Investing in Italy?

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A review of the latest decision of the European Central Bank from 12th September 2019, the current state of Italian politics, the general economic situation and why it might be worth again to consider investments in the south-European nation.

Highlights

- The latest ECB decision boosted Italian bonds, stock market also higher, spread with German Bund dropped
- After political turmoil over the last years, a new pro-European has been elected, which should reestablish confidence
- Improved, yet modest growth forecast for 2020, after a two-year decline

I. INTRODUCTION

The last decision of Mario Draghi as acting president of the ECB to restart the bond purchasing program together with a further reduction of the main deposit rate have exceeded market expectations. Italian bonds have gained and the decision might make the country's problem of overwhelming debt, at least in the short and middle run, less pressing than in the previous months. Moreover, the political situation has calmed down over the summer, as the old government of the Five Star Movement and the League collapsed and the south-European country is now run by a coalition of the Democratic Party and the Five Stars Movement. Hence, the overall political climate changed towards being more Europe-friendly. Adding to this new period of stabilization, lately the left-leaning coalition under prime minister Giuseppe Conte won a vote of confidence in the senate, which is the final step for the government to fully start working.

If a fiscal stimulus would be able to bring the economy back to its growth trend, it would effectively improve debt sustainability. This is why the low Italian growth rates are not a topic of austerity, based on the fact that a low-growth country can only sustain a lower debt. Rather, they are a stimulus because debt cannot be sustained with low growth. An exemplary case is Greece which, after years of severe austerity, has lost a quarter of its GDP and its debt-to-GDP ratio is now higher than before, even after substantial debt cancellation. A context of interest rates close to zero like the current one, confirmed again by Mario Draghi until the end of the first half of 2020, should be self-financing, even if it contributes to only slightly positive nominal GDP growth. Naturally, Italy pays a considerable interest premium, but a large part of this spread has already decreased thanks to the new Europe-friendly government.

II. THE CURRENT POLITICAL SITUATION

Italy's current political situation is the result of the collapse of the previous coalition government of League and Five Star Movement. Although both parties have opposite ideologies they decided to collaborate to gain the majority in the parliament, and they elected Giuseppe Conte as a 'neutral' Prime Minister. Because of this contraposition and consequent multiple clashes, the situation was marked by a stagnation of political, economic and social progress and instability. Moreover, this government was anti-european, refusing debates with Europe regarding budget deficit rules and it was also pushing for a possible exit out of the EU. As a result, the spread increased dramatically over the fourteen months of this government and rating agencies lowered their ratings. Given the struggles of both parties to compromise, Matteo Salvini, leader of the League, decided to let the government collapse, speculating he could become the new prime minister. Nevertheless, the President of the Republic, Sergio Mattarella, chose to establish a 'Conte-bis' government, consisting of the Democratic Party and the Five Star Movement. This resolution was needed for the country to bring on measures such as the approval of the budget law, the stabilisation of its VAT tax and the establishment of a minimum wage, but also to get its budget deficit approved by the EU. As the current government seems to be more cooperative than the previous one, the two ruling parties share a common intention to stabilize the country's situation. Moreover, the establishment of the Democratic Party in the government is seen as positive by markets, given its pro-European attitude, instead of threatening markets with an imminent exit. As a result, this might help Italy to get its increasing budget deficit approved and, as a consequence, to trigger economic recovery. The stability of this new government has been attested also by Moody's which confirms the bba3 rating and gives a stable outlook for Italy.

III. THE ECONOMIC SITUATION TODAY

Italy's economy struggled for a few years after the financial crisis of 2008. Following a weak recovery after 2014, the current economic growth has declined again, mainly due to uncertainties of its latest government to exit the Euro. For years, the country faced a drag of its growth by strong structural problems, which no government managed to tackle properly. However, growth in 2018 stabilized around zero and the latest economic outlook by the OECD looks positive, possibly hitting one per cent next year.[1]

Fig. 1: Italy GDP growth and forecast

Source: OECD (2019)

Regarding the current government's stand on debt reduction and fiscal policy, opinions are torn. The two parties intend to reduce the debt-to-GDP ratio by boosting economic growth via active public investments in education, public administration, the transformation towards a circular economy and digitization. Support for this stand also comes from the IMF itself, which underlines the critical impact of public spending on growth and positive future tax receipts.[2]

For investors this might sound interesting since many educational and environmental projects offer a return well above zero. Given that a pro-European government takes an active role in tackling main issue of the 21st century, this could provide great opportunities for private initiative. Improving the efficiency of public administrations can help business-owners to realize important innovations more quickly, which also would allow the country to overcome its weak productivity growth of the last decades. Recently, the OECD (2019) found that higher administrative efficiency is associated with higher productivity, by comparing regions within Italy.[3] As policy makers around the world are pushing for a more active role of governments on issues such as climate change and digitization, a well-defined, innovation-orientated fiscal engagement of Italy could open up immense investment opportunities. Depending on the nature of the measures, investors might also receive the chance to get involved in partly financing these projects.

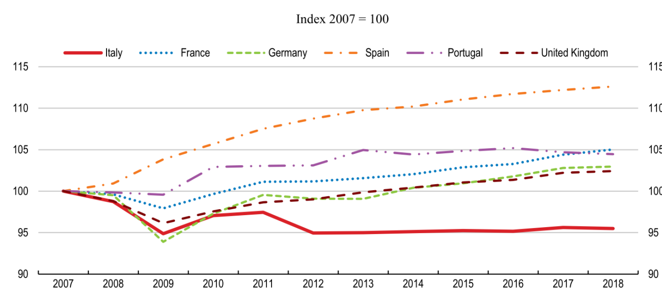

Fig. 2: Aggregate productivity has not increased for many years in Italy

Source: OECD (2019)

IV. THE LATEST ECB DECISION

Mario Draghi announced a refresh of the ECB's QE program during his last press conference.[4] In November Christine Lagarde, until recently president of the IMF, will replace Draghi as president of the ECB. Specifically, the ECB will restart purchasing bond purchases in terms of €20bn a month from November on with no end date specified so far. In addition, the bank cut its main deposit rate even further from 0.4 to 0.5 per cent. Markets valued this decision with Italian bonds gaining notably in value. This ECB decision can

[1] http://www.oecd.org/economy/italy-economic-snapshot/

[2] https://www.imf.org/external/pubs/ft/fandd/2016/06/ostry.htm and https://www.ft.com/content/6da72060-cfd2-11e9-99a4-b5ded7a7fe3f

[3] http://www.oecd.org/economy/italy-economic-snapshot/

[4] https://www.ft.com/content/97fe945e-27ed-3c59-a81f-8371cf78f27d

be seen as a stabilizer to the country's bond prices. Together with an improved political environment, this could stabilize the situation for investors. In the last week 10-year BTP yields reached a record low of 0.76 per cent (0.84 per cent the 14th of September). The spread with the German Bund fell to 130 points (trading started at 150 on Monday), the lowest level since May 2018, when the nascent Five Star Movement-Democratic Party government had not yet published the program that seemed to pave the way for the clash with the European Union. The yield curve also flattened extensively in comparison to previous months, reducing long-term borrowing costs for the new government.

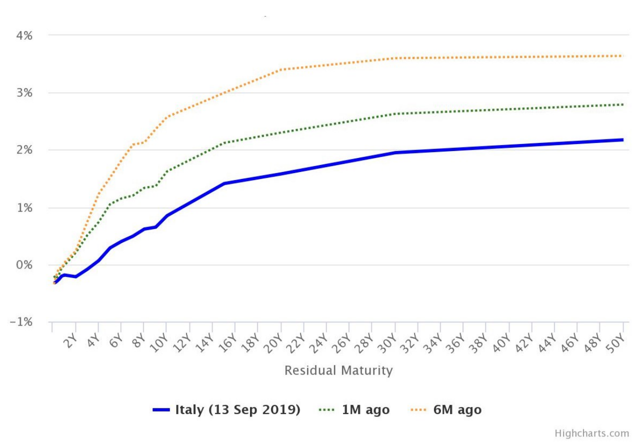

Fig. 3: Italian government bonds yield curve 13th September compared to one and six months ago

Source: World Government Bonds (2019)

By refreshing QE, the ECB continues to lower rates and buy bonds, which should fuel growth, but also implies risks and damage from excess liquidity. Excess that should cause inflation and finally should lead to an end of the stimuli. Instead, it is precisely the insufficiency of inflation (currently at one per cent) which motivates new expansionary decisions. These, even without inflation, have other undesirable side effects. With very low or negative rates, intermediaries fail to have adequate margins and to ensure, for example, holders of pension funds, the returns they had promised contractually. This effect, said Draghi according to Financial Times, is limited, bearable and well monitored by the ECB.[5] Moreover, it is offset by the benefits of low rates on the real economy. According to Draghi's statements during the latest press conference, financial intermediaries should not complain about the low rates but rather cut costs and become more efficient. The implied danger of skyrocketing asset prices due to the ECB's policies are coped with by means of macro-prudential controls and monitored carefully.

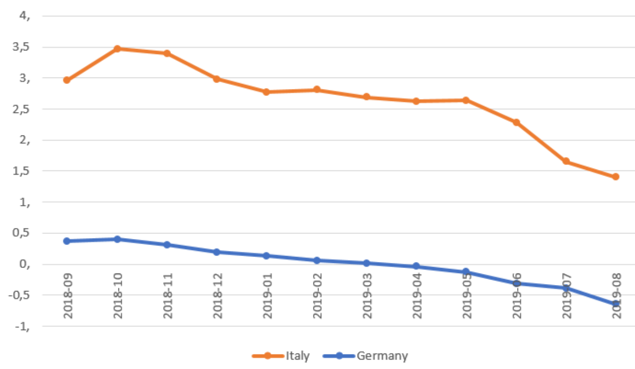

Fig. 4: Long-term government bond yields Italy vs. Germany

Source: Eurostat (2019)

Regarding Italy's stock market reaction, the FTSE MIB gained 1 per cent in the week of Draghi's announcement of QE2 (+0.44 per cent at the day after the announcement). This has been the fourth consecutive week of earnings. From the lows of August 9th - the highest point of the political crisis which culminated into the exit of the League from the government - the rebound of the Milanese list is 13 per cent. From the beginning of the year we are at +21 per cent. In Europe, only Athens has showed better performance, with +45 per cent.

V. INVESTING IN ITALY

Even though investors face a higher risk in the south-European economy compared to safe heavens like Germany, the recent development lighten up expectations. The ECB safeguards the country's bonds and political stability is back with a new pro-European government, reducing the likelihood of the country to leave the Euro. However, the biggest drag to reviving economic growth is its weak productivity growth and the mountain of debt, limiting its fiscal action capacities.

Even if the structural growth of the Italian economy could seem basically blocked, the stock market has been going very well in recent weeks as investors have regained confidence in the country's companies. As the fear of Italy exiting the Euro is decreasing due to

[5]https://www.ft.com/content/97fe945e-27ed-3c59-a81f-8371cf78f27d

Country	Yield	Spread
Germany	-0.47	-
France	-0.18	+29
Ireland	0.08	+55
Italy	0.93	+141
Netherlands	-0.20	+27
Portugal	0.33	+81
Spain	0.38	+85

Yields and spreads of 10 year government bonds of selected European economies. Source: MTS Markets (2019)

new political circumstances, investors should consider to invest in Italy again.

The new government intends to strengthen long-term investments to increase GDP. But the money Italy needs could come directly from investors, who believe that the country will grow. Recent developments give hope for a stronger economic expansion in the years to come. Public private partnerships can be a profitable way for investors to enter in the Italian market, via financing necessary projects of the country to overcome its structural problems as well as tackle the pressing issues of the 21st century.

Moreover, the relatively high yields Italian government bonds offer, can attract investors who search for profits in nowadays low-interest environment. Even though the last years were not marked by an environment of confidence, the new circumstances are exactly the possible location for high-yield investments.

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[6] Eurostat (2019): Long term government bond yields, https://ec.europa.eu/eurostat/web/products-datasets/-/teimf050 (last seen 17.09.2019 17:47)