Italy and the European Union:
What’s Next After the Referendum?

January 2017

In December, Italians overwhelmingly voted to reject proposed changes to the nation’s constitution. Like Britain’s Brexit vote and Trump’s presidential victory, the Italian referendum results reflected underlying anti-establishment sentiment. But unlike Brexit, there was no direct link to Europe and the markets were generally nonplussed. Meanwhile, the recent vote in Austria demonstrated that the political center continues to hold. While a disappointment for those hoping for continued reform efforts, Italy’s vote underscores our long-held view that Europe is consistently moving two steps forward and one step back. Italy’s problems, like many of its neighbors, are structural in nature. However, in our view, Italy will not go out on its own. In the end, peripheral Europe must fix its lackluster productivity and anemic growth problems. The biggest question is whether Europe can survive rising populism and its packed election calendar in 2017. Its future depends on it.

Italy’s political turmoil is inextricably linked to its troubled banking system, economic woes, and ballooning government debt. The country requires meaningful tax reform and simplification, a less bloated bureaucracy, less rigid labor laws, and less suffocating regulations, which are all hampering economic growth. And what happens in Italy won’t stay in Italy. The nation is the third-largest economy in the Eurozone, and its dour situation adds a big dose of uncertainty to the bloc’s immediate and long-term growth prospects. While remote, the referendum result could possibly strengthen populist and nationalist movements throughout Europe, which is already straining due to the combined impact of weak economic growth, immigration, terrorist threats, and the consequences of the Brexit vote. Most likely, Italy’s political and financial troubles will endure and cast its long-term shadow on Europe.

On our recent trip to Italy, we met with officials at Banca d’Italia – the nation’s central bank – and with members of the business and political communities. There is no question among serious-minded people that the country’s problems are grave and that there are strong headwinds to confront. Our reading is that Matteo Renzi, Italy’s former prime minister, placed far too great an emphasis on linking the referendum to himself. Many in Italy viewed the vote...
not in protest terms, but as an opportunity to get rid of the prime minister who had made many political enemies in and out of his own party due to his reform and austerity efforts. Our guess is that we will hear from Renzi and even Berlusconi again.

That said, Italians have a sense of balance that’s derived from practicality and historical perspective. Italians meet new governments with a shrug of shoulders rather than a wringing of hands: Renzi’s resignation ended Italy’s 63rd government in 70 years, so Italians have become somewhat inured to events that would be momentous in another country. It seems that governments come and go, but the debts and slow-growth concerns just keep mounting. On the other hand, the newly created debt fund to recapitalize Italy’s weakest banks will provide some near-term relief.

A FAILED REFERENDUM AND THE POPULIST MOVEMENT

The final tally came in at 59% against the reform proposals and 41% in favor of them. Renzi had made the referendum a vote on his leadership, vowing to resign if the proposals failed. He made good on that promise and Paolo Gentiloni, a member of Renzi’s Democratic Party, became the leader of the new center-left government that will guide Italy until the next elections, which could come as early as February or as late as 2018.

Renzi and other reform advocates argued that the alterations proposed in the referendum would have improved Italy’s cumbersome legislative process by revamping the country’s Senate, slashing its authority, and removing power from regional governments. Italy’s bicameral system gives its two chambers the same powers, which often leads to gridlock, and the reforms would have tipped the balance of power sharply toward the lower-house chamber of deputies. Populist groups and other opponents campaigned against the proposals, based on a mix of anti-establishment contrariness and fear that the changes would result in a concentration of power.

The rejection of the referendum was seen by some as a victory for Italy’s populists, especially the Five Star Movement (M5S). Born and bred on the internet, M5S initially focused on advocating for voting for policies and candidates through direct online democracy. Led by Beppe Grillo, a vulgar former comedian and convicted murderer, M5S has served more as a platform for anti-establishment rage rather than as a vehicle for advancing an ideology. Unlike populist parties in other countries, M5S does not take an anti-immigrant or anti-Muslim stance. Another populist party, the Northern League, fills that space.

Emboldened by its victory in the referendum and polling at 30% in a multi-party race, M5S is eager to hold immediate elections. Before any vote can take place, however, Italy needs a new electoral law to replace the existing Italicum (the nickname for the electoral law that governs Italy’s Chamber of Deputies). Approved in 2015, the Italicum would give the winning party in the Chamber of Deputies a majority, but not in the Senate, which was supposed to have had its powers curtailed if the referendum had passed. An advocate of the Italicum, Renzi had hoped that the law would give his Democratic Party a majority hold on the government. However, the threat of M5S gaining a majority under Italicum is leading establishment parties to call for a rewrite of the law to eliminate this possibility. Elections will take place only after the court ruling and a straightening out of the electoral laws.

While M5S has significant popular support, the vast majority represents a protest vote rather than a support of its policies. M5S has not produced a coherent and coordinated vision of how it would govern and even when it does have a clear position, it may not be in tune with voter interests. For example, M5S is anti-euro and has pledged to carry out a referendum on whether Italy should remain in the Eurozone if it comes to power. However, a poll published November 21, 2016 by La Stampa, an Italian daily newspaper,
found that only 15% of the population were in favor of leaving the euro, with 67% declaring themselves to be true single-currency believers. Even if a referendum were held and voters expressed a desire to leave the Eurozone, the Italian constitution bans the abrogation of international treaties via a popular vote. A constitutional amendment might be necessary even before calling a referendum and that would require a two-thirds majority vote by both houses of parliament.

M5S has other credibility problems. Last June, M5S’s candidate Virginia Raggi was elected mayor of Rome. What M5S hoped would be a demonstration of how well the party could govern became a mess – literally and figuratively. Garbage piled up in the streets through the summer and five senior officials resigned, including some accused of corruption. The troubles in Rome have damaged M5S’s image and its claim to competence.

Meanwhile, Matteo Renzi cannot be counted out as a player in Italy’s future. He’s young, ambitious, and highly energetic. And he will likely have to work with Silvio Berlusconi to make it work. Gentiloni is seen as a caretaker prime minister who’s keeping the seat warm for him. While Renzi suffered a defeat in the referendum, the “yes” camp still got 41% of the vote. If that 41% translates into popular support for Renzi’s Democratic Party in an election. He will likely surface again as a contender to run his nation.

ITALY’S BANKING CRISIS – NO EASY SOLUTIONS

The bottom line is that Italy wants the best of both worlds. It has socialized some of its debts via the local community bank deposits and yet wants to protect savers (i.e. voters), but not bondholders without falling afoul of taxpayers and new European Union (EU) bailout rules. Italy has two serious and connected problems, its banks and its economy, with the former being its most urgent concern. In short, the banking system is saturated with bad loans. Non-performing loans (NPLs) have tripled since the beginning of the global financial crisis: There are €360 billion in impaired loans in the Italian banking system, of which €200 billion are classified as being close to default. To put this in perspective, Italian NPLs account for about a third of those in the entire euro area, and the ratio of non-performing loans to total loans is over 16% – three times the European Union (EU) average.

The biggest immediate worry is Monte dei Paschi di Siena (MPS), the world’s oldest bank and Italy’s third largest. In crisis mode for years, it has by far the highest ratio of bad debts to outstanding loans among major Italian banks. MPS emerged as the worst performer in stress tests – which measure the capacity of a bank to withstand external shocks – conducted last summer by the European Banking Authority. Italy’s largest lender, UniCredito, was also among the banks that fared badly in the most recent stress test.

In our opinion, Italy’s banking problems require a system-wide bank clean-up or self-help. In December, UniCredito, Italy’s only globally systemically important bank, announced a plan to raise capital, sell assets, shed loans, and slash costs while writing down its worst loans. It’s looking to cut 14,000 staff and almost 1,000 branches. Other banks – especially MPS – need outside assistance. Private investors are scarce, especially in the uncertain political environment, and EU resolution rules place limits on a government bailout and are aimed at avoiding repeats of the bailouts in several countries following the 2008 financial crisis. Specifically, the rules require that investors take losses first before public money is used. Any resolution that involves bondholder losses will be politically problematic: A 2016 International Monetary Fund (IMF) report notes that retail investors in Italy hold €200 billion in bank bonds and an additional €60 billion in subordinated debt. Not a good combination.

It is our belief that at its root, the Italian banking system is in serious need of consolidation and reform. According to data from the Federal Reserve Bank of St. Louis, the country has 60 branches per 100,000 citizens, compared with
38 in France, 15 in Germany, and 25 in the United Kingdom (UK). In addition, the Italian insolvency system is complex and its procedures lack coordination and a unified philosophy. According to statistics furnished by the Italian Ministry of Justice, liquidations have lasted more than eight years on average and cases lasting twice that long are not unusual.

Italy’s politicians and bureaucrats are furiously trying to cobble together a plan to deal with the country’s banking problems. An exception to EU rules limiting state aid is permitted if there are exceptional circumstances when a serious disturbance emerges in the economy. So far, the bloc’s leaders have not accepted the argument that the problems are serious enough to invoke that dispensation.

Italy is between a rock and a hard place due to its lack of previous serious reform efforts. Even with the ballooning debt, nationalizing Italy’s weakest lenders remains on the table. Prime Minister Gentiloni is taking on what some refer to as “mission impossible” as Italy would be forced to take its medicine. In late December, the Italian parliament approved a backstop fund to borrow up to €20 billion to support its banking sector just hours after MPS had failed to raise the €5 billion it required as sufficient capital to stay afloat without state aid. Unless the problem is fully dealt with, the final straw for Italy may come when the European Central Bank (ECB) starts to reduce its quantitative easing program at some point next year. Without the ECB’s support, Italian zombie banks (banks which are insolvent but continue to operate) haven’t been subjected to the necessary market pressures and a subsequent crisis that would induce a forced restructuring. The ECB’s efforts have reduced Italy’s debt financing costs greatly. And, if and when that artificial safety net disappears, the Italian bond market may be in for a reckoning.

**TWO LOST DECADES...AND NOW LATE TO THE PARTY**

We believe that the problem with Italy’s banks will be compounded if the country’s economy doesn’t improve. In October 2016, the IMF cut Italy’s growth forecasts for the second time in less than three months, citing concerns about the outlook for the country’s banking system, low productivity and investment growth, an 11% unemployment rate, and a national debt that has risen to 133% of GDP. Projecting that Italy’s GDP would expand by only 0.8% in 2016 year and 0.9% in 2017, the IMF further forecasts that it will be the mid-2020s before Italy’s economy returns to its pre-2007 levels. This means that Italy will have suffered through two lost decades of economic performance.

Italy’s demographics are also not helping matters. An aging population combined with a low fertility rate (1.37 children per woman compared with a 1.58 EU average) has resulted in the number of people in the economically productive 25-to-49 year range shrinking by 700,000 in the last 10 years, according to data compiled by Bloomberg. Even worse, that age group has the potential to contract by another 2 million by 2029.

The prescription for getting Italy out of the doldrums has been hard to find. Unlike Ireland and Spain, which more quickly dealt with their own banking problems, Italy sat on its hands. New EU rules now constrain deficit spending and bank bailouts by member nations, and Italy’s already high public debt-to-GDP ratio in any event would limit capacity for extra borrowing to support greater public spending. Witness the divergences in yields between Spain and Italy late last year. Renzi had undertaken a number of reforms during his time in office to improve Italy’s competitive position. The issue in Italy, however, is not passing legislation – there have been dozens of so-called landmark reforms over the last 20 years. The issue is making reforms operational by getting through the thicket of bureaucracies in central and local government that are obstacles to change.

**SOME GROWTH ON EUROPE’S HORIZON**

The problem for Italy in our opinion is circular: Its banks cannot become healthy without growth, its economy can’t grow without healthy banks, and neither will flourish without real structural reform. Italy is the third-largest economy in the Eurozone and until its banking and economic problems are addressed, the country will be a drag on the EU’s vitality and future viability. The Italian economy remains sluggish. While consumer demand is resilient, the labor market is weak. Italian joblessness rose to 11.9% in December, its highest since June 2015.
Growth in the rest of Europe looks more upbeat as the labor markets continue to recover and manufacturers are entering 2017 on a strong footing. German exports jumped 3.9% in November. While the IMF estimates that GDP in Eurozone countries grew 1.7% in 2016 and will slow to only 1.5% in 2017, euro-area manufacturing actually expanded last month at the fastest rate since April 2011. Readings rose in all seven countries. Further, the Markit Eurozone Purchasing Managers’ Index held steady at 53.9 (a score over 50 signifies expansion) in December and the outlook for industry appears positive.

The recent strong U.S. dollar and weaker euro are also positive for the region’s economy. Meanwhile, the ECB continues its accommodative stance. In December of 2016, President Mario Draghi of the ECB announced the central bank would continue to pump more money via quantitative easing into the Eurozone economy until the end of 2017, an extension of nine months. From April 2017 on it will buy €60 billion of assets each month, down from €80 billion. Draghi also indicated that the ECB could boost the pace of asset purchases and run the program into 2018 if circumstances demanded. With European macro data continuing its recent strong relative run, 2017 will represent a major inflection point.

**2017 WILL BE THE YEAR THAT DETERMINES EUROPE’S FUTURE: A FATEFUL YEAR OF ELECTIONS**

We believe that this year will be about headline risk, but will likely see no fundamental changes. It is indeed ironic that Europe has sidestepped the now more populist-leaning UK and U.S., which are leaning more statist and leftward. Right-of-center party leaders in Spain, Germany, and possibly now France, may occupy the limelight. In addition to the ongoing possibility of a general election in Italy, voters will definitely be going to the polls in several European countries in 2017 to include the Netherlands, France, and, most importantly, Germany. Should anti-euro parties score big wins their ascent, coupled with the Brexit uncertainty, it may put Europe’s future in jeopardy. However, support for the euro across the continent remains stable as few Europeans really want to leave the EU.

The Netherlands is up first in March. If the Dutch elections were held today, the far-right, anti-immigration Party for Freedom (PVV) led by Geert Wilders would become the largest party in the parliament, according to Maurice de Hond, a well-regarded pollster. Wilders is leading calls for a referendum on the nation’s membership in the EU as he attacks Merkel’s pro-asylum position. Still, they have little chance of forming a government. The PVV’s projected 33 seats out of 150 seats in the lower chamber of the Dutch parliament would require it to build a coalition with other parties, which we believe would be no easy task.

Next comes France in May and June. In France, the anti-EU, Marine Le Pen of the anti-globalization and anti-immigrant National Front will most likely win enough votes in April’s first round of elections to put her in a two-candidate presidential run-off. However, recent polls show that she will lose by a wide margin in the second round as voters line up behind a less-extreme opponent. For example, an Ipsos/Sopra Steria poll released December showed Le Pen has lost ground as support grows for François Fillon, the pro-business candidate of the center-right Republicans. It seems as though Le Pen’s popularity peaked in 2013.

Finally, Germany is up in the fall. Germany’s Chancellor Angela Merkel announced in November that she will seek a fourth term in the nation’s next elections, which will likely take place in the early fall. The country is dealing with a flood of more than 1 million migrants, the threat of terrorist attacks, a dramatic rise in far-right extremism, and an ascendant populist party. According to a recent poll by German broadcaster ARD, the nationalist anti-immigrant Alternative fur Deutschland (AfD) party is on
track to become the third-largest party in the country and its 16% support level would put the party well above the 5% needed to win seats in the Bundestag. However, the ARD survey found that 54% of respondents were satisfied with Merkel, and her approval ratings have stabilized. And while support for the Merkel’s Christian Democratic Union and the Social Democratic Party has weakened, there is still enough electoral strength to maintain the grand coalition currently governing the country. In addition, the migration crisis has abated and the economy is running strongly.

While European populist movements have gained ground, they need to be put in their proper perspective. Nationalist parties tend to top out at 30% support, leaving significant room for mainstream parties to form coalitions and maintain control. Witness the recent presidential elections in Austria. In addition, the task of governing often proves to be a real challenge for populists, as evidenced by M5S’s failure in Rome. And in Greece, the left-wing populist Syriza party has failed miserably to deliver on promises to relieve the country of creditor-imposed austerity policies.

THE FUTURE OF EUROPE HAPPENS IN 2017

While the recent referendum was specifically not a vote on the euro, the real risk is still on Italy in 2017. While Italy benefits greatly from being in the EU, its inability to manage its own currency and engage in lasting reforms are hindrances. Specifically, Italy must address its structural issues and reenergize productivity and economic growth. Support for the euro remains stable, but is lower than elsewhere. Any whiff of a potential exit from the euro will be immediately followed by a market sell-off. The shorter-term risk is a mishandled bailout of MPS, which may raise the risk of contagion while the longer-term risk is not to engage in real structural reform. We don’t believe that Italy will leave the EU, but Italy must determine a way to become more competitive. In our opinion, fixing its slow judicial and inefficient insolvency process and system, protected service industries, rigid labor laws, and bloated bureaucracy will be paramount.

What about Europe? The big question is whether the recovering economy and unprecedented central bank stimulus survive populism and the political and electoral minefields in 2017. For those inclined to safety, the French presidential elections may serve as an entry point to increase holdings in the region. We stick to our long-held view that Europe remains in the two steps forward, one step back paradigm. European equities could experience a strong year if anti-establishment parties are held at bay as we expect. If populist parties triumph, however, the discount of a potential break-up could return to the markets. Longer term, Germany must allow for greater fiscal integration and less austerity for the European Union to survive.

PNC Capital Advisors’ International Growth Equity Team remains slightly overweight European equities. We believe that Europe is in line for modest GDP growth over the next few years especially in light of a weaker euro brought on by the divergent path of central banks. While unemployment is slowly declining, it remains stubbornly high relative to other regions. Brexit will likely be an overhanging issue for the EU for some time, and the UK must invoke Article 45 before the clock starts ticking for the country to actually exit. The UK and EU will be in negotiations about the terms of a future relationship during the two-year exit process and much of the final arrangement will probably remain unclear until near the end. As a result, we believe that some level of uncertainty will continue to pervade the continent’s environment even after 2017.
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In the market overall, international investment flows have been out of Europe the past year. While our team has been focusing increasingly on opportunities in Southeast Asia, we believe that Europe still looks promising. For those bold enough to remain vigilant in the face of the political turbulence in 2017, compelling valuations, decent economic growth, a weaker euro, and stronger banks could be exactly what makes Europe a potential outperformer in 2017. Call us in June.