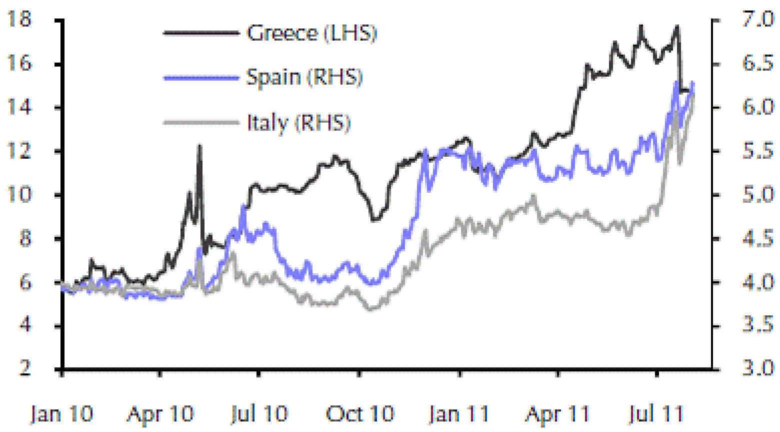
THE NEXT CHAPTER IN THE EUROZONE DEBT CRISIS: ITALY AND SPAIN

Introduction

The ink had barely dried on the second bailout agreement for Greece before markets have become concerned that Spain, and especially Italy, may require some form of financial assistance. The Eurozone summit that agreed a second €109bn bailout for Greece was initially greeted with enthusiasm by markets; it was a significant departure from previous policy decisions by the troika (the EU, ECB and IMF) in that it at last addressed some solvency as well as liquidity concerns and also included private sector involvement. While the measures on their own were not enough to provide sustainable debt relief for Greece, the announcement did represent a change in strategy that was necessary if a permanent solution to the debt crisis in the Eurozone is to be found.

It was hoped that the more radical steps taken by the policy measures would allay market fears and reverse the direction of bond yields in Spain and Italy that had risen ahead of the summit on fears that authorities were losing control of events. Indeed, the immediate reaction was for all periphery bonds to rally strongly but in the last week contagion has returned and now both Spanish and Italian bond yields and spreads to German bunds are trading at record highs again. It is also worth mentioning that the yield on French bonds has also decoupled from German bunds in recent days and is trading at record highs during the current crisis relative to German debt.

10 Year Bond Yields post Summit



Source – Thomson Datastream

The second Greek bailout, therefore, has failed in its objective of reversing contagion within the Eurozone and raises the prospect that we have entered a new, and more dangerous, phase of the sovereign debt crisis. This is because Spain and Italy, individually let alone collectively, are too big for the EU to rescue. If current yields persist or rise further something has to give. This note looks at what might happen.

Contagion spreads to Italy and Spain

The significance of Italy and Spain is that, like some financial institutions, they are too big to fail. While Greece, Ireland and Portugal are relatively small in the context of the Eurozone, the debt levels of Italy alone, at €1.9 trillion, is roughly the same as the other 3 countries that have received bailouts combined.

In recent days, as contagion has spread, Italian and Spanish 10 year bond yields have risen to over 6%, a level that is generally regarded as unsustainable by the markets. When the yields approached 7% for Greece, Ireland and Portugal bailouts were seen as inevitable and soon followed. The problem is that this is not a feasible option for either Spain or Italy as they are too big. The situation is made more acute by the failure of the recent emergency summit to increase the resources of the bailout fund, the EFSF, from its current lending capacity of €440bn and the increased powers that it has been granted, in particular the ability to buy government bonds in the secondary market, require new laws to be drafted and ratification by all the 17 members of the Eurozone in their respective Parliaments. Furthermore, once the spread of the respective bonds rises to 450bps over the German bund the leading bank clearing house (LCH) will demand an additional 15% margin call requirement. This contributed to a sharp rise in bond yields in both Portugal and Ireland.

Therefore, is it really possible that contagion can be reversed without some drastic intervention by the EU following so soon after the second bailout for Greece? It is true the rise in yields is not only due to the deterioration of the Eurozone debt crisis and partially reflects the increase in risk aversion associated with the saga involving the US debt ceiling level and poor economic data within the US and the Eurozone itself. However, the weakness in the periphery bonds is mainly due to the market's view that the strategy adopted by the troika to alleviate the debt crisis is insufficient to prevent more serious contagion.

With reference to Italy, JP Morgan has produced some recent analysis that argues that unless the government raises new money it will run out of funds as early in September (see table below).

Exhibit 11: Italy will run out of money in September if it loses access to bond markets...

Italian deficit, bond redemption and T-bill redemption data; €bn

	Deficit	Bonds	Tbills	Cumul. deficit+Bonds	Cumul. deficit+Bonds+Tbills
Aug-11	8	0	16	8	24
Sep-11	12	46	16	66	98
Oct-11	7	0	16	73	120
Nov-11	5	16	15	93	155
Dec-11	-9	0	13	84	159

Note: We assume that Italy has already raised sufficient cash over and above its cash balances of €44bn to cover 1st August redemption and coupon payment.

With yields above 6% the government is reluctant to borrow more because the cost of doing so will add to future debt levels. It has already cancelled one auction scheduled for mid August and could do so again or reduce the future size of future fund raisings. However, the country has a debt to GDP ratio of some 120%, the highest in the Eurozone, with much of it due for repayment in the next few years. It has over €380bn to finance before the end of 2012 with an auction due in September to raise €61.7bn.

It is the size of the overall debt and this significant funding hump that is concerning markets and why Italy has overtaken Spain as the principal target as the periphery country next in line for a potential rescue. The EU and the Italian government can justifiably argue that it has a relatively low annual fiscal deficit and is able to generate a primary budgetary surplus before interest payments, but this will count for little while bond yields are being driven up to levels that effectively threaten to lock Italy out of the public sector debt market. Soothing words by politicians may calm markets for a short while but the time frame for the Euro debt crisis has become increasingly compressed and action is demanded now or in the near future.

In July, the Italian government passed a €40bn austerity budget that was criticised for being back end loaded to 2013-14 when a new government, that could repeal the budget, could be in power. It is possible that the budget will be brought forward but it is unlikely to be enough to appease markets. At the heart of the problem, in common with other peripheral nations, Italy has an inefficient and uncompetitive economy that has barely grown for a decade. Big structural reforms are needed that will take time to implement and longer to have an effect. Therefore, a severe austerity budget combined with higher borrowing costs is likely to have the same result as it has had in Greece and Portugal: rising debt levels and slower growth. At the current level of bond yields of over 6% the economy needs to be growing at 1.6% just to keep the deficit from growing further.

What policy response is likely or possible?

In my view, this new chapter of the Eurozone crisis will probably get worse until it forces radical and drastic action by the EU and ECB that goes significantly beyond what was agreed with the recent bailout of Greece. The ultimate outcome of the Euro debt crisis is binary. Either it breaks up and the politicians admit the failure of the Eurozone and the single currency or the change of strategy that was signalled at the emergency summit 2 weeks ago is taken to its logical conclusion. This means fiscal and political union probably involving the creation of some form of Euro bond that consolidates all Eurozone debt.

In the short term it will be necessary for the ECB or/and EFSF to intervene heavily to stabilise the government bond markets. As stated above the EFSF does not have the firepower or legal authority to intervene so the burden will fall upon the ECB to take action. The central bank was a reluctant buyer of bonds in the first place and has ceased its security markets programme (SMP) since March while reasserting its monetary independence, including 2 increases in interest rates. However, for the sake of the Eurozone it may be forced to buy aggressively in the secondary market until the necessary measures are implemented for the EFSF to play a role.

Throughout this crisis the decision making by the authorities has been slow, reactive and subject to procrastination. Following the recent bailout of Greece involving a significant change in strategy the troika will feel that larger concessions are not warranted so it is likely the crisis will deepen further before action is taken. Furthermore, the holiday season is at its height this will further impede progress. The ECB will have its monthly meeting today (August 4th) but it is probably too early for it to adopt a change of strategy following the spike in yields in the last week.

Implications of above prognosis

The rising cost of government borrowing in these countries is adding to the funding costs of corporates and banks with the danger that the negative spiral accelerates. Indeed, the severe underperformance of Euro banks recently is testimony to the fear engendered by deterioration in the liquidity system of the banking sector. Funding for periphery banks is already difficult and the lack of confidence between counterparties will reduce the availability of credit further. The stress of banks can be gauged by the price of their CDS and some are around 500bps suggesting that what a contingent liability for the government could become an actual liability. By comparison the Icelandic banks' CDS rose to around 1000 bps.

The sclerosis of policy making that has been a permanent feature of the sovereign debt crisis will add to the uncertainty in financial markets as contagion has spread to Spain and Italy. As this phase of the crisis worsens, the policy makers will be forced, once again, into belated response. I do not believe the Eurozone will be broken up or the Euro currency abandoned as too much political capital has been invested in it. Hence, the alternative is a more drastic response firstly involving aggressive and heavy buying by the ECB and/or the EFSF. However, as we have seen with Portugal and Ireland this is unlikely to prevent the need for a more fundamental solution that will ultimately involve the creation of a fiscal and political union. What has happened in the last 2 weeks is another step, reluctantly taken by the EU, towards achieving it.

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