A market guide to Italian elections

A right-wing coalition is largely expected to win the 25 September election in Italy, and far-right leader Giorgia Meloni should be the new prime minister. Italian bonds may enjoy a temporary relief rally as results should point to a solid majority, but expect higher market scrutiny on key ministers, budget decisions and the relationship with the EU

Far-right leader Giorgia Meloni is expected to become the new Italian prime minister

A mixed electoral system for 25 September Italian general election

On 25 September Italians will go to the polls to cast their votes and elect the new parliament, some six months earlier than the natural end of the legislature. After a constitutional law amendment, confirmed by a referendum, the number of members of the Parliament has been reduced to 400 in the house of deputies and to 200 in the Senate.

In both branches of parliament, 37% of MPs will be elected with a first-past-the-post system, and 63% with a proportional system. In the proportional part, parties running in isolation have to pass a threshold of 3% of national votes to get parliamentary representation, while for coalitions of parties the threshold is set at 10% of the national vote. In the current system, the possibility for parties to build electoral coalitions is a key factor, which tilts the balance in the first-past-the-post part.

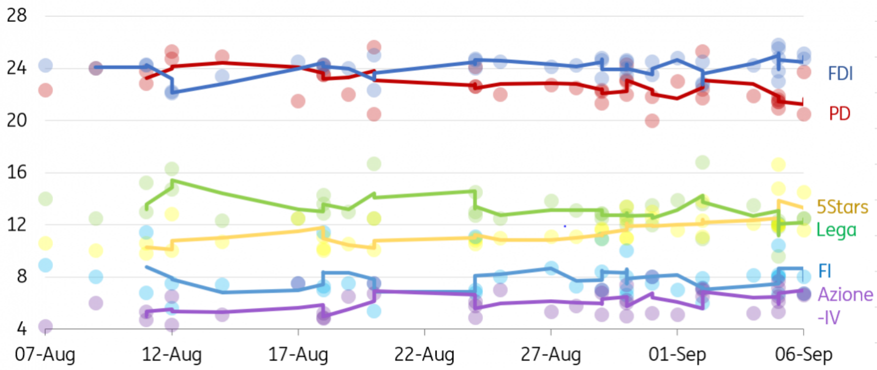
While the main centre-right parties (Fratelli d'Italia, Lega and Forza Italia) managed to strike a coalition agreement very early after the dissolution of parliament, the centre-left did not, with PD just managing to coalesce with a small party to its left and with centrist +Europa, but not with Azione/Italia Viva, the bigger Calenda/Renzi centrist ticket. As Conte's Five Star Movement (5SM) will also run in isolation, the centre-right will have a huge advantage in the race for first-past-the post seats.

Opinion polls point to a neat victory of the centre-right coalition under Meloni leadership

Opinion polls published before the start of the black-out period (9 September) have been consistently pointing to an ample margin in favour of the centre-right coalition, and, within the coalition, to a widening lead for Fratelli d'Italia (FdI), the right-wing party led by Giorgia Meloni, over Lega. Published simulations on seat attribution suggest that the centre-right coalition looks set to win an ample majority of first-past-the-post seats. Given the projected vote shares within the centre-right coalition, Giorgia Meloni looks set to be nominated by her coalition as the candidate for prime minister.

As far as the timing for the installation of a new government is concerned, it would likely take at least until the end of October if the result is clear cut, based on past experience.

Latest opinion polls (FDI, Lega, FI form the right-wing coalition)



Source: Various polls, ING

Reassuring characters will likely be needed for key ministries

So far, there has been little press speculation about the roster of an eventual Meloni government. As on other issues, Meloni has been prudent, carefully avoiding any collision with President Mattarella, who will have a say in the final choice of key ministers. As an unprecedented FdI leadership would likely lack credibility, we suspect that the choice for key ministries might fall on reassuring and experienced politicians. As far as the finance minister is concerned, this could translate into the choice of a technocrat with a proven track record, say among the ranks of the central bank.

No discontinuity expected on the international positioning of Italy in the short run

The coalition's programme offers clues about the extent to which a new centre-right government could diverge from the outgoing Draghi government. In the current critical geopolitical environment, the first crucial check is whether a Meloni government would follow a line of continuity with the Draghi government on the international positioning of Italy. Judging by the text, this would seem to be the case.

The programme affirms full support to Ukraine, the adhesion to the Atlantic Alliance and full support for the process of European integration. On the latter, however, the programme aims for a more political and less bureaucratic EU, suggesting that the powers of member states have to be strengthened in defence of the national interest. In other words, a call for more subsidiarity, without explaining what this would mean in practice. We don’t see this as a short-term relevant risk but acknowledge that in 2023 when the reform of the stability pact is discussed, a confrontational approach from Meloni’s side cannot be completely ruled out.

Scarce visibility on the fiscal stance, but we don’t expect a substantial derailment in the 2023 budget

This brings us to another key factor: fiscal policy. The coalition programme aims to extend the applicability of the flat tax and a reduction of the tax wedge, without providing details on the relevant cost or where the funding would come from. Once again, on the fiscal front, Meloni sounds much more prudent than Salvini, who would have already opted to increase the deficit to finance a new set of measures to help households and businesses weather the energy price shock.

Meloni here is in a difficult position: pressed on the one hand by her ally and on the other, by Draghi’s example of substantial support packages, launched without adding to the deficit. Given the very narrow time window that the next government will have to craft the 2023 budget (it has to be voted on by both branches of parliament before year-end), we believe it would be hard for Meloni to derail from the set track, and that available resources would be used to fund a reduction of the tax wedge (more palatable to the EU Commission), with only a symbolic extension of the flat tax.

> *We believe that a Meloni-led government would start its tenure with the aim of boosting its credibility*

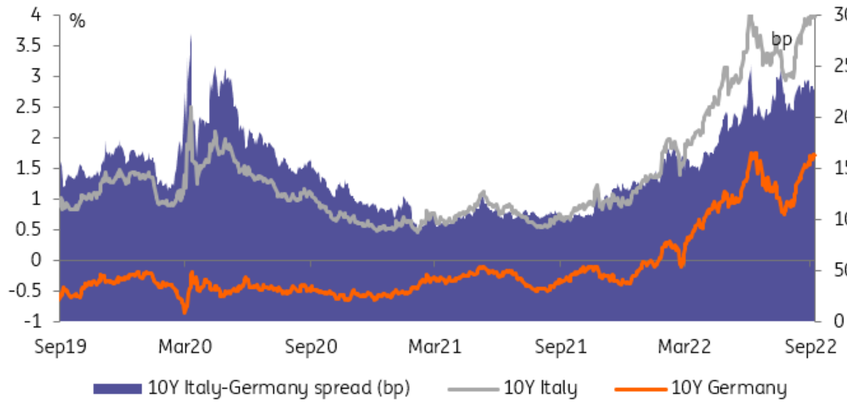
All in all, we believe that a Meloni-led government would start its tenure with the aim of boosting its credibility, trying to avoid collisions with peer eurozone members and EU institutions. Whether this attitude will last will depend on how the economic picture evolves and how the EU will respond. Don’t forget the Recovery Fund - the inflow of EU money covering the next legislature seems in principle a powerful incentive to keep a constructive approach to EU integration.

What's at stake for Italian bonds

The performance of Italian bonds into and around the election has to be assessed in light of the main risks they face. Primarily, investors will be looking nervously to the new government for signs of fiscal divergence compared to the previous administration. If we're right in expecting no wholesale change to the 2023 budget, markets would no doubt see this as an encouraging sign of budgetary restraint. Much is riding on this. Besides the credibility of the new government on fiscal matters, any clear departure from the EU's guidelines would raise fears that Italy could lose out on €69bn in grants and €123bn in loans from the NextGenerationEU recovery package, and may also no longer be eligible for European Central Bank support.

Provided Meloni doesn't yield to Salvini's push for a flat tax or for deficit-funded support for households and businesses, we think investors would give the new government the benefit of the doubt. Disagreements further down the line on the reactivation of the Stability and Growth Pact are a risk to this view, but not an immediate one. Along the same lines, appointing a finance minister from the Bank of Italy (BoI) would also be seen as a signal of stability and continuity on fiscal matters. Provided the right signals are sent, Italy could benefit from a 'stability premium', as this could be seen as one of the most stable governments in a long time.

The widening of Italian spreads has been orderly in the face of political risk



Source: Refinitiv, ING

A possible relief rally, but a short-lived one

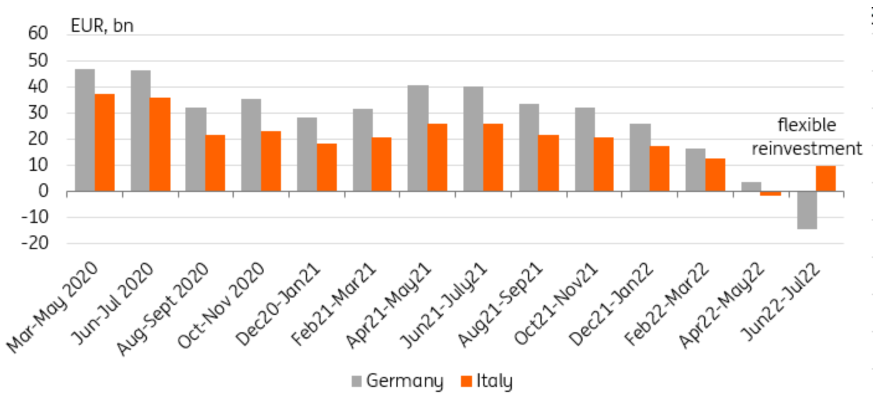
There is no saying how long the honeymoon period will last, however. Firstly because we are unsure if and when an FdL-led government will decide to adopt a more confrontational attitude towards Brussels, even if not on fiscal policy. Secondly because the macroeconomic backdrop isn't particularly friendly to peripheral bonds. 10Y Italian yields are already flirting with a 4% yield and we're expecting euro rates to continue rising, albeit at a slower pace. The ECB has stepped up to the plate with targeted reinvestments from the Pandemic Emergency Purchase Programme and could activate the Transmission Protection Instrument (TPI), thus limiting the speed, but not the magnitude, of any spread widening.

A key risk is persistent chatter of quantitative tightening into the

October meeting

Our view is that Italian bonds will benefit from a relief rally around these elections. Any outperformance relative to other peripheral bond markets, say Greece and Spain, may be sustained, but the widening relative to core rates will resume as the ECB goes ahead with monetary tightening. A key risk is persistent chatter of quantitative tightening into the October meeting. Whichever way the ECB proceeds, we doubt it can significantly reduce its stock of Italian bonds. The solution lies in either accepting that a bloated balance sheet is a cost worth paying to be able to hike rates or implementing differentiated monetary policy, with bond holdings falling faster in the core markets than in peripheral countries. Both point to wide Italian spreads, but not to an immediate sovereign bond crisis.

The ECB is still increasing its stock of Italian bonds



Source: ECB, ING

FX: For now, the euro has bigger issues that Italian politics

When Italian politics start to appear on the market's radar, downside risks to the euro often start to emerge. The last vote, in 2018, is a case in point as the post-election political uncertainty contributed to a 10%+ drop in EUR/USD that year.

As discussed above, markets may welcome a result that yields a stable majority, and barring some unwelcome surprises in the choice of key ministers, budget decisions or in relations with the EU, Italian political risk might have a rather muted impact on the euro into the new year. Even more so considering the prevalence of the energy crisis and the worsening economic outlook as a driver for the common currency.

When it comes to Italian sovereign spreads widening, EUR/CHF is normally the currency pair to watch, given the franc's role as a quintessential hedge for EU existential risk. However, since the hawkish turn by the Swiss National Bank and a radical shift in its stance on the franc, the correlation between Italian sovereign spreads and EUR/CHF has become less significant. We'll likely need a sudden and politics-driven re-widening of the BTP-Bund spread to see the pair react clearly to Italian bonds. And as we have highlighted, this is not our base case for now.

Authors

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Additional information is available on request. For more information about ING Group, please visit http://www.ing.com.