EU Economic Crisis: Italy's Debt Now Second Only to That of Greece

The impasse over Greece is bad enough. Several countries in the European Union, including the Netherlands and Germany, expect private holders — large European banks — of Greek bonds to share some of the burden for the next Greek bailout, reckoned at some €110 billion. But European megabanks, given the precedents set with numerous recent taxpayer-funded bailouts on both sides of the Atlantic, are refusing to consider losing any of their own money. And all sides are finally awakening to the realization that a Greek default in the form of some kind of debt restructuring is inevitable. As Julian Toyer and Dan Flynn of Reuters report:

> One senior EU source said the Eurogroup would ask technical teams to focus attention on two options — bond buybacks and a debt rollover.
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> "There is a strong possibility that a new Eurogroup meeting will be called at the end of July, to sign off on the solutions," the source said.
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> Both those schemes would likely be regarded by ratings agencies as a default, or at best a selective default, which could have profound repercussions for global financial markets.
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> The European Central Bank insists it will not accept anything that is termed a default, a position Germany also holds, even if some policymakers may be edging closer to effectively condoning a default to achieve a write-down in the value of Greek debt to make its debt mountain more sustainable.

Unfortunately for the almighty central bankers and their toadies in the big commercial banks, the laws of economics will have their say, sooner or later. The ironclad reality is that the eurozone is drowning in debt, and no amount of financial sleight-of hand can put off insolvency indefinitely. As negotiations over Greece reach an impasse, it is clear that Europe is running out of wiggle room. Buyers of government bonds are now turning away from Europe in droves, or demanding much higher interest rates — the primary factor that has forced Greece, Ireland, and Portugal to their knees in fairly rapid succession.

Enter Italy, which until late last week was being routinely dismissed by financial analysts as a potential follow-up to the debacles in other Club Med countries.

No more. Fears of Greek "contagion" rocked Italian markets last Friday, driving down Italian stock prices and pushing bond rates skyward. Suddenly, Italy is in very big trouble — but this time, the fire trucks are going to run out of water. As Toyer and Flynn report:

> EU sources said it would be impossible not to discuss [the Italian crisis] following a large sell-off

> in bonds and stocks that the Italian media have dubbed "black Friday."
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> The cost of insuring Italian debt against default jumped to a record high on Monday, the 10-year yield spread over German debt widened to a euro-era high of 300 basis points and bond yields rose above the 5.7 percent area which bankers say will start putting heavy pressure on Italy's finances.
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> The sell-off has increased fears that Italy, with the highest sovereign debt ratio relative to GDP in the euro zone after Greece, could be next to get dragged into crisis. If that came to pass, the euro zone's existing rescue mechanism, the EFSF, would have insufficient funds to help.

As was initially the case with the other countries now on the European dole, leaders are still denying that the growing Italian crisis will require anything more than improved communication and coordination. But it appears that Italy’s playboy premier, Silvio Berlusconi, is no less addicted to government spending than his counterpart in the White House. Berlusconi is apparently trying to push out his finance minister, Giulio Tremonti, for the latter's principled advocacy of deep cuts in government spending.

In any case, events of the last few days have lit the fuse on Italy’s debt time bomb. As a senior European Central Bank official admitted to Reuters, "We can't go on for many more days like Friday. We're very worried about Italy."