Italian bond yields reach worrying levels

10 November 2011

The planned resignation of Italy's Prime Minister Silvio Berlusconi has failed to calm the concerns about Italy's creditworthiness. Investors overnight drove up Italy's five-year bond yield to a euro-era record high of 7.5%, a level that makes borrowing too expensive for Europe's third-largest economy.

With the third-largest government bond market in the world and 167 billion euros in debt due to mature in 2012, Italy is considered "too big to fail". Concerns about Italy were exacerbated when a major clearing house, LCH Clearnet, asked for larger margin deposit to trade Italian bonds – to cover the increased risk of non-payment.

Italy's gross debt is expected to exceed 1.9 trillion euros by year end. This is 2.7 times the combined debt of Greece, Ireland and Portugal. If we multiply the costs of bailing out these countries, about 512 billion euros[1] by 2.7, then Italy would need a massive 1.4 trillion euro bailout package.

Europe's bailout fund, the 440 billion euro European Financial Stability Facility, is too small, so plans to leverage the bailout fund to 1 trillion euros might have to be doubled to at least 2 trillion euros.

The ECB must be bold

In recent days, the market action has been typical of the lead up to previous bailouts. Once Greek and Irish bond yields properly breached 7%, they went up exponentially. Time is now at a premium.

Unhelpfully, several banks have announced they have reduced their holdings of Italian debt to calm market concerns about their own well-being. This puts pressure on all Italian creditors to sell, encouraging the market pressures to become self-fuelling.

Most experts believe only the European Central Bank has the capacity to resolve this issue. But, it has no political mandate to act as lender of last resort. The problem is that the eurozone treaty doesn't support it: Article 101 prohibits the ECB from lending to governments and Article 103 says the eurozone should not be liable for member-state debt.

Acting as lender of last resort to sovereigns entails a great deal of moral hazard. It is different from being a lender of last resort to banks – at least they post decent collateral.

Even if Italy's borrowing costs are brought under control, the economic growth outlook remains weak: the IMF has forecast 0.6% GDP growth for Italy in 2011 – but annual GDP growth would have to match borrowing costs to prevent Italy's massive 120% debt-to-GDP ratio from growing.

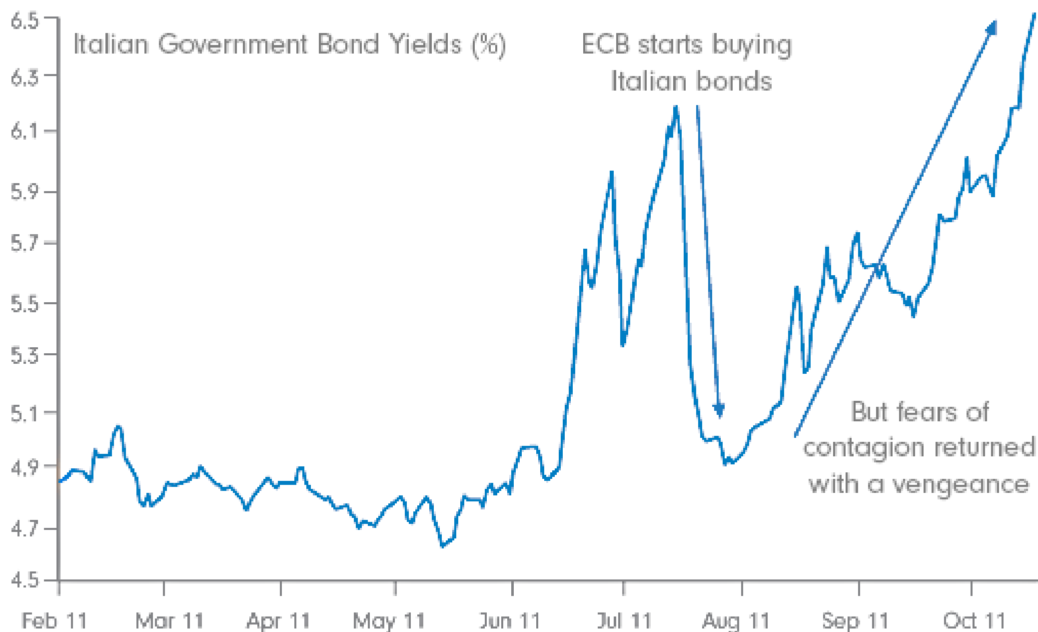
Political wrangles

In order to sustainably boost economic growth, Italy needs to restore its external competitiveness, which is a promise that Berlusconi has failed to deliver on over the past decade.

Berlusconi's resignation, which he announced on Tuesday, has to be followed by the formation of a new government that can push through the necessary structural reforms that Italy needs.

Alberto Chiandetti, Portfolio Manager of Italian equities at Fidelity, said it's important to end the uncertainty regarding a weak government. "The resignation of the Prime Minister Silvio Berlusconi is an essential step needed to move on," he says. "Now, the short-term focus is on what is next. The market's preferred solution would be a coalition technocratic government that would be able to provide more credibility to the approval of tough but necessary fiscal measures and reforms."

Italian 10-year yields are now becoming unsustainable



DataStream. 8 November 2011

1 Source: Gary Jenkins, Evolution Securities, 9 November 2011: 388 billion euros in bailout packages, 74 billion euros in ECB bond purchases and 50 billion euros from private-sector involvement.

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