

Fiasco fiscale

Italy is the hinge of the eurozone. The 17-member bloc can survive a crisis engulfing Greece, Portugal, Ireland and maybe even Spain. If Italy becomes infected, however, the eurozone has neither the financial nor the political resources to go to Rome's rescue. Italy must inoculate itself against the sovereign debt virus. Yet an incompetent political system has left it paralysed in the face of an abrupt re-pricing of Italian risk by increasingly nervous investors. A new bout of fiscal temporising will not solve Italy's problem this time.

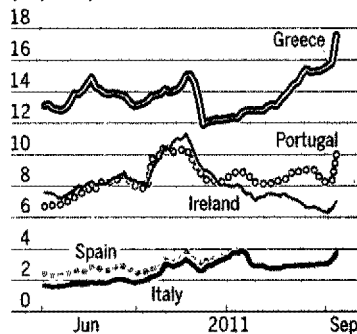
Since the start of July, Italy has been hit by the collapse of global economic growth predictions and of its policymaking credibility. In that time, the yield on 10-year Italian bonds has risen by 65 basis points, and on two-year bonds by 100bp. If the European Central Bank had not been an active buyer of Italian bonds over the past few days - market gossip suggests around four times as much as Spanish bonds - the yields would be even higher. A €45bn fiscal package has been watered down so much that it represents no more than sleight of hand. And the collapse in the bond market has devastated the share prices of Italian banks - UniCredit has fallen by 42 per cent since July 1 - partly because of the collapse in the value of their bond portfolios.

The austerity package on offer is likely to damage the Italian economy rather than accelerate growth. This has been the experience in Greece and Portugal; there is no reason for Italy to be different, especially with key export markets in Europe and the US heading into a recession. The government has ducked, once again, any structural reform that might actually boost the underlying growth rate, which is likely to be no more than 0.7 per cent this year and 0.4 per cent in 2012, **Deutsche Bank** notes, below the official targets of 1.1 and 1.3 per cent.

With a credit rating downgrade looming - one reason European equities fell sharply on Monday - Italy's risk premium may well rise further. Italy, not Spain, will decide the fate of the eurozone.

Government bond spreads

10-year yield spread over Bunds
(% points)



Sources: Thomson Reuters Datastream; BIS

World's largest bond markets

Government domestic debt securities
outstanding (\$'000bn)

