

5 October 2012

# Focus Europe

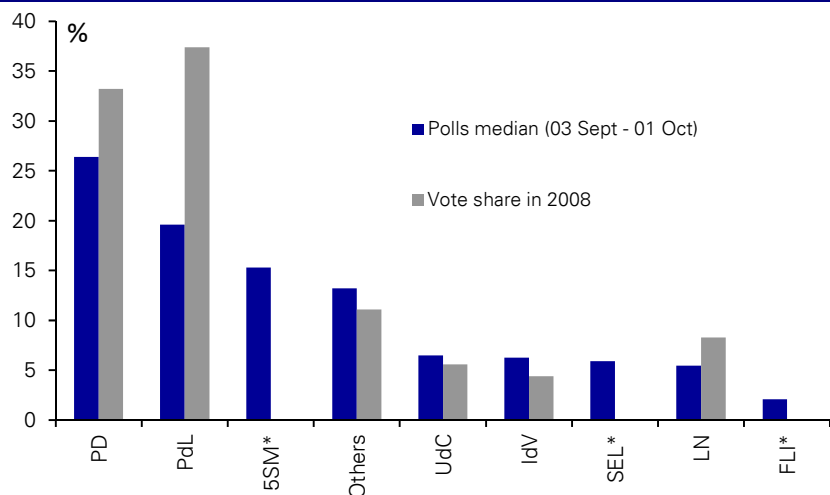
## Italy's political maze

We take a good look at the political situation in Italy. While uncertainty, six months ahead of the normal date for the general election, is made even higher than usual because of the ongoing discussion on the electoral law, we think that the most likely outcome is a broad coalition with Monti as PM.

The main risk for this week was that the ECB would either point to restrictions on the scope of OMT or make Spain's request of such support more difficult. Mario Draghi was reassuring on these two points. He repeated several times that the OMT's framework was ready to open fire once the request and the necessary MoU are signed. Draghi was sufficiently positive on Spain to signal that the central bank would not seek harsh conditionality. In our view, this leaves the timing of a request for support from the Spanish government to its discussions with Berlin. We are still faced with a classical "first mover problem", with the market as the ultimate deciding factor should the political conditions for an agreement remain too elusive. We also take a look in Eurowatch this week at lingering issues such as the relationship with Catalonia and Spain's "bad bank", as well as the coming Ecofin's agenda and latest data flow.

In the UK, this week's softer manufacturing and services PMI surveys pushed the composite index low enough to be consistent with underlying growth of just 0.1% qoq. This presents risks to our current view that the BoE will not sanction further QE when this round of purchases expires this month's end.

### Support for the main Italian parties is eroding



Source: Lorien, SWG, EMG, Euromedia, IPSOS, Datamonitor, DB Global Markets Research

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### Special Report

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## Economic Forecasts

	Real GDP % growth <sup>b</sup>			Consumer Prices % growth <sup>c</sup>			Current Account % of GDP <sup>d</sup>			Fiscal Balance % of GDP		
	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
<b>Euroland (top-down)</b>	-0.5	0.0	1.0	2.5	1.8	1.7	0.4	0.5	0.7	-3.2	-2.6	-2.0
<b>Germany<sup>b</sup></b>	0.8	0.8	1.5	1.8	1.6	1.9	6.1	5.3	5.0	0.0	-0.4	0.0
<b>France</b>	-0.1	-0.2	1.2	2.3	1.7	1.6	-2.5	-2.9	-2.7	-4.8	-3.6	-2.8
<b>Italy</b>	-2.4	-0.7	0.5	3.4	2.1	1.7	-0.5	0.3	0.2	-2.6	-2.0	-2.1
<b>Spain</b>	-1.5	-1.1	0.9	3.4	2.1	1.7	-2.9	-2.1	-1.2	-6.7	-5.3	-4.0
<b>Netherlands</b>	-0.4	0.4	1.2	2.9	2.5	1.8	8.0	7.0	6.0	-4.4	-3.5	-2.9
<b>Belgium</b>	-0.3	0.2	1.2	2.6	1.7	1.7	1.5	1.0	0.5	-3.6	-3.5	-2.9
<b>Austria</b>	0.8	0.4	1.2	2.4	1.8	1.8	2.0	1.5	1.0	-2.7	-2.6	-2.5
<b>Finland</b>	0.2	0.3	1.3	3.2	2.5	1.9	-0.5	-0.5	0.0	-0.5	-0.8	-0.7
<b>Greece</b>	-6.4	-3.0	1.5	1.3	0.5	0.2	-4.5	-4.0	-3.5	-9.2	-8.4	-6.2
<b>Portugal</b>	-2.9	-0.6	1.2	2.9	1.1	1.1	-8.0	-7.0	-6.0	-5.6	-4.5	-3.3
<b>Ireland</b>	0.2	0.8	1.9	2.2	1.7	1.5	1.5	2.0	2.5	-8.3	-8.0	-6.1
<b>UK</b>	-0.3	1.0	1.8	2.8	2.3	1.9	-2.3	-2.1	-1.8	-7.1	-7.2	-5.4
<b>Sweden</b>	1.0	1.5	2.2	1.4	1.7	2.0	6.2	5.4	5.2	-0.5	0.5	1.0
<b>Denmark</b>	-0.2	1.2	1.6	2.3	2.0	2.0	5.5	5.0	5.0	-4.5	-3.0	-2.0
<b>Norway</b>	3.5	2.0	2.5	1.0	2.0	2.0	15.0	14.0	13.0	11.0	10.5	10.0
<b>Switzerland</b>	1.0	1.5	1.7	-0.6	0.3	0.5	10.5	10.0	9.5	-0.3	-0.4	0.0
<b>Poland</b>	2.4	1.9	2.5	3.9	2.7	2.3	-4.0	-3.6	-3.9	-3.6	-3.3	-2.9
<b>Hungary</b>	-1.3	1.0	2.8	5.6	3.8	3.4	2.3	2.3	1.6	-3.0	-2.9	-2.5
<b>Czech Republic</b>	-0.8	1.0	3.4	3.2	2.4	2.1	-1.9	-2.0	-2.4	-3.5	-3.2	-2.7
<b>US</b>	2.1	2.0	3.1	2.1	2.4	2.6	-3.2	-3.5	-3.6	-7.2	-6.3	-5.3
<b>Japan</b>	2.4	0.8	0.1	0.0	-0.4	1.7	1.6	2.3	2.5	-10.0	-9.3	-7.6
<b>World</b>	2.9	3.2	3.8	3.3	3.4	3.5						

(a) Euro Area and the Big 4 forecasts are frozen as of 27/09/12. All smaller euro area country forecasts are as of 27/09/12. Bold figures signal upward revisions. Bold, underlined figures signal downward revisions. (b) GDP figures refer to working day adjusted data. (c) HICP figures for euro-zone countries and the UK (d) Current account figures for Euro area countries include intra regional transactions.  
Source: National statistics, national central banks, Deutsche Bank forecasts.

Forecasts: Euroland GDP growth by components<sup>1</sup> and central bank rates

Euroland, % qoq	12-Q1	12-Q2	12-Q3F	12-Q4F	13-Q1	13-Q2F	13-Q3F	13-Q4F	2012F	2013F	2014F
<b>GDP</b>	0.0	-0.2	-0.3	-0.2	0.0	0.2	0.3	0.2	<b>-0.5</b>	<b>0.0</b>	<b>1.0</b>
Private Consumption	-0.2	-0.2	-0.2	-0.2	0.0	0.2	0.2	0.2	<b>-0.9</b>	<b>0.0</b>	<b>0.6</b>
Gov. Consumption	0.2	0.1	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	<b>0.0</b>	<b>-0.9</b>	<b>-0.8</b>
Investment	-1.3	-0.8	-0.8	-0.6	-0.2	0.1	0.3	0.4	<b>-3.1</b>	<b>-0.9</b>	<b>2.2</b>
Stocks (contribution)	-0.1	-0.2	0.1	0.1	0.0	0.0	0.0	0.0	<b>-0.6</b>	<b>0.1</b>	<b>-0.1</b>
Exports	0.7	1.3	0.0	0.0	0.7	0.8	1.0	0.9	<b>2.5</b>	<b>2.3</b>	<b>4.4</b>
Imports	-0.2	0.9	0.1	0.1	0.4	0.6	0.7	0.7	<b>-0.3</b>	<b>1.7</b>	<b>3.5</b>
Net Trade (contrib..)	0.4	0.2	0.0	-0.1	0.1	0.1	0.2	0.1	<b>1.2</b>	<b>0.3</b>	<b>0.6</b>
HICP inflation, % yoy	2.7	2.4	2.5	2.4	2.0	1.8	1.7	1.7	<b>2.5</b>	<b>1.8</b>	<b>1.7</b>
Core inflation, % yoy	1.9	1.8	1.6	1.5	1.5	1.3	1.3	1.5	<b>1.5</b>	<b>1.4</b>	<b>1.6</b>
<b>EMU4 GDP, % qoq</b>											
Germany	0.5	0.3	0.1	0.1	0.2	0.3	0.4	0.2	<b>0.8</b>	<b>0.8</b>	<b>1.5</b>
France	0.0	0.0	-0.3	-0.4	0.0	0.1	0.2	0.3	<b>-0.1</b>	<b>-0.2</b>	<b>1.2</b>
Italy	-0.8	-0.8	-0.6	-0.3	-0.1	0.0	0.2	0.1	<b>-2.4</b>	<b>-0.7</b>	<b>0.5</b>
Spain	-0.3	-0.4	-0.6	-0.8	-0.4	0.1	0.2	0.3	<b>-1.5</b>	<b>-1.1</b>	<b>0.9</b>
<b>Central Bank Rates (eop)</b>											
ECB refi rate	1.00	1.00	0.75	0.75	0.50	0.50					
US fed funds target rate	0.25	0.17	0.10	0.10	0.10	0.10					
BoE bank rate	0.50	0.50	0.50	0.50	0.50	0.50					
BoJ O/N call rate	0.10	0.10	0.10	0.10	0.10	0.10					

Source: National statistics, national central banks, Deutsche Bank forecasts. (1) Forecasts in lower table as of 27/09/12

# A first step in the maze of Italian politics

- **We look at the main developments regarding the Italian parties, opinion polls and the possible change in the electoral law. The latter's influence on the election outcome should not be underestimated.**
- **Although there are still several elements of disagreement we think that on balance the parliament will find a compromise on a proportional system with preferences, entry threshold and a modest "majority" premium.**
- **Overall we think that such a compromise for a new electoral system would fail to deliver a clear winner in the next election. That would increase the likelihood of a broad coalition with Monti as Prime Minister.**
- **However, Monti may be reluctant to be the PM of a broad coalition unless the parties agree beforehand on a clear roadmap – a sort of internal MoU. An alternative is that Monti comes back after market pressure brings Italy on such trajectory.**
- **Uncertainty is however high and less market friendly outcomes cannot be discarded.**

## Overview

This note is a first step into the maze of Italian politics ahead of the general election to be held no later than April 2013 – probably in late March or early April.<sup>1</sup>

Uncertainty still reigns, indeed it is not even clear which electoral law will set the rules of the game. Since the end of last week, the debate has been focusing on those who are in favour and those who are against a new Monti government after the elections. Recall that on 27 September, while we were waiting for the Spanish budget, Monti said that although the most natural situation after next year election would be a political government led by a politician, he would be willing to serve again if (1) there were no clear winner after next year's election and (2) he were asked to do so.

To our knowledge, this has been the clearest hint so far that Monti would be willing to continue as PM in Italy. The first condition (no clear winner) is the most likely outcome. The second condition depends not only on the electoral performance of the pro-Monti parties but also on the rules

of the game. But we think that the outcome will likely favour the need for a broad coalition.

However, it is not a given that the current coalition (PDL-UDC-PD) is the only alternative. There is a risk that a party campaigning against Monti's reforms becomes part of the government coalition. Such an outcome would complicate a new Monti government.<sup>2</sup> That said, the market could be the greater ally of the pro-reform agenda. Straying away from Monti's path – or just announcing the intention to do so – will likely trigger an adverse reaction. The likely consequence would be to fall in the embrace of the ECB/ESM by signing an MoU focused (hopefully) on the need to implement and complete structural reforms.

Uncertainty and potentially high volatility are likely to characterise the journey towards the election and possibly the formation of the new government. But ECB Mario's strategy might turn to be an assist to the other Mario's agenda for structural reforms.

## Rules of the game

The current electoral system, along with the long debate about changing it, adds an extra layer of complexity to the already intricate political picture.

The 1993 electoral law was a step forward in terms of governability – for example it produced the longest serving government in the history of Italian Republic.<sup>3</sup> However, the electoral system was changed in 2005 by that very same Berlusconi's government.

The current electoral system represents a significant step back in terms of promoting government stability as it can lead to different majorities in the two houses of parliament. This might create an unstable Government or at worst a legislative and executive impasse given that the Italian Constitution is based on the complete equality of two houses of the Parliament. Furthermore the electoral system introduced in 2005 removed the ability of the electorate to appoint directly their representatives (for more details see the Appendix).

The importance of increasing the likelihood of a stable government is a necessity even too well known to those

<sup>1</sup> So that should give enough time for the new Parliament to be in place to elect the new President of the Republic in May.

<sup>2</sup> In our view it should not be a mere Monti 2.0, i.e. political representatives of the parties winning the elections are likely to be part of the Cabinet.

<sup>3</sup> The above statement is valid even when adding the governments of the Reign of Italy (1861.-1922)

familiar with Italian politics. And surveys confirm that the electorate strongly prefers a greater saying in the selection of the MPs.<sup>4</sup>

Indeed, parties in the Italian Parliament have been engaged in a debate on how to change the electoral system for more than a year. Unfortunately, no agreement has been found yet. We think that it is more likely than not that a compromise will be found – it is in the interest of the parties to show that they are not constantly locked in fruitless debates. Furthermore, the President of the Republic Napolitano is adamant that a solution is found; his moral suasion carries a heavy weight given his popularity. But there are several elements of disagreement.

In the appendix we discuss in more details the key elements of disagreement, here we simply summarise what we see as the two most likely outcomes:

- *Most likely*: the PD appears in minority in supporting a new electoral law based on a mix between the uninominal and proportional systems. Hence, the most likely outcome in our view is a proportional system (i) with preferences, (ii) parliamentary thresholds, (iii) possibly small electoral districts to partly gain the PD's support, (iv) but a modest majority premium. The consequence is that a grand-coalition will probably be necessary to form a government. In that case the most likely PM is Monti.
- *No agreement (second most likely)*: Although we think that a compromise will be found, there are several elements of disagreements – so there is the risk that an agreement will not be found. Voting with the current electoral list could lead to different majorities in the two houses and hence once again the need to form a broad coalition. This, however, is not the only possible outcome. As we discuss in the next section – there is the possibility that the PDL's share of votes falls further behind that of the PD and also below that of the 5SM. The 5SM could gain from this but it is unlikely to overtake the PD in our view. So in the lower house the PD or a PD coalition with SEL could obtain the 55% majority guaranteed by the current electoral law. For the Senate, note that the consensus for the 5SM could be distributed more homogeneously across regions than that for the PDL (and its Northern League's former ally) in the previous elections. So the PD could gain the 55% majority premium in several regions. In this instance a

government with the PD leader as PM would become more likely. This also implies that it could be in the interest of the UDC and PDL to find a compromise for the new electoral law.

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## External credibility factor

Italy's toxic combination of low growth and high debt requires a persistent, long decontamination process. Such process requires investors' confidence, otherwise higher yields will make any adjustment – fiscal consolidation and structural reforms – socially unacceptable. Recall that the impact of higher yields on growth in the first couple of years is more important than that on the deficit.

Hence, ex-ante credibility of a Government is essential. In our view, none of the political leaders provides an immediate, credible alternative to Monti. The above statement obviously applies to the candidates to different degrees – but it represents another element in considering the post-election options for a Government.

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## Participants

We provide here a brief description of the participants – in order of their performance in September surveys. We provide a preliminary summary of their likely stance towards a new Monti government – for a detailed analysis of their programme we will have to wait until we are closer to the elections. Note that this is a preliminary list; alliances might be defined closer to the elections.

**Democratic Party (Partito Democratico – PD):** PD is the main centre-left party, it was founded in 2007 through the amalgamation of eight centrist and social-democratic parties which had formed the coalition supporting ex-Prime Minister Romano Prodi. The PD is one of the three main parties together with PDL and UDC supporting the current Monti Government. The left of the party is close to the trade union CGIL, which is been very critical of Monti. His current leader is Pierluigi Bersani – who is also the leading candidate for the primaries at the end of November that will determine the leader for the forthcoming general election. His main rival appears to be the Mayor of Florence, Matteo Renzi, who would move the party to a more centrist position in our view. Nicola Vendola (Sel leader – see below) will also take part in the primaries. The part of PD closer to centre seems in favour of a continuation of Monti's agenda, but there is some possibility that the left of the party would not be willing to support a new Monti government.

**The People of Freedom (il Popolo della Liberta – PDL):** the PDL is a centre-right party founded in 2008 through the merger of ex-PM Silvio Berlusconi's party (Forza Italia) and Alleanza Nazionale, the leader of the latter party at the

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<sup>4</sup> For example in a survey on 24 September on what is "necessary to enter in a new phase of Italian politics" respondents' first choice was to reintroduce the possibility of selecting MPs.

time was Gianfranco Fini, the current Chairman of the Lower house (see below Future and Liberty party). At the moment it is unclear whether Berlusconi will decide to be the party's PM candidate or whether he will leave the role to the party's secretary Angelino Alfano. The strategy of the party is currently unclear. According to the Italian leading newspaper (*Il Corriere della Sera*, 5 October 2012) a conference redesigning the party's structure and strategy will be held on 2 December, around the same date of the second round of the PD primaries. The nature of disagreements within the PDL is similar to that in the PD but the internal tension within the founding parties is probably higher. The part of the PDL closer to centre (broadly identifiable with Forza Italia's original members) seems willing to support a broad pro-coalition for a new Monti government. The right of the party broadly identifiable with Alleanza Nazionale would be less willing, in our view, to support a new Monti government. Note that the poor performance in the local elections in May and in current opinions polls may exacerbate the divisions within the party. However, as we get closer to the elections, the likelihood of a split of the party is decreasing.

**The Five Star Movement – 5SM:** over the past 18 months the electorate has become more and more disillusioned with the main parties (the loss of consensus is particularly evident for the PDL – see next section). The number of undecided and those planning to abstain remains worryingly high for a democracy. But part of the protest vote is being channelled through the 5SM. The ideology of the 5SM is against the current political status-quo, pro-environment and in favour of direct participation of citizens in the political process. Populism also characterises the movement, which refuses to be called a political party. The 5SM has been built around Beppe Grillo, a comedian and political activist – however, the movement is supported by a heterogeneous basis. The common denominator seems to be disillusion with current political parties. Although the 5SM is often defined as a euro sceptic movement, there is no reference against the euro in its programme. Grillo has often spoken in the past about the possibility of leaving the euro to regain competitiveness, failing to see that Italy's public debt was accumulated when the country pursued that policy. He, however, recently denied that he wants Italy to exit the euro but that it should be a referendum to decide whether Italy should stay in the euro (*Corriere della Sera*, 22 September). Note that in a survey on 24 September 31.9% of the respondents said that going back to the Lira would benefit the country with 51.4% saying no (16.7%

did not respond).<sup>5</sup> The 5SM moved in polls from 3.6% on 13 January to a temporary peak of 20% in June as frustration with traditional domestic and European politics gained momentum (see next section). One of the most worrying aspects of the 5SM programme is not what it says but the lack of detailed, material policies on how to solve the key problem for Italy: the large stock of public debt accumulated before entering the monetary union and the lack of growth due to the disappointing productivity performance. Another concern is the movements' lack of experience in public administration. We think that it is unlikely that the 5SM will enter in alliance with any of the major parties.<sup>6</sup>

**The Union of Christian and Centre Democrats (Unione dei Democratici Cristiani e di Centro, UDC):** the UDC is a centre party; its leader is Pier Ferdinando Casini. Although in the past the party entered in alliance with Berlusconi's PDL, we think that it is more likely that UDC would side with the centre-left PD. However, an alliance with one (or both) of the major parties will occur only after the elections. UDC has been from the beginning the most enthusiastic support of Monti government in the current majority. So far, however, the party did not gain a boost from Monti's popularity – note that Monti maintained his distance from UDC as much as from the other parties. UDC officially supports a new Monti government. UDC is in favour of a proportional system with preferences which would increase the likelihood of a broad coalition and increase the importance of its role. An alliance with Fini's FLI is likely (see below).

**Italy of Values (Italia dei Valori, IdV):** IdV is a centrist, although more populist party than UDC. Indeed the party and his leader Antonio Di Pietro has strongly opposed Monti's policies. Di Pietro was Minister of Public Works in Prodi's first centre-left Government and Minister of Infrastructures in Prodi's second Government. Before entering in politics – he was a prosecutor of the so called "Bribesville" investigation against political corruption in the early 1990s. He is a long-standing critic of ex-PM Berlusconi, so an alliance with the PDL is to be excluded. However, since taking a strong stance against Monti's current government, it also seems unlikely that the party will re-establish its alliance with its former ally PD.

**Left Ecology Freedom Party (Sinistra Ecologia Libertà – SEL):** SEL was founded in 2009 by Nicola Vendola, the president of the region of Puglia and a former member of the Communist Refoundation Party. Vendola, a

<sup>5</sup> See 28 September entry (publication date)  
<http://www.sondaggipoliticoelettorali.it/ListaSondaggi.aspx?st=SONDAGGI>

<sup>6</sup> For the complete economic programme of the 5SM see pages 9 and 10 of the 5SM's programme <http://www.beppegrillo.it/movimento/>.

charismatic leader, used a less populist rhetoric against Monti Government than Di Pietro (IdV). However, the party's policies appear inconsistent with a continuation of at least some of recent structural reforms. For example together with Di Pietro, Vendola support a referendum to abolish even the small modifications to dismissal rules (Article 18) introduced by Monti Government.<sup>7</sup> We think that it will be difficult for the PD to reconcile the difference between SEL and UDC after the elections.

**Northern League (Lega Nord):** it was founded in 1991 from several regional parties in the North of Italy; the party's main ideology varies from seeking greater regional autonomy to invoking a highly unlikely independence of the North of Italy. The party's rhetoric tends to be among the most populist within the Italian Parliament. The party's has strongly opposed from the very beginning Monti government. This is not surprising, indeed even during the second part of the 2011 when regaining market confidence was essential, the Northern League took a populist stance against structural reforms. For example, it blocked any serious attempt at pension reform regardless of the Government's implicit commitment with the ECB in the summer of 2011. We think that a return of the Northern League to the government would make regaining investors' confidence more difficult. Following an alleged misuse of party resources by his family members and some close allies, the historical leader of the Northern League Umberto Bossi left the his position in favour of Roberto Maroni, Minister of Interior in the last Berlusconi's government. The party's performance in the polls is well below that in the 2008 election.

**Future and Liberty party (Futuro e Libertà per l'Italia – FLI):** FLI is a centre right party founded officially at the beginning of 2011 by the current chairman of the lower house Gianfranco Fini. In the summer of 2010 Fini created a new political group which exited the People of Freedom (PdL). FLI finally exited Berlusconi's government at the end of 2010. The party seems to have a very low support among the electorate but it could become an ally of UDC. Fini openly supports a new Monti government and continues to be a fierce critic of Berlusconi.

**An external player:** Luca Cordero di Montezemolo, the current chairman of Ferrari and previous chairman of FIAT, founded Italia Futura, a political think-tank and was seen as a possible candidate who could have led a pro-business centre coalition. After Monti's statement on 28 September that if asked he would be willing to serve again (see introduction above), Montezemolo said that he will not be a candidate, there will be no coalition with the

PDL or the PD but that he and his think-tank will strive to build consensus around the continuation of Monti's reforms.

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## Opinion polls

Deep dissatisfaction towards politicians seems to characterise public opinion. This is not a surprise given the lack of reforms over the past decade and the failure so far of the parties in the Parliament to grab their latest chance to show that they can at least improve Italy's institutional framework. The chance came into two forms.

First, changing the electoral law through a selfless process promoting (i) government stability and (ii) the ability of the electorate to select directly the members of Parliament. It is more likely than not that a compromise will be found – but once again the process has been too slow and apparently dominated by parties' short-term electoral considerations

Second, the Parliament had the chance to reduce costs of the bureaucratic process starting from the very top by reducing the Parliament headcount. While Monti pushed through a cut in the number of Provinces – one of the three layers of local governments – the parties did not follow their intentions of reducing the number of MPs. The latter was not important from a cost cutting point of view, but rather to decrease the anti-political sentiment which fuels support for parties such as the 5SM.

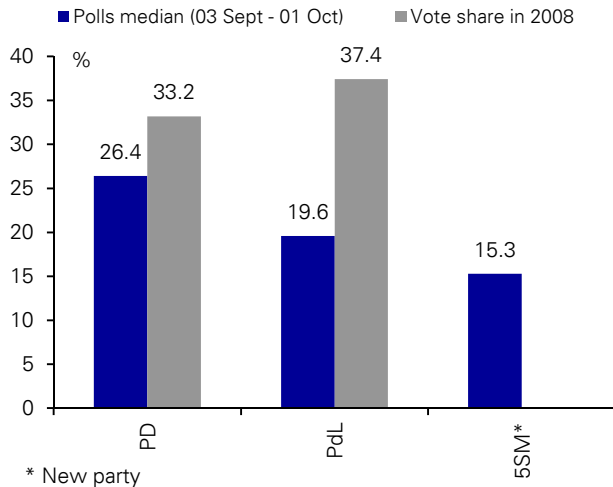
Taking into account that Monti government was dealing with emergency measures, the above disappointing performance becomes even more disheartening. This may be both a factor against or in favour of a new Monti government. On the one hand it increases support for the populist parties, on the other hand the weakness of the main traditional parties increases the likelihood of a broad coalition.

So it should not be a surprise that the key message from the current opinion polls is that the two major parties are likely to lose a significant proportion of their votes compare to the 2008 elections, but the fall in the PDL's share of votes far sharper (Figure 1).

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<sup>7</sup> See page 10 in Focus Europe on 1 June 2012.

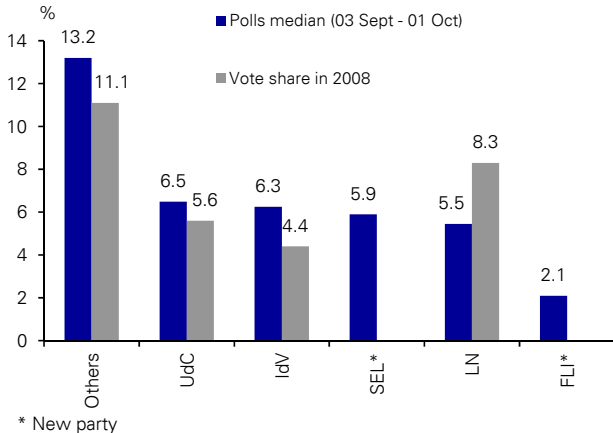
**Figure 1: Median of voting intention for the three largest parties**



Source: Deutsche Bank, Lorien, SWG, Ispo, EMG, Euromedia, EMG, Ipsos, IPR, SpinCon, Datamonitor, GPG

New entrants such as 5SM and SEL will become part of Parliament (Figures 1 and 2); unfortunately these appear unlikely to have a credible and clear plan towards solving Italy’s chronic low growth problem.

**Figure 2: Other parties**



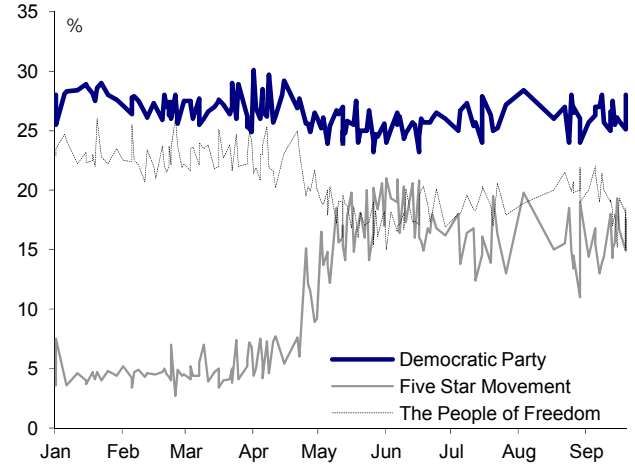
Source: Deutsche Bank, Lorien, SWG, Ispo, EMG, Euromedia, EMG, Ipsos, IPR, SpinCon, Datamonitor, GPG

Assuming an agreement based on proportional system with a parliamentary representation threshold, it is unlikely that the parties within the “others” category in Figure 2 will be able to pass the parliamentary threshold. So we could reassign their share of votes to the larger parties – however the net effect will depend on the “majority” premium.

The trend in opinion polls for the PD appears stable. Developments in the past month may affect the PDL: an alleged misuse of public resources in the region of Lazio led to resignation of the president of the region and the arrest of the former Lazio regional council PDL group leader on charges of embezzlement for using party funds

for personal purposes.<sup>8</sup> The main beneficiary may be the 5SM – so far no clear trend is visible in opinion polls although some surveys point to a weakening the PDL – see charts in the Appendix.

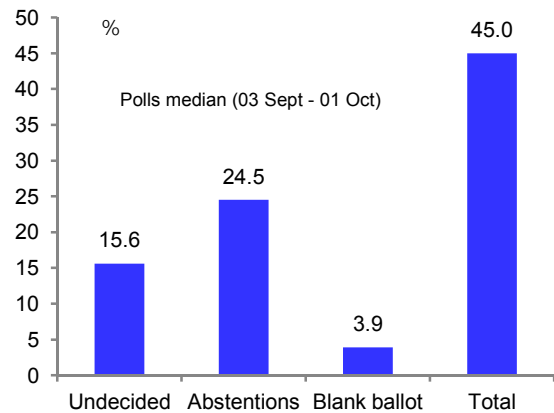
**Figure 3: PD leading, PDL and 5SM competing for second position, but ...**



Source: Deutsche Bank, Lorien, SWG, Ispo, EMG, Euromedia, EMG, Ipsos, IPR, SpinCon, Datamonitor, GPG

Another element that needs to be taken into account beyond the puzzle of the electoral law is that opinion polls show a high degree of uncertainty as summarised in the figure below (note that results are not reported consistently across surveys so the figure provides only a broad snapshot of the undecided voters and abstentions).

**Figure 4: ...there is room for surprises**



Source: Deutsche Bank, Ispo, Euromedia, EMG, Ipsos, IPR, SpinCon, Datamonitor

The greater risk is that a fragmented Parliament with a greater weight of populist parties leads to a standstill of reforms.

<sup>8</sup> See the following article from the Italian press <http://www.corriere.it/International/english/articoli/2012/10/02/fiorito.shtml>

## So what is the most likely outcome?

In the next sections we sum up the above elements by considering four possible outcomes – from what we see as most likely to the least likely.

### Outcome 1 – most likely: the full Monti<sup>9</sup>

Overall we think that the likely compromise for a new electoral system may not provide a clear winner in the next election. That would increase the likelihood of a broad coalition. As we see it, current political leaders will struggle to form a stable broad coalition. Hence, the likely compromise on the electoral law would increase the probability of a government where Monti is the Prime Minister.

It follows that, although uncertainty is high, the most likely outcome in our view is a broad coalition with politicians and technocrats in the cabinet with Monti as prime minister. Note that we think that it is unlikely that the approach of parties' external support to a technocratic government (i.e. no direct participation of key political figures in the Cabinet) will be replicated.

#### A commitment to an "internal MoU"

The key questions is whether with such a Government configuration structural reforms, along with fiscal consolidation and the privatisation programme, can be passed through Parliament and implemented without extreme market pressure.

The answer could be reassuringly positive if the major parties will decide to run on programme based on (i) completing the reforms initiated by the current government, (ii) maintaining a prudent fiscal strategy and (iii) supporting a gradual, realistic privatisation programme.

If that is not the case, there may be the need for external pressure. That could take the form of temporary periods of market pressure or a MoU, or both with the former leading to the latter. Any of these permutations could dent Monti's credibility. Recall that by not running Monti will remain vulnerable to claims that his potential continuation as PM is not a democratic outcome (an argument not too well-founded in a parliamentary republic in our view).

We think Monti will be reluctant to be the PM of a broad coalition unless the parties agree beforehand on a clear roadmap – a sort of internal MoU. An alternative is that Monti comes back after market brings Italy towards a MoU.

<sup>9</sup> The full monty is a British slang phrase of uncertain origin. It is generally used to mean "everything which is necessary, appropriate, or possible" [http://en.wikipedia.org/wiki/Full\\_monty\\_\(phrase\)](http://en.wikipedia.org/wiki/Full_monty_(phrase))

### Performance of the clearly pro-Monti parties

As we described before, UDC (and FLI) are the two parties that most clearly support a new Monti government. Hence, their performance in opinion polls could provide a useful metric to assess the likelihood of such an outcome.

### Acceptable versus counterproductive compromises

Having Monti involved in the government with a leading role may bring both short and medium-term benefits. It should increase the likelihood that the structural reforms needed to increase in the medium term the very low potential GDP growth of Italy are implemented. However, a possible short-term advantage of Monti's presence is to gain ex-ante credibility, or at least the benefit of the doubt. That would translate in lower yields; with benefits for the fiscal position and GDP growth. So two compromises may be sought by a winning coalition – a good one and a riskier one.

First the good compromise: rather than Monti as Prime Minister, a winning coalition on the centre left (more likely) or on the centre-right (less likely) could try to limit the risk of exit of its more extreme components by selecting the leader of the coalition as PM and Monti in a key role. Il Sole 24 Ore on 4 October suggested that such position could be the combined role of foreign and economic minister. So Monti would be in charge of a key ministry and at the same time represent Italy abroad.

Second, the riskier compromise in our view would be to elect Monti as the new President of the Republic. Recall that Giorgio Napolitano's seven-year presidential mandate terminates in May 2013 and he has already announced that he will not serve again. Although Napolitano by stretching his mandate played a crucial role in containing Italy's sovereign crisis, the role of President of Republic in Italy is mainly one of guarantor of the Constitution. The President cannot propose laws and does not proactively participate to the Government. We think that Monti's influence in that role would be weakened.

### Outcome 2: centre left coalition

Officially the leader of the PD Bersani does not support the return of Monti – his aim seems to be to form a coalition with Sel ahead of the elections and subsequently extend it to UDC to form a political government without Monti. We think that there is a concrete risk that a potential coalition with UDC and Sel, which may not be feasible, may not be stable.

The alternative would be to extend the coalition to IdV – however the relationship between PD and IdV seems to have been compromised by the latter party's aggressive rejection of the reforms introduced by Monti and the increasingly populist message over the past 12 months.

Hence we see the previous outcome – a new Monti government – as more likely. However, a few warnings are necessary before considering it as an inevitable outcome:

- It is not clear that the left of the PD would be willing to put up with a new government led by Monti.
- If the new electoral law allocated the “majority” premium to best performing coalition, the PD may form a pre-election coalition with Sel. Post-election, the leader of Sel, Vendola would have to be willing to abandon his opposition to Monti.

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### **Outcome 3: reform stalemate**

One of the key risks is that the complex political situation leads to a stalemate of the government functions leading to a failure to engineer policies aimed at boosting productivity and increasing the competitiveness of the domestic market. Such an outcome would not be tolerated by investors in our view.

In that case the best scenario is that Italy signs an MoU and with the help of the troika follows a programme centred on equilibrated structural reforms.

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### **Outcome 4: centre right or populist government**

The centre right does not seem to have enough electoral consensus based on current opinion polls to form a Government even if the UDC were to join PDL and Northern League (the parties were together in the second Berlusconi Government between 2001 and 2005).

A clear victory for the populist parties – for example 5SM, Northern League and IdV – would probably block the implementation of structural reforms.

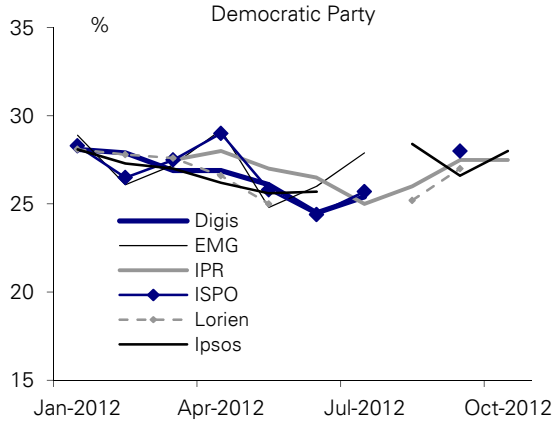
However, it does not appear very likely that the 5SM will decide to enter a coalition in a future parliament. Indeed, its ideology appears more suited to remaining in opposition. Although the 5SM is likely to attract some consensus from those who in the past voted for the centre-right PDL and the right-wing populist Northern League, we think that it could not enter a coalition with either of these two parties. So it would probably have to find allies from the centre (possibly IdV) and the radical left (e.g. Sel). But based on the above opinion polls they do not seem to have the numbers to form a majority. That said, there is still a large proportion of undecided voters.

***Marco Stringa, (44) 20 754 74900***

***See charts overleaf Appendix 1 for more opinion poll charts and Appendix 2 for a detailed description of the rules of the game***

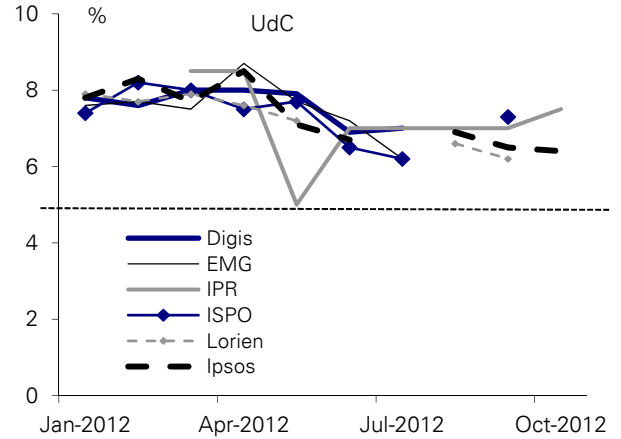
## Appendix 1: dispersion in opinion polls for top 6 parties

**Figure 5: PD (Democratic Party)**



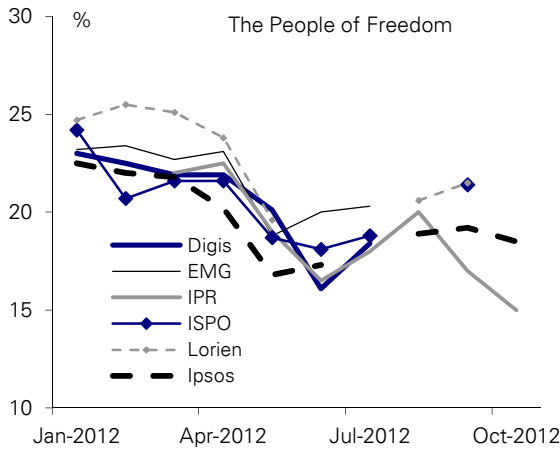
Source: see legend and Deutsche Bank

**Figure 8: UDC – The Union of Christian and Centre**



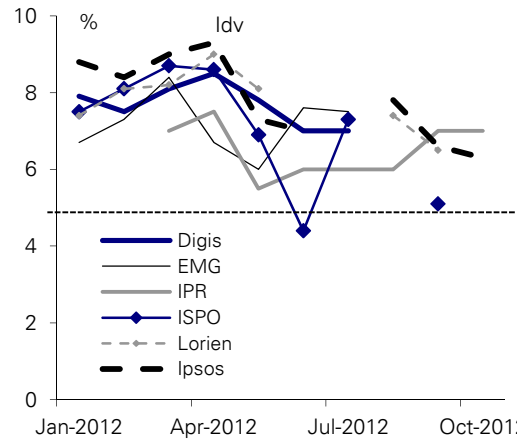
Source: see legend and Deutsche Bank

**Figure 6: PDL – The People of Freedom**



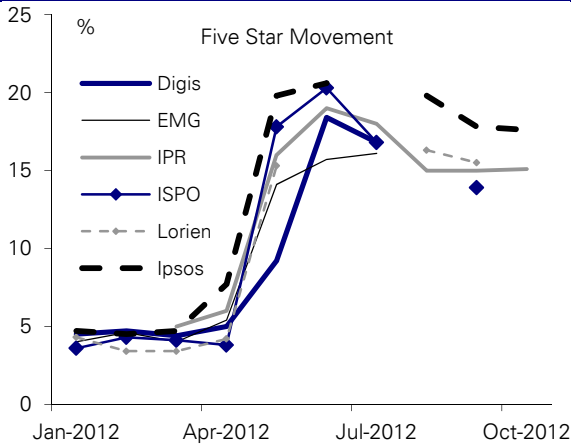
Source: see legend and Deutsche Bank

**Figure 9: IDV – Italy of Values**



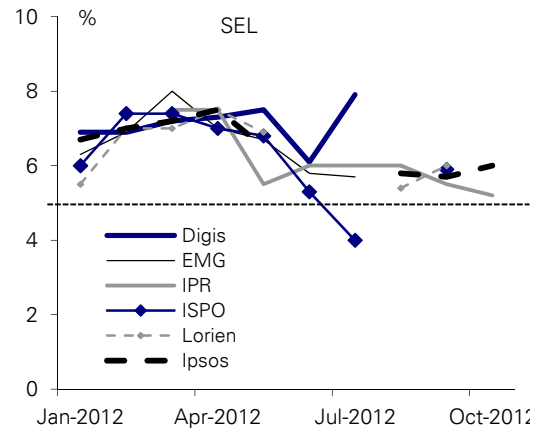
Source: Deutsche Bank

**Figure 7: 5SM – The Five Star Movement**



Source: see legend and Deutsche Bank

**Figure 10: SEL – Left Ecology Freedom Party**



Source: see legend and Deutsche Bank

## Appendix 2: Rules of the game

The current electoral system, along with the long debate about changing it, adds an extra layer of complexity to the already intricate political picture.

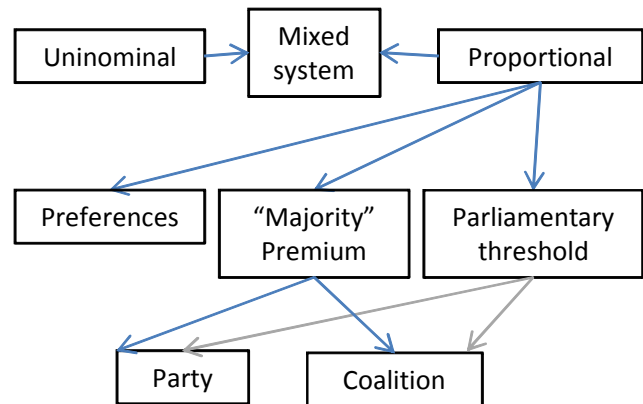
The 1993 electoral law was a step forward in terms of governability – for example it produces the longest serving government in the history of Italian Republic.<sup>10</sup> However, the electoral system was changed in 2005 by that very same Berlusconi's Government. The current electoral system represents a significant step back in terms of promoting government stability.

- First, the current electoral system could produce different majorities in the two houses of the parliament. In the lower house the parties forming the winning coalition at national level are guaranteed at least 55% of the seats. But in the upper house, the Senate, the 55% "majority premium" is allocated according to the results at regional level.<sup>11</sup> Given the heterogeneous popularity of parties across the country, a possible consequence is that the majority in the lower house will differ from that in the Senate. This might create an unstable Government or at worst a legislative and executive impasse given that the Italian Constitution is based on complete equality of the two houses of Parliament.
- Second, the electoral system introduced in 2005 removed the ability of the electorate to directly appoint their representatives. The individual MPs are selected based on the party performance and by pre-established lists chosen by the party leaders. The consequence, in our view, is to give a high discretion to the leaders of the parties and remove part of the electoral discipline in the selection of the best candidates. A risk is to decrease the debate within each party or, at worst, this aspect might be conducive in some instances to lower the average human capital of the Parliament.

The importance of increasing the likelihood of a stable government is a necessity even too well known to those familiar with Italian politics. And surveys confirm that the electorate strongly prefers a greater saying in the selection of the MPs.<sup>12</sup>

Indeed, parties in the Italian Parliament have been engaged in a debate on how to change the electoral system for more than a year. Unfortunately, no agreement has been found yet. We think that it is more likely than not that a compromise will be found – it is in the interest of the parties to show that they are not constantly locked in fruitless debates. Furthermore, the President of the Republic Napolitano is adamant that a solution is found; his moral suasion carries a heavy weight given his popularity. But there are several elements of disagreement. In Figure 11 we summarise the key elements and below we discuss the details.

**Figure 11: Elements of the electoral law puzzle**



Source: Deutsche Bank

### Uninominal vote versus proportional system with preferences<sup>13</sup>

There are at least three elements to discuss.

- First and most important the uninominal vote system, in our view, is more likely to produce a stronger majority and hence more likely to guarantee governability. This is particularly true if the system is based on two rounds as in France and at the same time the political spectrum is fragmented.<sup>14</sup> Indeed, our expectation is that the next election will likely deliver a fragmented parliament.
- Second, the uninominal system gives a greater say to the electorate in selecting MPs. That said the proportional system with preferences would at least improve the current system by reducing the discretion of the parties.
- Third, the choice of the system also influences the potential size of electoral districts. This is not a mere

<sup>10</sup> The above statement is valid even when adding the governments of the Reign of Italy (1861.-1922)

<sup>11</sup> The coalition winning at regional level receives at least 55% of the seats allocated to that Region.

<sup>12</sup> For example in a survey on 24 September on what is "necessary to enter in a new phase of Italian politics" respondents' first choice was to reintroduce the possibility of selecting MPs.

<sup>13</sup> Recall that in the traditional uninominal system only one candidate is elected per electoral district regardless of the victory margin.

<sup>14</sup> France uses a two-round uninominal system – where in general only the two candidates with the greater shares of votes go to the second round. The UK use only one round – "first-past-the-post"

technical factor. With a complete uninominal system the apportionment of the electorate is a function of the number of the seats. Preferences are compatible with larger districts. The larger is the electoral district the greater is the influence of traditional mass media such as television.

We think that the uninominal system would best adapt to Italy's needs. But an agreement on a complete uninominal system seems a near impossibility in the current Parliament. Our understanding is that only the centre-left PD supports a mixed system with a greater role for the uninominal system and a smaller one for the proportional system. Recall that based on 1993 electoral law – the one replaced by the current system – three-quarters of the seats were allocated through a uninominal system and the remaining one-quarter through a proportional system. However, it appears the majority of the other parties would prefer a proportional system with preferences.

#### **Elements to be decided in a proportional system with preferences**

There seems to be overall agreement that a pure proportional system without preferences is not among the possible choices, i.e. preferences will be included.<sup>15</sup> There are other elements that will influence the outcome of the election.

- *Parliamentary representation threshold*: a key risk of a proportional system is that it may produce an unstable majority that cannot effectively govern the country – for example by avoiding potential useful but controversial measures (e.g. structural reforms). The risk can be partially reduced by introducing a threshold. For example, in Germany half the seats in Bundestag are basically allocated by first-past-the post voting, the other half with a proportional system which includes a 5% threshold, i.e. parties collecting less than 5% of the votes obtain no seat in the proportional system. There seems to be a large consensus among the major parties in the Italian Parliament that a threshold will be included. There could be a threshold for single parties and a higher one for coalitions (the latter avoids that smaller parties form a temporary coalition with the only aim to pass the threshold).<sup>16</sup>
- *“Governability/majority” premium*. There seems to be a consensus among the parties that a premium to the

winner of the election is necessary if a proportional system is chosen; however the source of disagreement is twofold. The centre-left PD, currently leading the opinion polls, seems to be in favour of a *larger premium* (e.g.15%) given to the *wining coalition*. The PDL, Berlusconi's party, appears to be in favour of a *lower premium* (e.g. 10%) given to the *single party* winning the largest number of seats. Another option proposed by the Northern League is to give a material premium (~12%) at the *wining coalition* only if it obtains more than a given proportion of the votes (~40%-45%), otherwise the premium would be materially lower (~5%) or even null. However, the Northern League proposal seems to have been rejected by both UDC and PD. Note that the decision to assign the premium at the coalition or at the single party will influence the pre-election formation of coalitions.

<sup>15</sup> This means that there will be a small number of candidates per each party and the voter will give a preference to her favourite candidate(s).

<sup>16</sup> In the current Italian electoral law the threshold in the lower house is of 4% for single parties and 10% for coalitions calculated at national level. For the upper house the thresholds are roughly doubled but calculated at regional level.