Mario Draghi: Deus Ex Machina or Knight of the Apocalypse?

The Future of Italy and Implications for Europe

By Matteo Cominetta, London

Servicing Italian debt has never been so cheap. Interest expenditure is lower today than in 2007, when debt was €1 trillion smaller. Does this mean that the scarecrow of European financial markets, Italian debt sustainability, has flown away?

The answer is yes, for now. Looking ahead, though, it depends on how successful Mario Draghi's new government may be at introducing reforms that boost productivity enough to allow Italy to outgrow its debts. Draghi's predecessors have tried this before without success, but he has a better chance than they did. He is off to a good start with a political coalition that may keep him in power through 2023, but he will really need to deliver on education, taxes and public administration reforms to help the country turn the corner.

Italy has the European Central Bank to thank for its debt sustainability; the ECB's asset purchase programme is estimated to have cut longer-term rates by 150 basis points. Having pushed bond yields this low to support those sectors and countries most hit by the pandemic, the ECB is ensuring a rebound in growth in the years ahead. This will make it easy for economic growth to generate the income necessary to pay the debt bill.

Good news about a strong recovery in the euro area might brighten the Italian horizon, but that in itself will not be enough. There are two overall scenarios: either growth for Italy and the euro area accelerates in a similar fashion, or the two diverge, making the job of setting one monetary policy for the whole, single currency increasingly hard. Let's analyze the second, downside scenario first.

1) Stuck in the Status Quo…

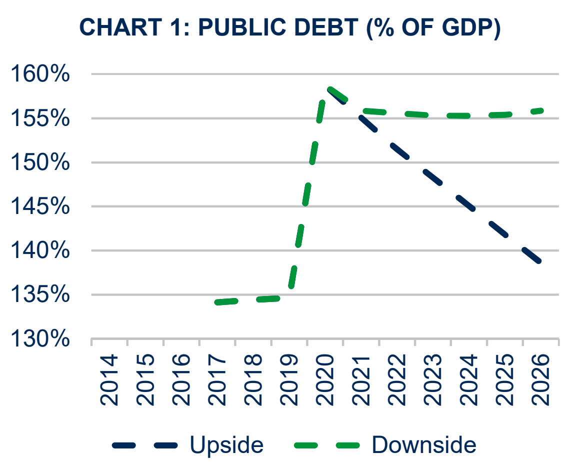
Examining Italian debt sustainability over the medium term shows that, if the unprecedented fiscal accommodation gets growth and inflation quickly above pre-COVID averages but does not increase Italy's productivity, so that the country keeps growing much slower than the rest of the euro area, the ECB could find itself in an uncomfortable position. It would have to consider withdrawing the necessary support to the Italian bond market, without growth being strong enough to reassure investors that the bond market can walk without the ECB stick.

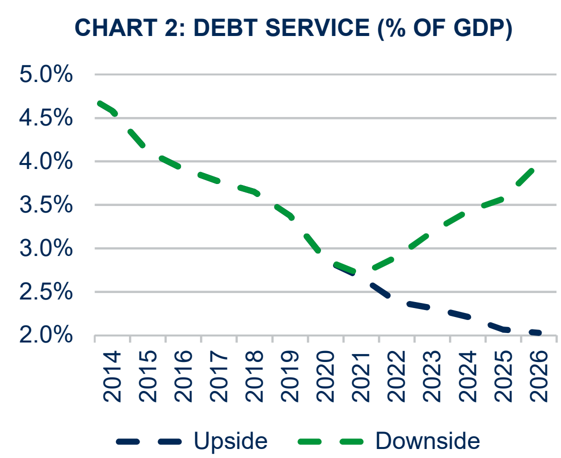
In this case, a loss of confidence could drive spreads wider. The ratio of debt/GDP would not explode but would remain high, close to its record-high 2020 level around 160%. More worryingly, debt servicing costs would rise quickly, requiring unrealistic primary surpluses to honor the debt (see Charts 1 and 2). Debt sustainability would come in doubt. Table 1 describes the key assumptions behind this scenario.

Table 1. Status quo scenario: Assumptions

	2020	2021	2022	2023	2024	2025	2026
Real growth	-9.0%	5.5%	3.0%	1.3%	1.3%	1.3%	1.3%
Inflation	-0.2%	1.0%	1.3%	1.0%	1.0%	1.0%	1.0%
ECB deposit rate	-0.5	-0.5	-0.5	-0.5	-0.25	0	0.5
BTP 7Y spread	1.54	1.00	3.00	3.00	3.00	3.00	3.00

Notes: The medium-term growth path from 2023 assumes potential growth is back at its 2010-20 average (0.6%) and additional 0.7% of growth is financed by deficit spending, with an assumed 0.5 fiscal multiplier. Inflation returns to its 2010-20 average. The BTP-Bunds spread is shocked at its 7-year maturity, which corresponds to the weighted average maturity of Italian public debt.





Source: Haver. As of February 15, 2021.

In such a scenario, could sovereign debt cancellation become an option? Debt cancellation's feasibility, both legally and politically, is minimal in the EU, which is why it will be the very last resort, when any other avenue has closed and a financial apocalypse, such as a breakup of the euro, is in sight. Fortunately, with most euro area governments issuing debt at negative rates, financing public spending is cheap and debt cancellation is just not needed now. It is however not possible to discard the thought that this may change much later down the road if, for example, inflation roars back and requires the ECB to raise rates so much that it makes debt servicing costs close to unaffordable for some.

2) …or Italian Renaissance

What if productivity and growth show solid acceleration in the euro area and in Italy, too? Then a healthy debt workout becomes possible. This is why the European Recovery Fund (ERF) is crucial for Italy and the euro: its aim is precisely to increase productivity and growth. The European Commission has established a good process and standards to evaluate the projects that countries put forward before disbursing, and has shown tentative signs that these standards will be upheld[1]. It also made clear funds

[1] The European Commission has requested Hungary to reform its public procurement laws to curb systemic fraud before ERF funds can be disbursed to the country. See: https://www.reuters.com/article/us-health-coronavirus-eu-hungary-exclusi/exclusive-eu-to-hungary-change-procurement-to-bar-systemic-fraud-from-recovery-stimulus-idUSKBN2A8156

cannot be used to back current spending, but rather only investment, so the intentions and the set-up are both good.

Then, of course, the implementation is the hard part, and this is why Draghi's government could be a watershed moment (again) for EU economic history. The debt sustainability analysis shows that if Italy manages to use the ERF to increase its potential growth to the euro-area average (i.e. 1.3%) and maintains fiscal accommodation to reach 2% annual growth, its debt service costs and debt-to-GDP ratio would both follow a declining trend. Italy could then afford a normalization of ECB policy. Markets would perceive Italian debt as risky as that of more dynamic peripheral markets, such as Spain. Italian spreads could converge to Spanish ones. This, in turn, would allow the ECB to gradually taper its intervention and eventually exit (Table 2 and Charts 1-2).

Table 2. Renaissance Scenario: Assumptions

	2020	2021	2022	2023	2024	2025	2026
Real growth	-9.0%	6.0%	4.5%	2.0%	2.0%	2.0%	2.0%
Inflation	-0.2%	1.0%	1.8%	1.8%	1.8%	1.8%	1.8%
ECB deposit rate	-0.5	-0.5	-0.5	0.0	0.5	1.0	1.0
BTP 7Y spread	1.54	0.85	0.43	0.43	0.43	0.43	0.43

Notes: The medium-term growth path from 2023 assumes potential growth rises 0.7 percentage points above its 2010-20 average thanks to productive investments financed by the EU Recovery Fund. An additional 0.7% of growth is financed by deficit spending, with an assumed 0.5 fiscal multiplier. The BTP-Bunds spread is shocked at its 7-year maturity, which corresponds to the weighted average maturity of Italian public debt. The ECB starts normalising rates in 2023, with a 50bp a year, 3-years long hiking cycle.

Reforming Italy and raising growth to the EU average is an extraordinary task, but equally extraordinary is the resources made available by the ERF (€209 billion or 11% of Italian GDP between grants and loans) as well as the commitment of EU authorities to see it through. Not only because the ECB supported Italian bonds so much that markets did not even sell them when the government fell in January, but EU fiscal rules that would require harsh fiscal austerity in the next years have been waived. Also, the management of the COVID crisis has been so incomparably better this time that it will not cause another lost decade as happened after 2008. This in itself will keep Italian growth higher.

And then there is Mario Draghi, one of the very few, if not the only person who can stay above ultra-partisan Italian politics and draw support from all sides. In fact, Professor Draghi's "unity" government started with the widest support since Italy became a republic in 1948. Only one party did not support it, an absolute first. It will not be smooth sailing; party support can shift rapidly once the emergency passes, as Mario Monti learned in 2012. There are however two major differences to be more optimistic this time. First, Monti had to implement a harsh austerity program, while Draghi has the happier task of spending €209 billion of EU money. Secondly, with such a wide majority, no party is indispensable for Draghi. He has the numbers to govern even if one of the unpredictable parties, Lega or the Five Star Movement, defects and the other supports him. It will be a fine balance to strike, but not an impossible one.

Judging from the hints he gave on the government program, Draghi will not waste any time tackling Italy's structural problems and raising growth. Besides the vaccination program, his first actions will focus on a throughout tax reform and on restarting public investment in education, logistics and decarbonization. The importance of these interventions for increasing Italian growth cannot be overstated. Italy ranks 128th for costs of paying taxes in the World Bank Ease of Doing business index, by far the worst in the European Union[2]. As for public investment, this has been cut brutally[3] since the 2012 crisis. Using the ERF to restart productive investment would have certain impact on Italy's productivity and growth.

2021 will be an exciting year: we will learn if Professor Draghi will again be the deus ex machina, unexpectedly solving Italy's and the euro's problems, or the knight of the euro apocalypse, showing that the inner contradictions of the common currency cannot be solved. Certainly, there is no better person to succeed, and the stars in Brussels, Paris and Berlin are aligned.

[2] The second worst is Bulgaria, ranked 97th.

[3] By 23% cumulatively, equalling now 3.5% of GDP, down from a peak 5.5% in 2006.

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed. Past performance is no indication of current or future performance. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document. For Professional Investors/Institutional Investors only. This document should not be distributed to or relied on by Retail/Individual Investors.

Barings LLC, Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sàrl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"), together known as "Barings." Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved and before making any investment decision, it is recommended that prospective investors seek independent investment, legal, tax, accounting or other professional advice as appropriate. Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking.

*As of December 31, 2020

21-1528852