

ITALY'S REFERENDUM AND FINANCIAL STABILITY

Lorenzo Codogno and Mara Monti

- Italy's constitutional referendum is fast approaching and financial markets are already jittery. While some observers have pointed out the risk of the Five Star Movement getting into power, or even of Italy leaving the euro, these are extremely unlikely scenarios, at least in the short term.
- The outcome of the referendum may be more evenly balanced than people tend to acknowledge, i.e., a 50/50 split. In the event of a 'Yes' victory, which would be a surprise for financial markets, the 10-year BTP-Bund yield spread could narrow sharply. If 'No' triumphs, there would be a potential further widening, but the real risk stems from financial instability.
- Ongoing problems in the banking sector, as yet modest economic expansion, and vulnerability in public finances, combined with political uncertainty, would produce a dangerous mix.

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The upside-down world of Italian politics

“I rebel—therefore I exist,” as Albert Camus used to say. There seems to be a wave of populism across the globe, with voters willing to make a statement in rebellion against the establishment by saying ‘No’. But, isn’t that too simplistic an interpretation? It is far too easy to look at the Italian referendum on constitutional change and interpret it as yet another episode of the growing international dissatisfaction with the status quo. The reality is probably much more complex, although admittedly there is an element of the above.

With Italy’s GDP still running almost 8 percentage points below its pre-crisis peak, it is no wonder there is some dissatisfaction and desire for change. However, what would a protest vote look like in Italy? Oddly enough, a ‘No’ vote would be in favour of the status quo and against the reforms proposed by Prime Minister Renzi and his government. The Prime Minister appears isolated in Italy’s ‘establishment’, sometimes even in his own party. So, who is the underdog in this case? The opposition to the constitutional changes spans from the extreme right to the extreme left and includes the populist Five Star Movement, as well as some centrists, such as the former Prime Minister Mario Monti.

Even odder is the fact that a sizeable number of members of parliament who voted in favour of the reform six times over the past two and a half years are now campaigning for ‘No’. The world of Italian politics is upside-down, as in Lewis Carroll’s *Alice’s Adventures in Wonderland*, and thus, two weeks ahead of the referendum, opinion polls may well be misleading.

What is it all about?

On 4 December, Italian voters will be asked whether they approve of amending the Italian Constitution to reform the appointment and powers of the Parliament, as well as the division of powers of the State, Regions, and administrative entities. The reform aims to improve the functioning of law-making and increase government stability. It is linked to an electoral law, although the electoral law is not part of the reform to the Constitution.

The constitutional bill, proposed by Prime Minister Matteo Renzi and his centre-left Democratic Party in 2014, was approved by an absolute majority of the MPs in both houses of the Italian Parliament. The government first introduced the bill in the Senate on 8 April 2014. The final vote took place in the Lower House on 12 April 2016. As approval lacked a qualified majority of two-thirds in each House, it has to pass popular vote as well.

This will be the third constitutional referendum in the history of the Italian Republic (the other two were in 2001 and 2006) and, if approved, the reform would be, by far, the most extensive constitutional reform in Italy since its approval by the Constitutional Assembly in 1947, which put an end to the monarchy. Opposition parties have criticised the bill, claiming that the reform is badly written and that it will make the government too powerful. The referendum question is clear, but it is likely that Italians will not vote on the basis of the question asked. Rather, it will sort of be a confidence vote on the government and the Prime Minister.

How has the situation changed over the past few weeks? Changes relate to (1) opinion polls, (2) political campaigning, (3) positioning by politicians for possible scenarios after the vote, (4) financial market jitters, (5) developments in the complex situation of Italian banks, which is closely linked to politics. Let’s tackle these issues one by one.

Why should opinion polls not be trusted?

Italian laws allow opinion polls to be made public up until two weeks before the referendum, i.e., up to 18 November. Recent opinion polls suggest that the number of undecided voters has declined but remains rather high, and there is an increasingly wide gap between the 'No' and the 'Yes' camp, of about 3 to 6 percentage points or even higher. The trend seems to be sufficiently clear and established. A [recent opinion poll](#) prepared by Cisa-Sole 24 Ore, which can be considered more reliable than similar polls, suggest 'No' at 34%, 'Yes' at 29%, and undecided and abstentions at 37%, still a high percentage.

It is striking to see that there is a very high degree of consensus on some aspects of the reform. For instance, 57% of respondents agree that only the Lower House should approve most laws, and 83% are in favour of the provision by which the government can ask Parliament to decide within certain time limits. In other words, there is more support for individual parts of the reform proposal than for the overall package. However, 60% of respondents say they know little of the reform, and 61% indicate that they are unsatisfied by the government's actions, which seems to have a strong bearing on their overall opinion of the referendum. In fact, at the end of the day, it will be a confidence vote on the government and the Prime Minister.

It is conspicuous that young voters are overwhelmingly in favour of 'No' (and, in large numbers, vote for the Five Star Movement, the Northern League, SEL-SI, and other parties outside the mainstream). There is an almost 20 percent gap between 'Yes' and 'No' in the lower age groups. In addition, it appears that the majority in favour of 'No' is much larger in the South. Economic stagnation or lack of decent recovery and the high level of unemployment (11.7%), especially youth unemployment (37.1%), are certainly the root of the dissatisfaction with the government. Finally, most opinion polls underestimate the importance of votes by Italian citizens abroad, and voters abroad tend to favour 'Yes'.

In the referendum on nuclear energy in 2011, the turnout was 57%, and in the 2006 referendum on constitutional changes, it was 54%. Young voters tend to say 'No' to pollsters, but then they do not show up on election day. This also happened in the past (elections for the European Parliament). If the turnout this time is close to those recorded in the past, there would be a chance for a 'Yes' victory. Conversely, if the voters who claimed to be voting 'No' all go to the polls on 4 December, there would be little chance for a 'Yes' victory. The bottom line is that it will come down to the voter turnout. Thus, the outcome may be more evenly balanced than people tend to acknowledge, i.e., a 50/50 split.

Campaigning can make a difference

Campaigning can make a difference in the final two weeks before the vote. Renzi and most of the PD's members are now heavily campaigning. The Five Star Movement is doing the same, but its leader, Grillo, is mostly absent. Matteo Salvini of the Northern League is very active. Berlusconi's Forza Italia is also campaigning for 'No', but a number of its members are in favour of 'Yes'. Moreover, Berlusconi himself seems to be absent.

The political campaign is also waged outside the purview of most important media, where *par conditio*, i.e., equal broadcasting time for both camps, does not apply. In social media, there appears to be an outsized support for 'No', while in local media, there seems to be a bias for 'Yes'. Being Prime Minister, Renzi also enjoys an oversized exposure to the media, which should play in his favour. But, this is debatable. Recently, the Prime Minister has been busy with his international agenda, fiscal matters, and the earthquake. Thus, he has effectively

started to push hard on campaigning only very recently, while the opposition seems much lighter in their support of the 'No' camp. This may also play a role in the final outcome of the referendum.

Are financial markets heading for another turbulent period?

Government bond yield spreads are again under pressure. The 10-year BTP-Bund spread has moved to 180bp and the spread BTP-Bonos to 50bp. Stock indices for the Italian banking sector have diverged from those for the rest of the Euro Area. Part of this is due to the sharp steepening of yield curves following the surprising victory of Mr Trump in the US. Another part relates to increasing jitters connected with the stability of Italy's political situation, as well as the stability of its banks.

International investors are trying to figure out what this referendum is really all about, but usually, their conclusions are simple or, sometimes, simplistic: (1) 'No' would be a vote against reform, (2) it would be yet another confirmation of the global populist tendencies (Brexit, Trump, etc.) in a country that can hardly afford any deviation from orthodox policies, and (3) 'No' would make existing banking problems very complicated and any capital increase very difficult.

Therefore, in the event of an unexpected 'Yes,' the BTP/Bund yield spread could narrow sharply. If 'No' triumphs, a period of financial market turmoil may well prevail, at least until a new government is fully in place, and the spread might further widen. The situation with the banks would become very complicated to solve, and the risks of a new financial crisis cannot be underestimated.

The risk of prolonged political instability would be a low probability event as the centre-right Forza Italia, which is steadily declining in opinion polls, would see the opportunity to gain a governmental role and the chance to contribute to redesigning the electoral law by joining a grand coalition. Despite the current official line, this would be too good an opportunity for them to miss. In any event, it is likely that a government would be in place by the year's end or early January at the latest. So, even in the event of a 'No' victory, financial market tensions may well turn out to be short lived, unless worries about the stability of the banking sector become truly high.

What would future political scenarios look like?

A 'Yes' vote would strengthen Renzi's position, possibly leading to a Congress of the PD ahead of schedule and result in the further tightening of Renzi's grip on his own party. The government would make some changes to the electoral law (possibly allowing for a majority premium to the coalition rather than the leading party or changes in the two-ballot system). Perhaps the problems of the banks would be resolved without government intervention. It would also be a way to sprint toward the next political elections in spring 2018, or earlier (although early elections would be very difficult to engineer). Next year would be a lost year anyway for reforms and fiscal consolidation, but there would be a chance if Renzi were to win the next political elections.

If 'No' wins, Renzi would likely resign. Recent statements suggest he would not accept being the Prime Minister of a weakened government. By taking a step back, he would effectively start the campaign for the next political elections. The possibility of staying as Prime Minister would also depend on the position that centrist groupings will adopt and the decisions within his own party.

In addition, the NCD-UDC position would become increasingly difficult. If they do not side with the centre-right after the referendum, they would be in danger of disappearing in the next general elections. If this happens, however, a 'grand coalition' with Forza Italia would become the only viable solution for forming a government.

The 'grand coalition' would likely last until the end of the political term in spring 2018 as making a new electoral law would not be straightforward. Such a government would not make any significant reform or economic change. At first glance, this scenario could be a gift for the electoral chances of the Five Star Movement in the next elections, but Renzi would likely stay as leader of his own party and would start behaving like an opposition leader, an easier position for gaining consensus.

Political developments in the aftermath of the referendum are crucial for the stability of financial markets. It is the combination of risks to political stability and financial stability that makes the situation particularly tricky.

How high is the systemic risk in the banking sector?

Italy's banking sector has been under pressure for a long time. Monte dei Paschi di Siena (MPS), the oldest Italian bank, was forced to increase capital while also speeding up disposal of NPLs. If the restructuring plan fails, it would hurt the whole banking sector in Italy, and possibly even in Europe. Recently, Bank of Italy underlined that the MPS recovery plan remains exposed to risks that arise mainly from the high volatility of stock markets. MPS restructuring plans could become the catalyst for a full-fledged banking crisis if it fails, or accelerate the solution if it goes well. This partly depends on a stable political backdrop.

As part of its restructuring plan, MPS has to complete a capital strengthening of up of 5 billion following its performance in EBA stress tests earlier in 2016. The plan is contemplating several possibilities, including the recently announced voluntary debt-to-equity swap of an outstanding 4.3 billion in MPS bonds, of which about half are in retail hands. Were MPS unable to complete a full capital increase, the only 'Plan B' would be government intervention combined with burden sharing, which would involve bondholders and equity investors.

The valuations offered to bondholders in the voluntary debt-to-equity swap are well above market valuations, with a substantial premium on current bond prices (up to 30%), but no details have been unveiled about the equity price at which the conversion will happen. This uncertainty could be a serious obstacle for some categories of institutional investors and retail investors alike. For bondholders, both retail and institutional, failure of the swap operation would make the risk of bail-in much higher.

Despite the risk of substantial losses, individual bondholders might still not participate in the hope that other bondholders would instead, leaving them with a safer bond in a recapitalised bank that still pays a high interest rate. It is a classic prisoner's dilemma. However, failure for MPS would mean widespread losses for a large number of retail investors and additional political fallout. MPS failure would sharply reduce the chances for capital increases by other Italian banks, i.e., UniCredit, Carige, and others, which are expected to ask for more than 10 billion in fresh capital and to sell off large tranches of NPLs over the next few months.

Separately, MPS is trying hard to securitise 27 billion in NPLs at a value of 9.2 billion. The government guarantees, GACs, will likely facilitate the sale of the senior tranches to investors, along with the Atlante fund focus on the riskier mezzanine tranches. Were MPS not successful in completing the capital increase, the NPL plan would be equally unsuccessful. This would

have an impact on the valuation of NPL portfolios of other Italian banks, such as UniCredit (which has 51.3 billion in NPLs as of September and is ready to approve a plan of capital strengthening).

Down the rabbit hole. How would the referendum affect financial stability?

The healing of the banking sector is conditional on the big MPS operation going smoothly and positively, thereby providing a positive backdrop for all other smaller operations. A positive conclusion needs a stable political environment to provide investors sufficient confidence to invest.

In turn, failure in the MPS operation would trigger government intervention, and this may prove difficult if there is no government in place or the new government is weak and has a limited mandate.

In Italy's already upside-down political world, the referendum, as with Lewis Carroll's Mad Hatter, would sentence Italy's banking sector to death by "murdering the time" needed for its recovery.