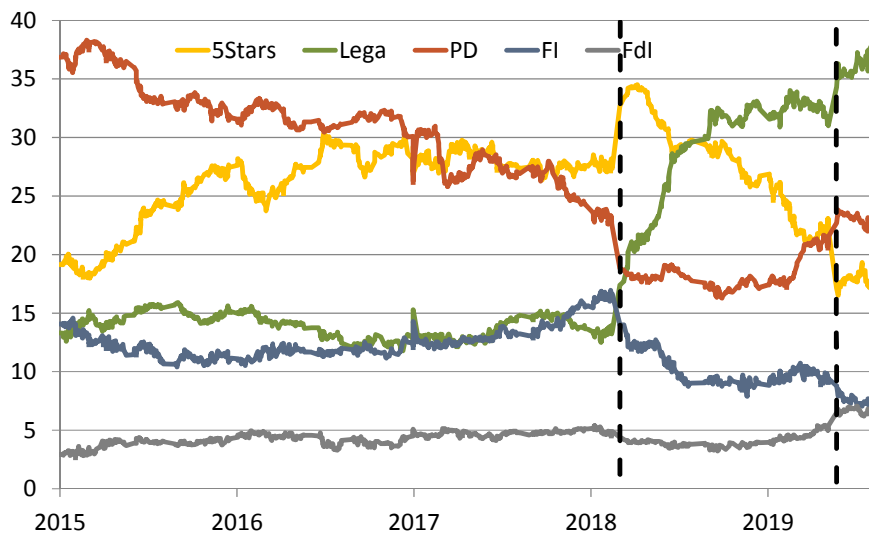


21 August 2019

Italian politics: three stylised scenarios

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

- Here we go again!** Italy's Prime Minister Giuseppe Conte offered his resignation yesterday. With the submission of the 2020 budget to the Italian parliament and European Commission looming by 30 September and 15 October, respectively, the timing is unfortunate: Italy needs to find more than €20bn in savings to avoid the already legislated rise in the VAT by 3ppt in 2020. We see three stylised scenarios how events in Rome could unfold over the next months. The probabilities we attach to these scenarios are very tentative with many moving parts for now.
- 1. Italy avoids snap elections for at least nine months – 40%:** The last-ditch attempt of Matteo Salvini, leader of right-wing Lega, to patch things up with the Five Star Movement comes to nothing. Instead, Five Star join forces with the Democratic Party (PD) for a new centre-left government, probably with Giuseppe Conte as PM. A shared dislike of Salvini and survival instinct by MPs is the glue that binds them together. Markets rally as the short-term uncertainty of snap elections is averted. The centre-left government agrees on a 2020 budget and sticks together afterwards. After some noise, the new government strikes a compromise with the European Commission on the 2020 budget. As the government turns more pro-European and promises to rein in spending, the European Commission reacts with some flexibility and accepts the budget.
- 2. Italy dodges the bullet in 2019, but holds snap elections in early 2020 – 50%:** The PD cannot bridge their differences with Five Star. President Sergio Mattarella appoints a technocratic government with the mandate to submit the 2020 budget, with snap elections to follow early next year. Five Star and the PD support the President's move as it shields them from having to announce painful adjustments to the 2020 budget themselves. Markets react calmly. In new elections in early 2020, Salvini would still be the frontrunner to become new Prime Minister with a parliamentary majority for his party on its own (unlikely), in a coalition with the far-right Brothers of Italy (more likely) or in a broad alliance also including Forza Italia (most likely). The stronger the Forza Italia element in such a government, the more pro-growth and less Eurosceptic its agenda would likely be.
- 3. Snap elections loom later this year – 10%:** Mattarella, unwilling or unable to install a technocratic government, calls snap elections for late October or early November. Judging by current opinion polls, Salvini would likely win and become Prime Minister. The stronger Salvini would be, the noisier the conflict with the EU over the 2020 budget could become. Bond yields could surge. To avoid a major confrontation with the EU and keep bond yields at affordable levels, Salvini would have to perform a major U-turn. To postpone the VAT hike and start with some tax cuts, he would have to put off spending and push most of his planned income tax cut into 2021 or later.
- Regardless of snap elections, the key issue remains:** Italy needs pro-growth reforms and a responsible fiscal policy. The more an Italian government gets real, the more flexibly the EU will interpret its fiscal rules and the less Italy will be a candidate for a debt crisis in the wake of the next serious economic downturn.

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