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POLITICAL UPDATE: WHAT NEXT FOR ITALY?

Berenberg Macro Flash

By Holger Schmieding and Carsten Hesse

No easy way out, new elections possible

Nearly two weeks after Italy's inconclusive election, the outlook remains murky. There is some talk that the two big political camps, the 5Stars and the centre-right/right alliance, may both want to install a technocratic government to change the election law before calling new elections in October. However, many other outcomes remain possible.

As the two big radical parties, the 5Stars and the Lega, have moved away from prior demands for a euro referendum, the risk that Italy could spark a major crisis in Europe in the near term remains small. However, the rise of the populists in Italy probably marks the end of serious pro-growth reforms. In the long run, a potential reversal of some earlier reforms and a return to fiscal deficits well above last year's prudent 1.9% of GDP could sow the seeds for serious trouble once the current cyclical upswing has run its course.

Before the 4 March vote, we had put the probability of repeat elections later this year at 10%. This has now increased to around 35%. On 4 March, no single party or alliance came close to the 316 seats needed for a majority of seats in the Chamber of Deputies (Chart 1). That the right-wing Lega party headed by Matteo Salvini is now leading the centre-right/right alliance and not Silvio Berlusconi's Forza Italia also makes it more difficult to build a stable government majority.

A lot will depend on the losers of the election, in particular the centre-left Democratic Party (PD). The party lost more than half of their voters relative to their 2014 peak. As a consequence, ex-prime minister Matteo Renzi resigned this week from his position as PD leader. The party is torn between going into the opposition and joining either the centre-right/right alliance or the anti-establishment 5Stars to remain in government as a junior partner. The party will elect a new leader in mid-April. Front runners are Transport Minister Graziano Delrio (a Renzi supporter) and the governor of the Lazio region, Nicola Zingaretti, who did well in the 4 March election and would likely be more open to working with 5Stars.

Potential scenarios

1) 5Stars (227 out of 630 seats) and Lega (124 seats) would have enough seats to build a government together (Chart 2). Nevertheless, 5Stars would prefer to govern alone and Lega would not like to be a junior partner in a coalition. Also, joining forces with the right-wing Lega would be very unpopular with the left-wingers among the 5Stars. It may even tear the movement apart. That the two big radical parties would jointly form or support a government meant to last a full term seems unlikely (5% probability).

However, the two parties may potentially agree on a temporary technocratic government with a limited agenda. Very high on this agenda would be a new election law with a majority premium. This would allow for new elections (earliest after the summer break in October) that may bring either the centre-right alliance or 5Stars to power. We attach a 35% probability to this scenario.

Would this option be bad for the markets? Only modestly so. Importantly, 5Stars have backed away from demanding a euro referendum and confirmed recently that they want to reduce government debt. While



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they would probably not achieve that, they may be less fiscally irresponsible in government than their recent campaign promises had suggested. If the centre-right/right alliance would win instead, Berlusconi's Forza Italia would have a close watch on Salvini's Lega and not allow their joint government to cause too much damage in the near term. For more information on the party election programmes, please see our [Italian election report](#).

2) 5Stars with PD (30% probability):

A collaboration between the two is now more likely than before as Renzi - who was a big opponent of an alliance with 5Stars - has resigned as PD leader. Depending on who will be voted in as new PD leader, the party could open up more towards 5Stars. Some observers speculate that they might even join together in an alliance in the future, similar to Lega and Forza Italia, to have a better chance of winning future elections. However, PD members are deeply divided as to whether they should work together with the centre-right/right, the 5Stars or go into opposition. The party split before, leading to the creation of the left-wing Free and Equal party in 2017 which won 14 seats on 4 March. Another split cannot be ruled out.

3) Centre-right/right alliance with PD (20% probability):

This option is numerically possible and very much supported by Berlusconi. The resignation of Renzi also helps as Berlusconi reportedly prefers to work with the current prime minister Paolo Gentiloni instead. But it is not for Berlusconi to decide as his Forza Italia came well behind Salvini's Lega within the centre-right/right alliance on 4 March. Salvini opposes such a coalition. Instead, the centre-right/right alliance may try to convince individual members from other parties to join them. However, as the alliance is 51 seats short of a majority, this will be a challenging task, to put it mildly.

4) Unity government or a technocratic government for more than six months (10% probability):

Such an arrangement would be similar to Mario Monti's cabinet from 2011 until 2013. Italy probably had more unity governments than any other country over the last 70 years. This could be president Sergio Mattarella's preferred option if no other coalition can be formed. The president would likely be keen on getting the 2019 budget and a new election law approved before a new election might no longer be avoidable in 2020. The problem is that a unity government normally only works well when a national crisis, such as in Italy at the end of 2011, forces the different political camps to set their differences aside for a while. Fortunately, Italy is now enjoying a cyclical upswing while bond yields are low. In the absence of a crisis, the major political parties will probably not want to back a technocratic or unity government for more than a brief interim period. Also, the parties would likely not allow a technocratic government to implement painful and contentious reforms.

A potential timeline

Italy's president Mattarella will start to consult with party leaders individually in late March or early April. Afterwards he will give one person (who need not be one of the party leaders and could also be a technocrat) the first go at trying to form a coalition. The two top contenders are the leaders of the radical parties that did best on 4 March, Luigi Di Maio from the 5Stars and Salvini from the Lega.

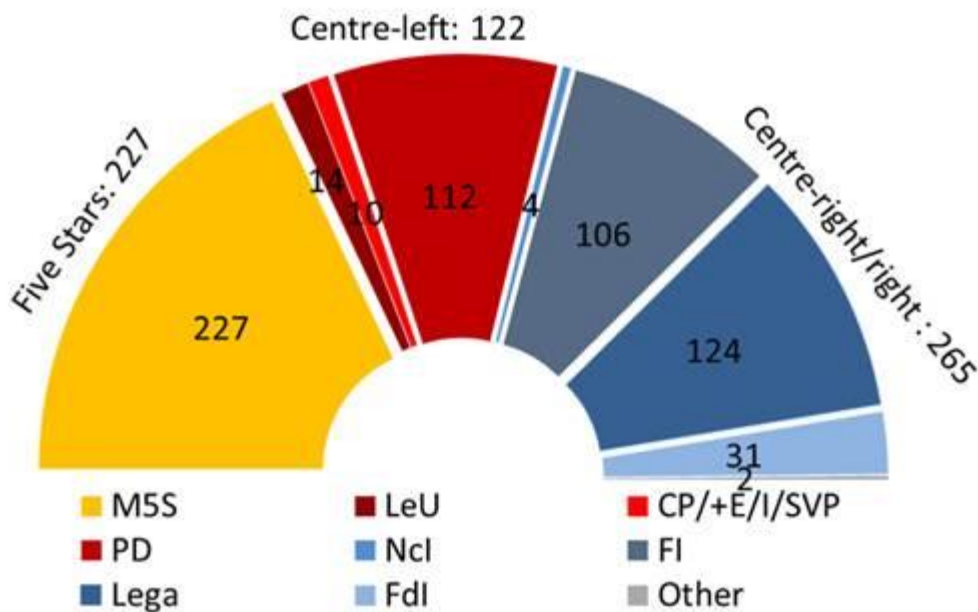
On 23 March, we may get a first indication of who may be ready to join forces with whom in the end. On this day, the Chamber of Deputies and the Senate will both convene for the first time and elect their speakers. A majority is needed for that.



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How long will the process of finding a new government last? Probably a while. After the 2013 election, it took around six weeks from the opening of parliament until a government was formed. As the political scene is now more splintered, it may well take longer this time.

Chart 1: Preliminary result of seat distribution for Italy's chamber of deputies

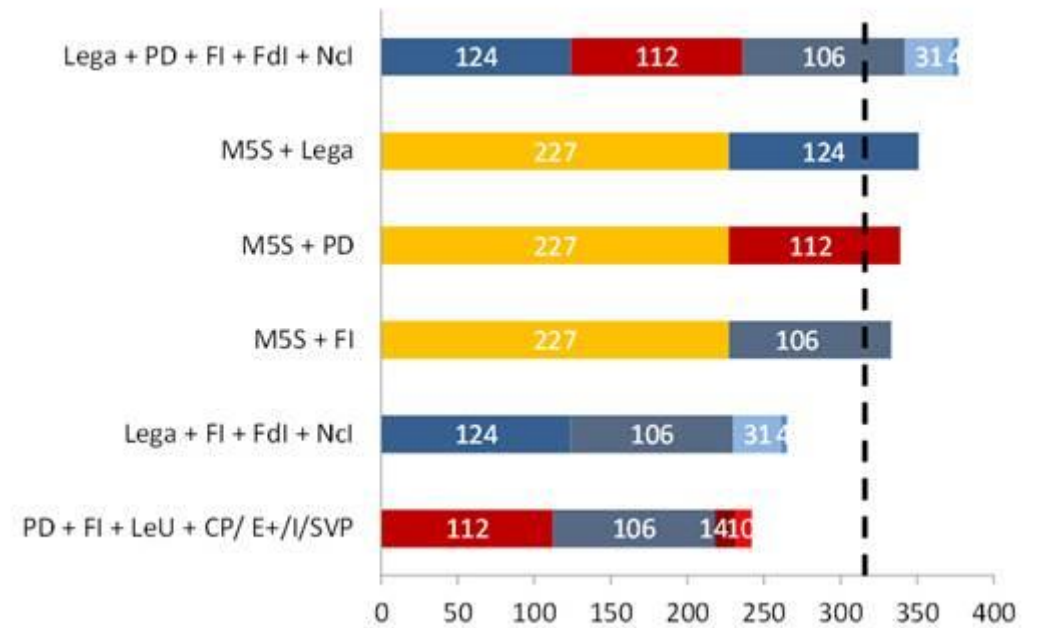


Distribution of seats in the chamber of deputies according to Wikipedia/Berenberg on 15 March. Very small changes in seat allocation still possible, as only 620 out of 630 seats are currently officially allocated. Centre-left Democratic Party (PD), Left parties include Popular Civic List (CP), More Europe (+E), Together (I) and South Tyrolean People's Party/Trentino Tyrolean Autonomist Party (SVP), radical left Five Star Movement (Grillo), centre-right – right alliance includes Forza Italia (FI, Berlusconi), ultra-right Lega Nord (Lega, Salvini), Fratelli D'Italia (FdI) and Us with Italy (Ncd).



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Chart 2: Which parties need to work together to build a coalition with a majority?



316 seats are needed to win a majority in the chamber of deputies. Source: Berenberg, Wikipedia Italia

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