

# Financial Market Turmoil

*Italy under the spotlight: growing tensions on Italian bonds*

*Beware of political solutions and the ECB*

9 November 2011

*In recent weeks, tensions surrounding Italian public debt have reached an exceptional level.*

## The EMU's third-largest economy under attack

The sovereign-debt crisis in the euro area is deteriorating rapidly, with Italy, the third largest economy of the area under attack by the financial markets.

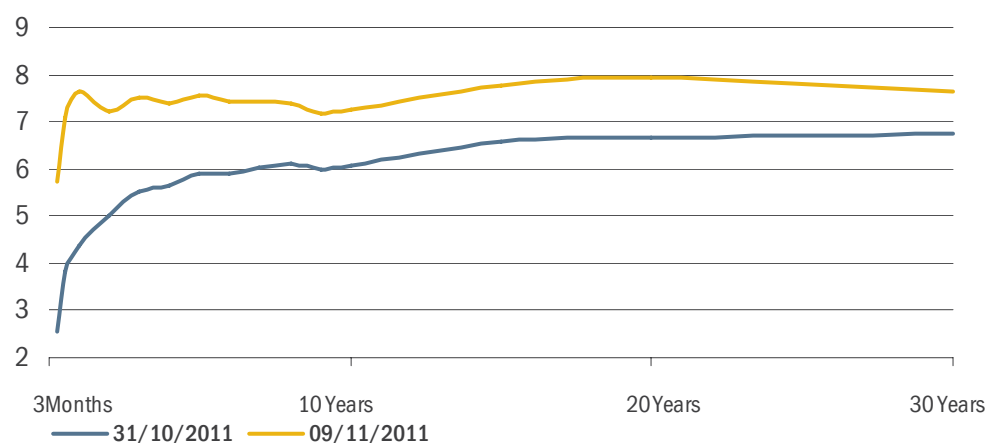
In recent weeks, tensions surrounding Italian public debt have, in fact, reached an exceptional level. The situation deteriorated even faster after the Italian government yesterday lost its parliamentary majority. The early reaction has been positive, as that was meant to spell the end of a government lacking in credibility.

Other euro countries hit by the crisis were treated better by financial markets after political changes (Spain being the most significant case). Italy's Prime Minister said he will resign soon after the budget law gets parliamentary approval, which is believed to be in two week's time. Financial markets appear to consider this pledge insufficient and may be calling for an immediate replacement.

The uncertainty is mainly due to the lack of details on the measures to be approved and on the evolution of the political situation. By law, elections must be held between 45 and 75 days after the Parliament dissolution. The situation has been worsened also by the decision by LCH Clearnet, the leading European clearing house, to increase the margin collateral required for the trading of Italian government bonds.

The result is a strong lack of demand for Italian government bonds, which has pushed up yields to over 7% and the BTP/Bund spread to new highs above 550 basis points, a level difficult to sustain.

### Italian government bond yields above 7%



Source: Bloomberg. Data as of November 9<sup>th</sup> 2011.

*Purchases of Italian bonds by the ECB can still play a decisive role.*

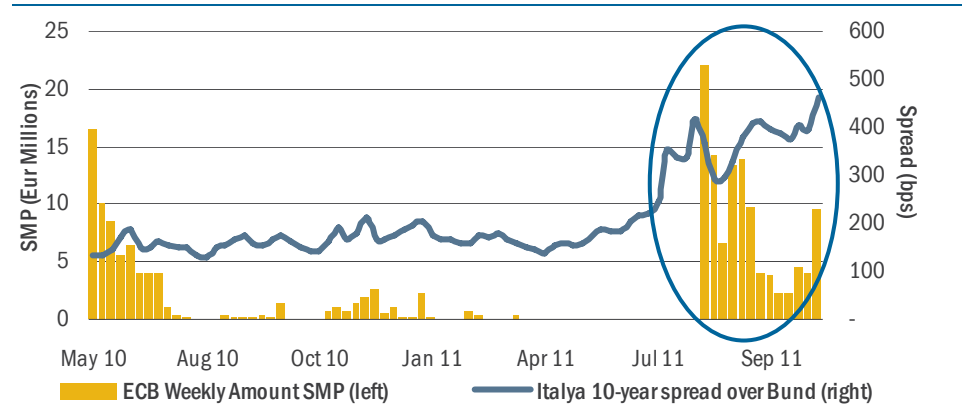
## The role of the European Central Bank

Throughout the crisis, political actions, both at national and international level, have been significant factors for the government bond markets.

Unelected bodies such as the European Central Bank can still play a decisive role with the Securities Purchase Program while awaiting the European Financial Stability Facility (EFSF) to be fully operational.

The Securities Market Program (SMP) could continue to support Italian government bonds, subject to the right policy measure to stabilise the deficit and promote growth, being put in place.

### ECB securities market program (SMP) support to Italian government bonds



Source: Bloomberg. Data as of November 9th 2011.

*We believe that the current valuations on Italian government bonds do not reflect the country's fundamentals.*

## Policy action required to manage the crisis

We believe that the current valuations on Italian government bonds do not reflect the country's fundamentals, but it is much related with a crisis in confidence. In this respect, the ECB role becomes more and more important.

The behaviour of the ECB is creating some debate. However, when it unanimously lowered the benchmark interest rate it took fully into account the region's economic slowdown and investor concerns about the sovereign-debt crisis. The new (Italian) head of the ECB admitted that "we are heading towards a mild recession" and observed that sluggish economic growth "has the potential to reduce medium-term inflationary pressure".

The decision marks a departure from the old ways. Instead of preparing the ground, the new chairman began his term with a seemingly bold move, more akin to the US Federal Reserve' speedy action. A second rate cut is now widely expected at the next meeting in early December, after he said that growth forecasts would be revised significantly downwards. Rather than blaming global trends, he stressed that the slowdown had to a large extent come from the uncertainties and financial strains generated by the Euro debt crisis.

The new head of the ECB was keen to emphasise the qualities of "continuity, credibility and consistency" he shared with his predecessor. He reassured Germany by expressing

his admiration for the German central bank and its orthodox policy to hold down inflation. He then stated that the ECB could not be a lender of last resort to governments. Despite his emphasis on continuity with the past, future developments may show the new growth-oriented approach more at work. There is no lack of available tools. Thanks to its ability to create money, the ECB can contain the euro crisis if it flares up and eventually becomes a full-blown confidence crisis.

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