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Italy's referendum: Short-term outlook and long-term implications

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ITALY'S REFERENDUM: SHORT-TERM OUTLOOK AND LONG-TERM IMPLICATIONS

Summary

The outcome of Italy's constitutional referendum on December 4th will probably have limited immediate impact on either the economy or the political system. The medium to long-term implications, however, could be severe. With a streamlined political system and a renewed commitment to reform, Matteo Renzi could finally address some of the deep structural flaws that have reduced Italy's growth potential to near zero. On the other hand, while we consider the risk that a No majority causes a full-blown political crisis as rather small, it would leave Italy with a lame-duck administration until 2018 (in the best case), push constitutional reform into the long grass and significantly reduce the outlook for economic renewal. If the eurozone's third largest economy does not grow in the medium to long term, the sustainability of the euro might be at risk down the line.

What is at stake?

Italians are set to vote on a reform of the Senate[1], the upper house of parliament, on December 4th. This reform (already passed by both houses in two rounds, as required for constitutional changes) would abolish the "perfect bicameralism" that has rendered governing Italy so difficult in the post-war period. The Senate would be reduced to a (much smaller) chamber of regional representation with very limited law-making competences. Future governments would solely depend on parliamentary support in the Chamber of Deputies, the lower house.

Italy's constitutional referendum: Key dates

Source: Allianz Group Economic Research.

Which way will it go?

Opinion polls, which at the beginning of the year indicated a sizeable (30ppts) majority for the reforms, have narrowed over the summer and more recently shown the No side in the lead. The polls are not very meaningful, however, because campaigning has not started in earnest and because 25-50% of Italians say they are undecided, depending on the poll.

Moreover, in recent elections and referendums, polls have often turned out to be of limited predictive value, since they have failed to capture disenfranchised, angry voter groups. Much will also depend on turnout of different groups, which will be very hard to

[1] The constitutional changes are much more wide-ranging, including a clarification of competences between the regions and the central government. Since the abolition of the second chamber in its current form is the most consequential of the proposed changes, we refer to the bundle of constitutional changes as the Senate reform.

predict, partly because of lack of precedents.[2] Attempts to predict turnout in other western democracies have usually carried large margins of error.

Prime Minister Renzi had originally tied his political fate to the referendum, pledging to resign if the vote was lost. The decline in his personal approval ratings this year therefore has also influenced attitudes towards the referendum. He has since backpedaled, saying he had made a mistake in personalizing the referendum and promising that no election would take place before the regular elections scheduled for May 2018. Whether the close association between Renzi and the constitutional referendum can be undone is not clear, however.

With over a month still to go, we consider the referendum too close to call, but we deem the risk of a No vote considerable – currently at over 50%.

Factors working in favor of a Yes vote:

- The slide in support for the Yes side over the summer may have been partly related to the bad showing of Renzi's Democratic Party (PD) in the May/June local elections. This effect should fade as we move into the fall. Also, Renzi's personal approval ratings have been recovering somewhat from their mid-year lows. Inasmuch as Italians still see the referendum as a vote on their prime minister, that should help the Yes side.

- The Senate reform is being billed as a step towards reducing the cost and complexity of Italy's public administration, which most Italians support.

- Renzi has embarked on a country-wide campaign to convince Italians of the merits of the reforms.

- Renzi is broadening the political debate to other issues, such as electoral and pension reform, in an attempt to deflect political frustration away from the question of constitutional reform. By adding other issues to the immediate agenda, Renzi also increases his bargaining power vis-a-vis coalition partners and other political parties.

- The discussions about the 2017 budget law (which is supposed to be passed in at least one chamber before December 4th) give Renzi an opportunity to shore up support through additional spending pledges. A confrontational stance in case the European Commission objects to higher spending may play into Renzi's hands, given that most Italians take a dim view of Europe's economic policies.[3]

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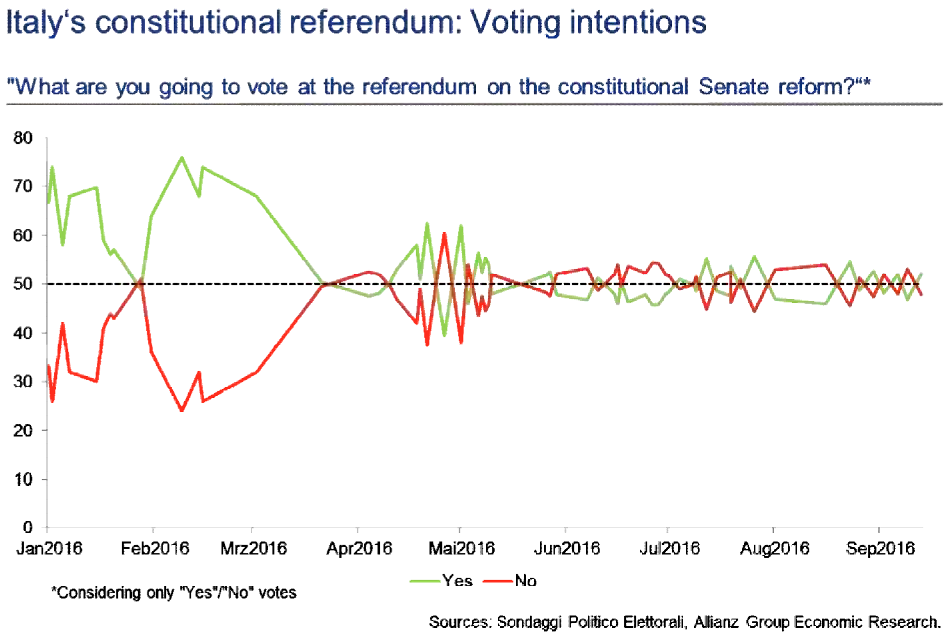
[2] Italy has held only two constitutional referendums in the post-war period. In the 2001 referendum, turnout was 34% and the changes (more powers for the regions) were approved. In 2006, turnout was 52% and the propositions (more powers for the prime minister and a division of tasks between the two chambers of parliament) were rejected. In both referendums, the outcome reflected prevailing government majorities. Italy has also had 16 referendums on ordinary laws but these, unlike constitutional referendums, have a minimum voting threshold of 50% to be valid.

[3] Although most Italians are broadly pro-European, two in three disapprove of the EU's economic policies. Pew Global Attitude survey, July 7th 2016.



Factors working for a No vote:

- All opposition parties as well as most trade unions and many media outlets will campaign against the constitutional reform. In past referendums, Italians often voted in line with their political loyalties.

- Usually when Europeans are asked to vote on a complex issue, they tend to ignore the question at hand and use the opportunity to express their support (or lack thereof) for their government, or vent their frustration with wider economic trends. This was the case not only in the 2016 Brexit vote but also, for example, in the French and Dutch referendums on the EU constitutional treaty, the Greek referendum on the Troika bail-out program or the Dutch referendum on the EU-Ukraine Association Agreement.

- Surveys show high levels of underlying frustration among Italians. For example, 84% of Italians think that their economic situation is bad[4], while the level of trust in government in Italy is 12 percentage points below the global average.[5]

- Economic growth has ground to a halt, although the change in the economic situation may be too imperceptible to sway many voters.

- We do not expect any further turbulences in the banking sector this year. But should renewed doubts emerge over the viability of the financial sector, this would reinforce doubts about the Renzi government.

- Since the Balkan route is closed, growing numbers of refugees are once again trying to reach Europe via the Mediterranean from Libya. Some 150,000 have so far arrived in Italy this year, according to UNHCR. In previous years, most refugees traveled on to other EU countries. Now, however, Italy's borders with Austria, Switzerland and France are closed. With unemployment in Italy at 11%, and real disposable income

4 In the UK ahead of the Brexit vote that share was 38%. 'Standard Eurobarometer, Spring 2016', July 2016.
5 30% vs 42%. 'Edelman Trust Barometer', January 2016.

falling since 2008, growing migration is likely to add to social and economic discontent.

Scenario 1: Yes vote – Italy reloaded?

If the constitutional reform passes the referendum, Italy has a chance of moving towards more stable governments and more effective law-making.[6] The Senate reform, together with a new electoral law (see below), would leave the executive in a stronger position, thus making it easier for future governments to implement their electoral programs. Increased political effectiveness, in turn, could reduce political dissatisfaction and cynicism.

A referendum win might also be seen as a popular vote of confidence in Renzi personally, which would put him in pole position for the 2018 elections. The next elections are set to take place on the basis of the new Italicum electoral law. Under this law, any party that gains at least 40% of the vote, or wins in a second-round run-off, automatically gains 54% of the seats in the Chamber of Deputies. The new law also favors single parties, in contrast to the existing electoral law that encouraged parties to enter fragile electoral coalitions.[7] That means that in case of a successful re-election, Renzi could hope for a clear majority in parliament, instead of leading one of the fractured coalitions that have often stymied Italian policymaking.[8] Renzi could then restart his reform program, which has almost completely ground to a halt this year.

While we see considerable upside from a streamlining of the political process in the medium term, the impact of the referendum on the political system and reform outlook will be gradual rather than immediate.

- The constitutional changes will not enter into force overnight. Some will need additional secondary legislation, while some will take effect only after the next election.

- Italy has, in any case, been moving towards a more executive system of government, with a stronger de-facto role for the prime minister. The Renzi government has frequently used executive decrees to govern, and there have been fewer instances in which a lengthy to-and-fro between the Senate and the Chamber of Deputies has paralyzed the law-making process.

- Although Renzi has ruled out early elections in 2017, he might still be tempted to capitalize on the political momentum generated by a referendum win to get an early mandate for reforms.[9] Much will depend, however, on how his Democratic Party is faring in the polls compared with the Five Star Movement (M5S, see Box 2). If he goes for early elections, economic reforms would remain on hold until a new government is in place.

A Yes vote would be a clear positive for the Italian economy and financial markets. In the short term, it would boost consumer and business confidence. Improving growth prospects would also reassure foreign investors. Credit spreads would tighten, albeit not

[6] Since the end of World War II, Italy has had more than 60 governments, of which only one completed its full five-year term.
[7] Although coalitions can run on a joint ticket under the Italicum law, the seat premium only goes to the biggest party. Therefore, the incentives for smaller parties to enter into an electoral pact are much reduced.
[8] At present, Renzi's PD lacks a majority in both the Senate and the Chamber of Deputies, which means he has to rely on a number of smaller parties in both houses to form a governing majority.
[9] Renzi took over as prime minister in 2014 after an internal coup in the ruling Democratic Party, so he has never been elected to this office. Nor were the previous two governments.

significantly given that only a small political risk premium is priced in. Equity markets would see limited gains.

As for the real economy, we expect the impact of improved sentiment to be limited in the short term while the growth impact of political reforms would take time to materialize, as explained above. We forecast GDP growth of only 0.7% and 0.9% in 2016 and 2017 respectively, even in our upside scenario.

In the medium term, increased political stability and effectiveness could raise Italy's growth potential, provided that a centrist government with a clear majority is taking advantage of the new political set-up to push through growth-enhancing changes (see Box 1 for details on these).

Box 1: How Italy can raise its growth potential

We view the following three areas as priorities to raise Italy's growth potential

1. Efficiency of public spending: By conducting a spending review, Italy could use its limited room for fiscal maneuver more effectively. This would allow the government to make growth-enhancing measures compatible with the ongoing consolidation of public finances.

2. Productivity and competitiveness: Reforms aimed at tackling the underlying reasons for Italy's growth deficit would encompass further product and labor market reforms, better regulation, further judicial reform and a more flexible wage bargaining system.

3. Tax system: Italy's tax wedge ranks well above the OECD average. Reducing the overall tax rate with a particular focus on labor and capital could be financed by broadening the tax base and introducing a modern real estate tax.

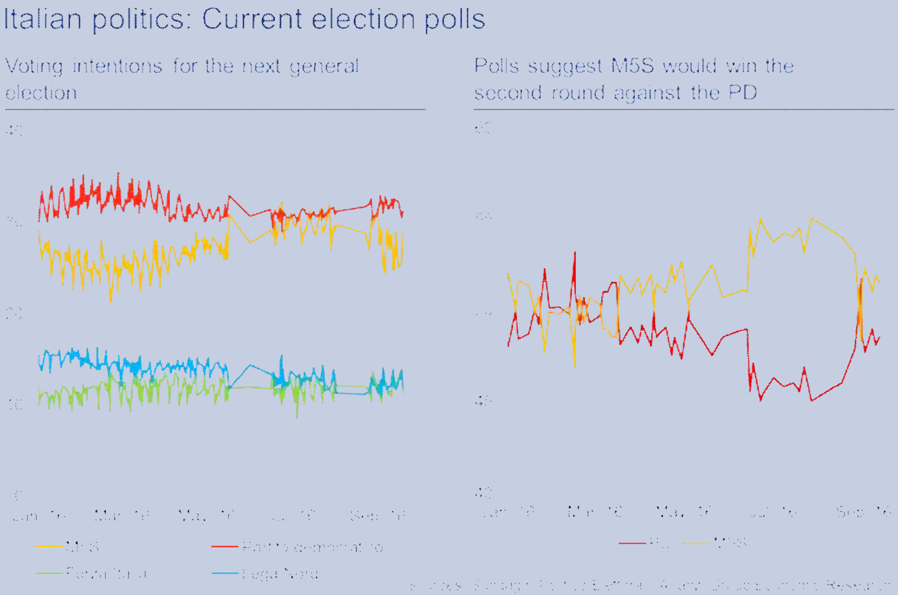
We estimate Italy's current growth potential at barely above zero – one of the lowest rates in the developed world. The combination of a more effective political system, streamlined state administration and comprehensive economic reforms could increase this rate to 1% over the medium term. Italy sorely needs higher growth to address its many fundamental problems, from stifling public debt to a fast aging population and an undercapitalized banking sector (of which more below).

There are several caveats to this upside scenario. Although the Italicum has been passed by parliament, there are legal challenges pending against it at the Italian High Court. The Court has postponed its review until after the constitutional referendum. If the Italicum law is declared unconstitutional in full or in part, it will have to be re-written and re-enacted before the 2018 elections. Another round of electoral reforms might take place even if the High Court approves the law. Smaller parties are opposed to its majoritarian elements while people even in the ruling PD fear that it could propel the M5S into power (see Box 2). If the Italicum is amended, for example allowing coalitions to claim the seat premium, another coalition government looks more likely after the next election.

Many of those now campaigning against the constitutional reform might be mollified by the prospect of further electoral reform. They argue that the move towards a unicameral system, coupled with an in-built majority for a single party, would leave Italy without effective checks and balances. Since some opposition figures accuse Renzi of autocratic tendencies, they seek to prevent a growing concentration of powers in his hands. The risk that the new constitutional setup – if accepted – will deepen the rift between the pro and anti-Renzi camps cannot be dismissed. With the center-right parties weak and fragmented, this may well play into the hands of the M5S, which has successfully capitalized on Italians' frustration with their ineffectual and seemingly self-serving political class.

Box 2: Downside in the upside – The Five Star Movement

Even if Renzi wins the referendum, political risks remain in Italy, with much depending on the outcome of the electoral reform debate. If the High Court accepts the Italicum in its current form, and the government desists from rewriting it on its own accord, it could end up mainly benefiting the populist Five Star Movement (M5S).



In Italy's fragmented political system, it is very unlikely that any one party will win the 40% required to gain the parliamentary seat premium in the first round. Therefore, the two parties with the biggest vote shares will go into a second-round run-off. Currently, the M5S is neck and neck with the PD in the polls. Unless the polls change, it looks highly likely that these two will be in the run-off in the next general election.

In the June local elections, which are conducted according to similar electoral rules, the M5S won 19 of the 20 run-off elections it entered. As an anti-establishment movement that borrows freely from the left and right, the M5S seems to be in a good position to attract voters from across the political spectrum. In a run-off election that translates into support of all those who do not support the particular party M5S is running against (70% of Italians do not support PD).

In June, the M5S won a couple of mayoral elections, most notably in Rome and Turin. In the months since the election, the local administration of Rome's high-profile M5S mayor, Virginia Raggi, has been plagued by scandals and resignations. Commentators have been quick to argue that Raggi's travails in Rome prove that M5S is unable to govern Italy. It is not clear, however, whether M5S voters, many of whom are motivated by a general disillusionment with Italy's established political class, will be put off by the M5S's practical difficulties.

There are, therefore, growing worries that the Italicum law, if unreformed, could lead to an M5S government in Italy (a similar seat premium helped Syriza into power in Greece). Such a government might be led by the 30-year old Luigi di Maio, who has been speaker of the Chamber of Deputies since 2013 and has trumped Renzi in popular approval for a while.

What such a government would mean for political stability, economic reforms and growth is extremely unclear. The M5S only has a limited party political program. To determine its stance on individual issues and personnel questions, the party relies on online polling of its registered members on a case by case basis. The M5S's five-person leadership has been trying to exert more control from the top, but that is not necessarily welcomed by the party grassroots, many of whom prefer to remain an 'anti-political movement'. The M5S's official line is that it seeks to abolish political parties and will not enter coalitions.

Since the height of the euro crisis, the M5S has been softening its stance on Europe. Neither a referendum on the EU nor on euro membership forms part of the party program, although party leaders have repeatedly been promising the latter (as does the nationalist Lega Nord). The M5S also campaigns for a more sustainable and more equitable economic model and for more opportunities of direct participation in democratic decision-making. Unlike most other European populist parties, it does not promise to stop immigration.

Scenario 2: No vote – Stuck in stagnation

If a majority of Italians votes No in the referendum, there would be an immediate blow to investor confidence but most of the impact – on political effectiveness, reforms and growth – would again be more gradual – albeit in this case clearly negative.

The political ramifications of a No vote in the referendum are hard to predict, but on balance we consider a return to political paralysis more likely than a full-blown political crisis. Hopes for political and economic reform would be dashed in the near term, condemning the country to policy gridlock and economic stagnation. Italy's continued economic decline may turn into a challenge for the EU and the eurozone in the medium to long term. But the referendum vote as such will not represent a make-or-break moment for Italy or the eurozone.

By officially ruling out an early election in 2017, Renzi has kept his options open. Although his political standing will be gravely weakened if he loses the referendum vote, it looks unlikely that he could be forced to resign. While the opposition parties (and some individuals in his own coalition) regard the referendum as an opportunity to get rid of Renzi, there is no obvious or easily available alternative to his continued leadership. Neither the PD nor the smaller parties in the coalition government would benefit from a messy early election that would follow a vote of no confidence.

Much will also depend on the actions of the president, who has considerable power and discretion in situations of political crises. The current president, Sergio Matarella, may demand that Renzi resign should he consider his continuation as prime minister a threat to the political stability of the country. Another leader from within the PD would then take over (just like Renzi took over from Enrico Letta in 2014) or President Matarella might try to put a caretaker government in charge, for example in the shape of a grand coalition with a limited mandate for the budget and electoral reform.

The president is extremely unlikely to call for an early election as long as there is no clarity on the electoral law. The Italicum only applies to the Chamber of Deputies since it was passed on the assumption that the Senate would in future consist of regional and local representatives. Hence, after a snap election, the Chamber of Deputies would likely emerge with a strong one-party majority while the Senate would remain fragmented. Both would still have equal powers in the absence of constitutional reform – a recipe for political gridlock and possibly yet another early election.

Although we do not expect a political crisis in Italy, a No vote would still weigh on Italy's economic prospects. Since Italy is the eurozone's third largest economy, this would also affect the wider European outlook. In the short run, the blow to confidence could derail Italy's fragile economic recovery, as firms cut back on investment and hiring plans. A bleaker growth outlook, coupled with heightened political uncertainty, will translate into wider spreads on Italian government bonds (the widening will likely be more pronounced than the tightening in case of a yes vote). Italy's fragile banks as well as its rising debt burden will move back into investor focus.

Nevertheless, we do not expect an economic crisis in either Italy or the euro area:

- A confidence shock is unlikely to cause a debt crisis in the short term, as refinancing risk is limited by several factors. The European Central Bank's bond-buying program provides a powerful shield against a sharp sell-off in Italian debt. Since the start of QE, the Italian bond market has become less sensitive to political and economic stress. Moreover, if sovereign stress re-emerges, the ECB is likely to activate OMT to keep Italian yields low and ensure continued market access.

- Even a sharp deterioration in sovereign financing conditions is unlikely to trigger a refinancing crisis. The average interest rate on Italian debt currently stands at just above 3%. Rising yields would take time to push up average lending rates to a dangerous level. In addition, given a long average debt maturity profile of 6.5 years[10] and a strong domestic investor base – more than 60% of government debt is held domestically – Italy should be able to withstand a temporary rise in interest rates.

- While a confidence shock could hurt growth prospects, making it harder to reach EU-agreed deficit targets, the resulting upward pressure on debt would be limited, given that Italy's 2016 budget deficit is expected at 2.4% of GDP.

- Italy has a current account surplus of around 2% of GDP and a solid net international investment position (-30% of GDP), suggesting that external imbalances are limited, which helps to contain the risk of a short-term debt crisis. Private sector debt is relatively low, at just above 100% of GDP.

- Although a confidence shock would rekindle concerns about the viability of the banking sector, we consider the risk of an immediate crisis as limited. The weakest links in the banking sector have already been stabilized, and banks have in recent months made progress in strengthening their capital position while the stress-test results have added to transparency about the sector's health.

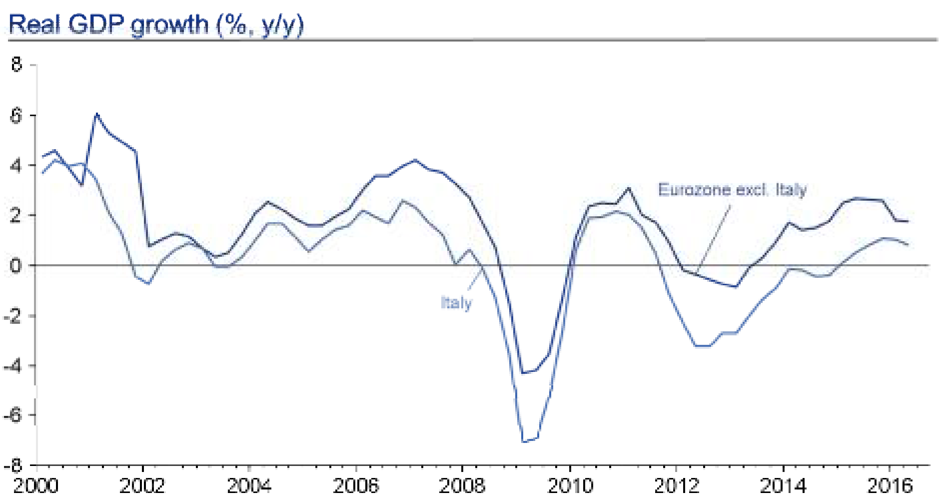
[10] Since 2012, the Italian debt management office has worked on lowering refinancing risks by substantially increasing holdings in debt instruments with maturities of more than ten years.

Provided a political crisis is avoided, the short-term confidence effect of a No vote would be tangible but not dramatic. Italian businesses and consumers have long become used to operating in an environment of political uncertainty. Under our central scenario of a No vote without a snap election, Italy's GDP growth would be a cumulative 0.5 percentage points lower in 2016-17 than in the upside scenario (we forecast 0.6% in 2016 and 0.5% in 2017 in this case). The impact would be greater if markets attached a higher probability to a M5S win at the next election.

Meanwhile, the ECB's bond-buying program will also shield other eurozone bond markets and help contain any contagion from Italy. We expect ECB policy to remain looser for longer in case of an Italian No, which we consider a negative for the eurozone, given the decreasing effectiveness of monetary policy, coupled with growing risk of distortions in financial markets and asset allocation.

We worry more about the implications of a No for Italy's medium to long-term outlook than the short-term shock effect. Economic reforms would remain on hold, at least until 2018 – suggesting another 18 lost months. If a weakened Renzi leads a lame-duck administration into the 2018 election, growing political frustration could further strengthen support for the M5S. The centrist parties may react by shying away from any contentious reforms.

Italy's chronically weaker economy



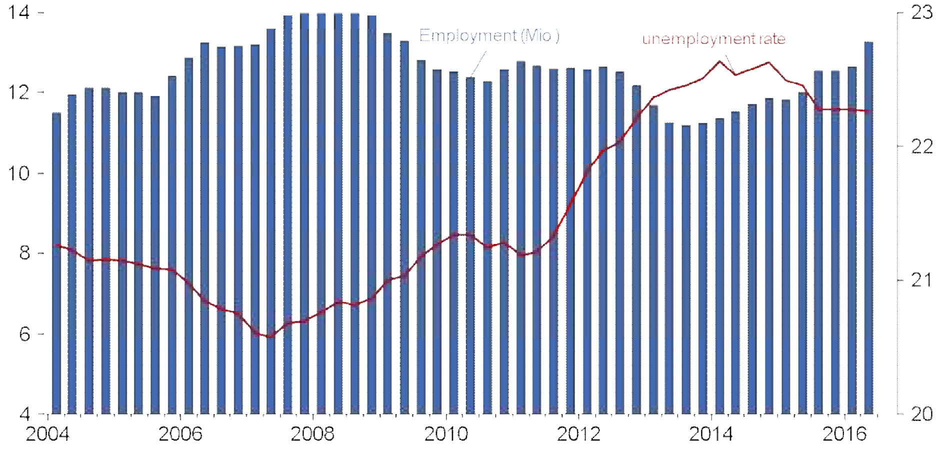
Source: Thomson Reuters Datastream

Italy's structural flaws, if left unaddressed, could depress potential growth into negative territory over the medium and long term:

- Although a recovery is finally under way in the labor market, it starts from a low base and is proceeding only slowly. The unemployment rate, at over 11%, is still among the highest in the EU, while the employment rate, at 64%, remains among Europe's lowest.

Italy's labor market: Signs pointing in the right direction but still a long way to go

Employment (Mio.) & unemployment rate (%)



Source: Thomson Reuters Datastream.

- With one of the lowest birth rates in Europe (1.37), a fast-aging population and a shrinking labor force, demographics will dampen economic growth prospects. Despite this projected scarcity of labor, Italy squanders key parts of its workforce. Almost one in four young Italians (15-29) is not in employment, education or training.[11] The female participation rate in the labor market is only 54% in Italy, which is well below the EU average of 67%.

- Italy's structural divergence – between a wealthier and more productive north and a lagging south – will continue to be a drag on the nation's overall economy. Big regional gaps in incomes[12], employment, productivity[13] and the investment climate[14] have given rise to ineffective fiscal transfers, which has been one reason for Italy's ballooning public debt.

- Italy boasts a successful and diversified manufacturing sector. It is one of only two EU countries with a sizeable export surplus in industrial goods. However, for almost all industrial sectors, global and European market shares have been falling over the last decade. Rising unit labor costs are eroding Italy's competitiveness.

- This last trend is related to Italy's productivity trend, which is one of the worst in the western world. Labor productivity growth has remained flat since the early 2000s while total factor productivity – a measure of how efficiently an economy translates capital and labor into value added – has actually been falling since the late 1990s. A rigid labor market, slow uptake of new technologies and an economic structure heavily skewed towards small firms are among the factors that are depressing productivity growth in Italy. With a shrinking labor force and flat productivity, the Italian economy will not be able to grow in the medium term.

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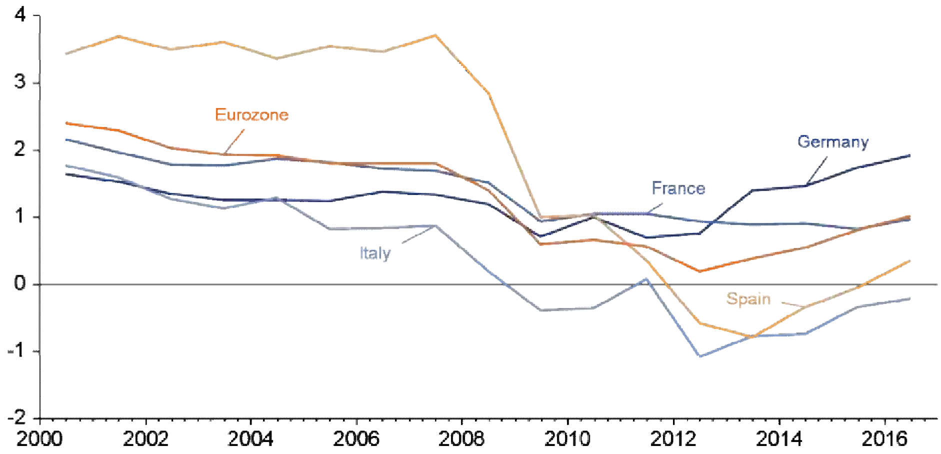
[11] Since young people with higher education are less likely to become unemployed, Italy's low share of people with tertiary education (around 20%) bodes ill for future labor market outcomes.
[12] GDP per head is roughly twice as high in many northern regions as in the south, according to Eurostat. While Italians in Lombardy enjoy incomes per head similar to Bavarians, Sicilians remain stuck at a level similar to Eastern Poland or Latvia.
[13] The gap in productivity and employment has widened considerably since the financial crisis. OECD, 'Economic Survey of Italy', 2015.
[14] For example, it takes almost a year to obtain a construction permit in Palermo, twice as long as in Milan. While in Turin it takes 2.3 years to enforce a contract, in Bari it takes 5.5 years. World Bank Doing Business database, 2016.

Italy's growth prospects: Bleak future

Potential GDP growth (%, y/y)



Sources: Thomson Reuters Datastream, Allianz Group Economic Research.

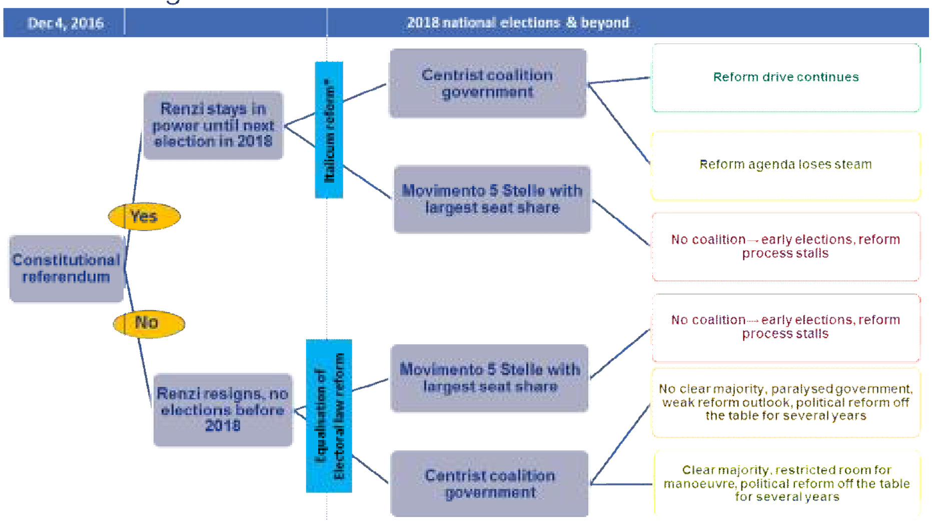
- While the business and household sectors have relatively low debt, Italy's public debt ratio is among the highest in the world, at 133% of GDP. Weak growth has frustrated efforts to reduce this ratio. Even in an optimistic scenario, Italy will have trouble meeting its deficit target for 2016/17. In the case of a confidence shock weighing on growth prospects, Italy's debt to GDP ratio, which has been stable over the last two years, would start rising again.

- Despite efforts to repair the financial sector, it still faces significant challenges from weak asset quality and low profitability. Non-performing loans have recently stabilized but still make up 18% of the total. Over the past 18 months, the ECB's QE program has helped to reduce lending costs substantially. But only decisive action on banking oversight and the resolution framework would turn the banking sector into an engine of growth.

If the Italian economy continues to stagnate, or even shrinks, over the medium to long run, this will represent a considerable challenge for the eurozone, economically as well as politically. Germany, France and the other eurozone countries will be unwilling to support a country that seems to be structurally unable to reform itself in order to remain competitive.

In conclusion, we see limited scope for immediate disruption through the referendum – either on the upside or the downside. We do, however, believe that the outcome matters for Italy's medium to long-term growth performance and hence for the cohesion of the eurozone.

Italy: Simplified political scenarios and impact on reform and growth outlook



*Assuming reform of the Italicum to a system which gives greater weight to proportional elements

Reform/growth outlook with respect to status-quo ■ improving , ■ broadly unchanged, ■ deteriorating, ■ deteriorating sharply

These assessments are, as always, subject to the disclaimer provided below.

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