Italy: Salvini’s political dilemma

A big success in European elections created a strong incentive for Italy's Deputy Prime Minister Matteo Salvini to cash in and pull the plug from the government coalition. The window for such a decision is relatively narrow and broadly coincides with that on the excessive deficit procedure

Italy's Deputy Prime Minister Matteo Salvini

Out of a short-lived technical recession...

Having exited a short-lived technical recession in 2H18 with a meagre 0.1% quarter-on-quarter GDP growth rate in 1Q19, the Italian economy is still struggling to find firmer ground. The 1Q19 expansion was built on a 0.5% net export drive, supported by import hoarding in the UK ahead of the March Brexit deadline, which is unlikely to be repeated. Equally, Istat's inventory report suggests that the marked 0.7% inventory drag is not sustainable. Meanwhile, domestic demand ex inventories has chugged along with private consumption and gross fixed capital formation together adding 0.2% to quarterly growth.

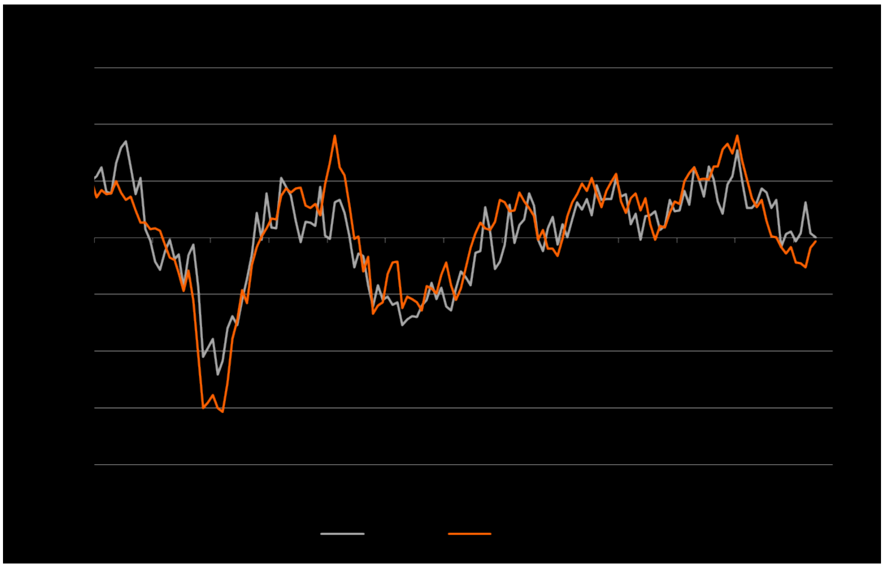
...the Italian economy should trudge along in 2Q19

The data flow on 2Q19 looks consistent with a continuation of the economic soft patch.

- Confidence indicators have broadly stabilised over the Apr-May period, with a slight uptick in manufacturing not matched by the service sector. The PMIs were broadly consistent, with the manufacturing index improving to 49.7 and services receding to 50. Consumer confidence in May interrupted a streak of six consecutive declines.

- On the hard data front, the evidence has been mixed. The poor April reading of industrial production was attenuated by a decent labour market report. In April, employment confirmed 1Q19 gains, and for the first time proved to be resilient to previous soft growth conditions. Detailed 1Q19 labour market data signalled a substantial conversion of temporary contracts into open ended contracts, possibly as a consequence of the introduction of the so-called “dignity decree”. This, against a decelerating inflation backdrop, should in principle help to support private consumption over 2Q19.
- Investment developments look more uncertain. Year to date, bank lending to non-financial corporations (NFCs), adjusted for sales and securitisations, has consistently contracted in YoY terms. In the April Bank lending survey, Italian banks signalled a marginal tightening of credit standards to NFCs in 1Q19 and, more worryingly, projected a softening in credit demand from businesses over 2Q19. For the time being it seems that Italian firms, rather than being credit-rationed, are instead more reluctant to borrow. We believe this has to do with lingering uncertainties on the international stage and, crucially, the lack of visibility on domestic political and fiscal developments. We are now tentatively pencilling in flat GDP growth in 2Q19 and a very modest 0.1% for the whole of 2019, as the potential small boost to 2H19 consumption from the introduction of the so-called “citizenship income” is being outweighed by a relatively low take-up of the scheme.

PMIs point to flat 2Q19 QoQ GDP growth



Source: Reuters Datastream, ING

Shift of focus in the government after the European vote

Economic developments over 2H19 will likely be affected by what happens on the domestic political front. The European election proved to be a repeat of the 4 March 2018 political election, albeit with inverted roles. The League came first with 34.3% of the vote while 5SM came third, at 17.1%. The gap between the two was wider than any poll had predicted since last year’s legislative vote. This is a big temptation for Salvini to pull the plug and cash in his political capital. So far, he has chosen not to, preferring to try to force the government's agenda to suit the

League's. Having targeted the migration/security themes throughout his first year in power, Salvini has now switched to a new flagship slogan: a tax shock via the extension of a broad-based flat tax system for personal income tax. Meanwhile, 5SM's battered leader Luigi Di Maio is proposing a minimum wage for the private sector to attract the non-farm workers, which make up his base. These two themes could put government members on a collision course sooner rather than later in a three-party challenge, with the EU Commission the third key player.

Negotiations to avoid a debt-driven excessive deficit procedure continue

The possible opening of a debt-driven excessive deficit procedure (EDP) against Italy following its breach of EU budget rules has taken centre stage in the domestic political debate. The measure is deemed justified by the EU Commission and has been backed by the Economic and Financial Committee (EFC) but still needs to be agreed by the EU Commission and, eventually, rubber stamping by Ecofin. Negotiations between the two parties to avoid disciplinary steps are still open and uncertainty on the final outcome remains high.

PM Conte formally took the lead in negotiations

With Salvini and Di Maio taking a challenging stance towards Europe, Prime Minister Giuseppe Conte has taken the lead in negotiations. In a letter to the EU Commission sent just before the meeting of the EU Council, he re-affirmed the case for reform of the eurozone “from within”, confirming that as long as fiscal rules are in place they must be followed by all member states. However, he devoted the bulk of the letter to a heartfelt solicitation to amend these rules and to align renewed European governance with citizens’ social and economic needs. It is not clear if this process implies “more” or “less” Europe. The rest of the letter dealt with an explanation of why the 2019 deficit data will likely turn out to be lower than expected, implying that a dedicated stop-gap mini budget would not be needed. Conte believes the deficit will be lower due to a combination of higher tax revenues and lower expenditures amid a limited take-up of the citizens’ income and “level100” pension reform measures.

Visibility on 2020 fiscal plans needed, to increase chances Italy will get off the hook

Even if in principle, with some leeway and more material commitments, the Commission deems the incidental 2019 deficit reduction to be enough to fulfil the structural adjustment requirement, we suspect that a clearer commitment about the 2020 budget would be needed for the EDP to be averted. Here, the starting point is not particularly encouraging.

The government’s latest stated plans for 2020 hardly fit with the deficit target set in the Treasury’s Economic and Financial Document (DEF). As we write, the League is betting on the flat tax plan, which could cost between €8 and €17 billion and both government parties are currently ruling out that the VAT safeguard clause- already budgeted and worth some €23.5 billion- will be activated. This leaves some €31-40 billion of fresh resources to be found for the incremental measures to be funded by vague expenditure cut promises. The road to a headline deficit target of 1.8% of GDP, recently confirmed by finance minister Giovanni Tria, seems very steep.

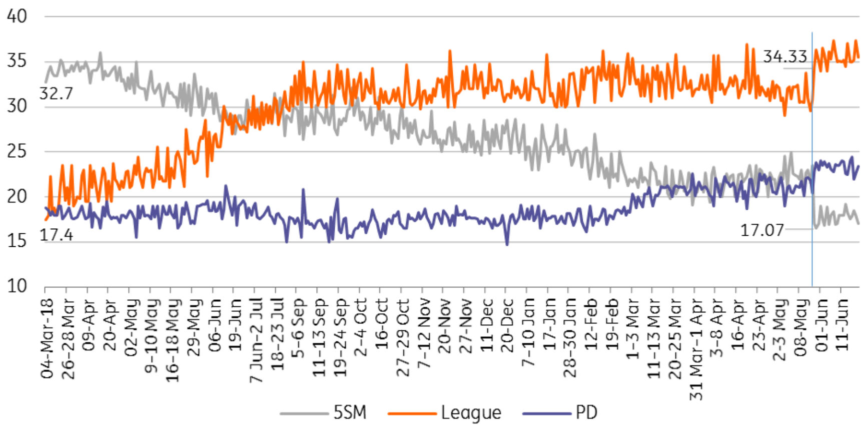
To pull or not to pull the plug?

Will Salvini agree to give in and backtrack on the tax cut call or will he blame the EU for placing Italy in a fiscal straitjacket and go for elections? Judging by his latest statements, it seems he is still sitting on the fence. Should he decide to continue in his current position, he may have little alternative but to downsize his tax call, possibly combining it with a partial kick-in of the VAT clause.

A "rush to the polls" alternative has never been as attractive, with opinion polls pointing to the distinct possibility of a right-centre alternative including the League, Fratelli d'Italia and Forza Italia garnering as much as 50% of the vote. In taking his decision, Salvini will have to take into account that the window for an early vote is fairly narrow. As President Sergio Mattarella is reportedly determined to avoid a situation where new elections put the next budget season at risk, it is now understood that the dissolution of the current parliament should not happen later than the 15 July. This would accommodate new elections sometime over the second half of September.

This article is taken from the Eurozone Quarterly, which you can find here

Latest opinion polls reinforcing Salvini's incentive to pull the plug



The Italian economy in a nutshell (%YoY)

	2018	2019F	2020F	2021F
GDP (%)	0.9	0.1	0.5	0.6
Private consumption (%)	0.6	0.2	0.5	1.5
Investment (%)	3.2	6.0	2.7	0.7
Government consumption (%)	0.2	0.1	0.1	0.3
Net trade contribution(%)	-0.1	0.3	-0.2	-0.1
Headline CPI (%)	1.2	1.0	1.1	1.3
Unemployment rate (%)	10.6	10.5	10.6	10.4
Budget balance (% of GDP)	-2.1	-2.3	-2.5	-2.2
Government debt (% of GDP)	132.2	133.5	134.2	133.9

Source: Thomas Reuters, all forecasts ING estimates

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