Four scenarios for Italy's latest political crisis

The 5-star Movement boycotted a confidence vote today, putting Prime Minister Draghi on the spot. He should be asked to either find a compromise or form a new majority, but chances of him exiting the political scene and of early elections have risen. A political vaccum could send Italian spreads above 250bp without help by the ECB, and add pressure to the euro

Italy has plunged again into political uncertainty. One of the key supporters of Prime Minister Mario Draghi's government, the 5-star Movement, walked out of a confidence vote in the Senate today, which prompted Draghi to meet with the President of the Republic – Sergio Mattarella – to hand in his resignation. Resignations are quite common practice in these situations, and don't necessarily mean Draghi is now out of the political game. It is entirely possible that President Mattarella will require Draghi to ask for another confidence vote in the parliament.

There are four scenarios for Italian politics at this stage, sorted by expected market impact (positive to negative). For each of them, we estimate what levels could be seen in the 10-year BTP-Bund spread and EUR/CHF.

1 Back to status quo

Draghi manages to mediate with the 5-star Movement, the government maintains the same majority and is not significantly weakened. No real policy implications.

Scenario 1:

BTP-Bund: 190 bp
EUR/CHF: 0.9900

2 Cabinet reshuffle

The 5-star Movement is excluded from the government, and after a cabinet reshuffle, Draghi secures a new majority in parliament for a second unity government. He is now in a more fragile position, and the path for policy reforms might be less smooth. Higher risk of an early election.

Scenario 2:

BTP-Bund: 200 bp
EUR/CHF: 0.9850

3 Draghi out

Draghi pulls out of the political scene, but major parties agree to a new unity government with another PM (Finance Minister Daniele Franco could be an option here). This new government will have the main task of delivering the budget plan in December, but early elections in the first months of 2023 are highly likely.

Scenario 3:

BTP-Bund: 215 bp
EUR/CHF: 0.9750

4 Snap elections

Early elections are announced, the first workable date could be the 2 October. Draghi or another PM would stay in power for a transition period until then. The government coming out of the vote would then be in charge of the next budget plan. Latest polls suggest that a populist right-wing coalition should be able to secure a majority.

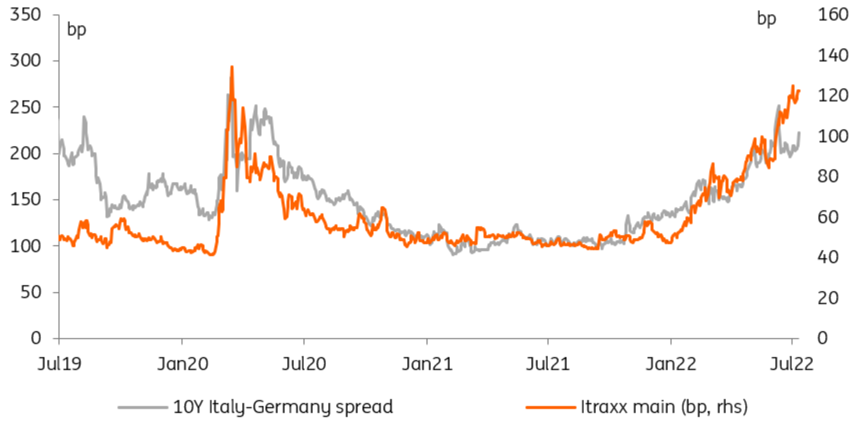
Scenario 4:

BTP-Bund: 260 bp
EUR/CHF: 0.9650

Italian bonds: don't look to the ECB

As it officially stopped net sovereign bond purchases on 1 July, the European Central Bank was dragged back kicking and screaming on the peripheral bond market, on the same day. Its response to fast widening spreads has been two-pronged. First, it pledged to reallocate core bond redemptions in its existing portfolio to peripheral bonds. This is only a temporary solution, however, and this measure is soon to be supplemented to the much-touted fragmentation instrument. Suffice to say here that the monetary (interplay with other policy objective), political (opposition from various countries), and legal (likely challenge in the courts) difficulties easily explain why the ECB has dragged its feet in delivering the new instrument. In addition, the mere announcement of a new tool was enough to cap sovereign spreads, when other credit and risk indicators continued to point higher.

Even after today's widening, Italian spreads remain too tight compared to credit indices



Source: Refinitiv, ING

> *Without a stable government and a pledge to abide by some sort of conditionality, the ECB can scarcely justify buying more Italian bonds*

All this amounts to little pressure on the ECB to finally unveil its new tool, and few expect a fully-fledged instrument to be unveiled at next week's meeting. A political crisis in Italy changes that. First, it has brought the 10Y Italy-Germany spread back to the 200-250bp 'danger zone' where the ECB has intervened verbally in the past, piling pressure into next week's meeting. More importantly, without a stable government and a pledge to abide by some sort of conditionality, the ECB can scarcely justify buying more Italian bonds.

In all of the four scenarios, except perhaps in the one where a snap election is called, the ECB could argue that a loose definition of conditionality has been met. There will likely be some political opposition to it, but the facility would at least serve its purpose to discourage speculation and prevent spreads rising above 250bp. In all cases, although less so if Draghi stays at the helm, this episode would have fired the starting gun on the budget season in the autumn, and to the campaign to the general election taking place in the spring of 2023 at latest. This makes tightening below 185bp challenging in our view.

Another downside risk for the EUR?

The concerning news coming from Italy may have helped EUR/USD break more decisively below 1.0000 today. However, we think it's still mostly the macro (grim eurozone outlook) and policy (Fed repricing higher) picture that has kept the pair under pressure. A blowout in perceived political risk in Italy would normally be channelled through a materially weaker EUR/CHF (which has the highest correlation with BTP spreads), but we've only seen a small reaction in the pair so far.

We may see a sizeable reaction in EUR/CHF only if the prospect of early elections or Draghi exiting the political picture becomes more tangible. Much will obviously depend on the reaction in the BTP market. Rising political risk in Italy can also have implications for EUR/USD, and may contribute to keep the pair below parity, although gas crunch fears and a hawkish repricing of Fed expectations should remain much more relevant drivers in the near term.

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