

Economics Group

Special Commentary

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Italy Back in Poll Position

Executive Summary

- Italian political risk is back in the headlines, with a confidence vote in the current government possible next week. If the current government falls, Italy could have another snap election in the coming months, perhaps around late October.
- The range of outcomes is fairly large at this point, but the biggest risk in our view is that a new Italian government pushes for significantly more fiscal stimulus, risking another showdown with the European Union over its budget plans similar to the one that occurred last year.
- Any scenario that averts the high-risk outcome would probably calm market jitters somewhat. However, even in the best case scenario, Italian political risks would likely remain dormant, but not disappear. Expect these risks to resurface again down the road.

Italy could have another snap election in the coming months.

Another Election in Italy?

Last week, news emerged that Italian Deputy Prime Minister Matteo Salvini, the leader of the League party, would call for a no confidence vote in the current government in an effort to force an election later this year. The current coalition government has been in place since mid-2018, when the last general election eventually resulted in a partnership government between the League and Five Star Movement (5SM). These two parties share some distinctly different political beliefs, but were united in their desire to shake up the political establishment and introduce bold policy changes in Italy.

Over the past year or so, however, the marriage between the two parties has been rocky as disagreements have occurred both internally and externally. The League and 5SM have at times disagreed over the best way to pursue fiscal expansion, for example, while externally, EU officials have expressed their disapproval of larger deficits given Italy's sizable debt burden. The European Commission has threatened to put Italy into an excessive deficit procedure (EDP) if Italy's budget is perceived to be in violation of the bloc's rules. Italy's debt-to-GDP ratio is already well above the 60% threshold (Figure 1 on next page), but its deficit in 2019 appears set to be about 2.5%, which would be a bit larger than last year but still below the 3% limit.

Thus far, Italy has avoided being placed in an EDP, but the risks appear to be growing. An increase in Italy's value-added tax is scheduled to take place next year, but Deputy PM Salvini has pushed ardently for tax cuts, rather than tax increases. In its spring economic outlook, the European Commission projected that the structural budget balance for Italy would widen to 3.5% next year under the assumption that the VAT increase would not go into effect. Should Salvini and the League get their way and introduce significant tax cuts, the deficit would likely be even larger next year, something that would test the European Commission's resolve on the matter.

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In the previous election, 5SM captured nearly 33% of the vote, while the League's share was just a bit over 17%. Fast forward to today and the fortunes of the two parties have flipped according to polling data. The League is polling on a national average basis at just under 40%, while 5SM's polling share has steadily declined to less than 20% (Figure 2 on next page). This polling data, along with the League's solid performance in the European Parliament election in May, have emboldened Salvini to push forward on a path that could result in national elections later this year.

Together we'll go far



Figure 1

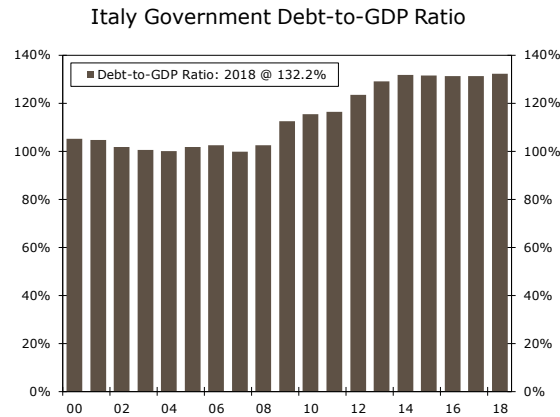
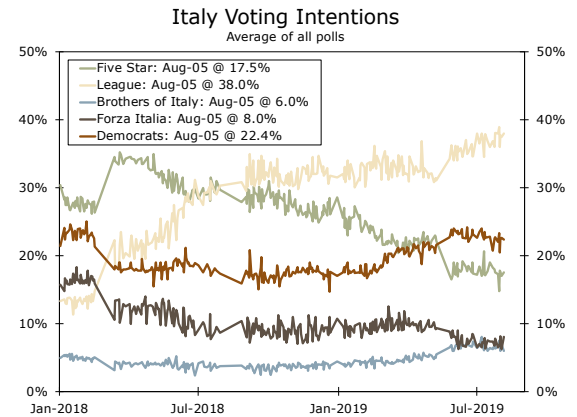


Figure 2



Source: Bloomberg LP, Various polling sources¹ and Wells Fargo Securities

What Happens Next?

The next steps are not fully clear at this point, but a parliamentary confidence vote in the government is likely to take place soon—August 20 has been discussed as a date. However, there are two important caveats around a confidence vote: first, it is not guaranteed that the vote will actually be held. It is still possible that 5SM acquiesces to Salvini’s demands, which may convince Salvini to call off the confidence vote. Another caveat is that it is not clear that a confidence vote will succeed in toppling the current government. The League has only 58 of the 320 seats in the Senate, and may have a hard time finding enough support from other parties to secure a majority to bring down the current government.

Still, it may be difficult to avoid a change of government at this point. Even if a confidence vote fails, Salvini has floated alternative methods to bring down the government, including withdrawing League ministers from the cabinet. Moreover, the fact that Salvini has called for a confidence vote in his own government makes it hard for the coalition to operate going forward. If the government is in fact brought down—by a confidence vote or otherwise—it is technically possible that an alternative government could be formed with the current parties, perhaps 5SM and the Democratic Party (PD), which could preclude the need for an entirely new election. However, given the difficulty the current parties had in forming a government in early 2018, we would view it as unlikely that another government could be formed without another election. If Italian President Mattarella decides that another government cannot be formed and elections are inevitable, a new election would need to be held within roughly two months, consistent with a late October timeframe.

How might the results of a new election shake out? As discussed earlier, the League is a clear frontrunner in the polls at present, with roughly 40% of total support from Italian voters. 5SM’s support has dwindled, while the two main right-wing parties with which the League could potentially form a coalition (Forza Italia [FI] and Brothers of Italy [BoI]) are both polling with just over 5% of support. In any case, if the election were held today, the League would likely gain the most seats in parliament, but may fall short of garnering an outright majority on its own. Instead, the League may opt to form a coalition with one or both of FI/BoI as it did in the 2018 election, which based on current polling would be more likely to gain a majority in parliament. Of course, the caveat here is that the election is not being held today. Polls can shift in either direction over the coming weeks, and the projected vote shares could look a lot different come the day of the election.

A parliamentary confidence vote in the government is likely to take place soon.

It is unlikely that another government could be formed without another election.

¹ Bidimedia, CISE, Demetra, Demopolis, Demos, EMG, Eumetra, Euromedia, GPF, Index, IPR, Ipsos, Ixe, Lorien, Noto, Piepoli, Quorum, Scenari Politici, SWG, Tecne, Termometro Politico, Winpoll.

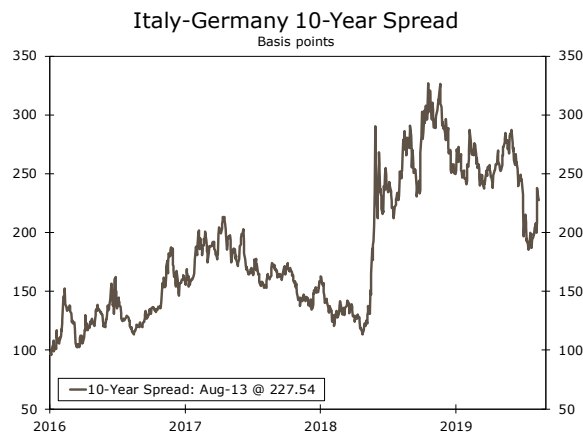
Gaming out the Scenarios

If it seems as though there are almost countless permutations for the Italian political situation still on the table at this point, it is because there are. Rather than trying to game out all the different ways in which the next few weeks could play out for Italy, we think it makes more sense to focus on two broad scenarios: the high-risk scenario and the more status-quo or neutral scenario.

The high-risk scenario for Italy is, in our view, any scenario in which Salvini and the League emerge from new elections with a stronger mandate to govern. One of the more extreme versions of that scenario is one in which the League wins an outright majority in new elections, leaving Salvini to rule without any hindrance from coalition partners. That would likely embolden Salvini to push ahead with larger-scale fiscal stimulus, a move which would probably lead to another flare-up with the European Commission.

We focus on two broad scenarios: the high-risk scenario and the more neutral scenario.

Figure 3



Source: Bloomberg LP and Wells Fargo Securities

As discussed earlier, the European Commission has already expressed concern about Italy's projected deficit next year. A big tax cut/spending increase without corresponding budget offsets could lead the 10-year Italian bond (BTP) spread over German Bunds to retest the highs reached in the fall of 2018 (Figure 3). The League possessing a sole majority would make a large fiscal expansion easier to pass than it was in the fall of 2018, which would suggest some further possible upside to bond spreads.

The League does not need to win an outright majority on its own for markets to get spooked. If the League falls short of a majority on its own but wins enough share to govern in coalition with BoI, Salvini could still push for more fiscal stimulus. Indeed, BoI may be inclined to support significant tax cuts as proposed by the League, while it also shares the League's anti-E.U. stance. The League would also be the clearly dominant partner in such a coalition, in contrast to the current government, where 5SM actually holds more seats than the League does.

That said, the market reaction may be dampened by two caveats. First, the 2020 budget must be mostly drafted by October, and likely before any new election takes place. It is unclear who exactly will be responsible for drafting the budget, but if the current government is dissolved, the budget may very well be done by a market-friendly technocratic group of lawmakers. That could mean Salvini would have a hard time implementing big bang stimulus until next year, when the 2021 budget is drafted. Meanwhile, the prospect of a return of quantitative easing in Europe, and the yield-starved global environment more generally, suggest to us that there is only so much room for Italian sovereign bond yields to rise.

In our view, any outcome that is less likely to result in a significant fiscal expansion/possible showdown with the EU would be a relatively neutral or even market-friendly scenario. This could

take many forms, but perhaps the most likely is that the League underperforms in a national election, forcing it to cede some power to other parties in order to form a coalition government. If the League needed support from 5SM or the PD to form a government, for example, it would likely be much harder for the League to enact all of its policies, as has been evidenced over the past year.

Alternatively, a caretaker government that takes over until the election could continue serving after the election if the vote ends up yielding a hung parliament. Under that scenario, a more market-friendly, technocratic government would be more likely to pursue a fairly even-keeled budget policy that avoids any major changes or disputes with the European Commission. Eventually there would need to be a more permanent solution, but that could be several months away by the time an election is scheduled, held and negotiations to form a government result in a workable coalition.

Even in the best case scenario, Italian political issues are likely to resurface again down the road.

In these scenarios, we would not expect a substantial rally in Italian assets, but rather some modest settling in market jitters. Still, it is hard to see a scenario in which Italy's longer-term political and fiscal issues disappear—instead, the best-case scenario seems to be more of one in which those issues become dormant for the time being. Thus, even in the best case scenario, Italian political issues are likely to resurface again down the road.

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