

# European economy

## Italy: PM Conte resigns, what next?

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- Outlook:** Following Lega's threat to withdraw its support for the government, PM Giuseppe Conte announced his resignation at the end of a heated speech in the Senate. Lega continues to push for snap elections to capitalize on its strong poll numbers, but it remains possible that a majority which included M5S, PD and perhaps other parties is found in the current parliament. Snap elections this year would delay the approval of the 2020 budget and trigger a 3pp VAT increase, according to safeguard clauses. This would impact domestic demand.
- Markets:** Widening sovereign spreads between Italy and Spain/Portugal over the last few months are indication of market concerns about the M5S-Lega government in our view. A M5S-PD coalition would likely introduce more fiscal discipline, but its lifespan would likely be short. Conversely, should elections take place, a win by the center-right might prove more market friendly than the current government, but the prospect of a populist win (for example a center-right coalition excluding Forza Italia) would lead to a bumpy ride for Italian assets.
- What we're watching:** Steps by President Mattarella following consultations with the main parties. On 22 August the lower house should approve a reduction in the number of MPs, which would delay any elections until next year. On 27 September parliament should start reviewing the budget law.



Source: iStock

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Source: UBS

### Fig. 1: BTPs lagging behind

Italian yield (10-years) compared to Spain and Portugal



Source: Bloomberg as of 20 August 2019.

### Our view

The political picture remains unclear, but we see three possible scenarios which we rank based on their likelihood at time of writing:

- A government with a limited mandate to approve the 2020 budget law which avoids a VAT hike before heading back to the polls. This could involve M5S, PD and perhaps other parties and would focus on fiscal discipline and environmental sustainability.

- Snap elections at the end of October. In this scenario, we think that the centre-right coalition would most likely win, but the political campaign may have populist tones. In addition, the VAT hike would go ahead, which would impact 2020 GDP growth.

- A reshuffle of the M5S-Lega government, which seems unlikely at the moment.

**M5S-Lega government comes to an end**

The relationship between Lega and M5S had become untenable after split votes on the EU presidency, high-speed trains, the reform of criminal justice and ongoing parliamentary discussions on the budget.

PM Conte announced his resignation at the Senate, formalising a government crisis which had been opened by Lega's leader Salvini who, two weeks ago, announced that his party might withdraw support from the government.

**Fiscal calendar offers no respite**

Timing is crucial. In fact, if elections occur at the end of October, then the new government would not be able to draft the new budget on time to approve it by year-end.

Because of the safeguard clauses approved by the Monti government, failure to approve a budget law would imply a 3pp VAT increase, pushing it to 25% (or EUR23 billion, or 1.3% of GDP). Such a rise in VAT would likely impact domestic demand and therefore GDP growth next year.

With a government in place, the 2020 budget may consider spending cuts and other taxes with more limited impact on domestic demand.

We have reduced our growth forecasts for Italy by 0.2pp in 2019 and 0.3pp in 2020. We now expect growth of 0.1% this year and 0.5% next year.

The main drivers of our estimate cuts are the weakness in global trade, which affects Italy's manufacturing sector, the risks stemming from the introduction of car tariffs and the political uncertainty which is impacting companies' capex plans.

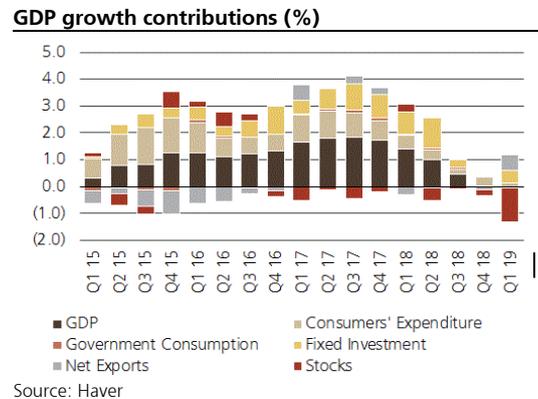
**What may happen next?**

The president holds the cards as to what happens next. We expect him to test the main parties to see whether an alternative majority can be found in the current parliament. Failing that, he would have to call snap elections as soon as this autumn or after a transition government is formed to take care of the budget law before elections take place early next year.

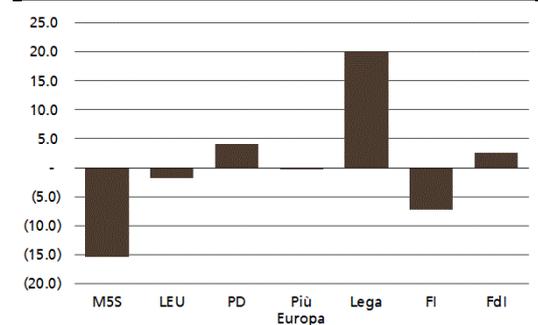
The main parties have diverging interests regarding snap elections:

- Lega has an interest in pushing for elections in October to capitalize on its strong polls numbers (c37%) and avoid to taking responsibility for a likely unpopular 2020 budget.

**Fig. 2: Political uncertainty and trade tensions impact Italian GDP**

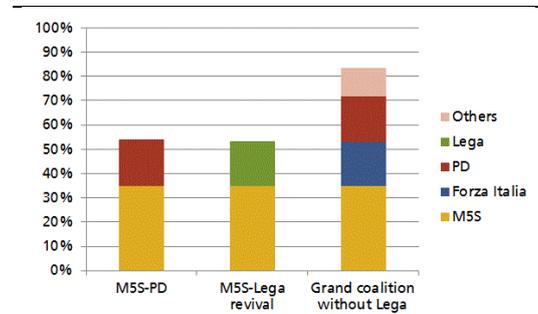


**Fig. 3: Change in political surveys since general elections in March 2018 (%)**



Note: Based on the average of the latest five surveys available. M5S=Five Star Movement; PD=Democratic Party; FI=Forza Italia; LEU=Libertà e Uguaglianza; Bol=Brothers of Italy. Source: Various pollsters including Tecne, SWG, Noto, EMG, Ipsos, Piepoli, Index, Euromedia, Bidimedia, Demos, Index. As of 20 August 2019.

**Fig. 4: Potential government coalitions in the Senate**



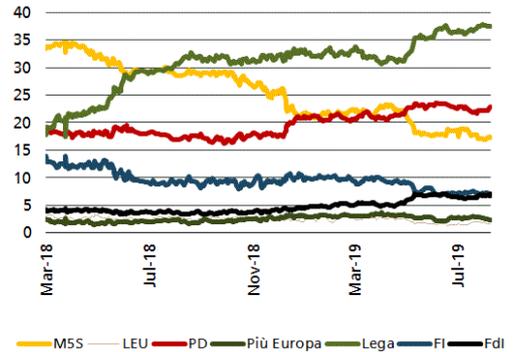
Source: Senato della Repubblica.

- Some in M5S want to avoid elections and are reported to be in discussions the Democratic Party (PD) to join forces in a technocratic government to approve a budget and thus avoid a VAT hike.
- As ever, the PD is divided. Current leader Zingaretti is reported to favor elections while Renzi (former leader) has announced his intention to team up with M5S to approve a sensible budget and avoid further market turbulence.

A center-right government ultimately may be more market friendly than the current one. In fact, Lega is now the largest party and could form a government with its traditional coalition including Forza Italia and Fratelli d'Italia. It is less likely that a right-wing government without Forza Italia, the most moderate and pro Europe of the three, will be formed, but if it were it would raise some eyebrows in the market.

The full center-right coalition (which includes Lega, Forza Italia and FdI) is now polling close to 51%, which implies that it could form a government on its own if new elections were held. The ultimate market reaction to such development may be positive because a center-right coalition government may prove more market and business friendly. Nevertheless, some parties may focus their electoral campaign on populist topics which may lead increase volatility in Italian assets for several months.

**Fig. 5: Political surveys since general elections in March 2018 (%)**



Note: Based on the average of the latest five surveys available. M5S=Five Star Movement; PD=Democratic Party; FI=Forza Italia; LEU=Libertà e Uguaglianza; Bol=Brothers of Italy. Source: Various pollsters including Tecne, SWG, Noto, EMG, Ipsos, Piepoli, Index, Euromedia, Bidimedia, Demos, Index. As of 20 August 2019.

## Appendix

### Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
A	actual i.e. 2010A	COM	Common shares
E	expected i.e. 2011E	GDP	Gross domestic product
Shares o/s	Shares outstanding	UP	Underperform: The stock is expected to underperform the sector benchmark
CIO	UBS WM Chief Investment Office		

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