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05 / 03 / 18

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ITALY: A MAJOR POLITICAL UPSET

Berenberg Macro Flash

Sunday's election seems to have landed Italy in a political quagmire. While none of the three big political camps is close to a majority, the two big radical parties have done significantly better than expected. It may take months of tortuous negotiations to form a government which apparently will need to be backed by one of the two big radical parties, the 5Stars or the euro-sceptic Lega. The tail risk that Italy may be heading for a euro referendum remains low. Still, it is not zero. The result will force parties of very different persuasions to compromise. That makes truly radical outcomes unlikely.

Projections based on a partial count suggest that the election result will have four features that may spell a period of significant political uncertainty for Italy and some concerns for financial markets:

- 1) The radical 5Stars have become by far the strongest single party with around 32.5%, some 5 points ahead of expectations based on the opinion polls two weeks ago.
- 2) Within the centre-right/right alliance, the radical and euro-sceptic Lega has surpassed Berlusconi's centrist and broadly pro-European Forza Italia. RAI projects 16.2% for the Lega in the Senate and 17.7% in the lower house versus 14.0% and 13.5% for Forza Italia, respectively. That gives Lega leader Matteo Salvini some claim to be the alliance's candidate for prime minister rather than Berlusconi's choice of Tajani, the current president of the European parliament. Whether the alliance sticks together after the vote could be an open question, though.
- 3) No government can be formed without the consent of at least one of the two big radical parties. While it remains unlikely that the 5Stars and the Lega will get together for a government, the tail risk that they could theoretically do so as they have a majority of seats could hang like a sword over Italian politics.
- 4) The staunchly pro-European and pro/reform centre-left Democrats have lost even more votes than expected, falling to roughly 19% versus expectations of 23%. Even with some small allies, the centre-left alliance achieved merely about 23% of the vote.

The inexperienced and radical 5Stars protest party can now play a crucial role in Italy. To broaden their appeal, they moderated their stance in the campaign significantly. Most importantly, they backed down from their earlier demand for a euro referendum. The risk that they may resurrect that demand probably remains low. Still, it is the key tail risk to watch. Furthermore, the 5Stars intend to abolish the Fornero Law (pension reform introduced under Monti in 2011). The introduction of a citizens income of EUR 780 per month is also a key policy proposal. Other aims are to change the budget rules (so that deficits can be higher), reduce taxes for SMEs, abolish 400 laws and fight tax evasion. For Lega, the key focus is on repealing the Fornero Law. The party aims to expel all illegal immigrants and introduce a 15% flat tax on personal income. Lega is euro sceptic and claims that higher GDP growth will pay for the election promises. However, few Italians expect the parties they voted for to keep their wild election promises.

Unless the 5Stars spring a positive surprise, the outlook for further pro-growth reforms in Italy looks dim for now. Instead, Italy could be heading for partial reform reversals and an increase in public spending that



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may lead to some conflict with Italy's partners in the EU. If the 5Stars focus more on their anti-corruption drive than their expensive spending promises, the outlook may be less concerning.

Much will depend on Italy's president Sergio Mattarella. He will decide after lengthy consultations whom he will give the first go at trying to form a coalition. For that, he need not follow the first recommendations of party leaders. Key options would be a broad "grand coalition" between the entire centre-right/right and the centre-left against the 5Stars or a government led by the 5Stars. The risk that new elections may have to be called – probably after the summer break – is not negligible.

Italian business confidence is likely to suffer. As it would be receding from a very high level, this will probably mean only a modest drag on Italian growth for now unless a new government were to adopt policies that were to scare businesses in a serious manner. Uncertainty now looms large for Italy. The result also complicates the outlook for European reforms. In an economic upturn, misguided policies may not make a dramatic difference. But in the long-run, Italy may have to pay a heavy price for reform reversals.

If we look at the projected seats won by the different parties and alliances for the Chamber of Deputies (lower house), the results are even more surprising. According to RAI (as of 6am GMT), the 5Stars are projected to win the most seats as a single party with 230-240 seats which is far above the c160 seats expected according to the last opinion polls before the two-week blackout period started, but still short of the overall majority of 316 seats needed in the 630 seat chamber. Lega is second place with 115-123 seats (vs. c.100 seats expected), followed by the Democrats and Forza Italia with 104-110 and 99-105 seats, respectively. The right-wing Fratelli d'Italia hovers around 24-32 seats and the left-wing Free and Equal around 11-19 seats. All other parties will likely not reach more than 4 seats. Overall, the centre-right/right alliance is still projected to be in the lead with 247-257 seats (although less than the c280 seats expected), ahead of the M5S with 230-240 seats and the centre-left alliance with 110-120 seats (vs. c.150 seats expected). A potential centrist coalition of Forza Italia and the Democratic Party would only have around 210 seats, far away from a majority. A hypothetical, though so far unlikely alliance of 5Stars and Lega would have a clear majority in the Chamber of Deputies with c355 seats.

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