



Italy: A crisis waiting to happen?

A country nearing an election and with high populist party support, with a generationally underperforming economy, a comparatively huge debt burden, and a fragile banking system which continues to have to deal with legacy toxic debt holdings ticks a number of boxes to us for the ingredients of a potential next financial crisis. Independently, Italy has been dealing with each of these issues for some time. Recently the country has been able to tolerate high debt levels with insulation from aggressive ECB QE and subsequent ultra-low global bond yields. Government dysfunction is also relatively well engrained with sixty-five governments having ruled since WWII, with parties united and subsequently separated in often short lived coalitions, albeit never including the then Italian Communist Party which has arguably been one of the main populist parties before the 5SM was established.

Figure 44: Italy Government Debt to GDP



Source: Deutsche Bank, Haver

However the next twelve months could see Italy arrive at a crucial juncture which will help dictate the medium-term road ahead. With an election looming, populist anti-euro support in Italy is hovering just above 45%. The timing of the election will also likely coincide with reduced ECB buying of BTPs and should Eurozone inflation rise (especially if Italian inflation remains weak), then the threat of rising BTP yields without a sustainable improvement in economic growth will likely test the limits of Italy's already elevated debt to GDP. Debt sustainability remains the biggest medium term problem and leaves Italy very exposed to a recession, in our view. Assuming limited tailwinds from structural growth, this places a huge burden on the need for cyclical growth. While the recent cycle has been strong, the fear is that this won't last forever and that Italy will be exposed when the global cycle rolls over.

One unexpected factor that could challenge Italy's currently strong cycle economic performance is the appreciating euro exchange rate. Contrary to perceptions, Germany is much less sensitive to currency strength than Italy despite both economies being known as large exporters. This may reflect various structural features of the Italian economy, including a smaller import content of exports, signalled less extensive global supply chains. According to European Commission estimates, Italian exports are three times more sensitive to changes in the real effective exchange rate than Germany.

Meanwhile the NPL story might be improving and less of a concern than it once was but holdings of BTPs by local banks adds another dimension to the equation. Mixed together, the ingredients are there, but whether or not this is a recipe for disaster, only time will tell.