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POLITICAL UPDATE: TROUBLE IN ITALY, SPAIN MOVES CLOSER TO A SOLUTION

Berenberg Macro Flash

ITALY: THE ERSTWHILE WORST CASE SCENARIO BECOMES REALITY

Before the 4 March 2018 election, we and many other observers had seen a coalition of the two big populist parties, the anti-establishment 5Stars and the right-wing Lega, as the worst-case scenario. This could now come true. Last night, the two party leaders reportedly agreed on key issues. Reports suggest that their joint government programme with a repeal of a key pension reform, a big tax cut and a generous basic income would defy economic logic and clash with EU fiscal rules. Italy's president Sergio Mattarella will meet the leaders of the two parties separately this afternoon, probably with an attempt to make the potential government programme less unrealistic.

Watch out for the risks: The Italian bond markets have been quite relaxed so far. The risk premium over German bonds is not higher than before the March 4th elections (c 130bps for 10 year bonds - see chart), despite the risks significantly increasing. Although the two radical parties seem to have backed away from their earlier euro-scepticism, possibly with just a pledge to study the idea of a "parallel currency", we need to watch two key risks:

1) **A potential clash with the EU over Italy's budget deficit.** Italy has already the second highest debt level in the Eurozone (c. 130% of GDP) and one of the highest budget deficits in the Eurozone (2.3% in 2017) despite above trend growth in 2017. Nevertheless, Lega and 5Stars reportedly plan to introduce a flat tax of 15%, a basic income for the poor and to cancel the 2019 planned VAT increase. Together, these measures could cost up to 6% of GDP. Although a 5Star-Lega government may not implement all of these measures fully, Italy's fiscal deficit could well breach the EU's 3% of GDP budget deficit limit. To force the EU to agree to a higher Italian budget deficit and avoid penalties for not meeting the EU budget rules, Italy might provoke clashes with the EU on other topics such as economic sanctions on Russia or European reforms that are currently being spearheaded by France and Germany.
2) Both the 5Stars and Lega want to reverse the 2011 **pension reform** which increased the pension age up to 67 by 2019 and based the pension level on the amount contributed over a working lifetime instead of on the final salary. Italy's pension spending is already the second highest in Europe after Greece (16% of GDP). Reversing the pension reform would become very expensive over the long-term.

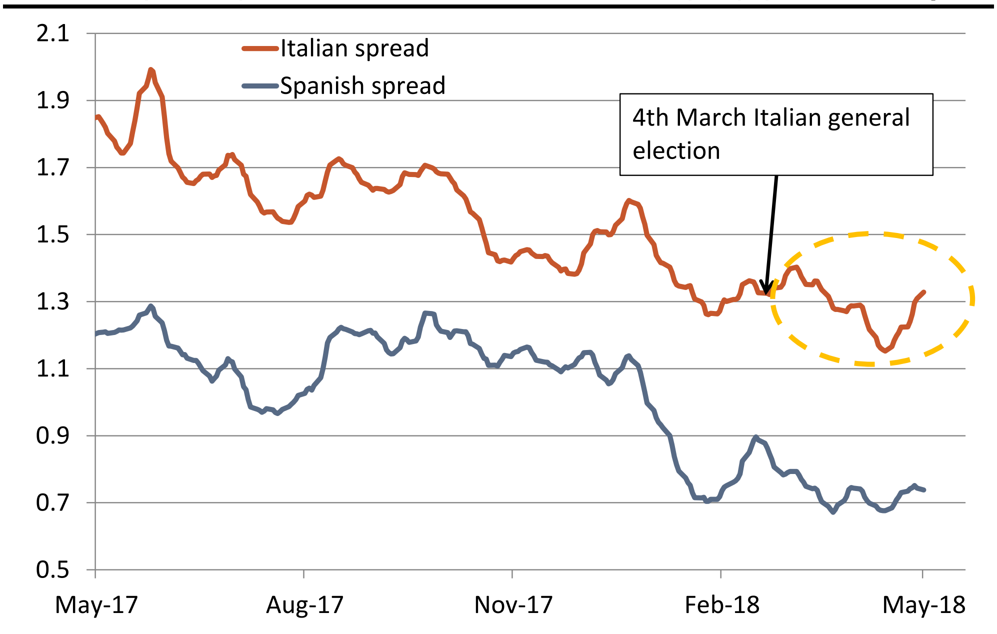
The question of who will become the Prime Minister is still open. 5Stars and Lega will likely present their candidate to Italy's President Sergio Mattarella either today or tomorrow. Mattarella may possibly refuse the candidate in order to exert influence on the policy plans of the future government. The president will probably prefer a technocratic candidate while 5Stars and Lega prefer a "political" candidate. If the parties and the Mattarella cannot find a compromise on this topic, the risk of early elections later this year might come up again. The presentation of the coalition programme likely later this week will be the second key event to watch out for.

Italy: the key long-term risk in Europe: Supported by the economic recovery and, at the margin, by the ECB bond purchases, markets have so far reacted rather calmly. However, a lack of fiscal discipline in combination with some reform reversals could potentially sow the seeds of a new Italian crisis once the current cyclical upswing is over. The risks are not imminent but nevertheless a serious long-term concern.

CATALONIA: TENSIONS EASING FURTHER
Remember the Catalan crisis which made so many headlines in late 2017? It has not affected Spain's overall economic performance very much and Spanish bond risk spreads are close to multi-year lows. The tensions seem to be receding further as, step by step, the Catalan nationalists are getting real. Today, the Catalan separatists will likely vote Quim Torra (a close ally of former regional president Carles Puigdemont) as Catalan President which should defuse the conflict further. It seems like the main separatist parties are shying away from new regional elections which would have been due on 22 May if no Catalan government would have been in place by then. Once again, secessionists are being forced to play by the rules outlined in the Spanish constitution.

With the election of a Catalan president, the probability that the Spanish government can end its current direct rule of Catalonia and return powers to the Catalan regional parliament is rising. This in turn will help Spanish PM Rajoy to pass the 2018 Spanish budget. He needs the support of the centre-right Basque PNV party (which favours greater autonomy for the Basque region but opposes political violence) which made the ending of the Spanish direct rule over Catalonia the main precondition to support the budget. Rajoy's budget proposal would increase all pensions in line with inflation for 2018, raise pay for police officers and increase tax breaks for families. The final vote on the budget will be on 24th May. If Rajoy manages to get the budget approved, the tail risk of early of early elections in Spain would decline further (the next general election planned in 2020). In May 2019 Spain will elect more than 8,000 majors in local elections, as well as 13 out of 17 regional presidents and European parliament elections.

Chart 1: Italy's risk spread did not increase since election despite populist risk rising



5-day moving average. Italian and Spanish 10 year bond yield spread over Germany in percentage points. Sources: Bloomberg, Berenberg calculation.

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