Italy’s coalition puzzle: mission impossible?

- **Two kings is one too many:** Six weeks after Italy’s inconclusive election, the coalition puzzle remains unsolved. The two big winners of the election, the leaders of the anti-establishment 5Stars party (Luigi Di Maio) and right-wing Lega party (Matteo Salvini), have both claimed the position of prime minister (PM).

- **Kingmaker, anyone?** Neither the 5Stars nor the centre-right/right alliance led by Salvini control enough seats for a majority in parliament on their own. As a result, they need to win over other parties and persuade them to join in a coalition. The Democratic Party (PD), the big loser in the election, also seems to be keen on going into opposition. That makes the coalition-building process more difficult. Many outcomes remain possible, including the two radical parties forming a coalition or a unity government consisting of all parties/coalitions.

- **Which coalition is most likely?** A combination of 5Stars, Lega and potentially Forza Italia (FI) remains most probable in our view (40%). Indeed, Lega and 5Stars are gaining further momentum, according to the latest exit opinion poll, which would seem to support the likelihood of such a coalition. In our view, the probability of a unity/technocratic government has increased from 10% to 25% following the lack of progress in coalition talks over the last few weeks, while the likelihood of a 5Stars-PD coalition falls from 30% to 15% after the PD rejected a coalition offer by 5Stars. Our expectation of a collaboration between the centre-right/right alliance and PD drops from 20% to 10%, as Salvini himself has ruled out such a coalition. We think that there is a 10% chance that none of the parties will work together, leading to new elections.

- **Should we be nervous?** Despite the surprisingly strong election result of the radical parties and an unsolved coalition puzzle, 10-year Italian bond yields are trading nearly 20bp lower than before the election. 5Stars and Lega continue to become less radical in their policy demands, supporting Italian asset prices. However, one should not underestimate the risks. Due to the weak Italian finances, any significant reform reversal or increase in the budget deficit could cause Italy to catch a severe economic and financial cold if the EU sneezes.

Chart 1: Seat distribution in Italy’s chamber of deputies

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Carsten Hesse
European Economist
+44 20 3753 3001
carsten.hesse@berenberg.com
What are the main obstacles to building a government coalition?

We identify four obstacles.

1) 5Stars leader Luigi Di Maio wants to be PM since his party came first in the elections. Nonetheless, he can only achieve this goal if the centre-right/right alliance breaks up. If the alliance stays together, they will have more seats than 5Stars and therefore can claim the PM position instead.

2) Matteo Salvini, who leads the Lega and the alliance of the Lega with Silvio Berlusconi’s FI and the right-wing Fratelli d’Italia, can only become PM if the alliance stays together and can convince either 5Stars or the PD to join forces with his party. However, both parties have ruled out this option so far. While Salvini would like the centre-right/right alliance to team up with 5Stars, Di Maio is strictly against joining forces with FI leader Berlusconi. In Di Maio’s eyes, Berlusconi represents the old discredited system.

3) Berlusconi would like the centre-right/right alliance to form a coalition with the PD. But this idea is not supported by Salvini. He holds the PD responsible for the migration issue and weak economic growth.

4) The PD rejects a potential coalition with the Lega, claiming they are too right-wing and anti-EU. Meanwhile, parts of the PD do not want to collaborate with 5Stars. In the election campaign, the anti-establishment party heavily attacked the PD. Also, ex-PD leader Matteo Renzi, who remains very influential, prefers his party to go into opposition after losing the election.

What happens next?

No progress was made at the second round of talks last week between Italian President Sergio Mattarella and the party leaders. Mattarella may now decide his next steps fast – even as soon as this week.

He could ask someone to build a coalition, the so-called “pre-mandate”, for which Salvini and Di Maio are the two favourites. More likely, he could give someone the so-called “exploratory mandate” to solve the puzzle through consultation with all parties again. Candidates for such a mandate could include Senate speaker Elisabetta Casellati of the FI or Roberto Fico, the speaker of the parliament from 5Stars. Casellati is a close ally of Berlusconi and might largely come out in favour of Berlusconi’s interests. The other candidate, Fico, could try to convince the PD and the small left-wing Free and Equal party to join a coalition with 5Stars.

Should all the negotiations fail over the coming weeks, the president may try to build a unity government made up of all parties, led by a PM of his choice. He could also opt for new elections. Meanwhile, the outcome of the PD leadership election on 21 April could give us more clarity about whether the PD really wants to go into opposition or if the party would be open for coalition talks with the other parties.

Furthermore, important regional elections are due on 22 April in Molise (southern Italy) and on 29 April in Friuli-Venezia Giulia (north-east Italy). The Friuli election will keep the centre-right/right alliance close together until then, as the alliance has fielded a joint candidate from the Lega in the region.

What do the polls say?

Lega and 5Stars are flying high. According to the latest Ixè poll, the two winners of the 4 March election are gaining further momentum, especially the Lega, and support for both together has risen by 5% since then. According to the poll, Lega would win 21% of the votes versus 17.4% won on 4 March, while 5Stars would receive 34%, up from 32.6%. FI would lose 2% of the vote, from 14% to 12.2%.

Thanks to the gains for the Lega, the centre-right/right alliance would receive 38.4% of the votes versus 37.0% at the election. The PD continues to fall behind, down to 16.6% from 18.7% on 4 March, pushing the centre-left alliance down to 18.7% from previously 22.3%.

The same poll also revealed that trust and confidence in Salvini jumped from 25% in February to now 39%, the highest rating among all surveyed politicians, except for
President Mattarella. In second place is Di Maio with 36% (+7ppt), followed by current PM Paolo Gentiloni with 33% (-2ppt). Berlusconi lost 1ppt to 23% and Renzi fell by 5ppt to 18%. Mattarella’s confidence rating improved by 1ppt to 51%.

These polls give Di Maio and Salvini a boost in the coalition talks and make it more difficult for Berlusconi to play a decisive role.

Which coalition is most likely?

1) A combination of 5Stars, Lega and potentially FI remains most likely, in our view (40% probability): The latest opinion polls support a coalition between Di Maio and Salvini. Also, the parties have already worked together on two recent occasions. First, the Lega and 5Stars joined forces to elect the speaker of the lower house and senate at the end of March. Second, all three parties agreed last week to elect their preferred candidates for the special committee in the parliament. Nonetheless, despite the comfortable majority in seats that this combination would have and their recent collaboration, this would be a fragile alliance as there are significant differences in between their respective election manifestos. We think it is unlikely that such a coalition would last long. Understandably, this coalition might be very unpopular with the left-wingers among the 5Stars party, as they would likely clash with the right-wing members of the Lega. The coalition might therefore only concentrate on implementing a new election law and call for new elections later this year. A possible scenario is that if Salvini does not leave the centre-right/right alliance, the coalition leaders could come up with a compromise which would give FI the PM position (eg Antonio Tajani), with 5Stars and Lega sharing most of the other powerful government positions. It is unlikely that Berlusconi will be allowed to participate in any official position until 2019 due to a 2013 tax fraud conviction.

2) Unity government or a technocratic government (a 25% probability, up from 10%): Following the lack of progress in coalition talks over the last week, we have increased the probability of this scenario to 25%. This could be President Mattarella’s preferred option if no other coalition can be formed. Recently, speculation increased that the PD would be open to this idea. The president would likely be keen to get the 2019 budget and a new election law approved before any new election, which may be unavoidable next year.

3) 5Stars with PD (a 15% probability, down from 30%): A collaboration between 5Stars and PD (and potentially the Free and Equal party) is now less likely after the PD rejected the coalition offer by 5Stars. However, the 21 April PD leadership election could bring some change and might open the party more towards 5Stars. The PD membership is deeply divided about whether it can work together with the centre-right/right, 5Stars or go into opposition. Also, the party has split before, leading to the creation of the left-wing Free and Equal party. Another split cannot be ruled out. Some commentators have noted the weak majority of just one or two seats that the two parties would have in the Senate. However, we believe that the two parties could convince other parties from the centre-left alliance (More Europe, Together, Popular Civic List, SVP-PATT and Aosta Valley) and the Free and Equal party to join them in a coalition, thus ensuring enough seats.

4) Centre-right/right alliance with PD (a 10% probability, down from 20%): We think the probability of this, Berlusconi’s favoured option, has dropped to 10% from 20%. FI came well behind Salvini’s Lega in the centre-right/right alliance on 4 March. Therefore Berlusconi does not have the power to decide alone about who will be his coalition partner. Salvini has repeated several times over the last few weeks that he will not team up with the PD. The latest opinion polls have strengthened the position of Salvini and reduced the likelihood that senior Lega lawmaker Giancarlo Giorgetti will gain enough power to open up Lega and partner with the PD.

5) No coalition agreement, new elections (a 10% probability): We think there is a small chance that none of the parties will work together, leading to new elections without implementing a new election law. A new election law could make it easier for the centre-right/right alliance or 5Stars to win the next election. Also, Salvini recently threatened new elections as early as next month if the other parties do not stop arguing with each other, a reference to the latest Di Maio-Berlusconi dispute last weekend. Salvini and Di Maio would perhaps not be afraid of new elections amid in light of their strong momentum in the most recent opinion polls.
Why are financial markets so relaxed and will they remain so?

Despite the surprisingly strong election result of the radical parties and an unsolved coalition puzzle, 10-year Italian bond yields trade currently at around 1.75%, around 20bp lower than before the election. The risk spread over German bonds narrowed as well. The MSCI Italy equity index has gained 7.3% since the election, outperforming the MSCI Europe index by an impressive 7ppt. 5Stars and Lega continue to become less radical in their policy demands, supporting Italian exposed asset prices.

In an effort to woo the PD, Di Maio recently promised to aim for a budget deficit of 1.5% of GDP, a significant change to his election campaign stance, where he announced plans to change the budget rules to be able to allow for deficits above 3%. For more information on the party election programmes, see our Italian election report.

Furthermore, Salvini seems to be keen to work together with Berlusconi’s FI, which would limit the risk that he would implement radical political ideas. Also, neither of these radical parties target a referendum on the euro any longer.

However, we do not underestimate the risks of Italy’s economy and financial markets taking a turn for the worse. Due to the weak Italian finances (the government has a debt to GDP ratio of c132%), any significant reform reversal or increase in the budget deficit to fund government consumption (rather than investment) could cause Italy to catch a severe economic and financial cold if the EU sneezes.
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