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Italy votes against austerity leaving EU in turmoil

Fears that deadlock will lengthen Italy's two-year recession and spill over into rest of the eurozone hit markets across Europe

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Italy's decision to revive Silvio Berlusconi's political career was a withering verdict on cuts and taxes. Photograph: Max Rossi/Reuters

Three years of German-led austerity and budget cuts aimed at saving the euro and retooling the European economy was left facing one of its biggest challenges as Italian voters' rejection of spending cuts and tax rises opened up a stark new fissure in European politics.

The governing stalemate in Rome and the vote in the general election – by a factor of three to two – against the austerity policies pursued by Italy's humiliated caretaker prime minister, Mario Monti, meant that the spending cuts and tax rises dictated by the eurozone would grind to a halt, risking a re-eruption of the euro crisis after six months of relative stability.

Fears that the deadlock will lengthen Italy's near two-year recession and spill over into the rest of the eurozone hit markets across Europe. The Italian banking sector fell 7% in value, dragging the main MIB stock market index 4% lower.

The market turmoil in Milan spread to Germany, France and the UK, with domestic banks among the biggest fallers. Deutsche Bank saw almost 5% knocked off its value, while Barclays suffered a 4% decline. The FTSE 100 fell 1.4%. The German Dax slumped more than 2% and the Paris Cac was down 2.75%.

The cliffhanger vote saw the maverick comedian Beppe Grillo's 5 Star movement take almost one in four of the votes and the political revival of the ex-prime minister Silvio Berlusconi. But the narrow victor, Pier Luigi Bersani, on the centre-left, claimed the mantle of the premiership, although it was unclear if he would be able to form a government.

Despite the withering popular verdict on cuts and taxes, Brussels and Berlin insisted the austerity programme had to be continued in Italy. France and others seized on the outcome for their own purposes, arguing for a relaxation of spending cuts and greater emphasis on policies to boost growth and job creation.

Bersani moved to try to cobble a government together by wooing the upstart Grillo with tentative talk of a reformist leftist coalition. Looking weary, Bersani said it was time for the 5 Star movement to do more than just demand a clean sweep of Italy's established political order.

"Up to now they have been saying 'All go home'. But now they are here too. So either they go home as well, or they say what they want to do for their country and their children."

Grillo said earlier his followers in parliament would not join a coalition, but would consider proposals "law by law, reform by reform".

Bersani said that, since his four-party alliance had won an outright majority in the lower house of the Italian parliament and more seats than any other grouping in the Senate, it had a responsibility to suggest ways in which Italy could be governed, despite the deadlock in the upper house.

Shunning the idea of a grand coalition with Berlusconi and the right, he proposed a government committed to a five-point plan for sweeping reform of Italy's political parties and institutions.

The north-south split in Europe opened up by the election presaged clashes between eurozone governments, likely to surface at an EU summit next month, amid calls for a shift away from the harsh regime prescribed and driven through by Berlin in recent years as the price of bailing out insolvent eurozone periphery countries.

The Italian stalemate combines with tough negotiations over a bailout for Cyprus, being resisted by Germany, worries about the French economy, an unresolved debt crisis in

Spain, and David Cameron's decision to throw Britain's future in Europe into question, making EU politics unusually volatile.

"Italy plays a central role in successfully overcoming Europe's debt crisis," said the German foreign minister, Guido Westerwelle.

"So we assume that the policy of fiscal consolidation and reform will be consistently followed by a new government."

Angela Merkel, bidding for a third term as German chancellor in September, has been banking on a period of eurozone calm in the run-up to her election, but Italian voters have wrecked that calculation.

The Dutch finance minister, Jeroen Dijsselbloem, recently made head of the political committee that runs the euro, said Monti's policies had to be continued. "They are crucial for the entire eurozone."

The European Commission echoed the calls for sticking with the austerity medicine. Italy has the highest national debt level in the eurozone after Greece, although its budget deficit is in better shape than many others, including France and the Netherlands.

But Paris led the chorus for a policy shift. French government ministers, including Pierre Moscovici, the finance minister, demanded a change of course in remarks directed at Berlin.

Spain waited anxiously to see what impact the Italian leap in the dark would have on its debt crisis. "This is a jump to nowhere that does not bode well either for Italy or for Europe," said the foreign minister, Jose-Manuel Garcia-Margallo, adding he was "extremely concerned" about the effect on Spain's borrowing costs.

Both Berlusconi and Grillo have been harshly critical of the Germans, decried Monti's austerity packages, and have raised questions as to whether Italy, the eurozone's third biggest economy, should remain in the single currency. Grillo has called for a referendum on the matter.

Berlusconi rounded on the Germans on Tuesday, declaring that the "spread" – the difference between how much Italy and Germany pay to borrow on the bond markets – had been "invented" two years ago. This was code for saying that Berlin and Frankfurt, the German government and the European Central Bank, conspired to push up the cost of Italian borrowing in 2011 in order to topple Berlusconi and bring in Monti, the technocratic darling of the eurozone elite.

The turmoil saw Italian bond yields also jump, indicating that any new government will be forced to pay a higher interest rate on its debts.

The 10-year Italian bond yield edged back into dangerous territory on Tuesday after it passed 4.9%, although this is a far cry from 2011 when the yields shot above 7%.

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offer a vote on euro membership and rip open politics 'like a can of tuna'