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Italian Election: The threat is fiscal profligacy, not "Italeave"

Sunday's general election is set to put an end to a near 15-month period where Italy has been run by a "caretaker" cabinet. With a hung parliament looking like a near certainty,[1] it could be some time before investors find out which political party or group of parties would be able to exert most influence over economic policies. In this note, our Chief Economist Megan Greene outlines the three most likely scenarios and how she believes each will affect Italy's economy, the country's relationship with Europe and the broader financial markets.

For the past year and a half, investors have watched nervously as the populist, anti-Euro Five Star Movement (M5S) consistently led the opinion polls in Italy. With the M5S having at one point declared it wanted to hold a referendum on Italy's membership of the Euro, the fear surrounding Italy's election was that the country might follow in the UK's footsteps and decide to abandon the European Project, posing an existential threat to the Eurozone. However, in the months leading up to the election, this immediate threat has all but disappeared. And based on the markets, investors have stopped worrying.

But don't breathe a sigh of relief just yet.

While it is impossible to predict which political party or individual will emerge as the ultimate winner, it is fair to say that the most likely scenarios will see Italy's deficit blown out over the next few years. This is a problem for a country that has the fifth highest debt burden in the world (relative to GDP, behind Japan, Greece, Yemen and Lebanon, according to the CIA Factbook)[2] and is facing an expected wind-down of the European Central Bank's (ECB) asset purchasing program. It may not be an immediate threat, but Italy is likely to face clashes with Brussels and rising borrowing costs as its budget deficit rises.

Election Scenarios

The composition of the next government is particularly uncertain after this election in part because of a new electoral law that has made it more difficult to transpose votes won into seats occupied.[3] On top of this, Italian government formation can often involve horse-trading between individual Members of Parliament (MPs) – over the last legislature nearly one-third of total MPs across the upper and lower house changed parties.[4]

[1] Reuters: Uncertainty Reigns in Final Polls Ahead of Italy Election, 16 February 2018.
[2] Central Intelligence Agency: The World Factbook – Public Debt (estimated 2017), as of 2 March 2018.
[3] The Independent: Untried Voting System Could Return Victory for Berlusconi's Right-wing Coalition, 9 February 2018.
[4] The idea and origin of party-switching, or 'trasformiso', is explained in this Politico article, and also detailed in The Economist's entry, Italy's Party-Hopping MPs, published in November 2017.

Scenario 1: Center-Right Coalition Most Likely

The most likely scenario in the Italian election in our view is a center-right coalition government between Forza Italia (FI), the populist Lega (formerly Lega Nord) and the smaller Brothers of Italy. This coalition has had the greatest momentum in the polls over the past month.[5] Its recent surge has been in part due to migrant-related violence, which has propelled immigration – an issue on which FI and particularly Lega have been firm – to the forefront of the campaign.[6] However, we must note that Italy President Sergio Mattarella is not obliged to give the mandate for forming a government to the biggest coalition or the biggest party; he can also give that honor to whichever leader he thinks can cobble together the biggest majority in parliament.

It is worth highlighting that in this scenario, the moderating figure in a center-right coalition would be Silvio Berlusconi. That's right – the same Silvio Berlusconi who was removed from office in 2011 for tax eviction.[7] Such a government will likely clash with Europe for two reasons. First, relations between Mr. Berlusconi and German Chancellor Angela Merkel have been widely perceived to be frosty. Just take this video from 2009 of Mr. Berlusconi making Ms. Merkel wait for him to get off the phone before greeting him as an example.[8] Furthermore, Lega leader Matteo Salvini's open support for Front-National leader Marine Le Pen during the last French election[9] may cast a shadow on Franco-Italian relations.

More importantly, in our view, a center-right coalition is likely to blow out Italy's budget deficit and break EU deficit procedure rules. Both FI and the Lega have proposed a flat tax (FI wants a flat tax of 23%, while Lega is arguing for 15%). Both parties argue that reducing taxes in Italy would pay for itself because it would reduce tax evasion. In case you thought I was being unfair to the US by constantly insisting that "tax cuts don't pay for themselves!!!" fear not – they won't pay for themselves in Italy either. Furthermore, FI and Lega would like to repeal a 2011 pension reform, which would see Italy's public finances deteriorate further. Lega has also argued that it would like to repeal parts of the Jobs Act implemented in 2014 in order to provide more job security to Italian workers.[10] While this wouldn't impact public finances, it would reintroduce structural rigidities into the workforce and serve as a drag on growth.

Italy's debt burden was estimated at roughly 131.5% of GDP at the end of 2017.[11] If the center-right coalition were to implement the policies on which it has campaigned, Italy's debt burden would rise even further. This is unlikely to be an immediate issue; the average maturity of Italian debt is over seven years. Still, the ECB is likely to end its bond buying program – from which Italy benefits massively – in September of this year. There is no plan for what to do at the European level if Italian bond spreads widen significantly and Italy faces an investor strike. The Outright Monetary Transactions program (OMT) remains in place in case any Eurozone countries need support,[12] but it is difficult to see any Italian government agreeing to the conditionality associated with such a program. So while the immediate market reaction to a center-right coalition may be positive on the basis that it should be business-

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[5] CNN: Why Italy's Unpredictable Election is Testing Nerves In Europe, 28 February 2018.
[6] NPR: Anti-Migrant Slogans Are Overshadowing Italy's Election Race, 21 February 2018.
[7] New York Times: Berlusconi Expelled From Senate in Italy After Two Decades In Government, 27 November 2013.
[8] Eurativ: Berlusconi Keeps Merkel Wiating by Taking Phone Call at NATO Summit, 4 April 2009.
[9] The Local: Italy's Far-Right Leader Congratulates Le Pen on Reaching Second Round, 24 April 2017.
[10] Politico: Italian Election Pledges – Pizza or Pazza, February 14, 2018.
[11] Reuters: Italy 2017 Debt-to-GDP Ratio Fell 0.5 Points vs. 2016 – Central Bank, 19 February 2018.
[12] European Central Bank: Technical Features of Outright Monetary Transactions, 6 September 2012.

friendly, the medium- to long-term implications of this government on the public finances and economy could be severe.

Scenario 2: Grand Coalition A Very Close Second

In our view, the second most likely election outcome is a grand coalition between the incumbent center-left Partito Democratico, or PD, and FI (possibly with other smaller parties). A PD-led coalition with Mr. Berlusconi would be viewed by the markets as “business as usual”. This government would probably be the best for Italy economically, though given ideological divisions between the PD and FI, it would probably be beset by gridlock and could achieve very little in terms of policy. That’s the best Italy can really hope for given the field of potential governments, which is a pretty profound statement.

While FI has been promoting a flat tax, this would likely be moderated in coalition with the PD to a more gradual reduction in taxes. Matteo Renzi (former PM and current PD leader) has already been pursuing this in recent years and in the election campaign. Furthermore, Mr. Renzi has recently pledged to increase the budget deficit from an expected 1.6% of GDP in 2018 to 2.9% of GDP for the next five years.[13] While a grand coalition would harm Italy’s public finances less drastically than a center-right coalition, even this government would likely follow through with a fiscal expansion.

We believe a grand coalition would be a benign outcome in the short-term, but it would also likely be unable to deliver on growth and employment. This would feed right into support for Lega and the M5S, Italy’s two most anti-European parties. While “Italeave” is not likely an immediate threat in this election outcome, a paralyzed government over the next few years could increase anti-European sentiment significantly.

Scenario 3: Populist Coalition Involving M5S

This scenario is the least likely but could have the biggest impact on the markets. Based on the latest opinion polls, M5S is the largest party in Italy, [1] but it is very unlikely to have enough seats to form a majority government on its own. M5S has up until recently been adamant that it will not form a coalition with other parties. While party leader Luigi di Maio has recently backed away from this stance,[14] it is hard to imagine any other parties wanting to partner up with it. M5S’s support has remained fairly steady in recent months and the party did decently in local elections in Sicily in November 2017 (seen as a bellwether for the general elections) but failed to capture any more of the vote than expected.[15]

M5S has recently backed away from its desire to hold a referendum on Italy’s membership of the Euro, but it remains Euroskeptic. An M5S-led government would probably also roil the markets by raising spending – the party wants to scrap the 2011 pension reform (albeit over a five-year period) and implement a minimum citizenship income (in theory financed by higher taxes). M5S also aims to repeal parts of the Jobs Act, which would weigh on growth.[16]

[13] Reuters: Italy’s Renzi Pledges to Hike Budget If He Wins Election, 19 October 2017.
[14] Bloomberg: Italy’s Five Star Leader May Seek ‘Grand Coalition’, 25 February 2018.
[15] The Local: Five Things We’ve Learned From Sicily’s Election, 7 November 2017.
[16] Reuters: Factbox – Italy’s Election, 28 December 2017.

Spending Spree

Given Italy's significant debt burden and lackluster growth, one might have expected this election campaign to be full of detailed plans to enhance the country's productivity and reduce the debt/GDP ratio. Instead, most of the parties have discussed how they plan to expand spending. This may just be a campaign tactic, but the policies put forward by all the major parties would raise Italy's budget deficit just as the ECB stops buying up assets.

Political and redenomination risk in Europe are considered by the markets to be soooo 2017. And in our view, that is a fair assessment of this Italian election. Instead, we think the real risk lies in fiscal profligacy in the medium-term. This may be beyond most investor's time horizon, but while the final outcome of the election is uncertain one thing is clear: the new government (whatever its composition) plans to spend. This is unsustainable for a country with a massive public debt burden and very little growth even with a buoyant global backdro