Financial strains in the euro zone have fallen sharply since last summer, when the president of the European Central Bank (ECB) committed to do whatever it takes to save the euro. The ECB quickly took action, implementing the Outright Monetary Transactions (OMT) program that allowed it to, under some conditions, make unlimited bond purchases on the secondary market to support struggling nations.

The inconclusive results of Italy’s elections on February 24 and 25 could very well erase the progress made in recent months. After several days, the situation is now clear. The centre-left coalition, led by Pier Luigi Bersani, holds a majority in the Chamber. However, in order to form a majority in the Senate and govern, it will need members from the right, allied with Silvio Berlusconi, or from the protest movement represented by former comedian Beppe Grillo. These two blocks are very opposed to the austerity policies implemented by Mario Monti’s government.

This political deadlock poses a serious risk, as Italy could have difficulty selling its bonds. Italy has been in this situation before. In the second half of 2011, 10-year yields jumped up more than 7% as a result of political problems. However, the arrival of Mario Monti and intervention by the ECB, which supported the European banking system and purchases Italian bonds, calmed things down.

The situation is different today. By announcing the OMT, the ECB waived unconditional purchases of sovereign bonds on the secondary market. Using OMT to support a country’s debt is therefore strictly conditional on the existence of a support program from the European Stability Mechanism. Such a program does not currently exist for Italy, and with no government, it is hard to see how one could be established quickly. Yesterday, Mario Draghi reiterated that the ECB can only intervene in instances where budgetary discipline is guaranteed.

While the possibility of a stable coalition seems remote, the most likely scenario is that a minority Italian government will rule with a very limited mandate, supported by a party opposed to austerity. This government would be quite unstable and would have substantial difficulty negotiating with its European partners.

The Italian 10-year yield has risen by around 30 basis points since the election. However, it remains below 5%. Moreover, demand during the bond auction on February 27 was fairly solid. Pressure on Italian debt could increase rapidly if investors feel that Italy is isolated.

Implications: The lack of an Italian government able to negotiate with its European partners makes Italian bonds very vulnerable. Watch for the ECB’s reaction. If the ECB refuses to compromise, the situation could deteriorate rapidly. Considering Italy’s economic weight in the euro zone, some turbulence could resurface in global markets.