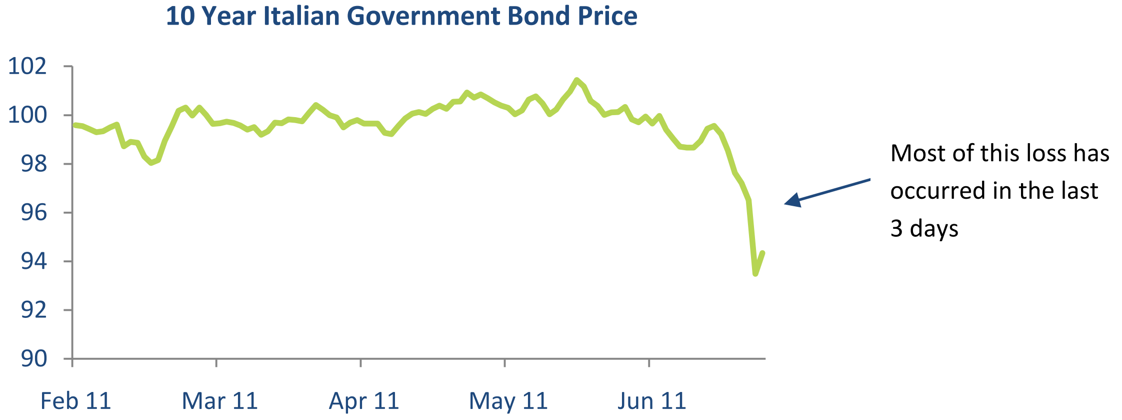
IPS View: Italy is dragged into the crisis

Prices of Italian government debt have fallen sharply in the last few days. This is an important, and bad, development in the ongoing Eurozone crisis. This short note for our clients and friends explains what has been happening, why it is important and what we think might happen next.

The sell-off in Italian government bonds

The chart below shows the price of the benchmark 10 year Italian government bond over the past year. It has fallen from near 100 to under 92 in under a week. In the normally calm world of government bonds this is a huge move and brings Italy firmly into the Eurozone crisis.



This is important as Italy is a very different sort of problem to Greece, Ireland and Portugal. The optimistic scenario for the Eurozone had been that Greece would be able to delay default for the next two or three years. This would be done via a combination of money from the IMF and their fellow Europeans and, possibly, the private sector agreeing to extend maturities for Greek debt. This would then give time for other European countries (including Italy and Spain) to put their finances in order and to recapitalise the banks where necessary. Thus, when the inevitable default came, the contagion effects would be limited and manageable. One of the reasons this scenario is plausible is that Greece is so small (less than 2% of EU GDP). The economic transfers involved in this plan seem a reasonable price to pay to avoid wider spread European problems.

Italy, though, is a different story. It is the Eurozone's third largest economy and the world's third largest bond market. The amounts involved in delaying the day of reckoning are simply too large. The market is, in effect, demanding a plan for Greece, now, which can be used as a credible basis for dealing with other European problem countries as and when it is needed. Without action, we would be left with the Eurozone pessimists' scenario: liquidity and funding problems move quickly from the smaller periphery countries to the larger ones (including Italy, Spain and, possibly, France). Bank funding in these regions dries up, lending goes with it and we are back to a full on Lehman-style liquidity crisis.

What happens next?

Eurozone leaders and the ECB are, we believe, are fully aware of what might happen if they drop the ball here. We therefore expect a more complete plan for Greece to be announced shortly. Any credible deal will need to allow for the fact that, ultimately, Greece will not pay all the money they have borrowed back. They will therefore have to apportion this cost between tax-payers and private investors. The cost to tax-payers needs to be reasonable enough that the deal is sellable in the other Eurozone countries. At the same time, the cost to private investors must be small enough that they do not run scared from the rest of the Eurozone.

This is not easy trick to pull-off. For the 2008 banking crisis, the right mix turned out to be 100% for tax-payers, 0% for bond investors, as the aftermath of the Lehman default proved. Here that deal is likely to prove politically impossible (as well as economically unfair – why transfer wealth from German tax-payers to, say, US hedge funds?). So, we can forgive the Eurozone leaders for taking their time to get this right. If they can, the next few weeks might prove to be the worst of the crisis and, with the benefit of hindsight, a buying opportunity. If they can't, the crisis will worsen again and Europe will face its Lehman moment. This will force the Eurozone to choose between a full fiscal union or slow disintegration. It will also be very bad news for risk assets with banks (and smaller countries) keeling over until a credible solution is found.

Even in the worst case scenarios, an Italian default seems unlikely. Though it has a debt to GDP ratio of 120% it is running a primary budget surplus and is slowly taking steps to improve its fiscal position. Also, unlike Spain and Ireland, Italy suffered no boom and bust in its housing market. De-leveraging is therefore only being done in the public sector. On this basis, Italian government bonds would be a good buy at close to a 6% yield, especially relatively to 10 year German bunds yielding 2.65%.

For now, though, we are comfortable with running higher than usual cash balances in our client portfolios, as we have since April this year. We have also avoided any direct exposure to Eurozone equities. Finally, we have allocated to a macro manager who is looking to benefit from a bearish outcome in the Eurozone. Ultimately we remain on a watching brief, though should liquidity carry on drying up in the Eurozone we remain ready to cut risk further.