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Arrivederci, Mario; Ciao, Giorgia

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The rest of the world, preoccupied with several major geopolitical concerns, may not be paying close enough attention to new developments in Italy. However, Italy's recent election could have the potential to reshape political allegiances in Europe, with economic and investment implications.

To understand how Italy got to where it is today, let us start with the former Prime Minister Mario Draghi. By all accounts, Draghi and his unity coalition were moving Italy forward. However, he ran into the buzzsaw of Italian politics. Italian governments simply do not last long, averaging a tenure of just 1.1 years since the end of World War II. Draghi managed to survive a no confidence vote in the Senate, but after three coalition partners abandoned him, he resigned.

President Sergio Mattarella next dissolved the Parliament and scheduled snap elections. Those elections took place on September 25 and produced the expected result: Italy will be governed by a coalition composed of three conservative political parties. These include the far-right Brothers of Italy, led by Giorgia Meloni, and Lega Nord, led by Matteo Salvini, as well as the center-right Forza Italia, headed by Silvio Berlusconi. Meloni likely will be Prime Minister, the first woman to fill that role. What does this mean for Italian assets? Markets are left to wonder about future policies: structural reforms, support for the war in Ukraine, the new ruling coalition's relationship with Russian President Vladimir Putin, and Italy's relationship with the European Union (EU). Markets certainly will look cautiously at the inexperienced, untested Meloni.

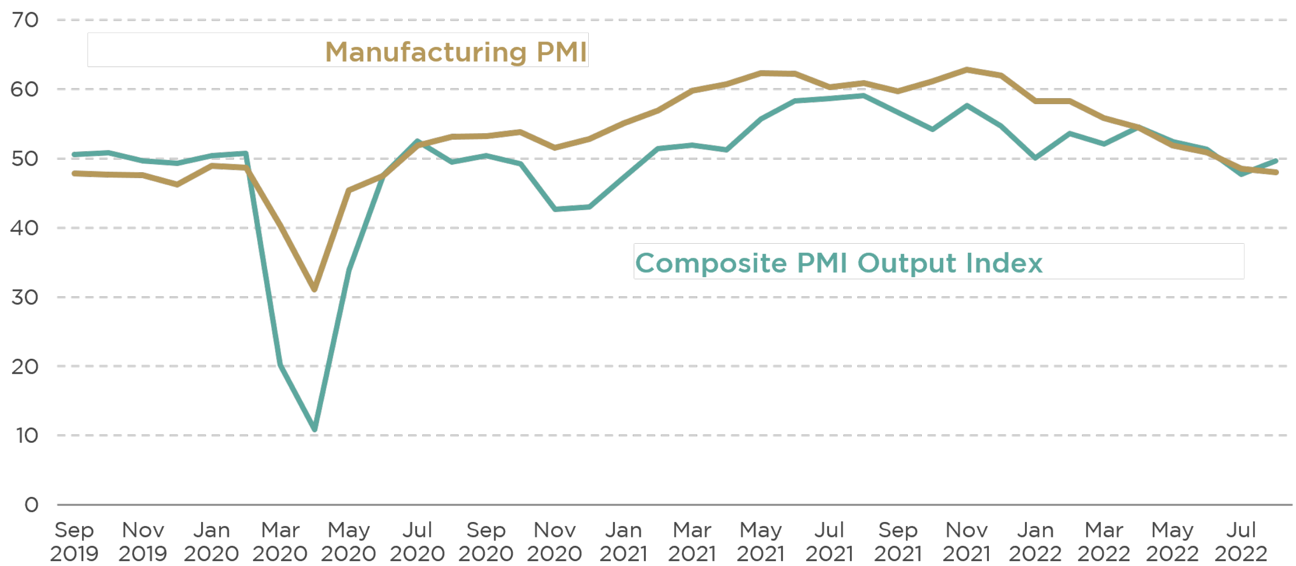
The Uncertain Backdrop

The ascent of a far-right government immediately conjured up memories of pre-World War II Italy. Yet, Meloni and her Brothers of Italy, which will be the most important coalition member, charted a more moderate, middle-of-the-road policy course during the campaign. Initially, that will be the new government's direction, but this new government faces an array of economic challenges, not the least of which are the Russia-induced energy crisis, the accompanying acceleration of inflation, and the onset of a regime of monetary tightening by the European Central Bank (ECB). All those factors point to recession, including Italy's Purchasing Manager Indexes (PMIs) (see Figure 1). While a shift to more nationalistic policies cannot be ruled out, extreme positions, i.e., a eurozone exit, appear off the table if campaign statements hold true.

1

Italy Business Surveys

Index, Seasonally Adjusted, As of 8/1/2022



Source: Brandywine Global, Macrobond

Surprisingly, this election cycle contained very little EU and euro bashing, perhaps a positive directional signal. Euro-skeptic rhetoric was a staple during the 2018 election, which saw the Northern League threatening to leave the EU and blaming the euro for Italy's ills. No such threats emerged during the most recent election campaign. Markets distrusted the government back in 2018, and that can be seen in the spread widening that occurred at that time. In 2022, markets have not priced in a 2018 political environment; the current spread widening is more reflective of the European energy crisis and the effect of a tighter ECB on Italian yields. Currently, Italian government bonds exceed the yield on German bunds by around 250 basis points (see Figure 2). The current 10-year bond yield is around 4.5%, about 400 basis points higher since February 2021. The snap elections in Italy were a 2022 affair. For now, there appears to be little political risk in the bonds.

2

10-Year Government Bond Interest Rate Spread, Italy vs. Germany

%, As of 9/26/2022

Source: Brandywine Global, Macrobond

What to Look For

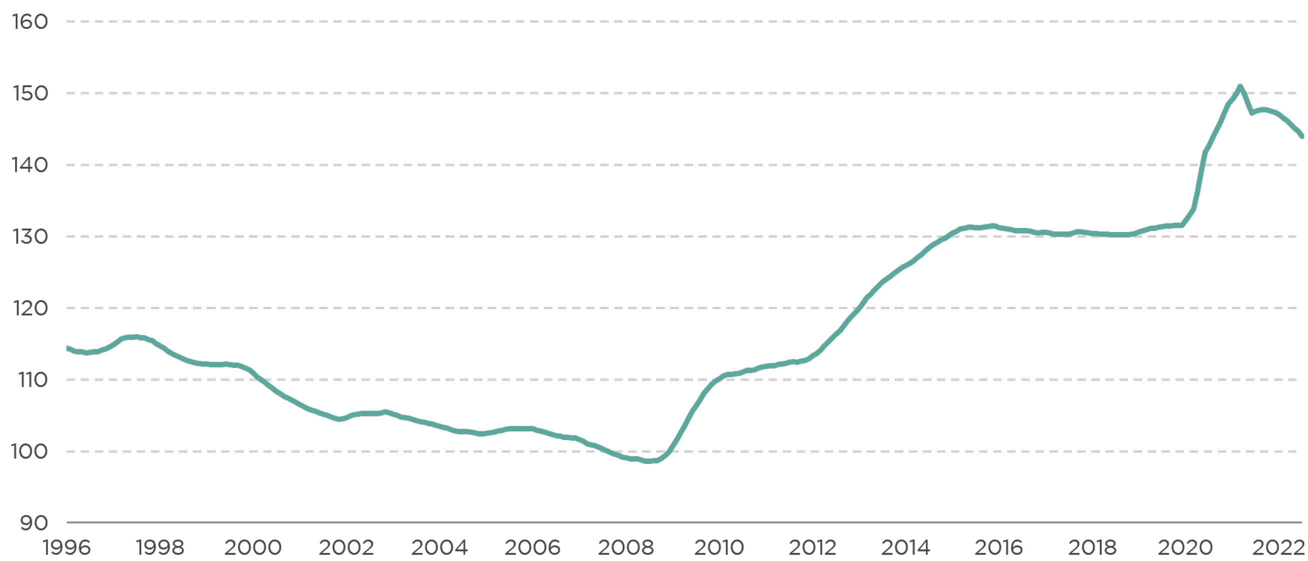
The new government should be formed and seated relatively quickly. This period in Italian politics is different from either 2013 or 2018. The center-right coalition received about 44% of the vote, led by Meloni's far-right party. An important check on the new government is that, while it received a majority in both houses, it failed to gain a two-third's majority in the legislature. This shortfall limits the ruling coalition's ability to amend the constitution without a referendum. Also, the moderate tone Giorgia Meloni struck during the campaign might give an idea of how she may govern, with more moderation and less confrontation. Once installed as prime minister, she will select cabinet ministers. A critical appointment will be the next finance minister. There is speculation Meloni will put technocrats into ministry positions, which should ease market nervousness.

More potentially troublesome is fiscal policy under the new government. The proposals coming from the parties in the conservative coalition, if enacted fully, would be budget busters, even though the Maastricht criteria have been suspended. Those proposals include: a tax amnesty, a flat tax, a corporate tax cut, pension reform, and family subsidies or allowances, among others. These proposals, if they come to full fruition, would be a boost to gross domestic product (GDP) but also would raise the deficit and call into question the sustainability of Italian debt. Italy saw some improvement in its debt as a percent of GDP, helped by rapid growth coming out of the pandemic and stronger revenues (see Figure 3). Increasing debt maturity at low interest rates helped, too. However, Italy will barely grow next year, and a government bond yield greater than economic growth will increase the interest burden and could raise government debt as a percent of GDP. At least two of the credit rating agencies have reduced the outlook to negative, raising some concerns over Italy's commitment to its National Recovery and Resilience Plan (NRRP), which was drafted to access funds from the Next Generation EU pandemic recovery tool.

3

Italy Public Debt

% of GDP, 1-Year Moving Average, Total Unconsolidated Gross Debt, As of 7/1/2022



Source: Brandywine Global, Macrobond, Bank of Italy

What is the likelihood of a massive budget proposal that increases the deficit and risks debt sustainability? That appears unlikely. Under Draghi, Italy was able to pass energy support measures without boosting the deficit (see Figure 4). The combination of additional support and weaker growth should increase the deficit. Given the energy impact on the whole economy, fiscal policy will likely become a bit looser. Debt issuance could be expected to rise. However, too aggressive a fiscal policy could affect ECB support under its current program. That includes the ECB implementing its newly created tool, the Transmission Protection Instrument (TPI), which is designed to address disorderly market conditions that are not the result of a country's underlying fundamentals. Currently, Italy meets the ECB criteria for the instrument, but a radical policy shift could affect the ECB's support and what interest rate Italy pays on its bonds. Italy currently complies with TPI criteria and should benefit from the ECB's programs. Why put the ECB assist in jeopardy?

A final constraint on the ruling party's fiscal profligacy will be continued receipt of EU recovery monies. Italy's NRRP has already been approved by the EU. Italy is slated to receive EUR69 billion in grants and EUR123 billion in loans to support structural reforms in its economy and improve its potential economic growth over the next five years. Italy's plan covers its green transition and improving digitization by focusing on fast broadband networks and 5G connectivity. Nonetheless, there are strings attached to the monies received in the first tranche of EUR25 billion. To get the next EUR19 billion, certain targets that were earlier commitments by the Draghi government must be met by year end. Here, Meloni has indicated a desire to renegotiate some of the plan's elements to obtain more energy support. This interchange could create the first bout of tensions between the Meloni government and Brussels.

4 Italy Current Account Deficit

% of GDP, 3-Month Moving Average, Seasonally Adjusted, As of 7/1/2022

Source: Brandywine Global, Macrobond, Bank of Italy

Probably the greatest political risk to Italy, the financial markets, and the country's future economic growth is how it interacts with the EU. A possible source of conflict between Brussels and Italy could arise from some of its nationalist policies. European Commission President Ursula von der Leyen did let the Italian right know the EU will fight any violations from any nationalistic stances the new government assumes. The Italian government is an added voice to nationalist and populist polices, à la Viktor Orban and Poland's Law and Justice Party. For example, Meloni has been critical of immigration, despite an aging population, and has argued for the EU limiting the arrival of migrants to Europe. Finally, the new government maintains an anti-globalization posture and does not welcome foreign investment in Italian sectors like tourism, putting the new government at odds with the need for opening up competition in the economy. Lastly, its anticompetitive stance fails to recognize the country runs a growing current account deficit that needs to be financed. Foreign direct investment would be a stable source of external financing.

Conclusions

- **Giorgia Meloni is an untested, largely unknown leader. She does not possess the stature of a Mario Draghi, but her election campaign was not focused on creating a conflict with the EU and the ECB.**
- **Italian bond spreads have widened because of external factors like the war in Ukraine and the subsequent rise in energy prices. Expect Meloni to continue supporting Italy's NATO commitments, including boosting its defense spending and supporting the Ukrainian efforts against Russia. Even though her party was in opposition, she supported Draghi and the Italian response to the Ukraine War.**
- **Meloni is constrained by EU fiscal rules, which will go into effect again in 2023, and the need for continued ECB support, including the ECB's implementation of the TPI. Italy simply cannot afford to lose institutional support, especially from the ECB, since the outcome could be rising financing costs and market volatility.**
- **The new ruling coalition could still become a thorn in the EU's side, however. The coalition is a strong proponent of national sovereignty, leading to vocal support of recalcitrant members like Hungary and**

Poland.

- Should the ruling coalition stray from its moderate campaign positions, investors can take solace in the fact that Italian governments typically do not exhibit longevity. That fact would appear to limit the economic damage arising from misplaced policies.

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