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ITALIAN ELECTIONS: MORE OF THE SAME POLITICAL DYSFUNCTION

Introduction: the main political parties

Italians head to the polls on March 4th in the foremost European Union (EU) election of 2018, in which the main political parties will scramble to form the 65th government since World War II (WW2). Given that a hung parliament is highly expected, we start by focusing on a short primer on the main parties and their respective political agendas.

The ruling Democratic Party (PD), the main centre-left party led by Matteo Renzi, plans to: 1) negotiate with EU partners to abolish the EU's Fiscal Compact that imposes steep budget cuts on countries with high indebtedness; 2) raise the budget deficit to 3% of GDP for five years in order to cut taxes and increase investments; and 3) maintain Italy's pro-NATO, pro-Euro stance.

The main anti-establishment party is Beppe Grillo's 5-Star Movement (M5S). It aims to: 1) guarantee minimum universal basic income of €780/month; 2) re-negotiate the Fiscal Compact; 3) raise the budget deficit above 3% of GDP to cut taxes and increase investments; 4) hold a referendum on Euro membership if the EU partners refuse any concessions on the Fiscal Compact; 5) cut the privileges of politicians, trade unions and well-off pensioners; 6) repeal 2011 pension/2014 labour reform to allow earlier retirement and make firing harder; 7) raise taxes on large corporates; and 8) cut red tape by abolishing 400 laws.

PD's counterpart on the center-right is Silvio Berlusconi's Forza Italia (FI). The party main aims are to: 1) introduce a parallel currency for domestic use to boost the economy while keeping the Euro for international trade and use by tourists; 2) replace current staggered income tax rates with a c.23% "flat tax" for both individuals and corporates; 3) double minimum pensions to €1,000/month; 4) abolish the housing tax, inheritance tax and road tax on most cars; 5) guarantee minimum income of €1,000/month for everyone; and 6) block the arrival of immigrants by establishing accords with North African nations.

The two main hard right wing parties are Matteo Salvini's Lega Nord (LN) and Georgia Meloni's Brothers of Italy (FdI). Both parties want to: 1) introduce a parallel currency for domestic use; 2) push for abolition of the Fiscal Compact; 3) leave the Euro as soon as it is politically feasible; 4) introduce a 15% "flat tax" for individuals and corporates; 5) repeal 2011 pension reform to allow earlier retirement; and 6) crackdown on immigration by intercepting and sending back migrant boats, as well as repatriating up to 100,000 illegal immigrants per year. Unlike the LN, the FdI's support base is in the centre and south of Italy.

Rosatellum 2.0: ~1/3 First-Past-The-Post (FPTP); ~2/3 Proportional Representation (PR)

Late last year, Rosatellum 2.0 (the new electoral law) was passed with a wide parliamentary support after being backed by PD, FI and LN, with the latter two abstaining. Rosatellum is a mixed system, with c.36% of the seats distributed on a FPTP basis (directly elected, akin to the U.K.) and c.64% by PR (indirectly elected based on party lists, akin to Germany), that is applied to both chambers. In the Lower Chamber, a total of 232 seats will be reserved for FPTP constituencies, 386 for the PR lists, and 12 for overseas constituencies, with a combined total of 630 seats. The equivalent seats in the Upper Chamber are 102, 207 and 6 (315 seats in aggregate). Unlike the current system, Rosatellum doesn't give an automatic majority to any party or coalition that wins 40% of the vote.

However, unlike other mixed systems, a "mixed vote" will not be permitted (i.e. voters get to either vote in the local FPTP or in the PR part, not both). For instance, if one votes for a candidate in the local FPTP, the vote will automatically be cast to the party/coalition backing that candidate at the national level in the PR, and vice versa. In essence, the new system puts parties (and party leaders) back at the centre of political scene as it re-introduces the possibility of political alliances among parties. Previously, coalitions were only possible in the Upper Chamber, not in the Lower Chamber under the Italicum law. Finally, in the few constituencies in which a pure PR system applies, candidates can only be chosen from a short "closed list" whose parties or pre-electoral coalitions have passed their respective thresholds of 3% and 10%, respectively. This is intended to prevent the proliferation of smaller parties.

What does it all mean?

At first glance, the Rosatellum isn't a game-changer, but the devil is in the details and its ultimate goal is the empowerment of politicians like Berlusconi - the real king-maker of the next election. It structurally benefits Berlusconi, who unlike Renzi, has a very inclusive and deep experience in forming coalitions with both sides of the political spectrum. We see FI as a major shareholder in any of the most likely post-election coalitions to be formed (see below).

The Rosatellum materially reduces the risk of a Eurosceptic coalition as the FPTP system deeply favours pre-electoral coalitions over single parties, which will heavily penalize M5S (and the left-wing parties) given that it has no natural allies and is handicapped by the lack of local leadership (recognisable faces) in both the centre and north. We envisage a scenario where M5S ends up coming 2nd or 3rd in most constituencies, in which it gains votes, but not seats.

The pre-electoral alliance between Salvini's LN and Berlusconi's FI adds uncertainty, as which candidate gets fielded in each FPTP constituency (one among FI, LN and FdI) will greatly impact the distribution of MPs. This is because once elected, these FPTP MPs will take a seat with their respective party; so if the right-wing coalition falls short of a majority, it could split and FI would then be free to seek other post-election alliances. Therefore the more candidates FI can win in the FPTP constituencies, the higher the likelihood of a moderate/centre government.

Possible post-election scenarios

Due to Rosatellum, post-election alliances will be vital, as no single party will obtain the majority needed to fully control the next parliament. Based on the Italian press and what party leaders have said in recent months, we see four possible outcomes:

1. Prorogation of Paolo Gentiloni government: This entails, in essence, a hung parliament, in which the caretaker government keeps operating until replaced by a newly formed government. Such a scenario could be positive for Italy (and Italian assets) as it would be better than a weak majority-led government. Objectively, if nobody is governing, no one can be blamed for introducing unpopular reforms and taxes. Also, the lack of action would prevent Rome from going on a full collision course with EU over fiscal targets.

2. Right-wing coalition (mainly FI + LN + FdI): Although quite likely to happen, key differences among party leaders (due to differing political agendas) will quickly hamper the coalition's governing. Indeed, we would also expect to see a slim majority prevent the coalition from governing properly and lead to a repeat election.

3. Grand coalition of moderates (FI + PD): This government would be similar to the one currently supporting PM Gentiloni's government. We don't see this as a very likely scenario given that the 20-year history of fighting and disagreement between the two parties means that a coalition would not last long.

4. Eurosceptic coalition (M5S + LN + FdI): While possible on paper (combined votes could reach 316 seats), we believe it is unlikely given that it would be very difficult to form such a coalition. M5S is strong in the South, where the LN remains unpopular because LN, with its northern base, wants more autonomy for richer northern regions (Veneto & Lombardia), which is in direct contrast with M5S's more Southern focused agenda. Such an alliance with the hard right parties could cause M5S to lose many of its supporters (especially the left-leaning Southerners) and do a disservice to the party. Even in the very unlikely event that a coalition is somewhat formed, it would not likely last long and would trigger new elections.

5. Left-wing coalition (PD + left-wing parties): Given the divisive nature of Renzi (the PD's party secretary), it would be very hard to form such a coalition, not to mention the technicalities of Rosatellum that penalises post-election coalitions.

Scenario	Probability	Impact on Italian assets
Gentiloni (hung parliament)	High	Positive
Right-wing coalition	High	Positive (ST only)
Grand coalition	Medium	Positive
Left-wing coalition	Low	Positive
Eurosceptic coalition	Low	Negative

Arrivederci Euro?

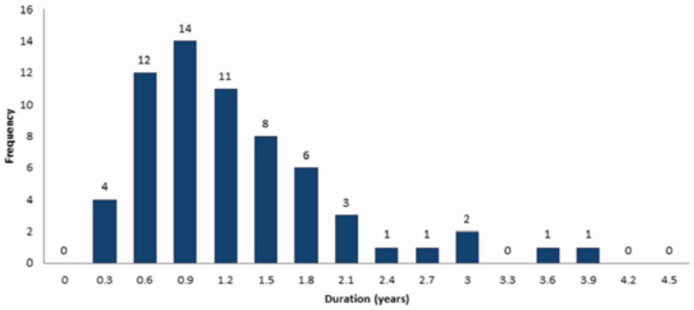
From a trade/positioning perspective, the main determinant to BTP spreads, at least over the next 12 months, is the perceived risk of Italy leaving the EU after the elections, especially if a Eurosceptic government is formed. The odds for that to occur are very low although some volatility cannot be ruled out amidst the formation of the new government. The following demystifies the myth on Euro referendum:

First and foremost, unlike the U.K., Article 75 of the Italian Constitution prohibits a referendum on international agreements/treaties, so for a Euro exit to occur, this article would have to be amended first. That said, for a Eurosceptic government to make such a constitutional amendment in a timely fashion, it would need a strong majority (2/3rd of the seats) as required by the law; we note, though, this is a highly unlikely scenario given the differing policies from the main centrist parties (PD and FI).

Ruling out the above, the remaining option would be for the Eurosceptic government to call an Italian constitutional referendum, as was with Renzi's case in 2016. If the referendum gets more than 50% of "Yes" votes (only a simple majority would suffice), Article 75 of the Italian Constitution would be amended and allow the government to call a referendum on the Euro. Assuming the ruling government hasn't collapsed by then, which is a big supposition, a Euro exit would then occur given the approval of a majority of Italian voters.

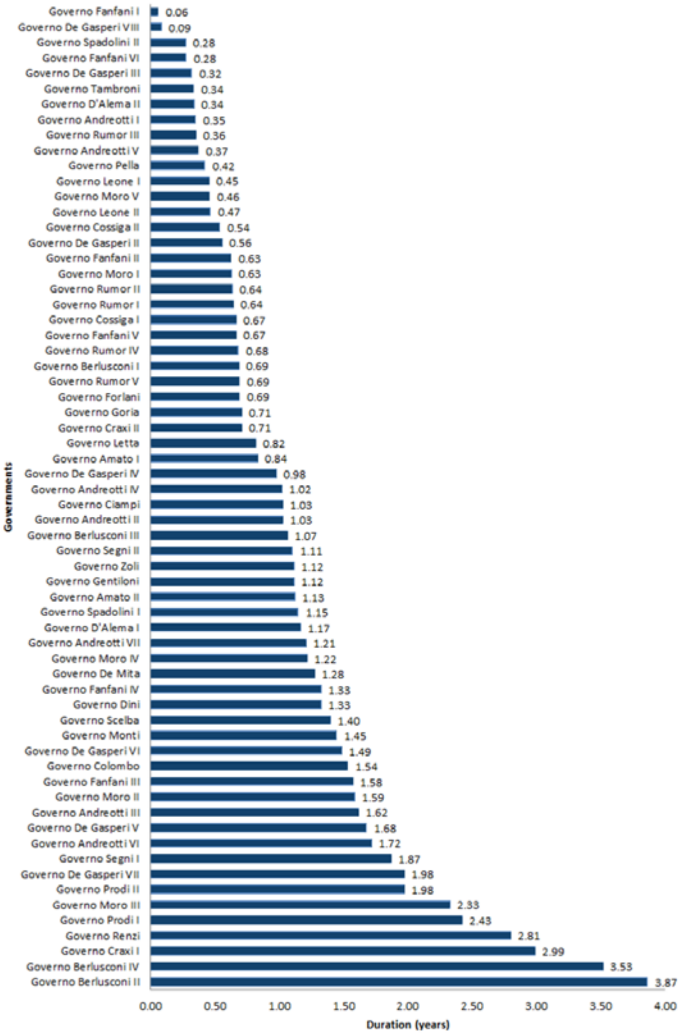
Although a Euro exit is within the realm of possibilities, we would assign a very low probability to it given the Eurosceptic government would have to: 1) pass both referendums with a "Yes" vote; and 2) prevent itself from collapsing during the process. If history can be any guide, the charts below illustrate the overwhelming difficulty of the task in hand: the highest duration of any serving government post WW2 is c.3.9 years, with only two governments lasting roughly that long out of the previous 64 (less than 5%). Moreover, not surprisingly, the three longest governments were centrist: Berlusconi (twice) and Craxi (Berlusconi's close ally). Putting the Eurosceptic government in this equation and simulating its duration is not a very useful statistical exercise given the low odds.

Distribution of time in office of Italian governments (post WW2)



Source: data from Wikipedia, https://it.wikipedia.org/wiki/Governi_italiani_per_durata

Italian governments per duration (post WW2)



Source: data from Wikipedia, https://it.wikipedia.org/wiki/Governi_italiani_per_durata

Ex-PM Berlusconi argues for a parallel currency

In recent months, Berlusconi re-surfaced the idea of a parallel currency in Italy (jargon for Lira) that could be pegged to the Euro and be legal within the constructs of European treaties. Berlusconi is no stranger to anti-euro remarks: back in 2005, when he was PM facing a general election, he used the idea against Romano Prodi; in 2012, while Mario Monti was in office, he argued that if ECB refused to print money, Italy should exit the euro; and in 2014 he half-floated the idea again. However, we note that we are talking about an Italian politician's statements here and he is notorious for flip-flopping on his promises and threats in order to gain votes, only to backtrack later. This time is likely no different, as the political motive behind this suggestion is to strengthen links with LN and FdI ahead of the elections. While re-denomination of Italian wages and domestic prices to this parallel currency might have its merits (e.g. to allow devaluation and make Italy a more competitive economy) the adverse economic implications far outweigh them, especially if the new currency is perceived as precursor to a Euro exit. If so, it might not gain acceptance as economic agents may anticipate a future devaluation and trigger a run on the banks (i.e. a flight to Euro cash) given that the ECB would no longer be the lender of last resort. This would cause a credit crunch as liquidity evaporates and ultimately lead to a deep recession. Devaluation is no panacea to high unemployment and the many problems afflicting Italy – it would likely cause more harm than good, as less-willing politicians would not undertake deeper structural reforms needed to re-shape the country. That said, the parallel currency is technically feasible, but the Italian political system lacks the capacity, discipline and negotiation to put it in place at such a large scale.

Short and long-term outlook for Italy

Irrespective of the outcome of this election, Italy will likely remain the same and, again, have a fragile government that will lack the ability to enact the structural reforms needed to increase the country's growth prospects and global competitiveness. Additionally, needless to say, poor economic and fiscal policies are, and will likely be, a recurring theme in Italian politics. While Renzi and the caretaker governments before him made sound reforms (i.e. pension and labour reforms in 2011 and 2014 respectively), M5S and the hard right parties (LN and FdI) have made it core to their agenda to undo them. In addition, all of the economic agendas so far proposed ahead of the election lead to more debt and a higher public deficit. In the long run, Italy will continue to suffer under its unsustainable debt load and entice investors to demand a higher premium for holding Italian assets.

However, from a trade perspective, we see Italy to remain a good carry/spread trade for at least the next twelve months against a backdrop of improving GDP growth in 2018 and 2019, which is expected to be in the 1%-2% area, and the ECB's PSPP, which remains a powerful backstop bid. We argue that any widening in 10Y BTP spreads (>200bps) could be an attractive entry point, from a risk/reward standpoint, especially if some investors start pricing in the risk of a Euro exit. In the past, being a risk-taker around political events (e.g. French 2017 Presidential election, Italian 2016 referendum, Catalonia independence and Brexit) has been a very positive endeavour, per the table below (based on a few simplifying assumptions), and we argue that this time will not be different.

	Country of Risk	Event Date	Holding Period (yrs)	Spread vs Bunds (bps) Entry Spread	Current Spread	Chg	Spread Duration	Excess rt over Bunds (bps) Spread Chg rt (a)	Carry rt (b)	Excess rt (a + b)	Excess rt (annu.)
Italian constitutional referendum	Italy	04/12/16	1.19	162	123	-39	8.7	339	192	532	446
French presidential election	France	23/04/17	0.80	68	24	-45	10.0	447	55	502	629
Brexit	UK	23/06/16	1.63	125	86	-39	8.4	330	204	534	324
Catalan independence referendum	Spain	01/10/17	0.36	114	69	-45	9.2	416	41	457	1315

Source: Bloomberg. Note: All trades are between event date and 8 Feb 2018.

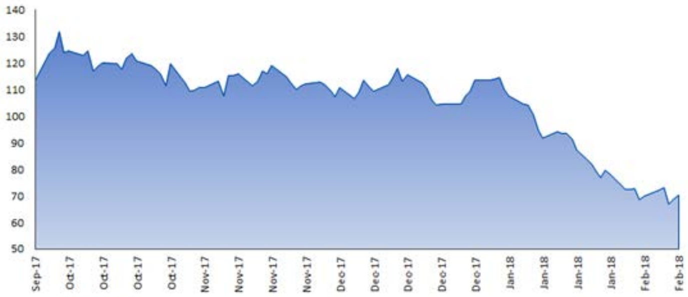
10Y Italy-Germany spread (bps)

Source: Bloomberg as of 8 Feb 2018

10Y France-Germany spread (bps)

Source: Bloomberg as of 8 Feb 2018

10Y Spain-Germany spread (bps)



Source: Bloomberg as of 8 Feb 2018

10Y UK-Germany spread (bps)

Source: Bloomberg as of 8 Feb 2018

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