Breaking the Bank

Italy's Finance Ministry watered down its infamous windfall tax on banks' "extra profits", a measure intended to address inflation in cost-of-living and its fiscal deficit, after intense discussions between rival political factions and the nation's banks.

This is the second time in as many months that Italy's Ministry of Finance has quietly watered down a windfall tax widely criticized by economists, the ECB, business leaders, and other politicians as bad economic policy.

In the immediate wake of precipitous sell-offs of Italian bank shares on August 8th, fueled by panicked investors when the measure was first announced on August 7th, Lorenzo Codogno, founder and chief economist at Lorenzo Codogno Macro Advisors Ltd, said in an interview with CNBC that Rome's measure was "regrettable" and "a major mistake".

The first time Italy watered down the tax was August 9, one day after the market panic. The announced 40% windfall tax on Italy's banking sector was changed to a levy on .1% of total assets.

Yet this was not enough to calm spooked investors and bank chiefs.

Commenting on the tax in early September, Carlo Calenda, leader of Italy's opposition centrist Azione party, said "It's a very stupid law. It's the principle which is very dangerous because of course it's something that all the international investors will look at saying 'Wow, this is very dangerous. I don't want to make an investment here in Italy, long-term investments, knowing that the government can jump in and say 'ok, I'm going to take part of your profits'".

This time around, Giancarlo Giorgetti, Italy's minister of Finance and the Economy, has given the banking sector an option to opt out of it entirely. The Ministry of Finance has laid out two options in a draft of a new amendment. Banks can escape the tax if they allocate at least 2.5 times the amount that would have originally been paid under the original tax to their core capital reserves, or banks may pay a modified version of the tax capped at 0.26 percent of risk-weighted assets.

It would seem the chaos and unease of the past two months with regard to this bill have finally settled down. The government's tax plan is now fully aligned with the pro-bank, Forza Italia wing of the coalition.

However, the important question to reflect on in the aftermath of this situation is what this means for the state of the European banking sector as a whole.

Italy was not the first country to implement, however briefly, a windfall tax on banks. In an effort to raise funds to offset rising cost-of-living, Spain passed a windfall tax on its banks in

December of last year, though imposing a far more modest levy of 4.8% of net interest above 800 million euros. Likewise, Hungary also passed a windfall tax of 37% on net profit in July of last year. In November of last year, the Czech government imposed a 60% tax on its banks to address soaring electricity and gas prices. In May of this year, Lithuania raised its tax levy on banks to 60% to boost military spending, though the government claims this is only temporary.

Though Italy has more or less backed off with a timid and tepid whimper, the overall trend in Europe's increasingly populist political climate is one that shows that governments are no longer as hesitant as they once were in taking banks' money.

In doing so, Europe's governments should be careful what they wish for. America's banking system, widely mocked by Europe's banking community in the wake of the regional banking crisis, has proven that, in spite of its lower stability and generally weaker balance sheets, it is still more profitable and internationally competitive than its European counterpart. But at least, it has been said, Europe's banks could still achieve healthy profits while retaining consistently stronger balance sheets and greater stability. Now, with governments all over the European continent helping themselves to banks' profits, the continent's banking system appears to have less and less to show for itself. Weaker and less attractive than it has appeared in decades, the only things many European banks have to offer are stability and strong balance sheets.

Through the tunnel-vision of a Europe-wide cost-of-living crisis and pervasive high interest rates, pressure has been put on governments across the continent to find money to relieve their debt obligations, provide financial assistance, and straighten-out their budgets. Banks look like a juicy target.

Even if the banks may be breathing a sigh of relief in Italy, other European banks, bending from the weight of the government's heavy hand, are hoping that they don't break.