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Quo Vadis Italia? – The 2018 general election in Italy and its importance to the economy

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The economic environment for Italy remains challenging. The fundamental problem is the low economic growth. Although the composition of the future government is still unclear, the party programs imply a persistent reform deadlock.

How is the election outcome interpreted?

Preliminary estimates point to a clear victory for the EU-skeptical five-star movement at 32% and gains from the right-wing populist Lega Nord (17%). The center-right bloc – which includes the national-conservative Fratelli d'Italia party – has reached 36% according to preliminary figures. The ruling Partito Democratico (Socialists) has fallen to just 19%. The conservative Forza Italia (former Prime Minister Silvio Berlusconi) is 14%, just behind the Lega Nord.

- 1) The anti-establishment five-star movement is soon becoming an establishment.
- 2) None of the election blocs has achieved the necessary 40% for forming a government. Italy is facing tough coalition negotiations.
- 3) The EU critical forces come to over 50%. The advocates for additional integrative steps within the Eurozone are getting a damper.
- 4) Similarly, the backlog of reforms in Italy is likely to increase. The problem-solving capacity of the new establishment is challenged.
- 5) This is especially true in the case of an economic slowdown or a recession. Italy is currently in a favorable cyclical situation. The key question is how the populist parties react to a difficult economic environment.

What do the elections mean for Italy's economy?

Italy is still the problem child of the Eurozone. As the third largest economy and with a debt of over 130% of GDP, Italy is in a fragile upswing. Since 2007, GDP per capita in Italy has grown by only 6%, that in Germany by 28%. At its heart is the question of whether yesterday's elections **1)** increased the prospect of structural reforms, **2)** whether "muddling through" remains the most likely scenario, **3)** or whether the environment could even become more negative. In addition, the country has been fighting for years against corruption, excessive bureaucracy and an inefficient political system.

The unemployment rate has fallen only slowly since the euro crisis in 2014 and is currently at 11.1%, the third highest in the EU after Greece and Spain. Particularly affected are young people under the age of 25, of which 31.5% of respondents said they were looking for work in January 2018.

The new government will be measured by its ability to implement key labor market and tax reforms to boost Italy's competitiveness in the single market. Only if it succeeds in boosting economic growth and sustainably creating jobs can the increasing dissatisfaction of the population be counteracted. At the same time, the government has little fiscal space if it does not want to push public debt further. International donors will pay more attention to what measures are implemented and how they are financed.

Are there also developments on the plus side?

The positive developments are only cyclical:

- 1) Strong external growth: The growth of the global economy and that of the eurozone is strong and broad based. This has led to an increase in export growth. However, the next one after the current economic phase (boom) is "downturn".

- 2) Low interest rates: The monetary policy of the European Central Bank is very expansionary. As part of the bond purchase program, Italian bonds are also bought and the prime rate is negative. However, due to strong economic growth in the eurozone, the ECB signals an end to very supportive monetary policy.
- 3) The defaulted loans of Italian banks have been falling since last year. However, the level is still considerable.
- 4) The Eurosceptic parties have decided to stay in the eurozone shortly before the election. Italy's already elevated euro skepticism could rise as soon as the next major recession hits the Eurozone.

Reaction of the financial markets to the outcome of the election

Since Macron's election victory in France last spring, spreads on periphery bonds in the Eurozone have narrowed significantly. Italian government bonds have also profited greatly. In the weeks leading up to the election, the growing uncertainty was priced in somewhat, but the financial markets were surprisingly unimpressed by a possible stalemate in the Italian parliament. Nevertheless, the election results surprised the stock markets and, as a first reaction to the election results, the spreads of Italian securities over those of German government bonds rose by around 10 basis points. Stock markets have also reacted to the rise of the populist parties and no clear majorities, and the Italian stock index FTSE MIB has opened about 1% below the close of Friday.

The Italexit is not entirely off the table

Even though the 5-star movement has clearly renounced its Euro-critical course and that probably contributed to its strong result, another turn-around is not carved in stone. The five-star movement is known for driving a zigzag course and frequent member polls make the party unpredictable. The center-right coalition, too, has been given a clearly European-friendly course, especially as a result of Berlusconi's return in recent months. This is remarkable, if you imagine that a few years ago he had to resign as head of government by pressure from Brussels.

Together, the Euro-critical forces around the 5-star movement, Lega Nord and Fratelli d'Italia bring together more than 50% of the vote. Although they have been tame in recent months, the relationship between Brussels and Italy is likely to suffer. An Italexit seems still very unlikely, but the topic is not quite off the table.

Investors need to adjust to volatile times

From an investor's perspective, one should adjust to more volatile times in Italy. On the one hand, the global economy and the eurozone continue to grow strongly and broadly, leading to rising exports and positive spillover effects. In addition, the Eurozone is currently experiencing new impulses for greater European integration through the new government in France and a probable coalition between the CDU / CSU and the SPD in Germany. The environment is therefore positive and should also be supportive for Italy. The yields on Italian government and corporate bonds are therefore attractive relative to the other Eurozone countries.

On the other hand, the elections have produced a politically unstable result. An important criterion for good development is the formation of a stable government that can drive reforms and benefit from the positive economic window before the next economic downturn is around the corner. At the latest then, the structural problems will come to the fore again, should it come to a political standstill in Italy.

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