



February 26, 2013

ITALIAN ELECTIONS: NO COALITION GOVERNMENT RISKS DANGEROUS FINANCIAL STRAINS

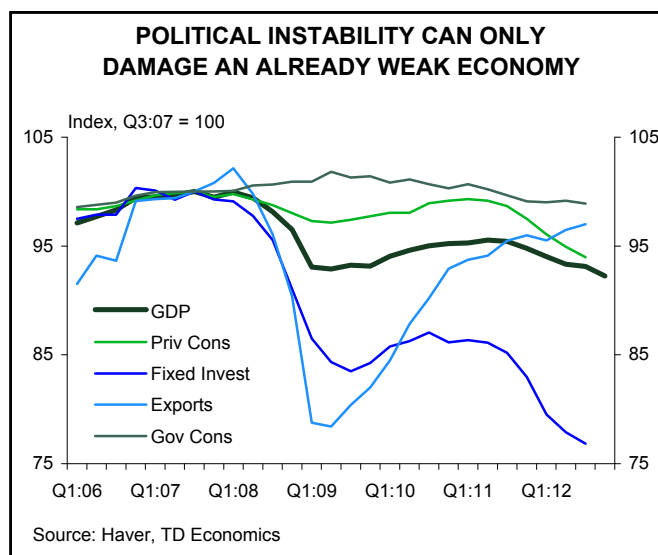
Highlights

- A senate race that yielded no majority party raises the spectre of political dysfunction, which, in turn, threatens Italy's sovereign debt stability.
- In the short term, financial conditions will deteriorate for Italian sovereign bonds, reinforcing the importance of avoiding a protracted political stalemate.
- There is potential for some reconsideration on fiscal adjustment targets across the euro zone, to give more breathing room for the countries facing the toughest economic backdrops. However, given that any relaxation requires investor buy-in, expectations should be kept on a short leash.

The Italian elections held on February 24 and 25 ended in victory for the center-left Democratic Party (PD) in the lower house and a fragmented outcome in the Senate. Seats secured in the Senate came to 116 for former Prime Minister Berlusconi's coalition, 113 for Bersani's PD, 54 for Grillo's anti-establishment Five Stars Movement, and 18 for outgoing Prime Minister Monti's coalition. Given these results, President Napolitano, Italy's head of state, will begin a consultation process with political leaders to decide whom to invite to form a government after the new parliament convenes on March 15. The process is further complicated by the fact that President Napolitano's term will end after the new parliament convenes. The election of a new president would take a month. If President Napolitano's term expires before a coalition is formed, new parliamentary elections would not be able to occur until mid-May. This potential delay makes forming a coalition now even more important.

Prior to the elections, political analysts speculated on a coalition government formed by Bersani's PD and Monti's alliance; however, the latter did not secure enough Senate seats to allow the two combined forces to reach a majority in the upper house. Therefore, if a coalition government can be formed, it will likely have to be between Berlusconi's centre-right and Bersani's centre-left coalitions, given Grillo's reluctance to participate in any coalition with the traditional parties.

Political instability in Italy would not only see the country's sovereign debt come under significant pressure, but it would also undermine Italy's ability to secure help from European partners. Both, access to a precautionary financial assistance program from the European Stability Mechanism (ESM) and the subsequent activation of Outright Monetary Transactions (OMT) by the European Central Bank, require having a stable government in office that can abide by the conditionality that comes attached to these assistance

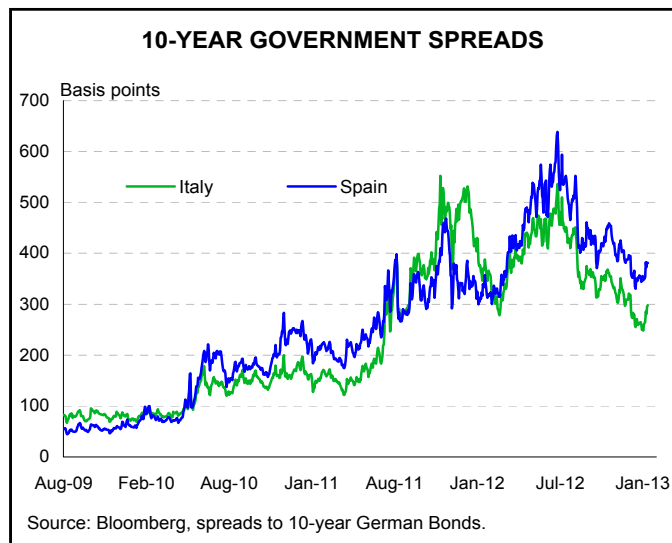


programs. Furthermore, access to a precautionary program can be granted to an ESM member country if:

- a) The country respects of the commitments under the stability and growth pact.
- b) It's general government debt is deemed sustainable.
- c) It still has access to international capital markets on reasonable terms.
- d) It has a sustainable external position.
- e) Domestic banks have no solvency problems that would pose systemic threats to the stability of the euro area banking system.

Given the current state of the Italian economy, a sustained spike in government bond yields triggered by political uncertainty would call into question the country's ability to comply with those requirements. Italian GDP has been contracting for the last six quarters and it currently stands 7.8% below its pre-crisis peak recorded in the third quarter of 2007. Total employment dropped to its lowest level in seven years in December and the unemployment rate has climbed to 11.2%. Even before the elections, the outlook for this year was not very encouraging. Italian real GDP was poised to decline by around 1% in 2013, weighed by a further contraction in domestic demand. Against this backdrop, gross government debt was expected to peak at 128% of GDP by year's end. If the political stalemate persists for too long, the actual results will likely be worse. This is why the stakes are high for Italian political parties to form a government, and this is also critical for the rest of the euro zone. Allowing market pressure to mount on Italy would also impact Spain, where the government does not enjoy much room for fiscal maneuver either. In turn, Germany will hold its federal elections in September and Chancellor Merkel's governing coalition does not stand to benefit from turmoil in the rest of the euro zone.

If we take things to the extreme, a scenario in which political dysfunction causes Italy's government to lose access to capital markets would force the country to request a fully-fledged, rather than precautionary, assistance program.



Contagion would then cause Spain to follow suit. Having both countries request financial assistance from the ESM and consequently dropping out of the pool of guarantors would put a tremendous strain on the ESM itself. And, with it, the entire crisis fighting infrastructure developed thus far by the euro zone would crumble.

For all these reasons, the incentives across the euro zone are aligned to have a working coalition in Italy, even if it is not a strong one that is guaranteed to last for the full 5-year term. This means that there could be some reconsideration on fiscal adjustment targets across the euro zone, to try to stem the decline in economic activity and give more breathing room for the countries facing the toughest economic backdrops. Otherwise, social discontent will keep rising and governments will become increasingly vulnerable. But, we have to keep expectations on a short leash, because any relaxation in fiscal tightening has to be funded through the market. As the market reaction this morning reminded us, investors will threaten to withdraw their support if countries do not show they are committed to their structural reforms agendas.

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