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Economics

Renzi's resignation will hurt Italy's long-term outlook

Referendum defeat leaves Renzi no choice but to resign and increases pressure on the ECB to maintain stimulus.

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Italian Prime Minister Matteo Renzi is set to resign after losing his referendum on constitutional and voting reforms. Having staked his political career on the vote, the larger-than-expected defeat (59% vs. 41%) left him no choice but to announce his intended resignation.

Electoral reform is still needed

Renzi was Italy's best hope of enacting badly-needed economic and structural reforms, and so his departure is a major blow for Italy's medium to long-term outlook. The question posed in the referendum was related to voting reforms, which would have given the ruling party more power to enact legislative change. Italy's equal system of power between the Chamber of Deputies (lower chamber) and the Senate (upper chamber) has created gridlock, and is a key obstacle to greater economic reforms.

Renzi's government has already changed the voting system for the Chamber of Deputies to give additional bonus seats to the party that wins the largest number of seats; this is designed to reduce the need for coalition governments. A "yes" vote in the referendum would have completed the reform process in harmonising the system in the Senate, and would have changed the Senate's role to an advisory role of checks and balances – similar to the UK's or Germany's upper houses.

Instead, with the result of the referendum, Italy now has an incomplete and incompatible electoral system. This will need to be resolved before the next election in 2018, meaning that Italy's next leader will be lumbered with this task instead of working on boosting growth.

Early elections unlikely

Italy's president, Sergio Mattarella, will proceed to find a caretaker leader as soon as possible, in order to minimise political uncertainty. The favourites include finance minister Pier Carlo Padoan, senate speaker Pietro Grasso and economic development minister Carlo Calenda. All three would provide a safe pair of hands, although there is a chance that the president is forced to bring in a non-political technocrat (like Mario Monti in 2011-2013) if the two houses are divided on the candidate.

In any case, the risk of a snap election remains low. An early election could allow anti-establishment parties like the Five Star Movement or the Northern League to increase the share of seats they have. Both have gained popularity in recent years while advocating anti-austerity policy as well as leaving the EU and euro.

Worsening outlook as economic reforms are delayed

The change in leadership in Italy will mean a delay in the introduction of economic and structural reforms. Without such reforms, Italy is likely to remain stuck in a low growth deflationary dynamic. Its ageing population is a major headwind, while its cumbersome business rules and complex labour laws make it an unattractive place for multinationals to invest. Worse still is that a lack of growth puts the sustainability of Italy's public finances at risk. Gross debt is the highest in Europe at 133% of GDP, and the debt servicing stands at 4% of GDP per annum. Should interest rates rise in the future, the government will have little choice but to implement more austerity, hurting growth further.

Market reaction subdued

So far, markets have been relatively calm since the result. This is because opinion polls had been flagging a defeat for Renzi for some time, and so investors have been reducing their holdings accordingly. The Italian FTSE MIB equities index is currently trading a little lower today, but year-to-date, the index has fallen just over 9%. This represents a substantial underperformance compared to the German DAX 30 (up 13.6%) or the French CAC 40 (up 13%) over the same period.

Meanwhile, the yield on a 10-year Italian government bond has risen by 0.139 percentage points to 2.035%. As with the equity market, Italian bonds have seen yields rise over recent months in anticipation of the result. While higher interest rates will increase the cost of borrowing for the government at the margin, the average interest rate paid by the government is still over 3% (due to debt issued when yields were even higher). Therefore, the rise in yield so far will not have much of an impact on public finances.

Italian banks in focus

Concerns over several Italian banks will persist. A high ratio of non-performing loans to equity is a concern, and one bank's private sector bail-out could now be in jeopardy. This could result in a "bail-in" of investors before the government can step in to recapitalise the banks. The trouble is that many of these investors are actually ordinary retail customers, with little capacity to absorb losses. None of this will be easy to manage, especially if a lack of leadership persists for too long.

Pressure rises on ECB

One of the key reasons for the muted reaction in markets is the dampening effect of the European Central Bank's (ECB) quantitative easing (QE) programme. The ECB's ongoing buying of bonds (including Italian bonds) means that investors are less concerned about a sudden stop in demand. However, the ECB's governing council will meet later this week where it is expected to provide an update on its outlook, and whether or not it will allow its QE programme to end in March 2017 as planned.

Given the events in Italy, the ECB's QE programme has become more important than ever. Although not designed to bail out governments, if the ECB were to announce tapering of purchases, or an end to the programme, then investors could panic and sell their holdings of Italian government bonds. This could trigger a wider crisis in financial markets, calling into question the solvency of the Italian government and the fragile banking system. Fellow countryman and ECB president Mario Draghi will be under pressure to maintain QE for the time being.

Conclusions

Events in Italy mark a missed opportunity for the nation to follow the likes of Spain in successfully implementing growth-supporting reforms. The political uncertainty that will follow will be short-lived, but the new leadership will suffer from political paralysis until the voting system is fixed, and a new election takes place. Even if the anti-establishment parties are fended off in the expected 2018 election, true economic reforms are unlikely to have an impact until 2020 or beyond.

In the meantime, Italy will remain highly vulnerable to global shocks, and could easily fall out of favour with investors, especially once the ECB's support is withdrawn as it inevitably will be at some point. More widely, this is the third major political upset in six months. Following Brexit, Trump and Renzi, attention will turn to the Dutch, French and German elections next year, where all three present more risks for investors.