

Italian Constitutional Referendum on December 4: A turning point in European Politics

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- Background information:** Following the June 23rd Brexit vote in the UK and the Republican candidate Donald Trump's election on 8 November for the post of the 45th US President, political risk is looming in the euro area over the next 12 months. Italy's referendum on Constitutional reforms and Austria's repeat presidential elections on 4 December are the first on the political agenda, followed by the general election in the Netherlands in March 2017, presidential election in France (April-May 2017) and federal election in Germany (September-October 2017). Among the most notable euro-area events in the immediate future is Italy's constitutional referendum on 4 December that could have significant global market implications.

- Italy's Institutional reforms:**

The Electoral law reform: Matteo Renzi's government took office in February 2014 with an ambitious programme of institutional reforms, including the electoral system for the national parliament and the reform concerning the role of the upper house. As far as the electoral law is concerned, the previous rules had failed to produce homogeneous political majorities in the two houses in the 2013 national elections. Adding to this, in December 2013 the Italian Constitutional Court ruled that several features of the so-called "Porcellum" electoral law that was in place at the time was unconstitutional, leaving Italy with a proportional system for both chambers of the Parliament, as was the case in the 1980s, setting the ground for more political instability. A new electoral law for the Lower House came into force in July 2016 (the so-called "Italicum"), where the single party that wins in the first or second round in general elections obtains a majority premium in the Lower House (340 of the 630 seats, i.e. 54%). If a political party wins a minimum of 40% of the vote in the first round of a general election, there will no longer be a second round vote. Otherwise, the top two parties will compete in a second round. The new system is similar to that in Spain (seats won by a single party would be proportional to the number of votes received), including elements from the French two-round system, designed to reduce the proliferation of small political parties and ensure that the political party receiving the majority of the votes wins an absolute majority in the Lower House, even if it has not received 51% of the votes at the national level.

The supporters of the new electoral law argue that it will promote government stability, provided that the Senate reform is also approved. Nevertheless, the Constitutional Court should ratify, dismiss or decide to examine the new Lower House electoral law in early 2017. If Italy's Constitutional Court finally rules against the new law, this would decrease the probability of new immediate elections regardless of the referendum outcome, but it could increase the risk of future political stalemate.

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The Upper House (Senate) Constitutional reform: Italy is one of the very few countries worldwide that still adopts a “perfect” bicameral parliamentary system, under which both chambers of Parliament have almost equal rights and powers. That said, both the Lower House (the Chamber of Deputies) and the Upper House (the Senate of the Republic) have to appoint the government through votes of confidence, while at the same time approving any new legislation that has to be passed, including the Budget. To complicate matters, the electoral rules governing the Senate and the House of Representatives have always been slightly different so they can be dominated by opposing parties, as was the case in the general election of February 2013, causing political standstill in Italy given that no political coalition could secure an outright majority in both Houses of Parliament.

A reform towards a unicameral system, reducing Senate’s legislative power to a minimum, has long been advocated in the Italian political foreground. Indeed, a more general Constitutional reform including a limited role of the Senate was approved back in 2005, but was rejected by a national referendum in 2006. Following two years of debate and three Parliamentary readings after the 2013 election, the constitutional Senate reform was finally approved in April 2016 under Matteo Renzi’s government. The Upper House reform, which was designed in tandem with the new electoral law, aims at considerably downgrading the role of the Senate into a chamber of Regional and Municipality representatives with limited powers. The formation and survival of a government would depend only on the Lower Chamber of Parliament and the confidence vote in the Senate would no longer be required, so as to ensure a more solid Parliament and facilitate the approval and implementation of new laws and generally the government’s ability to act. Among others, the Senate reform includes the reduction in the number of Senators from 315 currently to ca. 100, who will receive only a salary for their Regional/Municipality role, and not additional compensation for appointing the government or approving the Budget. The “perfect” bicameralism approval process will probably be limited to specific matters like electoral law changes and/or Constitutional modifications. The final step to approve the Senate reform is the December 4th national referendum. The Senate reform requires a referendum because the amendment of the distribution of powers between the two chambers of the Parliament prompts a modification of the Constitution, while a new electoral law for the Lower House does not require any Constitutional alteration.

- **What is the referendum question? What do opinion polls predict for the vote outcome?**

Do you approve the text of the constitutional bill concerning "Dispositions for the surmounting of perfect bicameralism, the reduction of the number of Members of Parliament, the reduction of institutional operating costs, the abolition of CNEL and the revision of Title V of Part II of the Constitution," which was approved by Parliament and published in the Gazzetta Ufficiale n. 88, on April 15, 2016?

Voting will take place on Sunday December 4th between 7am and 11pm local time. The counting of the votes will start immediately after the closing of the polling stations and the result should be known by the early hours of Monday. Given that polls are not allowed in the last two weeks before the vote, the latest polls that concluded about two weeks ago have shown a 5-7 pps lead for “No”, pointing to an expected turnout of 55-60%. History suggests that a higher turnout has been accompanied with a higher probability of a “No” result, given that in the 2001 constitutional referendum the turnout was 34% and the result was "Yes", while in the 2006 constitutional referendum the turnout was 52% and the result was "No".

Nevertheless, this does not mean that it is going to be necessarily the case this time, as the result of the 2016 constitutional referendum has been closely linked with the fate of the government with Prime Minister Matteo Renzi suggesting earlier in the referendum campaign that he would resign in the case of a “No” vote.

- **What are the implications of a “Yes” or a “No” Vote?**

Scenario A: Senate reform is rejected – “No” vote

In case of a rejection of the Senate reform, Prime Minister Matteo Renzi will likely resign with markets probably taking a hard hit and the healing banking sector suffering the largest losses. Given that in Italy the President of the Republic decides whether to dissolve the Italian parliament and call snap elections, he would most possibly refrain from dissolving parliament in the absence of an electoral law for the Upper House and going to a new election with a proportional system at the Senate. Nevertheless, he could appoint a new Prime Minister (possibly Italian Finance Minister Pier Carlo Padoan or another member of the Partito Democratico (PD) i.e. Senate President Pietro Grasso) or give the mandate back to Matteo Renzi for a limited time period. Hence, a new short-term government supported by a parliamentary majority will be formed with a unique objective to pass a new electoral law at least for the Senate. Provided that an electoral law is passed, we would expect an early election in the second half of 2017, roughly a year before the scheduled general election in May 2018. Adding to this view, deputy secretary of the PD Lorenzo Guerini has recently suggested that in the case of a “No” result early elections would only happen after an electoral law is passed, highlighting that “if there is the political will, we can work over a brief period on a new electoral law, and have elections with a new electoral law soon, by the summer of 2017”.

Scenario B: Senate reform is approved – “Yes” vote

In case the referendum for the Senate reform is approved, Prime Minister Matteo Renzi remains in office. Although this is actually the best-case scenario at the moment, it is not expected to be a panacea for political stability nor the beginning of a new era of reforms, at least not before the general election in May 2018. Growing opposition to Mr Renzi’s political stance, including members of his own political party, adds to the view that there will be neither a systemic solution for the banking sector nor a significant fiscal deficit narrowing in line with the government’s recent commitments before the next election.

- **What are the latest market developments and implications?**

Italian assets have come under pressure particularly since the Brexit vote and the US Presidential elections outcome. The yields of 10YR Italian government bonds have risen and the spreads against the German equivalent ones have widened from 120bps in early September to over 180bps one week before the referendum. Accordingly Italian bank stocks have underperformed their European peers. In the past couple trading sessions Italy’s spreads vs Germany have retraced by more than 20bps from the recent wide ahead of the referendum as spread widening positions are squared. However, in the case of a “No”- especially on a wide margin- it is very likely that market volatility will rise but not to the extent that it will become intense and prolonged. In our view, the market has already factored in the high probability of a “No” vote in the current level of prices and is becoming more comfortable with the resulting political implications. On the opposite side, if “Yes” prevails, an extension of the current rally should be anticipated.

- **Italian economy: State of Play**

The referendum is taking place at a time of weakness for the domestic economy. The Italian economy is currently recovering from the protracted recession of 2012-2014. Having contracted by -2.8% and -1.7% in 2012 and 2013 respectively, output growth remained stagnant at 0.1% in 2014 and recovered only modestly by 0.7% in 2015-2016. The recession of 2012-2014 came on top of the painful recession in the aftermath of the international financial crisis of 2009-2010, so that the Italian economy is gripped in stagnation for more than a decade. The average GDP growth in 2007-2016 switched to negative territory at -0.6% from +1.5% in 1997-2006. Investments stand now 30% lower than its pre-international crisis levels.

As a result, the investments ratio of the economy, a reliable forward-looking prediction of sustainable medium term growth, declined to 17% of GDP in 2016 remaining relatively unchanged in the past three years vs. 22% in 2007. As a consequence of low total factor productivity-the lowest among the advanced economies in the last three decades- the gap between Italy and the rest of the Euroarea is growing. Under the current conditions, the economy is not expected to return to its pre-international crisis real output peak until the mid-2020s according to the IMF. The latter reflects the failure to address the structural rigidities in the products and services markets as well as public sector inefficiencies in the economy and has raised the urgency of structural reforms.

Ceteris paribus, the outlook for 2017 could not be significantly different. According to the most recent official forecasts (EU Commission Autumn forecasts, IMF WEO, OECD), GDP growth is going to stand in the vicinity of 0.9% in 2017. The growth recovery was supported so far by the ultra-expansive ECB monetary policy, favorable world energy prices, ongoing fiscal policy stimulus, and improved confidence on the back of the Renzi's government reform efforts. Despite the set of hiring incentives provided by the government scheme, unemployment is projected to have declined only to 11.5% in 2016 down from 12.7% in 2014.

At the same time, the fiscal position is at a precarious condition. Even though the budget is running small primary surpluses for since 2011, the general government deficit has been edging towards, nevertheless coming below the 3% of GDP. From that point of view, the primary surplus is projected at 1.3% of GDP and the general government deficit at -2.4% of GDP. Accordingly, the public debt stood at 133% of GDP in 2016 which is the second highest in EU-28. On the positive side, the current account is in surplus in the past three years (around +2% of GDP in 2014-2016). On top, the banking sector is not in good shape either. Mirroring the protracted recessionary conditions, the NPLs ratio has climbed to 18% in 2015 putting further strain on the banking system balance sheet and increase capital raising needs (portrayed in the last SSM stress tests results).

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