

Is the political bill for Italy’s troubles finally coming due?

Italy’s upcoming election, scheduled for March 4, comes at a very difficult time. Despite a return to modest economic growth over the past few years, the country continues to struggle with many challenges. These include: an economy that has underperformed its peers since joining the Eurozone, a very high level of public debt, a banking system burdened with non-performing loans, high unemployment and a rapidly aging society.

On the political front, matters are just as challenging. The influx of migrants has generated a public backlash, support for mainstream parties is in decline and anti-EU sentiment is high. Tensions with the EU could grow even more over election promises—made to varying degrees by all the main parties—that risk straining Italy’s already precarious finances even further. Given that Italy is Europe’s fourth-largest economy, what happens in Italy will, for better or for worse, play a key role in shaping the destiny of the EU/Eurozone.

Italy’s long-struggling economy

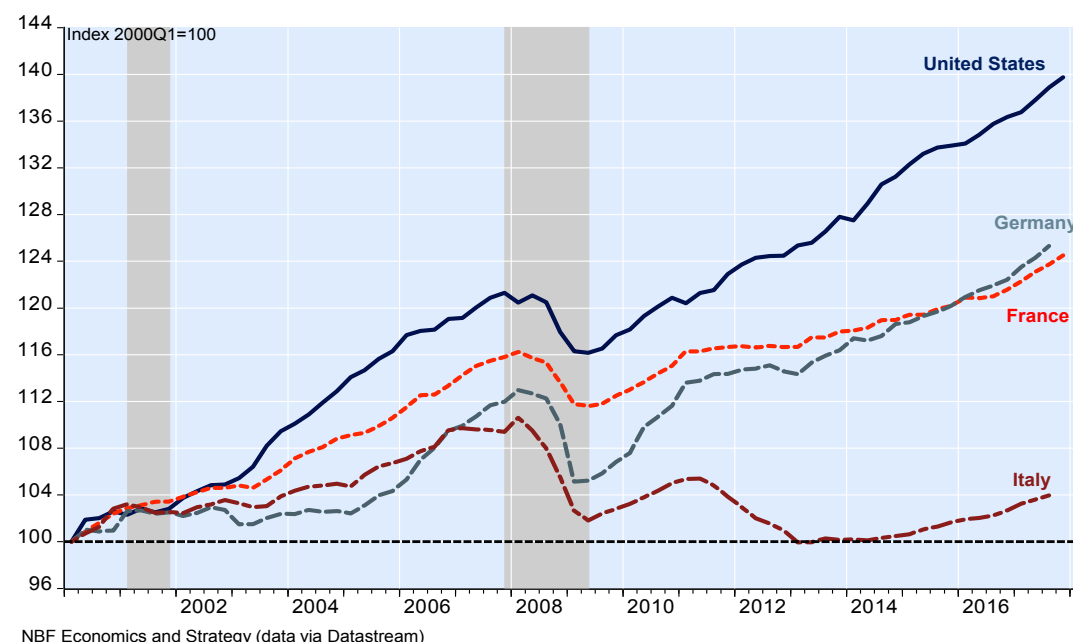
Though Italy’s economy has finally managed to generate some modest growth— 0.9% in 2016, 1.4% in 2017 and 1.4% projected in 2018¹—it still has a very long way to go before it can undo the damage caused by a long period of economic stagnation.

Indeed, since the formation of the Eurozone in 1999, the Italian economy has barely grown at all. Its total cumulative (not annual) increase in GDP since 2000 has been a measly 4%. This pales in comparison to France and the United States, which have recorded growth of 24.5% and 39.8% respectively over the same period.

One of the direct results of this lackluster growth is the weak state of its housing sector. Italy is one of the few countries in the developed world where house prices have not rebounded since the financial crisis. In real terms, they are now 23% lower than in 2007.²

Italy’s economy has barely grown since it joined the Euro zone

Real GDP



¹ IMF

² “Italy’s house price crisis as values drops 23 PER CENT in a decade in threat to economy,” Express, January 15, 2018

Prior to joining the Eurozone, Italy resorted to periodic currency devaluations in order to compete with economic powerhouses like Germany. Now that it no longer has its own currency, Italy can regain competitiveness only through economic reforms and wage cuts. **To put this into context, imagine how Canadians would react if, instead of periodically devaluing the currency to regain competitiveness (as we did in the 1990s under Paul Martin), they were told their wages would have to be cut 10%-20%.**

High debt levels

Italy has also Europe's second-highest level of public debt (133% of GDP) after Greece (180%). What makes the Italian debt situation particularly worrisome is the amount outstanding. The Bank of Italy estimates the debt at 2.3 trillion euros, in comparison to only 320 billion euros for Greece.

Further, Italy's banking system is struggling with 13% to 14% of its loans classified as non-performing, which means the borrower is at least 90 days behind on payments. This is in contrast to 6% of loans classified as non-performing for the Eurozone as a whole. In the United States, non-performing loans peaked at 5% during the financial crisis and have since fallen to just under 2%.³

Despite these strained finances, almost all of Italy's parties are proposing further spending and/or tax cuts.

- The Forza Italia party led by Silvio Berlusconi is proposing implementing a single low flat tax for companies and individuals, eliminating housing, inheritance and road taxes, doubling the minimum pension amount to 1000 euros a month, and guaranteeing a minimum income.
- The Five Star Movement is proposing a minimum monthly income of 780 euros by providing universal wage support and minimum pensions.⁴
- The governing Democratic Party is in favour of paying families 400 euros a month per child for three years, increasing the minimum pension amount to 750 euros, and cutting corporate taxes and social security contributions.⁵

Quantitative easing

Luckily for Italy, its borrowing costs have been kept down by the European Central Bank's quantitative easing program that began in 2015. To date, the ECB has purchased 319 billion euros of Italian debt.⁶ However, the risk is that as QE winds down, bond yields and borrowing costs could rise. The ECB has already reduced its bond purchases from 60 billion euros a month to 30 billion as of last of January.

High unemployment, particularly among youth

Italy's 11% unemployment rate is well above the 8.7% Eurozone average. Youth unemployment (15-25) is even worse at close to 33%.

The apparent neglect of Italy's youth can be partly explained by their lack of numbers, which translates into less political clout. Indeed, while voters over 55 account for 41% of the electorate, those 35 and under make up only 22%. In 2014, the last year for which there is available data, the government spent more than four times as much on seniors (e.g., pensions) as it did on items more geared to younger citizens (e.g., education and daycare).⁷ Italy has the world's third-most seniors as a percentage of total population, trailing only Japan and Germany.

Further, recent labour reforms have made it easier for employers to hire new workers via short-term contracts but did little to weaken job security for older workers who often enjoy permanent employment.

Brain drain

The tough economic climate has forced many people to emigrate. Italians living outside the country reached 5.4 million in 2016, an increase of 3.5% from 2015. Official figures show that 1.5 million people moved abroad between 2007 and 2017. The government estimates university graduates accounted for about 30% of emigrants, up from 12% in 2002.⁸

³ "A Specter Is Haunting Europe's Recovery: Zombie Companies," The Wall Street Journal, November 15, 2017

⁴ "Italy's election: everything you need to know," The Guardian, February 7, 2018

⁵ "Factbox: Italy's election - programs of the main parties," Reuters, February 9, 2018

⁶ "Eurozone's fleeting boom is an illusion - Britain won't remain the sick man of Europe for long," The Telegraph, January 3, 2018

⁷ "Young Italians are fed up with the traditional political parties," The Economist, January 6, 2018

⁸ "Italian emigration continues despite strong economic recovery," Financial Times, November 12, 2017

At first glance, one might think that the influx of young migrants is the perfect antidote to Italy's aging population and shrinking workforce. However, only a very small percentage of these immigrants have the training or language skills required for the skilled jobs most in demand. This means that the vast majority of migrants will need extensive training before they can fully enter the labour market. According to the International Organization for Migration, a division of the United Nations, only 16% of migrants to Italy in recent years have a high school degree.

The migrant crisis

Following the closure of the Balkan route via Turkey and Greece in early 2016, Italy has become the main gateway into Europe for migrants. Since 2014, over 600,000 migrants have arrived in the country. This influx is straining Italy's resources (which have already been depleted by many years of little growth) and risks creating a major political backlash. The situation has been exacerbated by the imposition of tighter border controls by Italy's northern neighbours, which have prevented many migrants from travelling to more economically vibrant countries. The perception of being abandoned by the EU to deal with these large numbers of asylum seekers is fueling Euroscepticism among Italians.

In an attempt to gain political mileage from this crisis and not lose support to the far-right Northern League, Silvio Berlusconi, the former Italian prime minister and leader of Forza Italia, has hardened his stance on immigration. He called the issue a "social bomb ready to explode" and promised mass deportations should his right-leaning coalition take power.⁹

What are the odds of Italy abandoning the euro?

As the election nears, both the Five Star Movement and the Northern League have walked back from their promise to hold a referendum on Italian membership in the Eurozone. Both parties have called holding a referendum a last resort if they cannot convince the EU to reform itself. These parties realize that, while many voters dislike the Eurozone, they also fear the risks that leaving entails (better the devil you know than the devil you don't). Further, the Italian Constitution prohibits the cancellation of international treaties via a popular vote. Overcoming this obstacle would require a two-thirds majority in parliament.

But the EU should not rejoice too quickly. For starters, as mentioned earlier, all of the main political parties have promised measures to undermine the EU by ignoring budgetary rules governing the Eurozone. Second, both Forza Italia and the Northern League have floated the idea of creating a separate currency for domestic use while keeping the euro for international trade. Third, a top economic advisor (Lorenzo Fioramonti) to the Five Star Movement went so far as to call for the EU to debate the restructuring of Italy's sovereign debt.

Elections: The main parties/coalitions vying for power

Under Italy's new electoral system, one-third of the seats in both the upper and lower houses will be elected via a first-past-the-post system and the rest via a proportional system. In order to be represented in parliament, individual parties must garner 3% of the popular vote and coalitions 10%. It is estimated that a party or coalition will need at least 40% of the popular vote to have a chance at obtaining a governing majority. The main parties/coalitions in this election are as follows:

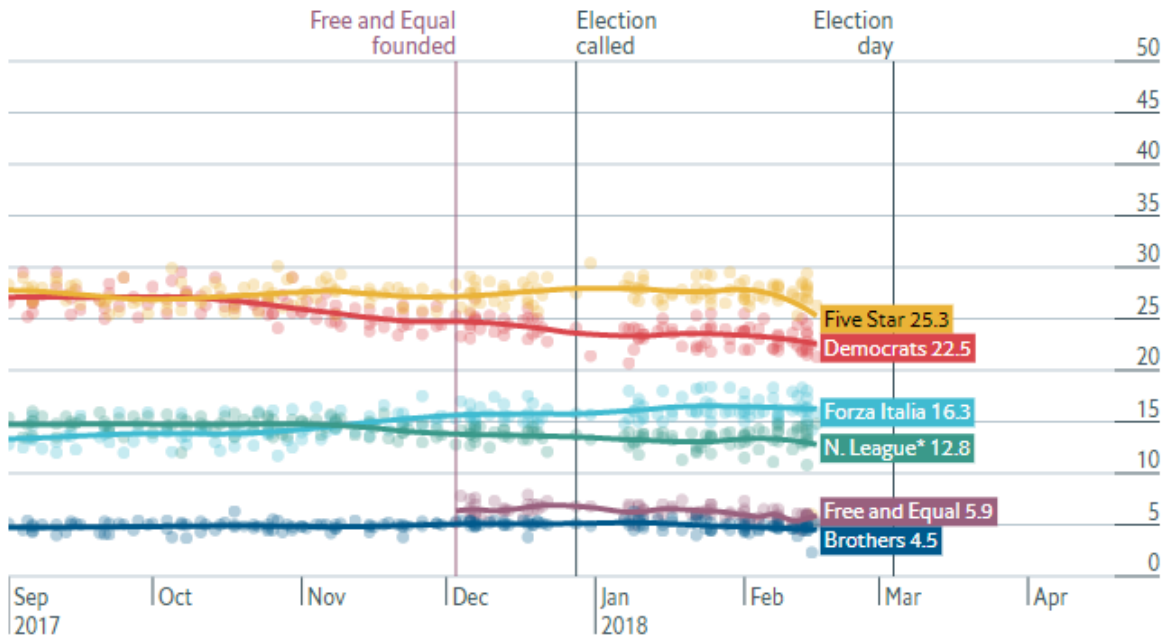
Five Star Movement: The Eurosceptic, anti-establishment party led by Luigi Di Maio tops the polls with 25%-27% of the overall vote. It is reportedly reconsidering its opposition to forming a governing coalition with other parties.

The ruling Democratic Party: The party led by Prime Minister Paolo Gentiloni is second in the polls, with about 22%-23% of the vote. The party has seen its popularity fall by about 15 points since peaking at 40% in 2015. Matteo Renzi was forced to resign as leader in 2016 after losing a referendum on constitutional changes. A coalition of like-minded parties led by the Democratic Party is polling in the 26%-27% range.

On the right side of the political spectrum is a potential coalition that includes former Prime Minister Silvio Berlusconi's Forza Italia party (polling at 16%-17%), the Northern League (12%-14%) and fascist Brothers of Italy party (4%-6%). This coalition is polling within few points of the 40% threshold vote needed to have a shot at obtaining a governing majority. While Berlusconi is officially banned from holding office owing to a tax-fraud conviction, he will play a key role behind the scenes in who gets to lead the coalition.

⁹ "Silvio Berlusconi says migrants causing 'serious social alarm' in Italy," CNN, February 5, 2018

While opinion polls indicate this right-leaning bloc will fall just short of an absolute majority, it is important to note that support for the center-right has been underestimated in the past. In 2008, Berlusconi's bloc went into the election with a mere two-point lead according the polls, but ended up winning by over nine percentage points. In 2013, the coalition led by the Democratic Party saw its six-point lead in the polls shrink to a few decimal points when the final votes were tallied.¹⁰



Sources: National polls; *The Economist*

*Includes Us with Salvini

The most destabilizing scenario for the EU would be a strong performance by the Five Star Movement. In this scenario, the Northern League could be a potential partner. Both are populist parties running on Eurosceptic platforms. The joining of these two forces would set Italy on a collision course with the EU.

At this point in time, the polls are predicting no clear winner. This outcome would result in months of negotiations culminating in either a new election or a very fragile coalition, which would make it exceedingly difficult to pass much needed economic reforms.

Italy is the latest sign of Europe's growing political fragmentation

Regardless of how the elections turn out, one thing is certain: Italy remains part of a broad European trend of declining support for traditional mainstream parties in favour of anti-establishment forces. As the last few years have shown us, a fragmented political landscape makes it harder to form stable governing coalitions:

- In October 2016, Spain's Popular Party formed a minority government after ten months of political deadlock and two elections. Spain is also struggling to contain separatist forces in Catalonia.
- The Netherlands has seen the combined support for its three traditional mainstream parties—Labour, Christian Democrats, and Freedom and Democracy—plunge from 86% in 1986 to 36% in the latest election (April 2017). It took over seven months of negotiations for four parties to recently agree on a fragile coalition with only a one-vote majority in the parliament. The far-right Freedom Party is now the largest opposition party in the Netherlands.
- Even Germany, long a bastion of political stability, is not immune. The combined support for its two main parties—the Democratic Union/Christian Social Union alliance and the Social Democratic Party—has plummeted from 90% in the late 1970s to under 55% in the last election. Recent polls have their combined support at under 50%. If these two succeed in forming a governing coalition, the far-right Alternative for Germany party will become Germany's largest opposition party.

¹⁰ "Berlusconi May Be Closer to Italian Majority Than Polls Show," Bloomberg, February 5, 2018

- Last June's British election saw the Conservatives lose their majority. They were forced to form a coalition with a tiny Northern Ireland party to stay afloat. Meanwhile, the center-left Labour Party has been taken over by a far-left-leaning leader, Jeremy Corbyn.
- In Austria, the center-right People's Party entered into a governing coalition with the far-right Freedom Party following the October 2017 election. The People's Party was forced to adopt much more hardline views on immigration and the EU in order to win the election.
- The Polish and Hungarian governments continue to pursue populist domestic agendas in defiance of the EU.

The challenge of containing of populist forces would be even more difficult if Europe entered an economic downturn.

Conclusion

The outcome of this election could pose a significant challenge to Italy and the EU. Scenarios for the election range from an unstable coalition that will be incapable of passing major reforms to the formation of an anti-Euro coalition that will challenge the EU on many fronts. Indeed, all parties, including the pro-EU Democratic Party, support policies that risk adding to Italy's already high sovereign debt load in defiance of EU budgetary rules. This will make it even more difficult to convince the likes of Germany and the Netherlands to support the creation of a Eurozone finance ministry in order to provide much greater financial assistance to struggling member states.

The Italian election could also reignite volatility in the European financial markets. Unlike Greece, its much larger size means there is a much greater risk what happens in Italy will not stay in Italy.

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