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BIZ INSIGHT

European capital markets rocked as Italians vote 'no'

SPECIAL TO THE NATION

EUROPE HAD a wake-up call on Monday morning as the result of the Italian constitutional referendum was revealed, with a "no" vote of approximately 59 per cent.

The result will rock the Italian economy, the European economy and the entire capital market. In addition, it could possibly bring the Five Star Movement political party into power in Italy.

As one of the European Union's vulnerable spots, Italy will remain beset with many other problems. At present, its gross domestic product is as low as it was in 1990. Beaten only by Greece, the level of its public debt is second-highest among the EU members, at 133 per cent of GDP.

Italian banks are struggling badly over non-performing loans, while the unemployment rate in October was as high as 11.6 per cent.

Consequently, the country is in grave need of continuous capital injection from the European Central Bank. However, voters' rejection of Prime Minister Matteo Renzi's call for constitutional changes could lead to early elections and the Eurosceptic Five Star Movement could gain support. That party has pledged to carry out a referendum on whether Italy should stay in the EU.

With this scenario, it's clear that the situation will lead to capital flight and severe market turmoil.

Overall, the economic and banking crisis together with high public debt will continue to be a huge challenge for the Italian government. The Italian banking crisis will be a major concern for investors and a big factor towards a dim future of the European capital markets.

European stock prices, especially in the banking sector, have dropped consistently since the end of November. Italian banks are suffering badly from bad loans – currently 18 per cent of total loans – and a tremendous debt burden caused by placing a very large portion of bank bonds directly with domestic households. Therefore, retail holdings amounted to close to 40 per cent of total debt securities. This percentage is four times that in Germany, and eight times those in both Spain and France.

Moreover, not long ago, the government attempted to add liquidity to the banking system by injecting money (bailout). This measure remains a controversial topic among economists, whereas the recent bail-in system forces borrower to bear the loss. This new implementation had a tremendous impact on the Italian banking system.

Unless resolved, the banking crisis will be a major obstacle to Italy's future economic recovery.

The Italian economy after the "no" vote will remain fragile. It will face many structural problems, including high government debt, a fragile banking system and inefficient public administration and civil justice. Therefore, it is unlikely that annual GDP growth will exceed 0.5 per cent, the lowest among developed countries. According to the International Monetary Fund, the Italian economy is unlikely to regain its pre-2008 growth rate within the coming decade.

The "no" vote is expected to cause medium-term fluctuation in the European stock markets. The level of risk depends on how the new government moves forward, and how the EU and the ECB react. Therefore, investors are strongly advised to pay close attention to Italian developments in order to make appropriate investment plans under an acceptable level of risks, and to consider suitable strategies for balancing their portfolios.

Contributed by Asset Plus Fund Management.

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