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Italy, out of the World Cup and the Euro?

Summary

- **On Italian politics, we see mostly two scenarios before year end:**

    - President Mattarella's strategy to make Euro exit a clear and decisive campaign issue in the next elections is efficient, PD and FI could boost their score and reverse the current trend; with a possible Lega-FI coalition or Lega-FI-PD coalition. Believe it or not, Mr. Berlusconi could be a key man in those discussions.

    - President Mattarella's strategy fails and both Lega and M5S would be reinforced and ultimately in power. We view this scenario as the more likely.

- **What would a M5S-Lega coalition mean for Italy and Europe?**

  Euro-membership is not a major worry and room for fiscal expansion is limited. Momentum for Italian reforms and European Banking Union would clearly slow down and the ECB's exit strategy remains very slow (and could be slowed again because of this).

  Despite all the uncertainties, the genuine systemic risk linked to Italy (i.e. Euro exit) seems low. It is likely that (very much like in Greece) the populist government would prove to be a failure (after a few years) and more mainstream parties would come back in power.

- **The dramatic moves in BTP obviously raise the question of who is exposed to Italian public debt?**

  The combined exposure of European banks to Italian public debt is 293bn€. Unsurprisingly, the main systemic holders are UniCredit and Intesa, both strong banks. Even with an across the board 20% drop in bond prices, the impact for e.g. Intesa would be limited to ~350bps (before tax shield.) We believe these impacts are manageable considering the current buffer these banks have against their minimum CET1 requirements.

  Italian banks' financial strength could be impacted by indirect effects (NPLs could be more difficult to sell and credit quality could deteriorate) but NPL buyers take a long-term view and the Italian economy has been performing well over the past quarters. According to the BIS, Italy is one of the less likely candidates for banking stress currently.

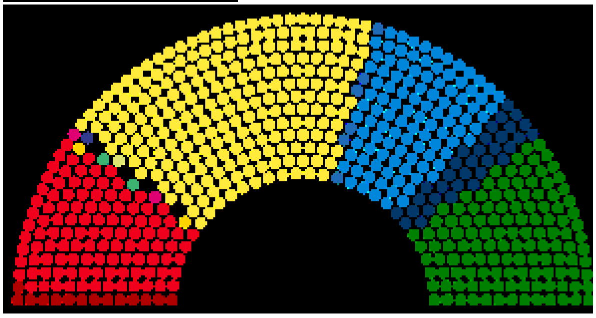
1. How did we get here?

The elections

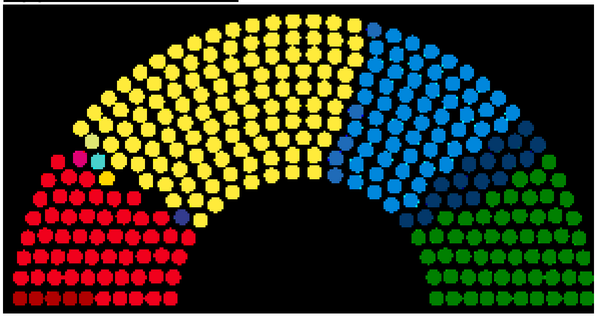
The outcome of the Italian elections was as expected by the polls and most analysts, including ourselves. More specifically, M5S performed slightly better than expected, at 32.7% of the popular vote vs 28%-29% in polls. PD's performance was slightly poorer than expected, at 22.9% of the popular vote for, the center left coalition vs. polls at 24%-25% but this was not of much importance.

Indeed, the final number of seats was awarded via a highly complex combination of "first-past-the-post" and "proportional" systems. This system, the result of many months of negotiations, was widely viewed as being designed to avoid a M5S majority. And indeed, it worked: under the first-past-the-post allocation, M5S got 40% of the seats in the Lower House, but this was globally reduced to 36.5% due to the proportional component. The detail of the number of seats can be seen below.

Lower House: seats



Upper House: seats



Green: League; Dark Blue: Brothers of Italy; Light blue : Forza Italia; Yellow: M5S; Red: PD. Source Wikipedia

However, there were two crucial pieces of news from the election:

1) The combined scores of the two most moderate parties (PD and FI) were too low to achieve a coalition;
2) The Northern League was ahead of FI within the center right coalition. This is partly a Northern League candidate who was chosen in many "center-right" strongholds of the North democracy.

This changed the dynamics of coalition possibilities. In our previous quarterly reporting, we had envisaged the following scenarios:

- Outright majority for any block; this is now excluded.
- A "German-type" coalition, with Forza Italia and PD – this is now impossible.
- A leftist coalition with M5S, PD and LeU is technically possible but would require some serious bridge building between M5S and PD and most probably a split of PD into two parties.
- An agreement between M5S and the Northern League to create a populist front – despite the different DNAs of both parties (Northern League was initially a pro-business party looking to secede from Southern Italy).

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- We believed a M5S minority government with the support of small leftist parties (LeU) was a possibility (of low probability) but is now ruled out as the combined seats are not enough.
- The centre-right block could form a minority government, with PD abstaining in a no confidence vote. If one removes the votes of PD, the "centre-right coalition" has 52% of the votes in the Lower House and 51.3% in the Upper House. This would work for a few months or maybe even to vote a necessary budget law with few amendments compared to the current budget, but it is hard to imagine how the situation could be sustainable.

The platforms of each party are briefly summarized below.

	M5S	**PD**	**Right**
EU / Euro	Anti €, organise a referendum	Pro €	Split: FI is pro €, League is anti €
Fiscal policy	Lower income tax by increasing the tax-free threshold.	Less progressive income tax (cost of €9-€12bn).	FI: replace income tax with a flat tax at 23%, only for income above €13,000. League proposes flat tax at 15%. Reduction of IRAP (regional corporate tax).
Public spending	Renegotiate the fiscal compact.	Exclude public investments from debt/GDP calculations.	Renegotiate EU treaties.
Pensions	Overturn the 2012 pension reform.		Overturn the 2012 pension refor.
Labour market	Abolition of Renzi's Job Act.	Minimum wage at 9-10€/h.	Abolition of Renzi's Job Act.
Immigration	Unclear	Pro-immigration	Anti-immigration
Benefits	Universal basic income (780€).	"Inclusivity income" (534€).	Dignity Wage (1000€), but not the League.
Financial sector	"Volker rule", creation of a public bank, national supervision.		

As you can see in the table above, the bridge to build between the League and M5S is not gigantic even though the two electoral bases are very different, as shown below.

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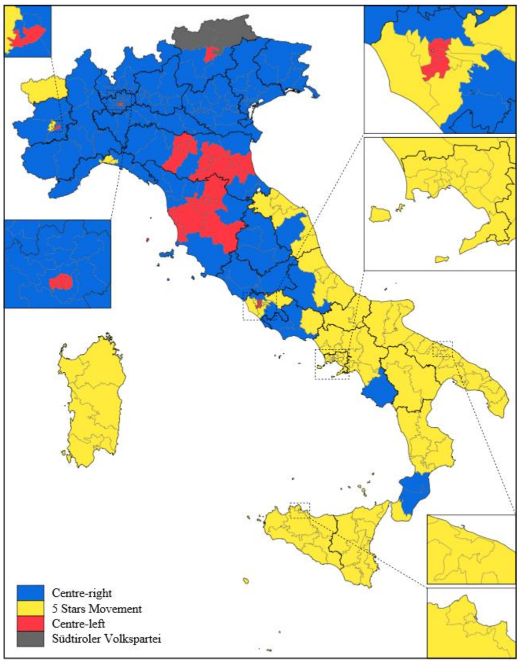
Italy is still divided North vs. South



Source: Wikipedia

Government Negotiations

The elections of the Presidents to the Lower and Upper Houses gave an insight into the dynamics of the talks. Ms. Casellati (of Forza Italia) in the Senate and Mr. Fico (of M5S) in the Lower House were elected easily but not without Mr. Salvini rejecting the first name submitted by Mr. Berlusconi for the Upper House.

The negotiations dragged on – to the point where President Mattarella threatened to dissolve the two chambers and organise elections in July. The idea did not please M5S or Lega, for different reasons. Under current M5S bylaws, members can only be appointed once to an official job – meaning that every single elected M5S MP would have had to be replaced by a new candidate within a few weeks – or the rules would have to be bent which is bad for the credibility of the movement. Moreover, elections in the summer appear more like a random toss of a coin (with most of Italy at the beach). This is far from an optimal solution for Lega who has a lot of momentum in Italy.

A series of events changed the situation somehow significantly.

- In Molise (south-east of Italy), on April 22nd, during local elections, the center right coalition won with 52%, vs. 31.6% for M5S (vs. 44.8% at the general elections).
- A week later, during local elections in Friuli-Venezia Giulia, M5S's score dropped dramatically compared to the general elections, from 24% to 7% whereas Lega achieved an extraordinary result at 35%. Nationwide polls confirm this trend as Lega is now polling at 25% vs. 17.7% achieved in March.

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- Finally, in an unexpected twist of events, on May the 12th an Italian tribunal canceled the remaining one-year ineligibility period of M. Berlusconi meaning he is now free to run for office.

Following this, the incentives somehow changed: Mr. Di Maio is still desperate to form a government (because of M5S bylaws) whereas Mr. Salvini and Mr. Berlusconi have a strong incentive to wait for new elections – just not in summer.

M. Salvini and M. Di Maio finally reached an agreement on a government coalition, selecting an unknown puppet with a dubious CV as prime minister (Mr. Conte) but Lega insisted on appointing a finance minister (Mr Savona) who was famous for having prepared (in 2015) a secret plan to exit the Eurozone. Memories of Mr. Varoufakis resurfaced. Moreover, even if the coalition agreement fell short of proposing a euro exit, it included controversial "Mini-BOTs" (effectively a parallel currency) and a leaked draft version included a request to the ECB to cancel the Italian public debt.

Faced with such proposals (and the negative market reaction) President Mattarella felt compelled to refuse the proposed list of ministers on constitutional grounds. Lega insisted that it was non-negotiable and government talks collapsed.

We do not know what actually happened, but we sympathise with a theory that is gaining grounds with Italian pundits: Both Mr. Salvini and Mr. Berlusconi have a strong incentive to see negotiations fail – but not immediately. Gaining time to avoid summer elections is obviously their best option. Is it possible that Mr. Salvini deliberately played President Mattarella and Mr. Di Maio to get to the point where we are now? Maybe, maybe not, but we find it odd that rumours that President Mattarella would abandon the option of a technocratic government to organise elections in June immediately triggered new talks of a possible M5S Lega government…

2. What's next ?

Unfortunately, our crystal ball is busy with the upcoming World Cup, so we have no definitive answer to the question of what is going to happen in the next few months in Italy.

We would however point out the following:

- Short term developments are largely irrelevant; we do not think summer elections or fall elections would make such a difference; we do not think having a technocratic and powerless government for two weeks or six months would make such a difference; we do not think the name of the finance minister (or even the prime minister) would make such a difference as he would not actually be the one making decisions.
- Ultimately, what we think is relevant is the (relatively) stable situation that will emerge in the short term (before year end.) Here, we see mostly two scenarios (*caveat*: this is Italy, so we are likely to be proven wrong!)
    - President Mattarella's strategy is rather obvious: he wants to make Euro exit a clear and decisive campaign issue in the next elections. In other words, he hopes to force

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M5S and Lega to clearly express their willingness to stay in the Euro (and possibly disappoint many of their core voting base in the process.) If he and more mainstream parties can achieve this, PD and FI could boost their score and reverse the current trend; with a possible Lega-FI coalition or Lega-FI-PD coalition. Believe it or not, Mr. Berlusconi could be a key man in those discussions.

  - If this strategy fails and both Lega and M5S can convince voters that they have been denied their democratic right to form a government by "foreign forces" (i.e. the European establishment) their score could increase, especially Lega. President Mattarella would obviously have to give in and a reinforced Lega + M5S would be in power. We view this scenario as more likely.

- From a timing perspective, we think elections must take place before year end because a budget must be voted – if only because otherwise automatic VAT rate increases will kick in and this is highly toxic politically.

3. What does it mean for Italy in the Eurozone?

What would be the real consequences of the M5S-Lega coalition?

Firstly, we should stress that Lega is a complex party. Born from an independentist, liberal, northern Italian party (which basically wanted to make a new Switzerland out of Northern Italy) it has evolved into a far-right, anti-immigration, anti-tax, anti-benefits party. But the old voting base of small business owners and wealthy people in Northern Italy is still very influential and cannot be completely dismissed by Mr. Salvini.

Secondly, the combination of the two platforms is terribly awkward: reducing taxes (flat tax proposed by Lega) and increasing public spending (universal income proposed by M5S) is unlikely to be very sustainable in the medium term and should trigger harsh opposition from European institutions (and recall that this was enough to oust Mr. Berlusconi a few years ago). We do not think this coalition would last very long and negotiations on a new electoral law (again!) would probably start rapidly.

All considered, on top of market volatility, we think the most significant structural impacts would be the following:

- The momentum of the reformed agenda of Mr. Renzi would stop - obviously this is not positive news but hardly dramatic either;
- It would strongly slow down any agenda for EU reform as no agreement could be reached among the three largest EU countries (Italy, France, Germany). This is particularly significant for the Banking Union which many Italians blame for the rise of populist parties (because of bank failures).

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As long as euro-membership is not called into question, these risks should be contained. Indeed, room for fiscal expansion is limited and the ECB's exit strategy remains very slow (and could be slowed again because of this).

Regarding the Euro membership, we are not very worried.

- All anti € parties have significantly watered down their rhetoric and are likely to be somehow trapped in the next campaign.
- A weak government will not have the required votes to pass drastic reforms (both on taxes and on Euro membership).
- The legal technicalities of the referendum in Italy mean that the start of a genuine Euro exit process is very unlikely, in our view.

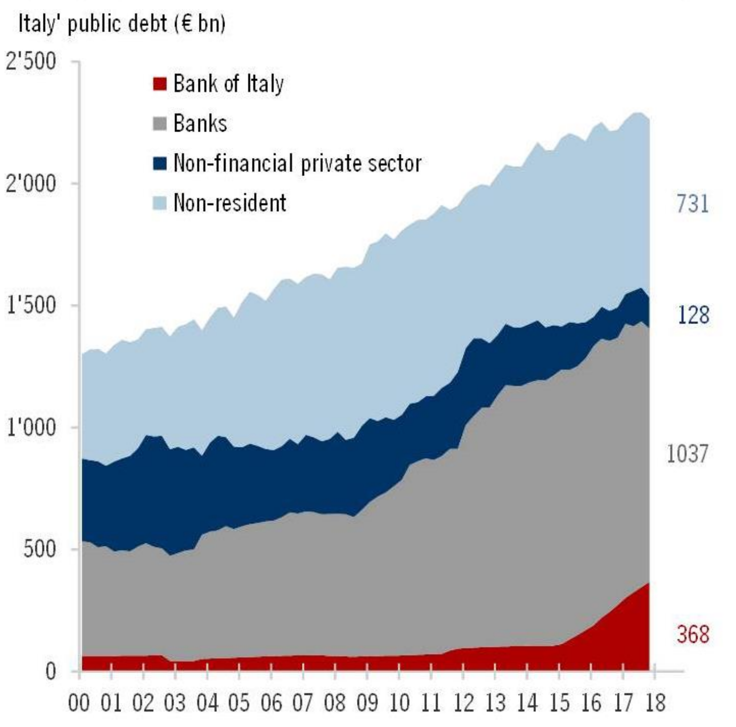
Hence, despite all the uncertainties, the genuine systemic risk linked to Italy (i.e. Euro exit) seems low. It is likely that (very much like in Greece) the populist government would prove to be a failure and more mainstream parties would come back in power.

4. What are the exposures?

The dramatic moves in BTP obviously raise the question of who is exposed to Italian public debt.

The official data is given below:

Exposure to Italian public debt



Source: Bank of Italy

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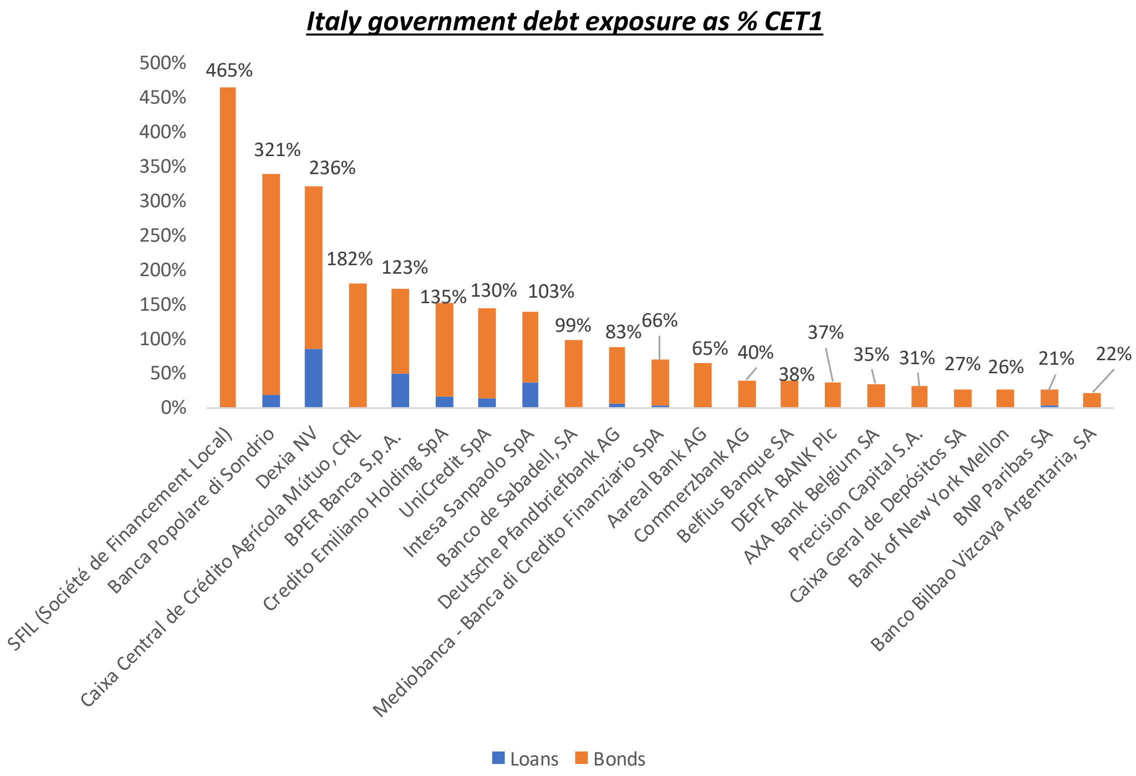
It is often said that we should not worry about Italian public debt because it is 70% owned by Italians! Not even mentioning the fact that Greek public debt was also largely owned by Greeks, we would caution against an inaccurate use of those statistics. First, the €368bn owned by "Bank of Italy" is actually the Eurosystem, so 82.5% non-Italian. Moreover, the €1037bn in "banks" is very misleading: the bulk of this is not banks' money (see below for details) but money belonging to the banks' clients. Obviously, there are many Italian clients in there, but we do not know the exact share.

What is the real exposure of banks, then? Thanks to very detailed EBA data we can break it down for the largest banks in the EU (representing ~76% of total EU risk weighed assets). The combined exposure is €293bn (as compared to €1037bn for Italian banks in official statistics…) The banks with more than 20% of their CET1 capital invested in Italian government debt are detailed below:



Source: EBA, Axiom AI

Out of the six most exposed banks, one is a French public bank, one is a bank in run-off and four are small sized Italian or Portuguese (!?) banks, all unlikely to have systemic importance. Unsurprisingly, the main systemic holders are UniCredit and Intesa, both strong banks in particular due to the drastic restructuring engaged by the new CEO of UniCredit.

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In the absence of a full-fledged default, the impact (for banks) of financial stress is that mark to market moves on government bonds are included in the fully loaded CET1 ratio – but not on P&L. Default has the same CET1 impact, but also a P&L impact. According to our calculations, the sensitivities of the largest Italian banks are the following:

Banks	+10bps widening
Intesa	-3bps CET1
Unicredit	-3bps CET1
UBI	-5bps CET1
BAMI	-4bps CET1
BPER	-1bp CET1
Monte dei Paschi	-4.5bps CET1

Source: EBA, Axiom AI.

Even with an across the board 20% drop in bond prices, the impact for e.g. Intesa would be limited to ~350bps (before tax shield). We believe these impacts are manageable considering the current buffer these banks have against their minimum CET1 requirements.

Arguably, indirect effects could also have an impact on Italian banks' financial strength (NPL could be more difficult to sell and credit quality could deteriorate) but we point out that (i) NPL buyers take a long-term view (obviously) and that the Italian economy has been performing fairly well over the past quarters. In fact, according to the BIS' own set of indicators, Italy is currently one of the least likely candidates for banking stress.

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Early warning indicators for stress in domestic banking systems

Table 4

	Credit-to-GDP gap	Debt service ratio (DSR)	Household DSR	Cross-border claims to GDP
Australia	−8.1	1.0	1.0	21.3
Brazil	−6.4	−0.9	...	0.5
Canada	9.6*	2.9*	0.7*	33.1*
Central and eastern Europe[1]	−12.5	−1.9	...	11.4*
China	16.7	5.1	...	−27.9
Finland	−5.2	0.9	0.8	−22.4
France	4.0	1.6	0.5	2.7
Germany	−2.1	−1.6	−1.9	6.9
Hong Kong SAR	30.7*	6.9*	...	−12.3
India	−7.8	0.5	...	−30.6
Indonesia	6.9*	0.5*	...	−10.9
Italy	−18.0	−1.2	0.0	−10.8
Japan	7.6*	−1.8	−1.0	20.5*
Korea	−1.3	0.1	1.7	−13.9
Malaysia	4.0*	0.4*	...	−1.6
Mexico	6.2	1.1	...	17.9
Norway	−1.0	−0.3	1.1	34.4
Russia	−4.6	1.8	1.8	−24.9
South Africa	−2.2	0.0	−0.3	22.1
Spain	−50.7	−3.6	−1.6	−19.5
Sweden	−11.2	−0.4	1.1*	−1.9
Switzerland	10.0*	0.7*	...	7.5
Thailand	6.7*	−0.6	2.8*	−16.6
Turkey	5.4	6.1	...	−1.2
United Kingdom	−17.7	−1.3	−0.8	0.6
United States	−6.9	−1.1	−1.5	−15.2
Legend	*Credit/GDP gap≥9*	*DSR≥1.8*	*DSR≥1.4*	*XB claims≥34*
	4≤Credit/GDP gap<9	*0.1≤DSR<1.8*	*0.6≤DSR<1.4*	*18≤XB claims<34*

Source: BIS. Credit to GDP gap is considered by the BIS as the most reliable indicator and is used to set countercyclical buffers.

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