OBSERVATION

TD Economics

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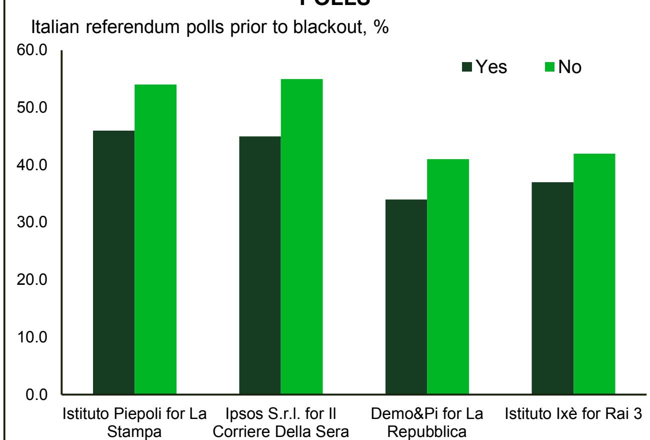
ITALY'S REFERENDUM VOTE: IMPLICATIONS FOR ITALY AND THE GLOBAL ECONOMY

Highlights

- Italy is set to hold a referendum on December 4th which seeks the public's approval of a series of constitutional reforms expected to reduce legislative gridlock by diminishing the legislative authority of the Senate. Final polls indicate that the "no side" will prevail.
- A yes vote would have few implications for our outlook for the Italian economy and financial markets. However, a rejection of the constitutional reforms could give rise to a bout of financial market volatility, with tightening of Italian financial conditions likely to drag on Italian growth next year.
- A no vote is unlikely to have material implications on our global growth outlook. Rather, it raises the chance of some of the downside risks to growth being realized.

The Italian referendum this upcoming Sunday has the potential to stoke another bout of volatility in global financial markets. Given pro-EU Prime Ministers Matteo Renzi's threat to resign in the case of a vote to reject the proposed constitutional reforms, the outcome would set the stage for a period of heightened political uncertainty in a core member of the euro-zone that has extensive trade and financial linkages in Europe and abroad. While the Italian economy has historically had to deal with regular spells of political uncertainty, the difference this time is that Prime Minister Renzi's resignation opens the door a little wider for populist, anti-EU movements to have a greater voice in Italian politics in elections either next year or in 2018. While much has been written about the potential political implications, the possible financial market and economic implications have been less widely covered. Although estimates of the potential impact are heavily contingent on how political events unfold after the vote, what's clear is that this is not on par with Brexit in terms of its potential for disrupting global trade, growth, or global asset prices. Financial market implications will likely remain limited to Italy, and to a lesser extent the EU. In terms of economic impact, a vote in favour of the constitutional reforms could see economic growth progressing largely as we forecast in our September quarterly economic forecast. On the other hand, a rejection of the constitutional reforms with or without the resignation of Prime Minister Renzi may bring to bear a more sluggish economic recovery in Italy over the forecast horizon. For 2017, our growth forecast could be lowered by about 0.2 percentage points relative to our current baseline.

CHART 1: NO VOTE LEADING IN FINAL OPINION POLLS



Source: Pollsters via Bloomberg (http://bloom.bg/2gmXV1S), November 18, 2016.

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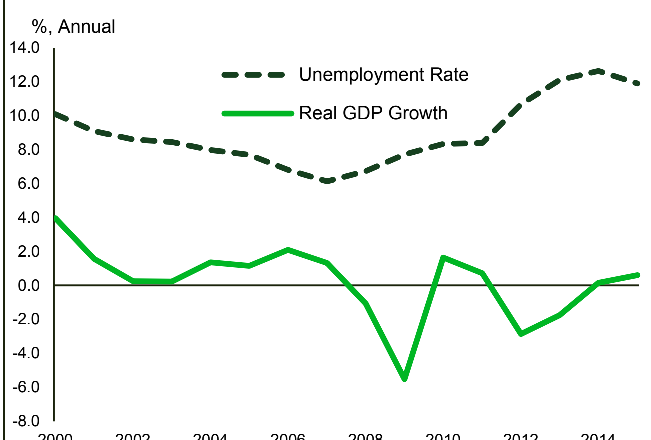
What's this referendum all about?

Unlike the UK's referendum this past June in which a vote to break ties with the European Union, Italy's referendum is about addressing legislative gridlock that many outside observers say has contributed to Italy's anaemic economic performance since its adoption of the euro in 2002. Italy's unique system of government known as bicameralism currently gives equal legislative authority to the Senate and the Chamber of Deputies. The referendum asks Italian citizens to approve of the current government's initiative to reduce the legislative authority of the Senate by removing the need for it to approve legislation passed by the lower house. While this change had already gained parliamentary approval earlier this year, the vote was too close to avoid putting the question to a referendum (for details of the constitutional changes see the box on page 6). A vote against the proposed constitutional reforms would be largely interpreted as a vote of non-confidence in the sitting Prime Minister's and his government, which is widely expected to lead to Matteo Renzi's resignation and could trigger early elections next year.

Italy's poor economic performance has fueled resentment of the establishment

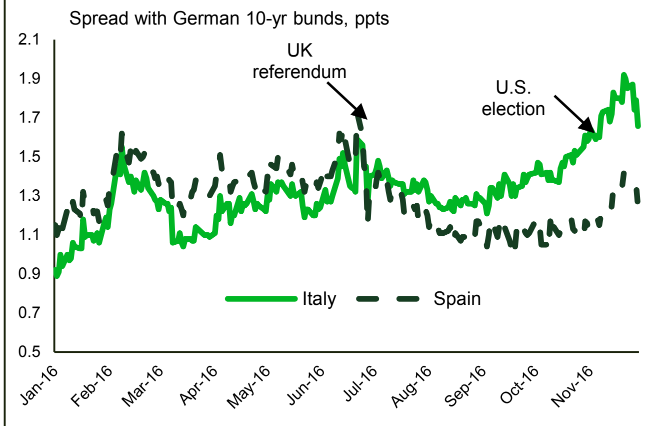
No matter the outcome of the referendum vote, political uncertainty in Italy and the Euro Area will continue to weigh on the fragile economic recovery underway in Italy. More specifically, the frail banking sector, overburdened by non-performing loans and desperately in need of recapitalization, is exerting a substantial drag on the Italian economy. Despite Italy escaping recession in 2015, unemployment remained stubbornly high at 11.6% last quarter – more than 3 percentage points above pre-crisis average (Chart 2). High unemployment and anaemic real wage growth have fueled resentment or establishment policies, leaving scope for populist ideologies to spread. This has culminated in Rome electing a mayor this past June from the anti-establishment Five Start Movement (M5S), Virginia Raggi. Co-founded and led by comedian Beppe Grillo in 2009, Italy's M5S is Italy's second most popular party, and is the largest opposition party, espousing a pro-environment, anti-austerity, anti-corruption, and anti-capitalist agenda. The party is widely panned as amateurish, too ideological, and incapable of running the government of one of core Europe's struggling economies. Nevertheless, the anti-establishment fervor currently sweeping the globe could result in M5S having a greater say in Italian politics after the 2018 election.

CHART 2: POOR ECONOMY HAS LIKELY FUELED ANTI-ESTABLISHMENT SENTIMENT IN ITALY



Source: Istituto Nazionale di Statistica, Eurostat via Haver Analytics

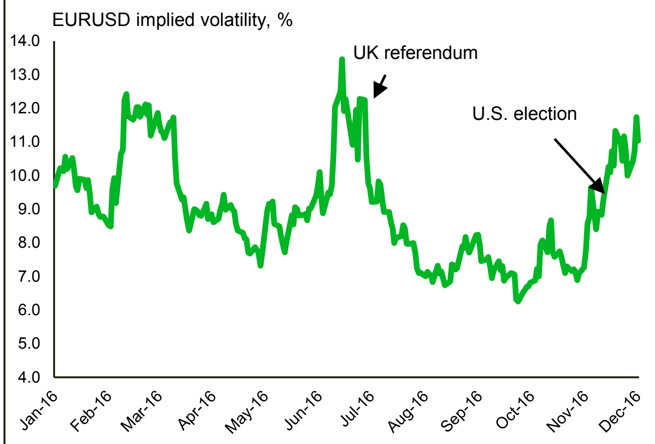
CHART 3: ITALIAN BOND SPREADS RISE IN LEAD-UP TO REFERENDUM



Source: Reuters via Haver Analytics, TD Economics. Last Observation: December 1 2016.

Our baseline outlook for the Italian economy from September assumes that some agreement will be reached between the Italian government and the European Banking Authority within the next two years. Once non-performing loans no longer act as a constraint on bank lending, economic activity in Italy is expected to pick up gradually, rising above 1.1% in 2018 – well above the OECD's estimate of trend rate of growth of 0.1% in its November 2016 projection update. Growth in excess of its trend pace implies a closing of the relatively large output gap estimated at over 3% of GDP in 2016. An absorption of excess capacity would lead the unemployment rate to drop, and eventually give rise to inflationary pressures. Underlying this baseline view is an expectation that the current government remains in power, pursuing a pro-reform agenda.

CHART 4: EURUSD VOLATILITY UP POST U.S. ELECTION LEADING INTO ITALIAN REFERENDUM



Source: Bloomberg. Last observation December 1, 2016.

A yes vote encourages policies that are expected to be supportive of economic growth

The economic implications of the referendum are governed by the largely subjective probability of political events that could unfold in its aftermath. As such, a vote to approve the constitutional amendments will likely leave Matteo Renzi as Prime Minister and his government holding on to power at least until elections in 2018. Emboldened by the vote of confidence, the government is likely to continue to pursue its agenda aimed at unlocking legislative gridlock, while initiating structural reforms with the goal of enhancing the productivity of the Italian economy. For example, the proposed constitutional changes will give the government in control more power to reform the judiciary, improving the time it takes to settle disputes particularly on bad debts. However, too many changes at once could confuse the bureaucracy in the near-term, which could delay implementation at the operational level. Furthermore, plans for banking sector reform including bank recapitalization could face fewer obstacles, and if implemented successfully should eventually result in a banking sector able to fulfill its role of supporting economic activity.

The financial market implications of a yes vote are likely to be relatively subdued relative to what we've observed so far in 2016 (China growth jitters in January; Brexit in June; and U.S. election in November). A vote for the constitutional referendum could see the spread between Italian and German bunds retreat from recent pre-referendum (and post-U.S. election) highs (Chart 3). Little movement in the EURUSD is anticipated, and Italian equities could see a firm bid as near term economic uncertainty wanes.

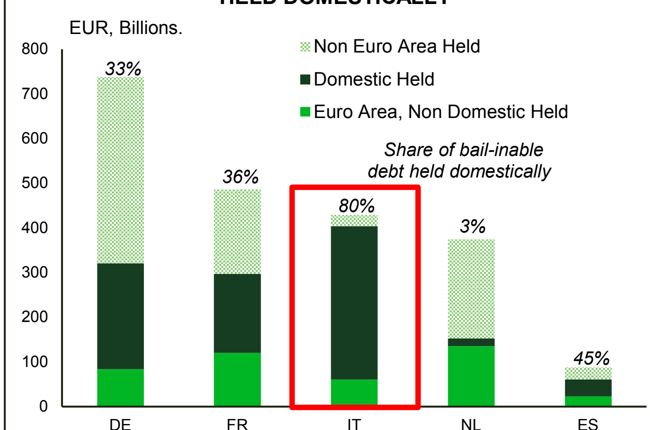
Relative to our outlook, the broader economic implications would also be relatively limited. The highly accommodative monetary policy stance by the ECB ensures that borrowing costs in the Euro Area will remain low over the next couple of years, supporting investment in Italy and the wider Euro Area. Adding further support to economic activity could be some enhanced fiscal spending targeted at helping to offset any potential drag from Brexit, serving more as an upside risk to our outlook for Italian economic growth through 2018 given that the extra spending has yet to be approved by Brussels. Moreover, solid progress in restructuring its ailing bank sector in the next few years would mitigate the damage an Italian banking crisis would cause to its neighbours. While a yes vote is generally good news for the Italian and European outlook, a slightly stronger economic outlook in Italy would have marginal implications for global economic growth.

After the referendum, the next challenge for Matteo Renzi's government in this scenario would be to convince the European Commission that its proposed 2017 budget deficit of 2.4% share of GDP – a 0.6 percentage point deeper deficit than initially communicated earlier this year and a violation of fiscal rules – is necessary in order to ensure Italy's economic recovery. After this, attention will likely refocus on working toward a bank recapitalization plan that complies with the European Banking Authority's Bank Recovery and Resolution Directive that came into force earlier this year.

A no vote could delay Italy's economic recovery

However, final polls suggest that the constitutional re-

CHART 5: MOST OF ITALY'S AT RISK DEBT IS HELD DOMESTICALLY



Source: ECB Securities Holdings Statisitics By Sector, ECB Calculations as per October 2016 ECB Financial System Review.

forms will fail to gain approval. A no vote could have some negative implications on our outlook for the Italian economy and Italian financial markets. While the chain of political events could ultimately see an M5S gain power and possibly push for a referendum on EU and euro membership, we are of the view that this is an extremely unlikely event, and focus our analysis instead on the economic implications of a continuation of the status quo: legislative gridlock, slow progress in implementing structural reforms, and a sick banking sector. Furthermore, our analysis discounts the implications of whether Matteo Renzi remains or resigns as Prime Minister, as any rise in political uncertainty would likely have limited implications for an economy that is accustomed to political uncertainty.

Undoubtedly, a no vote would be interpreted in a lost vote of confidence for the current government's constitutional and economic reform agenda. The Prime Minister's resignation could either leave the PD party to appoint another Prime Minister until elections in 2018, or if the government were to collapse could see the President of Italy, Sergio Mattarella, appointing a Prime Minister who would be tasked with forming a caretaker government until early elections next year or until elections scheduled for 2018.

Unlike in the case of a yes vote, the financial market implications are largely uncertain. Although part of core Europe, slower Italian growth and rising political uncertainty are factors that are unlikely to materially move the euro lower relative to the U.S. dollar initially. Nevertheless, investors are seeking protection ahead of the referendum, with 1-month EURUSD option volatility rising in advance of the Italian referendum, suggesting either that some market participants fear broad financial and economic effects from the Italian referendum or from policy uncertainty after the U.S. election (Chart 4).

On the other hand, the positive spread between Italian government bond yields and German bunds could rise further and remain elevated until political uncertainty dissipates. Italy's bourse could see a temporary sell-off as well until the political future firms up.

The economic implications of the rejection of proposed constitutional reforms would vary depending on the political chain of events that may transpire in the referendum's aftermath. Our realistic scenario, which assumes an appreciable rise in political uncertainty and borrowing costs, implies slower business investment growth next year. While there is some weak empirical evidence that a large enough move in the news index of policy uncertainty for Italy could have some material implications for the Italian economy once the index breaches a threshold, a prolonged tightening in financial conditions is likely to contribute more to slower business investment growth, potentially shaving 0.1 to 0.2 percentage points off Italian GDP growth next year. If financial conditions were to tighten considerably in the referendum's aftermath, the ECB would likely ramp up its purchases of Italian government bonds.

Our GDP growth impacts from this scenario are somewhat less than estimates from other forecasters. The Italian government expects that a no vote could shave 0.4 percentage points off of GDP growth next year, especially if the referendum outcome is interpreted as a vote of non-confidence in the current government and the suite of proposed budget and reforms are not implemented. Oxford Economics estimates that GDP growth could halve next year, falling to 0.4% from 0.9%. Moreover, GDP growth impacts could be even more negative if the referendum result reignites concerns about the Italian banking sector, which could see Italian financial market volatility spillover into peripheral Europe and more broadly to the Euro Area.

Limited global and market implications of the Italian referendum

The global economy is likely to remain largely unscathed in the near-term from the outcome of the Italian referendum. The Italian economy comprises just under 2.0% of global GDP (2015 PPP). Having said that, Italy is the third largest member of the Euro Area, and shares extensive trade and financial linkages with the European Union, particularly Germany and France. Banking claims on Italy are strongest with France, Germany, Spain, and the United States, suggesting some scope for broader consequences for the banking sectors of these nations if an Italian financial crisis were to materialize, which is not a highly likely event in the near-term. Altogether, the near-term implications of a yes or no vote should have very limited impact on Europe, and even less implications for Asian and North American economies and financial markets.

Having said that, the longer-term implications of a no vote could prove to be material for the European Union and consequently, the global economy. A failure to recapitalize its banking sector puts the Italian economic recovery at risk, and leaves open the possibility of a domestic banking crisis spilling over into other European nations via financial channels. Furthermore, if the rejection of reforms reflects an embrace of anti-establishment politics, Italian elections sometime in the next two years could see the shift to populist parties like M5S with limited vision on how to resolve the many structural issues facing Italy and the European Union, putting Italy's fragile economic recovery at risk. Ironically, a yes vote could help pave the way for a M5S majority in 2018 in that the change to a "winner-takes-all" electoral system could see voters looking for quick solutions to their problems rather than put up with the short-term pain of reforms. On a positive note, although M5S has advocated calling a referendum on Italy's membership in the euro and the European Union, Article 75 of the Italian constitution does not allow for referendums on international treaties. Therefore, without a constitutional change, any referendum would not be legally binding. This greatly mitigates the risk of Italy exiting the European Union in the next few years, but doesn't eliminate it entirely.

Bottom Line

Regardless of the outcome, Italy's constitutional referendum is unlikely to have material global economic or financial market implications. A vote for the constitutional reforms would pose some upside risk to our outlook for the Italian economy. On the other hand, a vote against the constitutional reforms could see the resulting rise in political uncertainty and tightening of financial conditions acting to shave up to 0.2 percentage points off GDP growth in Italy next year. Although the implications on financial markets and the global economy are likely to be small no matter what the referendum outcome, a no vote would raise the risk that some of our downside risks to global growth could be realized. A failure to make progress in recapitalizing the Italian banking sector, including resolving the issue of non-performing loans, would continue to see the banking sector acting as a net drag on growth. Moreover, a rejection of the establishment for a populist party without a credible plan to undertake the necessary structural reforms could derail the fragile economic recover underway in Italy.

Details of the proposed constitutional changes

The referendum asks the Italian people to approve a set of constitutional reforms that will fundamentally change the power of the Senate and work to centralize some authority away from the provinces. The main details of the proposed changes are discussed below.

- The legislative authority of Senate would be greatly reduced, ending Italy's system of perfect bicameralism. The first Chamber, the Chamber of Deputies, would become the primary legislative body, relegating the Senate to have a say on matters of constitutional reform and foreign affairs.
- The second chamber, the Senate, will no longer be able to participate in confidence votes on government. This will remain the primary domain of the Chamber of Deputies.
- The Senate reforms will remove the need for the Senate to approve government legislation, and reduce the number of senators to 100 from 315. Senators would no longer be elected, but instead be appointed by regional assemblies from regional councils. Most interesting is that the President will have the authority to appoint five of the 100 senators.
- The new electoral system that came into effect this past July, dubbed Italicum, is closely linked to the outcome of the referendum. If the referendum fails, than the Senate will remain an elective body and will be voted with a proportional system, likely based on regional and party coalition threshold.

Source: "Some neglected reasons to eliminate perfect bicameralism: The Italian constitutional reform and legislative efficiency"

http://voxeu.org/article/italian-constitutional-reform-and-legislative-efficiency

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