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THE WEEK THAT COUNTS: UPDATE ON EUROPEAN RISKS

Berenberg Macro Flash

The week that counts has started. After a drubbing for Italy's pro-European prime minister Renzi in local elections on 19 June, the German court verdict on the ECB's OMT programme on 21 June, the Brexit referendum on 23 June and the Spanish repeat elections on 26 June could make waves. If the UK votes to stay in the EU, markets may simply shrug off the other risks. However, a vote for Brexit could magnify the potential economic and financial impact of the other risks.

BREXIT POLLS: A SHIFT IN MOMENTUM?

The campaign to stay in the EU seems to have regained a little momentum, partly before and partly after the horrific murder of Jo Cox. A week ago, seven out of nine opinion polls had given a lead for those who want to leave the EU. The six most recent polls now show a roughly even split again, with the two latest poll suggesting a small advantage for those who want to stay in. If the tone of the campaign now becomes a little less shrill than it was before, that might help the side which in our view has the better arguments, the "in" campaign, versus those who have the catchy slogans, the "out" campaign. We put the Brexit risk at 40%.

For the potential impact of a Brexit on the UK and the EU as a whole, please see our report.

ITALY: FIVE STARS OUTSHINE RENZI IN ROME AND TORINO

Local elections have their own dynamics. Nonetheless, the results of Sunday's second round votes are a setback for Renzi as candidates of the populist left "Five Stars" movement won in Rome (as expected) and in the traditional centre-left bastion of Torino (more of a surprise). The results will be scrutinized for pointers as to whether Renzi may lose the October referendum on breaking Italy's perennial political stalemate. Renzi has tied his political fate to the referendum on downgrading the Senate from a US-style full second house of parliament into a small and mostly toothless chamber with powers more akin to those of the UK's House of Lords, to oversimplify matters a bit.

Most opinion polls still show the pro-reform camp ahead for October. However, two of the five polls published in June giving the edge to the anti-reform camp. Renzi is a good campaigner. We still expect him to win in October. If not, and if he then resigns, his government may try to soldier on without him until the next regular election in early 2018. But without Renzi's charisma, holding the government together could be difficult. The tail risk of early elections could excite markets. In opinion polls, parties that are occasionally toying with the idea of a referendum on euro membership (notably Five Stars, the ultra-right Lega Nord and the remnants of Berlusconi's once stronger and more reasonable centre-right) score about 50% or slightly more although a majority of Italians still seem to favour the euro and the EU.

GERMAN COURT: A TRICKY TASK

In the summer of 2012, the European Central Bank stopped the spread of contagion in Europe ('euro crisis') by announcing its readiness to back up European support programmes for struggling euro members with major bond purchases if need be. In January 2014, Germany's Constitutional Court voiced serious concerns about this never-activated OMT programme and asked the European Court of Justice whether the OMT is compatible with European law. Following the European court's verdict of 16 June 2015 that endorsed the OMT programme without serious restrictions, the German court will now rule whether the OMT, or the Bundesbank's potential participation in any OMT programme, would breach the German constitution.

Our best guess is that the German judges will not outlaw the OMT but place some constraints on any Bundesbank participation in a potential OMT programme. For example, the court could ask for sharp limits on any direct or indirect balance sheet risks that might be borne by the Bundesbank and some explicit quantitative limits on the OMT itself.

Would it matter? Probably not much for the time being. As the ECB is buying sovereign bonds as part of its quantitative easing programme anyway, the OMT backstop is not really needed at the moment. But if the German court were to pick a major fight with the European judges (unlikely) or further stoke the German public backlash against the best guardian of price stability that Germany has ever had (quite possible), it could nonetheless add to tensions in Europe. In turn, that would make it more difficult for the ECB to do its job.

SPAIN: BEYOND THE STALEMATE

Opinion polls still suggest that the repeat elections on 26 June could confirm the current stalemate, with no major shift in the polls so far.

- In case of a new stalemate, the most likely outcome after some noise would be a **grand coalition** between the two traditional mainstream parties, the conservatives and socialists (55% probability). The pressure on both to avoid a third round of elections would be immense. Such a grand coalition would not reverse many reforms but would not get much done either. For Spain, that would be good enough. It would allow the country to reap the benefits of the earlier Rajoy labour market and other reforms.
- If the result shifts by a mere 2 points in favour of conservatives or liberals, the two could form a **pro-reform coalition**. For Spain, that would be optimal (20% chance).
- If Podemos manages to lead a **left-left alliance** instead, possibly with some regional separatist groups, Spain could be heading for lower trend growth (perhaps down from 2.5% to 2.0%) by reversing some supply-side reforms. But a left-left government, for which we see a 25% risk, would probably shy away from a full confrontation with the EU about fiscal policy.

The Spanish population remains pro-EU and has little appetite for a confrontation with Brussels. The EU may use its delayed verdict on Spain's 2015 fiscal overshoot due in July to put serious pressure on any Podemos-led government in Madrid to not make too much nonsense. A government that does not reverse pro-growth reforms could expect a more lenient treatment.

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