The Telegraph

Italy's ailing banks now have to wade through the referendum quagmire to secure a rescue

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Matteo Renzi as he resigned from the Italian leadership CREDIT: REX

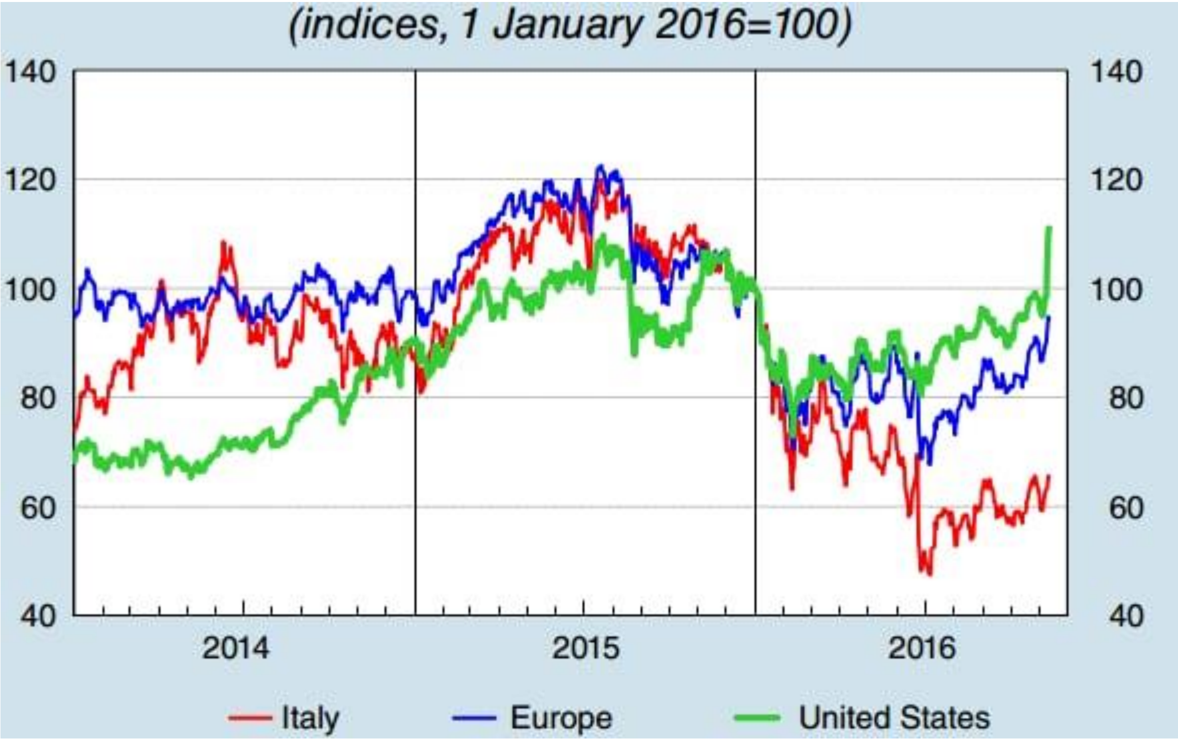
Italy's Matteo Renzi thought the "silent majority" would save him, if only he could chivvy enough of them to polls. The prime minister misjudged disastrously.

The voters certainly turned out. They smashed through the 60pc threshold that Mr Renzi thought would secure him victory in the constitutional referendum, but only to register their silent anger - with him, with his government, with Brussels, and with an Italo-European establishment that has run the Italian economy into the ground.

"I didn't realise they hated me so much," he confessed before his resignation, the wunderkind of European politics no more.

Markets have reacted with insouciance to the epic scale of Mr Renzi's defeat, betting that the Italian political class will somehow put together a new caretaker government and that business will carry on as usual. "It's not a psycho-drama," said the EU economics commissioner, Pierre Moscovici.

The reflex of traders after Brexit and the Trump shock is to "buy the dip" on political upsets, but it is far from clear whether the tumultuous events unfolding in Italy have anything in common with Anglo-Saxon episodes, or indeed with any other episode in modern Italian history.



Italian banks' share prices have tanked CREDIT: BANCA D'ITALIA

The European Central Bank has bought calm for now by intervening in the bond markets, holding down yields on 10-Italian debt to 2pc. This in turn has steadied the currency markets. The euro has risen slightly against the dollar.

But the ECB is effectively "front-loading" purchases of Italian bonds on a short-term basis, which means it will have to buy less early next year since it cannot alter the total volume under its €80bn programme of quantitative easing each month.

"I am worried about what is going to happen in February when the Italian treasury has to redeem €49bn of bonds. The ECB may not be able to remain aggressively in the markets that long," said Professor Erik Jones, director of European studies at Johns Hopkins University in Bologna.

The ECB cannot legally step in as a lender-of-last resort for Italian bonds unless Rome requests a formal bail-out under the European Stability Mechanism (ESM), and this requires votes in the German and Dutch parliaments, among others.

The terms would be draconian. Italy would lose even more control over its budget. It would amount to a Troika-style take-over of the economy, or a "commissariato" in the horror parlance of Italian politics. "If Europe humiliates Italy and puts the government under a tight rein, then you really will see a popular insurrection," said Professor Jones.

Belying the apparent calm, the Italian authorities are scrambling to prevent the collapse of their intricate rescue plan for banks, knowing that failure would set off a dangerous chain-reaction.

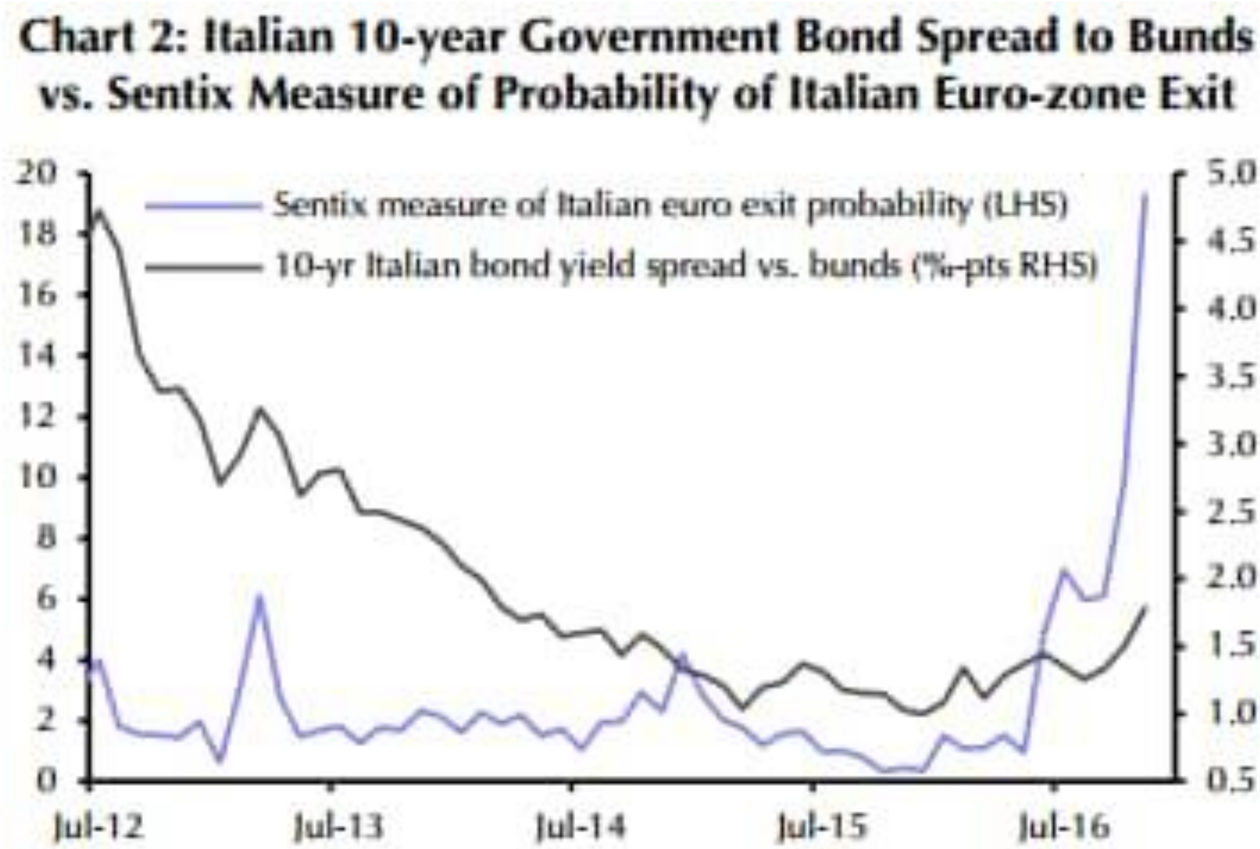
By unlucky timing, the referendum result has hit just as Banca Monti dei Paschi di Siena (MPS) struggles to raise fresh capital this weekfrom Qatar and other "anchor investors" - mostly big US funds such as Blackrock and Pimco - in a last-ditch effort to head off nationalisation.

Talks on Monday got nowhere and have been postponed for a few days until the dust settles. Yet the clock is ticking. Lorenzo Codogno, former chief economist for the Italian treasury and now at LC Macro Advisors, said Italy has less than three weeks to sort out the political mess. "If there is no solution by Christmas, financial markets will start getting nervous again," he said.

Everything now hangs on the success of the €5bn recapitalisation by the world's oldest bank. Failure by MPS would contaminate parallel plans for a long list of other banks, all trying to raise money to boost their core capital ratios and cut down €360bn of non-performing loans (NPLs) asphyxiating the financial system. Unicredit needs an estimated €13bn in fresh capital.

Francesco Garzarelli from Goldman Sachs said the chances of "successful market-driven recapitalisations of the weaker Italian retail banks" were low even before the vote. The likelihood of a "government restructuring" is now even higher.

The banks are in a trap where EU rules may force them to offload their NPLs into a fire-sale, fetching prices so low - often half book value - that it causes their key ratios to look even worse. The banks then have sell yet more in a self-feeding vicious circle, all to meet arbitrary deadlines set by the EU.



Italian bonds have barely shifted as the referendum drew near CREDIT: CAPITAL ECONOMICS

Italy's banks did not behave recklessly, though they have been slow to tackle over-manning. There was no property bubble. Household debt is extremely low. The damage is the result of an economic depression that has dragged on for almost a decade, cutting real GDP per capita by 13pc.

The forced nationalisation of MPS would in principle lead to a bail-in under new EU rules, wiping out bond holders. Banking sources say there is some scope to suspend the rules for banks deemed "systemically relevant", and there are ways of refunding small savers who were misled into buying junior bank bonds.

Yet the politics remain poisonous. The guillotine would fall immediately: any rebate would be unclear, and far off in the future. Millions of Italians hold these bonds through mutual funds or pension funds. These would not be covered.

The fear is that an MPS bail-in would shut off the chances for other banks waiting to raise capital on the markets, and lead to a cascading collapse of confidence through the whole system, triggering a full-blown recession.

Yet there was no sign of any latitude for Italy from eurozone finance ministers in Brussels on Monday. They continued to demand “significant additional measures” worth 0.6pc of GDP next year to meet EU fiscal rules.

It is this potent mix of hard-nosed EU politics and the banking crisis - clearly linked in the Italian public mind - that now awaits the next caretaker government.

The outlines of what it will look like are already emerging. The signs are that Mr Renzi's Democrats will join forces with Silvio Berlusconi's Forza Italia in a Left-Right coalition, probably led by a safe technocrat premier such as Pier Carlo Padoan, the current finance minister.

He would become the fourth unelected prime minister in a row, which is courting fate. The referendum was no ordinary vote and it may prove much harder this time to shrug off the volcanic effects. "The whole world was against us. They threw every piece of shit at us. Our achievement is a miracle," said Beppe Grillo, the flamboyant comedian behind the triumphant Five Star Movement.

A narrow 'No' had been discounted. Almost nobody expected a landslide rejection by 59pc to 41pc, with reaching 71pc in Sicily in what amounts to a primordial scream by the pauperized Mezzogiorno.

Beppe Grillo, leader of the Five-Star Movement, casting his vote in the referendumCREDIT: EPA

The persistent chatter on the steps of the Italian parliament today was that Five Star and the hard-line Lega Nord are edging closer to an electoral pact. This would create a nominal "coalition" of anti-euro parties with a serious shot at power, regardless of what electoral law is passed to try to block eurosceptic parties.

Mr Grillo crossed Left-Right ideological lines to team up with Nigel Farage for tactical reasons in the European Parliament, and a comparable arrangement may now happen in Italy - against all assumptions. "This the big news in Rome today," said one Italian banker.

Five Star and the Lega Nord have already demanded immediate elections. They may do even better if kept from power until elections in 2018. By then the political establishment - or "poteri forti" - will be saddled with the awful legacy of a banking purge imposed with little delicacy by Brussels and Frankfurt, and yet another year of economic stagnation.

The referendum does not in itself make Italy's exit from the euro any more likely. The politics surrounding it certainly do.