Italian politics: What now?

While speculations about an alternative majority have mounted in Italy, elections still seem the most likely outcome. Uncertainty is likely to linger, and the resilience of the euro to the political turmoil may not last for much longer

Luigi Di Maio (left) and Matteo Salvini

As the political situation in Italy becomes more turbulent, we identified three different political scenarios for Italy: a new election, a continuation of the current government or a new majority. Since last Friday, there have been two key developments.

1 Renzi's proposal for a coalition

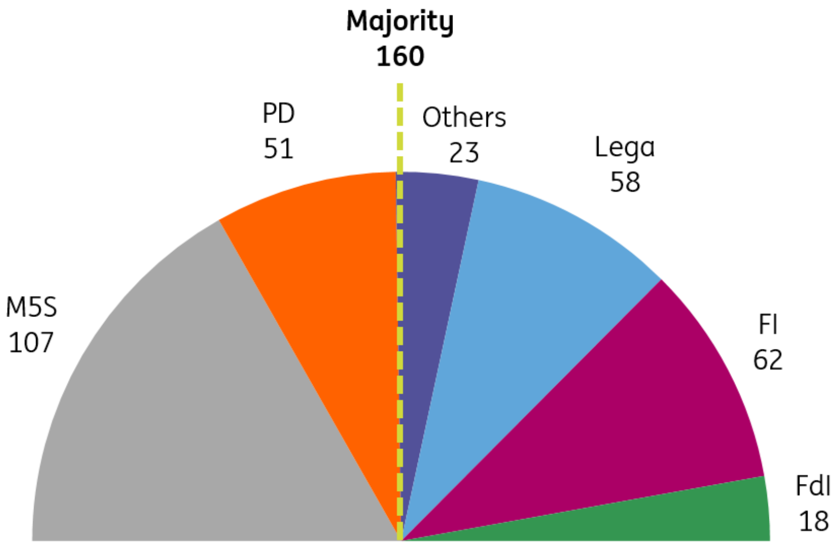
The former prime minister and member of the Democratic Party (PD), Matteo Renzi, proposed a coalition with the Five Star Movement to form a new government, to deliver an autumn budget, making crucial spending cuts and thus averting a VAT hike. Speculations about this possibility have mounted after both parties voted against Matteo Salvini's timeline to force an early no-confidence vote yesterday. Many have argued this option may still be quite impractical, for a number of reasons:

- The actual leader of the PD, Nicola Zingaretti, along with a number of other party members has categorically excluded an alliance with the Five Star Movement.
- Most of the Five Star MPs have also displayed extreme reluctance to a deal with what they

consider their number-one political enemy.

- The factions have opposite views on a number of subjects – including the rail link with France, which broke the previous coalition.
- Renzi can probably rely on the majority of the PD Senators (35-40 of the 51), but even if the entire party was to agree on the proposal, the new PD - Five Star coalition would still be two votes short from a majority in the Senate.
- Given the high risk, the government may prove to be highly unstable and President Sergio Mattarella may be quite reticent to give his approval.

Seats in the Italian Senate



Source: Italian Parliament, ING

2 MPs kicking the can down the road

Encouraged by the polls, deputy prime minister Salvini has been pushing for prime minister Giuseppe Conte's resignation to hold elections as soon as possible.

Normally, 60 days are required after elections are announced, and timing is key given the necessity to approve the budget by the end of the year. The Lega proposed a timeline to have a no-confidence vote this week, but the motion was defeated yesterday. Instead, the new date for the no-confidence vote is 20 August. If parliament votes in favour and forces PM Conte to resign, much will depend on President Mattarella's decision to call immediate elections or try and find a new majority. In the opposite case, the parties who voted against the no-confidence motion will be asked to form a new coalition.

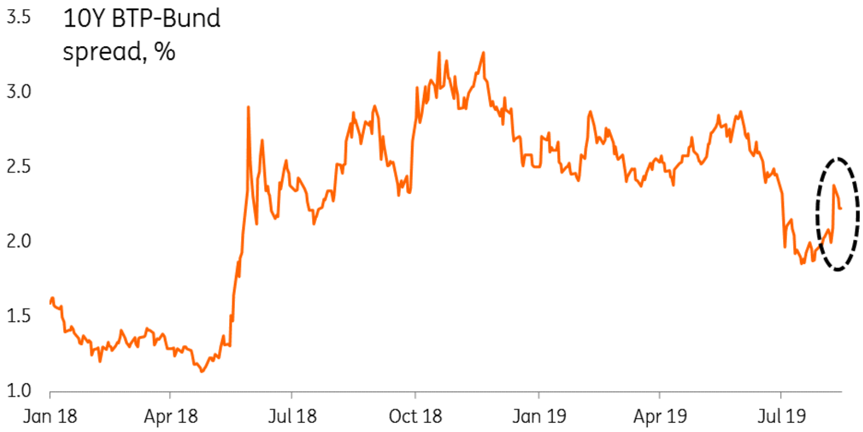
If this attempt fails, elections will inevitably be the only solution.

Elections remain the most likely option

According to the Italian press, the prevailing opinion is that there will be new elections, either at the end of October or early in November. We believe this scenario is likely to prove to be quite negative for risk sentiment in the eurozone, mainly because the new government (led by Salvini) will have very limited time to deal with the key 2020 budget proposal.

This increases the risk of the “provisional system” automatically coming into force, which limits government spending to a limited amount each month and would likely add more clouds to the Italian economic outlook. In addition, Salvini’s hard stance in negotiations with the EU and speculations of Italy possibly leaving the common currency may be another dragging factor on sentiment.

Fig. 2 - Political risk has weighed on Italian bonds



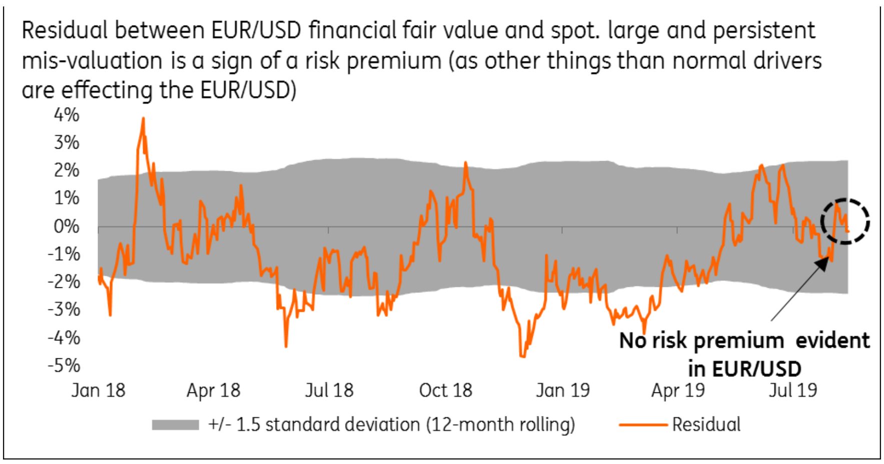
Source: Bloomberg, ING

FX Markets: EUR resilience may not last much longer

Since Salvini announced to break-up the coalition, Italian bonds have come under severe pressure and the 10-year BTP-Bund spread has widened by about 25bp. By contrast, the euro has not faced a similar pressure so far.

On a trade-weighted basis, the common currency has actually been broadly stable and the same is the case of EUR/USD, which currently reacts more to the market re-pricing of the Fed. At this point, markets seem to be reluctant to price in a meaningful Italian risk premium into EUR. This is corroborated by our short-term fair value EUR/USD model, which currently exhibits no risk premia for the cross. This contrasts with the more reactive Italian bond market (Fig. 2)

EUR/USD still in line with its fair value



Source: ING

The possibility of new elections and the threat of an extended period of political uncertainty in Italy continues to hint at downside risks for the euro, alongside the possible dampening effect of the ECB's easing package to be delivered in September. Given the historically high correlation of the EUR/CHF cross with the movements in the BTP-Bund spread, we think that a non-negligible EUR weakness will be concentrated on the pair.

If early elections are confirmed, we see EUR/CHF touching 1.08 in the near future unless trade tensions de-escalate further. Looking at EUR/USD, some Fed-easing re-pricing may put a floor below the dollar, but we still see the pair edge lower to 1.10 on the back of Italian political uncertainty.

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