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RENZI'S REFERENDUM: NOTES ON THE THE ITALIAN RISK

Berenberg Macro Flash

Brexit, Trump, Italy. For the third time within six months, a major political risk has materialised as Italian voters rejected Renzi's constitutional reform by roughly 60% to 40%. That small Austria rebuffed its right-wing populists and chose a solidly pro-European candidate as its new figurehead president on the same day is no more than a consolation prize in this context.

Italy has missed a splendid opportunity to reform its political system and streamline its public administration. The ultimate tail risk, namely that Italy could choose to leave the euro eventually, remains small, albeit not fully trivial. This tail risk has now increased slightly, but probably not by a lot. Voters have rebuked the pro-European reformer Renzi. However, they also cast their vote against change, preserving the full checks and balances which make it so difficult to change Italy for better (more pro-growth reforms) or worse (leaving the euro).

Unlike Brexit and Trump, the Italian vote does not come as a surprise. Although Renzi lost by a bigger margin than projected, the overall outcome is in line with the opinion polls before. That should limit the fallout. Nonetheless, Italy's financial markets, its underfunded banks and its overall economy could suffer unless Italy resolves its political crisis fast.

The heightened uncertainty strengthens the case for the European Central Bank to announce this Thursday an extension of its full asset purchase programme of €80bn per month beyond March 2017

How much do we have to worry about Italy?

First, remember the basics. Because the European Central Bank and the European Stability Mechanism stand ready as lenders of last resort, no banking crisis or financial turmoil could force any country to leave the euro against its will. Second, even a hypothetical spike in Italian bond yields by, say, 50bp would pose virtually no challenge for the Italian sovereign. Because most expiring bonds still have a coupon well above current Italian yields, Italy's interest burden of currently 3.8% of its GDP will continue to fall until average yields rise above 3% for a sustained period of time. We are far away from that.

What counts is the political will to stay in the euro. Neglecting the somewhat vague position of Berlusconi's Forza Italia opposition, the radical or ultra-right political parties ranging from the Five Stars to the Lega Nord and the Brothers of Italy that demand a referendum on the euro account for just above 40% of the popular vote in opinion polls. Early elections in Italy could turn into a significant concern for markets.

Political scenarios

After Renzi announced early Monday that he will indeed resign, Italy's president, Sergio Mattarella, will likely try to avoid a protracted period of political and financial instability or even new elections ahead of the regular vote in May 2018. In rapid consultations with key party leaders, Mattarella will likely explore three options:

- 1) Theoretically, he may still re-appoint Renzi. If Renzi concurs and wins confidence votes in both houses of parliament, the political crisis could be settled by the end of this week. However, the significant margin by which Renzi lost the referendum would make this difficult.
- 2) More likely, 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 include finance minister Pier Carlo Padoan, Senate Speaker Pietro Grasso or economic development minister Carlo Calenda. With luck, this could also



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happen fast, possibly even before Christmas, in order to curtail the damaging period of uncertainty.

- 3) If post-referendum defections among those parliamentarians who had so far supported the Renzi government in the two houses of parliament make it impossible to more or less carry on with the current government, Mattarella would probably ask Berlusconi's centre-right to join or support a caretaker or transition government. Such a government could be formed by late January, or earlier. It 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 - have a new go at constitutional reform. These tasks could keep it busy until the end of the regular parliamentary term in May 2018.

In all three cases, Italy could still 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. In case of a mere caretaker government (option 3), the risk of new elections would loom much larger than in the other two cases.

Although Forza Italia has behaved quite erratically in the last few years, it seems to crave influence and respectability. It should have little to gain from early new elections. Having helped to put Renzi in his place, as Berlusconi might see it, Forza Italia may thus be ready to 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.

Could Five Stars come to power?

If 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 30%, almost on par with the 31% for Renzi's centre-left (see chart below). The referendum could now give Five Stars some 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. On current polls, Five Stars would be the winner of such a runoff by 53% to 47%.

Nonetheless, Five Stars are not close to power yet.

First, the "Italicum" election law would likely be changed before early new elections. 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 shortly.

Second, even if Five Stars were to win a majority in the lower house, the "no" in the referendum has preserved the Senate as a chamber with equal power. The Senate will 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 makes it more difficult for Five Stars to do serious damage in the future as it preserves the checks and balances which make it so arduous to change Italy for the better - or for the worse.

Could Italy leave the euro?

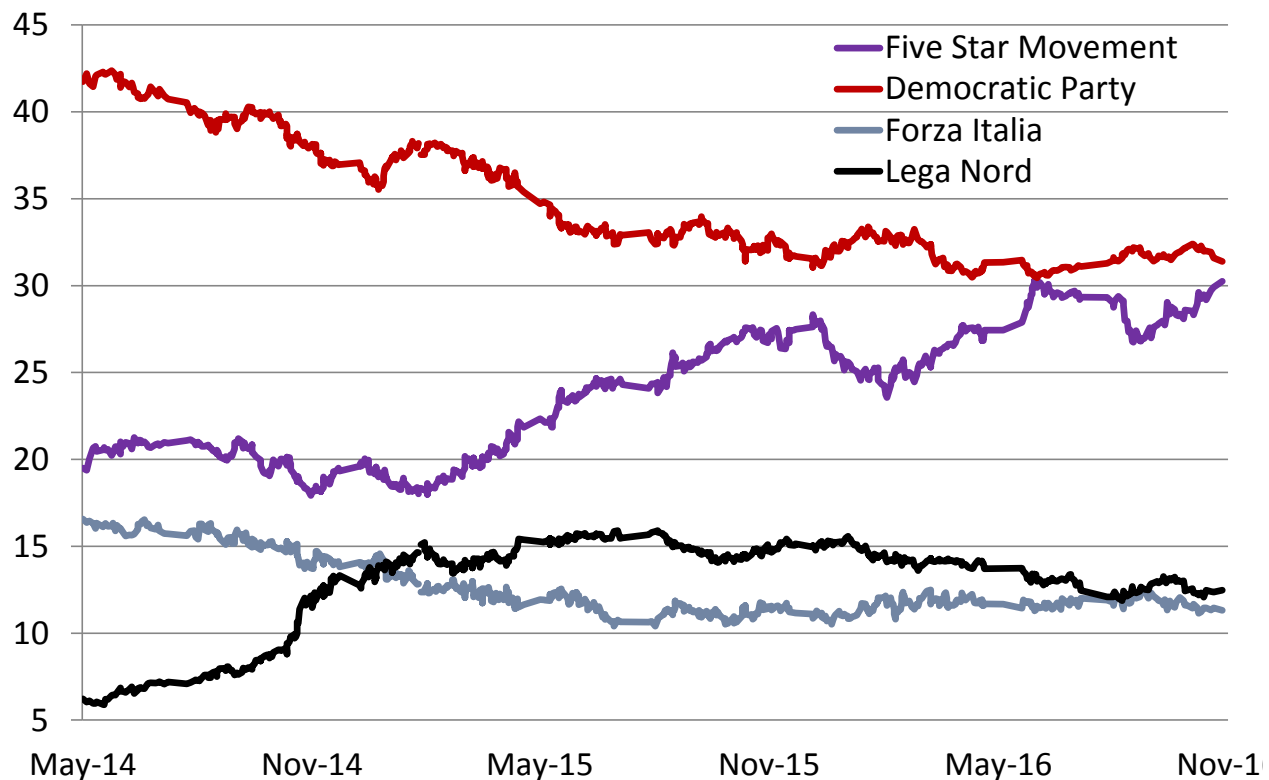
The Italian constitution does not allow a referendum on international treaties such as those establishing the EU and the euro. Changing the constitution or finding another way around this provision would be rather difficult. In addition, the turmoil into which a serious debate about euro membership could throw Italian markets and the economy would probably serve as a timely reminder of the risks of such a step. Also



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Bloomberg quotes a poll from last month showing that “only 15.2% favored leaving the single currency and 67.4% were self-described single-currency believers”. In the end, the risk that Italy would want to leave the safety of the euro still looks rather remote.

Italy: opinion polls for the next parliamentary election



Centre-left Democratic Party, centre-right Forza Italia (Berlusconi), radical left Five Star Movement (Grillo), ultra-right Lega Nord. Average of last five polls, in %. Source: National opinion polls, Berenberg calculations.

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