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Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

RENZI'S REFERENDUM: NOTES ON THE THE ITALIAN RISK

Berenberg Macro Flash

Ever since the Brexit vote, we have viewed a potential political crisis in Italy as the top event risk in Europe for 2017. Unlike Brexit, which poses a severe risk to the UK but not to the Eurozone, Italian problems could theoretically spark a systemic crisis in the Eurozone. Fortunately, the real systemic tail risk, namely that Italy could choose to leave the euro, remains highly unlikely. Nonetheless, we will have to watch Italian politics closely if Prime Minister Matteo Renzi loses the **constitutional referendum on 4 December**. A protracted period of political uncertainty after a “no” vote could exacerbate the Italian banking issues, unsettle the Italian bond market and weigh on business and consumer confidence.

60% risk that Renzi loses

Ahead of the official two-week blackout period that started nine days ago, opinion polls had projected a 53.5% to 46.5% lead for the “no” camp, with momentum in favour of a “no”. Of course, polls are no reliable guide to the outcome. Some whispers suggest that more than half of the up to 20% undecided voters may back Renzi in the end. Also, many of the rebellious young people who oppose Renzi may not bother to vote. Whereas the outcome is thus no foregone conclusion, I put the probability of a “no” vote at 60%.

What if Renzi resigns?

In early 2016, Renzi tied his political fate to the outcome of the constitutional referendum. In case of a “no”, expect him to resign. If so, Italy’s president, Sergio Mattarella, would likely do his utmost to avoid a protracted period of political and financial instability or even new elections ahead of the regular elections in May 2018. In rapid consultations with key party leaders, he would likely explore three options:

- 1) He could re-appoint Renzi. If the result of the referendum had been close and if Renzi believes that he would still win confidence votes in both houses of parliament, Renzi may possibly stay on. If so, this could be settled within ten days after the referendum.
- 2) If Renzi cannot or will not remain prime minister, Mattarella could give the mandate to form a new government to a different member of Renzi’s centre-left, who would need to be confirmed by confidence votes in both houses of parliament eventually. Potential candidates could be finance minister Pier Carlo Padoan or economic development minister Carlo Calenda. With luck, this could also happen fast, possibly even still before Christmas, in order to curtail the damaging period of uncertainty.
- 3) If post-referendum defections among those parliamentarians who currently support the Renzi government in the two houses of parliament make it impossible to more or less carry on with the current government, Mattarella may try to persuade Berlusconi’s centre-right to either join or at least support a caretaker or technocratic government. Such a government could be given clearly defined tasks, namely to stay the course on fiscal policy, reform the election law for the lower house of parliament and – possibly – devise a new constitutional reform. These tasks could easily keep such a government busy until the end of the regular parliamentary term in May 2018.

In all three cases, Italy would avoid early elections and the political and financial risks which they would entail. If none of these three options seems viable, new elections could come onto the agenda as a last resort.



MACRO NEWS

Could Five Stars come to power?

In the unlikely case that new elections had to be called, the radical populist “Five Star” movement could be the major beneficiary. Opinion polls currently put the Five Stars at 28%, modestly behind the 32.5% for Renzi’s centre-left. If Renzi loses the referendum, the Five Stars may pick up a little extra momentum. The recently reformed “Italicum” election law automatically awards at least 54% of the seats in the lower house to the strongest party that either garners at least 40% of the vote or wins in a run-off vote. However, this election law would likely be changed before early new elections anyway. If the current parliament does not change the law on its own, the Constitutional Court would probably demand it when it issues a verdict on the Italicum early next year. And even if Five Stars were to win a majority in the lower house, a “no” in the referendum would preserve the Senate as a chamber with equal power. The Senate would continue to be elected under different voting rules. That Five Stars could win a majority in both houses of the Italian parliament looks highly unlikely. One way or the other, Five Stars would have to build alliances with other parties if it ever wanted to exert power. That could help to soften the populists’ edges. In a way, a “no” in the referendum would make it more difficult for Five Stars to do serious damage in the future as a “no” would preserve the checks and balances which make it so arduous to change Italy for the better - or for the worse.

Could Italy leave the euro?

Five Stars and some right-wing parties (Lega Nord, Brothers of Italy) would likely campaign in early new elections with a promise to call a referendum on the euro. However, the Italian constitution does not allow a referendum on international treaties. Changing the constitution or finding another way around this constitutional provision would be rather difficult. And if the Five Stars called for, say, just an informal online petition on euro membership, I doubt that all Five Star members of parliament would feel bound by the unrepresentative result in the end. While most Five Star activists seem to agree with the demand for a referendum, that does not mean that all of them would actually vote either in parliament or in a referendum. In addition, the turmoil into which a serious debate about euro membership could throw Italian markets and the economy would probably serve as a timely reminder of the risks of such a step. In the end, the risk that Italy would want to leave the safety of the euro looks rather remote.

What is Berlusconi’s party up to?

Nobody knows for sure. Having first agreed key reforms including the constitutional reform with Renzi, Berlusconi’s “Forza Italia” is now campaigning for a “no”. Occasionally, Forza Italia even makes some euro-sceptic noises. The party languishes at 12% in opinion polls and would probably have nothing to gain from early elections. The recent behaviour of Forza Italia suggests that the party wants to (re-)gain some respectability and would like to be taken more seriously again. “Forza Italia” seems to argue for a “no” in the referendum in order to force Renzi (or a Renzi successor from the centre left) to once again negotiate key policy questions with Forza Italia. It hence looks likely that Forza Italia could back a new government in return for being given a say in the re-design of the electoral law for the lower house and a potential new attempt to reform the Italian constitution.

What is the referendum about?

On Sunday, Italians will cast their vote on a constitutional reform that would make it easier to govern and reform Italy in the future. First, the reform would downgrade the role of the Senate so that most laws in the future will have to be approved only by the lower house of parliament, and not by both houses. Second, the reform would streamline Italy’s public administration. A “no” to the constitutional reform would preserve the system of extensive checks and balances which has made it so difficult to reform Italy in the past.



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What is Italy's underlying problem?

Italy's economy still bears the scars of the rapid transition from mass market to luxury goods producer forced upon it by the rise of China. Few other developed countries had to bear such an adjustment burden. Deep-seated structural rigidities compound the problem. Recent pro-growth reforms have improved the outlook considerably. But they need time to work. At the moment, political uncertainty hampers business investment and makes it difficult to attract fresh capital to shore up the banks. In addition, the rise and demise of Silvio Berlusconi, who had been prime minister repeatedly between 1994 and 2011, has left a splintered and disorientated centre-right in its wake. As a result, Italy is the only major country in the euro-zone without an obvious responsible and broadly pro-European political alternative to the current government. A political crisis could thus open up a bigger can of worms in Italy than it would elsewhere.

See also [Assessing the Italian risk](#).

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Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
holger.schmieding@berenberg.com