



Written by [Bruce Walker](#) on September 21, 2011

EU Debt Crisis: Italian Bonds Downgraded

The sovereign debt woes of the European Union are nearing a critical stage. Greece's short-term bonds have recently shot to 60 percent, indicating an extremely high probability that the ancient country will default. Though Portugal and Spain, two of the other "PIIGS" member-states in the EU, are temporarily off the radar screen, neither has solved its fundamental debt problems.

In Finland, the only Scandinavian nation in the eurozone, the True Finns political party has enjoyed remarkable success running largely on a platform of refusing to bail out spendthrift EU members whose expenditure-to-revenue ratios would make full repayment of debt instruments unlikely without outside help. The other Scandinavian nations have become increasingly reluctant to join the eurozone over the last few years.



The sovereign debt crisis originally involved four governments — the so-called PIGS: Portugal, Ireland, Greece, and Spain. What is particularly disconcerting for those attempting to solve the EU's economic problems has been the inclusion of Italy in this group (now known as PIIGS). Depending upon which method is used to determine Gross Domestic Product — IMF, World Bank, or CIA — Italy's economy is approximately equal to all four of the original PIGS combined (about \$1.4 trillion). It is the seventh largest economy in the world, the fourth largest in Europe, and the third largest in the eurozone behind Germany and France.

Like that of the other PIIGS, the growth rate of the Italian economy is pathetic — .8 percent last quarter. Portugal's last reported quarterly growth rate was -.9 percent. Ireland is doing a bit better at .1 percent. (The Irish economy is actually growing, although at a microscopic rate.) Greece, whose bonds have been downgraded to junk status, reported a -5.4 percent growth rate. Spain is doing a bit better at .7 percent.

How bad are those numbers? The American economy, which everyone considers to be in awful shape, had a growth rate last quarter of 1.4 percent — much better than any of the PIIGS EU member states. What is worse, in the case of Italy, is growth since 2009 (the growth figures are adjusted). Beginning with the first quarter of 2009, the "growth" rates for the Italian economy were: -6.7 percent, -6.3 percent, -4.9 percent, -2.9 percent, .6 percent, 1.5 percent, 1.4 percent, 1.5 percent, 1.0 percent, and .8 percent.

Although at first blush it may appear that the Italian economy is improving (it is not shrinking every quarter, as it did throughout 2009), its "recovery" is nonexistent, with growth rates much slower than needed just to return it to the level of two years ago. Significantly, Italy's national debt is 120 percent of the nation's GDP — second only to Greece in the eurozone.



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Bond rating services have taken notice. On September 19 Standard & Poor's [downgraded Italian national bonds](#) from A+ to A, stating,

We believe that the reduced pace of Italy's economic activity to date will make the government's revised fiscal targets difficult to achieve. Furthermore, what we view as the Italian government's tentative policy response to recent market pressures suggests continuing future political uncertainty about the means of addressing Italy's economic challenges.

Financial analysts had expected a downgrade of Italian sovereign debt, but thought that it was more likely to be made by Moody's, which had put Italy in its "review" status this past June. [Paola Biraschi, a banking analyst at the Royal Bank of Scotland](#) in London, noted:

The ratings downgrade was not totally unexpected, even though it came from the agency we didn't expect. To me it seems like a competition between rating services to publish the downgrade first.

Though the downgrade is still five steps below "junk" status, that is small comfort to those keeping a worried eye on the eurozone situation.

Gary Jenkins of Evolution Securities called the downgrade "very damaging." Its practical effect will be that Italy will have to pay higher interest rates on its short-, medium-, and long-term bonds.

Nicholas Spiro of Spiro Sovereign Strategy in London agreed:

This is not just more negative news coming out of the euro zone. This is a confirmation that the world's third-largest bond market, and the euro zone's third largest economy, is in danger of succumbing to a self-fulfilling loss of confidence.

Sony Kapoor of the international think tank Re-Define observed,

Italy is now stuck in a self-fulfilling downward spiral from which it is unlikely to be able to extract itself without external help. Without full confidence in the credit-worthiness of Italy, it's impossible to have full confidence in the solvency of the European banking system.

Italy's Prime Minister Silvio Berlusconi lashed out at the rating service: "The assessments by Standard & Poor's seem dictated more by newspaper stories than by reality." French Foreign Minister Alain Juppé seemed to support that position, declaring, "We should not cave in under this dictatorship of rating agencies, whose transparency is in serious need of improvement."

Because eurozone banks, especially those in France, hold a substantial part of Italian national debt in their portfolios, any downgrade of Italian bonds reduces the value of bank holdings in the entire eurozone, producing a ripple effect of financial crisis in member-states such as France. What this may mean is that member-states which today are managing to stay above water may be pulled down by the downgrade of Italian bonds.

The downgrade of Italy's bonds also increases the chances of its defaulting. The cost of Italian 10-year bonds rose more than 5.6 percent, and the cost of insuring against an Italian default climbed sharply as well. More Italian government revenue will have to be dedicated simply to servicing the increasingly high interest rates on its sovereign debt. It seems likely that Moody's will also downgrade Italian bonds, which would raise the cost of servicing the debt even higher. And Standard & Poor's has indicated that it may downgrade Italian bonds yet again.

The Italian debt crisis also moves the center of gravity for bailouts. With the addition of Italy to what is



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now the PIIGS, a substantial percentage of the whole eurozone now faces default. The remaining member-states which are surviving economically are increasingly pondering what possible advantages the European Union and its common currency still have for them.

When the house of cards finally begins to fall, who will bail them out?

Photo: Bank of Italy, Via Nazionale, Rome



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