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Independent Thinking

IN DEPTH

Euro area

Europe's 'Super Sunday'

Andrea Zazzarelli

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Andrew Harris

Sunday 4 March looks set to be a crucial date for Europe as Italy holds a general election and Germany's Social Democratic Party (SPD) announces whether it will form a 'grand coalition' with Angela Merkel's CDU/CSU bloc. In Italy, we do not foresee any single party or predetermined coalition winning an outright majority and consequently expect any government to be short-lived and inherently unstable. Such a government is unlikely to implement the structural reforms that the economy requires and we do not expect it to maintain strict fiscal discipline. In Germany, if SPD members vote in favour of coalition we would view this as a significant step towards our 'golden scenario'.

The Italian election looks set to produce an inconclusive outcome

Italy goes to the polls with the strongest economic conditions in a decade, with unemployment falling and growth accelerating last year. Yet the country is split by a generational divide between those who seek change and those who resist it, seemingly brought together only by the schizophrenic nature of their respective arguments. Furthering divisions, a new electoral law has been deliberately over-engineered to appeal to the broadest political consensus and please none.

Unsurprisingly, polls currently point to a deadlock with no single party or coalition able to command a majority and with large swathes of the electorate still undecided. The Five Star Movement (M5S) is the single party polling the largest shares of votes, narrowly ahead of the incumbent Partito Democratico. However, it is the centre-right coalition of, mainly, Forza Italia and Lega Nord that is closest to a combined majority. In our central scenario, we expect no single majority and a short-lived government leading to fresh elections, at most, two years down the line.

Within this scenario, M5S, as the largest single party, could be mandated by the president to try and form a government. The party's reluctance to form alliances has been softening in the run-up to the elections, with its leader opening the door to a unity government centred on common points across all parties. Its manifesto seems designed for this eventuality: scant on detail, broad in scope. Ultimately, we believe that such a government would be likely to be short-lived. To be fair, without a cohesive majority we think this is the most likely scenario whichever party wins the most votes. Even the centre-right coalition, the closest to obtaining a combined majority, harbours within it such contrasting views that it would be unlikely to last a full term.

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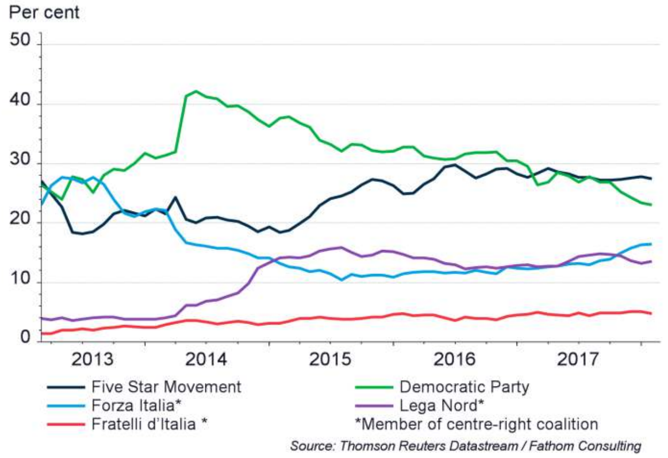
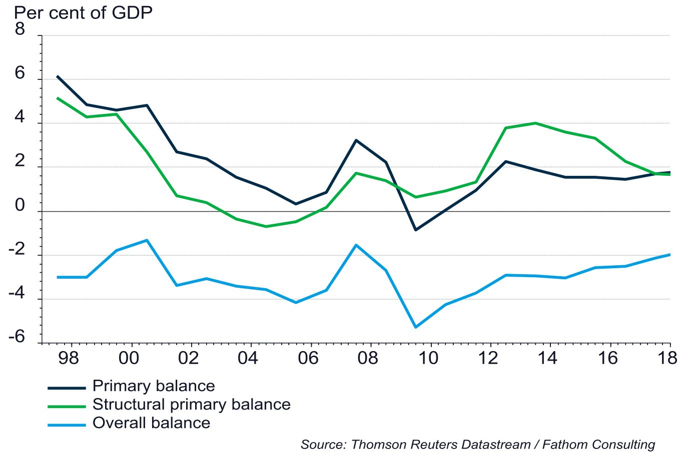
Italy political party support



Regardless of the exact patchwork of the government which is ultimately formed, the path of least resistance appears to be more government spending in the short term. From a fundamental standpoint, there is some scope for this as the deficit currently stands within 3% of GDP thanks to the favourable cyclical conditions and a solid primary surplus which, to some degree, offset the large interest payments that the country pays on its debt. Longer term, however, this will surely prove to be another missed opportunity to establish a countercyclical fiscal discipline and to implement further necessary structural reforms.

Regardless of the election's outcome, fiscal largesse is likely to follow

Italy government budget balance



One upside from this potential political paralysis is that it limits the election's potential to cause systemic contagion across the euro area. Given the closeness of the opinion polls, traditionally Eurosceptic parties such as M5S have toned down their anti-euro rhetoric in a bid

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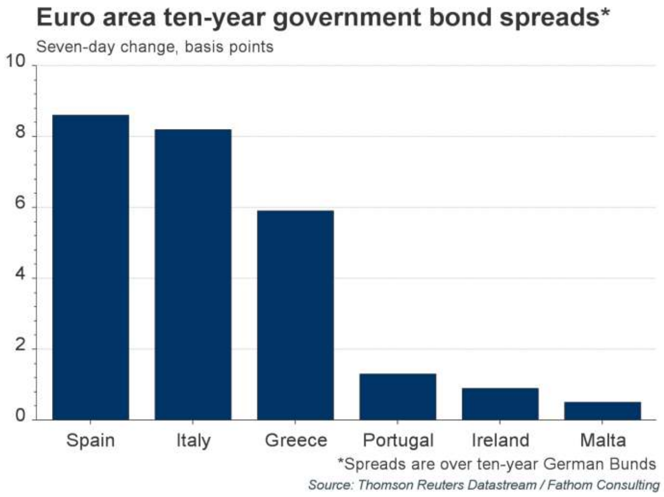
to broaden their appeal and gain extra votes. And, following the election, the formation of a loose coalition will necessitate compromise — Italy's membership of the currency union is unlikely to be called into question.

For now, the market has adopted a wait-and-see approach and, although the spread of Italian ten-year debt over German Bunds has risen in the past week, its spread over the equivalent Spanish debt remains broadly unchanged. We would argue that the balance of risks is skewed to the downside and see scope for spreads to widen further. This is partly due to the likely deterioration in fundamentals consistent with the short-term fiscal largesse of the above central scenario, compounded by our expectations that the ECB will end its quantitative easing programme in late 2018.



In Germany, members of the SPD may approve the coalition agreement; an important step towards our 'golden scenario'

Meanwhile in Germany, SPD members have been given a vote on whether to enter a 'grand coalition' with Angela Merkel's CDU/CSU bloc, the results of which are scheduled to be announced on Sunday. Given the SPD's pro-European stance, we view the outcome of this vote as important, not just for German domestic policy, but also for the success of President Macron's proposed European reforms.

The provisional agreement between the parties indicates only a modest increase in domestic spending (€46bn over the course of four years) and a commitment to keep running a balanced budget. Notable measures include: the targeted construction of 1.5 million new apartments (to counter rising rental costs); the phasing out of the solidarity surcharge for low- and middle-income taxpayers; and increasing research and development spending to 3.5% of GDP. Migration policy is left broadly unchanged and, absent the large inflow of non-EU refugees seen during 2015-16, net migration is expected to be between 180,000 and 220,000 per year — approximately offsetting the declining domestic population which would otherwise represent a large drag on trend GDP growth. Overall, given the size of the proposed fiscal expansion, we do not see these measures as sufficient to revise up our 2018 growth forecast for Germany, which remains at 2.4%.

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German economic policy under the coalition agreement					
Estimated cost, 2018-2021					
	Policy area	Estimated cost, € bn		Policy area	Estimated cost, € bn
1.	**Investment in the future: education, research, universities, digitisation**	**6.0**	**4.**	**Equivalent living conditions, agriculture, transport and municipalities**	**12.0**
	Day-care	2.0		Continuation of municipal and state programmes	8.0
	3.5% R&D target	2.0	**5.**	**International responsibility for safety and security development**	**2.0**
2.	**Families, children and social affairs**	**12.0**	**6.**	**Adjustments to the solidarity surcharge**	**10.0**
	Additional child benefit and allowance	3.5			
3.	**Building and living**	**4.0**			
	Further promotion of social housing	2.0			
				Total	**46.0**

Source: CDU/CSU/SPD/Fathom Consulting

On Europe, the coalition agreement outlined the parties' intentions to work "in close partnership with France" in order to reform the euro area. Key points included: proposals to increase German contributions to the EU budget; budgetary resources set aside for economic stabilisation and convergence; the intention to address both tax and wage dumping (e.g. through minimum corporation tax rates); and a willingness to transform the European Stability Mechanism into a European Monetary Fund**.** If implemented, these reforms would represent a significant step towards Fathom's 'golden scenario'.

A vote in favour of the grand coalition is by no means guaranteed and a rejection of the deal could see Germany return to the polls. Senior SPD officials were initially reluctant to join another grand coalition and the views of the wider party remain uncertain, with the 5% increase in party membership this year widely viewed as a sign of public disapproval with the coalition agreement. Nevertheless, a recent opinion poll suggested that the majority of SPD voters support the coalition. Overall, we expect the agreement to be passed, although we do not view this as a foregone conclusion.

Ultimately, we view the probable passing of the coalition agreement as a positive sign for our 'golden scenario'. However, if it were to be rejected and the Germans were forced back to the polls, then the political uncertainty could linger for some time. Thus far, it does not appear to have had an adverse impact on the economy, although the longer it persists, the more likely it is to weigh on growth. Meanwhile, the Italian election looks set to yield an indecisive outcome and the need for parties to work together in coalition reduces the scope for extreme policies to be implemented. We thus view it as providing only a limited downside risk to our central view and see little scope for any political fallout to spread to the wider region.

Ultimately, we do not see 'Super Sunday' as representing a significant downside risk to our central scenario

Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
andrea.zazzarelli@fathom-consulting.com
0203 879 9817
andrew.harrisi@fathom-consulting.com
0203 879 9826
www.fathom-consulting.com