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MACROCOSM

Elezione!

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Italy's byzantine election laws sow uncertainty. Berlusconi is a tail risk, but not a fat one.

Polls in the Italian general election open at 7am GMT on Sunday, February 24, closing at 2pm on Monday February 25th. The outcome of this election is very important for markets, because a return to power by Silvio Berlusconi would be very negative for euro area integration and reform. In his last tenure as prime minister, Berlusconi's refusal to cooperate with other leaders damaged the euro area's crisis response, and there is no reason to think that a new Berlusconi administration would be any different. He was forced out by pressure from the Italian president, the ECB and other euro area governments (see "Rome Makes Athens Look Good" November 10, 2011).

Before going into the likely election outcome, we need to understand Italy's byzantine electoral laws.

- The Italian parliament is a bi-cameral legislature, with control of *both* the upper house -- the Senate -- and the lower house -- Chamber of Deputies -- necessary for effective government.
- The election will be held under Electoral Law 270, introduced by Berlusconi's government in 2005. The law means there are different voting systems for each house of parliament.
- The Chamber of Deputies is elected on a *national* basis. The party that receives the largest vote-share *nationally* -- even if it is only a plurality -- is automatically guaranteed an absolute majority of 340 seats in the 630-seat chamber.
- The Senate is elected on a *regional* basis, rather than a *national* basis. The party that receives the plurality of votes *in a given region* is guaranteed 55% of the seats *of that region*.
- There are also thresholds that parties have to get over to allow them to enter parliament at all. In the Chamber of Deputies, it is 4% of the *national* vote, and in the Senate it is 8% of the *regional* vote.
- Under the law, parties may form pre-election coalitions -- as has happened in this election -- that must have a clear leader and common policies.
- This election has three broad coalitions: the right under Berlusconi, the left under Pier Luigi Bersani, and the center under Mario Monti.
- Voters do not get to vote for an individual candidate in the election. Instead they vote for a party list which allows the party to control which individuals will -- and will not -- get elected.

Update to strategic view

EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS: The complex Italian election system, and no polling data, means that predicting the outcome of the election is a risky exercise. But everything still points towards a Bersani-led government -- likely with Monti as coalition partner. Markets across the euro area have corrected somewhat, respecting the tail risk that Berlusconi could win, which would put integration and reform at risk. The correction would be extended if the election results in a hung parliament, necessitating another election. But the disastrous scenario of a Berlusconi victory is not being priced, and would result in a deep and protracted sell-off. We see that as acceptable tail risk, and reiterate our view that euro area debt and equities should be bought during this correction.

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- Last, Italians living outside of Italy also get to vote for their own representatives, with North America having two deputies and one senator, South America three deputies and two senators, Europe six deputies and two senators, and the rest of the world one deputy and one senator.

With that level of procedural complexity -- and a ban on publishing opinion polls until after the election -- picking a clear winner is difficult.

- In the lower house, because it is a national vote, Bersani is the most likely victor. His coalition should get enough votes to be given the majority. A Berlusconi victory here is very unlikely.
- The Senate is more complex. It comes down to five key regions -- Campania, Apulia, Piedmont, Sicily and Lombardy. The first three are likely to go to Bersani, with Sicily and Lombardy too close to call.
- If Bersani can win in Lombardy -- by far the most populous region in Italy, centered around Milan -- his chances of controlling the Senate, probably in coalition with Monti, are very high.
- If he does not, then there is a chance that it will be impossible to form a government. A Bersani/Monti coalition without a majority would not face a competing coalition that *could* form a majority. The main opposition would be Berlusconi and Beppe Grillo's Five Star Movement, which was originally formed in opposition to Berlusconi's previous government's policies.

By the time US markets open on Monday February 25, the first exit polls will be out. Once a clear idea emerges of the result in Lombardy, we will know whether Bersani will be able to form a government. At the moment the online political futures market at Intrade has him as a lock to be the next Prime Minister, with at 88% probability. We think that the correction in euro area markets over the last couple weeks has been driven largely by the tail risk that Berlusconi could win (see "Correction, Not Crisis" February 4, 2013). But the correction has been modest, which suggests that while markets are respectful of tail risk, they are generally comfortable with a benign outcome -- there has been no major sell-off.

- We think this is a sensible posture for markets to take, and when Berlusconi does *not* win, the correction will likely be definitively over. But this means that markets are not well positioned for a negative surprise.
- If Bersani cannot win Lombardy and there is a hung parliament, we may face new elections in the coming months. This would extend the period of uncertainty much longer than markets are now expecting.
- And there is always a chance -- however vanishingly small -- of a Berlusconi victory. That certainly would be a tail event for the market to absorb, and could lead to a large and potentially protracted sell-off both in Italy and across the euro area.

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Bottom line

The complex Italian election system, and no polling data, means that predicting the outcome of the election is a risky exercise. But everything still points towards a Bersani-led government -- likely with Monti as coalition partner. Markets across the euro area have corrected somewhat, respecting the tail risk that Berlusconi could win, which would put integration and reform at risk. The correction would be extended if the election results in a hung parliament, necessitating another election. But the disastrous scenario of a Berlusconi victory is not being priced, and would result in a deep and protracted sell-off. We see that as acceptable tail risk, and reiterate our view that euro area debt and equities should be bought during this correction.