



## Investment Note



2 December 2016

# Italian Constitutional Reform: A Choose Your Own Adventure

Trying to make sense of Italian politics is at the best of times like playing a three dimensional game of chess (it's no wonder the Italians gave us Machiavelli), and last weekend's referendum in Italy is no different. A vote about a series of relatively dry constitutional reforms has come to dominate international headlines in part because Prime Minister Matteo Renzi promised to step down if the reform is defeated<sup>1</sup>. On 2 December 2016 before the vote, our Chief Economist Megan Greene explains the key issues at stake.

The media has billed the Italian referendum as the next big populist event following the Brexit referendum in the UK and the victory of Mr. Donald Trump in the US earlier this year. It is true that there is a populist element to the vote given that many people will be casting their ballot either for or against the establishment on Sunday. But that is a simplistic view of the referendum and, much like Italian politics; the vote this Sunday has many dimensions.

In considering the ways in which the referendum may lead to political and financial uncertainty in Italy, we have to look at three dimensions in particular: the content of the constitutional reform itself, the Italicum (a new electoral law) and the banking sector.

## A Divided Electorate on Constitutional Reform

I came to Rome a few days ago convinced that a "Yes" vote (in favor of the constitutional reform) was a slam dunk market positive and a "No" vote would be unequivocally negative. That may be the case, but if given the chance to vote myself, I am no longer so sure how I would cast my ballot. In a nutshell, the constitutional reform aims to significantly reduce the size of the Senate (the upper house of parliament) and downgrade its role so that it is consultative. The reform also aims to centralize some powers from the regions to the central government.

## Why Yes

There are a lot of things to like about the constitutional reform itself. Currently, legislating anything in Italy can take years because of the bicameral parliament. Both the Chamber of Deputies and the Senate have to agree on the text of the legislation before it can be passed, so documents get endlessly bounced back and forth between houses of parliament as each house demands edits<sup>2</sup>. The resulting legislation is often a complicated, awkward compromise between the two houses that suits very few people. If the Senate is reduced and given a consultative role, this ping ponging of legislation between houses of parliament is no longer necessary and legislating should become

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<sup>1</sup> Wall Street Journal: [Italian Referendum to Determine Matteo Renzi's Fate](#), December 2, 2016

<sup>2</sup> Library of Congress: [The Italian Legislative Procedure](#), June 17, 2013

more streamlined. As a result, Italy should find it easier to push through the structural reforms it badly needs to liberalize its labor and product markets.

Centralizing power from the regions to Rome is also designed to streamline decision-making. The regions currently have considerable power to block national initiatives such as infrastructure projects, delaying them significantly. In addition, with power more centralized in Rome, it will be easier to standardize availability and prices of goods and services (an often-cited example is medical supplies).

## Why No

Still, the constitutional reform is far from perfect. No one has much of a sense of how senators will be chosen under the new system, but it seems likely that mayors and regional council members might form the bulk of the Senate. While corruption is endemic throughout Italy<sup>3</sup>, it is particularly pronounced at the regional rather than the national level<sup>4</sup>. In addition to giving regional politicians a seat in the central government, the constitutional reform will give Senators immunity from prosecution. This is understandably unpopular with many Italians. It is also easy to see why Italians may not be in favor of centralizing power. Italy was governed by a fascist government until 1943, after all. The bicameral system was established in part to prevent the reemergence of fascism in Italy.

## Implications of the Less Understood Italicum

There are clear reasons to vote for and against the constitutional reform. If only most Italians were actually voting with these in mind! According to one recent survey, only one in ten Italians were going to cast their ballot in response to the actual constitutional reform proposed. Because Prime Minister Renzi said he would step down in the event of a “No” vote, many Italians are casting their vote in favor of or against the establishment.

Voting against the establishment means a lot of things, but given that the main opposition party, the Five Star Movement (M5S), has polled neck-and-neck with the governing Democratic Party (PD) this year it amounts to tacit support for this populist, anti-elite, anti-European party<sup>5</sup>.

The markets do and should fear the rise of the M5S in Italy. The party has vowed it would like to hold a referendum on Italy’s membership of the Euro<sup>6</sup>. The M5S has campaigned against the constitutional reform, but ironically a “Yes” vote is the only potential path for the M5S to eventually find itself in government.

You read that right. A “Yes” vote in the referendum (which most investors favor) could pave the way for the M5S to eventually run Italy (which investors fear). This is because of the Italicum (an electoral

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<sup>3</sup> The Local: [Italy Is \(Still\) One of Europe’s Most Corrupt Countries](#), January 27, 2016

<sup>4</sup> The Economist: [Why Italy Should Vote No In Its Referendum](#), November 26, 2016

<sup>5</sup> Financial Times: [Renzi Rocked As Five Star Surges In Polls](#), July 6, 2016

<sup>6</sup> Wall Street Journal: [Italy’s 5 Star Movement Calls for Euro Referendum](#), June 22, 2016

law) that the Italian government tabled last summer. According to this law, the winning party in the second round of an election will be granted bonus seats as long as it has at least 37% support. This should boost government stability by giving the winning party a majority and reducing the political horse trading that usually occurs after elections in Italy as coalitions are formed. The Italicum was originally conceived when the M5S had less support and PD expected it would benefit from the bonus seats in an election. But now the M5S could well win the second round of an election. The M5S refuses to form a coalition with any other parties, so these bonus seats are the only realistic way that it could have a majority and be in government.

What does the Italicum have to do with the referendum? The Italicum assumes that the constitutional reform will be passed and only governs the Chamber of Deputies. If the constitutional reform is accepted, some tweaks will probably still be made to the Italicum (it is also under review from the Supreme Court, with a ruling due out in February) but the final version could well look like the current one. If the constitutional reform is rejected, the Senate will be governed by one law and the Chamber of Deputies by another. As a result, the Italicum will have to be completely renegotiated, and it is likely parliament will agree an electoral law based on proportional representation. This would effectively block M5S's path to government.

## The Sorry State of Italian Banks

The referendum must also be viewed in light of Italy's banking sector. Italy's sickest bank, Monte Paschi di Siena (MPS), is in the midst of a €5 billion capital raising effort that it aims to complete by the end of the month<sup>7</sup>. €1 billion is likely to come from a voluntary debt-to-equity swap offer. If Italy is plunged into a period of political uncertainty following a "No" vote in the referendum, investors may well steer clear of participating in MPS' capital raising efforts. MPS would then need to be rescued. This past summer, Mr. Renzi went out of his way to avoid a bailout for MPS because it would require a bail-in of investors as well, and 65% of MPS' outstanding subordinated debt is held by retail investors. Bailing-in retail investors would be incredibly politically toxic. One way to avoid a bail-in would be to nationalize MPS, but this would be a very expensive option for a government that already has a soaring debt burden. A final option may be for Mr. Renzi to just break the European Union's banking union rules and bailout MPS without imposing a bail-in. The problem with this option is that the European Central Bank (ECB) could refuse to recognize the new capital and the SSM (Single Supervisory Mechanism) could push MPS into resolution. However, it would not be in the ECB's best interests to risk sparking a banking crisis in Italy, so Mr. Renzi may get away with breaking the rules without any real repercussions.

If MPS' capital raising fails and a rescue is disorderly, we could see contagion to the other parts of Italy's banking sector in need of fresh capital. Three of the four small banks that were put under administration last year (Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio della Provincia di Ferrera SpA and Cassa di Risparmio della Provincia di Chieti<sup>8</sup>) are likely to be bought by UBI Banca (Italy's fifth largest bank)<sup>9</sup>. UBI might back out of the deal if political uncertainty sends Italian bank equities sharply down. The mid-sized banks Popolare di Vicenza and

<sup>7</sup> Financial Times: [Monte dei Paschi di Siena Prices €4.3 Billion Debt-For-Equity Swap](#), November 15, 2016

<sup>8</sup> European Commission: [State Aid – Commission Approves Resolution Plans For Four Small Italian Banks](#), November 22, 2016

<sup>9</sup> Reuters: [UBI Banca Receives Initial ECB Nod To Buy Three Small Lenders – Sources](#), November 25, 2016

Veneto Banca are likely to offer a new business plan soon that may involve a merger<sup>10</sup>. Fresh capital will almost certainly be needed and the new merged bank may not be able to raise it if investors are spooked. Finally, Unicredit will present its new industrial plan on December 13<sup>th</sup> and is likely to include a substantial capital increase<sup>11</sup>.

A financial crisis in Italy would likely sharply tighten financial conditions domestically, providing a huge headwind for already lackluster economic growth. Failing banks in Italy could of course spark contagion across the region. It was only a few months ago when concerns about Deutsche Bank dominated the front page of every major newspaper.

The constitutional referendum does not necessarily have to result in banking crisis in Italy though. If the “Yes” vote wins, MPS is more likely to succeed in its capital raising efforts. If the “No” vote wins and the Italian government swiftly rescues the bank, contagion could be muted. Another option is to ask the European Stability Mechanism for a bank bail-out in exchange for some reforms. This would be politically toxic for the government, but it may be less toxic than bank bail-ins.

Finally, the ECB has reportedly suggested it would support Italian assets in the event of rising spreads following the referendum<sup>12</sup>. The ECB can eschew the capital key, focusing on hoovering up Italian debt, for a period before it has to even its purchases up over the course of the year according to the capital key.

There have been concerns for the past year that the ECB would run out of German assets to purchase. This would limit the number of Italian bonds that could be bought given that Germany’s contribution to the capital key is larger than Italy’s. This problem has been alleviated in the past month by rising bund yields<sup>13</sup>; the ECB can only buy assets with yields above the deposit rate (-0.4%), and with yields rising across the developed world the universe of eligible German bonds has been expanded. This of course works both ways—if investors decide they’ve been overly ebullient about inflation and rate expectations going forward and yields start falling again, the ECB will be more limited in how many Italian assets it can purchase.

## No Good Options

If the “Yes” vote wins on Sunday, Mr. Renzi will be strengthened in the short term but, given the Italicum, could be weakened in the next election. The result may be a government led by the M5S that may pursue a referendum on Italy’s membership of the Euro.

If the “No” vote wins on Sunday, Mr. Renzi will be weakened in the short-term but could emerge stronger in the next election. If bank bail-ins are required or the Italian banking crisis comes out of remission, Mr. Renzi will probably be happy to step down and distance himself from the financial and economic fallout. That way he can run in the next election (due by May 23, 2018) and argue that none of the pain would have happened if people had passed the constitutional reform and he had

<sup>10</sup> Reuters: [Italian Veneto-based Banks Start Process Towards Tie-Up – Exec](#), October 28, 2016

<sup>11</sup> Bloomberg: [UniCredit Says Share Sale, More Cost Cuts May Lie Ahead](#), November 18, 2016

<sup>12</sup> Reuters: [ECB Ready To Buy More Italian Bonds If Referendum Rocks Market – Sources](#), November 29, 2016

<sup>13</sup> Manulife Asset Management, Bloomberg, as of December 2, 2016



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remained as Prime Minister. A likely replacement for Mr. Renzi in this case is Finance Minister Pier Carlo Padoan.

But even if Mr. Renzi emerges stronger in the medium- to long-term, we should not all breathe a sigh of relief. If the “No” vote wins and a new government is quickly put in place so that political uncertainty remains muted, Italy’s economic prospects still look bad. The new government will spend all of its time and energy on reforming the Italicum. As a result, the kinds of structural reforms that Italy badly needs to find sustainable growth are unlikely to be passed any time soon. This means we can expect a few more years of economic stagnation.

When I point out to my friends in Rome that the rosier scenario in the event of a “No” vote is that Italy does not enjoy economic growth for a few more years, they shrug their shoulders and remind me that they’ve already survived 20 years of that, so what’s a few more? And maybe that is the most important lesson we should all keep in mind as we watch the results of the constitutional referendum on Sunday night—this is Italy, and it has experienced everything. Political instability? What else is there! Banking crisis? They’ve been there before! Economic stagnation? It’s hard to even remember what robust growth felt like! When your history is as long and rich as Italy’s, people can always find a time when things were worse and they persevered. This constitutional referendum will be no different, whatever bumps there are along the way.

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