Investment Solutions

We assess what an upcoming no-confidence vote means for Italy, the markets and the eurozone.

What has happened in Italy?
The country faces yet another political crisis, with a no confidence vote in the government scheduled for 20 August. Deputy Prime Minister Matteo Salvini is seeking early elections to dissolve the fractious coalition between his far-right, anti-EU League party and the anti-establishment Five Star Movement. The League is a junior coalition partner, but power has shifted: Mr Salvini has boosted its popularity from 17% of the vote in 2018, to 34% in European Parliament elections in May 2019. Current polls suggest 38% of Italians would vote for him – very near the 40% he needs to win a majority.

Why are markets worried?
Markets are not worried per se by the prospect of Italian elections: this government has already exceeded the average 14-month lifespan of a post-war Italian administration. But autumn is generally off-limits for a ballot (no autumn elections have taken place since 1919), because of the need to draw up a new budget. The EU wants Italy to run a sub-2% deficit, but forecasts a 3.5% gap for 2020. The two previous budget negotiations have brought the populist coalition – which wants to cut taxes and boost spending – into conflict with the European Commission. Investors fear a re-run. Spreads between Italian and German debt jumped some 25 basis points after Mr Salvini called for the vote. Italian stocks fell around 2% and banks by some 5%.

What is the underlying problem?
Run-ins with the EU could dent confidence in Italy, damaging growth and driving up the cost of credit for businesses and households. The longer-term concern is that the Italian economy stands on a knife-edge. On the plus side, it runs a primary surplus (tax receipts higher than spending, excluding debt interest payments). Its debt is largely held by the European Central Bank (ECB) or by domestic banks it tried to clean up in 2017. But debt is high at 132% of GDP. And growth is perennially low – the economy can’t seem to grow its way out of trouble. Italy’s economy is still smaller than it was pre-financial crisis. Real incomes have not risen since it joined the euro (see chart 1). Having high debt levels makes it vulnerable to rising financing costs. At the current level of interest rates there is little risk in terms of debt sustainability, but levels above 3% would require it to run an even bigger primary surplus to prevent debt levels rising further (see figure 2). The worst case scenario is that a market correction disciplines Italy by force, causing problems at its banks, or even sparking another eurozone crisis – as the world’s eighth largest economy, Italy is too big to bail out.
Chart 1 – Since the euro was introduced, Italy has performed much worse than Germany, France and Spain
Real incomes in Italy have seen no improvement in decades

![GDP per capita in PPP terms](image)

* Purchasing Power Parity

Sources: IMF, Bloomberg

Figure 2 – We estimate Italy’s break-even interest rate to be 3%
Italy’s primary surplus was 1.7% of GDP in Q4 2018

<table>
<thead>
<tr>
<th></th>
<th>2% interest on debt</th>
<th>3% interest on debt</th>
<th>4% interest on debt</th>
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</thead>
<tbody>
<tr>
<td>Real growth</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
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<tr>
<td>Inflation</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>Nominal growth</strong></td>
<td><strong>1.00</strong></td>
<td><strong>1.00</strong></td>
<td><strong>1.00</strong></td>
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<tr>
<td>Interest on debt</td>
<td>2.00</td>
<td>3.00</td>
<td>4.00</td>
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<tr>
<td><strong>Difference</strong></td>
<td><strong>1.00</strong></td>
<td><strong>2.00</strong></td>
<td><strong>3.00</strong></td>
</tr>
<tr>
<td>Debt/GDP</td>
<td>130%</td>
<td>130%</td>
<td>130%</td>
</tr>
<tr>
<td><strong>Primary surplus needed</strong></td>
<td><strong>1.30</strong></td>
<td><strong>2.60</strong></td>
<td><strong>3.90</strong></td>
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</tbody>
</table>

Source: Lombard Odier calculations
What could happen from here?

1. **Scenario 1 – Coalition survives, minor changes, elections in 2020**

   Italian President Sergio Mattarella will likely want to avoid autumn elections. Mr Salvini’s proposal for an immediate no-confidence vote was voted down, and he has since tried to appease Five Star by pledging support for one of their key parliamentary reforms, if fresh elections follow. It is just possible that the current coalition can survive – perhaps with bigger League representation – until at least early 2020. In this scenario, it seems likely that an acceptable budget compromise will be found, as it has on previous occasions, averting an immediate crisis.

2. **Scenario 2 – Caretaker government, elected or technocratic**

   President Mattarella could also try to form a new government before calling an election, and rival parties have an interest in keeping the League from power. Former Prime Minister Matteo Renzi has proposed an alliance of his Democratic Party with Five Star, uniting the second and third-polling parties. But divided factions in both could make this challenging. Another option would be for the President to install a government of technocrats, as happened in 2011, perhaps with a remit to pass a budget before fresh elections are held – a market-friendly solution.

3. **Scenario 3 – Early elections and a League-led government**

   This is the biggest unknown. The earliest elections could take place is probably October, around the Commission’s budget deadline. The risk is that a ‘provisional budget’ comes into force, obliging the government to spend only limited amounts each month, blocking long-term investment and damaging growth further. Longer-term, there are plenty of concerns over a League-led government (likely with support from Silvio Berlusconi’s Forza Italia, or the Brothers of Italy, with neo-fascist roots). Even amid the recent rise in populist parties across Europe, Mr Salvini would be the first far-right leader to come to power in one of its major economies. Liberals are outraged by his immigration policies, including a ban on rescue boats bringing migrants lost at sea to Italy. So what kind of Prime Minister might Italy get?

4. **Scenario 4 – Early elections and a left-leaning government**

   This could see a Democratic Party-Five Star coalition enter government, perhaps if the League could not form a working majority. As with Scenario 2, this could prove a comparatively market-friendly outcome.

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**Mr Salvini as Dr Jekyll?**

More fiscal spending – on infrastructure for example – might be no bad thing. The EU could potentially allow higher spending in return for some pro-growth reforms, perhaps on bureaucracy, labour laws or the judiciary. The League grew up in Italy’s prosperous northern industrial heartlands – its business-heavy supporter base wants lower taxes, but are unlikely to support a euro exit. In coalition government, Mr Salvini has toned down his previous “basta euro” (“enough of the euro”) stance, and has largely acquiesced with EU budget demands. It’s possible Italy could see more of the same.

**Mr Salvini as Mr Hyde?**

Alternatively, Mr Salvini could resurrect his EU-bashing. He might revive a scheme mooted in May for a parallel currency to pay public sector contractors – a possible first step to leaving the euro. He could dust off plans for a 15% flat income and corporate tax, leading to a sharply higher deficit, at least in the short-term. He could even revive regionalism in some form – in the 1990s, the League sought northern Italian independence.

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**The long-term prognosis**

Meanwhile, few of Italy’s leading politicians – of any stripe – have a convincing plan for boosting growth. As long as Mr Salvini remains at or close to the centre of power, fractious relations with the EU look set to continue. While expected ECB rate cuts and asset purchases should provide more market support from September, Italy’s long-term problems remain the same. And with them, the threat of an accidental bond crisis never fully recedes.
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