Florian Hense, Economist | florian.hense@berenberg.com | +44 20 3207 7859

ITALIAN POLITICS: NEW COALITION OVERCOMES NEXT HURDLE

Berenberg Macro Flash

Italy's Prime Minister Giuseppe Conte can get on with forming a new government now that grass-roots members of the 5Stars endorsed the planned coalition with the centre-left Democratic Party (PD) by a 4:1 majority. A 5Star-PD alliance reduces the risk of a major confrontation between Rome and Brussels. One of the big risks to our European outlook, that of an Italian debt crisis, has receded significantly further for the time being. Governing will be trickier than agreeing a coalition.

Conte will see President Sergio Mattarella today. Ministers will likely be sworn in thereafter. The 5Stars' party leader, Luigi di Maio, is supposedly in the running to become the next foreign minister. Roberto Gualtieri who is from the PD and has chaired the European Parliament's committee on economic and monetary affairs for the past 5 years looks to be frontrunner for the finance post.

The coalition may not last much more than a year, judging by the average reign of Italian governments since the Second World War. Conte's first government was the 66th in 73 years. Apart from a joint desire to avoid new elections and to keep League leader Matteo Salvini out of government, there is little love lost between the new partners. The upstart 5Stars have been the bane of the established PD for the past six years. Conte's ability to broker compromises between the parties will be even more crucial than it was for his previous coalition.

The coalition faces a big challenge right away: It has to submit the 2020 budget to the Italian parliament and the European Commission by 30 September and 15 October, respectively. Finding more than €20bn in savings to comply with EU rules and avoid the already legislated rise in the VAT from 22% to 25.2% in 2020 will be a challenge.

Two tailwinds are helping Rome: First, the drop in the 10-year bond yield (see Chart 1) from 2.5% in April – just before the European Commission presented its last full Italian forecasts in early May – to below 1% is lowering the government's debt service costs by roughly 0.1ppt of GDP in 2019. Second, revenues have surprised on the upside thanks to higher tax receipts, higher social security contributions and higher dividends from the Banca d'Italia. Possibly up to 25% of the additional revenues are one-offs. Tax amnesties have allowed people to settle disputes with the authorities by paying a limited sum by 31 July. A settlement of past tax liabilities from a large Italian company and revenue for CO_2 auctions have also boosted tax revenues in H1 2019. Tax receipts may, therefore, increase less strongly in H2 2019 and 2020. We expect Italy's headline fiscal deficit to come in at 2.1% of GDP in 2019. The structural deficit could be slightly lower at 1.9%. The headline deficit would thus be below the 2.4% level in 2018 and the European Commission's forecast, also 2.4%, from May. Our forecast would be in line with the 2.04% Rome and Brussels agreed upon in late 2018 and again in July 2019.

The new government and Brussels can probably avoid a major conflict about Italy's 2020 budget. Assuming yields remain roughly at current levels, lower interest payments create fiscal space for 2020 of some 0.25ppt of GDP on top of the 0.1ppt in 2019. However, slightly weaker growth in GDP and tax receipts will mostly offset this. Based on current government plans to cut taxes on labour, introduce a minimum wage and raise public investments etc., the fiscal deficit could increase by 80-90bps to 2.9-3.0% in 2020 without a VAT hike. The structural deficit would likely be 10-20bps lower. The fiscal deficit would still be well below the European Commission's May 2019 forecast of 3.5%. In euros, the deficit could be c10bn euros lower than the European Commission estimated in May. With some further offsetting measures and a little creative accounting, Italy could close the 2020 fiscal gap that the EU had originally put at c20bn euros by enough to avoid the VAT hike.

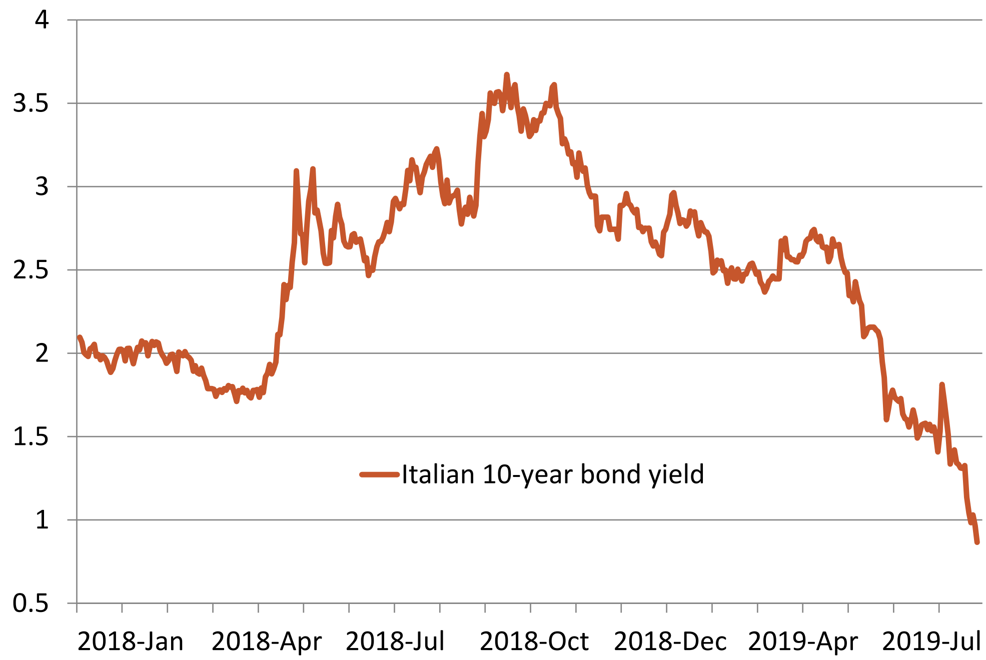
If Rome also moves in the right direction in terms of structural reforms and strikes a conciliatory tone towards Brussels, expect Brussels to accept some fiscal overshoot and creative accounting by Rome. It helps that the designated President of the European Commission, Ursula von der Leyen, has said that fiscal rules should be interpreted flexibly.

In the unlikely case that the government fails to convince the EU, the Italian government may have to go ahead with a partial rise in the VAT of say 1ppt. As this would allow Salvini to rail even more loudly against the new government and the EU, all parties involved – including Brussels – will try to avoid that.

5Stars and the PD – an uneasy alliance. The risk of snap elections and the return of Salvini as head of a potentially more Eurosceptic government will hang like a sword over Italy for the foreseeable future. We see a 35% probability of this within the next 6 months. While Salvini has lost some of his appeal since leaving the coalition with the 5Stars (see Chart 2), the League remains comfortably ahead of all other parties in opinion polls. After snap elections, it could probably build a parliamentary majority with the far-right Brothers of Italy.

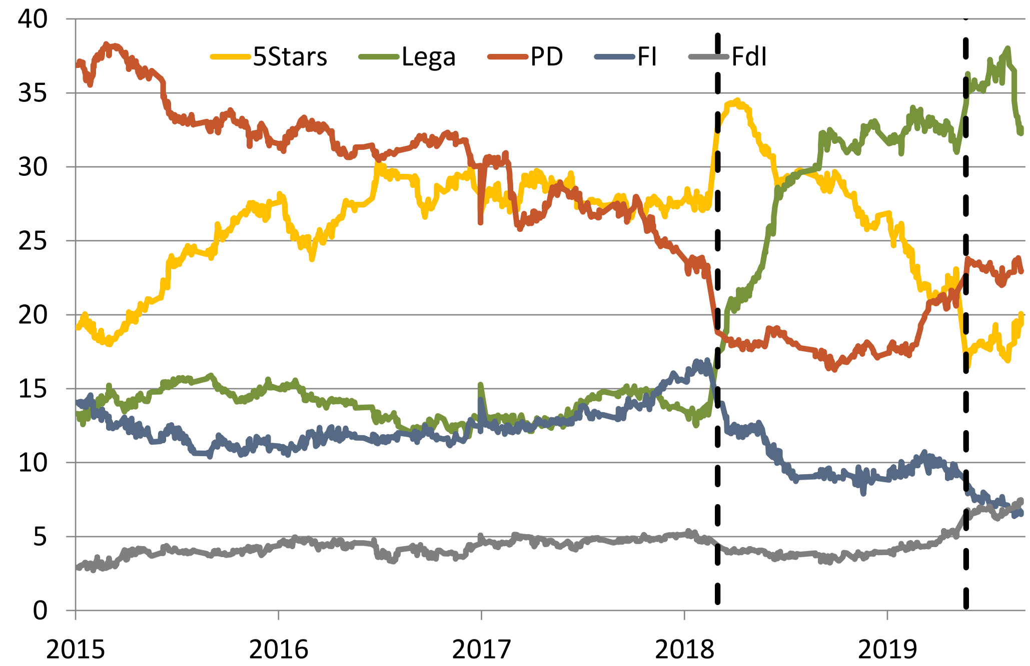
The new 5Stars-PD coalition looks unlikely to implement the serious pro-growth structural reforms that Italy needs in the long run. But it probably will not make the situation worse. At a record-low in bond yields, Italy can continue to muddle through for quite a while. However, at some time in the future, higher bond yields could finally force it to get back on a reform path.

Chart 1: Italian 10-year bond yield (in %)



Daily data. Source: Bloomberg

Chart 2: Italian opinion polls (in %)



Five Star (Di Maio), Lega (Salvini), PD: centre-left Democratic Party, FI: centre-right Forza Italia (Berlusconi), FdI: right-wing Fratelli d'Italia, average of seven latest available polls, vertical lines mark result in national election in March 2018 and European election in May 2019. Sources: National opinion polls, Berenberg

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com