

## Comments on the Italian Referendum Result

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Together with the vote on Brexit and the US presidential election, the Italian referendum on constitutional reform has been on global investors' radar over the past few months. On 4 December 2016, Italian citizens voted "No" in the referendum, thus rejecting the reform proposed by the government led by Prime Minister Matteo Renzi.

The main objectives of the reform were to:

1. Significantly reduce the authority of the Senate or Upper House in the Italian Parliament. Currently, the Senate and Lower House have exactly the same powers. The reform would eliminate duplicate powers and transform the Senate to a consultative chamber of local government representatives.
2. Reduce the number of senators from 315 to 100 and the number of elected politicians in parliament from 945 (630 in the Lower House plus 315 in the Senate) to 730, thus lowering the cost of a political apparatus which is one of the most expensive in the western world.
3. Introduce several new paths for a law to be approved.

In our view, the reform would have been a positive step for Italy. However, as we have written recently in our Lazard Insights series, *Italian Constitutional Referendum: Basics for Investors*, the majority of Italians had limited knowledge on the actual reform and used the referendum as a vote for or against the government after Renzi threatened to resign in the event the referendum was rejected. It is our view that on 4 December, the Italian people voted against the government and Renzi.

## What Happens Next

Renzi has announced that he will resign.

We expect some political and market instability over the short term. There are two scenarios that are most likely at this stage:

1. The President of the Republic, Sergio Mattarella, will convince Renzi to remain as prime minister, but with a new government.
2. Mattarella will facilitate the formation of a new technocratic government led by one of the senior members of the current cabinet (e.g., Finance Minister Pier Carlo Padoan).

We believe that early elections are possible but unlikely at this stage as, with the current system, there are two different electoral laws in the Senate and the Lower House, which virtually guarantee no one party reaches a majority in both houses.

In either scenario outlined above, the new government will likely have limited scope other than passing next year's budget and drafting a new electoral law to ensure some ability to govern after the 2018 general elections. Italy's economy will likely continue to muddle through, but it may now be more difficult to find a political solution to the troubled banking sector.

Despite the outcome of the referendum, it is our view that Italy is in dire need of structural reforms. We believe these remain key priorities for any future government:

1. **Draft a new electoral law for the Senate and modify the electoral law (the so-called Italicum) for the Lower House.** In particular, we believe the majority premium in the Italicum is too high, with 54% of the seats going to the party or coalition that wins 40% of the votes in the first round of the election or that wins the second round. In our view, it is important to design a new system that can allow a party or coalition to achieve a majority in both houses. The new government should be able to accomplish this.

2. **Fix the banking sector.** In our view, issues with Italian banks are not just economic, they are political. However, we doubt the new government will have enough political capital to try to fix the problem while at the same time providing guarantees to retail investors who own the subordinate debt of several of the troubled banks.
3. **Enact a comprehensive reform of the judicial system, to make it faster and more efficient.** In our view, this is a key structural reform that will help modernize the country and make it more competitive in the global economy. For example, it is estimated that in 2015 there were 4.5 million open civil court cases, 36% of which had been with a court of appeal for more than three years. This is a deterrent for entrepreneurs and businesses to invest in Italy. Renzi's government has already passed a reform of bankruptcy proceedings which, over time, should accelerate the repossession process, thus increasing the value of the underlying collateral for non-performing loans (NPLs). This should help to mitigate the issues with NPLs in the banking system, which have reached €200 billion this year and are distributed across a number of sectors. However, a more general reform of the judiciary is needed. Unfortunately, we do not think the new government will be able to accomplish this.

## Investment Implications

While the outcome is not what most investors had hoped for, it was already partially priced in by the market. We can now expect some political noise and market instability over the next few days and weeks. The main concern in the markets is that the “No” result will open the door to the populist Five Star Movement coming into power in Italy. This group has promised multiple times to have a referendum on the euro once they are in the government. Therefore, the risk of Italy exiting the common currency—which would lead to a disintegration of the euro project—appears to be a real possibility. We believe that these concerns are legitimate but are also exaggerated. First, the Italian constitution does not allow for referenda on international treaties. Second, we would expect the Five Star Movement to moderate their tone and become more pragmatic after winning an election. Finally, and somewhat ironically, the new system proposed with the referendum would have made it easier for the Five Star Movement to win the next election. We now expect that the new electoral law will be designed in a way to minimize the risk of non-conventional parties like the Five Star Movement coming into power (for example by changing it from a majority system to a proportional or hybrid system).

We still believe Italy is in dire need of reform and it will eventually get done. How and when will depend on what happens on the political front.

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### Notes

- 1 Source: Fubini, Federico. *“Esplora il significato del termine: I numeri della giustizia civile in Italia: sono 4,5 milioni le cause arretrate I numeri della giustizia civile in Italia: sono 4,5 milioni le cause arretrate.”* Corriere Della Sera, 16 April 2016.

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