Italian banks are reeling. A budget fight with Europe won’t help

Italy is battling the European Union over government spending levels. The country’s banks may end up paying the price.

The European Commission rebuked the Italian government on Tuesday over a draft budget that calls for a sharp spending increase in violation of EU rules. Italy will have to back down or face fines.

The escalation caused Italian stocks to drop and government bond yields to rise, pushing up borrowing costs. The euro slipped against the US dollar.

Italian banks own huge amounts of the government’s $2.6 trillion of debt, and investors have punished the sector this year as the value of those bonds has dropped.

An extended budget battle between the country’s government and the European Union could cause bond prices to dip further, eroding the financial position of banks.

“Italian banks are directly exposed … through their holdings of Italian government debt,” Fitch Ratings warned last week. “Many of the country’s banks hold large amounts of Italian sovereign debt relative to their capitalization.”

Italy’s banks have been struggling for years with high costs, low returns and over 200 billion ($229 billion) worth of bad loans. Fitch analysts said that the sector has gotten better at dealing with bad debt, but they warned that progress could stall if investors are scared off by the government’s economic plans.

“We can get into a situation where things were slowly getting better, to one in which banks are again under pressure,” said Federico Santi, an analyst at the Eurasia Group.

Shares in Banca Monte dei Paschi di Siena (BMDPY), the world’s oldest lender, are down a staggering 62% since January. Intesa Sanpaolo (IITSF) has lost 29% in the same period, while UniCredit (UNCFF) is down almost 28%.

The stock declines reflect investor fears over the strength of the banks and the election of a government formed by populist parties who have at times questioned whether the country should continue to use the euro.

Italy has spent tens of billions of euros in recent years propping up the banks, which has in turn put more pressure on the government's finances.

Declining bond prices weaken the balance sheets of banks that hold government debt. Banks that get into trouble may then require bailouts that stretch government finances further.

"It's the infamous doom loop between the government and banks," said Santi.

Investors are also worried about the risk of contagion because roughly one fifth of Italy's government bonds is held in other eurozone countries.

"Linkages through the banking system tie Italy closely to its European partners," said Holger Schmieding, chief economist at Berenberg bank.

Investors will be watching carefully to see how Italy responds to the EU ultimatum. While the country has three weeks to revise its budget, Standard & Poor's will update its rating of government debt on Friday.

"It is tempting to try to cure debt with more debt, but at some point the debt [becomes] too heavy and at the end of the day, you end up having no freedom at all," Valdis Dombrovskis, vice president of the European Commission, said during a press conference on Tuesday.

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