

MNI POLITICAL RISK ANALYSIS-Early Election In Italy As PM Draghi Resigns

by Tom Lake

Following a week of political upheaval and parliamentary intrigue, Prime Minister Mario Draghi tendered his resignation to President Sergio Mattarella for the second time this morning. The president accepted his resignation this time, before asking the former ECB President to remain in office in a caretaker capacity and dissolving parliament on the afternoon of 21 July. The collapse of the Draghi government is likely to lead to a snap general election in the autumn, around nine months ahead of the latest date the election could have been (1 June 2023).

Executive Summary

- Draghi government collapses as warring factions within his broad coalition refused to back down when threatened with the PM's resignation.
- Snap elections confirmed following dissolution of parliament on 21 July, with 18 September mooted as a potential date by Italian media outlets. Autumn is usually a time the government would be putting together next year's budget, a timeline that a September election could disrupt.
- Opinion polls show that a right-wing coalition involving the nationalist Brothers of Italy (*Fratelli d'Italia*, FdI), the populist League, and centre-right Forza Italia is in pole position to form the next government.
- The loss of Draghi, seen as a pragmatic and non-ideological leader, comes at a difficult time with inflation rising, energy prices spiking, and concerns about EU unity regarding sanctions towards Russia.

Background

The crisis that eventually led to Draghi's resignation began in earnest in early July, when the populist 5-Star Movement (M5S) announced that it would boycott a Senate vote on the multi-billion euro government aid package intended to deal with the spike in energy costs. M5S leader, former PM Giuseppe Conte, argued that the package did not go far enough, and included a controversial plan for the construction of a large waste incinerator in Rome, long opposed by the party.

Draghi's government, which came about in February 2021, was a broad coalition involving the populist M5S, right-wing populist League (Lega), centre-right Forza Italia (FI), centre-left Democratic Party (PD), centrist Italia Viva (IV) and left-wing Article One (Art.1), and other minor parties. Given that Draghi was not voted into office, but governed as an independent technocrat, he stated that without the support of all parties in government to ensure a broad alliance he would step down as prime minister.

The Senate vote boycott on 14 July saw Draghi offer his resignation to Mattarella, only for the president to turn him down and encourage the PM to seek a resolution with confidence votes in both houses of the Italian Parliament. On 20 July, Draghi delivered a scathing

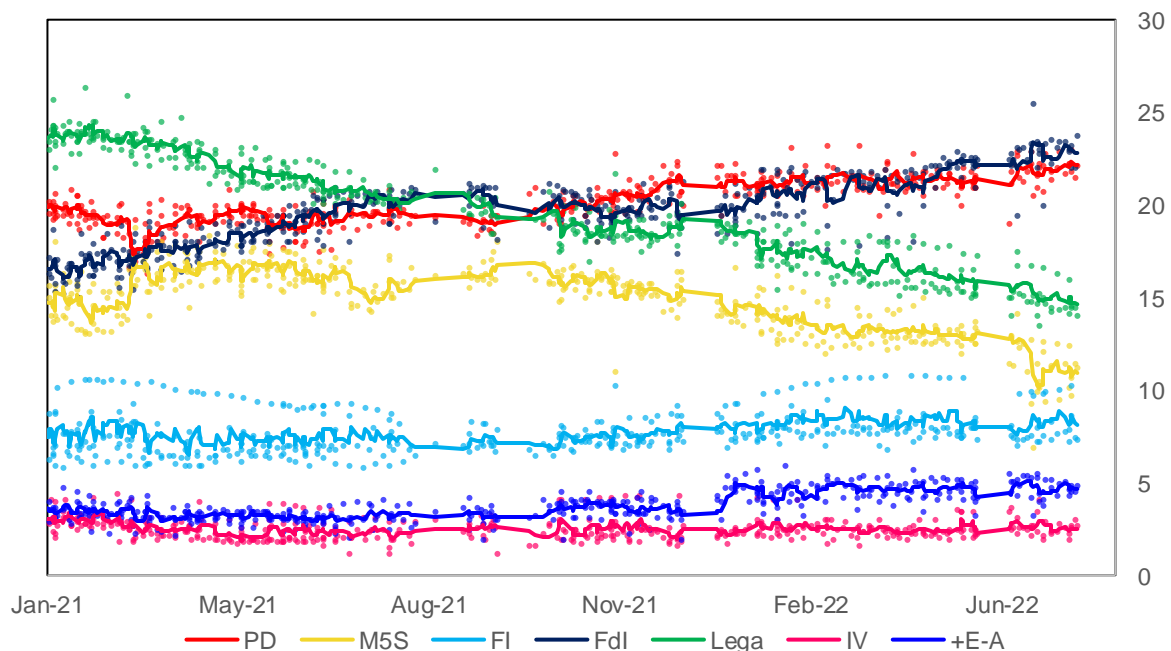
address to the Senate, calling out M5S for breaking the 'pact of trust' between the parties, while also chastising the League for engaging in actions that the PM stated destabilised the government.

As the situation developed throughout the day it appeared increasingly likely that the government would collapse. M5S continued to state they would not support the Draghi administration unless there was more action on social issues, while the League and Forza Italia offered the ultimatum of them not participating in the government if the 5-Stars were still involved. Draghi's refusal to govern without the support of all parties initially involved in the coalition meant the administrations collapse became a *fait accompli*.

Polls Show Three Parties On The Right In Pole Position To Form Next Government

With an election in the offing, focus will turn to opinion polls as voting day approaches. Over the course of 2022 support for the nationalist FdI – the only major party that has sat in opposition to the Draghi government – and the PD has risen steadily. This has mirrored declining support for the League and M5S.

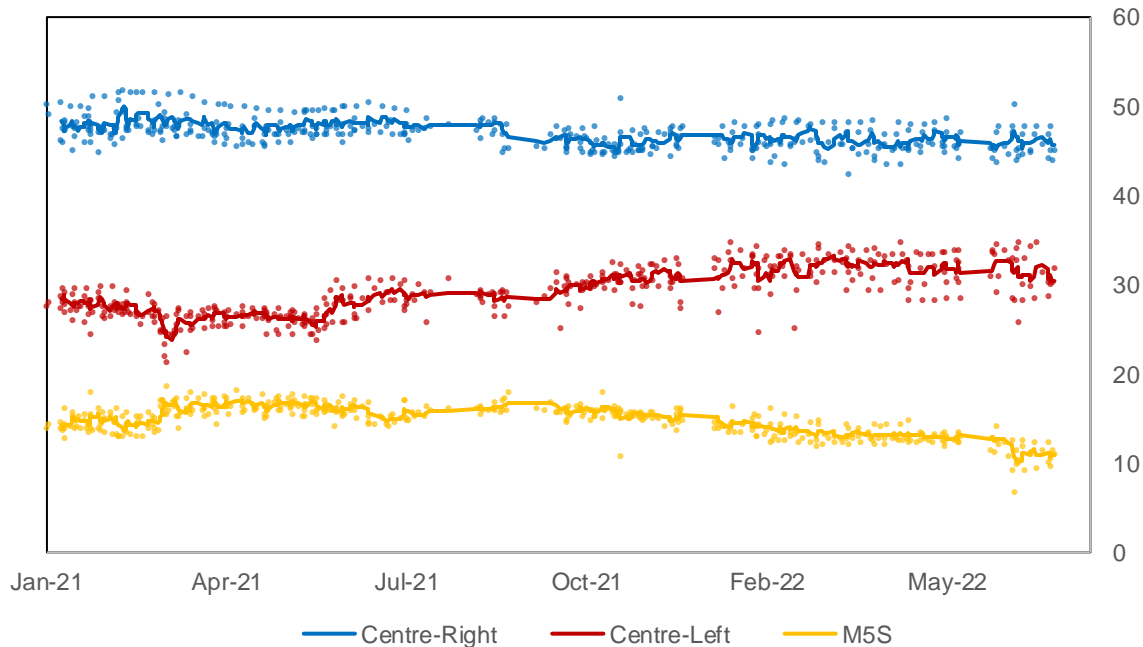
Chart 1. Italy General Election Opinion Polling by Party, % and 6-Poll Moving Average



Source: SWG, Piepoli, Tecne, Euromedia, Termometro Politico, BiDiMedia, Ipsos, Demopolis, EMG, Noto, Winpoll, Demos & Pi, Index, MNI

Many League supporters, angry at former Deputy PM Matteo Salvini's decision to go into coalition with parties from the centre and left, have deserted for the FdI. Meanwhile the 5-Stars' internal divisions have seen its supporters shift to the PD, despite M5S originating as an anti-establishment party opposed to mainstream parties such as the PD. The centre-right Forza Italia has seen its popularity remain largely stable around 8-10%, while the centrist alliance between the pro-EU More Europe and liberal Action (+E-A) group has seen its support climb to around 5%, putting it in sixth place ahead of other minor parties.

Chart 2. Italy General Election Opinion Polling by Group, % and 6-Poll Moving Average



Source: SWG, Piepoli, Tecne, Euromedia, Termometro Politico, BiDiMedia, Ipsos, Demopolis, EMG, Noto, Winpoll, Demos & Pi, Index, MNI. N.b. Centre-right combines FdI, League, and FI support. Centre-left combines PD, IV, +E-A, Article 1 and Green Europe support.

Polls aggregated by political blocs shows the centre-right grouping retaining a stable, if marginally narrowing, lead over the past 12 months. Were these support levels reflected in a general election, it would likely lead to a comfortable majority for the parties of the right, with FdI as the largest single party in government making party head Georgia Meloni favourite to take over as prime minister.

The impact of a right-wing government coming to power in Italy could be notably destabilising on a regional basis politically. Draghi was a highly-respected leader inside Italy but also in Brussels and other EU capitals, whereas a new leader from the right would likely be viewed with a degree of unease given the often anti-EU pronouncements made by Meloni and Salvini's parties. There would also be significant concern in Kyiv and Brussels regarding Italy's continued support towards Ukraine and maintaining sanctions on Russia. Populist and right-wing parties in Italy have often been the most reluctant to hit Moscow hard with sanctions, with Salvini's League in particular having had close relations with Putin's Russia ahead of the invasion of Ukraine.

Sell-Side Views

Barclays

- Early elections could now take place in early October (2nd). President Mattarella could dissolve the Chambers of Parliament over the coming days, launching the process leading to early elections, after having confronted the presidents of the

Lower House and the Senate. He could still verify the existence of an alternative majority, but we think it will be politically difficult and therefore highly unlikely.

- In the meantime, Draghi could remain as the head of a care-taker government until a new one is installed, but the executive's remit would be limited and time-constrained. Draghi's departure from the political scene and snap elections are a clear negative for Italy and the EU.
- The political crisis itself and uncertainty that it generated will complicate the potential design and use of the [ECB's] anti-fragmentation tool. We think Italy will not benefit from this tool if its financial conditions deteriorate due to political developments, for which OMT is the most appropriate instrument. That, however, will require relying on an ESM programme.
- The process of [Italy] achieving the 55 NGEU objectives in H2 22 could be halted, postponing associated disbursement of EUR21bn. While a postponement of the NGEU deadline is allowed in the case of elections, we are concerned that future governments could lack the political capital – or interest – necessary to approve the reforms included in all the H2 22 NGEU objectives.

Danske Bank

- While Italy has a tradition of recurrent political turmoil, the government crisis could not have come at a worse time. The economy has lost momentum at the end of Q2 and a drought is putting one-third of agricultural production at risk.
- Despite recent diversification efforts, Russia still supplies 25% of Italy's gas (down from 40% since the start of the year), and a complete Russian gas cut-off could lead GDP to decline by 2-3% next year (according to Bank of Italy and IMF estimates).
- Overall, we see the recession risk increasing for H2 22. The political crisis also has negative repercussions for Italy's long-term growth prospects, as structural reform implementation will likely slow down, in the worst case even endangering continued NGEU disbursements (EUR145.5bn still outstanding). A renewed spike in yields could reignite market fears about a looming Italian debt crisis.
- The debt to GDP ratio stands at 150% of GDP and neither the Italian Finance Ministry nor the EU Commission expect Italy to run a primary surplus before 2025. While Italian borrowing costs remain below levels seen during the Eurozone crisis or the 2018/19 government crisis, it would not take much in terms of yield rise to bring the debt ratio to a dangerous upward-sloping trajectory, especially if potential growth remains stagnant.
- If early elections are called, we would expect further underperformance of Italian government bonds as well as the EUR. We see scope for BTP-Bund spreads widening to 250-260bp, but expect them to remain below 2018/19 crisis levels, as Euroscepticism has been toned down. [...] We doubt the ECB would cap spread widening if it ultimately reflects dimming growth prospects and rising fiscal vulnerabilities, especially if the political situation should turn more EU hostile.

Goldman Sachs

- The unravelling of the crisis now makes early election in the Autumn likely. If this will be the decision by President Mattarella after meeting with the main political leaders, it

would be the first time since WWII that Italy holds general election in the second half of the year.

- Early election would delay the budget and challenge the implementation of the Recovery Fund, adding policy uncertainty to the economic risk posed by the energy crisis.
- The defection of the 5Star from the ruling coalition in the confidence vote has drawn a wedge within the centre-left coalition (5Star and PD). In fact, we believe it will be very hard, if not impossible, for the PD - the most loyal supporter of PM Draghi - to run an electoral campaign next to the party who some have directed blame for weakening his office.
- Therefore, the consequence of the current political crisis is that the electoral strength of the centre-left coalition has been severely weakened and, as a consequence, the centre-right coalition led by FdI, finds itself even better positioned to win the next election.

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