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Macroeconomics **ITALY'S STEP INTO THE UNKNOWN**

KEY POINTS

- The forthcoming Italian election looks set to deliver a fragile coalition government or a stalemate, leading to uncertainty.
- There is a risk that a new government may loosen fiscal policy but has little appetite for reform.
- A “grand coalition” between the Democratic Party and Forza Italia would probably be the least damaging of the four main possible outcomes; the most damaging would be a coalition between the anti-establishment Five Star and the right-wing Northern League.
- While it may be prudent to regard Italian debt with caution at present, there could be a buying opportunity ahead.

On March 4, Italy will go to the polls to vote in a general election whose outcome is highly uncertain. Under the country's new electoral system, the vote looks set to result in a hung parliament with no outright winner, which, in turn, will likely lead to the formation of a weak coalition government or a rerun of the election, both leading to further uncertainty.

The key risk of the election is that a new government heavily loosens fiscal policy but doesn't implement offsetting structural reforms. The Italian economy has performed relatively well recently, but growth still lags its EU peers because of structural impediments in labor and product markets. Yet so far, none of the major political parties has presented clear ideas about how to boost growth through reform, while some have also pledged to reverse previous reforms in order to boost spending on populist causes.

EU AND EUROZONE MEMBERSHIP SLIPPED FROM THE ELECTION AGENDA

In the runup to the election, debate has focused on loosening fiscal policy, reversing reforms enacted by the previous three governments, and reducing immigration. The ruling center-left Democratic Party (PD) has pledged to raise the minimum wage, while

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Silvio Berlusconi's center-right Forza Italia and the right-wing Northern League say they will introduce a flat income tax rate for individuals and companies and raise the minimum pension. The populist Five Star (M5S) wants to cut taxes and introduce minimal citizen income, with some analysts estimating the total cost of its program at €63 billion (close to 4% of GDP).

In contrast to last year, most political parties in Italy no longer talk about a potential referendum on EU membership. The biggest shift within a party seems to have occurred within M5S, which used to openly talk about the necessity to hold a referendum on eurozone membership but more recently has pledged to keep the euro. Only the Northern League has openly discussed abandoning the euro currency during the election campaign and is probably using the issue as a way to differentiate itself from the rest of the center-right bloc.

In our view, there are four main possible outcomes of the election. In order of likelihood, these are:

1. A "grand coalition" government comprising PD and Forza Italia;
2. A center-right coalition government of Forza Italia, the Northern League, and one or two smaller parties;
3. A rerun of the election; and
4. A radical coalition government of Five Star and the Northern League.

OUTCOME 1: GRAND COALITION PROMPTS RALLY

A grand coalition between PD and Forza Italia (possibly also including the right-wing Brothers of Italy and the Northern League) would probably be the least damaging of the four main possible outcomes as it would keep the populist Five Star party out of government. If, as is likely, the Democratic Party becomes the majority party of a grand coalition, the new government may seek to increase the minimum wage and negotiate with the EU an even more gradual path of fiscal deficit reduction in order to cut taxes and increase investment—both signature PD policies. It may also try to follow through on Forza Italia's promise to introduce curbs on immigration. Another Forza Italia policy—the flat tax on individuals and businesses—is less likely to be enacted.

In aggregate, the policy mix likely to be pursued by a grand coalition would be regarded as the most mainstream of the three main types of coalition. And while the lack of a strong parliamentary majority would make it difficult for such a government to undertake radical economic reforms, it would also be unlikely to reverse recent key reforms of pensions, labor laws, and the banking sector. As such, we expect there to be a relief rally in the event that DP and Forza Italia form the next Italian government. Italian 10-year bonds could rally to 20 to 25 basis points above Spanish 10-year debt, which, in our view, would be closer to fair value than the current spread of around 55 basis points (see Figure 1). Steady growth of 1.5% to 2.0% also should be a supportive factor for an expected rally in bond spreads.

OUTCOME 2: CENTER-RIGHT ALLIANCE REGARDED WITH CAUTION

A center-right coalition comprising Forza Italia and the Northern League, supplemented by the far-right Brothers of Italy and the centrist Us With Italy, would probably result in the new government pursuing more radical policies than a grand coalition, although it would probably be similarly restricted in its ability to legislate due to the absence of a commanding majority in parliament.

Figure 1: Italy 10-year spread to Spanish 10-year debt

As of January 31, 2018



Sources: T. Rowe Price and Haver Analytics.

The precise mix of policies pursued by a center-right coalition would be determined by which of Forza Italia and the Northern League wins the most seats in parliament and—in all likelihood—supplies the prime minister. Recent polls suggest that Forza Italia will be the larger party, but party leader and former Prime Minister Silvio Berlusconi is barred from holding public office, meaning a more technocratic figure would be more likely to become leader of the country. Overall, it is likely that a center-right coalition would be likely to seek to introduce a form of flat tax, reverse some aspects of recent reforms, and reduce immigration. The markets would respond neutrally or marginally negatively to this package of reforms, with limited reaction in bonds and equity prices.

OUTCOME 3: GRIDLOCKED PARLIAMENT WOULD LEAD TO UNCERTAINTY—AND POSSIBLY RELIEF?

It is possible that a likely fragmented parliament after the election will not be able to agree on a government coalition, despite inevitable pressure to do so from President Sergio Mattarella. In this case, the incumbent Prime Minister Paolo Gentiloni will probably be reappointed to lead Italy to another election likely to be held in the autumn. Although a political gridlock scenario such as this would not be regarded as ideal, it may also provide some relief as it will mean that the more radical parties have been kept out of power for at least the next six months. Given this, we anticipate there would not be a major sell-off of Italian debt if no government can be formed, with markets remaining relatively calm (barring other negative effects) until the next vote takes place.

OUTCOME 4: SELL-OFF EXPECTED IF THE “ANTI-EU” PARTIES TAKE POWER

A coalition of the populist Five Star and far-right Northern League is the least likely of our four main scenarios, but it is also the most risky. The two parties are quite different: The fiercely anti-immigration Northern League has traditionally campaigned for independence for Northern Italy, while Five Star represents a largely middle-class protest against the establishment. However, both are generally eurosceptic (even though M5S has stopped talking about abandoning the euro) and favor broad-based tax cuts, so there is also common ground between them. A right-wing coalition would likely seek to test Italy's 3% deficit limit and introduce strict curbs on immigration, although a referendum on EU membership would be unlikely, in our view.

A eurosceptic coalition governing Italy would be a major headache for the EU and would be greeted negatively by the markets. The spread on Italian 10-year sovereign debt versus Spanish 10-year debt could widen to 100 basis points to 125 basis points, and we would also expect peripheral debt to sell off. However, there would also likely be a buying opportunity at some point as the risk posed by a right-wing coalition may be overpriced in comparison with the actual damage that such a government would be able to do given its likely slender majority.

Our base case remains that the next Italian government will likely seek to ease fiscal constraints, increase spending in some areas, and seek to reduce immigration—but not to the extent that poses a major risk to the country’s economy or that of the eurozone as a whole.

LACK OF CLARITY PRESENTS RISK—AND POTENTIAL OPPORTUNITY

The Italian election is unusual in its range of possible outcomes and the lack of a clear favorite among them. Although the worst-case scenario from a risk perspective—a populist/eurosceptic coalition of Five Star and the Northern League—is the least likely of the four main scenarios described above, it cannot be dismissed entirely. Moreover, the fact that all of the main parties contesting the election want to loosen fiscal policy one way or another means that a degree of risk will be present whatever the outcome of the vote.

Our main concern is that the new government loosens the purse strings too much without undertaking the necessary reforms to strengthen the economy. However, given the likelihood that whichever coalition (if any) ultimately takes power will have only a slender parliamentary majority while grappling with internal ideological differences between its partners, the likelihood of the new Italian government embarking on such a path is probably small. Our base case remains that the next Italian government will likely seek to ease fiscal constraints, increase spending in some areas, and seek to reduce immigration—but not to the extent that poses a major risk to the country’s economy or that of the eurozone as a whole. As such, we are broadly neutral on Italian debt at present and will be looking for buying opportunities ahead of the vote if the polls indicate that a grand coalition is becoming more likely.

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