

## Italian Update: Quitting but not leaving?

Italian Prime Minister Silvio Berlusconi's offer to resign was highly conditional. In comments to the press on Tuesday, Berlusconi offered to resign following his failure to secure an absolute majority in a procedural budget vote in the lower house of parliament. In recent days, the prime minister has lost the support of many from within his own party, as well as his main coalition partner, the Northern League. However, Berlusconi made his resignation conditional upon the passage of a package of reforms, something that is unlikely to take place until the end of November. Markets have reacted negatively to the news, with rates on Italian 10-year bonds rising to the highest levels in 14 years, increasing the country's borrowing costs dramatically and raising the risk of default on its \$2.6 trillion debt burden.

### Proposed timeframe could prolong political uncertainty

Citi's political analysts believe the timeframe proposed could prolong the country's political uncertainty for weeks, if not months. With two parliamentary votes ahead on the package, plus subsequent consultations between President Napolitano and Italy's political parties on the country's next steps before a new government could be formed or new elections agreed, the timeframe for attaining a measure of political clarity in Italy has lengthened significantly. If new elections were to be held, these could most likely take place in February 2012 at the earliest.

An extended period of uncertainty is likely to be troubling not only for markets, but for other international and EU players, Citi analysts say. In their view, the announcement that a leader plans to exit from the political scene would make his ability to command a parliamentary majority in an upcoming vote more difficult under normal political circumstances. By attempting to tie his personal fate to the passage of a package of measures demanded by both the EU and the financial markets, Berlusconi has demonstrated the political acumen that has helped make him one of Europe's longest-standing political survivors. In the meantime, EU Economic Affairs Commissioner Olli Rehn said after Tuesday's EU finance ministers meeting that Italy should pass reforms "the sooner the better, because time is of the essence". In Citi analysts' view, this message signals the EU's desire for politicians to come together promptly in support of stronger measures to restore faith in the economy.

### Italy's president wields the power to break the deadlock, but cannot force Berlusconi to resign

Citi's political analysts see a technocratic government of national unity as the best option for implementing structural reforms and maintaining investor confidence. A composition that would span the left and right sides of Italy's political spectrum and include trusted non-political figures stands the best chance of being durable enough to enact reforms, in their view. Such a construct has precedent in Italian history in the 1990's when unpopular measures were also required to bring debt burdens down for EMU entry.

Berlusconi's ruling party has underscored its support for new elections, while the opposition supports a technocratic government of national unity. According to polling data, a majority of the Italian public also supports the creation of a technocratic government. The ultimate arbiter on the next step will be the president, who will likely consult widely before taking a decision.

## What lies ahead

Citi analysts see two possible political scenarios for Italy: either a new center-right government under different leadership, or government of national unity, with either scenario ultimately leading to early elections in 2012. Berlusconi has said in widely reported remarks yesterday that he will not stand again for reelection, stating it is time for his deputy, Angelino Alfano, a former justice minister, to lead his center-right PDL party into new elections. Based upon his previous record of political re-invention, there is widespread doubt amongst Italian commentators that he will make good on his vow to resign and not run again. In Citi analysts' view, Berlusconi's personal credibility has been severely diminished by the combination of the loss of support from within his party and his coalition partner, as well as the international community, making a further political reincarnation difficult. The lack of faith in his leadership from market participants will be a further obstacle to a potential political return. It is now possible to speak of a post-Berlusconi era in Italy.

## Stability of Eurozone challenged

The political crises in Greece last week followed by Italy this week mark a serious challenge to the stability of the Eurozone, Citi analysts say. While European leaders will be reluctant to be seen to interfere in member state politics, the alarm evident in the bond markets may provide the political cover necessary to increase the pressure on Berlusconi to resign sooner than the timetable announced last night. One way this could transpire is in the event that Italy is compelled to ask for European Financial Stability Facility (EFSF) and IMF support, this support could be made conditional upon broad parliamentary backing for the program. In Citi analysts' view, without an earlier exit by Berlusconi and a clear move toward broad-based political stability than the late November timeframe that has been proposed, the Italian crisis could potentially trigger broader Eurozone contagion risks.

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