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FOCUS NOTES

Italian Referendum: Political uncertainty on the rise after PM referendum defeat

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- Italian Prime Minister Matteo Renzi announced in the early hours of Monday his decision to resign, after a government-backed referendum held on December 4 on Constitutional changes was rejected by the public by a wide margin. The plebiscite entailed proposals for curtailing the size and powers of the upper house of Parliament (the Senate of the Republic) and of regional authorities. Proponents of the reform argue that it would facilitate the legislative process and promote political stability as well as support investor confidence and economic recovery. The constitutional amendments had passed in Parliament in April, but a referendum was required as the bill fell short of receiving the required quorum of 2/3 of MPs in the second vote.

- According to the final count, the "No" campaign led with a share of 59.1% against 40.9% for the "Yes". The difference between the two outcomes exceeded earlier opinion polls that concluded about two weeks ahead of Sunday's ballot and indicated a smaller lead of 5-7pps for the "No" as well as a 55-60% turnout. The turnout also exceeded expectations coming in at almost 66%, surprisingly high for the standards of a referendum in Italy, in a vote largely perceived as a gauge of public support on the current government's policies, at a time when the domestic economy is mired in stagnation while the migration problem in Europe is fanning support for Euro-sceptic parties.

- The resignation of Prime Minister Matteo Renzi cuts short his four year tenure after just two and a half years in office. As we noted in our earlier Focus Note on the Italian referendum (December 2, 2016) this development stirs domestic political uncertainty and could pave the way for early elections. However, a snap poll does not appear to be the most probable scenario, at least at present. The Prime Minister is anticipated to hand in his resignation to President Sergio Mattarella later on the day. 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. As an alternative, he could appoint a caretaker government, supported by a parliamentary majority 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 ruling Democratic Party 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".

- Finance Minister Pier Carlo Padoan is currently considered as a favorite for the post of the new Prime Minister. However, Senate President Pietro Grasso and Transport Minister Graziano Delrio have also been rumored as possible candidates. The President may also give the mandate back to Matteo Renzi for a limited time period, for example until the 2017 budget is adopted by Parliament by year-end. In any case the incumbent Prime Minister will remain in his post until a new government is approved by Parliament. During this time, it is our understanding that the outgoing government will have to submit the 2017 budget law that needs to get parliamentary approval by December 23rd.

- The referendum outcome was not only a blow for the government but also a strong hit for the party leadership of Prime Minister Renzi. From the referendum result, one could conclude that the vote in favor of constitutional changes was favoured only by PD supporters. Inter alia, the referendum outcome raises doubts on his ability to lead PD in the next general parliamentary elections. From that point of view, the next PD party congress scheduled for next year will be crucial for his political career. In contrast, the Five Star Movement (M5S) and its leader are among the winners of Sunday's plebiscite and is broadly expected to boost further their popularity. Assuming that the new electoral law, that is underway, will need to incorporate stronger proportional elements at the expense of governability, the power of opposition parties will increase in future coalition governments.

- **Market reaction confirms our earlier expressed views:** Italian assets came under pressure on Monday, in a knee-jerk reaction in view of the referendum outcome. However, vindicating our expectations that the said result had been largely priced in by financial markets, the initial move proved rather short lived on the prevailing market perception that early elections will be avoided for now and that an interim government will manage to secure parliamentary support in the near future. In this context, the yield of the 10-year government bond rose to levels around 2.07% earlier today, before easing around 2.04%, not far from a multi-session trough of 1.89% reached last week and remained below the multi-week peak of 2.23% tested about two weeks earlier on mounting speculation that the ECB is ready to temporarily step up Italian government bonds purchases if the referendum outcome resulted to a spike in yields. In a similar move, the euro came under pressure against major currency peers, with the EUR/USD sliding to a 21-month low near 1.0505 in Asian trade, but later recovered by more than 2% to trade as high as 1.0740 in European markets. That said, the initial EUR/USD down-move may have been exacerbated by position squaring ahead of the ECB meeting later in the week.

- **Italian economy: State of Play**

  The referendum took 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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