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Italy – the third domino

Gerhard Winzer

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On Sunday 4 December Italy will be holding a referendum on an amendment to the constitution. This is relevant particularly because in case of a rejection, the political uncertainty would increase.

Mutual blockade

The referendum will basically be about questions of centralisation (i.e. a weakening of the regions) and the easing of the passing of laws in parliament (i.e. a weakening of the Senate, which is on equal footing with the Chamber of Deputies). This is meant to do away with the mutual blockade of the two political institutions.

Negative economic development

The constitutional amendment was motivated by the bad economic development, which has fuelled the necessity of structural reforms. GDP has been stagnant since 2008, and government debt (133% in terms of economic output), unemployment (11.5%), and the share of bad debt in terms of total loans outstanding (16%) are high. In such an environment it comes as no surprise that Italian bank shares have shed more than 50% since July 2016 and that the yield spread of Italian government bonds on German government bonds (10Y) has just reached a two-year-high at 1.7 percentage points. The mutual blockade, the unwillingness to see through reforms, and currency devaluation not being an option increase the pressure for an “internal” devaluation. This means that the pressure on prices to fall is on the rise. Indeed, consumer price inflation, or more precisely, the core rate without the volatile components such as energy and food, hit a new low in October of 0.2% y/y.

Anti-establishment

The referendum is taking place against the backdrop of a global rise of the anti-establishment movement. Could the anti-camp be victorious a third time this year, after the Brexit referendum and the victory of Donald Trump? The polls suggest a neck-to-neck race, with the No camp slightly ahead in recent weeks. The referendum in Italy is special in that Prime Minister Renzi has declared himself in favour of reforms, but he is also pro-EU, a representative of the establishment, and does not promise easy solutions.

Two safety nets

In case of a sell-off of bank shares and government bonds there are two safety nets available. Firstly, the government may bail out banks if the financial stability of a country is in jeopardy. And secondly, the ECB could trigger the OMT programme (outright monetary transactions) and buy Italian government bonds. While the purchase volume is theoretically unlimited, it comes with certain terms. Also, the triggering would probably run into political resistance from other countries. In the short run, the ECB could change the current purchase key in favour of Italy.

Rejection of the amendment

Prime Minister Matteo Renzi announced his resignation for this case, which would of course result in a government reshuffle. The reform momentum would decline, and the status quo would be prolonged. Italy has seen 65 governments since 1945. Urgent tasks, especially the restructuring of the banking sector, would be on top of the agenda. However, a sustainable improvement of the macroeconomic environment would be unlikely for the foreseeable future. The impression of a lack of competence and willingness when it came to reforms in Italy would be confirmed. Also, this scenario would give a heightened sense of urgency to the question of how the Eurozone could survive in the long run without reforms in Italy.

If we were to see snap elections as a result, we would be confronted with the risk of an anti-EU party joining the government. But even without snap elections, we would see spill-over effects on the EU, because a “no” would also be interpreted as a strengthening of the anti-EU camp.

Acceptance of the constitutional amendment

Of course this would not solve the problems, but Renzi would emerge stronger and could push through his reforms more easily. In addition, this would also not support the centrifugal forces in the EU. A “sigh of relief” could bring about narrowing spreads and rising bank shares, at least temporarily.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.