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MACROCOSM

The Sack of Rome

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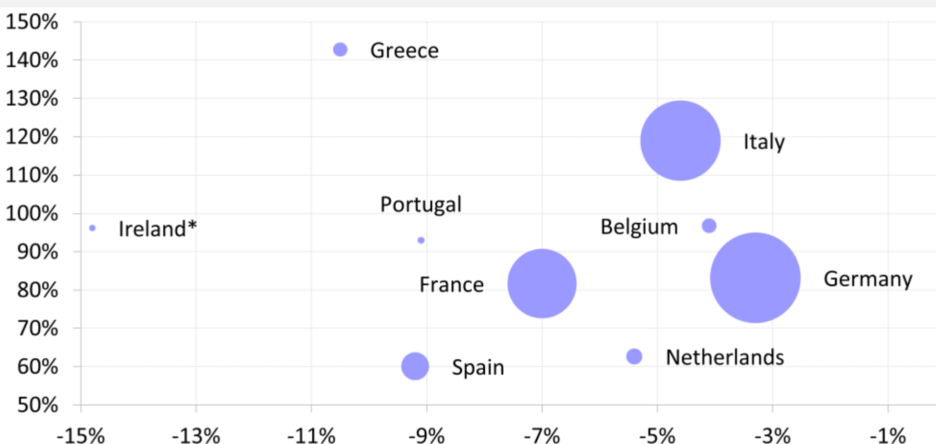
Lorcan Roche Kelly

Europe stumbles into a speculative attack on the biggest of the PIIGS -- and survives.

We've been saying for some time that debt crises would continue to strike throughout Europe, but that a systemic meltdown would be averted (see for example, from exactly one year ago, "Europe Gropes toward Stress-Tests" July 12, 2010). Following the selloff of Italian bonds and equities that started in earnest on Friday, let's begin with two questions: *why Italy?* and *why now?*

- With a debt/GDP ratio of 120% and one of the world's largest stocks of outstanding total debt (please see the chart below), Italy was always likely to come under pressure.
- The foreshock was when Moody's placed Italy's sovereign rating under review for possible downgrade on June 17, and then on June 23 placed the ratings of 16 Italian banks under review for possible downgrade. These banks have long been under pressure from their regulators to bolster their capital. While this had fed through to pressure on Italian yields and Italian bank share prices, both had recouped any losses by early July.
- The timing of the latest selloff has been caused -- as is usual in Europe -- by political disagreements.

Vertical: **consolidated government debt/GDP**
Horizontal: **deficit/GDP**
Size of circle: **stock of debt outstanding**



Source: Eurostat (*Ireland's deficit of 32% not shown to scale)

Update to strategic view

EUROPE MACRO, EUROPE BONDS: The speculative attack on Italy began with a destabilizing internal political squabble, and intensified after reports of aggressive loss-sharing to be imposed on Greek sovereign bondholders. But the reaction from Euro area institutions has been to increase the scope of their bailout mechanism, and possibly, in the case of the ECB, to directly intervene in the markets. Once again, a systemic crisis averted. Now… on to the next crisis.

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- Italian Prime Minister Silvio Berlusconi publically undermined his finance minister Giulio Tremonti, apparently in the wake of a dispute between them about the regulatory status of one of Berlusconi's companies. Berlusconi was quoted on Friday accusing Tremonti of arrogance, saying he "thinks he is a genius and thinks everyone else is a cretin."
- Tremonti, meanwhile, is under pressure due to his close relationship with Marco Milanese, an Italian MP who is being investigated for corruption. Tremonti moved out of an apartment owned by Milanese on Friday.
- Tremonti is guilty of over-stating his own importance, but he had managed to keep Italy beneath the radar since the start of the European debt crisis last year. He got cross-party consensus on a €40 billion austerity package that should be voted through parliament before the end of the week.
- Successful passage of the austerity package in Italy should reduce pressure on Italian bonds in the immediate term.
- At the moment, Italy's problem is one of *liquidity*, but due to the level of Italian debt, this could translate into a *solvency* crisis if rates remain elevated for an extended period.

But these internal Italian catalysts for the crisis only explain *Friday's* sell-off. On *Monday* the sell-off accelerated. Why?

- Press reports over the weekend of a possible major shift in Euro area policy on Greek default must have added fuel to the Italian fire. While Italy has comparatively little financial exposure to Greece, a change of EU policy -- especially in requiring bondholders to take losses, as it began to be rumored late last week that Germany is pressing for -- implicitly increases risk for bondholders everywhere in the Euro area.
- As we have been saying repeatedly, it is essential that an inevitable default of some kind for Greece be -- and be understood by the market to be -- Greece's own fault, *not* a Lehman-like willful failure to rescue on the part of the authorities (see, for example, "Confidence Game in Greece" June 23, 2011). Insisting on large private sector losses cuts the wrong direction on that.

Thankfully, emerging from the panic in Italy, there have been some positive developments in the other direction.

- Late Monday night following a lengthy Eurogroup meeting, a press release renewed the pledge to halt contagion, and confirmed rumored enhancements to the European Financial Stability Facility (EFSF).
- The EFSF will be enhanced to allow the lengthening of maturities of loans and reduction of interest rates on those loans. The EFSF will use collateral arrangements to achieve these loan changes, where appropriate.
- In the press conference following the meeting, commissioner Olli

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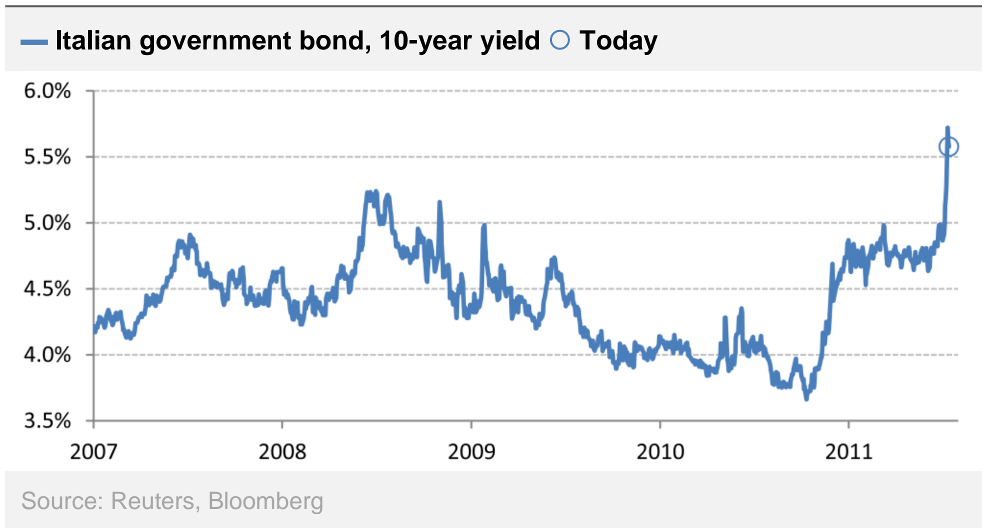
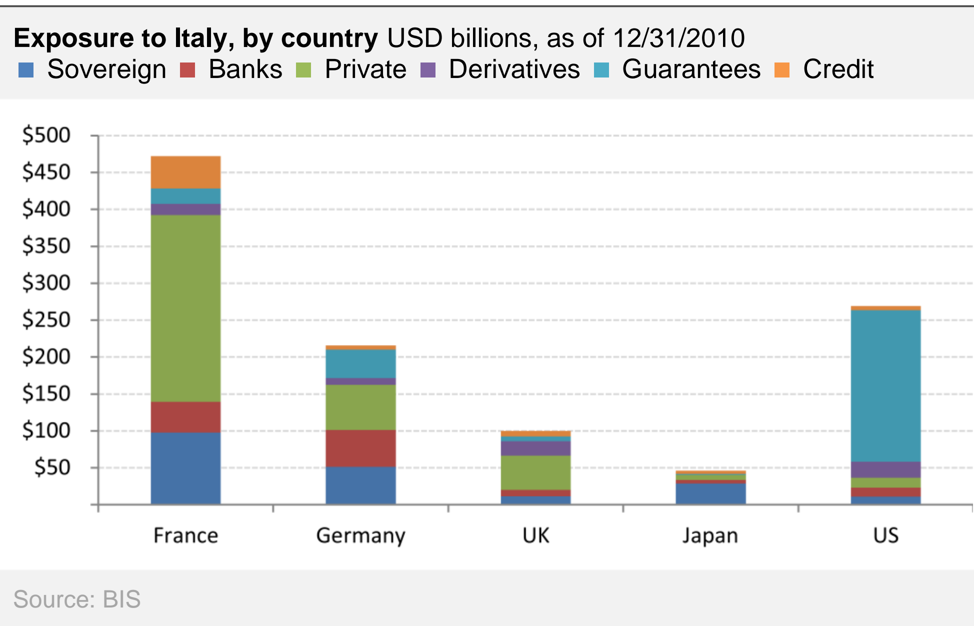
Rehn did not discount the EFSF purchasing of sovereign debt in the secondary market.
- It is widely rumored that the ECB intervened in the Italian bond market on Tuesday -- we will know for sure next Monday when data on the Securities Market Programme is updated.



- As a result of all this, yields on Italian debt (please see the chart above) ended Tuesday lower, while stocks on the Milan market closed up 1.18%, a massive turnaround from the morning's -4% print.

It would appear that the Eurogroup understands that Italy is no mere domino -- it is a potential game-changer. While Greece, Ireland and Portugal are not big enough to permanently damage the Euro area, a disorderly Italian blowout could result in a true global panic -- its entanglements in the world banking system are quite significant (please see the chart below). This would be an existential crisis for the euro currency, and possibly, the union.



The next important question to answer is: *what next?*

- If the speculative attack on Italy has been successfully turned back by the Eurogroup's response, we will see the Italian 10-year return to 5% in the coming weeks.
- As scary a shot across the bow as this has been, this remains our baseline scenario. Euro area institutions *will* continue to do just enough to stop a major systemic crisis. But while European crisis response has been robust thus far, it does tend to be reactionary -- and uncoordinated. We note especially the ECB's very counterproductive rate-hiking exercise, which puts growth pressure on the very countries the ECB inevitably must play a role in saving (see "On Europe's July Rate Decisions" July 7, 2011).
- So while we do not expect a world-shaking systemic crisis, we continue to believe -- just as we have for the last year -- that individual countries will still come under speculative attack, and may require rescues to avert a systemic crisis. With this in mind it is worth looking at which other countries might be liable to such an attack in the near term.
- While Ireland was downgraded to junk on Tuesday by Moody's, neither that country, or its banks, are in the market at the moment -- there is nothing there to attack.
- Our favorite candidate is Belgium, a high debt/GDP country without a government for over a year.
- Belgium's debt maturities are concentrated in the next five years. It has €38 billion of T-bills maturing in the next year. It sold 12-month bills today at 1.884%, the highest rate since early 2010.
- While Belgium's *deficit* -- expected to be 3.6% in 2011 -- does not seem worrying, it has recently been warned by the European Commission on its future budget.
- Belgium is heavily exposed to Dexia, the Belgian-French bank that was downgraded by Moody's last Friday, and has been on life-support since its near-collapse in 2008 (when it became a major emergency borrower from the US Fed). If Dexia fails to pass the upcoming bank stress tests with flying colors, expect Belgium to come under serious pressure next week, as support for Dexia will likely have to come from the sovereign, rather than the markets.

Rumors have abounded concerning the results of the third round of EU-wide stress tests, due out on Friday after European markets close.

- The European Economic and Financial Affairs Council (Ecofin) met Tuesday to address the possible fallout from the stress test results.
- The statement from Ecofin emphasizes the need for sufficient financial backstops for the banks following the publication of the stress tests, and says that these backstops are in place.
- Meanwhile, the leaking of results has already started, which reports this morning suggesting that six Spanish banks have failed the tests.

- There are no specific rumors about Italian banks failing, but as we noted at the outset, many are already under pressure to bolster capital.
- There are rumors of an emergency meeting of European leaders on Friday, Olli Rehn refused to comment on these rumors at today's press conference.
- The stress tests conducted a year ago were an outright sham, failing to even model the impacts of potential sovereign defaults. We argued at the time that this failure had a bright side -- at least it implied the authorities' intentions to do whatever it takes to prevent such defaults (see "On the EU Bank Stress Tests" July 23, 2010). We hope and expect that this time it will be different. Ideally, the rumors will prove to be true, and a more honest approach allowing more banks to fail the test will lay the groundwork for painful but necessary capital strengthening, of the kind that proved so salutary in the wake of the US stress tests in early 2009 (see "The Stress Tests' Hidden Mickey" May 4, 2009).

Bottom line

The speculative attack on Italy began with a destabilizing internal political squabble, and intensified after reports of aggressive loss-sharing to be imposed on Greek sovereign bondholders. But the reaction from Euro area institutions has been to increase the scope of their bailout mechanism, and possibly, in the case of the ECB, to directly intervene in the markets. Once again, a systemic crisis averted. Now… on to the next crisis.