Luiss
School of Government

in collaboration with
Luiss CISE
Centro Italiano Studi Elettorali

Mapping Italy: scenario and political risks

No.3 May 2020

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Italian politics has always been an arcane subject. A handful of specialists and enthusiasts love to talk of its Machiavellian intricacies for hours on end, but most people, especially north of the Alps, not only do not understand it, but see no reason why they should bother to understand it. Today there are at least three reasons why they should. First, in Italy the crisis of the political establishment that is now evident in many advanced democracies began a quarter century ago. This means that the country is further down the road of the democratic malaise – it is a laboratory and a bellwether. Second, Italy is the first country from within the historical core of the European community to be governed by anti-establishment parties. Third, its politics represent the greatest threat to the stability, or possibly even the existence, of the common European currency.

Founded in 2010 in a University that has a very strong international vocation, the Luiss School of Government aims to facilitate the connection between Italy and the world outside of it. It aims to prepare the future Italian public elite for the complexities of an ever more integrated planet, and to provide first-class education to non-Italian students in Italy's capital city. SoG professors have often helped non-Italian journalists and newspaper readers understand Italian politics. Thus, it seems only natural to me that the Luiss SoG should offer a monthly report on Italy that provides an interpretation of the country's recent political events, and makes an educated guess about what happens next.

Giovanni Orsina
Director, Luiss School of Government

1. Scenario and risks

1.1. Politics

Sometimes crises offer opportunity and in the short term, **the pandemic has been a godsend to Conte, blocking any attempt to open a government crisis**. The Prime Minister made political use of the outbreak to depict himself as a statesman, at the same time criticising those who tried to use the pandemic for political advantage (namely the opposition). Palazzo Chigi centralised decisions and communication to address the emergency, the Prime Minister produced second-level regulation, prime ministerial decrees, to manage sanitary and security measures and he widely used press conferences and Facebook broadcasts, monopolising the political attention of the country.

The pandemic temporarily obscured the weakness of the "Conte 2" solution: the electoral and political collapse of the 5 Star Movement (populism has roots in the electorate: if populist parties stop being populist, populist voters go elsewhere); tensions between the populist 5 Star Movement and the establishment democrats on industrial policies, Renzi's intemperance for a more moderate and centrist agenda on justice reform and social policies; the growth of the opposition in polls and local elections. Moreover, **the pandemic stopped the strategy of the opposition, which was calling for snap elections if the flawed majority collapsed.**

However, the **pandemic overshadowed, but did not remove, Conte's weakness**. This is particularly evident when we look at the "history" of the policies adopted to face the Covid-19 outbreak. Pressed by the opposition (and by the regions), Conte was forced to tightened the lockdown, after having used a softer approach in the first weeks of the crisis; he adopted a hardline (which largely failed) in the negotiation with the European Union; the government was forced to close down ports to migrants for security reasons (Salvini's motivation). **What the pandemic showed was that the Conte 2 government, with weak consensus, was largely influenced by the opposition in terms of its policy choices. Another frailty is the tendency of Conte to delegate to an increasing number of technocrats in the policy-making process**. The government has created 15 task forces with hundreds of experts in order to manage the crisis. However, the impression is that technocrats are used by the Government as "human shields" on whom to dump responsibility for eventual failure. The constant consultation of experts can be read as a sign of a leadership vacuum and as an abdication by representative politics of its duty to run the decision-making process.

Moreover, there is a double scapegoating exercise going on in Italian politics. The government is blaming the northern regions governed by the League, in particular Lombardy where the outbreak was very severe, for mismanaging the healthcare system (which is under regional governance) in contrasting the pandemic. Meanwhile, the regions are accusing Rome of having acted too slowly and lightly in the first weeks of the Covid-19 outbreak. In the last few weeks, the central government has been under siege by regional governors, included one from PD, for being late in providing healthcare materials to the hospitals through a centralised procurement procedure. The crisis highlighted an unsolved problem of the Italian political system, which is the relationship between the regions and the central government. **Conte appeared uncomfortable in managing this relationship also in "Phase 2" of the crisis, indeed regions are now pushing the government to speed up the procedure for re-opening of industrial and commercial activities, while the executive is holding back.** The impression is that the control of the policy agenda on the pandemic is more in the hands of the Regions rather than of the Government.

In the end, however, at least **in the short-term and at a superficial level, Conte has played a successful strategy.** The Prime Minister now has the highest-ever ratings in the polls, and, in this moment, Italian voters are looking for institutional reference points and are ready to forgive much, also considering the exceptional situation. Moreover, the opposition parties are in trouble in having to oppose a government which is doing much of what they asked for. **In the end, Conte, propped up by the pandemic, is the europhile establishment's best card to keep the national-populists (Salvini and Meloni) away from power for a long time.**

At European Union level, Conte suffered his worst defeat. During the negotiation for the emergency measures, the Prime Minister supported the eurobonds proposal and he opposed the use of the ESM. However, eurobonds were immediately dismissed by the German and northern bloc, while ESM remained as one of the possible tools to face the crisis (together with EIB and SURE loans). Despite Conte agreeing on an ESM with no conditionality only for healthcare expenditures for 2% of GDP, it seems that conditionality is, in any case, implicit with use of the ESM. Indeed, the fund is lending to Member States (new public debt) and States should refund it with interest. It is unavoidable that the political economy will be affected by the use of the ESM, also in the case of lending limited to healthcare expenditure. This is even more valid for a high-debt country such as Italy. **Looking at the outcomes of the EU Council and the balance of power within the EU, it is likely that the "external tie" exercised by EU governance and the financial markets over Italian politics will be strengthened in coming years.**

Moreover, the proposal advanced by France to create a Recovery Fund in order to set up a soft mutualization of eurozone public debt was accepted by the EU Council, but the discussion on the amount of resources to fill it and the details on its operating mechanism (subsidies or loans) has been postponed to the next month. In conclusion, taking into account the promises made by Conte to the electorate and his political propaganda for the Eurobond idea, the result at European level seems modest for the Prime Minister.

1.2. Scenario

In coming months **it is likely that the Conte 2 Government will survive, but many risks are piling up for the majority.** Snap elections are not an option on the table for now, but changes in the majority might occur in the next few weeks, impacting on the future of the Prime Minister. We should not forget how precarious the political equilibrium of the government was before the pandemic. Until three months ago, there was a harsh standoff between Renzi and the Five Star Movement on the government agenda, Conte was trying to mediate between the two parts, but the former Prime Minister seemed on the verge of leaving the majority. **The emergency re-absorbed the conflict, but it is likely it will revive in the next few weeks when the executive will have to face the economic and social crisis. The first signs have already appeared, with Renzi and his party pushing to re-open industrial and commercial activities as fast as possible, while Conte was taking time in order to bring the healthcare emergency firmly under control.** We expect friction will increase rapidly.

Against this background, **these are the possible scenarios**:

A) **Conte 2 goes on with the same majority.** It is difficult to predict how long, but the executive resists for the next few months. The economic and healthcare crisis is too important to allow the overthrow of the government. Conte ties Renzi to the majority with some concessions on the Government's programme and the President of the Republic presses to maintain stability. The Five Star Movement is fractured and disappointed at the outcome of the European negotiation, but too weak to risk a government crisis and, eventually, a snap election in 2021. The government goes on weak and divided for some months, but its future might become very difficult in autumn when a new, and potentially tough (in terms of increasing taxation) budget law has to be drafted. This remains our baseline scenario for now.

B) **Forza Italia helps and possible change of government.** Silvio Berlusconi is open to cooperation with the majority on European policies. Forza Italia is part of the EPP and it is declining in consensus, its MPs may not want to come back to the polls before the end of the legislature. In particular, Berlusconi let it be understood that he might help the government on the ratification of the ESM loans, whether Conte decides to use them or not. Rumours are indicating that Conte's majority could become wider, with eventual external support from Forza Italia. However, in this scenario there are two risks for Conte: 1) the Five Star Movement as we know it would never allow Forza Italia to join the majority, consequently such an event might encourage the radical faction to split from the Movement, disappointed at the outcome of the European agreement made by Conte and at the enlargement of the majority. In this case, Forza Italia would substitute the Five Star rebels, but the majority would become more centrist and less stable (numbers in Parliament would be marginal); 2) an official widening of the majority might imply calling into question Giuseppe Conte as Prime Minister. Another technocrat, such as the former CEO Vittorio Colao now appointed leader of a government task force to address the pandemic crisis, or another independent figure might form a new government on the impulse of the new majority. There would be a gradual change of leadership with a similar majority to the Conte 2, with a more centrist, europhile government programme to definitively neutralize the populist flagship policies of the Five Star Movement.

C) **An input from the President of the Republic for a change of pace.** The economic and the social crisis may spiral out of control and the President of the Republic is forced to take some initiative to stop the bleeding. In this case, a new majority will be indispensable and consequently a non-gradual change of leadership (Draghi would become the most palatable candidate as prime minister in this case). This kind of government might be a national unity government involving all the political parties in Parliament. It would need a very strong agreement on a programme and with the political direction of the President of the Republic. For these reasons, we consider it as a residual option in practice. Not impossible or implausible, but not very likely either.

1.3. Forecasts

Probability of snap elections:

Elections within Q2 2021: **20%**

Elections after 2022: **80%**

Elections in 2020 are implausible not only due to the political scenario, but also for security reasons. The emergency and uncertainty in economic terms will drive member of parliaments to avoid an early vote. Except for Salvini and Meloni, all the other parties and leaders have no incentive to come back to the polls. Moreover, the President of the Republic has proven to be conservative in the last few months and he avoided snap elections in autumn 2019. Probably Mattarella will not risk having an early vote before spring 2021, if a government crisis occurs, he will look at a parliamentary solution and it seems likely he might get one. **Our baseline scenario is: the legislature continues, but the future of the Conte 2 government is uncertain. While snap elections within Q2 2021 are not likely, a new government with a different majority and led by someone else is not implausible.**

1.4. Mapping risks

There are three major risks at this moment concerning the Italian political system:

1) **Recession.** It is evident that the Government mismanaged the healthcare system in facing the spread of the virus. In coming weeks, the price of this mismanagement will become clear, both in political and economic terms. At economic level, it could be a disaster for some sectors, such as tourism and commerce. More broadly, there is the risk of a sharp rise in unemployment and widespread closing of economic activities. Furthermore, northern Italy has been hardest hit by the pandemic, and it is the economic driver of the country. All of it is administered by political forces that are in the opposition in Rome, while the governing forces are well-known for being insensitive to the needs and even mentality of the North. For the first time since the end of the 2010 financial crisis, GDP could decline severely. If the response of the government (and European policies) does not prove effective, debt restructuring cannot be excluded in coming years.

2) **Social unrest**. The government has promised a lot of money (subsidies and loans) both to individuals and to enterprises, but delivered nothing thus far. Given the well-known inefficiency of the Italian public machinery, it is not difficult to predict that money will be distributed slowly, unevenly and unsatisfactorily. This could generate significant social unrest.

3) **Rising probability of political instability.** In the next few months it is likely that Conte 2 will survive, but many risks are piling up for the majority. Snap elections are not an option on the table for now, but changes in the majority might occur in coming weeks, impacting on the future of the Prime Minister.

2. Public Opinion trends

2.1. Polls

Alongside the sadly known effects on health and those that are equally worrying from the economic point of view, the pandemic has affected, at least in part, also the balance of power between the main parties in the Italian political system. **After a long period of electoral stability, with voting percentages above 30%, support for the League has dropped to 28.3% on average (Figure 1). This is a decline in line with a negative trend which had already emerged in the months preceding the outbreak of the epidemic infection and which has now undergone a clear acceleration in the context of the health emergency.** In part, the electoral decline of the League is compensated by the success of Brothers of Italy (FdI), which in the last week has gained 1.3 percentage points compared to its average performance at the end of February. The data show, once again, the growing attractiveness of the party led by Giorgia Meloni. A growth, however, presumably confined within an exclusively centre-right electorate. In general, the performance of Go Italy (FI) remained stable at around 6.2%, on average, therefore in line with the figure recorded at the end of February.

Overall, the centre-right (League + FdI + FI) reaches 47.9% of the votes, in fact a relative majority in the Italian electorate which, in case of elections, would guarantee to the coalition a comfortable majority in parliament. However, although this is a positive performance, the figure, if seen in perspective, shows an electoral contraction compared to recent months, when the centre-right obtained, overall, almost 49% of the votes. **Certainly this is not a collapse, but it is interesting to note that there is a share of the centre-right electorate (and, presumably, of the League) that is beginning to shift its voting preferences, a clue that part of the losses of the main partner of the coalition (the League) are not fully reabsorbed by the minor allies in the coalition.**

The electoral dynamics relating to the parties which support the current government majority are different and varied. With the only exception of Italy Alive (IV) (which lost very little compared to the last week of February), both the Five Star Movement (M5S) and the Democratic Party (PD) and the left alternative to the PD (the Left) are growing. The Movement in fact went from 14.4% to 15% (+0.6 percentage points), the PD from 20.8% to 21.4% (+0.6) and the Left from 2.7% to 2.9% (+0.2). Overall, the pro-government area collects 43.1% of the votes, with a growth of 1.3 percentage points compared to the end of February (when the percentage was still at around 41.8%).

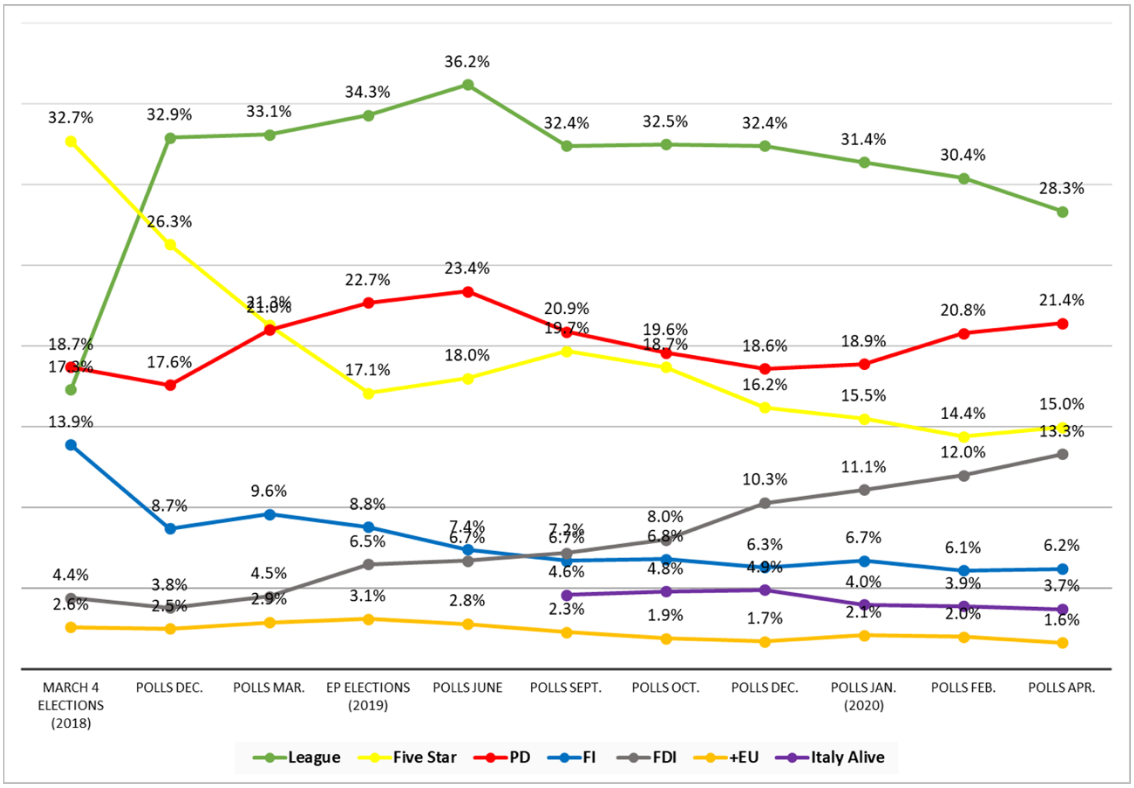
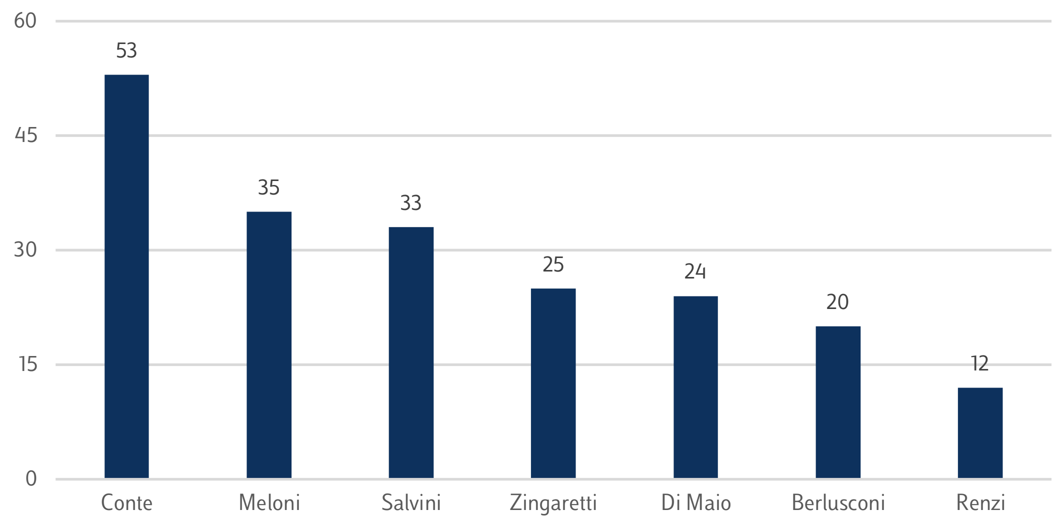


FIGURE 1: Electoral trends in most recent polls

These electoral dynamics are related, at least partially, to the particular emergency situation that the country has been experiencing for weeks. **In the context of a crisis that cuts across all sectors of society and that involves the population as a whole, voters tend to line up behind the rulers, a phenomenon well known in political science as "rallying around the flag". In other words, in case of critical junctures, citizens of a given country gather around those who hold power by referring to a common, shared identity.** Certainly not a new phenomenon, which indeed is a constant, for example, during wars. In part, the slight convergence between the centre-right and the centre-left bloc in electoral terms can be attributed to this phenomenon.

The phenomenon emerges more straightforwardly if we look at the data about the level of trust of public opinion towards the main leaders and political actors in the Italian political system (Figure 2). The Prime Minister, Giuseppe Conte is the personality that more than any other - setting aside the President of the Republic, Sergio Mattarella - is having more success in public opinion. **In the past week, 53% of voters declared their trust in Giuseppe Conte, fully 20 percentage points above the main leader of the opposition party, Matteo Salvini** (33%), **but also decidedly above Giorgia Meloni's share** (35%). Even more relevant is the gap with the leaders and representatives of the two main governing partners: Zingaretti is trusted, on average, by 25% of the voters, while Di Maio by 24%.

FIGURE 2: Trust in political leaders in most recent polls (% of respondents who trust the leader)



The data relating to voters' trust towards the leaders and representatives of the main Italian parties, if analysed together with the latest electoral trends, provides a clear example of the effects of "rallying around the flag", but also of its limits for those who benefit from it (i.e. those who hold power). Voters are enormously supportive of the Prime Minister, and this happens at a time when unity is needed to overcome the crisis (i.e. 'rally around the flag'). **However, it is worth noting that Conte's personal success at this stage cannot be considered as political capital to be used in the future. In fact, the cross-cutting support granted to the Prime Minister does not correspond to an electoral success of equal proportions of the political parties that support the Conte government.** Although, therefore, citizens rally around the flag and support the action of those who temporarily hold power (in particular, the action of the Prime Minister), the pandemic does not seem to have deconstructed the dynamics of the political conflict. And, above all, Conte's current success has not translated into particularly significant increases in votes for any of the major parties that support his government, much less a strengthening of his governing coalition, which still remains particularly divided. In the coming weeks, when the health emergency gradually will leave room for issues related to the impending economic crisis, it will therefore be necessary to understand if and to what extent the Prime Minister, in spite of his broad consensus in the public opinion, will be able to hold together a majority that on various issues (think of the negotiations within the European institutions) has already shown signs of increasing tension.

3. Economic Scenario

On March 17 the Italian government, in order to fight the negative impact of the Covid-19outbreak, launched the so-called "Cure Italy" Law Decree aimed at strengthening health services and supporting the income of employees and self-employed workers. The work of the government in its first intervention was aimed at limiting the negative effects from the current pandemic on the real economy. It proved necessary but not sufficient.

Subsequently, on April 8, the Italian government introduced the "Restore Liquidity" Law Decree, strengthening the so-called Central Guarantee Fund (CGF) for small and medium-size enterprises (SMEs), giving public guarantees on bank loans potentially equal to €400 billion. The new decree has strengthened government guarantees on bank loans up to €800,000 and up to a turnover by borrowers of no more than €3.2 million, reaching coverage of 100% (both directly and indirectly). The new Fund extended the aid to companies with fewer than 500 employees and increased the amounts of guarantees, with a limit on the interest rates on the loans guaranteed. Moreover, the government made a deal with SACE (the Italian Export Credit Agency, a joint stock company controlled by Cassa Depositi e Prestiti), extending the coverage also to exporting companies, useful for the riskiest sectors and countries. The decree provides banks with the opportunity to offer SACE-guaranteed loans with financial conditions that would allow firms to receive rates lower than pre-pandemic (unsecured) loan rates. However, the regulation does not protect borrowing companies from opportunistic behaviour by banks; in fact, it encourages the fixing of excessive financial charges and does not contrast the possible replacement of pre-existing unsecured loans with the new guaranteed loans. Lastly, at the beginning of May we should expect another law decree for Italy with an amount, yet to be confirmed, of around €150bn to strengthen the support to Italian firms and households.

To face the current economic disruptions and heightened uncertainty due to the spread of the Covid-19 shock, various European institutions acted to support member states, households and firms. The quick response by the ECB to the global outbreak of Covid-19 is motivated by the sharp and abrupt degree of tightening in prices in equity, bond, foreign exchange and money markets. This threatened to unleash a perilous macro-financial feedback loop that, if left unaddressed, would have put at risk the ECB's price stability mandate and endangered financial stability more broadly. On March 12, the Governing Council of the ECB, on top of the pre-existing asset purchase programme (APP) which restarted in November 2019, introduced a temporary package of additional net asset purchases of €120bn until the end of the year. In addition, enhanced targeted longer-term refinancing operations (TLTRO-III), with a rate of 0.75%, were necessary to ensure that banks remain reliable in lending to the real economy. Lastly, the ECB's key interest rate on deposits allows banks to get liquidity over longer time horizons at a negative rate (minus 0.5% from September 2019) without any conditions attached.

On March 18, the ECB introduced the temporary Pandemic Emergency Purchase Programme (PEPP). It is the key instrument in addressing illiquidity and heightened volatility in the core segment of euro area financial markets. The PEPP has a volume of €750 billion of eligible private and public securities for the year, and longer if needed.

On April 22 the ECB expanded the category accepted as collateral for its lending operations. Collateral easing measures in response to the Covid-19 crisis must be seen as a way to prevent eventual collateral shortages and providing reassurance that banks will continue to benefit from access to ample central bank liquidity on favourable terms.

On March 20, in one of the first steps taken, the European Commission, in order to grant full flexibility to member states, proposed the activation of the 'general escape clause'. In this unprecedented decision, to suspend the Stability and Growth Pact obligations, the EU finance ministers approved the clause on March 23, pausing the structural adjustments that countries must implement to meet their fiscal targets.

On April 9, the Eurogroup agreed upon a €540bn package to support member states, companies and workers in the Covid-19 crisis.

On April 16, the European Parliament agreed on the aid package together with the necessity for a Recovery Fund, but voted against the use of coronabonds. Overall, since "recovery bonds" should not be used to pool existing debt, but to mutualise debt for future investments aimed at recovery from the current pandemic, the Recovery Fund seems to be a more suitable solution. The use of recovery bonds, instead of coronabonds, will ensure that the EU has more control over where the money goes, constituting also a form of indirect insurance by limiting the risk of giving additional resources for management by nationalist parties, resources that might be of strategic use for a more integrated Europe.

The half a trillion-aid package will be jointly financed by three different institutions, the European Stability Mechanism (ESM) for euro area countries, the European Investment Bank (EIB) for European companies and the European Commission for European workers.

First, EU finance ministers decided to strengthen and use the EIB, with €200bn of new loans to European SMEs. Second, the EU Commission's fund, SURE (Support to mitigate Unemployment Risks in an Emergency), provides up to €100bn in the form of loans from the EU to affected European countries, allowing coverage of part of the costs related to the creation or extension of national short-time work schemes. To finance the loans, the Commission will borrow on financial markets benefiting from the EU's strong credit rating, hence borrowing at low costs. Third, the Eurogroup proposed that the ESM establishes a (temporary) Pandemic Crisis Support, based on its Enhanced Conditions Credit Line (ECCL) already available to all euro area Member States.

Due to scepticism towards seeking loans from the eurozone bailout fund, it is worth spending a few words on the temporary credit line of the ESM. When a country applies for the credit line offered by the ESM, the Board of Governors (chaired by the 19 finance ministers of the euro area, the ESM's highest decision-making body) needs a unanimous vote to approve the support. There would be standard terms for the loan, not to be negotiated country by country as happens in normal circumstances. The credit line, open to all EA19 countries on a voluntary base, amounts to 2% of the respective member states' gross domestic product as of end-2019, as a benchmark, that is approximately up to a total of €240 billion. Moreover, it is worth saying that even if a country applies for the credit line, funds do not have to be drawn, in fact, those money are designed to be a protection in case of need. The one and only requirement to access the credit line from euro area Member States is the commitment to use this credit to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID-19 crisis, hence with no subsequent requirements on deficit reduction. It is worth noticing that when a Member State accesses the precautionary credit line of the ESM (Enhanced Conditions Credit Line - ECCL), it automatically unblocks the Outright Monetary Transactions of the ECB to intervene, if necessary, in secondary sovereign bond markets by buying bonds to nearly unlimited amounts for that country.

Overall, the EU is mobilizing all available resources to respond quickly, forcefully and in a coordinated manner to the COVID-19 emergency. The leaders at the last meeting on April 23, on top of signing the €540bn package of emergency measures, opened the door to an overhaul of draft plans for the EU's upcoming multiannual financial framework (MFF).

In the last meeting of April 23, EU Council members agreed on the urgency of establishing a Recovery Fund of sufficient magnitude aimed at targeting the sectors and the geographic parts of Europe most affected by the current pandemic. Despite recognizing the importance and the urgency in setting up a Recovery Fund, the EU Council did not end with a firm idea and tasked the EU Commission to analyse the exact needs and to urgently come up with a proposal that is commensurate with the challenge we are facing by May 6.

Therefore, what comes out from the last EU Council meeting (April 23) does not include a clear definition of what **the Recovery Fund will be, with the key point being the financial framework in which it should operate. There are two alternatives at this point. The less likely is to introduce European taxes (proposals include taxes on digital services and fossil fuels) collecting revenues to be managed outside Member States' budgets, offering non-repayable grants or investing directly in the country. In the more likely scenario, the fund (with an order of magnitude of trillions) could be financed via long-term or perpetual bonds (on which the principal does not have to be repaid) by the EU Commission and the Multiannual Financial Framework (MFF), but nothing has been said on whether EU countries will or will not be jointly responsible for country-specific loans in case of necessity. That would make a huge difference.**

Credits

Lorenzo Castellani
Davide Angelucci
Alessandro Franconi

Luiss
School of Government

Via di Villa Emiliani 14
00197 Rome
T +39 06 8522 5052-5065
F +39 06 8522 5056
sog@luiss.it