Italy's referendum is next test for Eurozone stability

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1. Italy's referendum could be critical for the Eurozone

Italy was one of the 6 founding members of the European Union (EU) in 1957, along with France, the Netherlands, W Germany, Belgium and Luxembourg. Its referendum next month will therefore be a critical test of whether the Eurozone and EU can survive the pressure from the Populists.

If the Populists win, the future of the Eurozone and the EU itself will be in doubt.

As often happens at critical moments, the subject of the referendum is of relatively minor importance. It was called by Premier Matteo Renzi to amend the constitution by approving a reform of Italy's Parliament. The problem is that he then made himself the key issue in the referendum, by promising to resign if he lost, as he confirmed to Italian media recently:

"If the citizens vote no and want a decrepit system that does not work, I will not be the one to deal with other parties for a caretaker government"

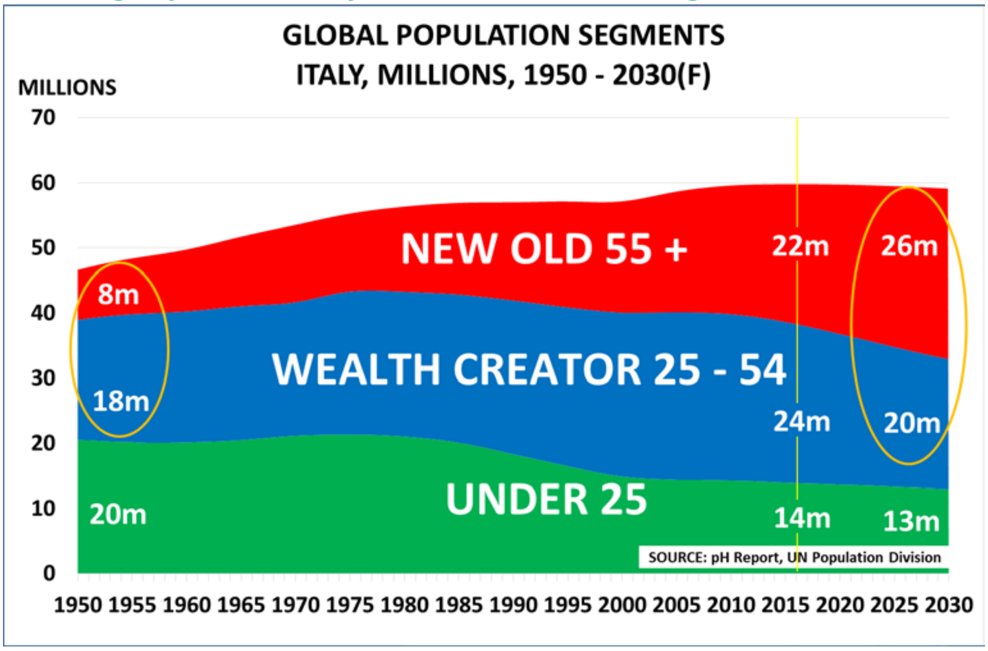
Italy is now in a 2 week blackout period for polling before the vote on 4 December. But the final polls showed the "No vote" with a comfortable lead. There is therefore a major risk that Renzi will soon be following UK premier Cameron out of office. 3 quite different Scenarios could then develop:

- **Another premier takes over**. Italian premiers have historically not lasted long. Before Renzi took over in 2014, there had been over 50 different premierships since Italy's first post-War premier, Alcide de Gasperi, resigned in 1954. So maybe, the revolving door revolves again, and a new premier is appointed by the President
- **New elections are held, and another premier takes over**. Renzi was the 3rd Italian premier in a row to take office without have a personal mandate from an election (neither Mario Monti or Enrico Lette had this). An election may therefore take place, after which perhaps the revolving door revolves again
- **New elections are held and an anti-euro coalition takes office**. This would seem to be the base case Scenario, with a probability of at least 50%. It would likely means that Beppe Grillo's anti-euro 5 Star Movement would take office with Berlusconi's Forza Italia and the Northern League, and would then hold a referendum on leaving the euro – with the aim of capping Italian debts and nationalising its banks, as Grillo has promised

Given that around €360bn ($400bn) of all Italian loans are classed as "troubled", and amount to around one-fifth of total loans, capping the debts would cause major disruption to the Eurozone and global financial systems. Leaving the euro would also mean, that foreign holders of Italian debt would be paid in Italian lira, not euros. And presumably this would be after a devaluation of the lira. So as the Financial Times has warned:

"Since banks do not have to hold capital against their holdings of government bonds, the losses would force many continental banks into immediate bankruptcy. Germany would then realise a massive current account surplus also has its downsides. There is a lot of German wealth waiting to be defaulted on."

2. Demographic reality is now confronting stimulus fantasy



Italy's real problem is not its Parliament, but that its economic policies haven't adjusted to the New Normal world. Like most developed countries, politicians of all parties have failed since the end of the BabyBoomer-led SuperCycle, to understand the trade-off that has taken place between increased life expectancy and economic growth. Italy has a median age of 45 years, and as the chart above shows:

- It now has only 24m in the Wealth Creating 25 – 54 cohort, versus 22m New Olders in the 55+ cohort
- By 2030, it will have just 20m Wealth Creators and 26m New Olders
- This is completely different from the 1950 position, when there were 18m Wealth Creators and only 8m New Olders

The New Old already own most of what they need, and their incomes decline as they enter retirement. So it is not surprising that economic growth has stalled.

In addition, of course, Italy has become the main route for migrants and refugees following the EU's deal with Turkey. 168k people have already arrived this year, compared to 154k in the whole of 2015 and 170k in 2014. Resources have been further strained by the sequence of earthquakes, which are made worse by the lack of anti-seismic regulations for its buildings.

It is small wonder, therefore, that the 5 Star Movement is building support, having won Rome in this year's elections, whilst the Lega Nord (Northern League) won the Veneto and Lombardy regions.

Nor is it surprising that investors are starting to panic. Italy's 10 year interest rate has doubled to 2% since the summer. It could go very much higher if Renzi loses, as the prospect of a vote to leave the Eurozone and cap Italy's debts comes closer.

This is the Great Reckoning in action, and there is probably little that the European Central Bank (ECB) can do to mitigate the position. In a few weeks' time, investors may well wonder how they allowed Italian interest rates to trade below US rates for much of the past few years. And in a few months' time, it may well seem equally incredible that anyone ever believed ECB's President Mario Draghi's 2012 boast that:

"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough".

It could be a very difficult H1 in 2017. Next month's Italian referendum is followed in March by Dutch elections and in May by France's Presidential election. Both may well be won by parties committed to leaving the EU itself.

It is therefore hard to ignore the possibility that by June, the EU could have effectively ceased to exist in its current form.

About IeC

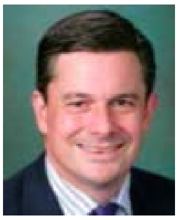
IeC is a London-based strategy consultancy advising Fortune 500 and FTSE 100 companies, investment banks and fund managers.

Paul Hodges

Is a trusted adviser to major companies and the investment community, and has a proven track record of accurately identifying key trends in global marketplaces. He has been widely recognised for correctly forewarning of the 2008 global financial crisis. His analysis of the key role of demographics in driving the global economy is now attracting increasing interest from senior policymakers and executives.

Paul is Chairman of International eChem (IeC), non-executive Chairman of NiTech Solutions; and non-executive director of Recycling Technologies.. Prior to launching IeC in 1995, Paul spent 17 years with Imperial Chemical Industries (ICI), both in England and the USA, where he held senior executive positions in petrochemicals and chloralkali, and was Executive Director of a $1 billion ICI business. Paul is a Global Expert with the World Economic Forum's Industrial Council and a Freeman of the City of London. He is a graduate of the University of York, and subsequently studied with the IMD business school.

Daniël de Blocq van Scheltinga



Was the first foreigner to be granted permission to run the finance company of a top-tier Chinese State Owned Enterprise, when establishing and managing ChemChina Finance Company. Previously, Daniël held a variety of senior positions in corporate and investment banking, including as Asia Pacific Head of Chemicals and Asia Head Asset Based Finance for ABN AMRO.

He has lived in Hong Kong for 16 years, and continues to spend much of his time in China, advising international and Chinese firms, as well as leaders in the public and private sectors. Daniël is a graduate of Leiden University in the Netherlands, holding a Master of Law degree with a speciality of International law.

James Gruber

Is a 14-year veteran of financial markets, having covered them as a leading fund manager, stockbroking analyst and journalist. Most recently, he spent 20 months as the founder/publisher of the widely-followed investment newsletter, Asia Confidential, which focused on key macroeconomic issues facing the Asia Pacific region. Prior to this, he was a Portfolio Manager for Asian Equities at AMP Capital, managing Asian and China A-share funds totaling US$1bn, for two years.

The performance of the China A-share fund was ranked no. 1 globally over one and two years during his time there. For five years prior to this, James was a senior research analyst at leading Asian brokerage, CLSA, where he covered multiple sectors in Hong Kong, Australia, Malaysia and Indonesia. He began his working life as a news journalist at the Australian Broadcasting Corporation.