Confluence Investment Management

Weekly Geopolitical Report

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The Italian Elections: Part II

In Part I of this report we outlined the geopolitics of Italy and its political economy. This week, we continue the report with an analysis of the upcoming elections and Germany's impact on the EU, concluding with potential market ramifications.

The Election

There are four major parties in Italy. Below we detail each party, its current support in the polls and major policy positions.

Five-Star Movement

Current Polling: 28.0%
Alignment: The Five-Star movement is not currently part of a coalition and has indicated it won't join one.
Policy Positions: This party would be best described as left-wing populist. Since inception, the Five-Star Movement has been a Eurosceptic party and has threatened to exit the Eurozone. However, leaders have recently backed away from that position as Italians, while unhappy with the euro, are not committed to the disruption that leaving would entail. Instead, this party wants to see the EU fiscal compact abolished and wants Italy to run high deficits to boost growth. It has also called for universal income for low income households.

Democratic Party

Current polling: 22.1%
Alignment: The Democratic Party is a center-left establishment party. It makes up the majority of a coalition of four other parties that have very little support.
Policy Positions: This party is the least Eurosceptic of the major parties, but it wants a revision to the EU fiscal compact.

Forza Italia

Current Polling: 18.3%
Alignment: Forza Italia is part of a right-wing alignment of three other parties, including the Northern League (see below), which is polling at 39.3% as a group.
Policy Positions: Forza Italia is a center-right establishment party but is led by the controversial Silvio Berlusconi, who often portrays himself as a populist. He is calling for lower taxes, labor market liberalization and tighter immigration controls. Their position on the single currency is that it has been bad for Italy but the country cannot exit it.

Northern League

Current Polling: 13.2%
Alignment: The Northern League is part of the center-right coalition, led by Forza Italia.
Policy Positions: With its base in the northern part of Italy, the Northern League is a right-wing populist party. It wants lower taxes, a smaller federal government and a referendum on remaining in the Eurozone.

At present, neither the center-left nor center-right coalition commands a majority. The Five-Star Movement could link up with either the center-left or center-right and form a government but, to date, has shown no interest in actually governing. Italy has a mixed system of voting; 37% of seats are determined by simple majorities ("first past the post"), with the remaining seats selected by proportional representation.[1] Because of this system, it is difficult to translate polling numbers into securing seats. The consensus is that the vote will be a hung parliament and the current PM Paolo Gentiloni will remain in power during the process of building a coalition or until new elections take place. However, there is some speculation that preference falsification[2] may be underestimating the center-right coalition's support. Additionally, if the Five-Star Movement were to join with another party, it could team up with the populist Northern League.[3]

However, there are two common elements among all the parties. First, there is a shared distaste for the EU's current fiscal restrictions. As we showed in the Political Economy section in Part I of this report,[4] the Italian economy doesn't work without a steady expansion of fiscal policy, rising inflation and a weaker currency. If Italy is going to stay in the Eurozone and flourish, and assuming major political and economic reforms are unlikely (which they are, given the history and geopolitics), then some relief on fiscal spending is probably necessary. Second, none of the parties really wants to leave the single currency. Although it is obvious that entering the European Monetary Union was a mistake, leaving the Eurozone would be extraordinarily painful. Figuring out what currency Italy's debt would be denominated into (either a new lira or in euros), the capital flight that would precede the change and the potential that leaving the Eurozone might lead to Italy being ousted from the EU are all outcomes that no large Italian political party seems to want to accept. Thus, Italy wants to stay in the Eurozone but wants to end fiscal austerity.

The German Problem

Since its founding in 1870, Europe has struggled with Germany's role on the continent. The inability to accommodate Germany's rise was one of the key factors that caused two world wars. The division of Germany, the creation of the EU and NATO combined to prevent the German problem from undermining security during the Cold War. After the Cold War ended, there was fear that a unified Germany would become a problem again; the creation of the Eurozone was, in part, a response to this fear.

Although Germany has not become a military threat (yet!), its economy has dominated the Eurozone. In return for giving up its beloved D-mark, Germany negotiated fiscal rules to prevent Eurozone nations from expanding their fiscal deficits while relying on Germany's austere reputation for keeping European interest rates low. In other words, Germany feared its traditional anti-inflation policies would lead to lower interest rates across the Eurozone, giving the profligate spending nations cover at Germany's expense. As a result, the fiscal rules were an attempt to prevent this outcome.

In the early years of the Eurozone, Germany embarked on a series of labor market reforms that stifled consumption and led to a widening current account surplus. The primary targets for German exports became the nations of the Eurozone who could no longer use currency depreciation to offset German policy and competitiveness.

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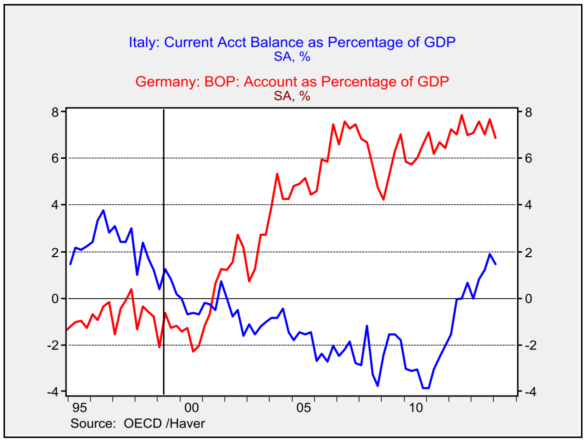
[1] Former PM Matteo Renzi, leader of the Democratic Party, held a referendum to change the system and improve the likelihood that a coalition could win a majority, but the reforms failed to win approval. Renzi resigned after the defeat.

[2] https://www.bloomberg.com/news/articles/2018-02-05/berlusconi-may-be-closer-to-a-majority-in-italy-than-polls-show

[3] https://www.ft.com/content/7a13e0c6-02ac-11e8-9650-9c0ad2d7c5b5

[4] See WGR, The Italian Elections: Part II, 2/12/18.

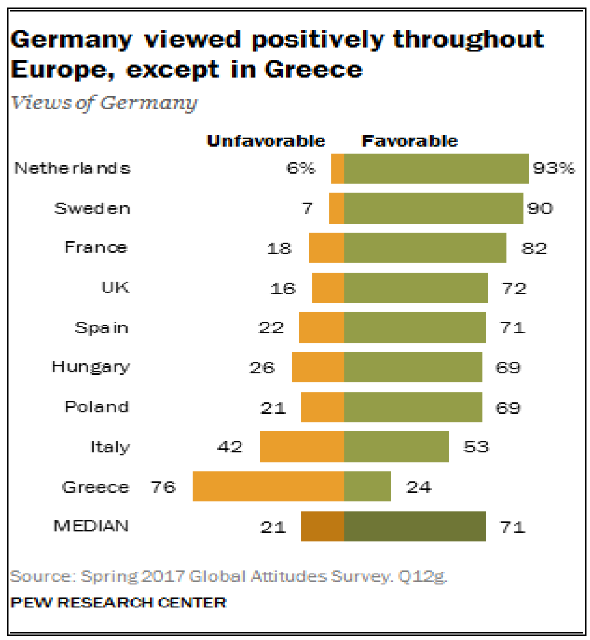


As Germany's current account surplus swelled, other nations in the Eurozone began to run current account deficits. The above chart shows Italy and Germany's current accounts, scaled to GDP. Note that before joining the Eurozone, Italy ran surpluses and Germany had deficits. Once Italy lost its own currency, the current accounts reversed. In 2012, as Italy's economic growth slowed, it too started running current account surpluses. But, that has occurred at the expense of a recession and persistently weak growth.

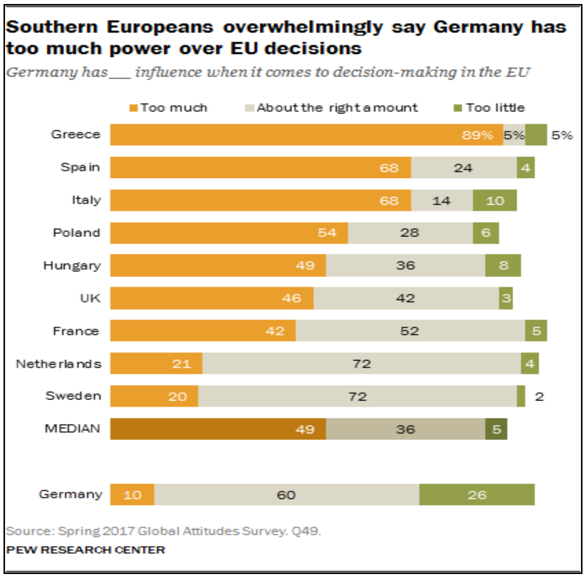
Exports now represent 47% of German GDP. The German economy is heavily dependent on its export sector. Dominating the Eurozone has been a key part of building an export-driven economy.

Germany now has to decide how it wants to manage this situation going forward. It can opt for the status quo and rely on the high costs of exiting the Eurozone to keep the currency bloc together. The risk it runs is that a country like Italy will simply rebel against fiscal restraints and dare the EU to sanction it. Eventually, Germany will have to decide if it can tolerate a Eurozone that is less fiscally restrictive with higher inflation, or make other arrangements. No nation in the Eurozone wants to see it break up, but current tensions are elevated and will require adjustments.

It should be noted that Italians have less regard for Germany than most other Europeans.



Although the Greeks are clearly not enamored with Germany, Italy has the lowest favorable polling among the major European countries.



Italians are tied with Spaniards in thinking that Germany has too much power in the EU. These political polling trends suggest Italy is potentially a "weak link" in the Eurozone.

Ramifications

Currently, the financial markets are showing little signs of concern over the Italian elections, probably because the current polls are signaling a hung parliament. However, the political situation in Italy has the potential to severely disrupt the Eurozone. Given the small size of Greece's economy, its exit from the single currency could be managed. However, Italy's economy is much larger so if it threatens to exit, or is willing to confront the Eurozone on fiscal spending, it could cause a crisis.

Nevertheless, this still isn't the most probable outcome. Instead, we expect the EU to allow Italy more flexibility on fiscal spending. The fact that Chancellor Merkel gave the German finance ministry to her grand coalition partners, the Social Democrats (SDP), may give Italy more political room to violate EU fiscal rules. The SDP is more supportive of EU integration and would be open to making EU rules more flexible. If Merkel's conservative parties had kept the finance ministry, there would likely be more German opposition to Italy breaking the fiscal rules.

If our assessment is correct, and Italy is granted some flexibility in its fiscal spending, the impact on European equities will likely be favorable and the euro will mostly be unaffected. A direct confrontation with Germany over fiscal rules would likely lead to a sharp decline in the euro and weakness in European risk assets. If Merkel had won decisively in September, the chances of a confrontation would have been elevated. But, an unexpected consequence of the German elections could be that Italy gets some relief from its weak economy.

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