

ITALY: ECONOMY & POLITICS

BACK TO POLLS IN Q4 2019?

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SUMMARY

- › Last week, political tensions in Italy intensified as Matteo Salvini, the League's leader triggered a no confidence vote against Prime Minister Giuseppe Conte.
- › PM Conte will address the Senate on 20 August. A confidence vote will likely follow the speech, though further delays remain a possibility.
- › Once the government dissolves, the President of the Republic Sergio Mattarella will open a consultation period, from which point we see three potential scenarios: (i) a new majority with the current parliament's arithmetic, (ii) a caretaker government is assembled with early elections in Q1 2020 or after and (iii) early elections in Q4.
- › The key issue is how political events would clash with budget deadlines.
- › The 2020 Italian budget is complicated by controversial VAT hikes that the Italian government is set to introduce to abide by the EU's fiscal rules.
- › From a macroeconomic perspective, Italy's growth outlook remains challenging. Like other economies, Italy faces a difficult external backdrop. We expect a meagre real GDP growth of 0.2% in 2019, with risks tilted to the downside.
- › From a market perspective, the main short-term question for BTPs will be who drafts the 2020 budget. The rhetoric ahead of a potential election would be key. Markets will remain sensitive to comments from the League regarding Europe, but also the idea of introducing a parallel currency.

Three potential scenarios

Last week, League leader and Deputy Prime Minister of Italy, Matteo Salvini, pulled the League out of its alliance with the Five Star Movement (M5S). He submitted a no-confidence motion against Prime Minister Giuseppe Conte. Playing for time, the M5S, the Democratic Party (PD) and the leftist LEU party voted to push **the debate on the government out to 20 August**. Meanwhile, Salvini pledged to pass a constitutional bill aiming to cut the number of MPs by more than a third from the next Legislature. The vote is scheduled for 22 August and will not take place if the government collapses before then. Thus, the latter could further delay the end of the current government. Once the government falls, President of the Republic Sergio Mattarella will open a consultation period, from which point we see three possible scenarios:

- **Scenario 1: new majority with current parliament's arithmetic**

Given the current composition of the parliament, there are several alternative alliances that could be formed with an absolute majority. For example, M5S, PD and LEU have enough lawmakers to form a government. M5S want to avoid snap elections and recover in the polls. However, the position of the PD appears less clear. The party is facing political division. Nevertheless, the idea of a new government between PD and M5S has gained traction recently.

Considering the unthinkable, the League and M5S could find a new government agreement, even though given the recent tensions between both parties and their

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disagreement on some important issues, such an alternative appears unlikely at this stage.

- **Scenario 2: caretaker government with early elections in Q1 2020 or later**

The President could grant the exploratory mandate to a technocrat, with the goal of nominating a technocratic/political government that would seek a confidence vote in Parliament. In the event of a positive confidence vote, this government would pass the 2020 budget law and new elections would likely be held in early 2020 (or later).

- **Scenario 3: early elections in Q4**

If no alternative Parliament majority can be formed, the President will dissolve the Parliament and a general election will take place within 45-70 days (logistically about 60 days are needed to include the votes of Italians living abroad). In this case, the government of incumbent Prime Minister Conte would stay in office and run the day-to-day government affairs until elections are held and a new government takes office.

A potential technicality to block Mr. Salvini's aspirations?

Despite ongoing tensions in the governing coalition, our baseline scenario since last year was that early elections will not take place in 2019, but rather in H1 2020 for several reasons, namely the budget, the composition of Parliament and the President (see our previous Flash Note [here](#)). Recent developments have increased the probability of seeing early elections in Q4 2019, but the situation is not so straightforward. The League, seeking to capitalise on its strong performance in voter intentions polls, wants elections as soon as possible. Forza Italia voted in favour of having the no-confidence vote as soon as possible, hinting that it would follow Salvini. Nevertheless, **Salvini is facing some resistance from the left-wing political spectrum**. His coalition partner, M5S, is falling in polls and wants to avoid a snap election. Meanwhile, forces within the PD are increasingly in favour of a deal with M5S to avoid an early election. Indeed, **PD has an incentive to wait, at least a little, to allow their recent rise in polls to gather further momentum**.

The budget and the 2020 VAT increase

One key issue remains the 2020 budget and how new elections or the formation of a new government would clash with budget deadlines. By September 27th, the Parliament should start reviewing the budget law for 2020 and present the Update of the Economic and Financial Document (NADEF). The 2020 draft budget has to be submitted to the European Commission (EC) by October 15th. However, while this is an important deadline, the EC might allow some flexibility on timing. In this case, Spain offers a precedent as it delayed its budget calendar due to electoral matters. **The key deadline is 31 December, the last day to approve the budget law in parliament.**

Should the budget law not pass by year-end, VAT tax rates (worth 1.3% of GDP or EUR 23bn) would automatically increase on 1 January 2020 as part of a law previously passed to abide the EU's fiscal rules and a temporary budget cycle would be in place¹.

¹ During this period that could last a maximum of four months, spending capacity on each line of the budget would be capped at one-twelfth of the existing budget, for each month the temporary arrangement is in place.

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ITALY: KEY UPCOMING DATES – BUDGET, POLITICS AND RATING AGENCIES

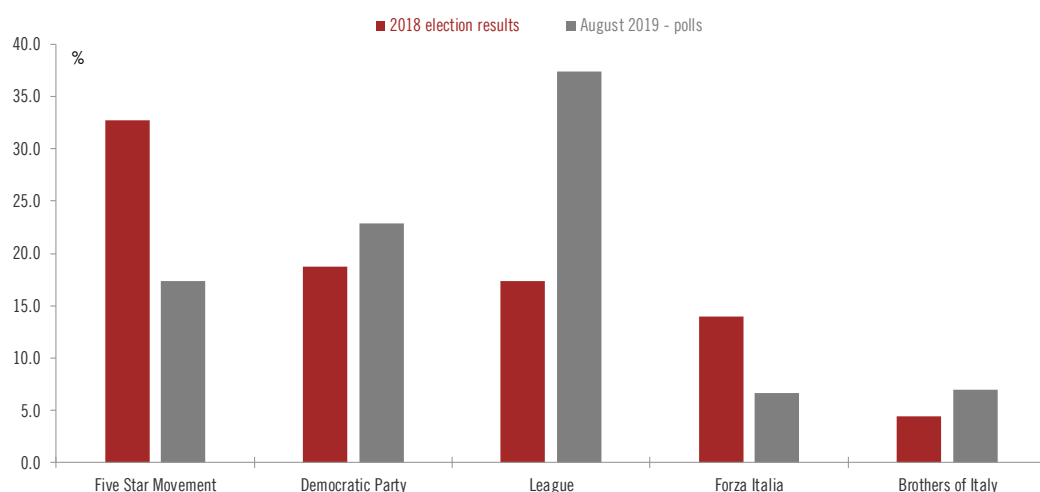
2019	
20-22 August	Debates in parliament
06 Sep	Moody's rating review
27 Sep	Update of the Economic and Financial Document (NaDef)
15 Oct	Deadline for the submission of the 2020 draft budget plan to the European Commission
20 Oct	Presentation of the draft budget to Italian Parliament
25 Oct	S&P's rating review
27 Oct	Earliest date for an early election
15 Nov	DBRS's rating review
30 Nov	Deadline for the European Commission's assessment on the budget plan
31 Dec	Deadline for Italian Parliament's approval of budget plan

Source: PWM - AA&MR, August 2019

What polls are telling us? – a turn to the right

Since the general elections of March 2018, a key trend has been the widening gap in voter intentions between the two governing parties. **The League's support has more than doubled, compared to its election results. By contrast, support for the M5S has withered away.**

CHART 1: ITALIAN OPINION POLLS (AUGUST) VERSUS 2018 ELECTION RESULTS



Source: PWM - AA&MR, Various polls, August 2019

If elections were held today, polls suggest that the League would be able to secure around 38% of votes. Along with the right-wing Brother of Italy party, currently polling at around 7%, the League would be able to win an outright majority in Parliament, without the support of Forza Italia. Such a government would make it easier for Salvini

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to drive his political agenda. However, he could also be tempted to join forces with Forza Italia to strengthen the right-wing majority. Unless M5S and PD form a pre-election alliance (with the support of small left leaning parties), challenging the League's leadership will be no easy task.

A challenging macro outlook

From a macroeconomic perspective, Italy's growth outlook remains challenging. The country exited a short-lived technical recession in H2 2018 with a meagre 0.1% q-o-q GDP growth rate in both Q1 and Q2. Leading indicators point to a small pick up in economic activity in Q3. Nevertheless, like other economies, Italy faces a challenging external backdrop. It is being hurt by external weakness and a range of uncertainties. Manufacturing, which is highly exposed to external demand, accounts for a bigger share of total value added in Italy than in France or Spain (but for a lower share than in Germany). This explains part of the Italian economy's current underperformance relative to more domestically-oriented Spain and France.

In addition, domestic demand has been showing signs of weakness. Another wave of domestic political volatility and/or tense discussions with Europe over next year's budget could dent business and consumer confidence again. **Thus, economic developments in Italy in H2 2019 will likely be overshadowed by domestic politics.** As things stand, we continue to expect meagre real Italian GDP growth of 0.2% in 2019, with risks tilted to the downside.

From a market perspective, the prospect of more stimulus from the ECB has helped to alleviate pressure on Italian bonds (BTPs). **The main short-term question for BTPs will be who drafts the 2020 budget.** The rhetoric ahead of a potential election would be key. Notably, markets will remain sensitive to comments from the League regarding Europe but also the idea of introducing a parallel currency.

CHART 2: ITALY GENERIC GOVERNMENT 10Y YIELD

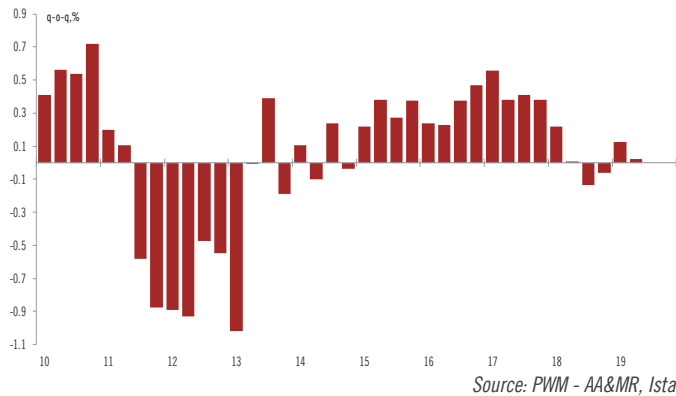


Source: PWM - AA&MR, Thomson Reuters, August 2019

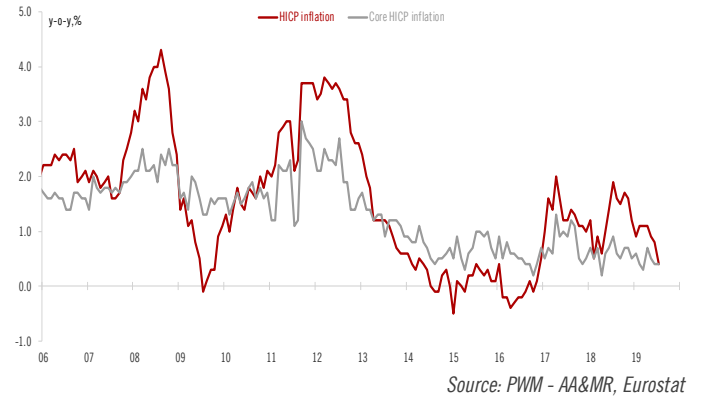
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ITALY: REAL GDP GROWTH



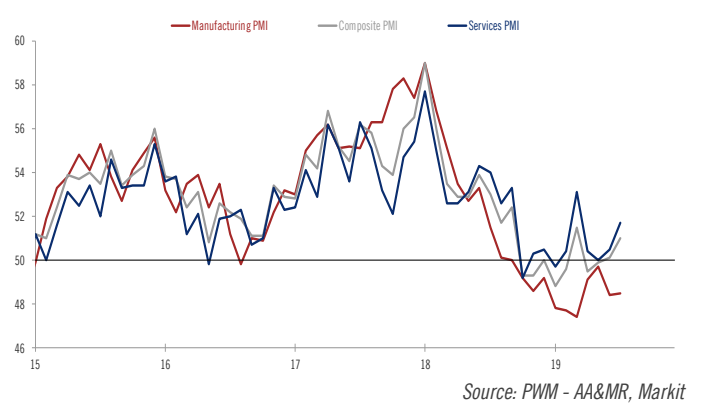
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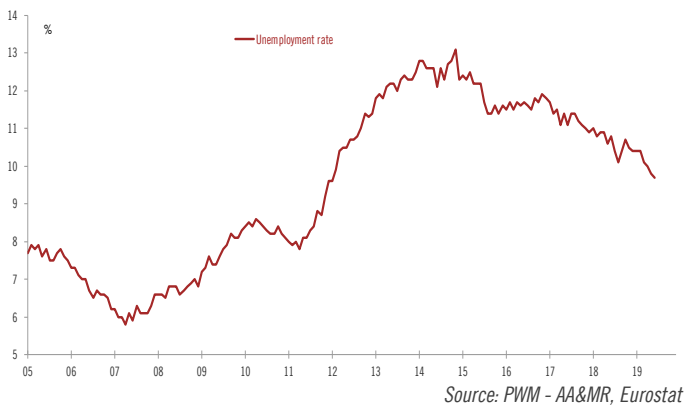
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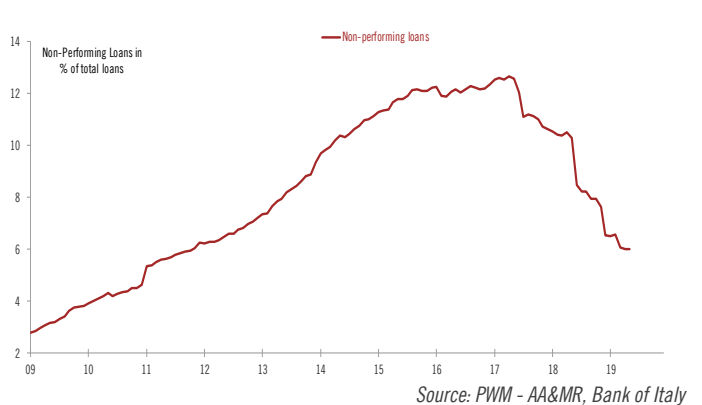
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