# Financial sparks fly as Italy stands ground against EU

*By Elisa Barwick*

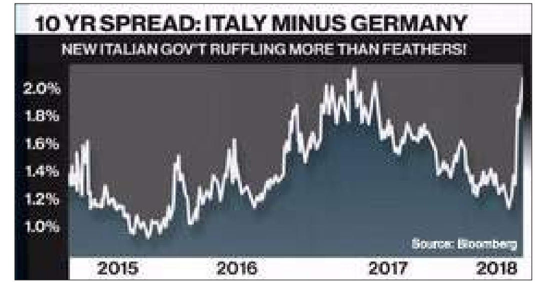
Ratings agency Moody's downgraded Italian sovereign debt on 19 October to a Baa3 rating, one notch above junk. While Moody's kept its outlook at "stable", on 31 August Fitch upheld the current BBB rating (which is two levels above junk) but moved its outlook to "negative"; S&P, the third major ratings agency, did the same. Canadian agency DBRS rates Italy three notches above junk.

It was widely expected that the ratings agencies would make such a move, given the spat between the European Union and Italian government over Italy's plan to breach EU rules by expanding its budget deficit 1.4 per cent beyond allowed limits ("Winter is coming", *AAS* 17 October). In response to the latest EU Commission threat demanding the Italian government change its plan, the government wrote: "We are aware of having chosen a budget policy approach not in line with the rules of the Stability and Growth Pact. It was a difficult decision but a necessary one, in view of the persistent delay in recovering pre-crisis growth levels and of the dramatic conditions of the most disadvantaged layers of society." (For comparison, Italy's "illegal" 2.4 per cent deficit is less than or equal to five of the budget deficits Australia has run since 2010.)

The Commission gave Italy three weeks to rewrite its budget proposal, or face violation proceedings, which in the worst-case scenario would result in a fine of 0.2-0.5 per cent of Italian GDP. In an interview with Sky television, Minister for European Relations Paolo Savona blamed the EU for the instability, given that it has usurped the role of sovereign states: "If the spread rises, it is the ECB's task to intervene to reduce it", or it will inevitably endanger the stability of Italian banks. "We made the Banking Union" in Europe, he said, so, "Who is responsible for stability of the banking system? We cannot have an institution that takes over powers of control, monetary powers and does not perform typical functions of every central bank, what the Bank of Italy always did."

The EU's original reprimand of Italy had set off tremors in the bond market, and its further actions amount to playing with fire. Bank bond yields are the highest since 2014, and have risen more than 340 points higher than the German benchmark—indicating the so-called "spread". As bond yields rise the value of the actual bond falls, forcing banks to "mark-to-market" their holdings (revalue based on current market prices). The banks' capital reserves are thus reduced, leading to increased borrowing costs and tightening credit. Smaller banks are unable to issue new debt altogether at these higher rates. According to a Wolf Street report, August data from the Italian Banking Association puts new loans to business and consumers at the lowest level in two years, sparking fears of a credit crunch.

Here's where it can spiral out of control: If one of the ratings agencies downgrades Italian government bonds one step further, to junk, most financial institutions would have to sell their holdings. Many funds cannot hold sub-investment-grade bonds. This could affect hundreds of billions of euros worth of Italian bonds, worldwide. ABN AMRO warned on 16 August that this "would be a major market event, which would lead to significantly higher spreads". If all four ratings agencies were to downgrade to junk, the implications would be even greater as the European Central Bank could no longer buy Italian bonds. Junk rated bonds are not eligible for the ECB's asset purchase program.




JP Morgan already warned, earlier in the month, that if one ratings agency downgraded Italy by one notch, which has since happened, it would "trigger an exodus from Italian debt by foreign funds with portfolio restrictions", according to City of London insider Ambrose Evans-Pritchard. There are also rumblings of contagion spreading to Portugal and Spain as their debt comes under pressure, leading to warnings of a new eurozone sovereign debt crisis akin to that following the Greek crisis.

### 'Violent crash' coming, steal the people's money *now*!

The latest from Ambrose Evans-Pritchard is a 29 October *Telegraph* article, reprinted in the *Sydney Morning Herald*, citing the chairman of Société Générale and former ECB board member, Lorenzo Bini Smaghi, who compared the new crisis to the onset of the 2011 eurozone debt crisis, also characterised by surging bond yields.

He warned that Italy is going to hit the wall: "You can't see the wall yet, but the crash is going to be violent." He forecast "mass selling by investors" and a "snowball effect". In addition, funds for the real economy will dry up.

Economics chief for the Italian coalition government's Lega Nord party, Claudio Borghi, warned that "We're going into a *world economic downturn* and that is a disaster for the eurozone." (Emphasis added.) Putting the Italian crisis in that context, he said Europe simply "cannot survive without the cushion of QE [quantitative easing]".

The article also reported on a German proposal by veteran finance head at the Bundesbank, Karsten Wendorff, which while a private opinion comes on the back of the 2016 Eurozone adoption of "bail in" which requires junior bonds and deposits above the guaranteed €100,000 to be converted into worthless bank shares before any bail out can occur. This is in addition to, according to Evans-Pritchard, "a drumbeat from the Bundesbank and the German Council of Economic Experts for debt-restructuring before there can be any rescue of Italy or other eurozone states". Wendorff's plan is to create "national solidarity bonds" funded by a mandatory 20 per cent wealth tax on net private assets to recover half of Italy's debt! Like other EU and IMF proposals, it is designed to avoid the need for an EU bail out, sparing the "taxpayers". The IMF proposed a "one-off capital tax" of 10 per cent as an option to reduce sovereign debts of eurozone economies in October 2013. In November 2017 the ECB proposed the power to freeze deposits *including those backed by government deposit guarantees*. (CEC Media Release, 29 Nov. 2017, "Europe to extend 'bail-in' to guaranteed deposits—don't give crisis powers to banking technocrats!")

None of these approaches represent anything close to an actual solution, rather they are fingers in the dyke of the crumbling financial edifice supposed to guard us from an approaching tsunami.