

Europe Grows Anxious After Italy Votes 'No'

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Italy's rejection of reforms and Renzi's resignation may lead to early elections or other scenarios that could spook investors already facing a tumultuous political year in Europe. Then again, markets may have already discounted future bad news, and the ECB stands ready to step in.

Key takeaways

Understand

- This referendum was a significant loss for Renzi and might also be viewed as a vote against the EU and euro, with the failure of establishment parties and policies continuing to resonate post Brexit and Trump.
- In saying "no", voters have missed another opportunity to enact much-needed reforms to Italy's electoral law, which means the government will continue finding it difficult to make effective decisions.
- The backlash to the referendum's result will depend on whether investors feel that Italy – which is already in near-permanent economic stagnation – has thrown away its last chance to elect an effective government.
- Perversely, the referendum's rejection also delays the possible threat of a more radical, anti-EU government; this should reduce regional fears for a while.

Act

- If this triggers a severe political reaction in Italy, it may cause a run on shares of Italy's banks. This could trigger a run on Europe's banking system and create a euro crisis similar to the one seen in 2010-2011.
- The rejection of Renzi and his reforms means funding costs to Italy's borrowers will likely widen substantially, further hurting increasingly leveraged borrowers and undermining ECB policy.
- In keeping with our previously identified theme, politics will clearly remain a key investment consideration in the coming years. During that time, however, Italy will be domestically focused, and will therefore likely be unable to help push for the changes Europe needs in a post-Brexit world.

The constitutional reform referendum held in Italy on 4 December was an attempt to modernize the antiquated institutional framework of the Italian government and speed up its sluggish decision-making processes. Equally important, in asking for this vote, Prime Minister Matteo Renzi and his government had hoped to win the political support they needed to alter the balance of Italian politics in the future.

With the referendum's "no" result now clear, Renzi has suffered a stinging defeat and has said he will resign after failing at his attempts not only to make the existing legislative process quicker and more direct, but to consolidate power with his centre-left Democratic party.

After "no", what happens next?

At this stage, we see four distinct possibilities:

- After offering to resign, Renzi may still hope to get a new mandate from President Sergio Mattarella before trying to win a confidence vote in Parliament; this would enable him to continue to lead until the next scheduled election, which will take place in spring 2018.
- This interim government – reminiscent of the Monti administration of 2011-2013 – could then try yet again to reform the electoral law. In the process, Renzi could be challenged through a no-confidence vote by several parties, including the Five Star Movement, Lega Nord and Forza Italia.
- Italy has been in a similar predicament with an interim government many times since World War II: *64 administrations have been in office since 1945*. If Renzi follows this path, political stability will remain as delicate as it is today, and Italy will be unable to offer any significant leadership to the European Union's other problems. But if electoral reforms somehow gain traction, full elections would then be held in late 2017 or 2018.
- On the other hand, if the president is unable to find a replacement who can win a confidence vote, then the Parliament will be dissolved and the president will call a new election in 2017. Although unlikely, this scenario would lead to full elections under the existing laws – and in the absence of any reforms, those elections would likely produce another weak government or coalition.

Ramifications for the markets

Barring a severe political backlash for Renzi's party, the markets have already discounted much of the nervousness and bad news that will almost certainly be triggered by Renzi's defeat. Reforms were already behind schedule, the banking crisis seemed to be intractable because of the bond bail-in rules, and Italy was not conforming to its EU budget obligations to reduce the deficit.

While the defeat to the status quo will be seen as a continuation of the political trend that started with Brexit and continued with Donald Trump winning the US presidency, it may also give Italy time to consider its future during an otherwise volatile political year. Populist nationalism is on the rise in Europe – especially in Austria, which also went to the polls on 4 December – and major elections loom in Holland, France and Germany.

All eyes on early elections

With the "no" campaign now victorious, the next big question is whether early elections will be triggered – something that Renzi's party had said they favoured if they were to lose. This could have a range of negative implications that certainly bear watching, including further delays in the quest to reform Italy's government, more political chaos at a time when the economy remains delicate, a reduction in investor confidence and questions about the sustainability of Italy's public debt.

At the same time, this "no" vote won't necessarily trigger early elections, but if they are held, the Five Star Movement that is breathing down the neck of the governing central-left democratic party could come to power.

- The Five Star Movement are a populist, anti-establishment party with no governing experience. They have a limited political program and rely on polling its registered members online on a case-by-case basis.
- If there is an early election, it will likely happen in the latter part of 2017, but it is too early to speculate on whether the populist parties would win – especially considering the other elections that would be held first in the Netherlands and France.

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