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Italian dances

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Summary

- After more than two months of political stalemate a new coalition government in Italy is only a matter of hours, or is it...?
- The draft government contract between Five Star and the League was leaked to the press and contains some highly radical and expensive proposals, but some have supposedly already been watered down
- It remains uncertain if Di Maio and Salvini can work out the final remaining stumbling blocks
- If they would make it to government, fiscal slippage seems inevitable, but to what extent is rather unpredictable at this moment, due to a lack of known policy specifics

Finalmente!

Finally! After more than two months of political stalemate a new coalition government in Italy is only a matter of hours, or is it...? Over the past few days Five Star leader Di Maio and League leader Salvini plus a bunch of unnamed sources have tried to make us believe that a deal was imminent. Today (again), Five Star stated that there were only three issues left to be resolved and that an agreement may be presented soon (yet it may also not). It was not made public what those issues actually are, but it seems that it has to do with who should be named Prime Minister (in any case neither Di Maio nor Salvini) and to what extent the European budget rules should be respected or being pushed for change.

Both parties went back to the negotiating table last week and the supposed details of the German style government contract they are drawing have flooded the press. Yesterday evening a leaked draft version of the agreement between M5S and the League was published on the Italian Huffington Post website. Both parties have already responded that the leaked version is an old one, dating back to Monday morning, and that by now it has already been revised, most probably after pushback from President Mattarella. In general, the President mainly has a ceremonial role, but at the moment it is up to Mattarella to mandate a Prime Minister to form a government. He has said that he will only do this when he is convinced that this PM can form a stable government which will pursue prudent fiscal policy and respect Italy's membership of the European Monetary Union.

So while it is still not certain at this moment whether a Five Star – League government will actually be formed and we do not have the details of the final government contract, it is worthwhile to look at what policies at least have been on the table to get an idea of what kind of government might be heading Italy in the not too distant future. As indeed the probability of an entirely populist government has increased over the past week.

Dio mio!

The leaked draft government contract contains several highly sensitive, radical and expensive proposals. For example, they want the ECB to cancel the EUR 250bn of Italian bonds that are purchased under QE, they want to “radically reform” the Stability and Growth Pact and the fiscal

compact, reduce Italy's contribution to the EU budget, while, at the same time, they also want money from the European Social Fund to fund their basic income plans, and they want to lower income taxes. And if that's not enough, they also want to create a mechanism for a Euro exit, scrap sanctions against Russia and implement pension reforms that effectively lower the retirement age. Since then, some officials have already explicitly stated that they will not request the ECB to cancel debt and that they don't want to question the Euro.

The extent to which the fiscal compact should be challenged still seems to be one of the stumbling blocks, both between M5S and the League and between both parties and the President. The League is least willing to be compliant. In the campaign it advocated it only wanted to remain part of the euro area if the Stability and Growth Pact would be scrapped. Five Star has become more moderate in the past months. The President just wants them to fully comply.

Deficit to sky-rocket?!

Well, one thing is for sure, campaign pledges made by both parties regarding the fiscal policy proposals that have made it to the draft government contract would not fit the European budget rules. In fact it would not even be possible to finance all these proposals, even when the coalition chooses to neglect those rules, as the market would definitely not neglect the devastating impact the measures would have on Italy's debt sustainability.

To make it concrete, we look at the estimations of the costs of party programmes of several institutions and economists. Specifically we look at the costs of the income tax cuts proposed by both parties, the so-called citizens' income proposed by Five Star, and a reversal of the 2011 pension reform, also proposed by both parties. The flat tax rate of 15% proposed by the League is estimated to lower government tax receipts by between EUR 64bn and EUR 102bn a year, and changes to the income tax brackets as proposed by M5S would lower tax receipts by between EUR 13bn and EUR 31bn. Estimates for the cost of a citizens' income of EUR 780 a month range from EUR 15bn to EUR 30bn a year. A reversal of the 2011 pension reform, known as the Fornero law, would effectively imply a fall in the retirement age, leading to additional pension spending of around EUR 20bn a year. So in a 'worst case scenario', the government would need to find additional financing of between EUR 100bn and EUR 152bn a year, i.e. between 5.8% and 8.8% of GDP. Just to be sure, this comes on top of the deficit-reducing measures of around EUR 12bn it would need to implement to prevent the VAT rate to automatically increase in January 2019, which both parties have pledged to do.

Not so fast...

Yet despite all the campaign pledges, there are several reasons to believe that fiscal policy will not spiral out of control if a Five Star – League government emerges. The first is that President Mattarella is expected to only give the coalition a go (by mandating a PM to the coalition's satisfaction) if he believes that it will pursue sensible policies. Secondly, different ideologies and the combination of inexperienced policy makers with the difficulty of implementing several of the proposed measures will slow the actual implementation of their policy. And finally, while rather absent since QE, some form of market discipline will expectedly warn them not to overplay their hand. We've seen the first signals of this today.

Still, a Five Star – League policy agenda will likely lead to some fiscal slippage. While Mattarella's role is not purely ceremonial, his influence over policy decreases as soon as the new government is installed. And while a full-fledged overhaul of the tax system and implementation of a basic income might be unlikely, some of these measures could make it to the finishing line in a watered-down form.

Euro will stay, tensions could grow

While we believe Euro membership is not at risk, the government would strike a more defiant tone towards Brussels, has limited experience in European politics and will try to stretch flexibility of the European budget rules even more. This worsens the relationship. The coalition-to-be has even mentioned in the draft contract that it wants to radically reform the stability and growth pact and the fiscal compact. At worst, Italy will become isolated and the government's Eurosceptic view will increase Eurosceptic feelings among Italians further. Regarding the Eurozone project, we believe a Five Star-League government could complicate further Eurozone reforms.

Il risultato

We have long argued that a government between Five Star and the League was unlikely as they make for strange bedfellows. Yet we have also stressed that the risk of a populist government should not be totally neglected nor should the damage they can do to the economy and public finances be underestimated. We still have trouble imagining how they can work out remaining issues and if they do how they could rapidly implement the measures. Importantly, if they can implement far reaching measures before their different ideologies trigger a government collapse.

Still, we think the market currently underestimates Italian risks. If Five Star and the League cannot work it out, fresh elections seem the only alternative and polls predict that the political landscape would not significantly change. If anything, the League would win more seats at the expense of the centre-right Forza Italia of Berlusconi. And if Five Star and the League do make it into government, at best we should expect that some minor tweaks to simplify the tax system and lower the tax burden, and a 'conditional' basic income have some positive impact on economic growth, while fiscal slippage is being actively contained. At worst, fiscal slippage spirals out of control and previous pension reforms are being rolled back, worsening debt sustainability and as such the economic growth outlook in the longer term. Even if even if fiscal slippage would be contained, such a government seems ill-equipped to deal with Italy's structural problems, to increase the low potential growth rate and to make the country less vulnerable to shocks.

In fact, if financial turmoil returns to levels seen during the debt crisis, while Five Star and the League are still at the helm of the government, it is very unlikely that the government would be able to navigate the country out of a crisis. At this moment we don't think debt sustainability will become an issue in the foreseeable future. But, the large debt stock makes the country vulnerable to shocks and especially if pension reforms will be rolled back, debt sustainability could become an issue in the medium or long term.

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A summary of the methodology can be found on our website www.rabobank.com

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