"No" vote in Italian referendum could spark banking crisis

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The outcome of next Sunday's Italian referendum, in which Prime Minister Matteo Renzi is seeking to reduce the size and power of the Senate, has the potential to set off a crisis in the Italian banking system that possibly could spread to the euro zone as a whole.

Renzi has championed the referendum, even threatening at one stage to resign if it does not get passed. He is seeking to move to a more authoritarian government with greater capacity to push through pro-business, neo-liberal reforms. The financial fallout from a No vote could be immediate, calling into question a rescue plan for the troubled Monte dei Paschi di Siena bank that went into operation yesterday.

Under the rescue plan, there would be a €5 billion debt for equity swap, coupled with an injection of fresh capital through the placement of shares on the market.

Monte dei Paschi, the world's oldest bank, is the most prominent expression of the deteriorating situation for the entire Italian banking system, having been the worst performer in European Central Bank (ECB) stress tests conducted last July.

The rescue plan is seen as part of a broader agenda in which Renzi would promote "market solutions" for the €4 trillion Italian banking system, which is burdened with €360 billion worth of impaired loans, €200 billion of which are considered to be non-performing. This compares with a total of €225 billion of equity in the banking system.

However, finance capital is demanding that in return for an injection of capital the Renzi government must push through the restructure program it is demanding, including the consolidation and elimination of many smaller banks, which play a key role in support of small businesses, and a deepening assault on the social position of the working class.

Summing up the outlook of key sections of finance, a note published earlier this month by Peter Donisanu, global research assistant at the US bank Wells Fargo, said the Renzi reforms would "make it easier to implement important legislation (such as measures to assist the country's ailing banking sector) without the threat of a government collapse during periods of political disagreement."

A No vote in the referendum would send a signal that the Renzi government cannot carry through this agenda. According to Goldman Sachs, not only would the rescue plan for Monte dei Paschi be under threat but there could be a domino effect for other banks that have to raise billions of euros in order to recapitalise.

The bank itself has cast considerable doubt over the rescue plan in a 146-page prospectus published yesterday outlining the debt swap that forms its key component. "In light of the considerable uncertainty surrounding completion of different parts of the overall deal, there is a risk that the deal itself may not succeed and cannot be concluded," it said.

Shares in the bank fell a further 13.8 percent yesterday and have lost 86 percent of their value over the past year.

The outcome of the referendum is still unclear, with opinion polling prohibited for the last three weeks of the campaign. But the most recent poll showed the No vote some 7 percentage points ahead. The No campaign, which comprises a group of right-wing nationalist and populist parties, with the Five Star Movement of comedian Beppe Grillo playing a prominent role, has received a major boost from the victory of Donald Trump in the US presidential election. They have hailed the Trump ascendancy as a victory for the people against the political and financial elites.

The possible ramifications of a No vote extend throughout the Italian banking system and to the European financial structure as a whole.

"Sunday's referendum on constitutional reform is Italy's Brexit moment and a No vote would send tremendous shockwaves through the markets and the banking system. It could also heap pressure on the euro," Neil Wilson of ETC Capital told Reuters.

Defeat of the referendum would make the overhaul of Italy's banking system "a lot tougher" as investors would be deterred from pumping in the fresh capital that is required. "The risk of contagion spreading through the rest of Italy's banks and other European lenders is high," Wilson said.

The alternative to the Renzi market-based plan is the "resolution" agenda of the European Union. This involves winding up banks by imposing losses on both equity and debt investors. Implementation of this plan would create massive political opposition because many individual Italian bank retail customers have been lured into purchases of shares and debt as an attractive alternative to savings products.

A major report in the *Financial Times* published on Sunday warned that as many as eight of Italy's troubled banks could go under if Renzi's referendum is defeated. Apart from Monte dei Paschi, the list includes three medium-sized banks and four small banks that were rescued last year.

Citing "senior bankers and officials," the report said the worst-case scenario was where the failure of the Monte dei Paschi recapitalisation translated "into a wider failure of confidence in Italy" which would imperil a "market solution" for ailing banks. They warned that "contagion" from smaller bank failures "could threaten a €13 billion capital increase at Unicredit, Italy's largest bank by assets and its only globally significant financial institution, planned for early 2017."

The banking crisis is not confined to Italy but extends throughout Europe. As the ECB noted in its Financial Stability Review published last week, the "euro banking sector remains vulnerable." The main structural problems for bank profitability" related to the "large stock of non-performing loans in a number of countries" as well as "over-capacity in some euro-area banking sectors."

The problems go back to the response of European authorities to the global financial crisis of 2008. Fearful that recognition of financial losses and capital restructuring would weaken the position of European banks vis a vis their powerful rivals, particularly US financial institutions, they hoped that a return to economic growth would allow the banks to overcome their problems.

But the hoped-for economic upturn has not materialised and consequently, according to the ECB review, bank profitability has been adversely impacted by a "low growth and interest rate environment."

Nowhere is this more sharply expressed than in Italy. Gross domestic product per head is 9 percent below where it was in real terms in 2007 and remains near levels achieved two decades ago. Unemployment is running at 11 percent and is close to 40 percent among young people. Family income is below where it was in 2007.

It is these social and economic conditions that have helped fuel the rise of right-wing populist movements, as in the US, Britain, France and internationally, on the basis of their proclaimed hostility to the political and financial establishment, and to official "left" parties whose response to the financial crisis has been to move ever further to the right.