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# Italy tests the viability of the eurozone


- European sovereign bond market tensions have again picked up, with Italy being at the epicenter of investors' worries.
- A permanent debt servicing cost close to current levels of around 7% will keep Italy's debt-to-GDP ratio on an upward trajectory.
- The size of the Italian government bond market sets the biggest threat for the eurozone, with systemic implications for the world economy and global financial markets.
- The successful execution of the austerity package and the implementation of structural reforms by the new government of Mario Monti are necessary to increase confidence in the Italian debt and, thus, lower borrowing costs.
- However, past experience of Greece, Ireland and Portugal has shown that once a eurozone country has come to the bonds' market spotlight, it is very difficult to regain market access in time to avoid a credit event without external financial assistance.
- In times of crisis such as the current, the ECB should increase the size of its SMP program sustantially, establishing ceilings for peripheral sovereign yields. The introduction of a Eurobond would calm markets and allow the ECB to detach gradually from the responsibility of lender of last report to governments.


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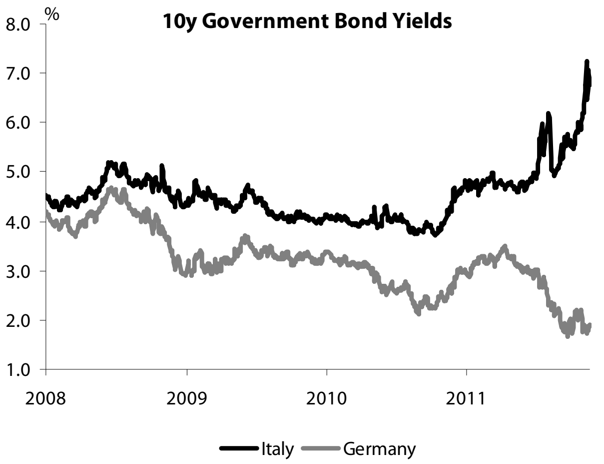
**Overview**

Over the past week, European sovereign bond market tensions have again picked up, with Italy being at the epicenter of investors' worries. Italy's ten-year government bond yields exceeded 7% on November 9 for the first time since the introduction of the euro (Figure 1), reinforced by market concerns about the country's debt sustainability. Even though the Securities Market Program (SMP) activated by the ECB in the middle of the week managed to push 10-year Italian bond yields by about 30 basis points, the central bank's intervention in the European government bond markets has a rather temporary positive effect, so the risk that the sharp loss in market confidence may drive the country into default remains evident. The size of the BTP government bond market, which is the second-largest in the Euro area after Germany's bond market, has systemic implications for the world economy and global financial markets, given the large exposure to BTP securities in several core Euro area countries. Although latest political developments in Italy with the resignation of Silvio Berlusconi and the new technocratic unity government may ease somewhat the pressure in the market, this does not change the fact that the ongoing contagion of the

Greek sovereign debt crisis to the rest of the Euro system sets the biggest threat for the eurozone as a whole.

**Figure 1**

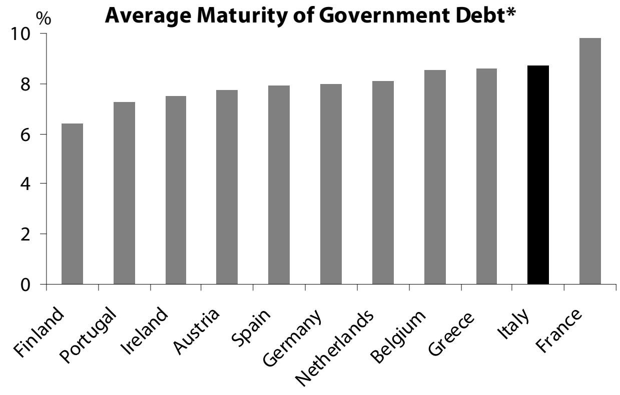



*Source: Bloomberg*

**Italian debt dynamics are highly dependent on yield levels**

Bond yields demanded by investors to compensate for increased credit risk in Italy are currently too high to be compatible with sustainable debt dynamics. However, it should be highlighted that increases in interest rates do not imply the immediate transfer of higher debt servicing cost for a country, as they only feed through when the country refinances or raises new debt. Meanwhile, Italian debt has a relatively long average maturity profile (more than eight years, Figure 2) and a low proportion of variable rate bonds, which means that the sensitivity of Italy's debt servicing costs to rising bond yields is rather gradual. Indeed, although the increase in Italy's 10y bond yields has totaled about 200 basis points since the beginning of July (from 4.9% to 6.9% currently), the total debt servicing cost has increased only marginally from 4% to 4.3% in the corresponding period. Nevertheless, a permanent debt servicing cost close to the recently observed levels of around 7% will keep Italy's debt-to-GDP ratio on an upward trajectory. Given our assumptions during the forecasting period of 2011-2020 of an average annual primary budget balance of 3.2%, along with real GDP growth of around 1.0% per annum and inflation at 2.0%, a total service cost of around 6% is sufficient just to maintain Italy's public debt at the already high level of 120% of GDP. Last but not least, our analysis suggests that a debt servicing cost of 5% is the threshold in order to keep the debt-to-GDP ratio on a downward trend (Figure 3).

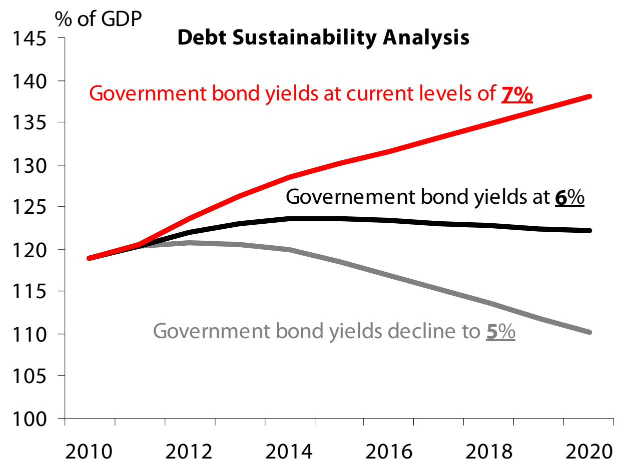
**Figure 2**




** FTSE Global Government Bond Indices: the average life or time to maturity is derived by the time to maturity and weighted by the nominal amount outstanding*

*Source: Bloomberg*

**Figure 3**




*Source: Eurobank EFG estimates*

**Market's loss of confidence could become a self-fulfilling prophecy**

Investors' concerns about Italy's sustainability have been translated into higher levels of borrowing costs, which can be sustained by a country in Italy's position until policy adjustments gradually re-establish the country's credibility. Italy is a country with primary budget surpluses for more that fifteen years (excluding the 2008-09 crisis period), low private sector indebtness and no major external imbalance compared to the ones in the periphery. However, the real danger is that high cost of funding may reinforce markets' concerns about sustainability, leading to even higher rates and, consequently, an ultimate run from the Italian debt. It is not the high borrowing costs alone, but the ongoing pessimistic market dynamics that may bring the sustainability of public debt into question and, thus, restrict the sovereign's ability to roll-over its liabilities, generating a self-fulfilling credit event. In other words, Italy is solvent unless investors test its fiscal sustainability.

**Fiscal consolidation and structural reforms necessary conditions to regain confidence**

The successful execution of the austerity package and the implementation of structural reforms by the new government of Mario Monti are necessary to increase confidence in the Italian debt and, thus, lower borrowing costs. The new government's official program may include additional fiscal measures ranging between €15-25bn to secure a primary surplus this year and a balanced budget through 2013. Emergency consolidation measures are requisite in order to immediately boost its revenues through the introduction of a wealth tax and, perhaps, a property tax. In addition, the implementation of privatizations is very important for the stock reduction of public debt in order to rehabilitate the Italian debt dynamics and regain market confidence. Given that privatizations of public enterprises would not have a meaningful effect on the debt stock, the program should be based on fire sales of state real estate assets, which according to the Treasury, worth about €420bn. Furthermore, the fiscal consolidation program should be accompanied by a comprehensive structural reform plan, enhancing productivity and competitiveness. Structural reforms in the labor market, the public sector and the pension system, as well as the opening up of closed professions, could help boost potential growth well above 1%.

**The ECB should continue and enhance its intervention to prevent contagion in other member countries**

However, past experience of Greece, Ireland and Portugal has shown that once a eurozone country has come to the bonds' market spotlight with bond yields exceeding 7%, it is very difficult to recover market confidence and regain market access in time to avoid a credit event without external financial assistance. Given that a credit event could lead the eurozone to a financial collapse, what is urgently needed is an institution that could act as a lender of last resort in the government bond markets of the eurozone. The levered European Financial Stability Facility (EFSF) is an important step towards that direction, but its financial guarantees committed by the eurozone will not be sufficient to cover Italy's financing needs. Italian debt standing at about €1.9tr is the largest in the eurozone and way larger than the rescue capacity of the EFSF. Upsizing the EFSF has received political opposition by strained core euro area members, as such an event would put additional pressure on the fiscal stance of the European guarantors.

Hence, the only institution with the balance sheet available to act as a lender of last resort in order to prevent contagion between sovereign bond markets is the European Central Bank (ECB). Although the ECB has increasingly bought Italian government bonds over the past few weeks through its SMP program, it has repeatedly emphasized that its price stability mandate does not give it the authority to act as a lender of last resort to government bond markets. However, in times of crisis such as the current, the euro zone runs out of alternatives to prevent contagion in other euro member countries; the ECB should increase the size of its SMP program substantially, therefore establishing ceilings for peripheral sovereign yields. Furthermore, the euro area leaders could announce the introduction of a Eurobond, which would calm tensions in the sovereign bond markets and, in the long term, could allow the ECB eventually to detach gradually from the responsibility of lender of last resort to governments.

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