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POLITICAL UPDATE: ITALIAN ELECTION, GERMAN COALITION

Berenberg Macro Flash

ITALY: BACK TO BAD OLD TIMES?

After years of unusually stable and reform-minded governments, Italy seems to be heading back to the messy and potentially instable coalition governments of previous decades. Whereas centre-left leaders Matteo Renzi (prime minister 2014-2016) and Paolo Gentiloni (PM since December 2016) introduced some useful reforms beyond the austerity pursued by Mario Monti in 2011-2013, chances are that Italy is heading for small-scale reform reversals and a less disciplined fiscal policy after the election on 4 March. The tail risk of a major upset, namely a genuine discussion about a euro exit, remains small but not zero. We put it at roughly 2%.

Opinion polls published just before the start of the two-week blackout period projected 37% for the centre-right/right alliance, 27.5% for the radical Five Stars and 26% for the centre-left alliance. Within the centre-right/right, Silvio Berlusconi's broadly pro-European Forza Italia was ahead by 17% to 14% versus the euro-sceptic Lega. Since these polls were conducted, Italy's political debate seems to have focussed mostly on immigration, a contentious issue that may suit the radical right more than other parties. Italy's new combination of proportional representation (for 64% of the seats) and first-past-the-post (36% of seats) makes the final result difficult to predict.

While we see a 10% chance that the centre-right/right alliance can win an outright majority of seats, it is significantly more likely that the shape of a new government will emerge only during potentially lengthy consultations with president Sergio Mattarella and among the parties.

Exit polls will be published upon the closure of polling stations at 22h GMT on Sunday. We will have to wait for the final result including the potentially decisive distribution of seats on first-past-the-post basis until Monday. For financial markets, the key issues to watch are:

- Would the **radical parties** of all stripes (Five Stars, Lega, Fratelli d'Italia) have a hypothetical majority of seats for a potential anti-euro alliance? While these parties would most likely not exercise that option, the mere risk that they could would be the most negative outcome for markets. This seems unlikely.
- Will the **anti-euro Lega** come ahead of Berlusconi's **Forza Italia** within the centre-right/right alliance and thus claim the right to nominate its leader Matteo Salvini as the alliance's candidate for prime minister? Berlusconi himself favours the staunchly pro-European Antonio Tajani (currently president of the European parliament) instead. Lega ahead of Forza would be market negative.
- Do the centre-left Democrats fall below 23% of the vote and thus do even worse than expected - that could be mildly negative.

Most other outcomes should be either neutral or possibly mildly positive for markets. For more see Carsten Hesse's [Italian election report](#) and presentation (attached).

GERMANY: LIMBO OVER AT LAST?

Will the political limbo be over on Sunday? We expect the 463k SPD party members to approve the coalition deal which party leaders have struck with chancellor Angela Merkel's CDU/CSU. The result will be announced this Sunday. Although many of the SPD rank-and-file would apparently prefer to renew their party in opposition, the fear that the SPD may drop even well below last September's dismal 20.5% in potential new elections will probably tilt the balance towards a "yes". Also, various opinion polls suggest that SPD voters want the SPD to join the coalition with Merkel (with 66% of SPD supporters in favour according to an Emnid poll published last Friday). The fact that the SPD has secured the finance ministry for itself in the



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envisaged new coalition should also help. If the SPD says yes, Merkel will be formally re-elected by parliament for a fourth term as German chancellor ahead of the EU summit on 22-23 March.

In the unlikely case (perhaps 25% risk) that the SPD votes down the coalition agreement, German president Frank-Walter Steinmeier would again play a key role. While repeat elections would be quite possible, he may first try to persuade Merkel to stay on as head of a minority government. Even in new elections, Merkel would likely continue to lead her party – and have another go at forming a coalition after such a repeat election. Judging by opinion polls, repeat elections would strengthen the Greens and – to a lesser extent – the right-wing AfD and the left-wing Left party mostly at the expense of the SPD and – to a lesser degree – also the FDP. Support for the CDU/CSU would be roughly stable. See also [German Politics: What If?](#)

On substance, we do not expect the likely transition to Olaf Scholz (SPD) as new German finance minister to make a decisive difference to domestic or European policies. The current mayor of Hamburg is seen as a safe pair of hands on the more conservative side of his party. He has vowed to maintain the “black zero”, that is a small budget surplus at the federal level. On European issues, he will be highly visible and play a significant role in negotiations. But as was the case with Wolfgang Schäuble, Merkel will ultimately call the shots. The German position will not soften by more than the conservative parts of Merkel’s CDU/CSU can accept. Offers of more German money will remain tied to tough conditions. A major increase in powers for the European Commission and/or the European parliament looks unlikely, especially as Martin Schulz (former head of the European parliament) had to resign as SPD leader two weeks ago. Instead, expect modest progress towards a banking union (such as the ESM turning into the final backstop in case that a major bank needs to be wound down) and some steps towards a building up a joint deposit insurance in the euro-zone over time. We also look for progress on non-economic issues such as defence.

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