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Article

Italians go to the polls, finally

This Sunday's elections could lead to a hung parliament, opening a prolonged phase of negotiations to form a new majority. As the outgoing Gentiloni government will act as a caretaker, market reaction could be limited to a temporary widening of spreads in a more volatile environment

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Italy votes on 4 March with a mixed electoral system

On 4 March Italy will hold its much-awaited political elections.

A newly introduced mixed electoral system, combining a purely equal part with a first-past-the-post part, the latter allowing for the formation of coalitions, will be used for both branches of Parliament.

In more detail, the proportional part will allot around two-thirds of seats (386 out of 630 at the House of Representatives, 193 out of 315 at the Senate) and the first-past-the-post part around two-thirds (193 out of 630 at the House of Representatives and 116 out of 315 at the Senate). The remaining seats (12 at the House of Representatives, six at the Senate), reserved to Italian residents abroad, will be awarded a different system. The new electoral rules include both houses - a somewhat complicated system of entry thresholds.

Polls will be open from 7:00am till 11:00pm CET, and the official results should be out the following morning.

Competing coalitions

The new electoral law has created an incentive to form coalitions to better compete in the first-past-the-post part, and many parties took the opportunity.

The electoral test will see three main political aggregates competing: a centre-right coalition, a centre-left coalition and the Five Star Movement (M5S), which will run in isolation. Liberi e Uguali, a party putting together a group of MPs who split from the PD party early in 2017 and other small

parties of the left will also run in isolation. The centre-right puts together Forza Italia, Lega Nord, Fratelli d'Italia and Noi con l'Italia. The centre-left coalition, built around Partito Democratico, includes +Europa, Insieme and Civica Popolare.

A vocal campaign, but light on key issues

The campaign has so far been vocal, mostly focusing on non-economic issues such as the migrants, public order and the morality of candidates.

Interestingly, so far the theme of Europe has notably been almost absent from campaign discussions. The Five Star Movement, which for long had been indicating an (undoable) referendum on ITexit as its first move if in power backtracked on the issue, claiming that necessary amendments to the European governance will have to be made "from within". Forza Italia, which had been flagging the idea of the adoption of a parallel currency, apparently shelved it.

Lega Nord, probably the most eurosceptic party on the political scene, turned quiet on European themes after finalising the formation of a centre-right coalition.

Programmes or untenable promises?

The common feature of programmes published by the three main contenders was the announcement of lower taxes. If the centre-left follows a line of continuity with the current government's action, maintaining tax progressivity as its core, the centre-right points instead to a sharp twist towards a flat tax system. The M5S, on its own, is less specific, preannouncing lower personal and business taxes. As these promises are accompanied in many cases by commitments to increase minimum pension outlays, more public investments and other spending promises, one could wonder where the funding would come from.

The contrast with very ambitious projected declines in debt/GDP ratios is quite striking. Here, the programmes are vague enough to evaluate how difficult it will be to fulfil electoral promises.

A shift towards European/economic issues seems unlikely

With one week to the polls, we don't believe there will be a sharp shift in focus in the campaign themes. If in principle discussions on the perspective of the European governance might be resurrected, external conditions are not adding extra pressure.

In particular, the delay in the formation of the German government in principle gives the competing Italian parties some extra time to keep their cards close to the chest on the issue. The notable absence from the campaign calendar of any televised debate putting the leaders of the main competing parties face to face also suggests that there is limited appetite to shift gear. If this will be true, we will have witnessed a campaign where the contenders have mainly aimed at strengthening the link with the vocational (sometimes disillusioned) electorate rather than trying to expand the electoral base.

Pretending not to extend alliances after the vote does not mean doing it

In the current political setting, most political actors are officially pretending they will be unwilling to coalesce with competitors after the vote in case of a non-decisive result in the polls.

However, as normal in a quasi-proportional system, they might eventually have to. Notwithstanding post-vote alliances have not been part of the campaign debate, their sheer possibility has been fuelling reciprocal mistrust within coalitions. This seems particularly true within the centre-right between Berlusconi's Forza Italia and Salvini's Lega Nord, who have conflicting views on many key issues while officially sharing a common programme. In case of an inconclusive result, we suspect that the cohesion of the centre-right alliance might evaporate.

The centre-left coalition, being dominated by the PD party, and looking less dis-homogeneous, seems less exposed to this risk. Ironically, the only party relatively openly hinting at the possibility of a post-vote alliance was the M5S, a long-time opponent of any idea of any compromise. Reportedly, during a closed-door meeting with investors in London, M5S leader Luigi Di Maio opened to the possibility of post-vote coalitions, or, as he clarified subsequently, to the possibility to accept the (post-vote) convergence of other parties on the M5S programme points. An interesting opening, indeed.

Opinion polls point to the centre-right leading, but not an outright victory

Italian electoral rules prohibit the publication of opinion polls results over the two weeks preceding the election day. Opinion polls published this year before the start of the blackout period (17 February) have been describing a stabilising political scene. Averaging the last ten days of officially available opinion polls on the proportional part of the vote we have the centre-right coalition leading with 37.3%, followed by the M5S with 27.5% and by the centre-left coalition with 27.3%.

Available simulations trying to put together the proportional and the first-past-the-post part of the system indicate that in order to reach the absolute majority in the Parliament (316 seats at the Lower House, 158 at the Senate), any party/coalition should gain 40% of proportional votes and 70% of available seats in the first-past-the-post part of the electoral system. In the current setting, based on available opinion polls, only the centre-right would be in the position to get any closer to these thresholds. To reach the first-past-the-post threshold, the centre-right would have to win in most contendable constituencies of Southern regions, which are deemed a stronghold for the M5S. A very ambitious target.

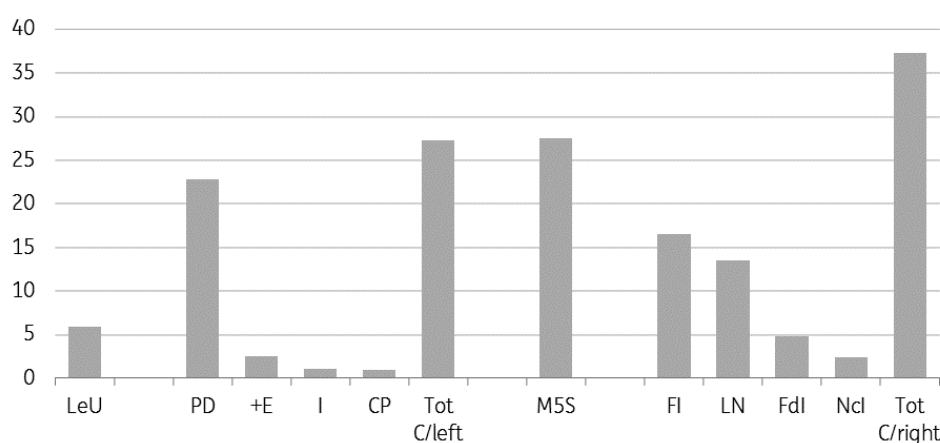
In principle, available opinion polls point to an inconclusive result, with no aggregate in the position to easily reach the absolute majority in the parliament.

Turnout rate could be a game-changer

However, due to a very high number of undecided voters, in our view, some prudence in the interpretation of these projections is necessary.

In fact, the latest available polls put undecided/would-be-abstained voters between 33% and 38%. If, as some analyses suggest, there are more undecideds among the centre-left electorate, the ultimate turnout rate might not be neutral on the overall results.

Opinion polls point to an inconclusive result



Source: Various sources, ING

Our base case remains a hung parliament

On the back of the above considerations, our base case is to expect a hung parliament, with no party/coalition reaching the absolute majority on 4 March.

If that's the case, some form of coalition would be sought; an exercise which would likely call for the break-up of part of the original coalitions. In this light, in our view, a centre-left + Forza Italia ticket might eventually be better placed to attract other parties (on both sides of the traditional political spectrum) to reach a majority. The extent to which the boundaries of such a coalition will be pushed would characterize the prospective majority as a grand coalition or a national unity government.

Should instead the centre-right manage to win an absolute majority outright, the next developments would likely heavily depend on the relative electoral result of Forza Italia and Lega Nord, the heavyweights in the coalition. The indication of the PM candidate for the coalition might in principle be a possible first stumbling block, but we believe that a convergence on a name such as that of Antonio Tajani, the current president of the European Parliament, would then be an acceptable compromise to all parties involved.

When dealing with the Italian election risk, market observers have typically seen as the less market-friendly solution a victory of the populist and eurosceptic front. Notwithstanding the change in tone in political message, this remains to many a reason of concern. How likely is it? In our view, a post-vote convergence of M5S and Lega Nord cannot be ruled out but remains unlikely. Based on opinion polls the populist couple would not manage to reach a majority in the parliament and would likely be difficult to attract other parties to form a broader coalition. The very radical twist in the Lega Nord makes it scarcely compatible with enlarged majorities, which

intrinsically need the willingness to compromise. To be sure, the simple fact that the two populist parties attempted to form a coalition would raise concerns in the market, as the temptation to resurrect anti-euro rhetoric might be strong for both. However, the institutional twist in the M5S and the strong polarization of the Lega Nord in the rich and productive North makes us think that such rhetoric would be to some extent contained.

Forming a new government might turn out to be a lengthy process

In our base case, the hung parliament outcome, the formation of a new government would take some time. Two key factors would then be at work: the role that President Mattarella will decide to play and the willingness of parties to reach a compromise. On the president's role, we expect him to be very respectful of the parliament sovereignty, acting more as a facilitator than as a kingmaker. In so doing, we believe he would choose not to force the hand of party leaders. The timeline of post-vote institutional passages might turn out functional. The first gathering of the new parliament is scheduled for 23 March and will have as a first official task the election of the presidents of the two houses. This, in turn, will be a useful first test of the willingness of political parties to compromise, giving President Mattarella the first indications about possible future parliamentary geometries. A useful piece of information given the round of consultations which will follow next. In the meantime, party leaders will have some time to absorb the electoral result. If such approach is indeed followed, the time to form a government might extend into the summer, or even longer if multiple attempts were needed. We tend to exclude the possibility that a deadlock could bring the Italians back to the polls before the summer break; however, repeated failures to form a new majority by the summer could increase the risk of new elections in 4Q18.

The good news is that over that period Italy will not be in a political vacuum. The outgoing Gentiloni government, which has not been voted down, will remain in place as an empowered caretaker until a new one is voted. This seems to be highly valued by financial markets, which have so far given almost any relevance to the Italian political risk.

Markets overcomplacent?

Over the past few months, financial markets have shown an almost complete lack of concern about the Italian electoral risk. After picking up around the announcement of the polling date late in December, the BTP-Bund spread in the 10y tenor has been shrinking ever since.

In our view, the recent slight re-widening, common to other peripherals, can hardly be ascribed to an Italian-specific factor.

Are investors over-complacent? This is possible, but it depends on the assumption one makes about the electoral outcome. Our relatively benign base case, which assumes that some form of the enlarged coalition government will be formed, still contemplates a relatively long time until it is realized.

Over this period, a phase of increased volatility might intervene, with the spread of Italian government paper versus bunds temporarily widening, following the vagaries of negotiations. As an enlarged coalition built around a PD-FI ticket would presumably not derail from the current policy of an orderly, slow, fiscal adjustment, we would expect that when a government agreement is in sight, spreads might resume shrinking, also in a rising rates environment.

Alternative outcomes would likely entail different dynamics for market pricing of the Italian risk. If in principle an outright centre-right victory should bring in a quick solution to the formation of a government, markets might still wonder to what extent aggressive electoral

promises would be translated into a government programme, and where a compromise compatible with European fiscal rules' requirements could be reached.

In this case, we suspect that market volatility could be more marked, but that some spread re-tightening might materialise when the picture gets clearer, particularly if a Europe-friendly PM was mandated. The most challenging outcome from an Italian risk pricing perspective would likely be the one foreseeing a series of inconclusive attempts to form any government and a return to the polls with the current electoral law. In this case, a phase of spread volatility could likely turn into a sustained spread widening, as markets might reasonably expect a radicalisation of non-mainstream parties and a revival of anti-European, anti-establishment rhetoric.

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