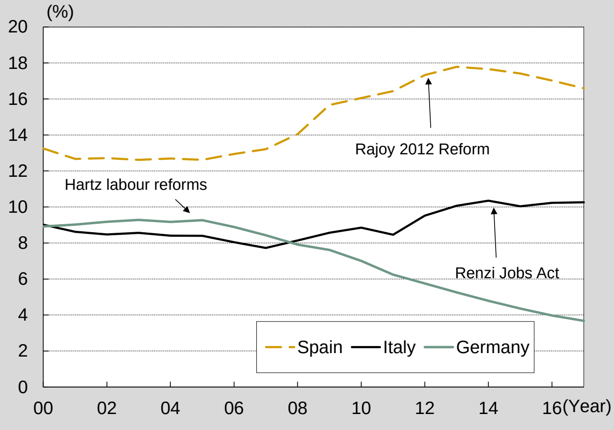
Box 1: Italian Structural reforms

When Mario Draghi, the ECB president, read out his introductory statement at the most recent monetary policy press conference he ended with his usual plea for more support from fiscal and structural reforms. This time, it felt as though he could have been speaking to his native Italy in particular when he said "The implementation of structural reforms … needs to be substantially stepped up **to increase resilience, reduce structural unemployment and boost euro area productivity and growth potential**. Regarding fiscal policies, the increasingly solid and broad-based expansion strengthens the case for rebuilding fiscal buffers … **particularly in countries where government debt remains high**." We cover public finances later in this report, but below is a discussion of some of the structural measures that may help boost productivity and potential growth:

- A 'National Industry 4.0 Plan' was launched in summer 2017 which gives tax incentives for private investment. Start-ups and innovative small businesses are offered extra perks. Higher investment should help to improve productivity.

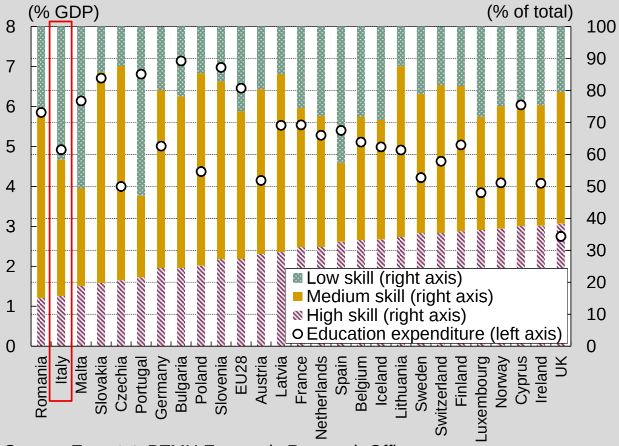
- A Jobs Act was pushed through by then PM Renzi in late 2014. This made it easier for firms to fire workers on permanent contracts, enhanced unemployment benefits, and enhanced administration for active labour market policies. This was based on the so-called Hartz reforms in Germany which have been very successful (it seems remarkable now that a decade ago the Italian unemployment rate was well under the German equivalent). Public opposition and union pressure has meant that the measures have been watered down (public sector workers are excluded, and it did not apply to those already in work), so there is scope for more to be done. And, as chart A shows, it can take several years for labour reform to filter through and affect the jobs market (estimates for NAWRU, the non-accelerating wage rate of unemployment, are used as a proxy for the structural unemployment rate).

Chart A: NAWRU Estimates



Source: European Commission, BTMU Economic Research Office

Chart B: Skill Levels and Education Expenditure



Source: Eurostat, BTMU Economic Research Office

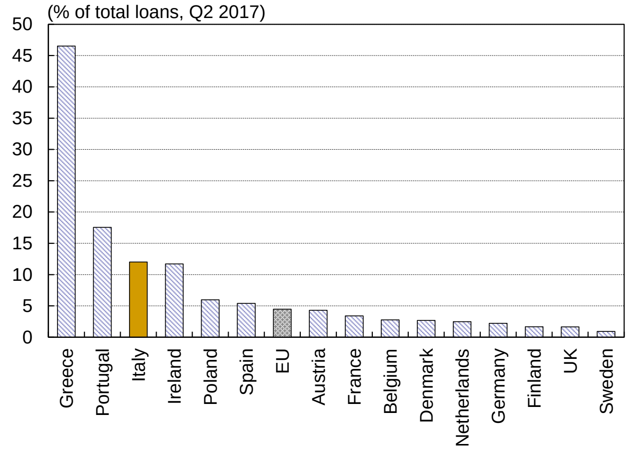
- Lastly, as chart B shows, Italy has the smallest share of highly skilled workers in the EU, behind Romania – and relatively low expenditure on education (in % of nominal GDP). More investment would help with the productivity problem, improve young persons' prospects and boost the long-term outlook against challenging demographic headwinds.

3. More work to be done to fix the banking sector

The double-dip downturn between 2008 and 2014 left Italian lenders' balance sheets severely damaged. The high profile concern is the amount of non-performing loans (NPLs). [2] The flow of new NPLs rose gradually in the wake of the 2008 GFC (initially, the Italian banking sector held up relatively well in comparison to European peers and less state support to banks was required). The NPL ratio then rose further after the 2011 sovereign debt crisis. The Bank of Italy suggests that "inadequate or illegal lending policies" exacerbated the problem, and "the lengthy credit recovery procedure" disincentivised loan write-offs. The result is that Italy now has one of the highest NPL ratios in the EU (chart 7). In June 2017, 12% of total loans (€199.7bn) were classed as non-performing, according to the European Banking Authority (EBA). Most of these loans are to non-financial corporations (NFCs), and in particular manufacturing and construction firms.

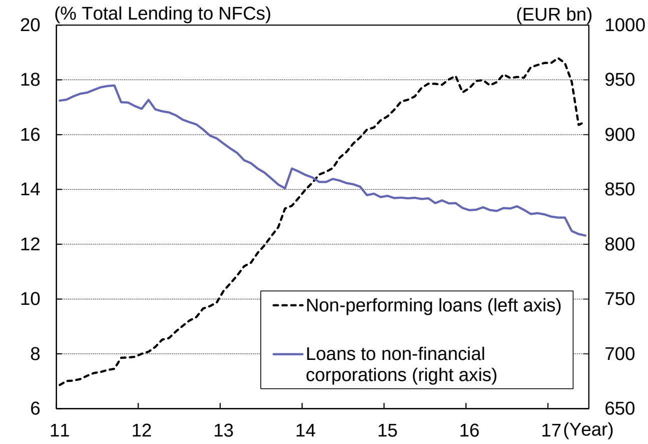
[2] The ECB definition is that "a loan is non-performing when payments of interest and principal are past due by 90 days or more, in accordance with the Basel II definition of default, or when there are good reasons to doubt that debt payments will be made in full."

Chart 7: NPLs as Share of Total Loans



Source: EBA, BTMU Economic Research Office

Chart 8: NPL Ratio and Loans to NFCs



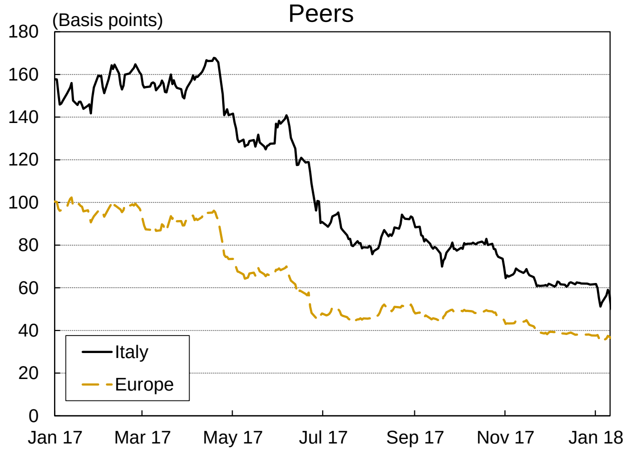
Source: OECD, ECB, BTMU Economic Research Office

Things are looking much better after progress was made last summer. In July 2017, Unicredit sold a €17.7bn tranche of bad loans to Pimco and Fortis. In the same month, Monte dei Paschi di Siena, Italy's oldest bank, was bailed out by the Italian government after the European Commission agreed that state aid was necessary. And Intesa Sanpaolo, Italy's second largest bank, was subsidised by the government to take over the good assets of two failing regional banks (Popolare di Vicenza and Veneto Banca). This has meant that, although the banking sector remains vulnerable, there are no further rescues looming on the immediate horizon. The amount of bad loans, as a percentage of total lending to NFCs, plunged between May and July in the OECD measure (chart 8) and have then stabilised at levels last seen in 2014.

Markets have responded positively. Charts 9 and 10 show CDS spreads and share prices for Italian banks compared to European peers. (Simple averages are used. For Italy, we take UniCredit and Intesa Sanpaolo. For the rest of Europe we take BNP Paribas, Société Générale, Crédit Agricole, Deutsche Bank, Commerzbank, Barclays, RBS, HSBC, Lloyds, BBVA and Santander).

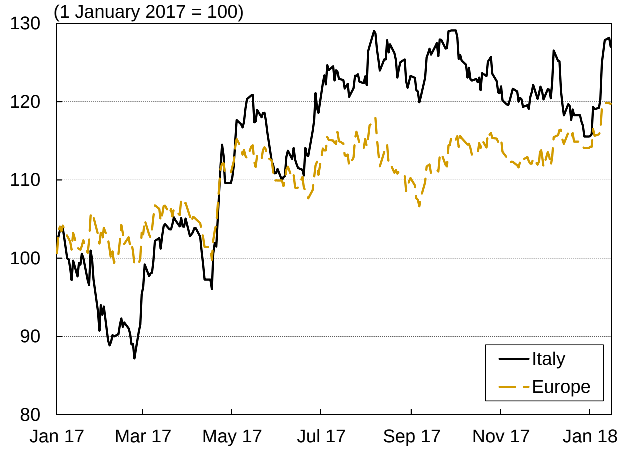
CDS spreads have plunged since last summer and are gradually converging with other European banks. After a bumpy start, Italian banks' share prices outperformed the European comparison group over much of 2017 – and have started off well in 2018.

Chart 9: 5Y CDS Spreads: Italian Banks vs European Peers



Source: Bloomberg, BTMU Economic Research Office

Chart 10: Italian Banks Share Price vs European Peers



Source: Bloomberg, BTMU Economic Research Office

Still, there is clearly more work to be done to further reduce the NPL ratio. Ongoing reform to improve the efficiency of the civil justice system and make it easier to write down loans and for corporates to declare insolvency will help, but more ambitious (but credible) reform is needed.

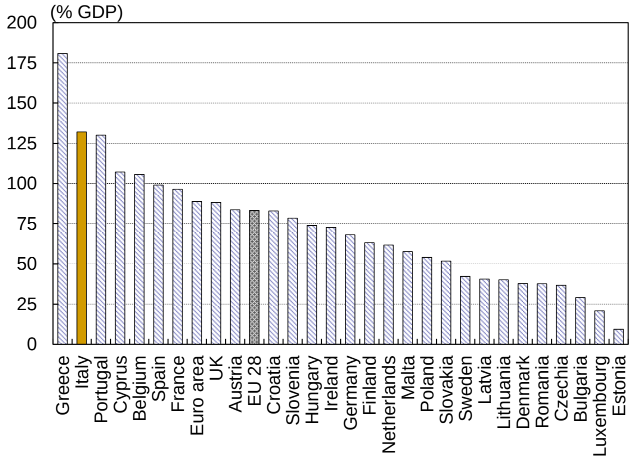
Attention will then start to turn to the demand side. A high share of NPLs can mean higher real financing costs and discourage those firms with stronger balance sheets from seeking finance for investment. Indeed, chart 8 shows how credit growth is still stagnant. We expect this will change as the economic recovery continues. The latest ECB bank lending survey shows loan demand increasing, notably from enterprise. This will feed through to economic activity as industrial firms continue to benefit from strong external demand and invest in their capital stock.

We see real GDP growth slowing from 1.6 to 1.3% YoY in 2018. But NPLs should soon account for considerably less than 10% of nominal GDP given the current rate of progress. This means that, in the event of a crisis, a forced fire sale of bad loan books at heavy discounts and subsequent state recapitalisation would be feasible. ECB statistics on government assistance to the financial sector show that recent public policy interventions were worth 5.5% of nominal GDP in Ireland (2011), 3.8% of nominal GDP in Spain (2012) and 3.2% of nominal GDP in Portugal (2014). An emergency move in Italy would likely be in this range. However, as we detail in the next section, this would mean a backward step in Italy's battle to reduce its public debt.

4. Public finances unlikely to improve dramatically

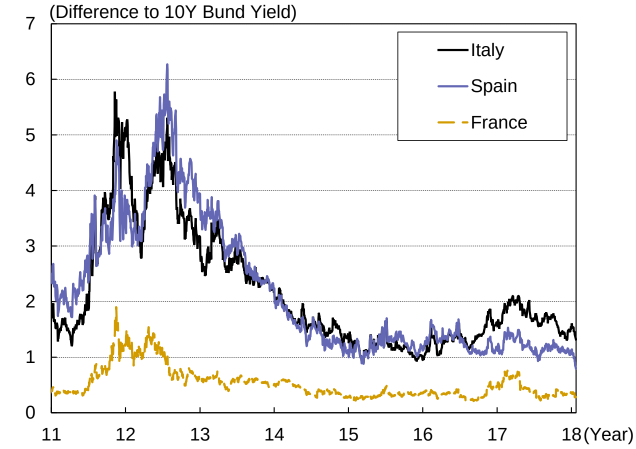
Italy has the second highest level of government debt in the EU, after Greece (chart 11). At 132% of nominal GDP it has among the highest ratios in the developed world. This is not new; debt-to-GDP has exceeded 100% since 1990.

Chart 11: General Government Gross Debt in 2016



Source: Eurostat, BTMU Economic Research Office

Chart 12: 10Y Yield Spreads

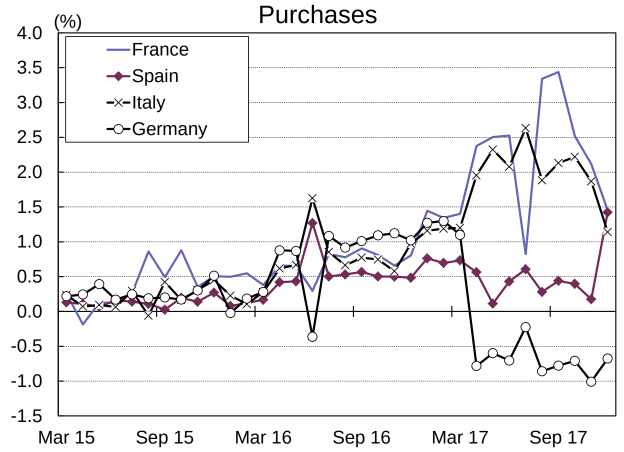


Source: Macrobond, BTMU Economic Research Office

The high level of debt brings with it high debt servicing costs, even though ultra-loose monetary policy has helped to compress yields (chart 12). As of December 2017, the ECB has bought a total of €318bn of Italian debt. The ECB's recent flexibility has provided extra support (chart 13 shows how monthly purchases have deviated from the capital key in 2017 and meant a higher share of Italian bonds than were strictly required). However, the Italian government's annual interest expenditure is still around 4% of nominal GDP. This is forecast to only fall to 3.5% by 2020 in Italy's 2018 Draft Budgetary Plan.

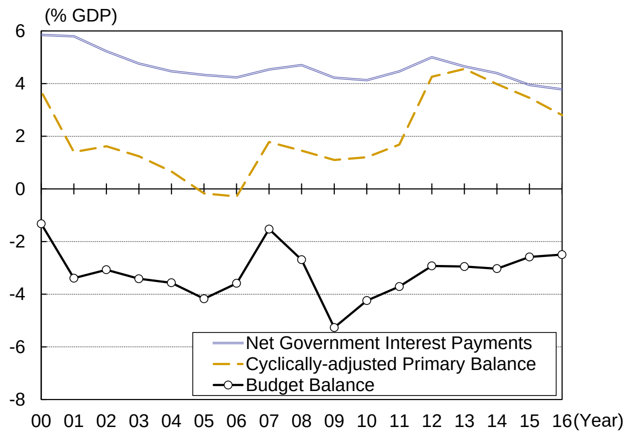
This means that even though the Italian government has been running one of the highest primary surpluses in the euro zone since 2011, gross government debt has since steadily risen by almost 20pp over the same period. And as chart 14 shows, the primary surplus has reduced since 2014 suggesting that the Democratic Party government loosened the purse strings somewhat.

Chart 13: Deviation from Capital Key in Monthly PSPP Purchases



Source: ECB, BTMU Economic Research Office

Chart 14: Public Finance Flows



Note: The cyclically-adjusted primary balance is percentage of potential GDP.
Source: OECD, BTMU Economic Research Office

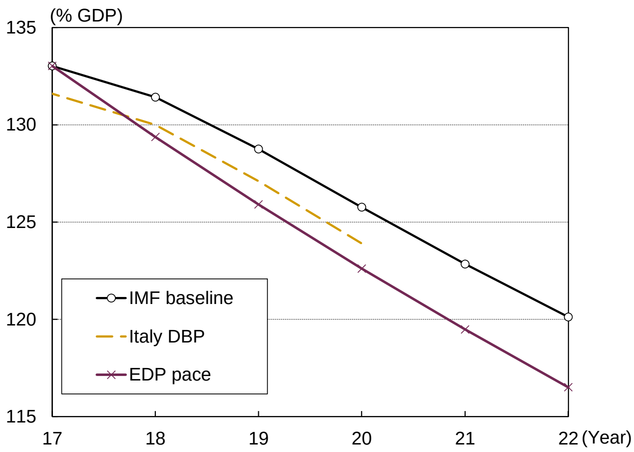
The overall budget deficit is likely to be a Maastricht-compliant 2.1% of nominal GDP in 2017 according to the Italian Treasury, which forecasts that it is on course to have a more or less balanced budget by 2020. Indeed, the deficit in Q3 2017 was the lowest since 2008 at 2.1% of GDP. However, the budget balance is not really the issue; the European Commission is concerned about the high level of public debt. It responded to Italy's Draft Budgetary Plan (DBP) for 2018 by saying it is at risk of non-compliance with the provisions of the Stability and Growth Pact. It was stated that high public debt "constrains the government's room of manoeuvre for more productive investment" and is at risk of worsening if the growth outlook deteriorates. The Commission may decide to open a debt-based Excessive Deficit Procedure (EDP) against Italy in the spring if it deems there is not sufficient progress in reducing the debt level. This would require that Italy reduces the portion above 60% of its public debt ratio to GDP by 5% a year.

Chart 15 shows the IMF's baseline projection for Italian general government gross debt-to-GDP over a five year horizon. We have also shown the Italian Treasury's forecasts from the 2018 DBP (which forecasts a lower 2017 number), and the pace that would be the requirement if an EDP were to be opened. Note that even with the EDP required pace of reduction, Italy's public debt would not fall to 100% of GDP until 2029.

Using the IMF's projections, we look at various scenarios to examine how gross debt may evolve over the next few years. Note the implied interest rates have been derived from the IMF's baseline numbers using a simple formula.[3]

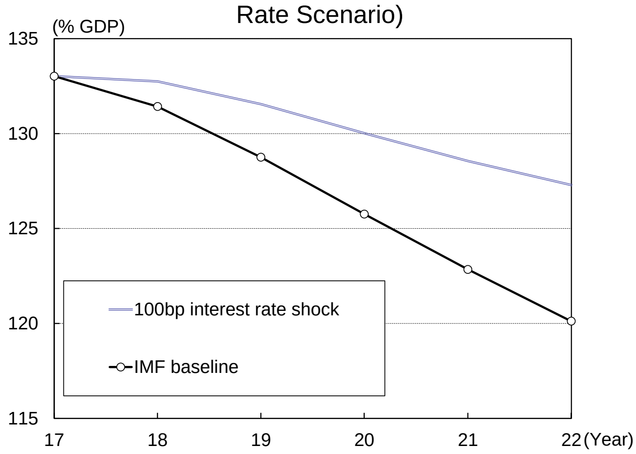
[3] $\Delta b = d + (r - g)b$, where b is the current debt-to-GDP ratio, d is the primary deficit as a proportion of nominal GDP, r is the real interest rate, and g is the real GDP growth rate.

Chart 15: Gross Public Debt Forecasts



Source: IMF, European Commission, BTMU Economic Research Office

Chart 16: Gross Public Debt Forecasts (Higher Interest Rate Scenario)



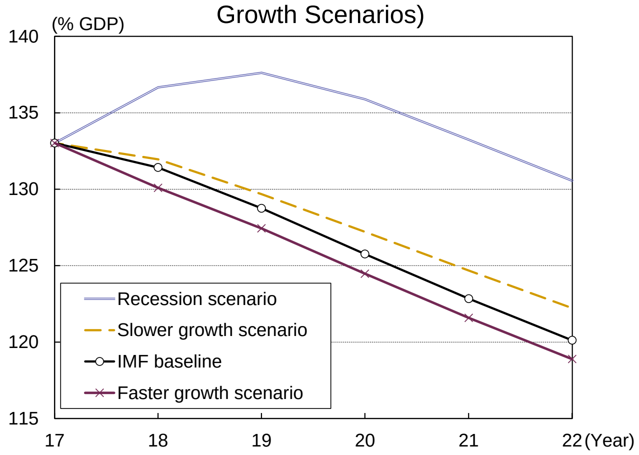
Source: IMF, European Commission, BTMU Economic Research Office

First, in chart 16, we show how the debt-to-GDP ratio may change if borrowing costs rise. Under this scenario, interest rates have been shocked higher by 100bp in 2018 with this spread maintained over the rest of the forecast horizon. This would not be that extreme: 10Y yields were up to 300bp higher in 2012 than they are now (although we note that only a small part of government debt is refinanced annually). Under this scenario, the debt-to-GDP ratio decreases just 5.5pp by 2022. High debt means high sensitivity to changes in interest rates; Italian public debt would be vulnerable to even a moderate increase in yields, constraining fiscal policy. This raises concerns as the ECB steps away from net purchases under its Public Sector Purchase Programme (PSPP).

In chart 17, we look at how different growth outlooks would affect public debt. First, the slower growth scenario assumes annual real GDP growth of between 0.6 and 0.7% YoY. The effect on public debt is not especially notable. The faster growth scenario is the IMF's annual real GDP forecasts plus 1pp. Again, there is little effect. However, the recession scenario sees a downturn in growth of the magnitude seen in 2012 (-2.8% YoY) followed by a similar recovery path. This would have a significant effect on public debt, which increases to 138% initially before falling to just 130% by 2022.

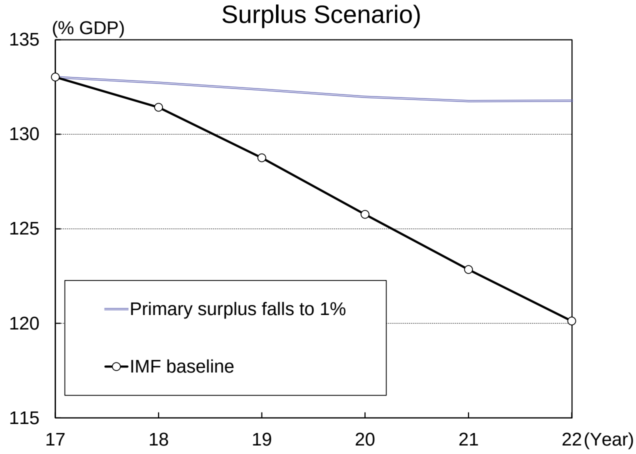
Lastly, in chart 18, we look at how the primary balance assumptions change the picture. If the primary balance remains in surplus, but falls to just 1% of nominal GDP (which is the 2004-2013 average), then the overall public debt-to-GDP ratio is barely reduced over the five years.

Chart 17: Gross Public Debt Forecasts (Alternative Growth Scenarios)



Source: IMF, European Commission, BTMU Economic Research Office

Chart 18: Gross Public Debt Forecasts (Lower Primary Surplus Scenario)



Source: IMF, European Commission, BTMU Economic Research Office

The fact that relatively small adjustments to real GDP growth, the primary balance and interest rates can all change the debt outlook significantly shows how vulnerable Italy is. In reality, a downturn would likely provoke a simultaneous deterioration in all three factors in which case debt could easily become unsustainable. If we apply all three shocks simultaneously (with the recession scenario for growth), public debt increases sharply across the five years to over 150% of GDP by 2022.

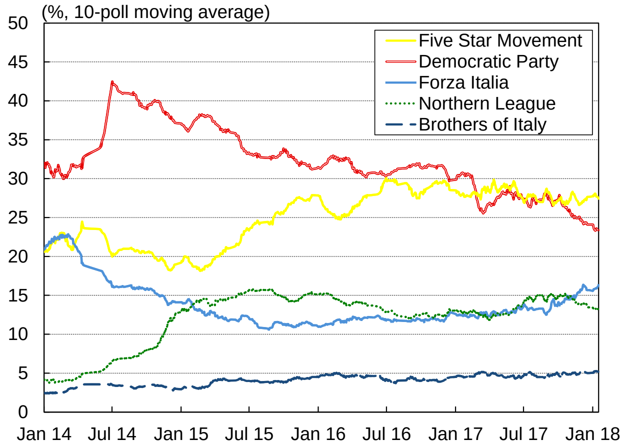
Even if the news flow remains positive, the IMF's baseline scenario looks optimistic to our minds – and the EDP path very unlikely. Italy has to maintain its primary surplus, enjoy above-potential real GDP growth, and all the while hope that borrowing costs do not rise. The banking sector has to stay healthy, too. The Treasury estimated that (relatively small-scale) interventions in the banking sector will be worth 0.6% of GDP in 2017.

5. Political uncertainty will not help

With the issues of high public debt and a vulnerable banking sector in the background, political uncertainty is causing additional concerns. President Mattarella dissolved parliament on 28 December 2017 as the current five-year parliamentary term approached its end. This means that the next Italian general election will be held on March 4 2018.

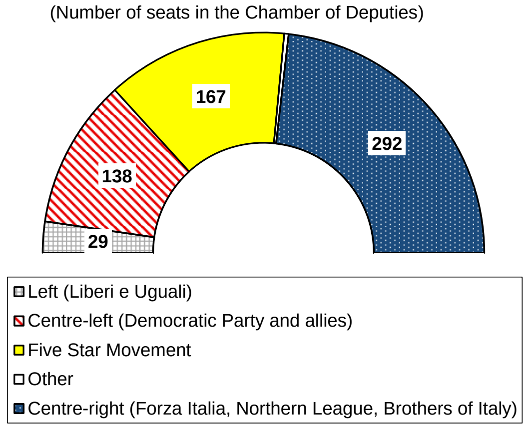
The most recent polls (chart 19) show the populist Five Star Movement just ahead of the incumbent Democratic Party. But both these two parties could be eclipsed by a centre-right coalition of Berlusconi's Forza Italia, the anti-immigrant Northern League and right-wing Brothers of Italy. If the polls are accurate, this bloc is on course to win most seats at the election, but probably not an outright majority (chart 20 shows a recent simulation for the Chamber of Deputies). The Democratic Party should benefit too from some alliances with smaller parties (a new electoral law will promote link-ups – see Box 2) and could be in the frame. However, Five Star, leading in the polls, has stated it would shun any coalitions. This means that a hung parliament is the most likely outcome and then an unstable coalition or a weak minority government.

Chart 19: Opinion Polling



Source: Political Thermometer, BTMU Economic Research Office

Chart 20: Seat Simulation



Source: Ixè (30 December 2017), BTMU Economic Research Office

We note that repeat elections are unlikely. After the election, President Mattarella will consult with the party leaders and decide whom to ask to form a government. He is not obliged to ask the largest party (probably Five Star) – rather, he may want to establish which coalition is most likely to endure. This may not be at all obvious. With polling suggesting that Five Star is far from being able to govern on their own, and even a Grand Coalition of Forza Italia and the Democratic Party looking unlikely to achieve enough seats, we may have such a scenario. The centre-right coalition is closest to achieving enough seats – but still not quite enough, and that would require a stable relationship between three relatively large parties (Forza Italia, Northern League, Brothers of Italy). If relations between Brothers of Italy or the Northern League break down then the coalition would not be viable (for example, if the Northern League achieves more seats than Forza Italia and demands to have the Prime Minister position – this would probably be uncomfortable for Berlusconi to accept).

So, there could be a similar scenario to 2013 when gridlock meant that there was the possibility of repeat elections (which were ultimately avoided). If Mattarella cannot find a viable government, he may ask current Prime Minister Gentiloni to lead a new government until new elections are held. Of course, even if new elections are held, they are not guaranteed to produce a clear outcome either (consider the case of Spain in 2016). But we stress this is a low probability scenario.

Box 2: Italian Electoral Reform

New electoral laws passed in October 2017 (the so-called Rosatellum, named after the Democratic party leader in the Chamber of Deputies who drafted them) will come into effect for the next election. The new law is a mixed system with 37% of seats allocated using a first-past-the-post system and the remaining 63% allocated using a proportional representation system. This is harmonised in both the upper and lower houses, replacing the different 2015 systems ('Italicum') which could have led to different majorities in each chamber.

The change was supported by the Democratic Party, Forza Italia and the Northern League. The new system may advantage larger parties with established local-level organisation and stronger candidates to contest the first-past-the-post seats. The sense is that Five Star, with its distributed support, will fare much better with seats elected by proportional representation. Also, the reform is less likely to result in a clear majority, which should promote coalition formation. For both these reasons, Five Star, which stated it would shun any allegiances, strongly opposed the electoral reform.

Table 1: The main parties

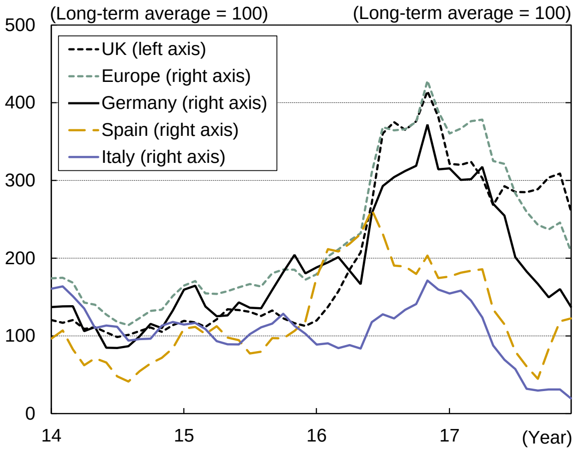
Democratic Party	The governing centre-left party led by former PM Matteo Renzi. Renzi quit as PM a year ago after losing a referendum on constitutional reform, but won a subsequent leadership election. The Democratic Party fared poorly in the recent Sicilian elections and has been fading in the polls after struggling to form a united left. The only openly pro-Europe major party.
Five Star Movement	Currently leading in the polling. Anti-establishment, populist, historically Eurosceptic, but have recently adopted a softer stance towards the euro. Founded by comedian Beppe Grillo. Inexperienced 31-year old Luigi di Maio is the prime ministerial candidate. Against forming any alliances with other parties.
Forza Italia	Centre-right party led by Silvio Berlusconi who has made a notable comeback after scandal and a tax fraud conviction. Berlusconi is now banned from public office and has suggested that Leonardo Gallitelli, who led the military police force until 2015, could be the prime ministerial candidate. The party is targeting older voters, who are more likely to vote, with promises of higher pensions.
Northern League	Eurosceptic, anti-immigration, populist. Led by Matteo Salvini who has transformed the party from a regionalist group into one of the largest in Italy (regional autonomy is now hardly mentioned).
Brothers of Italy	Right-wing party founded in 2012. Nationalist, Eurosceptic. In a successful coalition with Forza Italia and the Northern League at the recent regional elections in Sicily.

Source: Party websites, Bloomberg, Reuters, BTMU Economic Research Office

Despite looming uncertainty and the possibility that populist parties may end up in power, Italian 10Y yields are subdued (and are in fact lower than they were in October 2017). Economic policy uncertainty is flat and lower than in other European countries (chart 21). In fact, PM Gentiloni told reporters "we must not dramatise the risk of instability, we are quite inoculated against it". He also suggested that there has been an "Italianisation of political systems" in other European countries with minority governments and hung parliaments becoming more familiar.

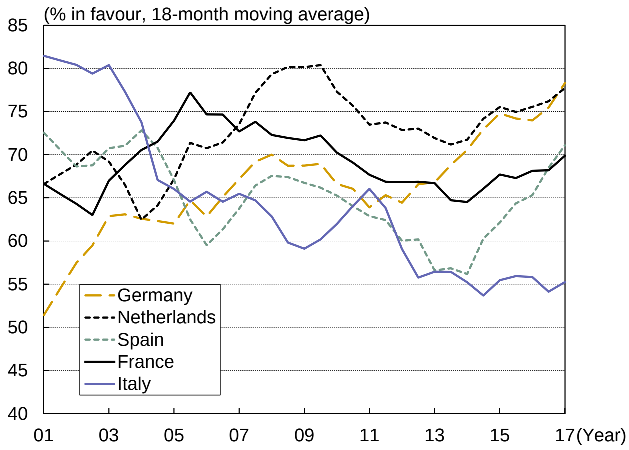
This may be the case, but one of the key concerns for external observers is that the rise of Eurosceptic populist parties could lead to Italy dropping out of the euro zone and the unravelling of the whole single currency project. However, both Five Star and the Northern League have softened their stance on membership of the euro. Luigi di Maio, Five Star's PM candidate, told reporters "We are pro-EU and we intend to contribute to creating the future of Europe" while pushing for EU reforms. A commitment to a referendum on the euro has been dropped. Salvini, the leader of the Northern League, has also changed his tone on European integration. This reflects some pragmatism – it would make a coalition with Forza Italia more likely. And for both Five Star and the Northern League, a softer stance on the euro seems necessary to boost their economic management credentials. Also, as chart 22 shows, there is still a majority in favour of the euro. The most recent Eurobarometer suggests that support for the single currency has bottomed out at around 55%.

Chart 21: Economic Policy Uncertainty



Source: www.policyuncertainty.com, BTMU Economic Research Office

Chart 22: Support for the Euro



Source: Eurobarometer, BTMU Economic Research Office

What would a Five Star government mean for euro reform? Expect opposition to the European Commission's fiscal rules (the Stability and Growth Pact). As shown above, the Excessive Deficit Procedure pace of debt reduction would be very arduous for Italy. Of course, sanctions for non-compliance are never applied (famously France and Germany both ran excessive deficits but were not sanctioned, which makes it hard politically for ECOFIN (Economic and Financial Affairs Council) to apply them to smaller countries). But Five Star is opposed to European intervention in national budgets and may look for looser rules (but for them to be "enforced equally"). Also, it would be interesting to see how Five Star would react to Macron's euro zone reform proposals if he comes to an agreement with Germany. On the one hand, Five Star is eurosceptic – but on the other, some of his proposals (a "common budget capacity" and a "real euro zone of investments" that could help "reduce the divergence among our economies") would surely be positive for Italy.

Overall, an 'Italexit' remains a low probability (but high-impact) scenario. Over the medium term we are more concerned about the effect of political uncertainty on the domestic Italian economy. While on course to enjoy the best annual growth in real GDP since 2010, any meaningful further progress on public finances or the banking sector is unlikely if the election does not return a strong government. Of particular concern is the potential effect on efforts to reduce public debt.

6. Risks from political instability

(1) Public debt
Firstly, Italy has enjoyed very low borrowing costs over the last few years. A messy election in spring could see yields on Italian bonds rise considerably.

Meanwhile, in the scenarios above (charts 15 to 18), the IMF appears fairly generous with its primary surplus assumptions (steady increases out to 2022). Pension expenditure is a particular concern:

- Social benefits account for around half of total primary spending, of which most goes on pension expenditure (16% of nominal GDP). The ageing population means that this is due to increase unless addressed.

- Pension reform (to reduce payments and raise the retirement age in 2019) is still scheduled under the current Democratic Party government, but it has bowed to pressure for concessions and has recently exempted 15 job categories.

- Salvini, Northern League leader, has said scrapping the reform should be the first act of the next government. Five Star, meanwhile, has called the reform a scandal.

- Forza Italia (which is targeting older voters) has pledged to raise the minimum pension to €1000 a month.

Whatever the outcome of the general election, we feel that the new government will be under domestic pressure to ease away from fiscal consolidation. None of the main parties are pushing for measures to reduce public debt. The Democratic Party and the Northern League have proposed tax cuts. Forza Italia would increase pension expenditure (as detailed above). A Five Star government could lead to ballooning public debt if their radical proposal for universal basic income were to be enacted.

Given this, it seems highly unlikely that the election will result in increased fiscal consolidation, whatever the outcome. The European Commission may well place Italy under an Excessive Deficit Procedure in February which could help. But this may intensify Eurosceptic sentiment ahead of the election and give a boost to Five Star – the party which poses the greatest risk of increasing public debt.

(2) Banking sector
The NPL problem has improved recently but still remains an issue and poses an extra risk for public debt in the event of a crisis. However, it is harder to assess how the election result may affect efforts to fix the banking sector. Primarily, we are concerned about general political uncertainty and subsequent lack of impetus to reform. Individually, the major parties are yet to announce any serious proposals.

7. Conclusion

A lot can change in politics but the current polls point to a messy and fragmented political landscape after Italy's March 4 election. An unstable coalition or weak minority government seems most likely, and repeat elections, while unlikely, cannot be ruled out. It is an unfortunate time for political uncertainty. If a government is formed, it would inherit an economy in reasonably good shape for the first time in a decade, which means Italy is finally in a position to address longstanding issues. Of these, public debt is perhaps the most important. At around 130% of nominal GDP, a serious downturn could push it unstably higher. We find that even with fiscal discipline, low borrowing costs, and no significant slowdown in real GDP growth, public debt is unlikely to fall below 115% over the next five years. A smaller reduction is more likely: none of the major parties are proposing measures to reduce public debt, and, in fact, a government led by any of the major groups could see increased spending. Furthermore, a weak government will struggle to push through pro-growth structural reforms which would help reduce government debt over the medium-term. The banking sector is another concern. Recent fixes have helped but the high level of NPLs remains.

In short, while Italy could become a market concern again in 2018, it is not our base scenario. The election looks unlikely to produce a stable government – but Italy is used to that. More worrying is the medium-term outlook. There is a high chance that the new government will struggle to deliver reform while the sun is shining. When the next recession arrives, Italy is unlikely to be in much better shape to deal with it than it is now.