



Lorenzo Codogno

LC Macro Advisors Ltd

Founder and Chief Economist

+44 758 3564410

lorenzo.codogno@lc-ma.com

Visiting Professor at London

School of Economics

L.Codogno@lse.ac.uk

Europa, economia e mercati finanziari post tornate elettorali

Le sfide, i rischi e le opportunità di un'Europa in cambiamento tra squilibri macroeconomici, riforme, vincoli di bilancio e revisione della governance

AIPB Private Talk, presso Cordusio SIM, 9 aprile 2018

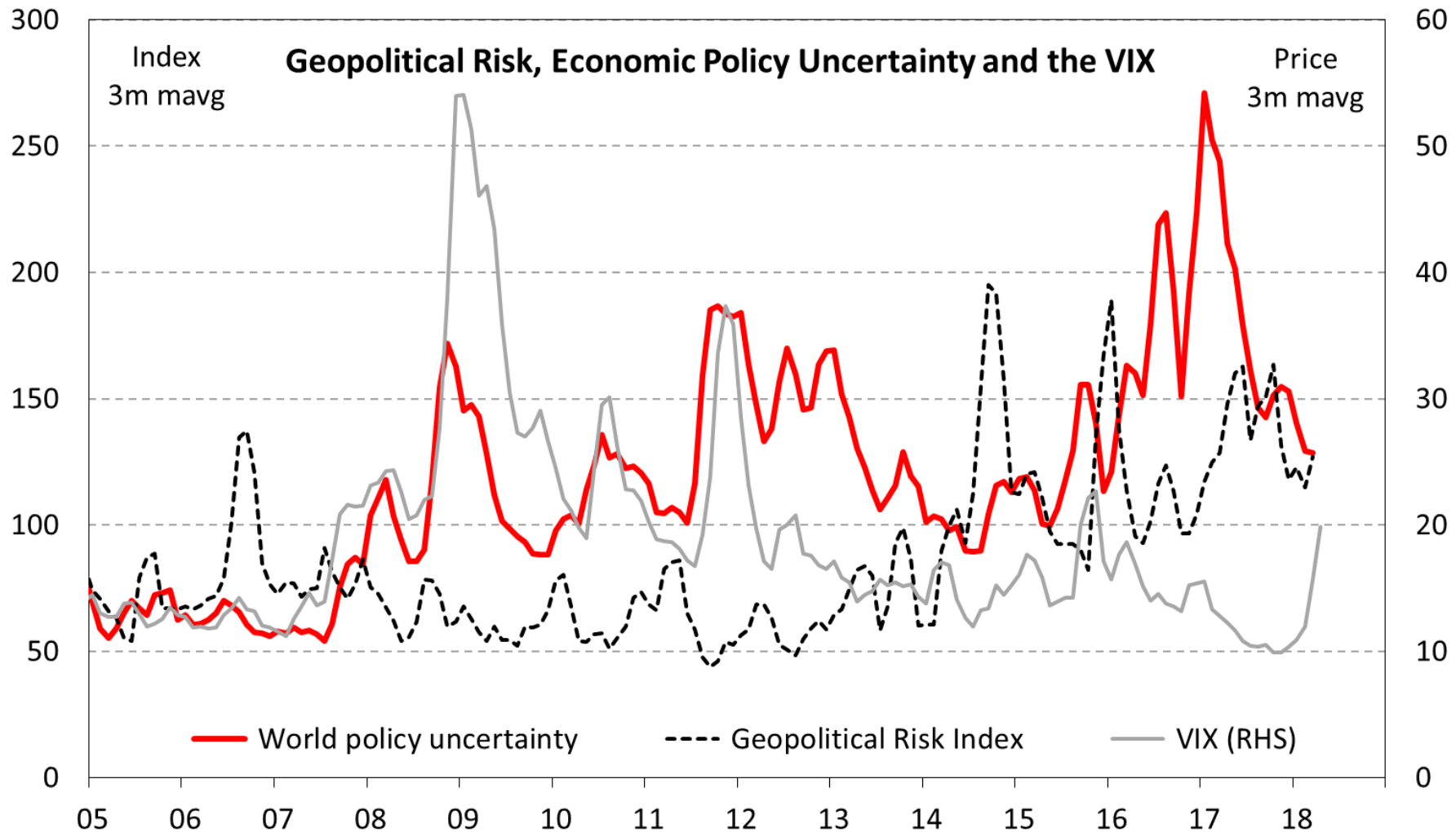
AGENDA

Italy and Europe in a changing global environment

- ◆ **Global geopolitical risk/policy uncertainty:** Still elevated.
- ◆ **Global growth:** Still strong momentum despite some softening.
- ◆ **Financial markets:** Valuations are overstretched.
- ◆ **Eurozone:** Can the ECB manage normalisation smoothly?
- ◆ **Italian economy:** Recovery strengthening, lack of fiscal adjustment.
- ◆ **Italian elections:** Surprising outcome. What are the risks?

GEOPOLITICAL RISK/POLICY UNCERTAINTY

Geopolitical risk/policy uncertainty remain elevated

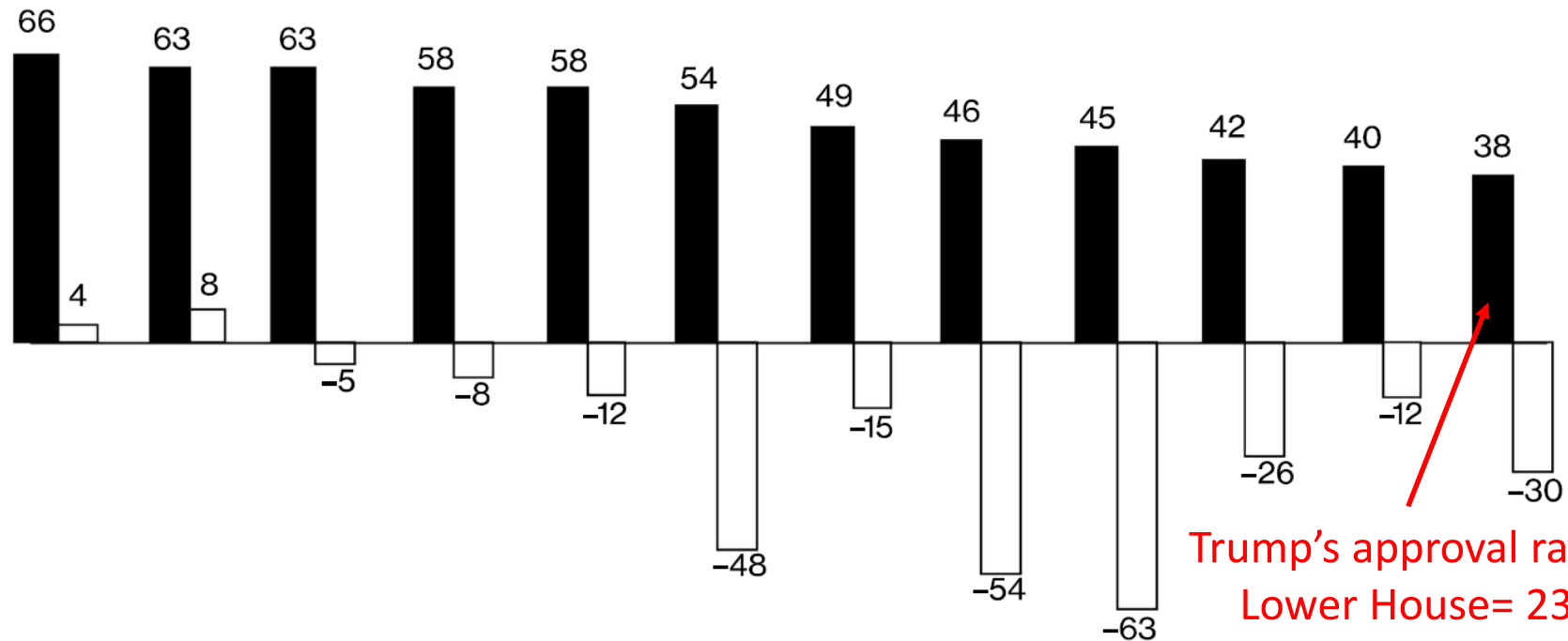
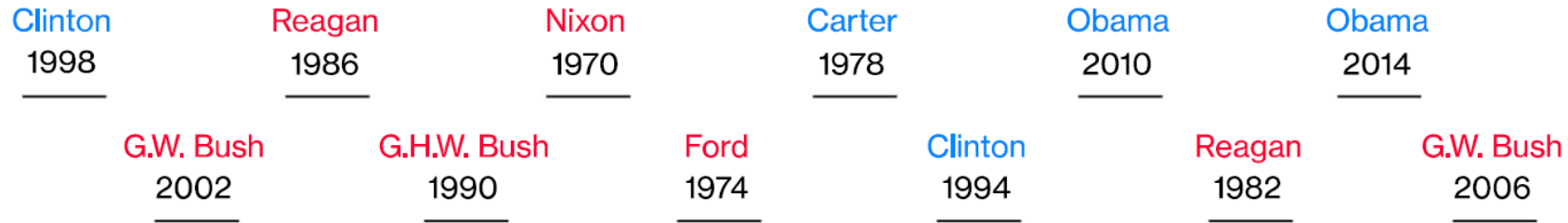


Source: "Measuring Economic Policy Uncertainty" by S.R.Baker, N.Bloom and S.J.Davis at www.PolicyUncertainty.com; current prices, GDP weight. Caldara, Dario and Matteo Iacoviello, "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve Board, August 2017.

GEOPOLITICAL RISK/POLICY UNCERTAINTY

US: Republican dominance to a screeching halt?

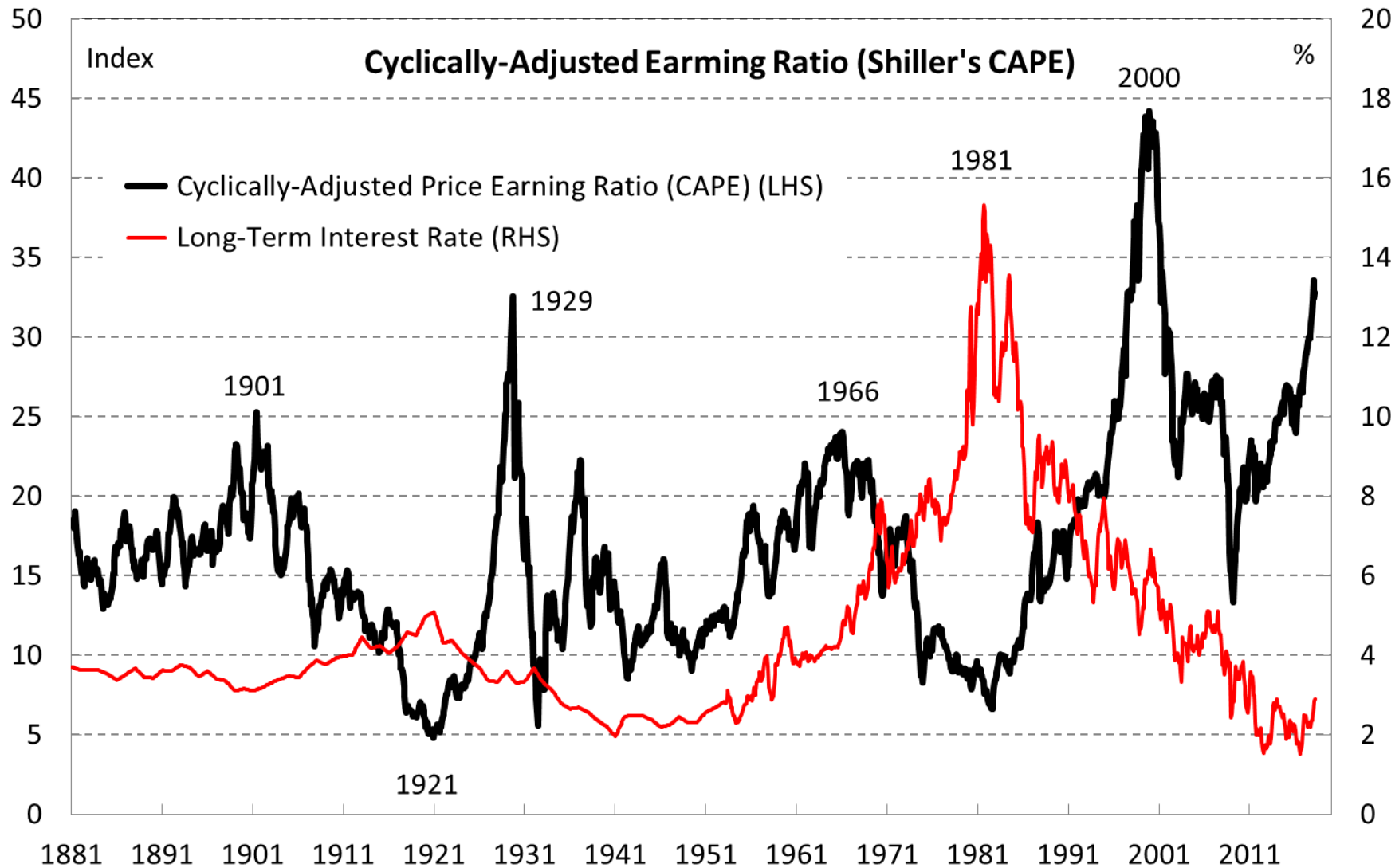
■ Presidential job approval at midterm □ Midterm election House seats gained or lost by President's party



Trump's approval rate = 38%
Lower House = 238-193
Senate = 51-49

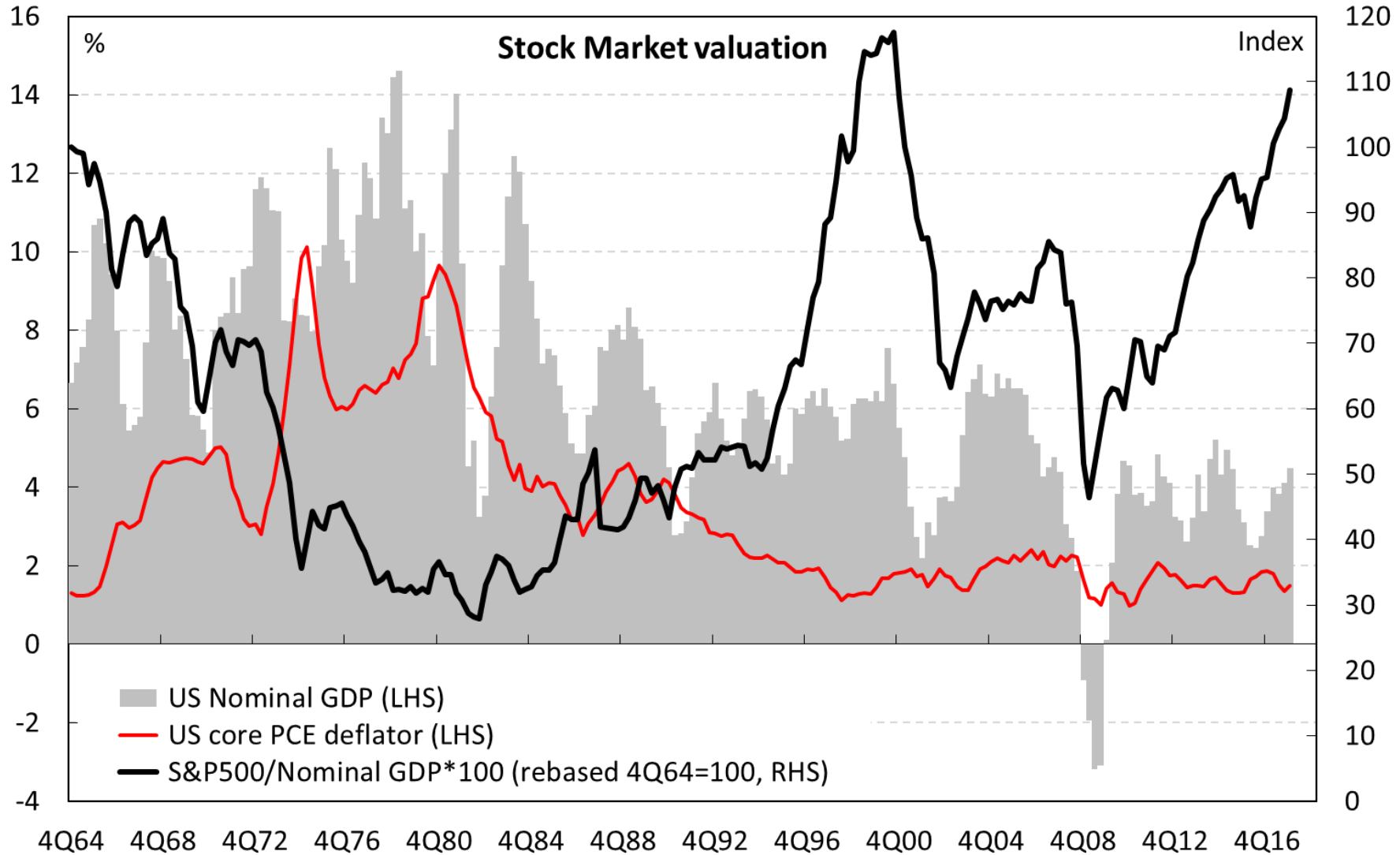
Sources: Gallup, American Presidency Project

Are valuations too high relative to earnings prospects?



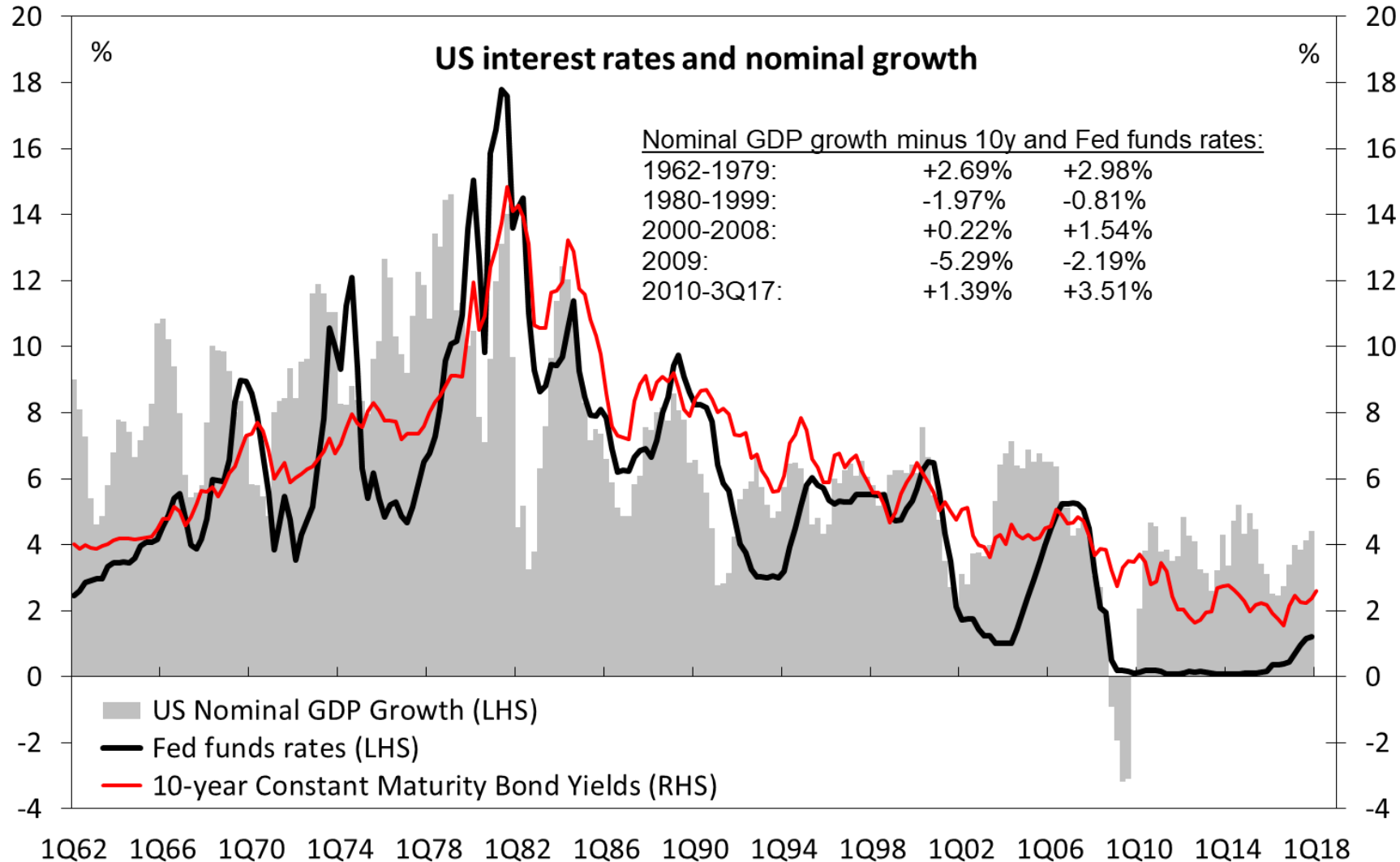
Source: Thomson-Reuters Datastream, LC-MA calculations, Robert Shiller's CAPE model.

Are valuations overstretched relative to GDP?



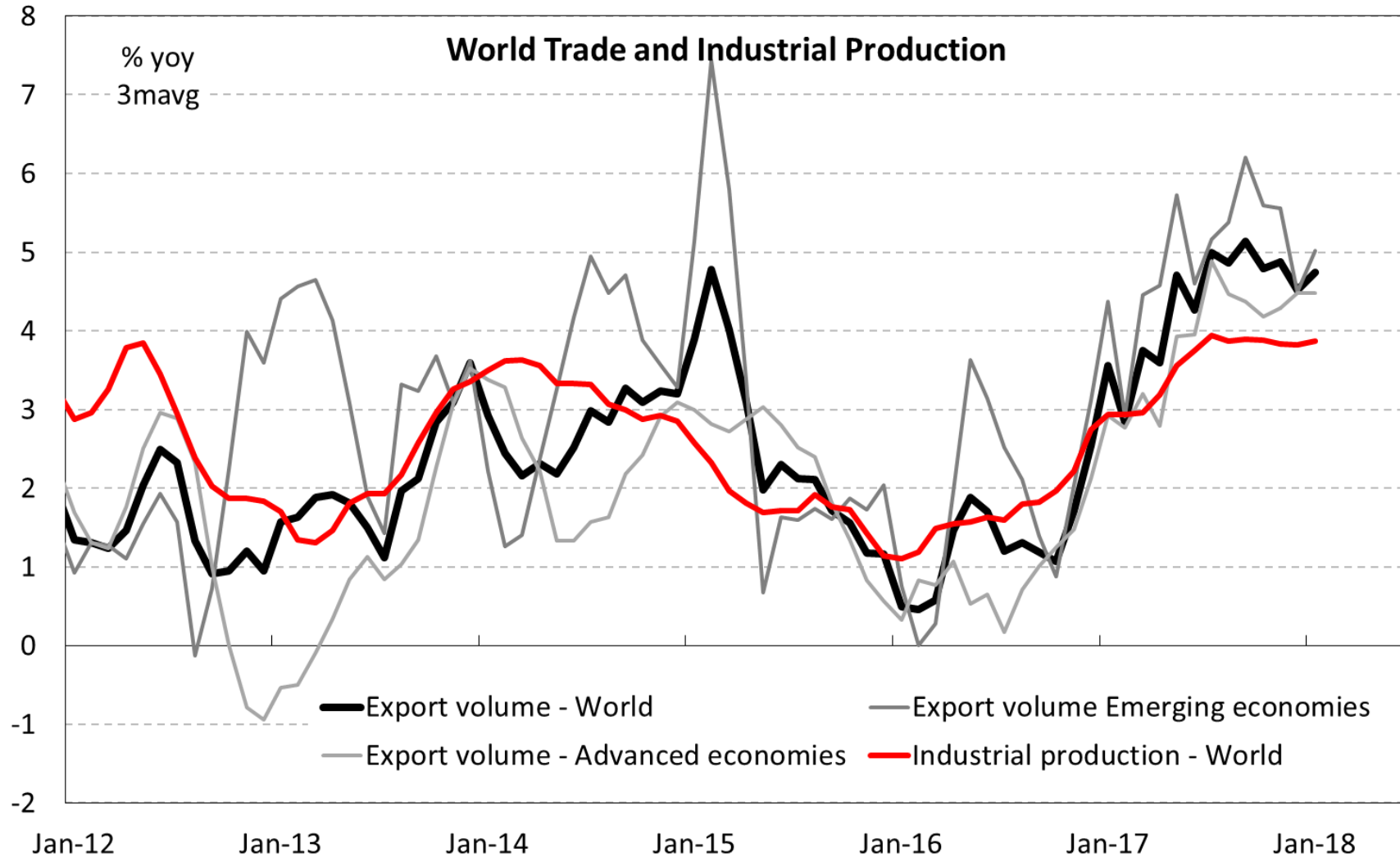
Source: Thomson-Reuters Datastream, LC-MA calculations.

Short and long-term rates are too low: NPV will suffer



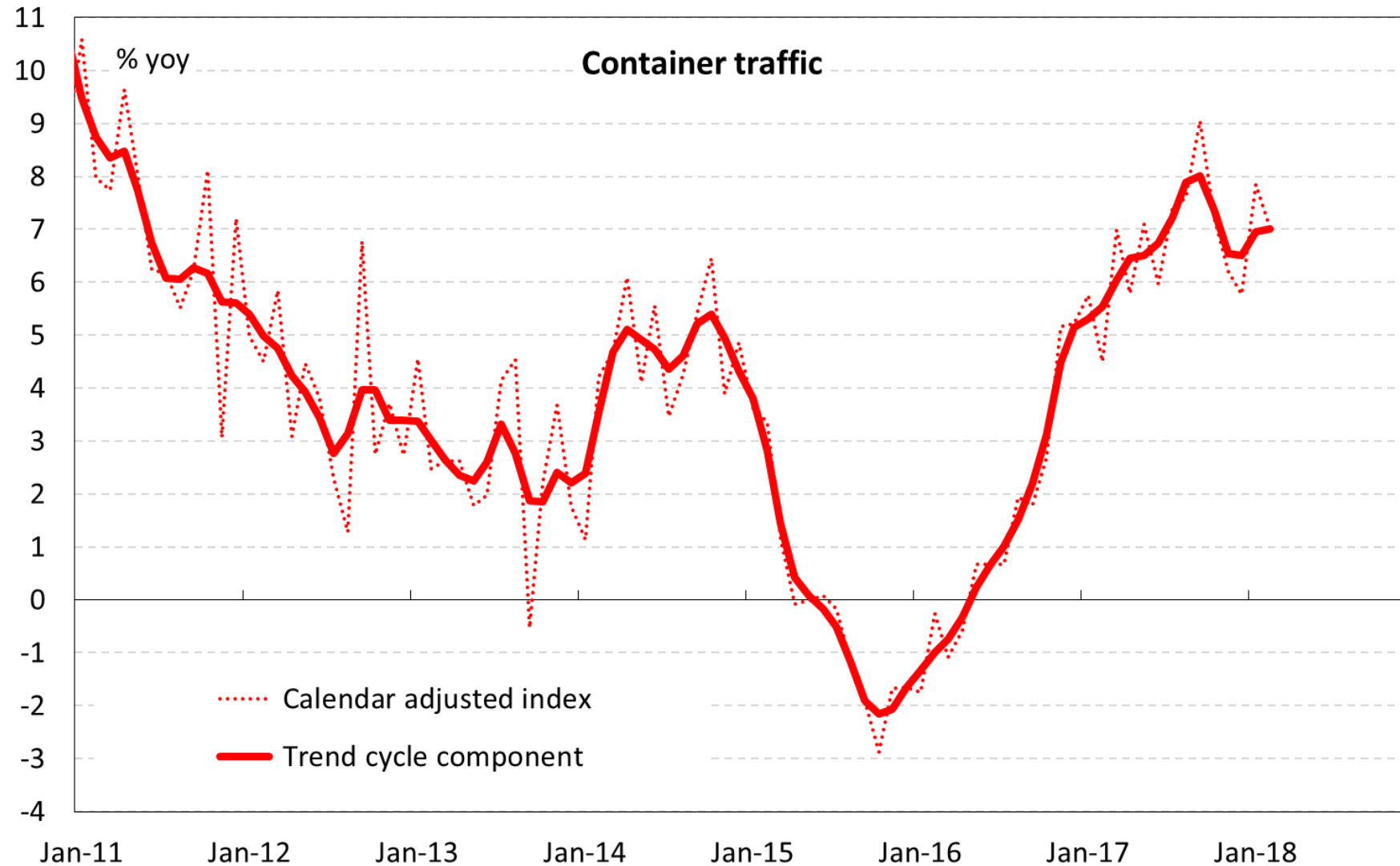
Source: Thomson-Reuters Datastream, LC-MA calculations.

Can trade wars derail global growth?



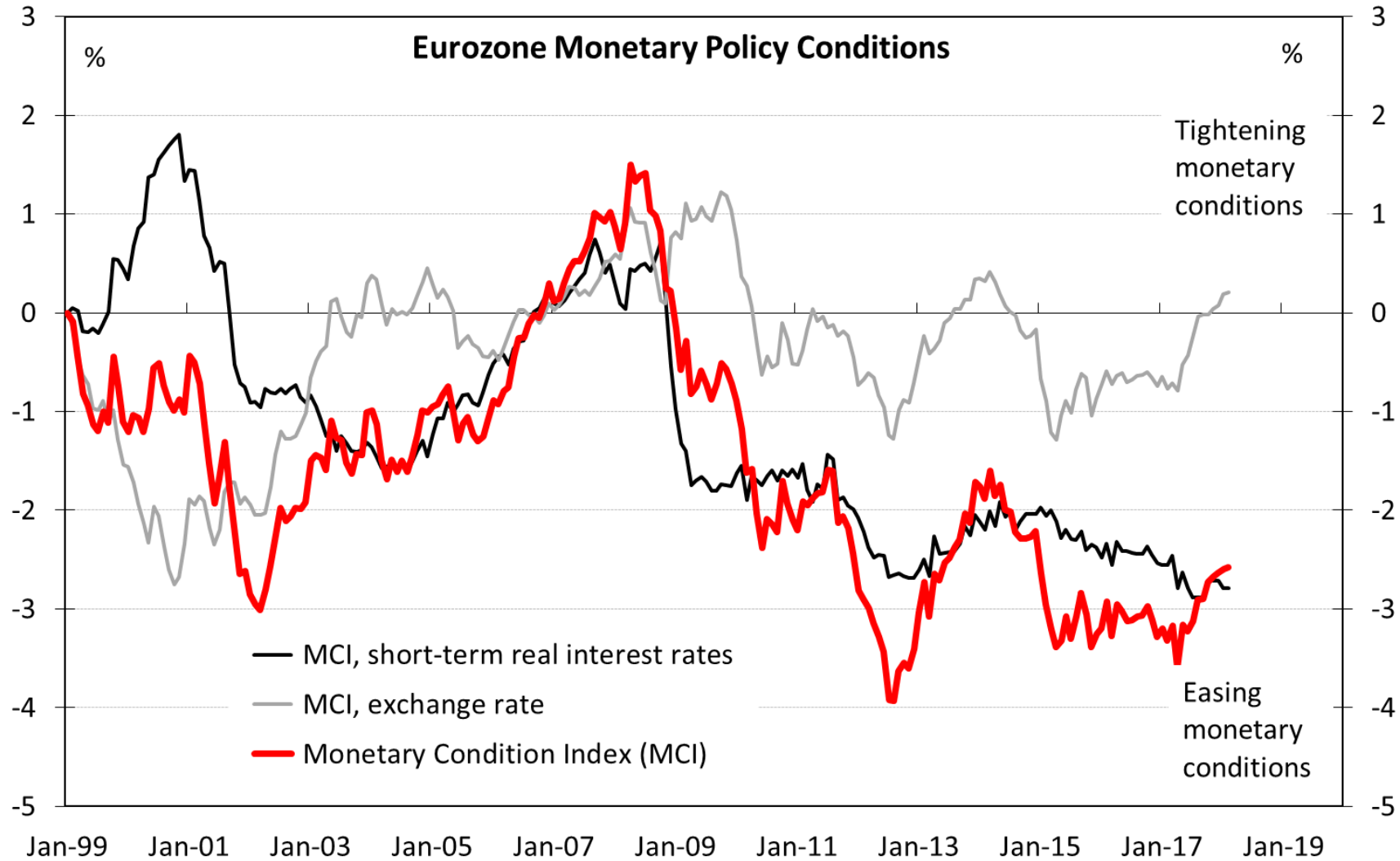
Source: Thomson Reuters Datastream, CPB Netherlands, LC-MA calculations.

Despite creeping trade barriers. traffic has grown



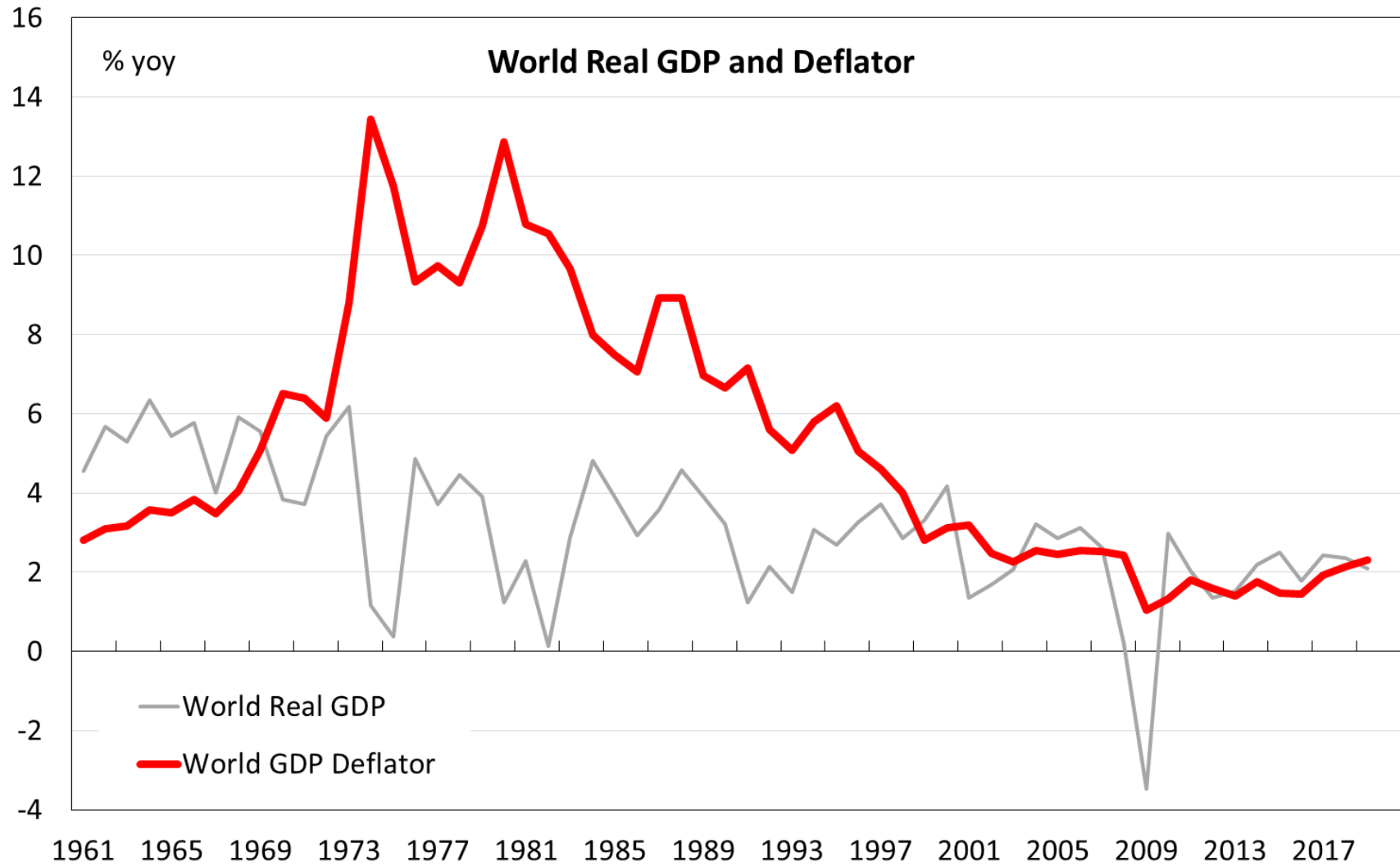
Source: Thomson Reuters Datastream, RWI Leibniz Institute for Economic Research, Institute for Shipping and Logistics.

Currency wars on top of trade wars?



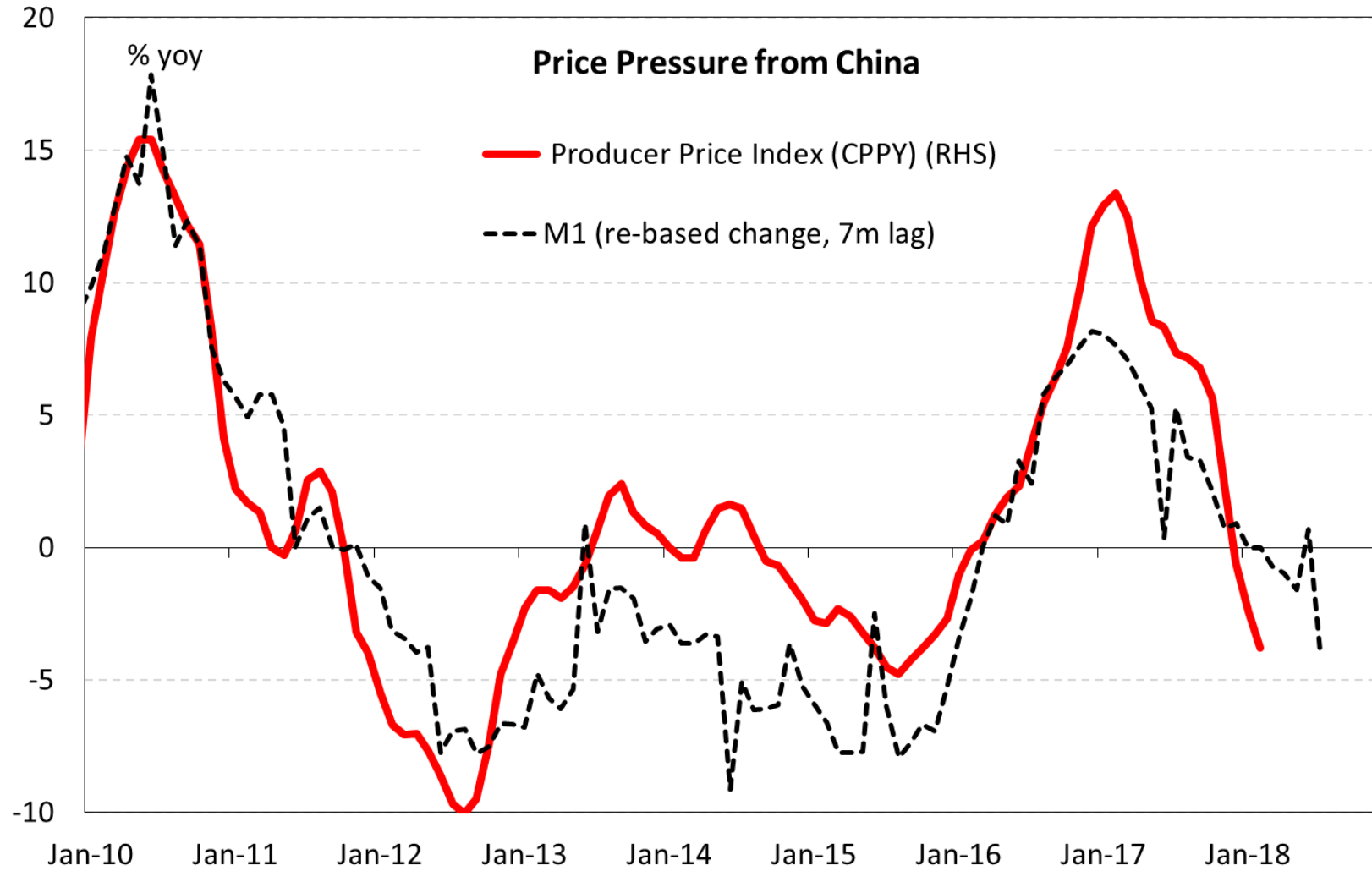
Source: Thomson-Reuters Datastream, ECB, LC-MA calculations.

Is there any turn in the supply-side of the economy?



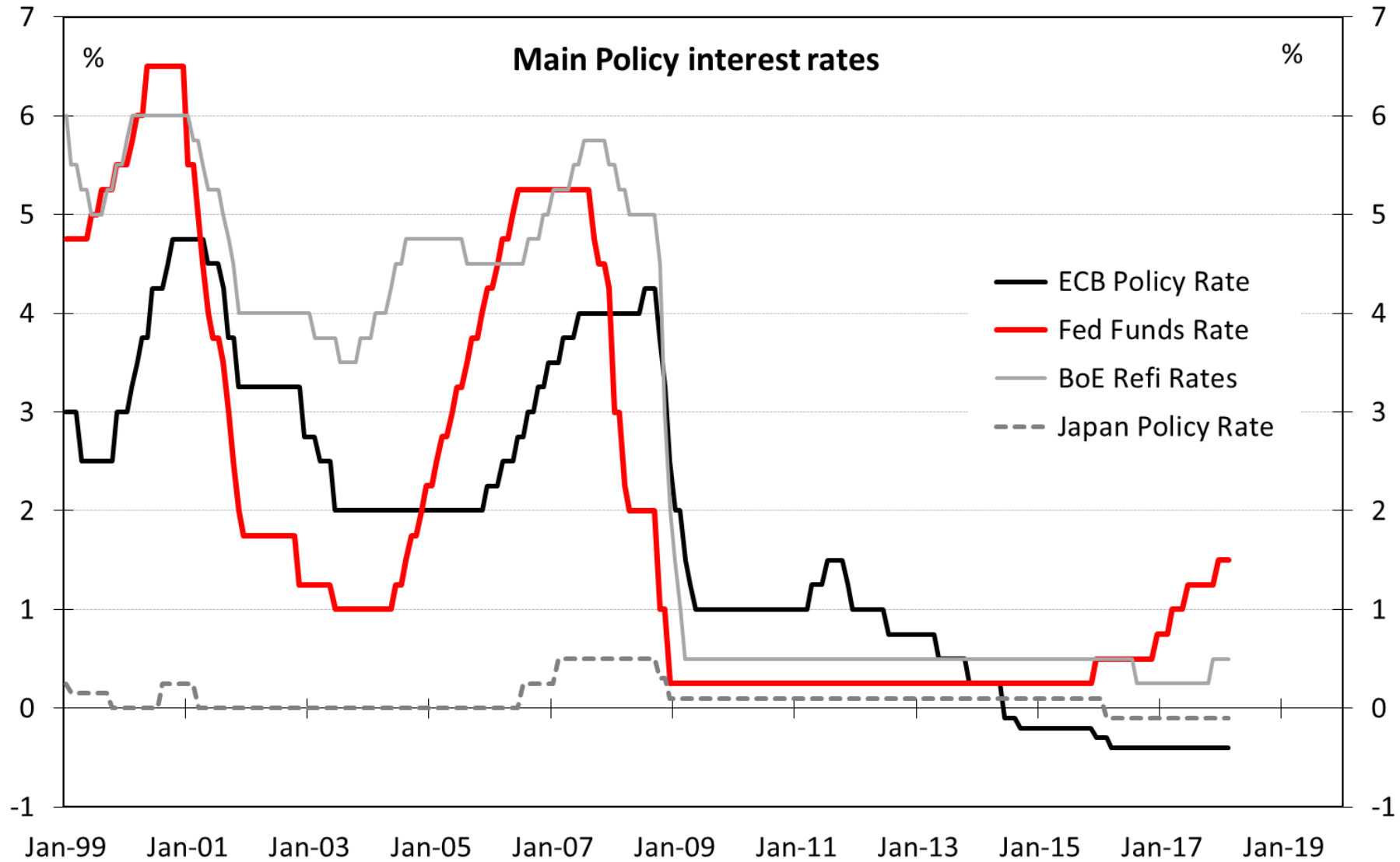
Source: Datastream Thomson Reuters, OECD, LC-MA calculations.

International price pressures remain subdued



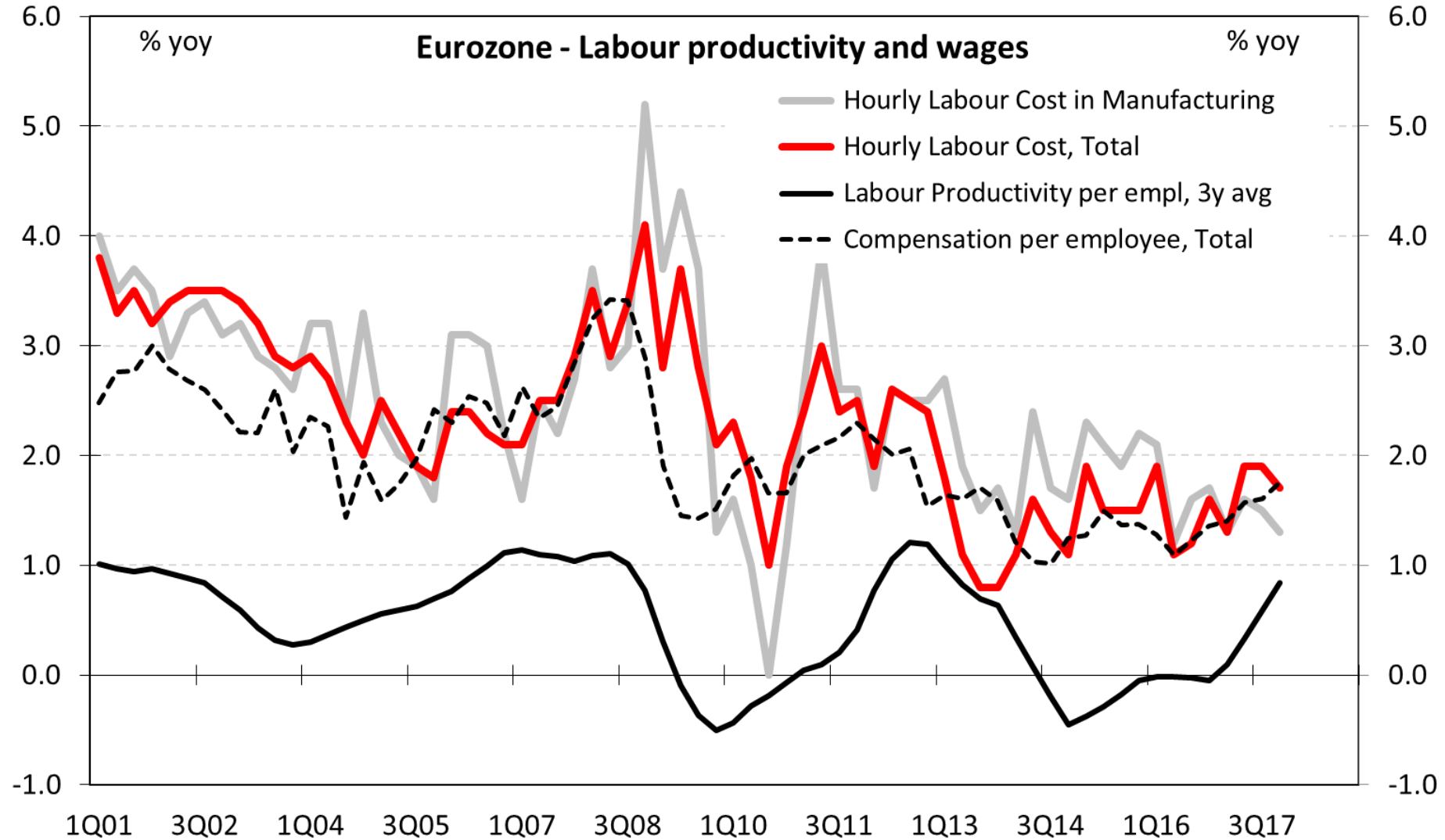
Source: IMF, National Bureau of Statistics China, LC-MA calculations

Central banks are at different stages of normalisation



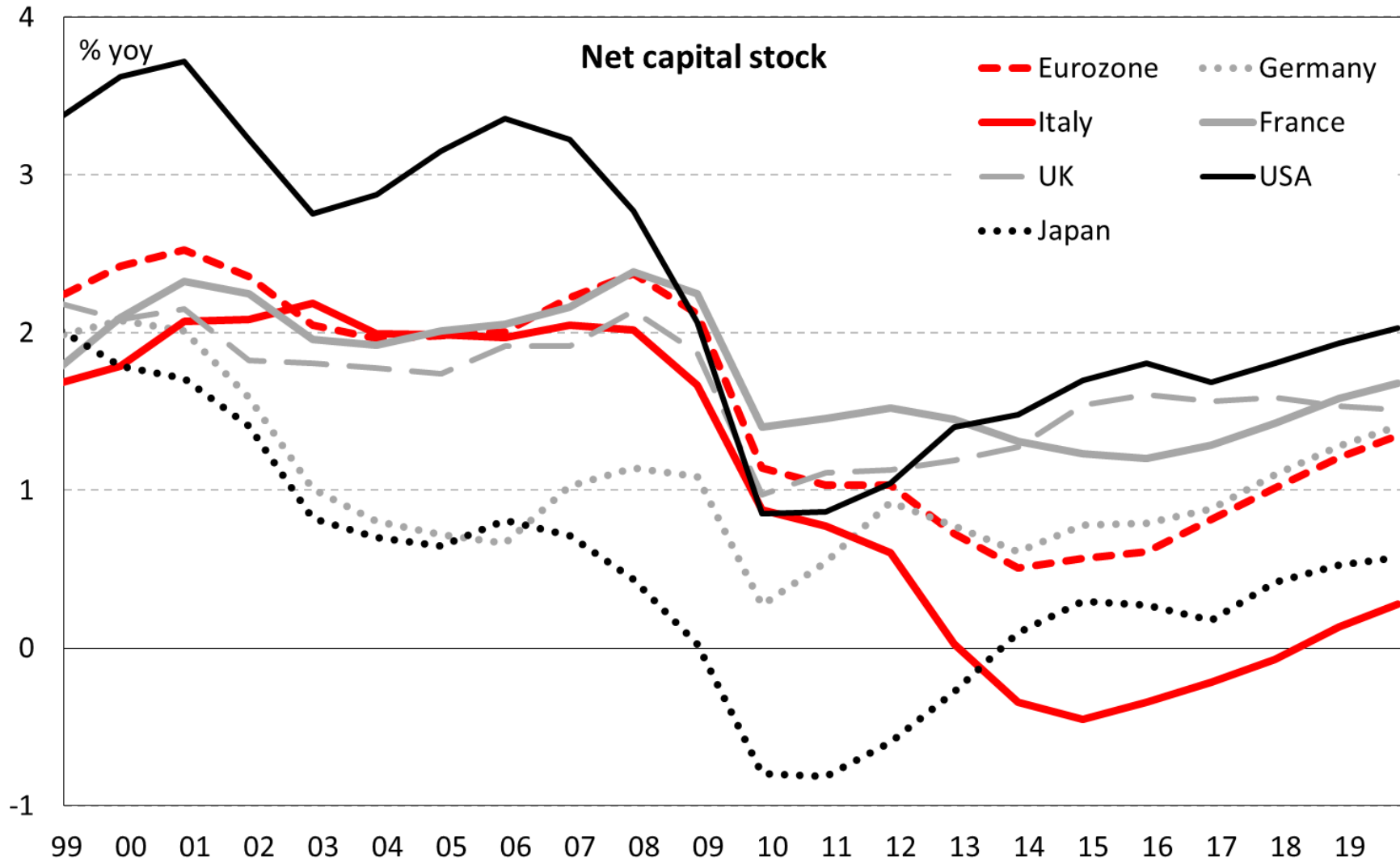
Source: Thomson-Reuters Datastream, Federal Reserve, ECB, Bank of Japan, BoE, LC-MA calculations.

Small improvement in productivity keeps a lid on ULCs



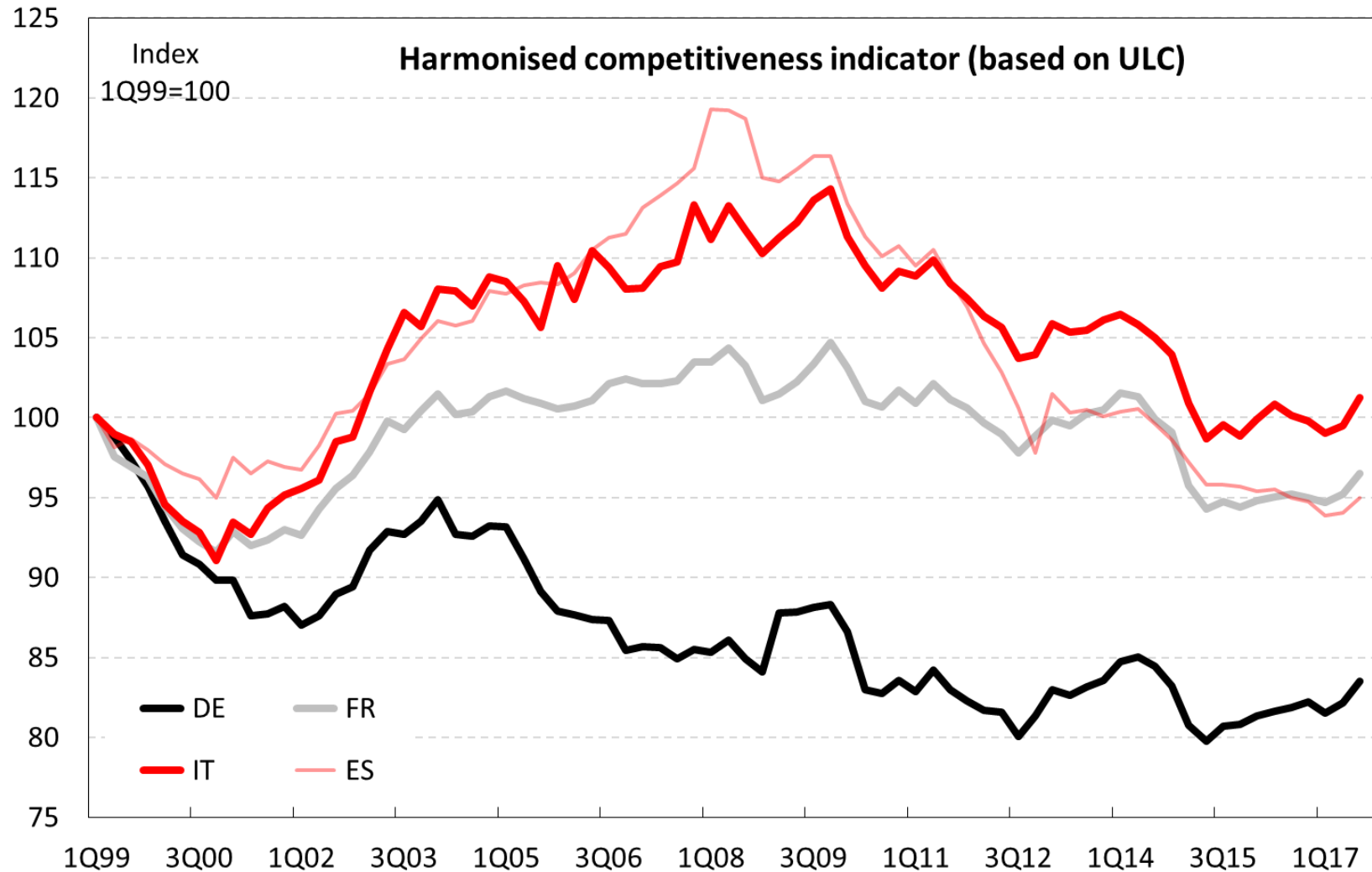
Source: Thomson Reuters Datastream, ECB, Eurostat, LC-MA own calculations.

Capital stock at very low levels



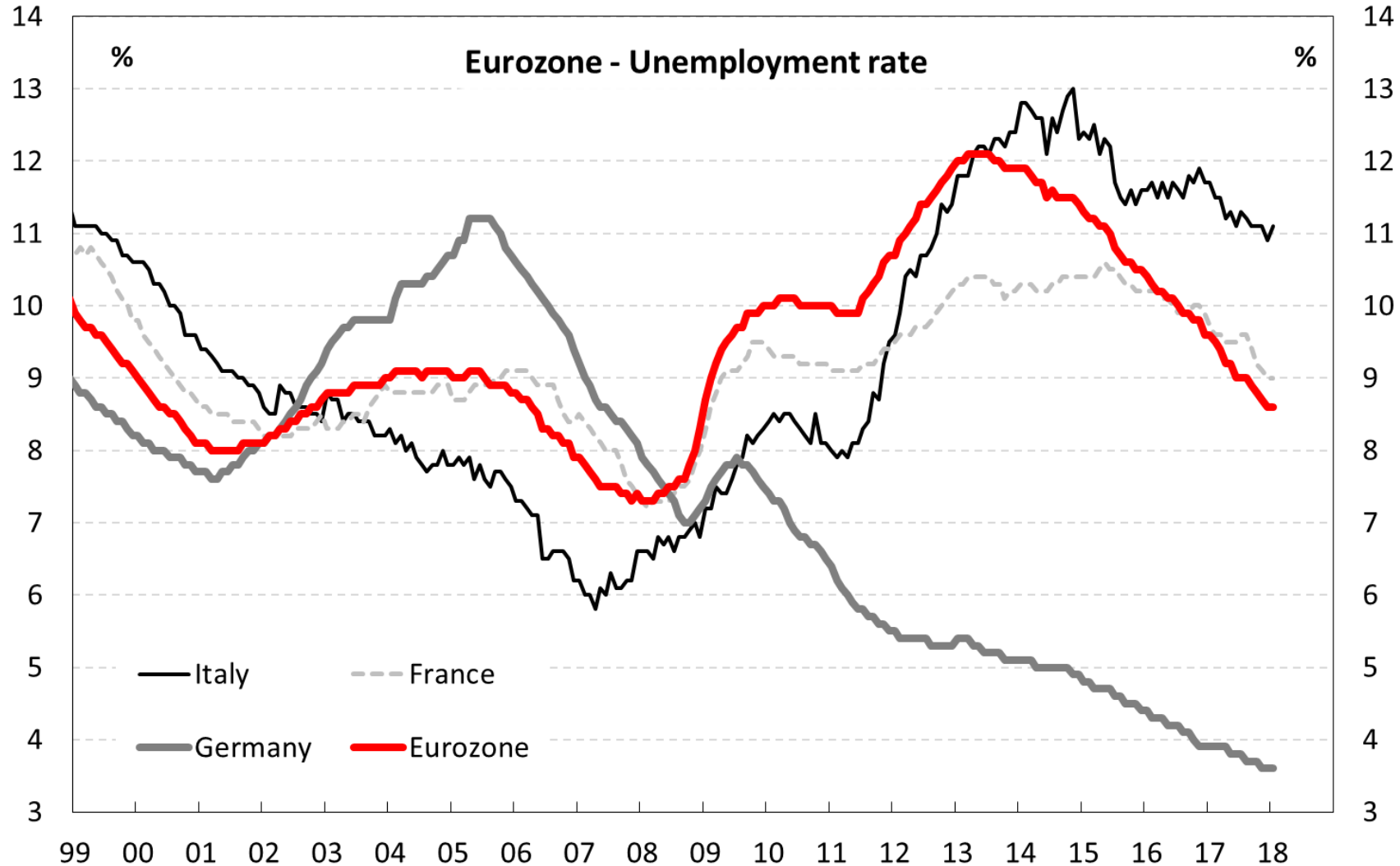
Source: Ameco, Thomson Reuters Datastream, LC-MA; European Commission forecasts for 2017-2019

Still large price competitiveness gaps



Source: Thomson Reuters Datastream, ECB, LC-MA calculations.

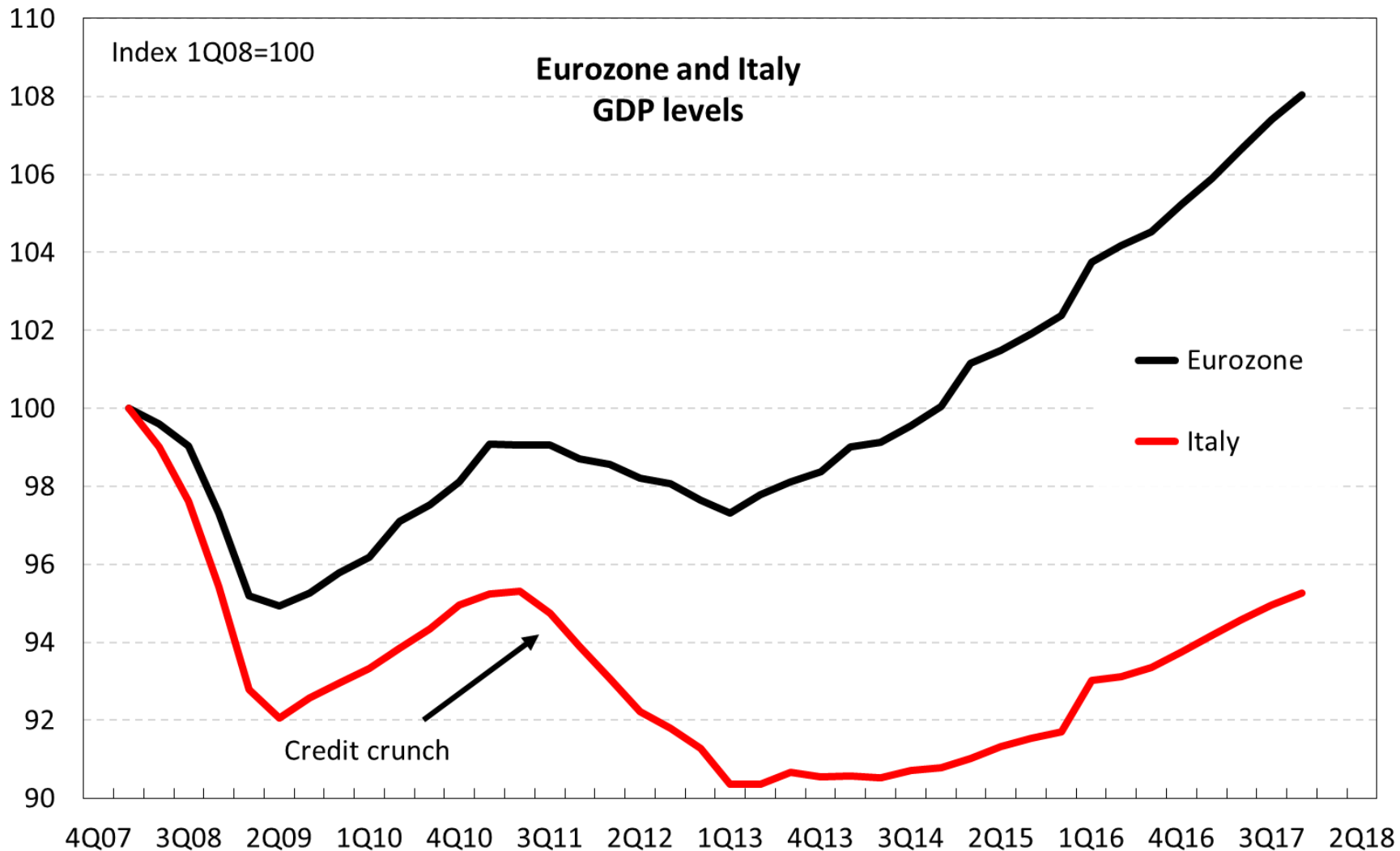
Large differences in unemployment



Source: Thomson Reuters Datastream, Eurostat, LC-MA calculations; seasonally adjusted data; % of total labour force.

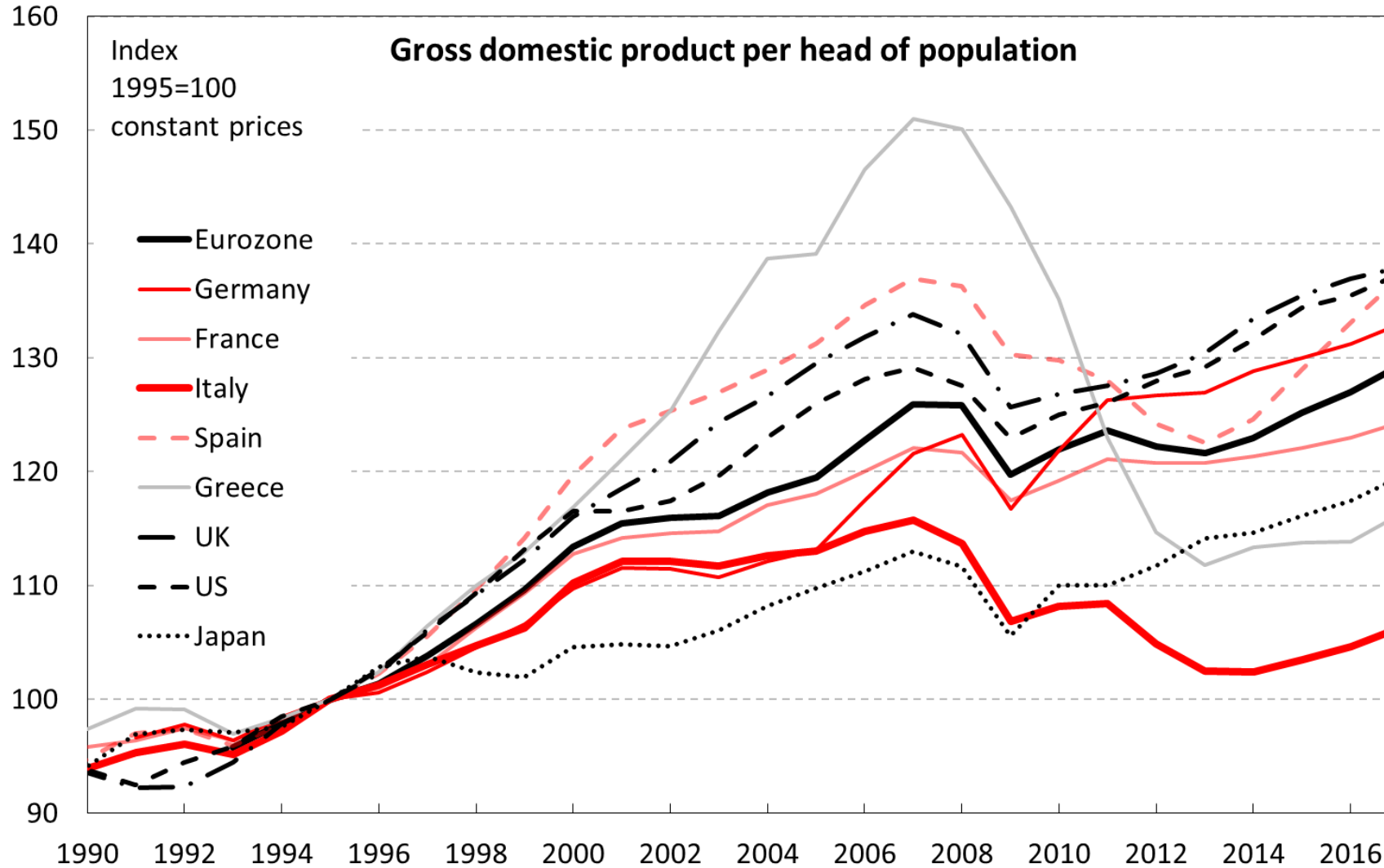
ITALY – ECONOMY

GDP: 12pp gap vs the Eurozone (5.8pp vs pre-crisis levels)



Source: Eurostat, ISTAT, Thomson Reuters Datastream, LC-MA calculations

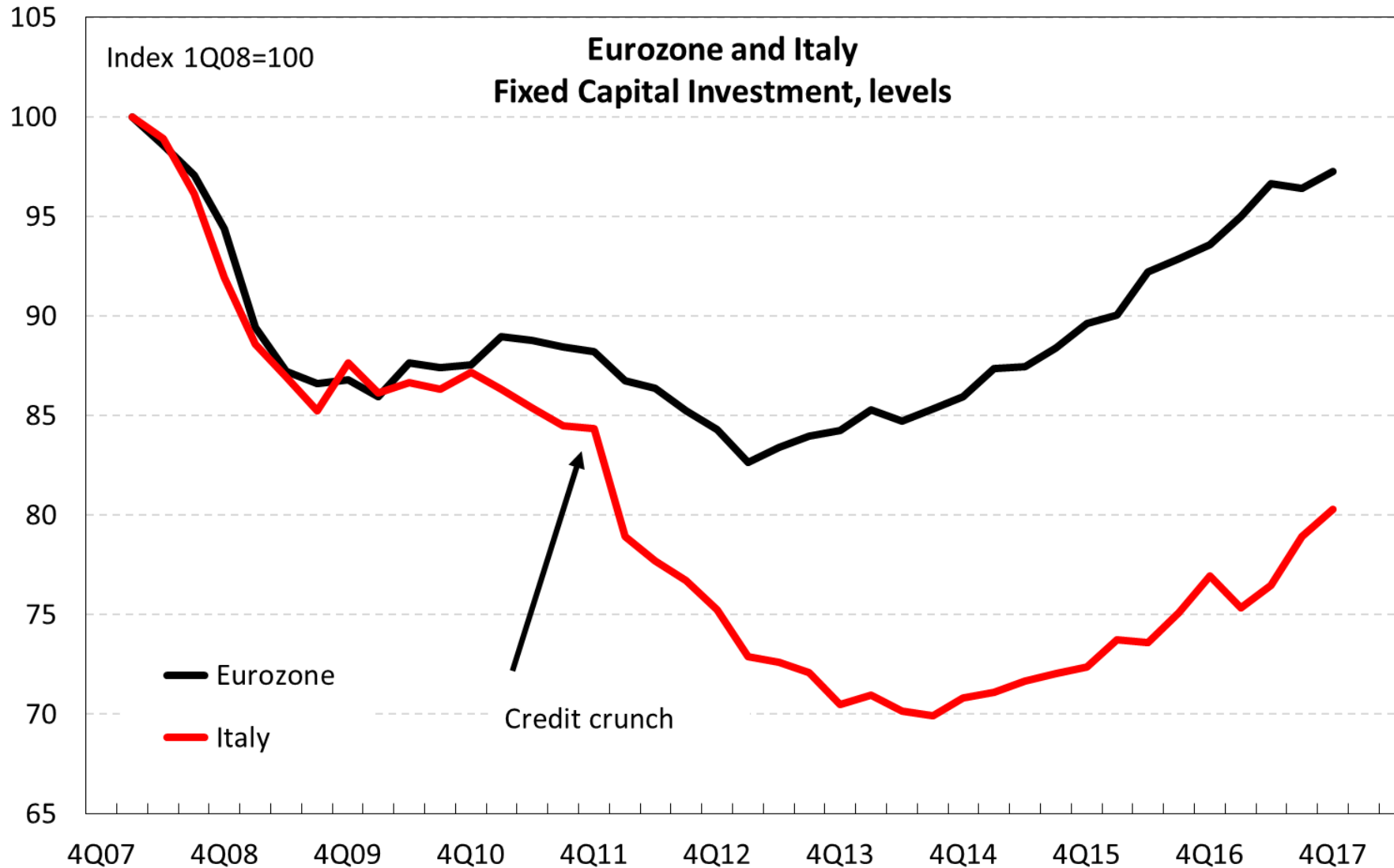
Italy's GDP per capita since 1995: at the bottom of the club



Source: Thomson Reuters Datastream, European Commission AMECO, LC-MA calculations.

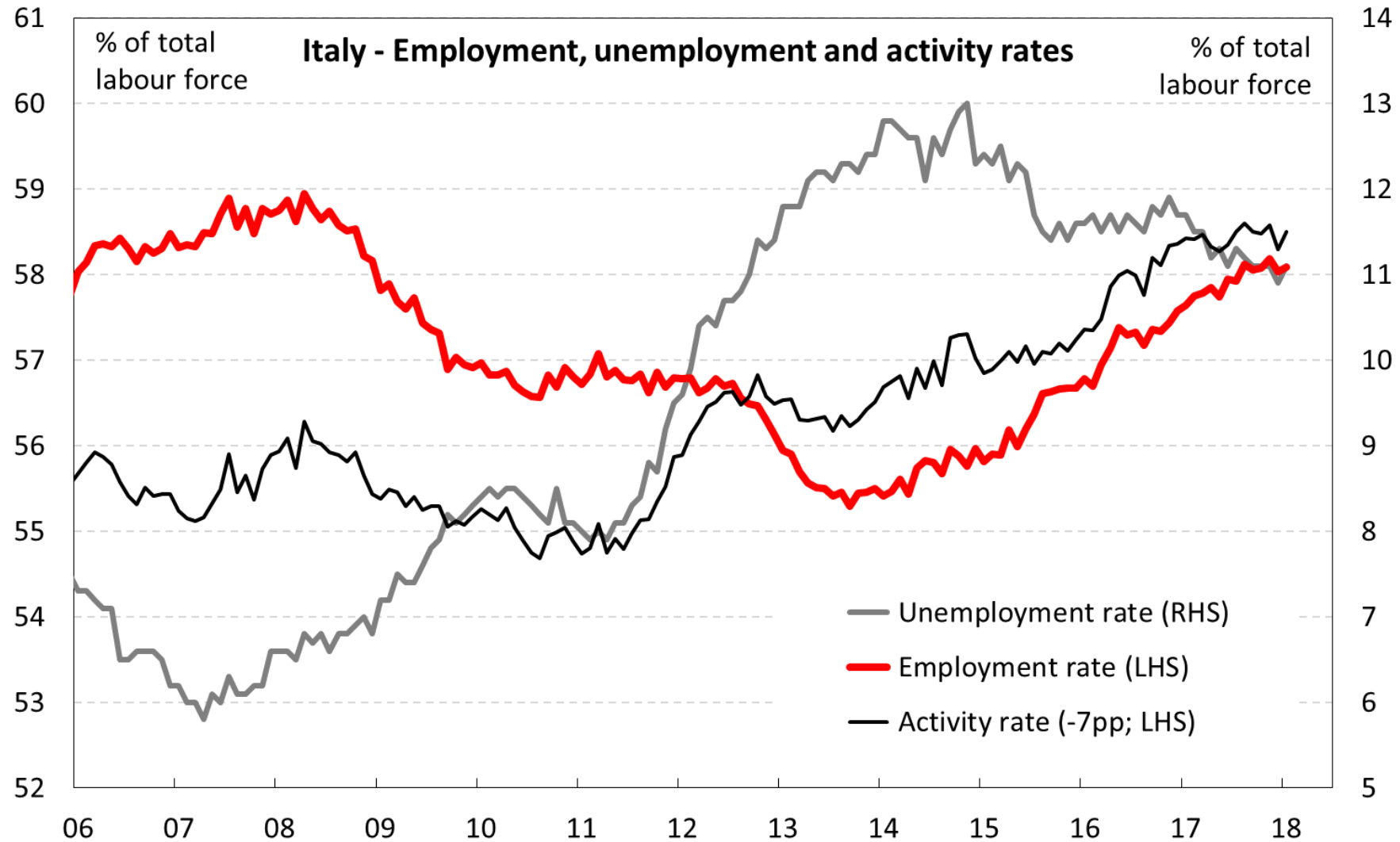
ITALY – ECONOMY

Italy's investment: -20.4pp vs pre-crisis, -17.0pp vs EZ



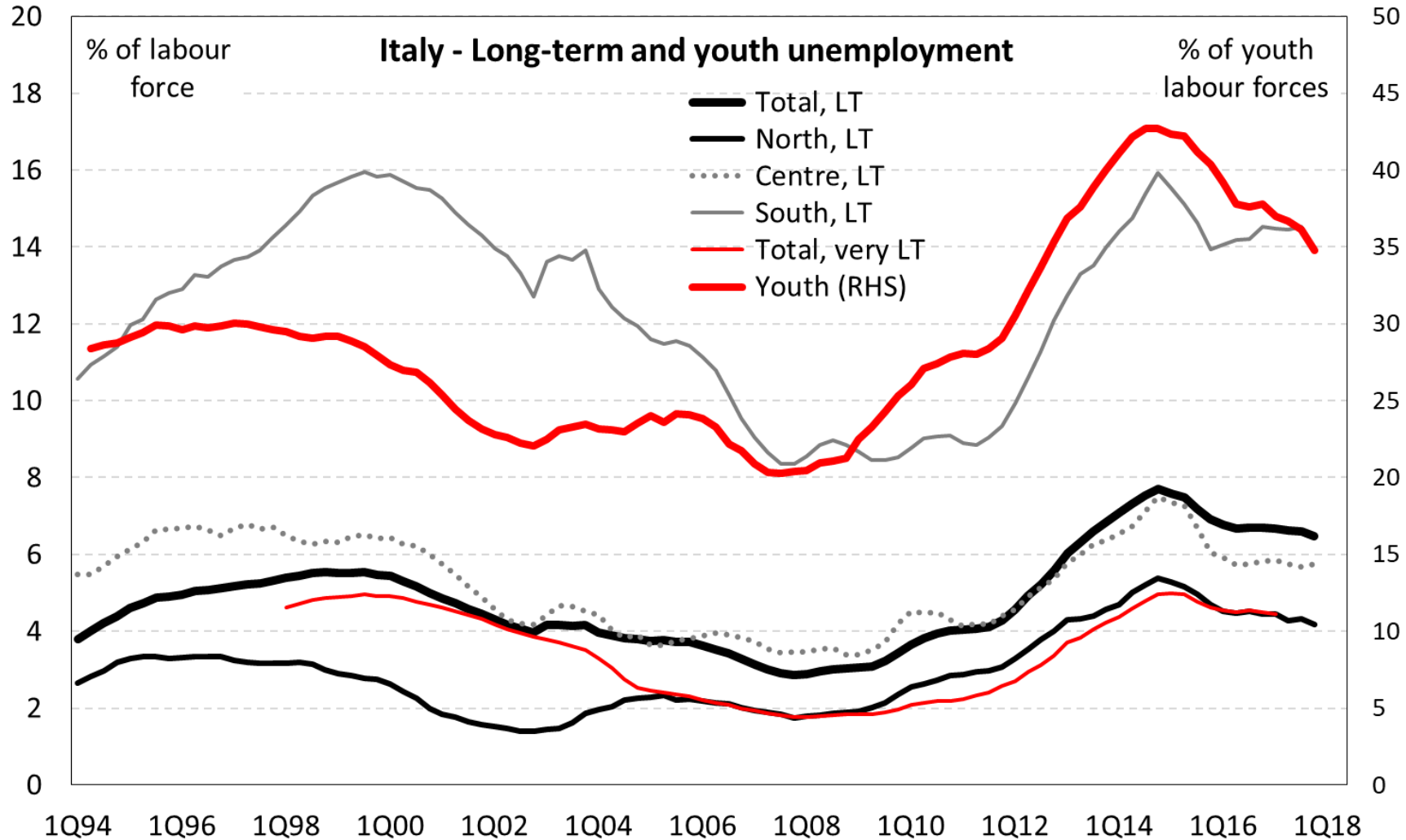
Source: Thomson Reuters Datastream, ISTAT, LC-MA calculations.

Employment: steady progress amid growing participation



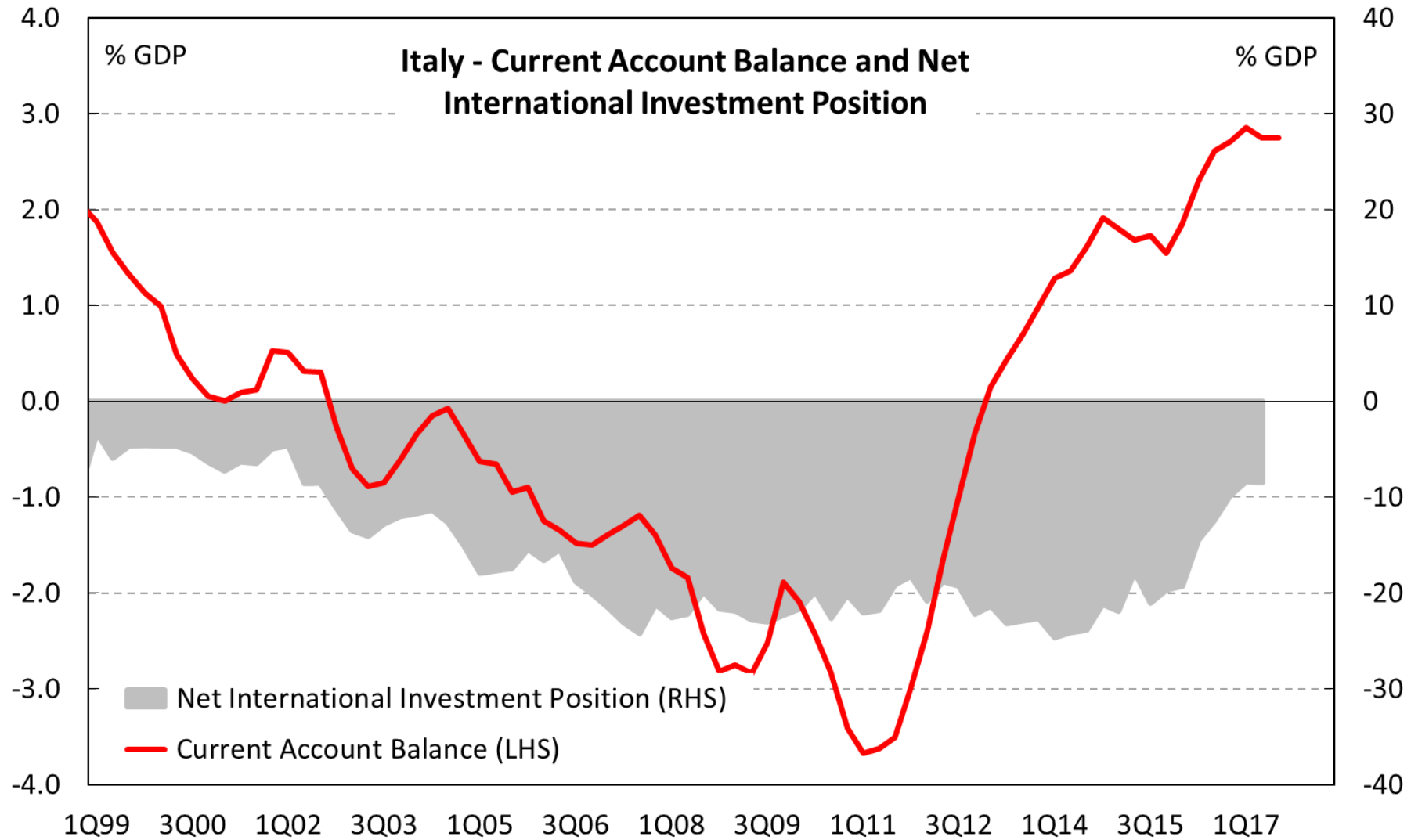
Source: ISTAT, LC-MA calculations; seasonally adjusted monthly data.

Youth and long-term unemployment: a big concern



Source: Thomson Reuters Datastream, ISTAT, Eurostat, LC-MA calculations; 4-term moving average of quarterly data. (Very) Long-term unemployment = ratio of job seekers for more than (24) 12 months to labour force.

Turnaround in the current account



Source: Thomson Reuters Datastream, ISTAT, Bank of Italy, LC-MA calculations.

The end of the long decline in potential growth?

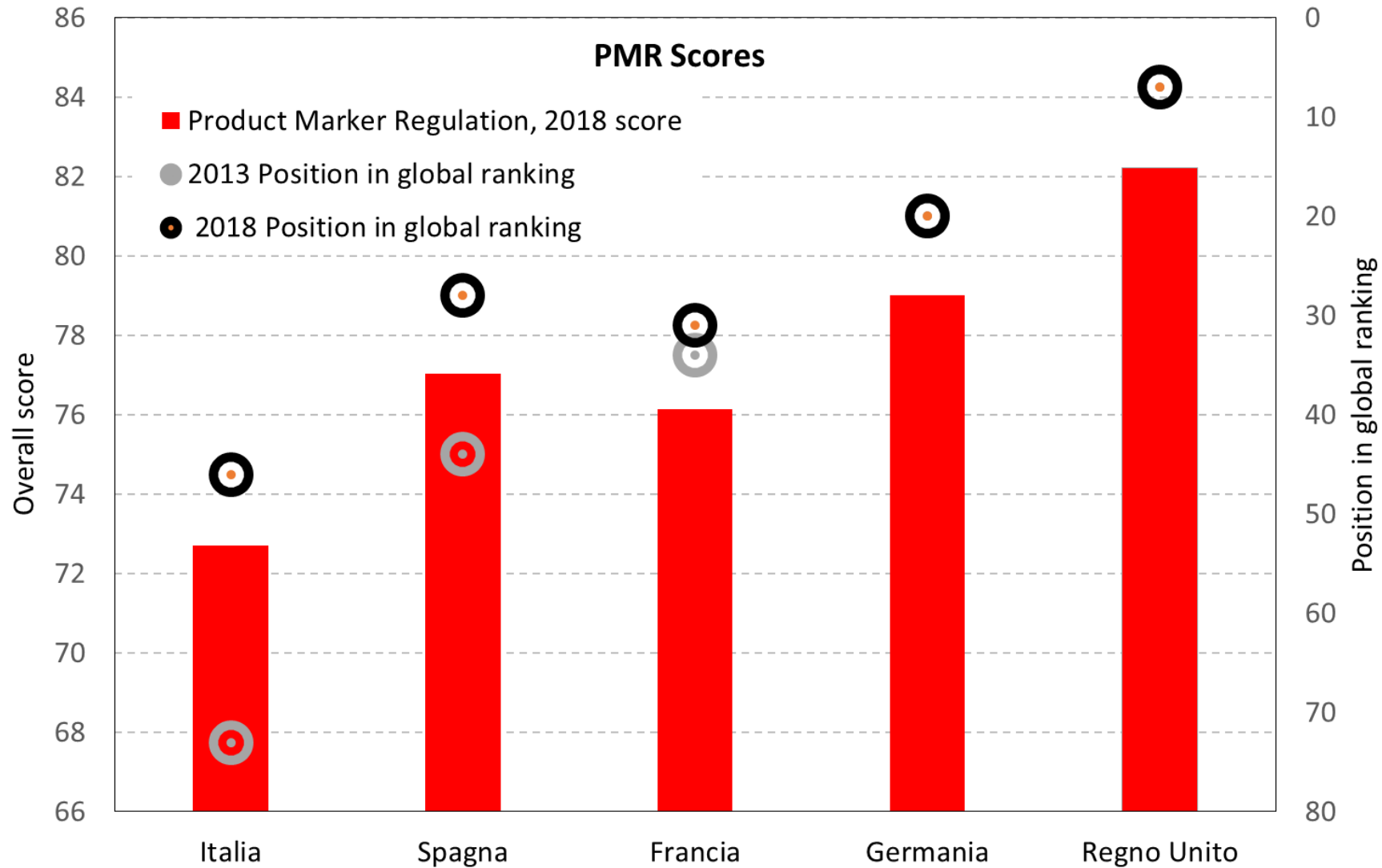


Source: OECD, European Commission, LC-MA calculations.

The puzzle of productivity and potential growth

- ◆ **Demographics:** It remains unfavourable, unless immigration of skilled workers increases sharply. Despite rapid ageing, cohort effect of women entering the market to increase labour participation.
- ◆ **Productivity:** TFP growth has been negative in several of the past 15-20 years. Moderate cyclical upswing likely. No convincing signs of structural improvement. Misallocation of resources?
- ◆ **Supply side damage:** Squeeze in aggregate demand has produced damage on the supply side, which is difficult to assess but is sizeable.
- ◆ **Education attainment:** Weak results in PISA and other surveys. Decline in the number of students at universities during the crisis. Low return on education.

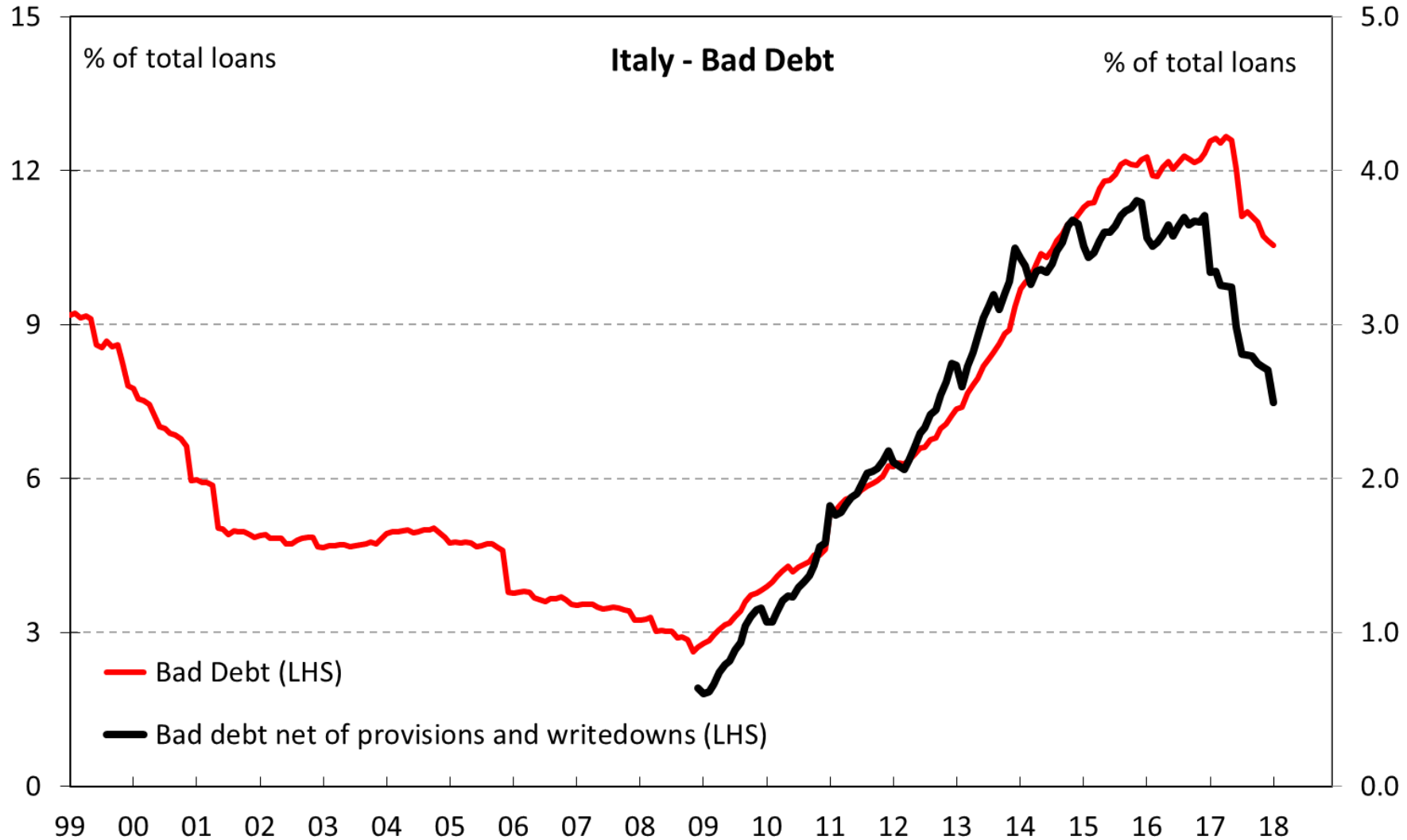
Structural reforms: a mixed picture



Source: OECD, LC-MA calculations.

ITALY – BANKING SECTOR

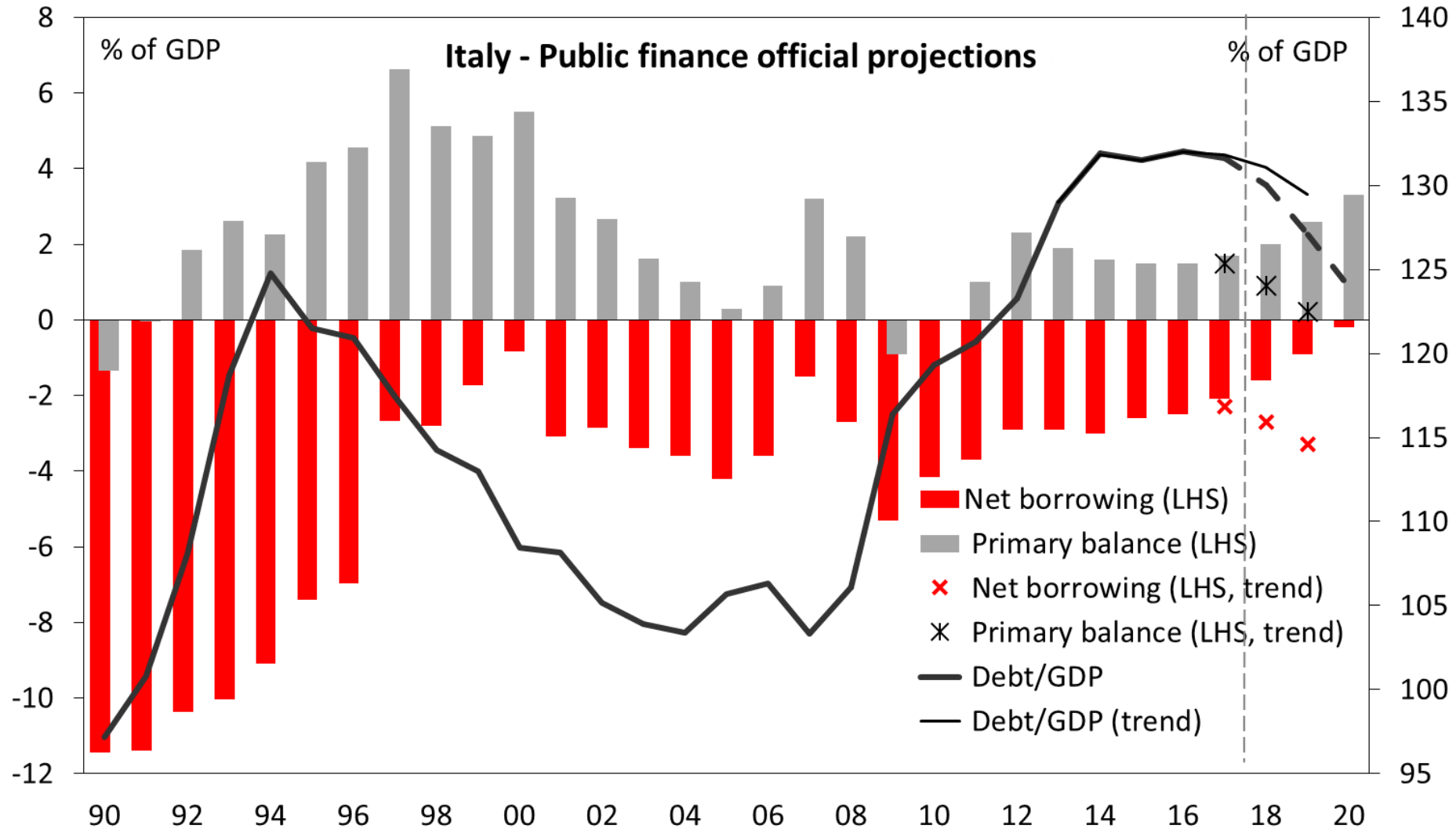
Banks are reducing NPLs more forcefully



Source: Thomson Reuters Datastream, Bank of Italy, LC-MA calculations

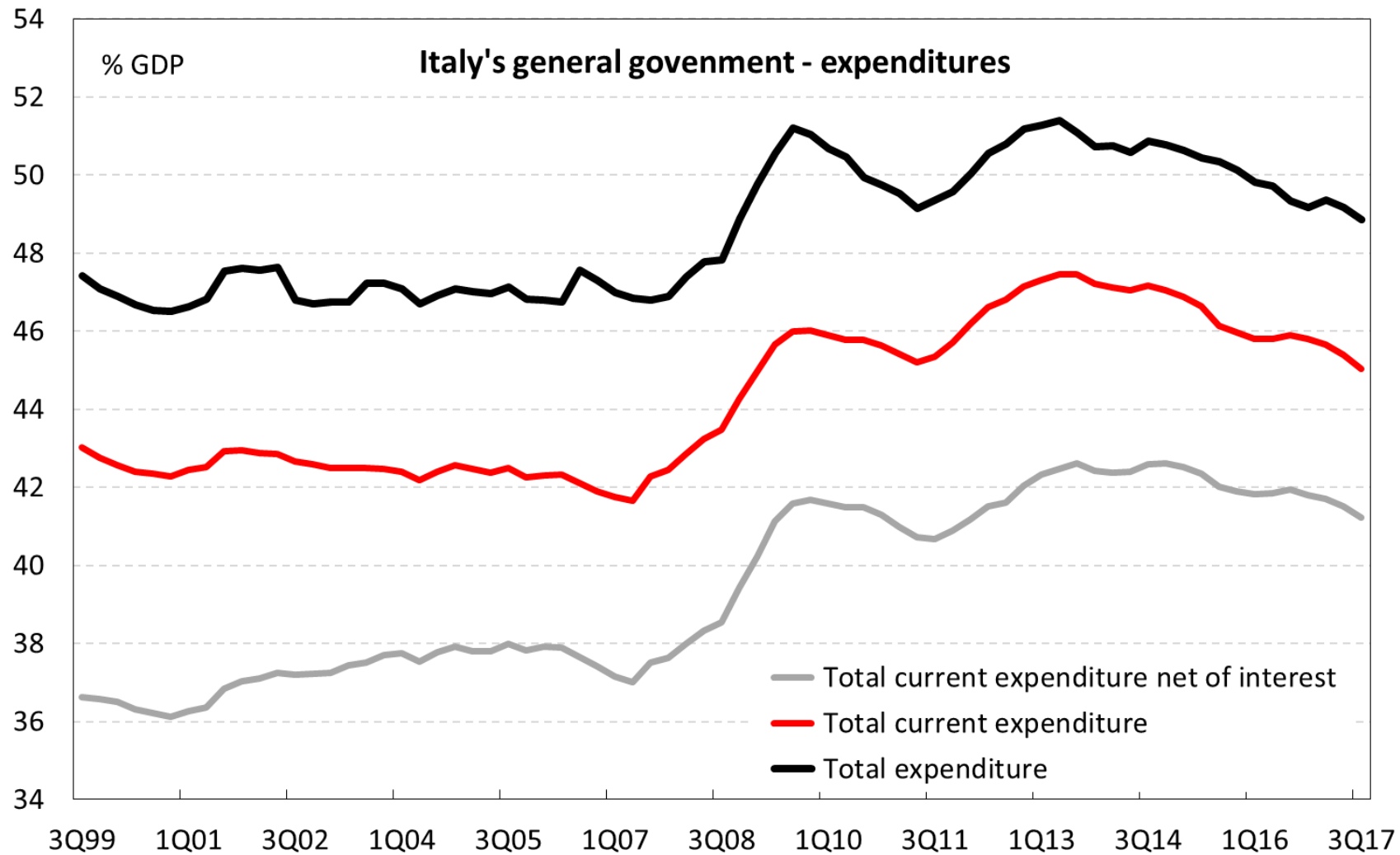
ITALY – PUBLIC FINANCE

Without doing anything, net borrowing at 3.3% in 2020



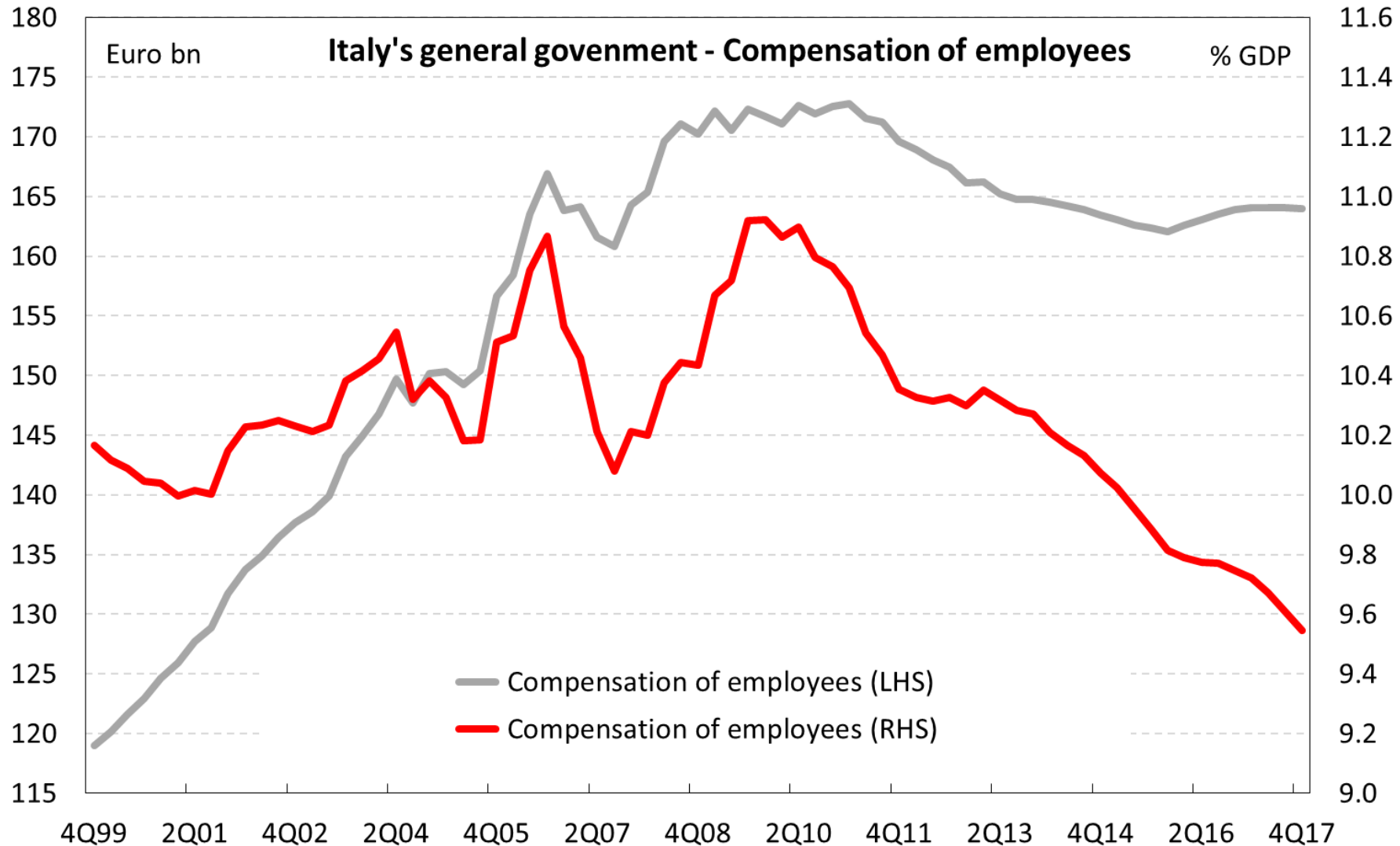
Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculations.

Expenditures: modest decline as a % of GDP



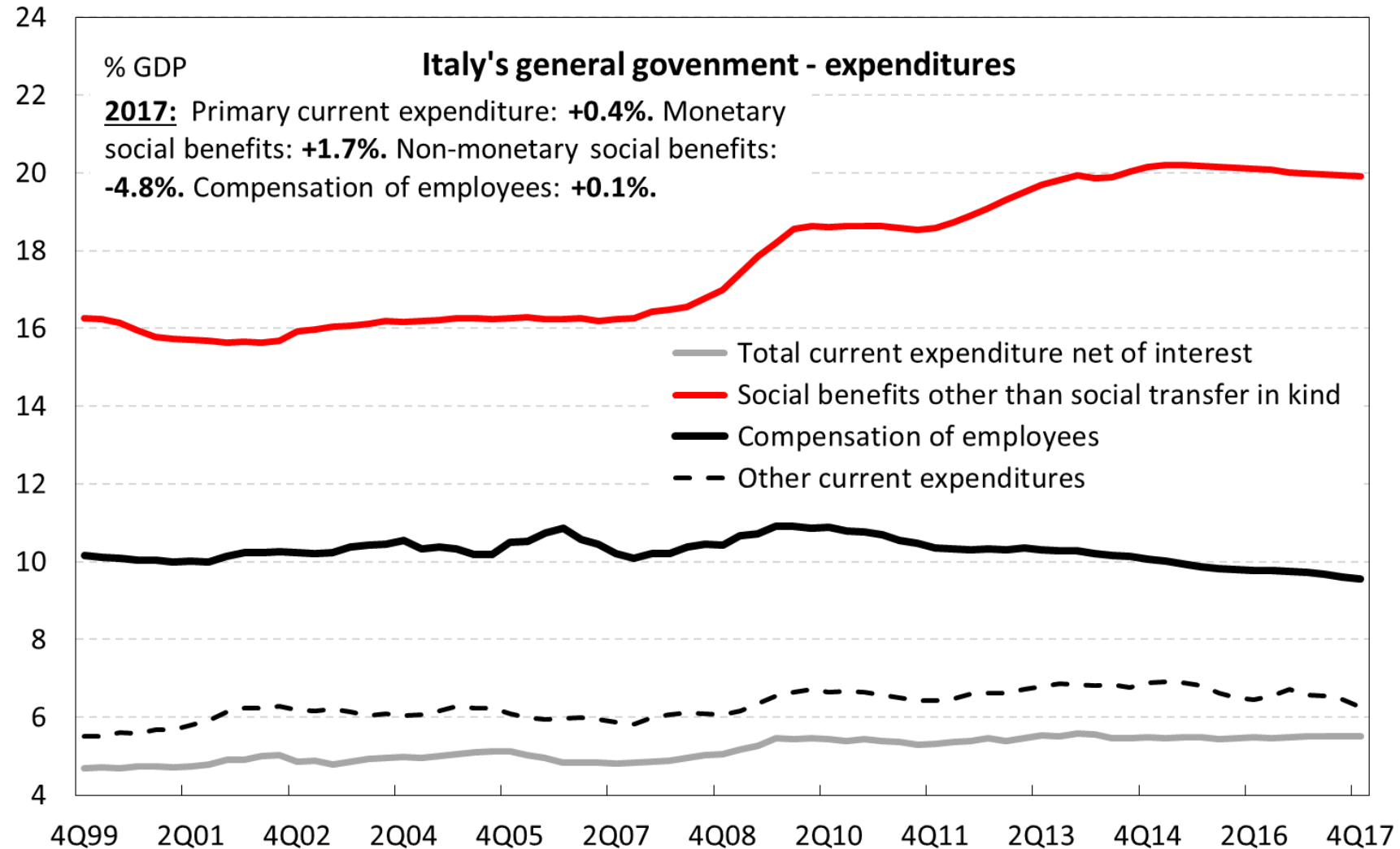
Source: TR Datastream, Italy's Ministry of Economy and Finance, LC-MA; four-term moving average of quarterly data.

Compensation has gone down, but can it remain subdued?



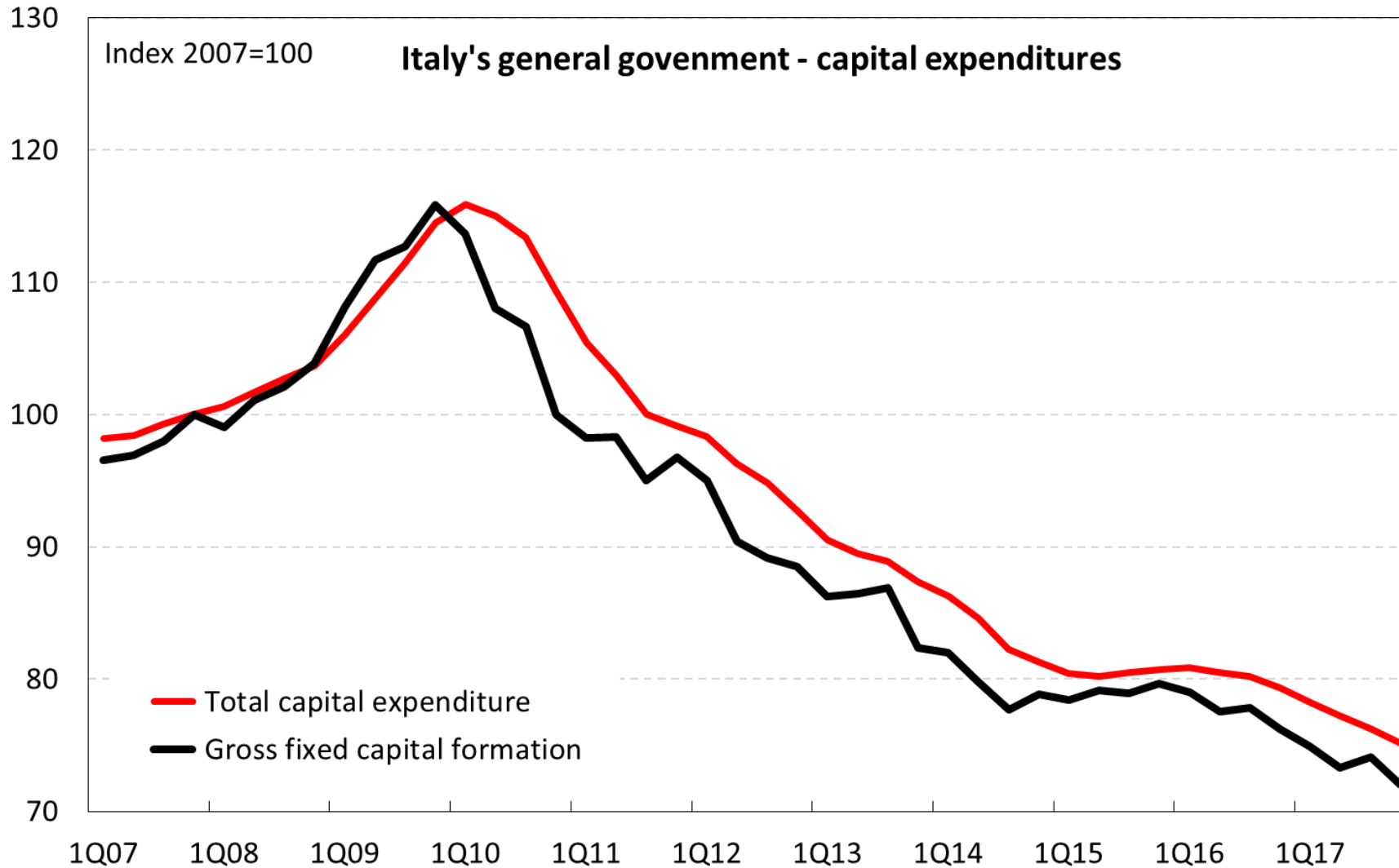
Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculatons; 4-term moving average.

Social benefits close to 20% of GDP (pensions)



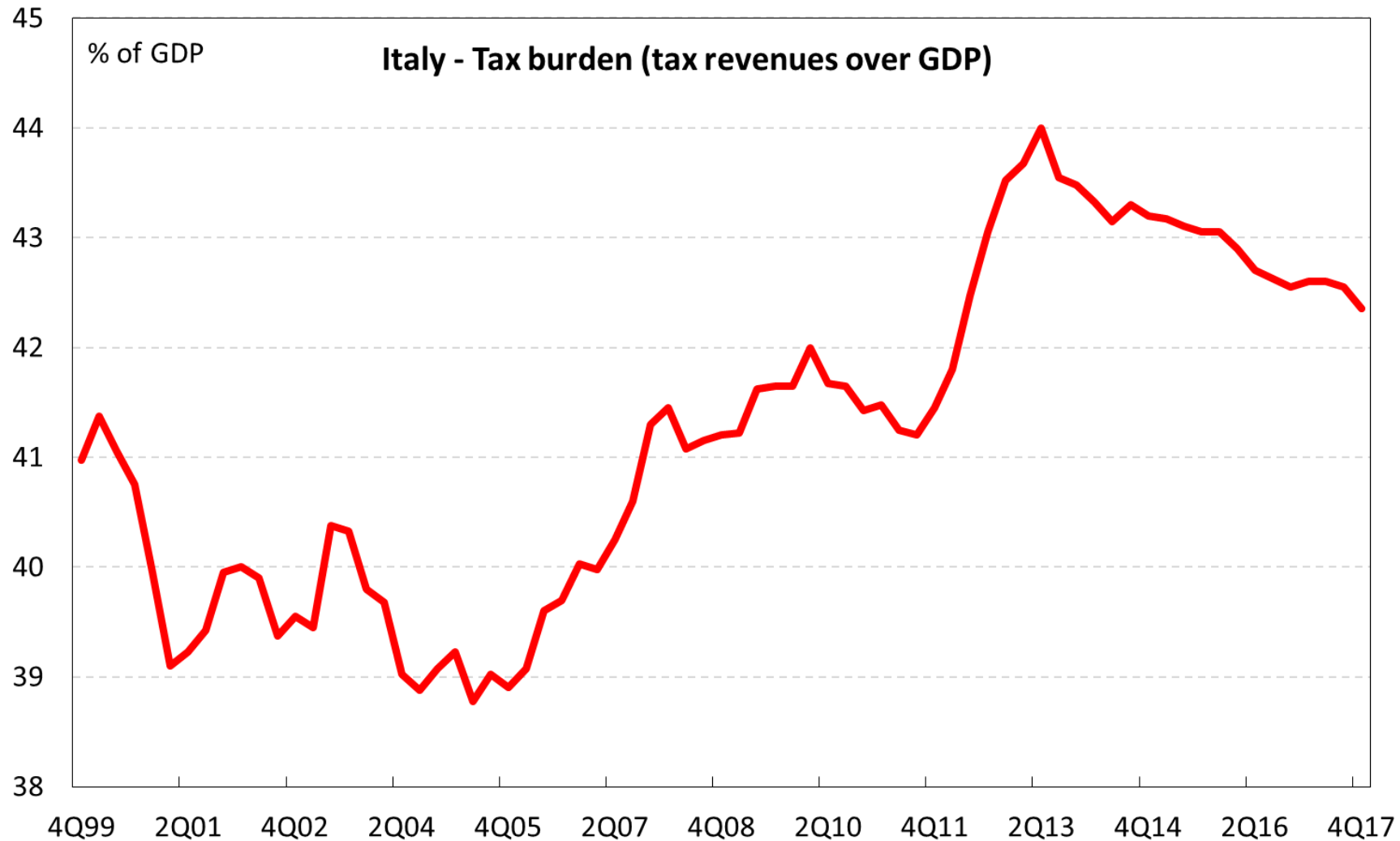
Source: TR Datastream, Italy's Ministry of Economy and Finance, LC-MA; four-term moving average of quarterly data.

Level of public investment down 35% since 4Q09



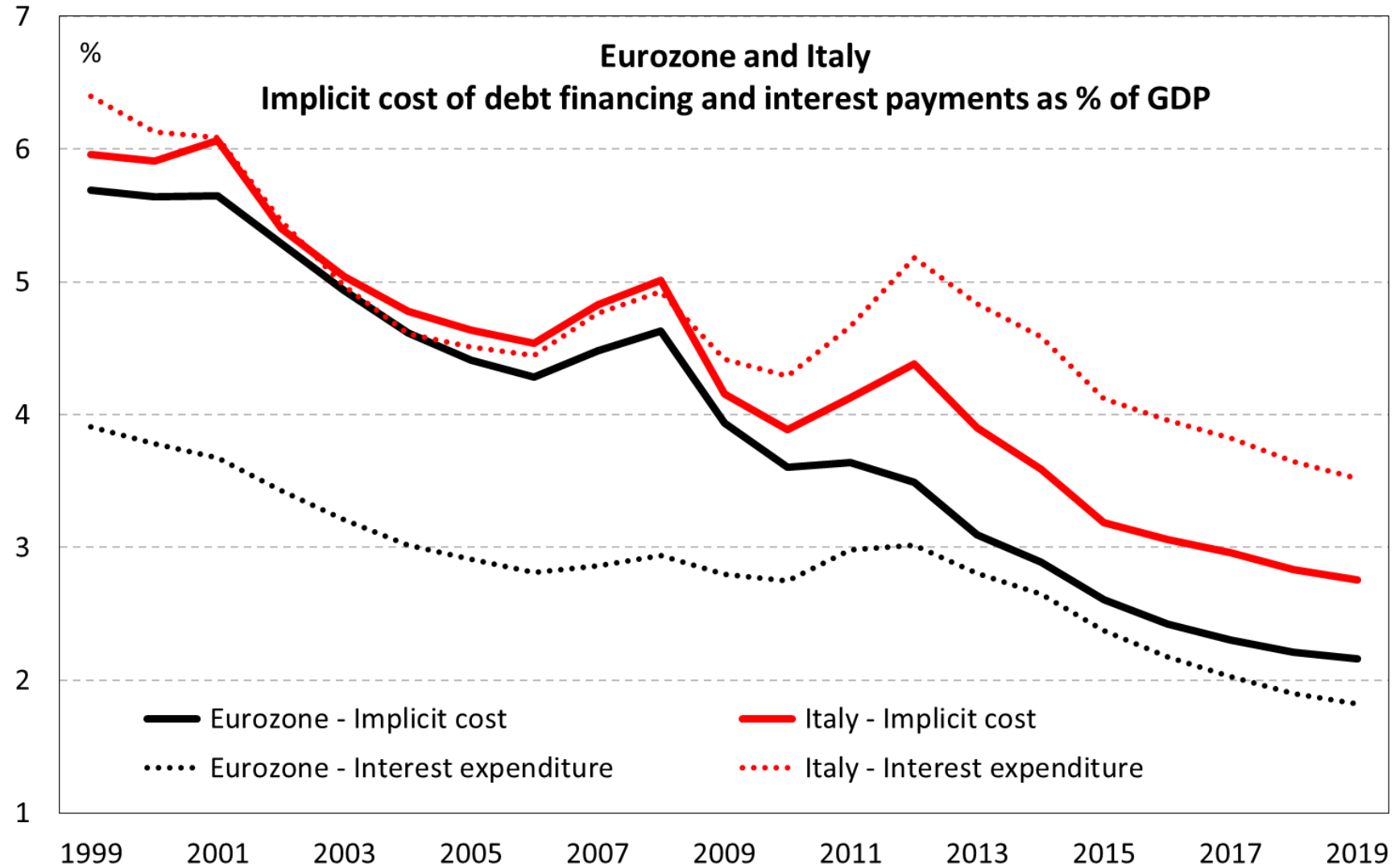
Source: TR Datastream, Italy's Ministry of Economy and Finance, LC-MA; four-term moving average of quarterly data.

The tax burden started to decline gradually only in 2013



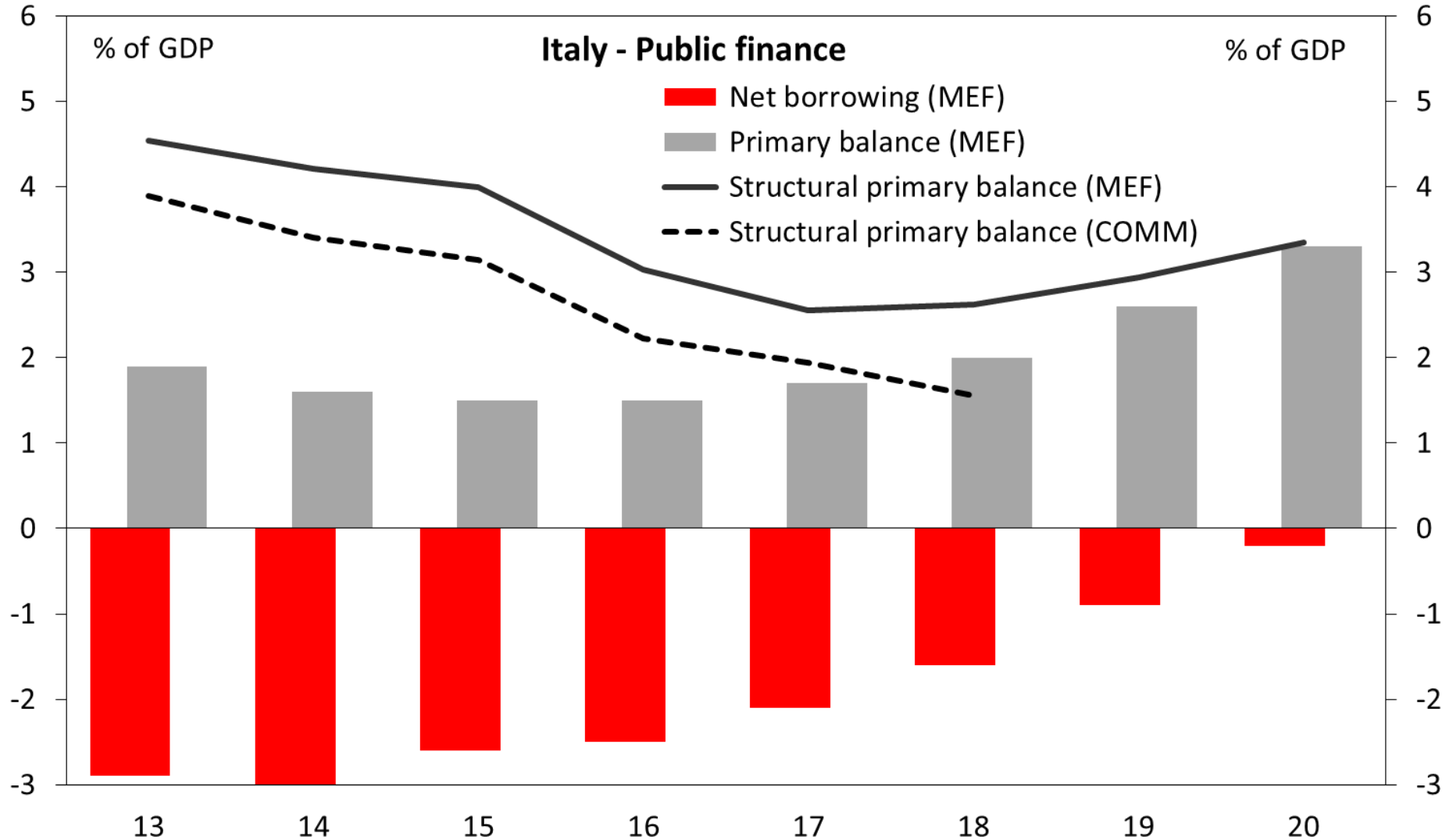
Source: TR Datastream, Italy's Ministry of Economy and Finance, LC-MA; four-term moving average of quarterly data.

Interest payment as % of GDP twice as high as Eurozone's



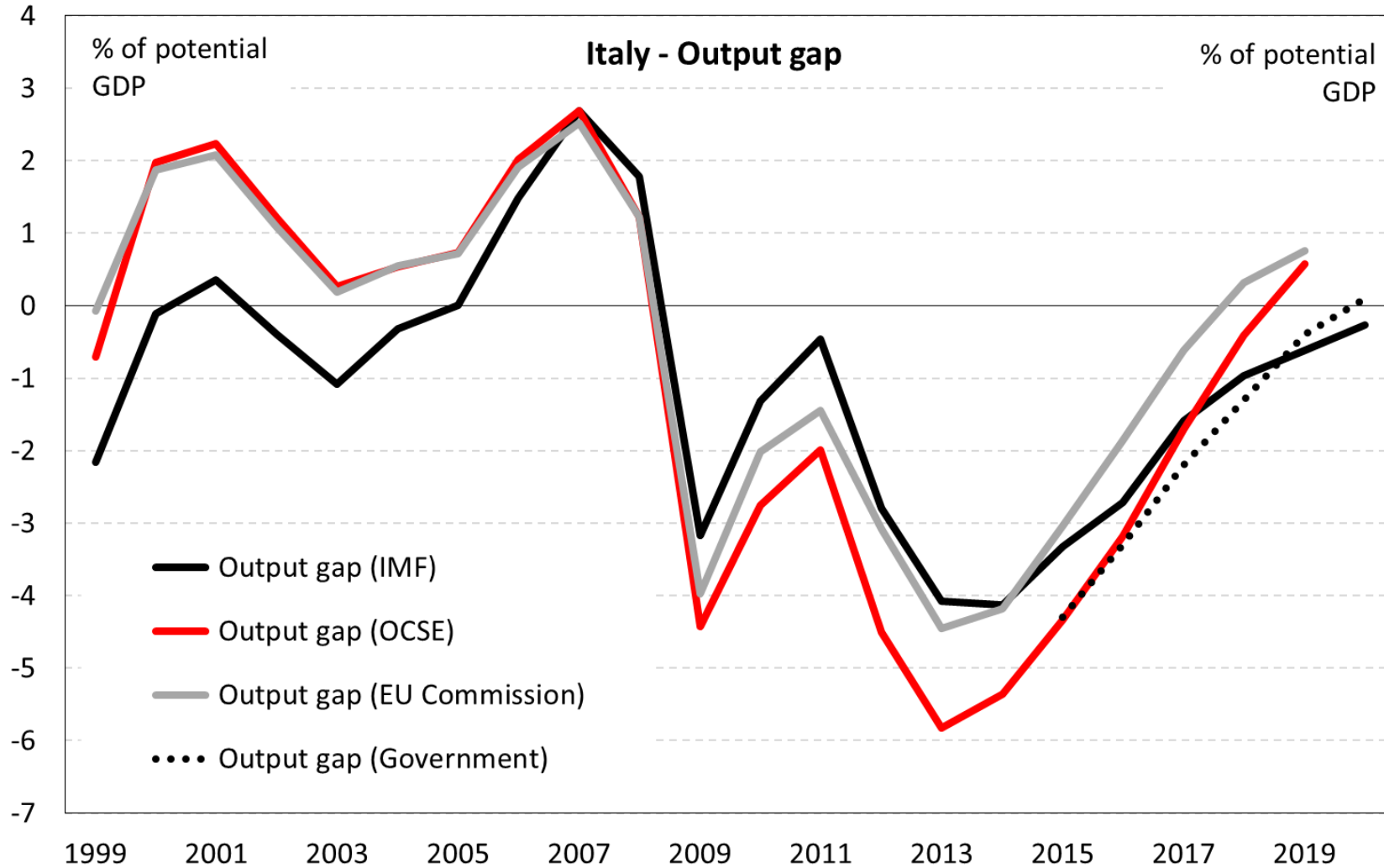
Source: Thomson Reuters Datastream, European Commission Forecasts, LC-MA calculations.

So-called “austerity” was already over in 2013



Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculations.

Uncertainty on the level of the output gap, but it is closing

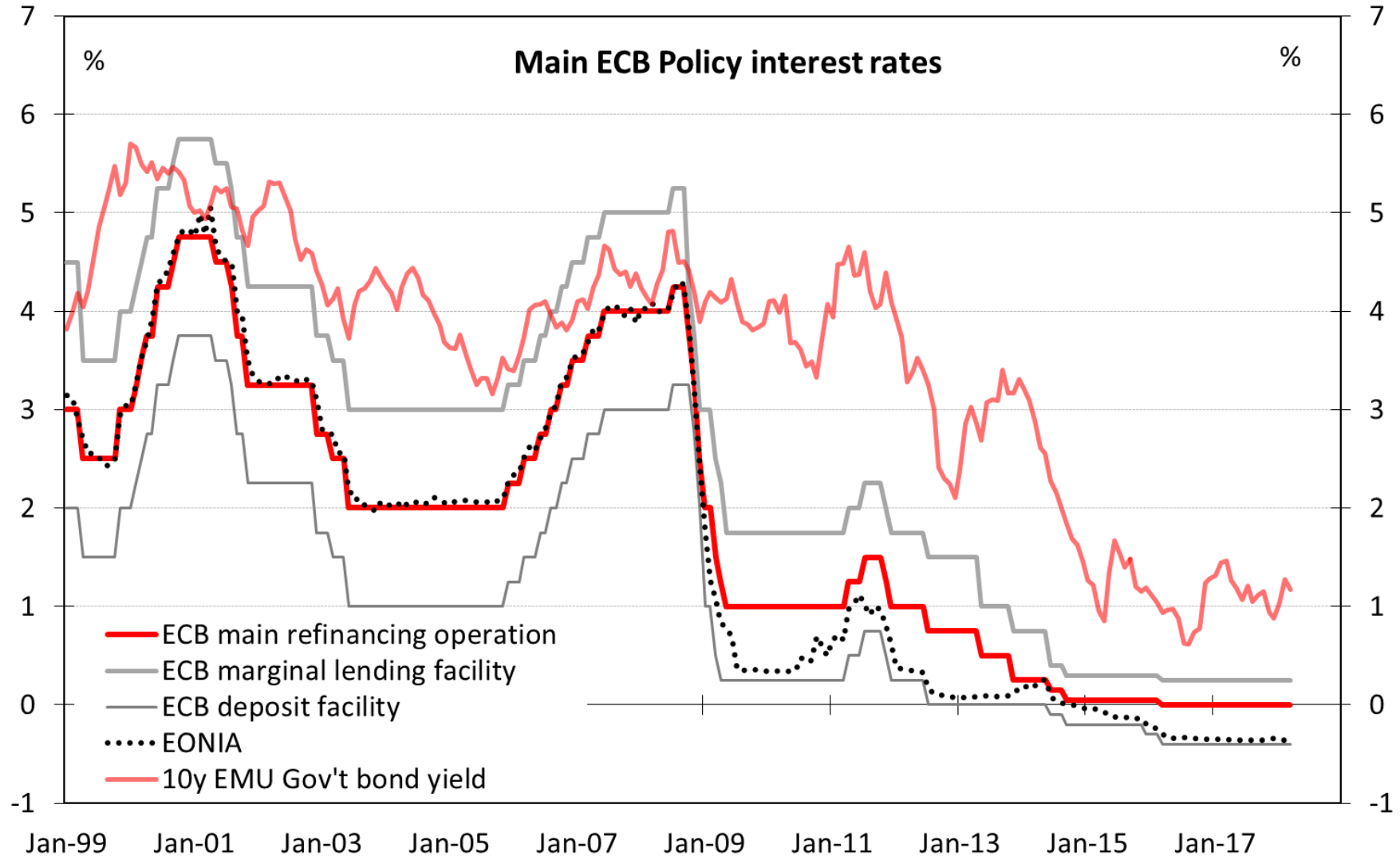


Source: Thomson Reuters Datastream, Italian Ministry of Economy and Finance, IMF, OECD and European Commission.

Poor demographics to worsen sustainability

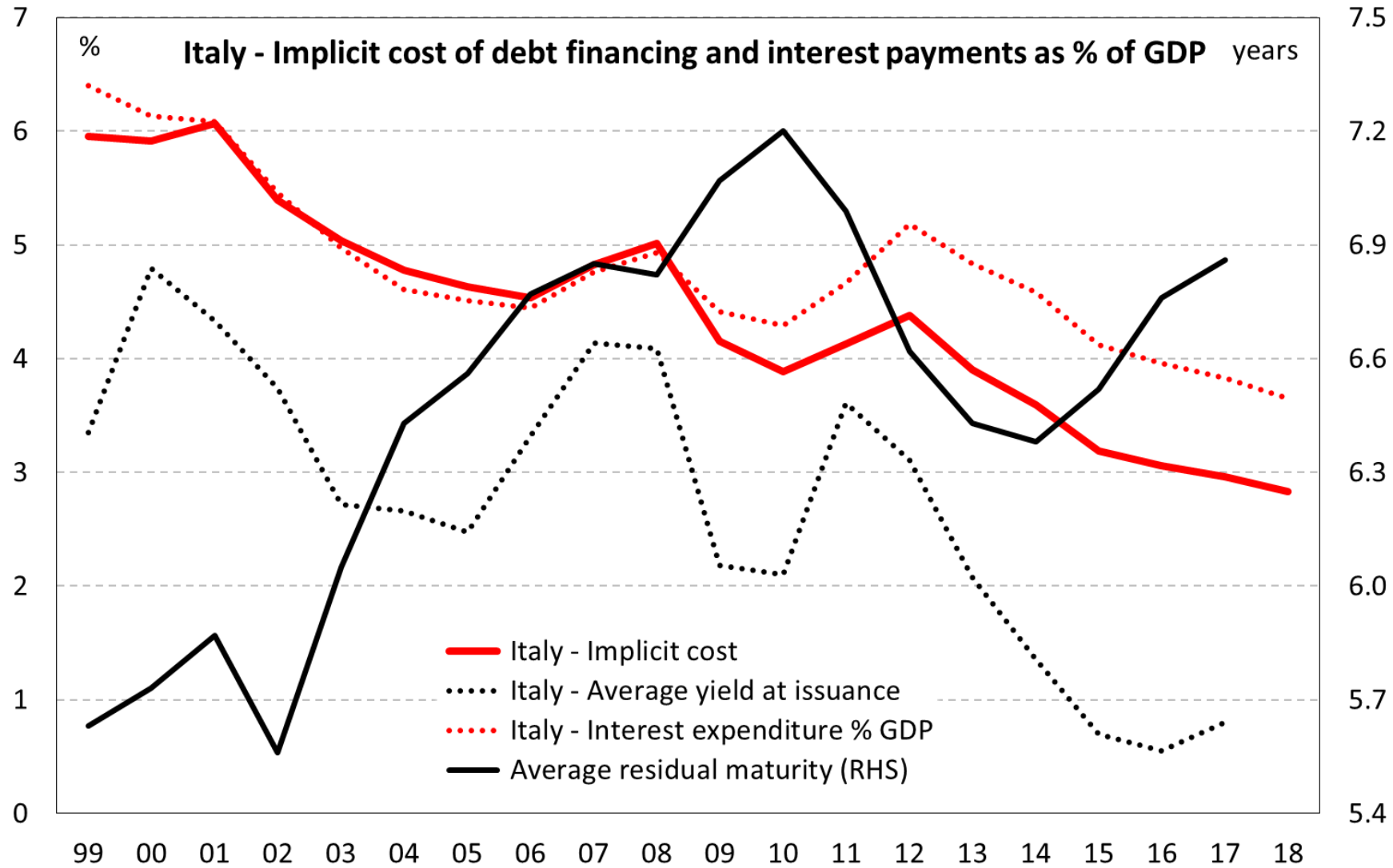
- ◆ Both Eurostat and Istat revised **demographic projections** (Istat even more drastically).
- ◆ The change will worsen the outlook for long-term growth.
- ◆ The Ageing Report (spring 2018) and the Sustainability Report (autumn 2018): a worsening in sustainability indicators.
- ◆ With a revision of long-term growth projections and S2, even the **MTO will be revised up** from a balanced budget to an 0.5% surplus or even higher.

Will a rise in interest rates cause problems for Italy's debt?



Source: Thomson Reuters Datastream, ECB, LC-MA calculations.

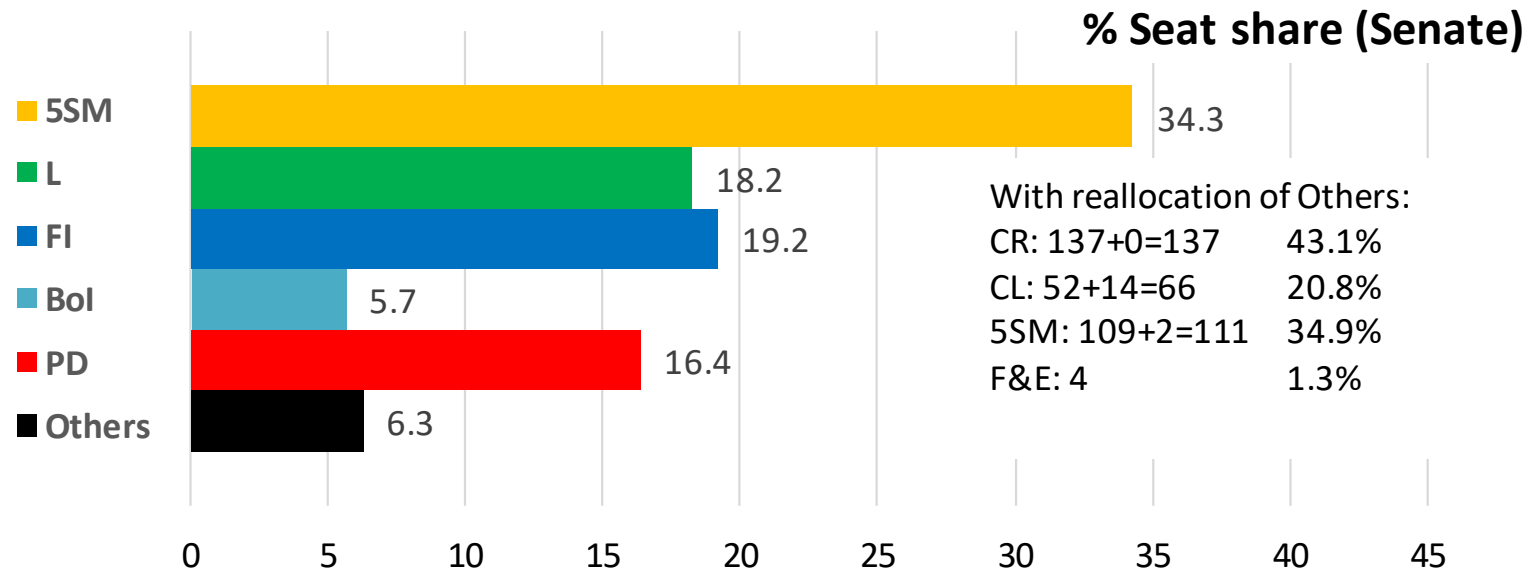
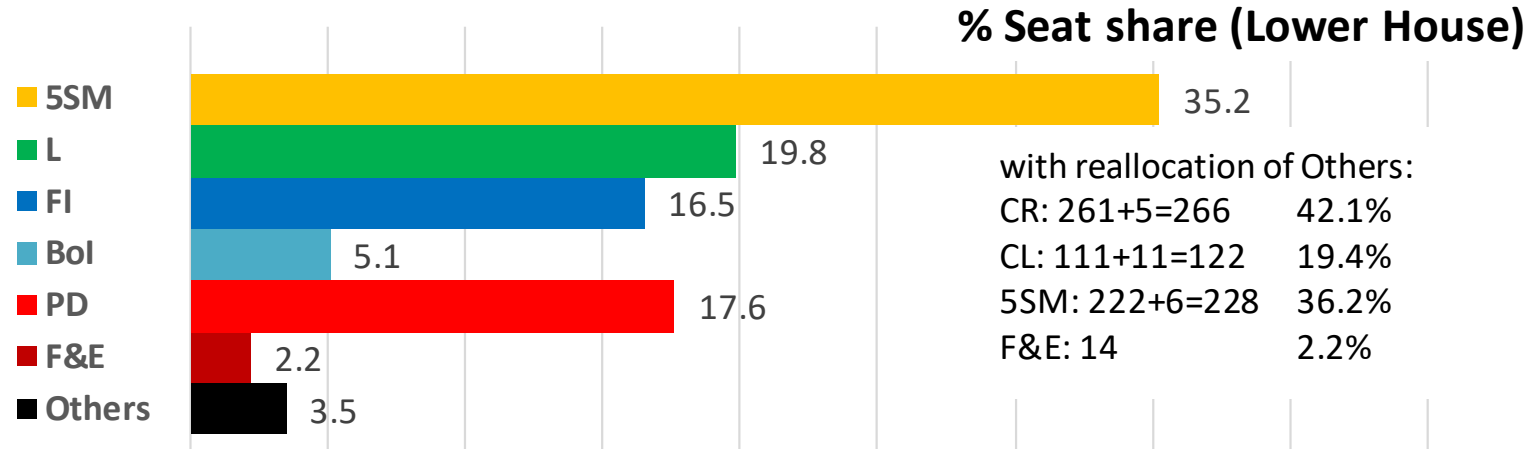
Sensitivity of interest rate payments as % of GDP



Source: Thomson Reuters Datastream, European Commission Forecasts, Italian MEF, LC-MA.

ITALIAN ELECTIONS

The outcome in a nutshell: seats in Parliament



Source: LC-MA, Wikipedia, Italian Parliament, Ministry of the Interior

5SM: Clashing with any idea of European integration

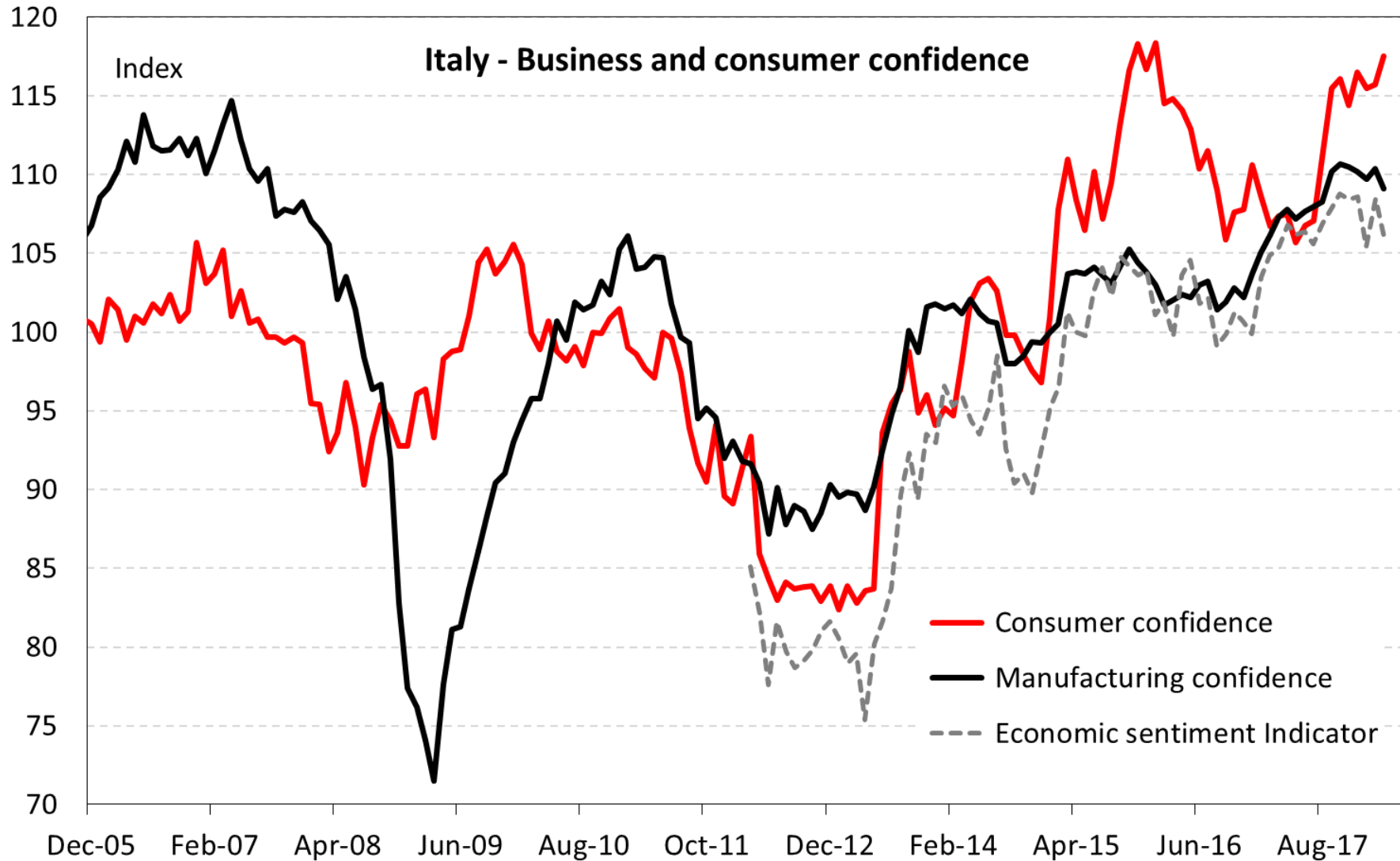
- ◆ Abolishment of **TTIP and CETA**: any international treaty must be approved by national parliaments. **Protectionist measures** to reduce imports.
- ◆ Introduction in Treaties of procedures to exit monetary union. Possibility for MSs to **permanently opt-out** in case there is a clear popular mandate.
- ◆ Reform **European institutions**. Strengthen the role of **national parliaments** on European matters. **Bring back sovereignty** to MSs in economic matters. Substantial cut of **European budget**. Abolishment of the Juncker Plan. Abolishment of **the BRRD**, i.e. bail-in procedure.
- ◆ Change in the **Dublin rules** for immigration. Redistribution of immigrant. Entry points embassies and consulates.

League: Sovereignty back

- ◆ **Identification and expulsion centres.** Repatriations Agreements with countries of origin. Reception centres in the country of origin. No landing authorisations for ONGs.
- ◆ Stay within the EU only if the **Treaties that limits national sovereignty are renegotiated.** Seek a partners in Europe for a coordinated exit. Plan B.
- ◆ **Return to the pre-Maastricht status.** Exclusive national competence on **trade treaties. Abolishment of the Schengen treaty and Dublin regulation.** Reverse subsidiarity rule. Cut EU budget.

ITALIAN ELECTIONS

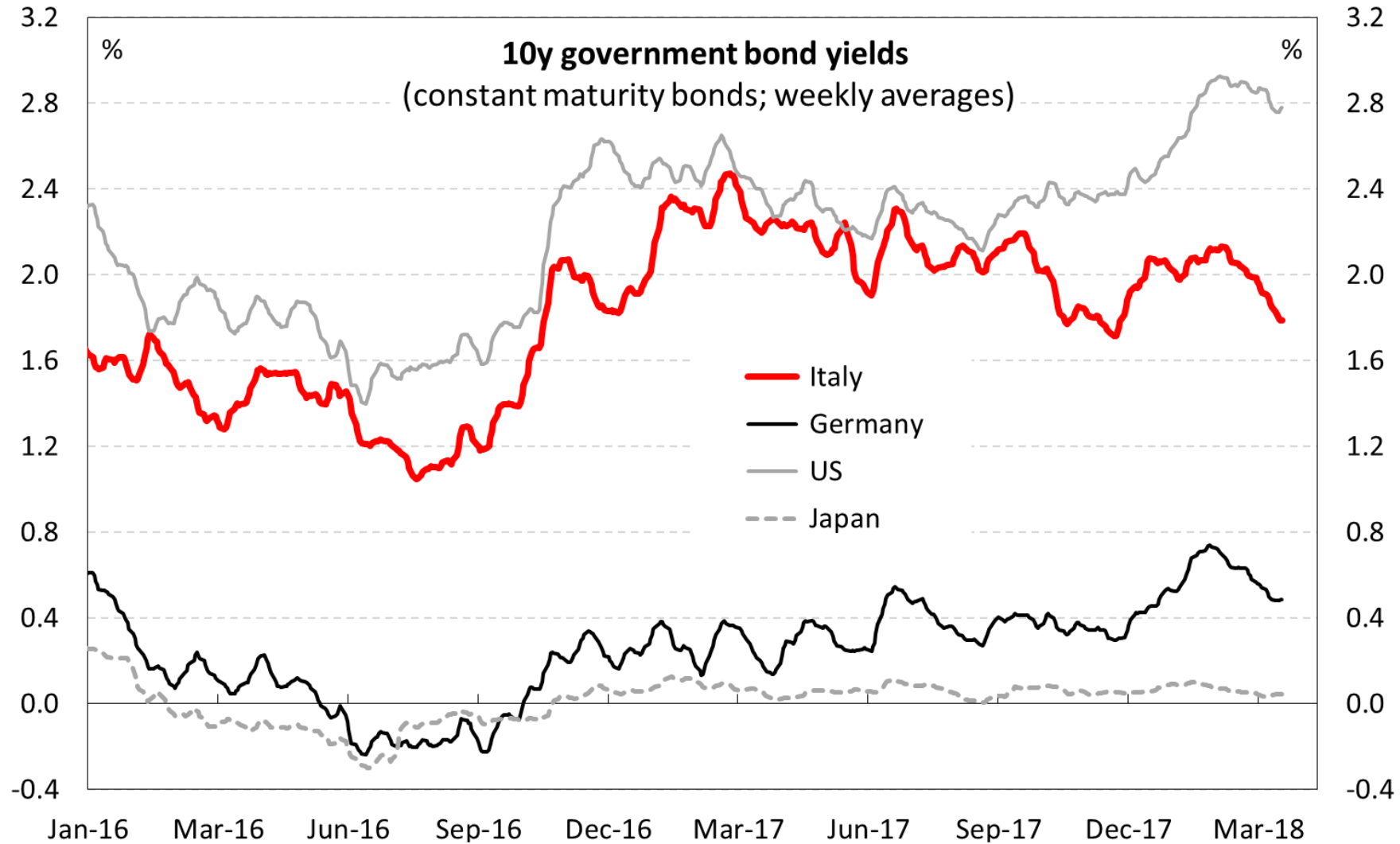
Will the outcome of Italian elections dent confidence?



Source: Thomson Reuters Datastream, ISTAT, LC-MA calculations.

ITALIAN ELECTIONS

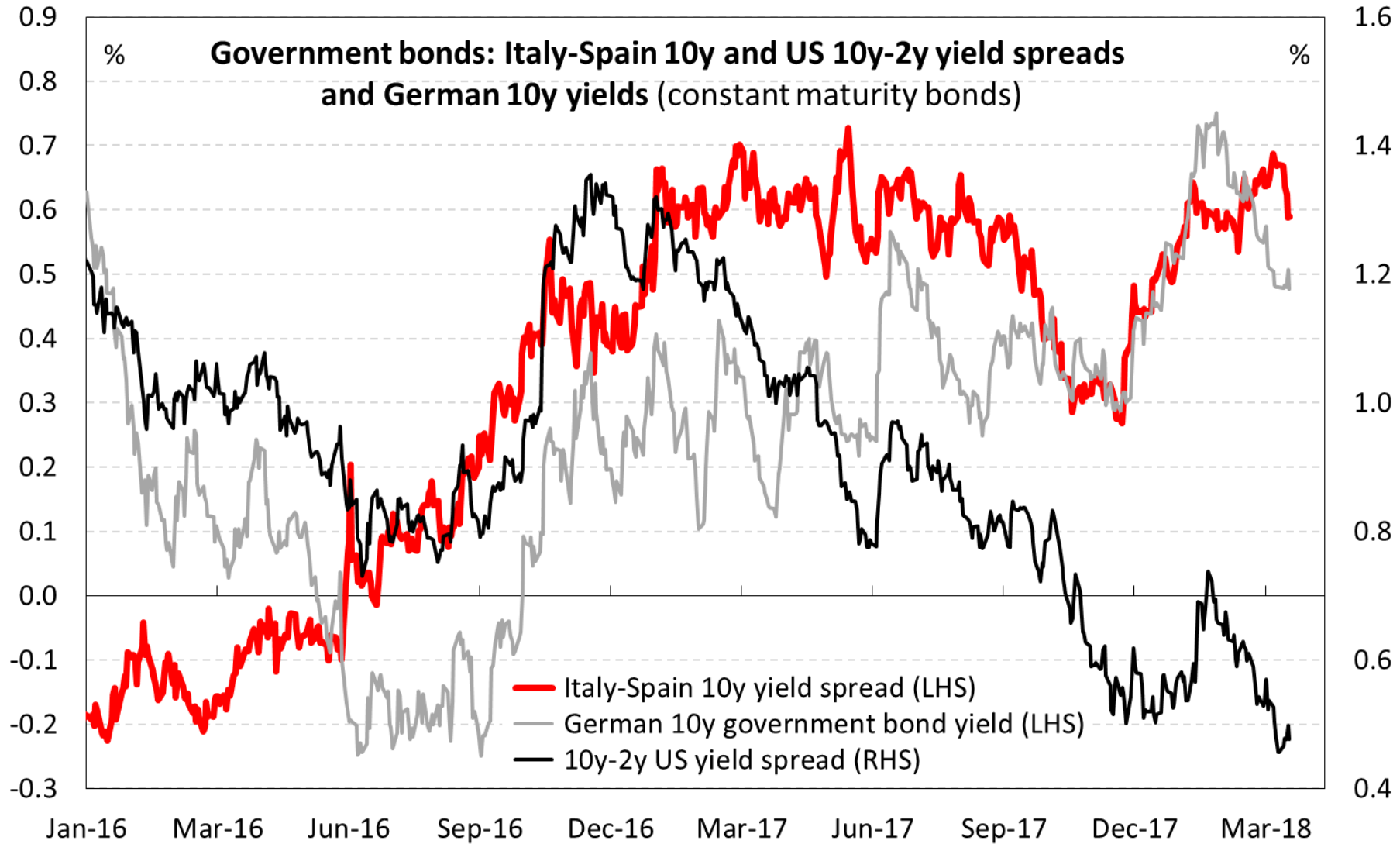
Government bond yields remained rather stable



Source: Thomson-Reuters Datastream, LC-MA calculations.

ITALIAN ELECTIONS

Yield spread widening versus Spain



Source: Thomson-Reuters Datastream, LC-MA calculations.

Complacency, but will it last?

- ◆ The economic environment is **favourable**? There must be a huge shock to move markets away from global themes.
- ◆ Is **the ECB** perceived to be ready to intervene? OMT?
- ◆ Is there **complacency** and confidence that a solution will be found eventually?
- ◆ Is there a perception that Italy **cannot deviate** from orthodox policies?
- ◆ **Past experience**? Betting against Italy has proven wrong many times.
- ◆ Just a need for a **catalyst**?