



MARKET INSIGHT

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THE ITALIAN REFERENDUM: WHAT IS REALLY AT STAKE?

On December the 4th, Italian voters will go to the polls to decide on a constitutional referendum that has drawn much attention by international observers. Although the referendum itself is rather a technical vote with complex implications, the local media have morphed it into a simple vote of confidence for current Prime Minister Matteo Renzi. Latest polls are pointing towards a no vote. What is the referendum about exactly and what is the mid-term implications of a no vote should it materialize?

The current Italian political system is composed by a perfect bicameral framework with a total of 945 elected members split between deputies and senators. The house of deputies has the same powers than the house of senators and bills need the approval of both chambers to be passed into laws. Because of the bicameral system, Italy is facing a certain degree of inertia when it comes to reforming taxes, courts, labor law and other legal aspects of the economic life.

Under the proposed referendum, the dual-chamber system will be dismissed and the powers granted to senators will be decreased while the number of senators reduced. Finally, a number of functions currently attributed to regions will be re-centralized in order to create more efficiency. Ultimately, the senate will no longer have the power to approve new proposed legislation. The

last bit of change comes in the form of a new electoral law called "*Italicum*" which is subject to much debate even within the democratic party of current Prime Minister Renzi.

At a first glance, the objectives stated in the referendum are generally positive as it would create a more efficient legislative framework for facilitating reforms. From the outset of the campaign, Matteo Renzi has personified the reform, compelling voters to express (or not) their confidence in the current Prime Minister. However the European landscape is nowadays defined by a general defiance from the public for current leaders, their politics and the Brussel's bureaucracy. Even if the referendum has a number of merits, voters will take the opportunity during the polls to express their fatigue in the current establishment and their desire for change.

From a reform perspective, the judicial system is in dire need of improvement. According to the IMF, it can take up to 8 years to resolve a civil procedure taking into account the first, second and final instances. This compares to an average of 800 days for the OECD. Resolving such latencies could help boost growth in Italy as judicial inefficiencies are deemed to cripple the economy. First, international investors are reluctant to deploy and invest capital in a country served by a weak judicial system and slow courts as their

degree of protection is at best uncertain. The cost of capital is therefore higher as investors are factoring in the weak enforcement process in their premiums, hence lending to Italian SMEs at a much higher rate than in other developed countries, indirectly penalizing growth.

Should the referendum pass, Prime Minister Renzi will have the flexibility to implement a number of changes to the judicial system. A reduction in the number of courts, higher barriers to entry in the form of increased court fees, active promotion of mediation to resolve disputes as well as the digitalization of courts in order to measure and track results are all being considered. Although compulsory mediation was deemed unconstitutional in 2012, it was reinstated a year later but it is sparingly used as the public are not well informed of this faster and cheaper option. A more efficient legal system is likely to attract foreign direct investments and promote growth in the long run.

Politically, a no vote could have several short term implications. Because Prime Minister Renzi has maneuvered this vote into one of confidence, by mentioning numerous times that a no vote would trigger his resignation from the government. While his communication strategy has changed as of late, Renzi will certainly feel the pressure from the opposition should a no vote



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prevail. The extreme scenario of a no vote would mean a resignation of Renzi, followed by early elections and significant advances for the Eurosceptic party *Cinque Stelle in government*. Should the referendum succeed, Renzi will come out stronger and Italy is unlikely to vote until the end of the current legislation in 2018.

From an economic point of view, a no vote is likely to impact Italy negatively, at least on a mid-term basis. The country is perceived by investors as subpar to its southern Europe counterparts such as Spain, or even Portugal in terms of ease to invest as well as creditor protection. The country's banking sector in particular is in desperate need for judicial reform. Most banks are crippled with piling stocks of non-performing loans ready to be sold on a non-existent secondary market. Even if a small number of institutional investors have set foot in Italy to buy bad loans, the amount of capital deployed is far from sufficient to tackle the €340bn potential problem faced by banks.

The outcome of bad loans is heavily reliant on the ability to enforce contracts and the ease of access to a functioning judicial system; it is hard to see the prospect of any significant improvement on that front without substantial reforms being undertaken.

The key to this referendum is confidence. Will Italian voters show confidence in Prime Minister Matteo Renzi or will they defy his politics and the current government? For investors, a yes vote will be seen as continuity in current politics and demonstrate that the country has what it takes to reform its institutions. On the other hand, a no vote will erode the faith of investors in the ability of Italy to carry out the much-needed reforms and could result in a loss of confidence and lack of ability to move forward.



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