Italy cannot afford to allow political instability to affect its troubled banking system

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One of the key concerns raised since Matteo Renzi's resignation as Italian Prime Minister is that a period of financial instability could damage Italy's already fragile banking system. **Mara Monti** *writes that although the short-term market reaction to Renzi's resignation was fairly mild, there may be a more severe reaction if the political situation cannot be resolved before the end of the year.*

After the strong vote against the proposed constitutional reform in Italy's referendum, Prime Minster Matteo Renzi has announced his resignation. Younger voters and southern regions mostly contributed to the vote against the proposal, which was almost 60-40 in favour of No, with a high turnout of 65.5 per cent. Both the percentage of voters rejecting the reform bill and the turnout were higher than projected by opinion polls, with close to 33 million people casting their preference (19.4 million voted 'No' and 13.4 million 'Yes'). By comparison, the turnout in the UK's EU referendum was 72.2% (corresponding to 33.6 million people). Voters abroad nevertheless backed the reform, with almost 60 per cent voting Yes.

As for what happens next, the fear is political instability will emerge, with the financial budget law still under discussion and the Europe asking who will replace Renzi as PM. The name circulating at present is the Finance Minister, Pier Carlo Padoan, who may be charged with setting up a new government with the goal of approving a new electoral before a general election in May 2018. The decision lies in the hands of the President, Sergio Mattarella, who has responsibility for deciding both over the terms of Renzi's resignation and how to appoint a new Prime Minister.

Renzi tendered his resignation on Monday, and while Mattarella accepted it, he asked Renzi to remain in power to oversee the passage of Italy's 2017 budget law, which is expected by the end of the week. Any sign that the new Prime Minister will follow in the footsteps of the current government and help to bring about market stability will be seen as a positive development for financial markets and in particular for troubled banks that are under pressure for capital increases.

With the Constitutional reform rejected, the current two-house system remains in place, as has been the case since 1948. Under the electoral law that is currently in place, the Parliament would be highly fragmented, possibly with different majorities in the lower and upper house, making it almost impossible to form a government. The scenario is highly volatile and the country could be headed for a long period without a stable government. However, Italy is not in the same negative position that it experienced in 2011, when Mario Monti's government took over from Berlusconi at a time when the spread of the Italian government against the German bund sat at 600 points. As in the case of Spain, which remained without a government for over 300 days, the lack of a stable government does not mean Italy is headed for a European bailout.

Market reaction has been mostly soft with market participants already positioned for a No result and the spread lower than Friday before the referendum. However, if there is no solution before the end of the year, financial markets will start to get nervous again: next year, the Treasury has government bond maturities for more than 370 billion euro, albeit thanks to the European Central Bank, interest rates will stay at a low level. ECB President Mario Draghi is expected to announce an extension of Quantitative Easing on 8 December.

The risk rests on Italian banks, with the focus on two main banks in particular, Monte dei Paschi di Siena and UniCredit. The wider fear is that problems could spread to other troubled European banks, such as those in Spain and Portugal. Investors are meeting to discuss a crucial 5 billion euro recapitalisation plan for Monte dei Paschi, an operation that could prove to be more difficult following Renzi's resignation.

Europe and Germany have said it is necessary to help Italy open the door to state aid for banks. On Monday, European Central Bank Governing Council member Ewald Nowotny indicated that "Italy might have to spend public money to rescue some of its banks, including by taking stakes in them". He noted that "the difference between Italy and other states, like Germany and Austria, is that, until now, in Italy there has not been any significant state aid or state takeovers (of banks)" and that "it therefore cannot be ruled out that it will be necessary for the state to take stakes (in banks) in some way." Only time will tell whether Italy is capable of negotiating these financial challenges against the backdrop of the new political challenges that have emerged since Renzi's resignation.

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